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Inquiry into the Supervision of The Bank of Credit and Commerce International

Chairman: The Right Honourable Lord Justice Bingham

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INQUIRY INTO THE SUPERVISION OF THE BANK OF CREDIT AND COMMERCE INTERNATIONAL

THE RIGHT HONOURABLE LORD JUSTICE BINGHAM

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To: **The Right Honourable Norman Lamont MP, Chancellor of the Exchequer, and The Right Honourable Robin Leigh-Pemberton, Governor of The Bank of England**

The failure of any substantial company is likely to cause loss, and often hardship, to creditors, employees and shareholders. But when the company is a bank these results are magnified, because banks deal in other people's money and the creditors will include the bank's depositors and customers, who may lose almost everything they have.

The closure of BCCI by supervisory action on 5 July 1991 provoked widespread public concern. Some, particularly in the financial community and the press, criticised the United Kingdom authorities (above all, the Bank of England) for not taking this action long before. Others, particularly depositors, employees and shareholders, criticised the closure as precipitate and unjustified. It was against that background of public concern that the establishment of this Inquiry was announced on 19 July 1991.

The Inquiry's terms of reference are:

> "To enquire into the supervision of BCCI under the Banking Acts; to consider whether the action taken by all the UK authorities was appropriate and timely; and to make recommendations."

I have understood these terms of reference as calling for consideration of five broad questions:

(1) What did the United Kingdom authorities know about BCCI at all relevant times?

(2) Should they have known more?

(3) What action did the United Kingdom authorities take in relation to BCCI at all relevant times?

(4) Should they have acted differently?

(5) What should be done to prevent, or minimise the risk of, such an event recurring in the future?

It is important to emphasise that this is an Inquiry into the *supervision* of BCCI by the United Kingdom authorities. I have not attempted to investigate the activities of BCCI in the many countries of the world where it did business, or the frauds in which it is said to have been involved, unless these came (or should have come) to the notice of the United Kingdom authorities. The investigation of BCCI's worldwide activities and malpractice, if a possible task, is one which would take many years to carry out, and it is not what I was asked to do. For the same reason, since auditors in private practice are not "United Kingdom authorities", I have not attempted to evaluate the professional quality of the audits of BCCI's accounts conducted over the years, in London or the Caymans or elsewhere, or to form a judgment whether irregularities in its business should have been discovered by the auditors earlier. I have, however, paid close attention to communications, direct and indirect, between the auditors and the authorities, which became much more frequent in later years.

The directors of the various BCCI companies also are not "United Kingdom authorities": reference has been made to their role where it bears relevantly on the knowledge or conduct of the United Kingdom authorities, but I have not investigated the corporate governance of BCCI in order to form a judgment whether or not the directors performed their duties in a competent and professional manner. The Inquiry has, lastly, received a number of letters from BCCI depositors describing, sometimes in very moving terms, the hardships suffered as a result of the closure: I have not thought it right to become involved in the plight of depositors, whether individually or collectively.

I have taken the reference to "all the United Kingdom authorities" to mean exactly that. Thus I have attempted to investigate and describe the role of every official United Kingdom authority which had any involvement whatever in the affairs of BCCI, even if the involvement was not in a strictly supervisory capacity. The bulk of the report is, however, devoted to supervision by the Bank of England as the body responsible for banking supervision.

I wish to acknowledge with gratitude the help I have received from all those listed in Annex 1, who have given written or oral evidence, or supplied documents, or made representations, to the Inquiry. Without a very high level of co-operation, particularly by the Bank of England, the Treasury and the UK firm of Price Waterhouse my task would have been even more difficult and protracted.

As announced at the outset, the Inquiry has sought to disclose provisional findings of fact to the subjects of them, so that they may suggest corrections and modifications, and to give those upon whom the Report may be thought to reflect unfavourably or who are subject to criticism an opportunity to challenge criticisms and rebut adverse findings. In response to this invitation the Inquiry has received written comments and representations and heard oral submissions, all of which have been considered and changes made where points were accepted. It should be made clear, however, that most of the criticisms made, and a number of factual conclusions, remain the subject of challenge.

In deciding what was said and done during the nineteen year history of BCCI, I have relied heavily on contemporary notes and minutes of meetings and conversations, particularly those made by the Bank of England and Price Waterhouse, believing these to be, on the whole, the most reliable guide to what was said and done at the time. In the later stages of the history a number of these notes and minutes involve or refer to the majority shareholders, who have made valuable written submissions to the Inquiry and addressed me during a visit to Abu Dhabi but have not given formal oral evidence. They have challenged the accuracy of a number of these notes and minutes. They have also challenged the truth of a number of statements made about them in their absence, and they reject the criticisms of their conduct made both before the closure of BCCI and in this Report. It is fair that this should be clearly stated.

The Inquiry has received valuable help from the liquidators of BCCI SA. The Inquiry gave them the opportunity to comment on factual passages and opinions affecting BCCI, but they felt unable to do so for a variety of reasons: these included the liquidators' lack of direct knowledge of the group before the date of their appointment and the wish to avoid prejudice to any claim by the liquidators on behalf of the creditors in any forthcoming litigation. It is again fair that their position should be recorded.

I wish to acknowledge with much gratitude the help I have been given by Trevor Robinson and Ian Watt CBE FCA as assessors to the Inquiry. They have read all the substantial documentary material submitted and heard or read all the evidence, save that summarised in Appendix 8*. Drawing on their experience and expertise as banker and chartered accountant respectively, they have contributed invaluable insights and guidance; I have also found their judgments on more mundane factual issues consistently shrewd and realistic. Responsibility for the findings and opinions in this Report is of course mine alone. But they have been studied in detail by the assessors, and I am reassured that there is no point on which either of them has indicated dissent.

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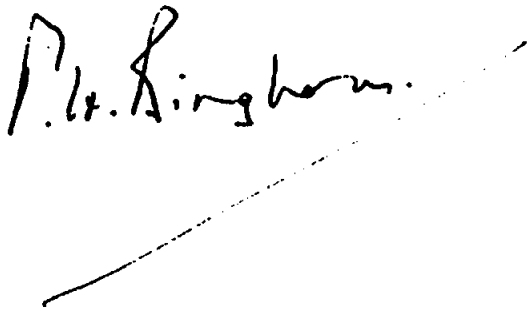
* Not being published

I owe sincere thanks to the expeditious and very professional team of shorthandwriters from Palantype Reporting Service who transcribed the oral evidence; to Evelyn Stevens, the Treasury Solicitor's Librarian, who undertook the formidable task of compiling the Indices; to Moira Goatley, from the Treasury, who ably assisted the Secretary and undertook much valuable research; to Ashleigh Roberts, who managed the office with quiet efficiency and tamed the flood of incoming papers; and to Sue Reid, whose virtuosity in producing almost faultless texts, as draft succeeded draft and second thoughts gave way to third and fourth, was beyond praise.

Lastly, I owe a debt of gratitude to the Treasury Solicitor, not only for accommodating the Inquiry and servicing its varied needs, but also for lending Richard Jackson to act as Secretary to the Inquiry: he has been a tower of strength in every imaginable way, and a most congenial colleague, to whom I am deeply indebted.



July 1992

Contents

Preface

In Chapter 1 of this Report a summary account is given of the banking supervisory regime which existed in the United Kingdom between 1972 and 1992. The story cannot be fully and fairly understood without a grasp of this background.

Chapter 2 describes the part played in the history of BCCI by the Bank of England, the Treasury and other government departments and public bodies.

Chapter 3 contains my recommendations.

Appendices 1 to 8* recount this history in greater detail, much of it subject to statutory restrictions on disclosure, some of it sensitive for other reasons and some of it subject to a high security classification.

In this Report the Bank of England is referred to throughout as "the Bank", always with a capital "B".

Bank of Credit and Commerce International Holdings (Luxembourg) SA, Bank of Credit and Commerce International SA and Bank of Credit and Commerce Overseas Limited are referred to respectively as "BCCI Holdings" or "Holdings", "BCCI SA" or "SA" and "BCCI Overseas" or "Overseas". Where the reference is to the group at large, and not to any particular company, reference is made to "BCCI" or to "the bank", always with a small "b".

Companies in the International Credit and Investment Corporation group are similarly referred to as "ICIC Holdings", "ICIC Overseas", or, where the reference is to the group, simply as "ICIC".

The banking supervisory authority in Luxembourg was, until May 1983, the Commissariat au Controle des Banques. It was known in the UK as the Luxembourg Banking Commission, and is referred to in the Report as "the LBC". After May 1983, when its name was changed to the Institut Monetaire Luxembourgeois, it is referred to as "the IML".

The expression "the majority shareholders" is used in this report after April 1990 to mean The Department of Private Affairs of His Highness Sheikh Zayed Bin Sultan Al Nahyan, President of the United Arab Emirates and Ruler of the Emirate of Abu Dhabi and the Crown Prince of Abu Dhabi, the Department of Finance of the Government of Abu Dhabi and the Abu Dhabi Investment Authority.

Ernst & Whinney, auditors of the BCCI group, BCCI Holdings and SA until 1987, are referred to as "E&W".

Price Waterhouse, auditors of BCCI Overseas from 1975 and of the BCCI group, Holdings, SA and Overseas from 1987, are referred to as "PW".

The practice generally (although not uniformly) adopted in this Report is to introduce individuals by their full name and title on their first appearance in any chapter or appendix* and thereafter to refer to them in that chapter or appendix* by surname only. No discourtesy is intended and it is hoped that this usage, intended to speed up the narrative, will not cause offence. Where an individual's title has changed, I use the correct title as at the date of the reference.

The BCCI group drew up its accounts in United States dollars. All references to dollars or $ are to United States dollars unless the contrary is expressly stated.

Reference has on occasion been made to the Banking Acts 1979 and 1987 as "the 1979 Act" and "the 1987 Act" respectively.

* Not being published

Chapter 1
Banking supervision in the United Kingdom 1972-92

The Bank of England's supervision of banks over the last twenty years has been carried out in an environment of law and practice which has changed, both nationally and internationally, to a marked degree. The history of events given in Chapter 2 of this report cannot be fully or fairly understood without understanding how law and practice, here and abroad, have developed over the period. The purpose of this chapter is to describe in broad outline the framework of supervision as it existed at the outset of the period and to chronicle the main changes which have taken place since then.

1 The development of banking supervision

1.1 The supervision of banks is now one of the major functions carried out by the Bank of England. It was not always so. Until 1979 the Bank had no formal power to grant or refuse authorisation to conduct banking business in this country. A broad and unspecific power under section 4(3) of the Bank of England Act 1946 to make recommendations and (with the authority of the Treasury) issue directions to bankers was never exercised and was not understood to provide a statutory basis for supervising banks. But even before 1979 there existed a framework of rules, some written and some not, some exercised by the Bank and some by others, which enabled some control, imperfect though it was, to be exercised over banking institutions.

1.2 The Bank's involvement dated back to the mid-nineteenth century when its Discount Office was concerned to monitor the creditworthiness of bodies with which the Bank was itself willing to do business. This, together with its concern for the health of the financial system as a whole, led it to take a close interest in the conduct and standing of certain banking institutions, who were willing for the furtherance of their business interests to accept the Bank's informal supervision. Its position in the heart of the City of London well fitted it to perform this role.

1.3 Under section 123 of the Companies Act 1967 the Board of Trade was empowered to grant certificates to institutions which it was satisfied could properly be treated for the purposes of the Moneylenders Acts 1900-1927 as bona fide carrying on the business of banking. The effect of such a certificate was to exempt the recipient from the provisions of the Acts, themselves designed to protect borrowers against extortion and oppression. Certificates were granted by the Board of Trade after consultation with the Bank, but the test for certification related to the nature of the business and not to its quality. It was a test which any deposit-taking institution, regardless of its reputation and market standing, could readily meet.

1.4 By section 54 of the Income and Corporation Taxes Act 1970, which derived from section 22 of the Finance Act 1915, any company recognised by the Inland Revenue as conducting a bona fide banking business was entitled to pay and receive interest gross of tax. In this case also the test of recognition depended on function not reputation, and recognition was readily given to deposit-taking institutions.

1.5 In the 1950s and early 1960s there was some disquiet at the freedom of fringe deposit-taking institutions to solicit deposits from the public while disclosing little information about the nature and scale of their business. The Protection of Depositors Act 1963 was enacted to remedy this mischief. But certain banks and discount houses were exempted from complying with the Act. At first it was banks on the Schedule 8 list (described in paragraph 1.6 below) which were exempted. Later, section 127 of the Companies Act 1967 created a further list of banks agreed between the Board of Trade and the Bank specifically for the purpose of exemption. To be included in the list it was ordinarily necessary for a company incorporated in the United Kingdom to satisfy the Bank that it was a bank in the full sense of the word. A branch of a foreign bank was ordinarily required to show that it enjoyed a high international reputation and had enjoyed exchange control authorisation for at least two years. These were very much stiffer tests than those so far considered.

1.6 The Companies Act 1948 required the Board of Trade and the Bank to establish a list of banks accorded certain accounting privileges. These were the Schedule 8 banks.

The provision only applied to institutions incorporated in the United Kingdom and accordingly had no application to unincorporated UK branches of banks incorporated overseas.

1.7 The Exchange Control Act 1947 required the Treasury and the Bank to establish a list of banks authorised to deal in foreign exchange and to exercise certain delegated powers under the Act. Since exchange control could be evaded by institutions which were incompetent or dishonest, such authorisation was only given to institutions with a proven record of competence and integrity. In practice decisions on authorisation were made by the Bank, in reliance on its own judgment and that of the financial community. The grant of authorisation, like inclusion on the Schedule 8 list, was the seal of approval by the Bank. But an institution not judged to be ready for authorisation could be granted interim exchange control permissions to enable it, over a trial period, to demonstrate its fitness for authorisation. Even interim permissions were not lightly given.

1.8 These oddly-assorted statutory powers did not provide an effective framework for the supervision either of banks properly so called or other deposit-taking institutions. But an important ingredient has to be added: the influence which the Bank was able to exercise by virtue of its role as "the arm of the government in the City" and the "banker's best friend", its power in the market, the respect in which its senior officials were held and the deference habitually paid to its opinions. To an extent unexplained by its very limited formal powers the Bank was able to exercise an effective tutelary role in relation to discount houses, accepting houses and aspirants to that status. But the Bank did not exercise prudential supervision over the clearing banks and branches of banks incorporated overseas. And its informal supervisory role, very largely dependent on mutual trust and co-operation, was harder to achieve (if it was achieved at all) in relation to the newer, less substantial, institutions which sprang up in the 1960s and 1970s: to these the grant of the less important statutory recognitions and exemptions considered above gave an aura of reliability which was not always justified.

1.9 The secondary banking crisis of 1973-74 exposed weaknesses in the existing system of supervision, for while some financial institutions were subject to informal but effective supervision by the Bank as described above other deposit-taking institutions were not, and it was some of these which ran into trouble. The heightened importance of banking supervision was recognised by the Bank when in mid-1974 a new department (the Banking and Money Market Supervision Section) was established to take over this responsibility from the Discount Office. In the atmosphere prevailing at the time the Bank was able to establish on a voluntary basis a more intensive system of supervision which also covered a wider range of institutions than hitherto. A move towards freer and more open competition was accompanied by a move towards more effective supervision.

2 The Basle Committee

1.10 The Committee on Banking Regulations and Supervisory Practices was established at the end of 1974 by the governors of the central banks of the Group of 10 (actually 11) nations plus Luxembourg. It met at the Bank for International Settlements at Basle and became known as the Basle Committee. Its object was to achieve international agreement on standards of good practice and collaboration in the banking supervisory field. From the outset the Bank played a leading role in the Committee. Mr George Blunden of the Bank was its first chairman. He was succeeded by Mr Peter Cooke, who served as chairman from 1977-1988 with such success that the committee was often called the Cooke Committee. Even when agreed the reports of this Committee lacked legal validity or binding force, but they have commanded great respect as statements of good practice agreed internationally by bankers and supervisors of acknowledged experience and influence.

1.11 In 1975 the Committee produced a report on the supervision of banks' foreign establishments. This report was accepted by the G10 governors and became known as the Basle Concordat. The Concordat distinguished between subsidiaries, branches and joint ventures and provided guidelines on the allocation of supervisory responsibility between host and parent authorities in regard to liquidity, solvency and foreign exchange exposure. No definition of 'host' or 'parent' was given, but the intended meaning of these expressions was not obscure. The 'host authority' was that in the country where the subsidiary or branch or joint venture was actually carrying on business. The 'parent authority' was that in the country where the parent company of the subsidiary or the head office of the branch or joint venture was incorporated or established. The Concordat was intended to ensure that no foreign banking establishment should escape supervision and that supervision should be adequate. To this end the Concordat favoured a free flow of information between supervisory authorities and the facilitation of inspections, either directly by parent authorities or indirectly through the agency of host authorities.

3 The 1976 White Paper

1.12 In August 1976 the then Labour government published a White Paper outlining proposals to remedy the supervisory weaknesses noted above.[1] These proposals were later embodied in the Banking Act 1979 and are summarised below. It is enough to note at this stage that:

(i) although branches of overseas deposit-taking institutions were, like UK deposit-takers, to be licensed, arrangements for their supervision were to remain primarily a matter for the supervisory authorities in the country of origin;

(ii) although the criteria to be applied by the Bank in licensing deposit-takers were to be agreed with the Treasury and reported to Parliament, it was the Bank which was to act as supervisor and the handling of individual cases was to be a matter for it;

(iii) the proposals were directed to the better protection of depositors.

[1] Cmnd 6584

4 The Banking Coordination Directive of 1977

1.13 In the following year the European Community took its first major step towards creation of a common market among banks and credit institutions in the First Council Banking Co-ordination Directive of 12 December 1977.[2] This important Directive was addressed to member states, which became bound to require credit institutions having their head office in their territory to obtain authorisation before commencing their activities.[3] Article 4 regulated the rights of member states in relation to branches of credit institutions having their head office in another member state. A member state could make the commencement of business in its territory by such branches subject to authorisation according to the law and procedure applicable to credit institutions established on its own territory. Thus, taking this country as the example, the United Kingdom was required to authorise domestic credit institutions to carry on business, and it could require branches of credit institutions authorised in another member state to be authorised to carry on business here; but it could not, in the latter case, impose conditions on the foreign branch which it did not impose on its own domestic institutions. The Directive required collaboration and exchange of information between the competent authorities of different member states to supervise the activities of institutions in member states other than those in which the head office was situated.[4]

1.14 The expression 'head office' was repeatedly used in the Directive but was nowhere defined.

[2] 77/780/EEC. Official Jo 17/12/77
[3] Article 3.1
[4] Article 7.1

5 The Banking Act 1979

1.15 The 1976 White Paper and the 1977 Directive led to the Banking Act 1979, which was intended to give effect to the Directive and was understood to do so. The Act established a new system of supervision on the foundations of the Bank's existing practice. It was to be administered by the Bank. Its object was to protect the interests of depositors.

1.16 The Act made a distinction between banks, which the Bank was empowered to recognise, and other deposit-taking institutions, which it was empowered to license. The major functional difference between the two was that the Bank could only recognise a bank if satisfied that it provided or (if not yet in business) would provide either a wide range of banking services or a highly specialised banking service.[5] A licensed deposit-taking institution did not have to meet this requirement. Bodies not recognised or licensed were no longer entitled (subject to certain exceptions not relevant to this report) to carry on deposit-taking business.

1.17 To obtain recognition a bank already carrying on business in the UK had to satisfy the Bank on four counts:

(i) it had to enjoy, and to have enjoyed for a reasonable time, a high reputation and standing in the financial community;[6]

(ii) it had to have carried on its business with integrity and prudence and with those professional skills which were consistent with the range and scale of its activities;[7]

(iii) its business had to be effectively directed by at least two individuals ("the four eyes criterion");[8] and

(iv) it had to show that it maintained net assets of an amount considered appropriate by the Bank.[9]

If the principal place of business of a bank was in a country outside the UK, the Bank might regard itself as satisfied that the criteria numbered (ii) and (iv) above were met if the supervisory authorities in that country informed the Bank that they were satisfied with respect to the management of the bank and its overall financial soundness and the Bank was satisfied as to the nature and scope of the supervision exercised by those authorities.[10]

1.18 To obtain a licence, a deposit-taking institution had to meet criteria expressed rather differently, save for the four eyes criterion which was the same. Such an institution, if already carrying on a deposit-taking business in the UK, had to satisfy the Bank

(i) that every director, controller or manager of the institution was a fit and proper person to hold that position;[11] and

[5] s.3(3)(a); Sch.2, Pt I, para 2(1)
[6] ibid, para 1(1)
[7] ibid, para 3
[8] ibid, para 4
[9] ibid, para 6
[10] s.3(5), (6)
[11] s.3(3)(b); Sch 2. Pt II, para 7

(ii) that the institution conducted its business in a prudent manner, with particular reference to the sufficiency of its net assets and resources, the maintenance of adequate liquidity and the making of adequate provision for bad and doubtful debts.[12]

If the principal place of business of a deposit-taking institution was outside the UK, the Bank was entitled to rely on the foreign supervisory authorities in relation to both these criteria to the same extent and subject to the same conditions as in the case of a bank.[13] Directors, controllers and managers were defined to include large voting shareholders, chief executives and managers under the immediate authority of a director or chief executive, but in the case of an institution whose principal place of business was outside the UK the expression "chief executive" was to include a person responsible for its deposit-taking business here.[14] Generally, only a recognised bank could describe itself as a bank, but a licensed deposit-taker whose principal place of business was in a country outside the UK could use here the name it used there provided the description "licensed deposit-taker" was added.[15] Thus when an institution applied for either recognition or a licence the location of its principal place of business had a potentially important bearing on the procedure which the Bank could follow; and when the application was for a licence the location of its principal place of business also had a potentially important bearing on the institution's right to call itself a bank.

1.19 The effect of these provisions was that even if a body already in business here could show that it provided a wide range of banking services it might not obtain recognition as a bank if it could not satisfy the Bank, for example, that it had for a reasonable time enjoyed a high reputation and standing in the financial community. But it might still obtain a licence if able to satisfy the rather less stringent conditions for a licence, and if its principal place of business were elsewhere the Bank might be able to rely on the judgment of the foreign supervisory authorities and the body could continue to call itself a bank here (subject to the statutory postscript) if it called itself a bank there.

1.20 The Act laid down a number of grounds on which recognition or a licence already granted could be revoked. The power to revoke arose if it appeared to the Bank, for instance, that any of the criteria applicable to the institution in question had not been fulfilled, or if the institution had failed to comply with any obligation imposed by the Act or if the institution had in any other way so conducted its affairs as to threaten the interests of its depositors.[16] The Bank could attach conditions to a licence, but to do so it had first to revoke, which required it to have grounds for doing so; the conditions could be such as the Bank considered necessary for the protection of depositors and might require the institution to take certain steps or refrain from a particular course of action or restrict the scope of its business in a particular way.[17] Decisions of the Bank to refuse or revoke recognition or a licence were subject to appeal to the Chancellor of the Exchequer, advised by a specially constituted tribunal, and ultimately (on a point of law) to the court.[18]

1.21 The Act gave the Bank important new powers. Under section 16 it could require a licensed institution (but not a recognised bank) to give information and produce documents. Section 17 empowered the Bank to appoint persons to investigate and report

[12] ibid, para 10
[13] s.3(5), (6)
[14] s.49(2), (3), (4), (5), (6)
[15] s.36(1), (8)
[16] s.6(1)(c), (h), (i)
[17] ss.7(1)(b), 10(2)
[18] ss.11, 12, 13

to it on the state and conduct of the business of a recognised bank or a licensed institution if it appeared to the Bank desirable to do so in the interests of the depositors. In certain specified circumstances the Bank could apply to wind up the bank or institution.[19]

1.22 True to its purpose of protecting depositors, the Act introduced a deposit protection scheme. Under this a depositor could in case of default by a bank or institution recover up to three quarters of a sterling deposit made with a UK office of the bank or institution, subject to a maximum recovery of £7,500.[20]

1.23 The Act required the Bank to report annually to the Chancellor on the discharge of its functions under the Act. This report was to contain a full list of recognised banks and licensed institutions and outline the principles applied by the Bank in granting and refusing recognitions and licences. The report was to be laid before Parliament and published. An up to date copy of the list was to be available on application.[21]

1.24 In March 1980 the Bank formed a new Banking Supervision Division of which Cooke (previously head of banking supervision within the Banking and Money Market Supervision Section) became head. The Division's primary task was to implement the 1979 Act.

[19] s.18
[20] ss.28(1), 29(1)
[21] s.4(1), (2), (3), (4), (6)

6 The criteria for recognition or licensing

1.25 As required by the 1979 Act the Bank included in its first annual report under the Act a statement on the interpretation and application of the statutory criteria for authorisation to carry on a deposit-taking business.[22] These criteria remained unchanged until the Act was repealed.

1.26 In its statement the Bank explained how it set about obtaining the information needed to see if the statutory criteria were met. It sought information about those responsible for running the business and required detailed statistics concerning the business itself. In addition, in respect of institutions with a principal place of business outside the UK and carrying on a deposit-taking business through a branch here, the Bank sought assurances from the appropriate overseas supervisory authorities that they were satisfied with respect to the management of the institution and its overall financial soundness.

1.27 In its statement the Bank referred to the twin requirements (the functional requirement and the high reputation and standing requirement) for recognition as a bank. Both had to be met. It could not therefore be assumed from the fact that an institution was licensed rather than recognised that the Bank had reservations as to the high reputation and standing of the institution in the financial community.[23]

[22] Bank of England Report and Accounts 1980, p.44
[23] ibid

7 The Basle Concordat 1983

1.28 In May 1983 the Basle Committee issued a paper revising and updating the 1975 Concordat to reflect lessons learned from the failure of Banco Ambrosiano.

1.29 This paper, which did not in any way reflect the UK distinction between recognised banks and licensed deposit-takers, was like its predecessor concerned with the problem of supervising the foreign establishments of international banks. It acknowledged that gaps in supervision can arise out of structural features of international groups (for example where a group is headed by a non-bank holding company) and recorded agreement on four important matters: first, that supervisors cannot be fully satisfied about the soundness of individual banks unless they can examine the totality of each bank's business worldwide through the technique of consolidation; second, that no foreign banking establishment should escape supervision; third, that supervision should be adequate; and fourth, that there should be co-operation and exchange of information between the supervisors in a bank's parent country and those in its host country. If supervision by a host authority is inadequate, the parent authority should either extend its supervision so far as practicable or discourage the parent bank from continuing to operate the establishment in question. If a host authority considers supervision by a parent authority to be inadequate or non-existent, the host authority should discourage or, if it can, forbid the operation of such foreign establishments in its territory; alternatively, it should impose specific conditions governing the conduct of the business of such establishments. The principle of consolidated supervision was said to be that parent banks and parent supervisory authorities monitor the risk exposure of the banks or groups for which they are responsible on the basis of the totality of their business wherever conducted.

1.30 The paper repeated the distinction previously drawn between unincorporated local branches of a foreign bank and locally incorporated subsidiary companies and recorded agreement, in terms no doubt revised in the light of experience since 1975, on the proper general approach in each case to the three central areas of concern to banking supervisors: solvency, liquidity and foreign exchange operations.

1.31 In the case of local branches, their solvency is generally indistinguishable from that of the parent bank as a whole, so while there is a general responsibility on the host authority to monitor the financial soundness of foreign branches, supervision of solvency is primarily a matter for the parent authority. By contrast, the host authority has primary responsibility for monitoring the liquidity of foreign branches in its country; the parent authority has responsibility for monitoring the liquidity of the banking group as a whole. The supervision of foreign exchange operations by local branches should be a joint responsibility of the parent and host authorities, and this rule should apply in the case of locally incorporated subsidiaries also.

1.32 In the case of locally incorporated subsidiaries, the supervision of solvency was to be a joint responsibility of host and parent authorities. Host authorities were concerned because the subsidiaries were separate legal entities. Parent authorities were concerned because the solvency of parent banks could not be adequately judged without taking account of all their foreign establishments and because parent banks could not be indifferent to the situation of their foreign subsidiaries. The primary responsibility for supervising the liquidity of subsidiaries should rest with the host authority, in liaison with the parent authority which has a general responsibility for overseeing the liquidity control system of the group.

1.33 The 1983 Concordat highlights the attention which banking supervisors were by this time giving to consolidated supervision, that is the supervision of banking groups on the basis of all their operations wherever conducted. This same concern is reflected in the Consolidated Supervision Directive of 13 June 1983.[24] The Directive did not, however, extend to non-bank holding companies.

[24] 83/350/EEC. Offic. Jo. 18/7/83

8 Johnson Matthey Bankers

1.34 Johnson Matthey Bankers Limited ("JMB") was established in 1965 to conduct the bullion and banking business of its parent Johnson Matthey & Co Limited. In 1967 it was authorised under the Exchange Control Act. In 1970 it obtained exemption under the Protection of Depositors Act. It was supervised by the Bank before the 1979 Act came into effect. In April 1980 it was recognised as a bank under that Act: although its main business and reputation were in bullion and foreign exchange dealing, it also had a commercial banking sideline in specialised trade finance and this spread of business was considered to amount to a wide range of banking services.

1.35 Over the next three or four years the company's commercial lending increased exponentially. Much of its lending was to traders in Pakistan, the Middle East and Nigeria. Its two largest exposures were to loosely associated groups of companies run by businessmen from Pakistan, one of them a shipping group. At a later stage another large exposure was discovered, to a company related to the larger of the two other borrowers. It was these large exposures which precipitated a crisis in September 1984 when it became clear that these debts were not fully recoverable and that JMB's parent lacked the resources to support its subsidiary.

1.36 The Bank was of the opinion that the failure of JMB would gravely undermine confidence in the London gold market and in the UK banking system more widely. It accordingly mounted a rescue operation financed partly by itself and partly by other City institutions. Price Waterhouse were engaged by the Bank to investigate JMB's loan book and ascertain its true position.

1.37 The causes of the crisis were various. The problems did not relate to JMB's bullion business, and no fraud by JMB's directors or staff (with one exception immaterial to the collapse) was discovered. But it was plain that the management had been guilty of a catalogue of rudimentary banking errors: controls and systems had been inadequate; the monitoring of credit had been defective; insufficient attention had been given to concentrations of risk; proper security had not been taken; provisions for bad and doubtful debts had not been assessed with appropriate care. These serious failings had been compounded by a failure to make accurate and timely returns to the Bank: the extent of JMB's exposure to major borrowers was substantially understated, and at a crucial stage in the spring of 1984 a significant return was made three months late.

1.38 Coming as it did only five years after a new statutory regime of supervision had been introduced, this crisis caused concern both to the government and to the public at large. It was widely felt that either the 1979 Act provided a defective framework of supervision or the Bank's performance as supervisor was inadequate, or both. This concern led to the setting up of a Committee to consider the system of banking supervision ("the Leigh-Pemberton Committee"), a Treasury working party, a Treasury White Paper and a new statute, the Banking Act 1987.

9 The Leigh Pemberton Report

1.39 The Leigh-Pemberton Committee was established in December 1984 under the chairmanship of the Governor of the Bank. Its members included the Deputy Governor, the Associate Director of the Bank responsible for banking supervision, the Permanent Secretary and a Deputy Secretary of the Treasury and an independent member who was a Director of Barclays Bank.

1.40 The Committee reported in June 1985.[25] It said that no system of banking supervision had been developed which would avoid all bank failures. It did not consider the existing system in the UK to be fundamentally flawed, and praised its flexible character. But it suggested a number of improvements which should be made.

1.41 Very briefly summarised, the more significant suggested improvements were:

(i) abolition of the distinction between recognised banks and licensed deposit-takers, with some amendment of the criteria and conditions of authorisation;[26]

(ii) increased dialogue between the Bank's supervisors and bank auditors without restraints of confidentiality between the two;[27]

(iii) increased assistance by auditors to supervisors in assessing a bank's control systems;[28]

(iv) increased powers for the Bank to require statistical returns to be audited and to commission reports from accountants who were not auditors to a bank;[29]

(v) the limitation of exposures to individual borrowers and groups of closely related borrowers;[30]

(vi) more effective oversight of bank control systems and increased contact between supervisors and bank managements with visits by supervisors to all authorised institutions;[31]

(vii) tightening of the Bank's reporting requirements;[32]

(viii) closer attention to the position of parent companies and other large shareholders including the provision of comfort letters to confirm the support of large shareholders;[33]

(ix) increase in the number of staff devoted to supervision, improvement of their experience and increase in the number of professional accountants employed;[34]

(x) removal of barriers to the exchange of information between the supervisory authorities of international groups;[35]

[25] Cmnd 9550: Report of the Committee set up to consider the System of Banking Supervision
[26] Paras 3.7, 3.9, 3.10
[27] Para 4.7
[28] Para 4.9
[29] Paras 4.11, 4.13
[30] Paras 5.7, 5.10
[31] Paras 6.1, 6.2
[32] Para 7.4
[33] Para 8.4
[34] Paras 9.1, 9.2, 9.4
[35] Para 10.3

(xi) power for the Bank, with the consent of the Treasury, to disclose information to other government departments (except the Inland Revenue and HM Customs and Excise) in the interest of depositors or the public interest;[36]

(xii) increase in the deposit protection scheme limit;[37]

(xiii) revocation of the power to exempt certain overseas banks from the obligation to contribute to the Deposit Protection Fund.[38]

[36] Para 11.4
[37] Para 11.7(i)
[38] Para 11.7(iii)

10 The Treasury Working Party

1.42 The Treasury working party was unofficially known as the Lankester Group, taking its name from the official, then at the Treasury, who chaired it. It was a committee of officials, including representatives of the Bank, and it worked in parallel with the Leigh-Pemberton Committee. It made no formal report, but its work is reflected in the Treasury White Paper issued at the end of 1985.

11 The Treasury White Paper on Banking Supervision

1.43 In December 1985 the Treasury published a White Paper on Banking Supervision.[39] This adopted many of the recommendations of the Leigh-Pemberton Report and the Lankester Group. Since its proposals foreshadowed the Banking Act 1987, which are summarised in section (12) below, no summary of the White Paper need be attempted here.

1.44 The government's purpose was made plain by the opening paragraph of the Foreword contributed by the Chancellor of the Exchequer, the Rt Hon Nigel Lawson MP:

> "An effective system of banking supervision is as important as the banking system itself. For without it there will not be the confidence on which sound banking depends – from the confidence of the individual depositor that his money is safe, to confidence in Britain as one of the foremost financial centres in the world."

In paragraph 8 of his Foreword the Chancellor went on to say:

> "Finally, there remains the ever-present problem of financial fraud. The Government are determined to do all in their power to eradicate this cancer, and have already taken action to that end. But an important deterrent to financial fraud is effective supervision. The banking supervisors require that banks are managed by fit and proper persons, and that they conduct their business prudently. The proposals in the White Paper strengthen the supervisors' powers to achieve this, and thus greatly reduce the scope for banks to be managed incompetently or dishonestly – and there is always a risk that the one will lead to the other. They should ensure that better internal controls further reduce opportunities for fraud. The proposed dialogue between supervisors and auditors will provide an additional important defence. London's pre-eminence as a world banking centre is based on freedom and probity. We are determined to preserve both."

1.45 The problem of fraud is one to which explicit reference had not been made in the Basle Concordats of 1975 and 1983, or in the Community Directives, or in the Banking Act 1979.

[39] Cmnd 9695

12 The Banking Act 1987

1.46 The Banking Act 1987 (which repealed almost all the 1979 Act, including in particular the distinction between recognised banks and licensed deposit-takers) is a substantial statute, running to 110 sections and 7 schedules. Only the barest outline of its provisions relevant for present purposes can be given here.

Supervision

1.47 The Bank was confirmed in its role of supervisor.[40] But it was to be assisted by a Board of Banking Supervision, consisting of three ex-officio members (the Governor as chairman, the Deputy Governor and the executive director of the Bank responsible for banking supervision) and six independent members.[41] The independent members were to advise the ex-officio members on the Bank's exercise of its functions under the Act either generally or in relation to particular institutions and on related matters.[42] The Bank was to report to the Board and make information available to it.[43] If in any case it was decided that the advice of the independent members was not to be followed the ex-officio members were obliged to give written notice of that fact to the Chancellor.[44] As explained in the Treasury White Paper, the Board was intended to bring independent commercial banking experience to bear on banking supervisory decisions at the highest level.[45] Both the Bank and the Board were required to report annually on their activities.[46]

Authorisation

1.48 The acceptance of deposits, otherwise than by authorised institutions, was (with irrelevant exceptions) prohibited.[47]

1.49 The Bank was permitted to authorise an institution only if it was satisfied that certain minimum criteria were fulfilled. One of these, the four eyes criterion, was exactly as in the 1979 Act.[48] The others were similar, although somewhat differently expressed. For an existing foreign-incorporated deposit-taking business they were:

(i) Every director, controller and manager of the institution had to be a fit and proper person to hold his particular position.[49] These expressions were defined to mean very much the same as in the 1979 Act.[50] In deciding whether someone was a fit and proper person the Bank was to have regard to his probity, competence, judgment, diligence and whether he would be a potential threat to the interests of depositors, as also to the honesty, propriety and competence of his previous conduct.[51]

(ii) The institution had to conduct its business in a prudent manner.[52] It was not to be regarded as conducting its business in a prudent manner if it did not maintain

[40] s.1
[41] s.2(1), (2)
[42] s.2(3)
[43] s.2(4)
[44] s.2(5)
[45] White Paper, p3, para 1.5(i)
[46] ss.1(3), 2(6)
[47] s.3(1)
[48] Sch.3, para 2
[49] ibid, para 1
[50] s.105
[51] Sch.3, paras 1(2), (3)
[52] ibid, para 4(1)

net assets of appropriate amount, maintain adequate liquidity, make adequate provision for depreciation and bad or doubtful debts, and maintain adequate records, accounts and control systems.[53] Records and systems were not to be regarded as adequate unless they were such as to enable the institution to be prudently managed and the institution to comply with the duties imposed on it by the Act.[54]

(iii) The business of the institution had to be carried out with integrity and the professional skills appropriate to the nature and scale of its activities.[55]

(iv) The institution had to have net assets of or equivalent to not less than £1 million.[56]

1.50 In the case of (i), (ii) and (iii) a rule similar to that under the 1979 Act applied if the institution's principal place of business was outside the UK. The Bank might regard itself as satisfied that these criteria were fulfilled if the relevant foreign supervisory authority informed the Bank that it was satisfied with respect to the prudent management and overall financial soundness of the institution and the Bank was satisfied as to the nature and scope of the supervision exercised by that authority.[57] In the case of a corporate body the Bank could take into account matters relating to other corporate bodies in the same group and their directors and controllers.[58]

1.51 Any institution which was a recognised bank or a licensed institution under the 1979 Act when section 3 of this Act came into force was deemed to have been granted an authorisation under this Act.[59] Thus an existing licensed institution did not have to satisfy the Bank afresh that it fulfilled the criteria for authorisation.

Revocation

1.52 Section 11 of the Act listed the grounds on which the Bank might or was obliged to revoke an authorisation.

1.53 The Bank was empowered to revoke an authorisation if (among other things) it appeared to it that

(i) any of the criteria for authorisation "is not or has not been fulfilled, or may not be or may not have been fulfilled, in respect of the institution";[60] or

(ii) "the interests of depositors or potential depositors are in any other way threatened, whether by the manner in which the institution is conducting or proposes to conduct its affairs or for any other reason".[61]

1.54 The Bank was obliged to revoke an authorisation if (among other things) it appeared to it that

(i) a winding-up order was made against the institution in the UK;[62] or

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[53] ibid, paras 4(2), (4), (6), (7)
[54] ibid, para 4(8)
[55] ibid, para 5
[56] ibid, para 6
[57] s.9(3)
[58] s.9(4)
[59] Sch.5, para 2(1)
[60] s.11(1)(a)
[61] s.11(1)(e)
[62] s.11(6)(a)

(ii) where an institution's principal place of business was in another member state of the European Community, the supervisory authority in that member state had withdrawn its authorisation.[63]

Restriction

1.55 The Bank was empowered to restrict an authorisation instead of revoking it if it appeared to the Bank that there were grounds on which the Bank could exercise its power to revoke but that the circumstances were not such as to justify revocation.[64] An authorisation could then be restricted in duration (to a maximum of three years), or by imposing such conditions as the Bank thought desirable for the protection of depositors or potential depositors, or both.[65] The conditions which the Bank could impose might require the institution to take certain steps or to refrain from adopting or pursuing a particular course of action or to restrict the scope of its business in a particular way.[66] Failure to comply with a condition could expose the institution to criminal penalties and also provide ground for revocation.[67]

Publication

1.56 The Bank was required, as under the 1979 Act, to publish a statement of the principles on which it acted in granting and revoking authorisations and to publish annually and make available a list of authorised institutions.[68]

Appeal

1.57 An institution aggrieved by a refusal, revocation or restriction of authorisation was entitled to appeal as under the 1979 Act, save that the appeal lay to the appeal tribunal and not to the Chancellor.[69] On an appeal the issue in the ordinary way was whether the Bank's decision was unlawful or not justified by the evidence on which it was based.[70]

Large exposures

1.58 Section 38 of the Act required any authorised institution to report to the Bank if

(i) it had entered into a transaction or transactions relating to any one person as a result of which it was exposed to the risk of incurring losses in excess of 10 per cent of its available capital resources; or

(ii) it proposed to enter into a transaction or transactions relating to any one person which, either alone or together with a previous transaction entered into by it in relation to that person, would result in its being exposed to the risk of incurring losses in excess of 25 per cent of those resources.[71]

1.59 These requirements, elaborated in a little detail in the section, applied if the transactions related to different persons if they were so connected that the financial soundness of one might affect the financial soundness of the other.[72] But they did not apply to an institution whose principal place of business was outside the UK.[73] Solvency was then a matter for the home country supervisor.

[63] s.11(3)
[64] s.12(1)
[65] s.12(2), (3)
[66] s.12(4)(a)
[67] s.12(6), (7)
[68] ss.16, 17(1), (2)
[69] s.27
[70] s.29(1), (5)
[71] s.38(1)
[72] s.38(2)
[73] s.38(1)

The Bank's supervisory powers

1.60 The Act conferred on the Bank several important powers.

(i) Under section 39 the Bank could require an authorised institution to provide information[74] or documents[75] or to commission a report by an accountant nominated or approved by the Bank to be provided to the Bank on any matter about which the Bank could require information under the Act.[76] It could require production of documents by a third party.[77] The Bank could exercise these powers, if it appeared to the Bank to be desirable in the interests of depositors or potential depositors to do so, in relation to a holding company, subsidiary or related company of the institution,[78] and in relation to a significant shareholder.[79] This power was reinforced by a right of entry[80] and criminal penalties for non-compliance.[81]

(ii) Section 41 of the Act provided that if it appeared to the Bank desirable to do so in the interests of the depositors or potential depositors of an authorised institution the Bank might on notice to the institution appoint persons to investigate and report to the Bank on the nature, conduct or state of the institution's business or any particular aspect of it or the ownership or control of the institution.[82] A person so appointed could if necessary investigate holding, subsidiary and related companies,[83] require the production of documents[84] and the attendance of relevant persons[85] and enter the institution's premises.[86]

Whereas under section 39(1)(a) the reporting accountant is formally instructed by and reports to the institution, his report being provided to the Bank, under section 41 it is the Bank itself which gives the instructions and receives the report. This invasive power was reinforced by criminal penalties.[87]

Auditors' duty of confidentiality

1.61 The Act relaxed the ordinary duty of confidentiality owed by an auditor to his client, the company subject to the audit. It provided that no duty to which the auditor of an authorised institution or a reporting accountant might be subject should be regarded as contravened by reason of his communicating in good faith to the Bank, whether or not in response to a request made by it, any information or opinion on a matter relevant to the Bank's functions under the Act and of which the auditor or reporting accountant had become aware in his capacity as auditor or reporting accountant relating to the institution.[88] The Treasury was given a reserve power to procure the making of professional rules giving effect to this relaxation,[89] but it was unnecessary to invoke this: in March 1989 the Institute of Chartered Accountants in England and Wales issued a Guideline on the Audit of Banks in the United Kingdom which the Bank and the Treasury approved.[90] This Guideline dealt at some length with the duty of bank auditors and reporting accountants under the 1987 Act. In particular it dealt with the circumstances in which accountants acting as auditors or reporting

[74] s.39(1)(a), (3)(b)
[75] s.39(3)(a), (b)
[76] s.39(1)(b)
[77] s.39(4)
[78] s.39(6)
[79] s.39(10)
[80] s.40
[81] ss.39(11), 40(3)
[82] s.41(1)
[83] s.41(2)
[84] s.41(5)(a)
[85] s.41(5)(b)
[86] s.41(7)
[87] ss 41(9), 44(1), (2), 94(4), (5)
[88] s.47(1), (2), (3)
[89] s.47(5)
[90] Audit Guideline 307, p.4

accountants should make ad hoc reports to the Bank, that is reports they had not been specifically commissioned to make.[91] The principle laid down was that they should take the initiative when they considered it expedient to do so in order to protect the interests of depositors because there had been a material loss or there existed a significant risk of material loss.[92] Ordinarily, they should ask their client bank to make the necessary report to the Bank.[93] But the Guideline recognised that there could be exceptional circumstances in which they should report direct, as where they no longer had confidence in the integrity or competence of the directors or senior management,[94] or where the bank (having been advised to report a matter to the Bank) had failed to do so within a period specified.[95]

Deposit protection

1.62 The Deposit Protection Scheme was continued, but with an obligation on all authorised institutions to contribute and an increase in the maximum sum recoverable to £15,000.[96]

Description as bank

1.63 An authorised institution incorporated outside the UK could describe itself as a bank irrespective of minimum capital requirements (of modest amount) applied to locally incorporated institutions.[97]

Restriction on disclosure of information

1.64 Part V of the Act (sections 82-87) contained detailed provisions prohibiting the disclosure by any person of information received whether directly or indirectly under or for the purposes of the Act or the 1979 Act[98] relating to the business or other affairs of any person without his consent and the consent of the person (if different) from whom the information was received, save in certain specified situations and for certain specified purposes. This restriction has had a bearing on the Bank's relations with other authorities and on the conduct of this Inquiry, and will have a bearing on publication of this Report. These provisions cannot be accurately summarised, and are set out in full in Annex 2 to this Report.

Winding up

1.65 On a petition presented by the Bank the High Court may wind up an authorised institution on grounds of insolvency or if the court is of opinion that it is just and equitable that the institution should be wound up.[99]

[91] Paras 171-191
[92] Para 181
[93] Para 183
[94] Para 184
[95] Para 185
[96] ss.50, 52(1), 58(1), 60(1)
[97] ss.67(1), (2), 68(3), (4), (5)
[98] Sch.5, para 14
[99] s.92

13 Statement of principles

1.66 As required by the 1987 Act, the Bank in May 1988 issued a statement on the principles underlying the statutory criteria and how the Bank interpreted and applied them.[100] In this the Bank drew attention to a number of technical papers issued by its Banking Supervision Division. Certain amendments were later made to add new papers to the list.[101]

1.67 The Bank's statement contained a clear and comprehensive account of the principles on which the Bank conducted its supervision. In its introduction it stated:

> "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 depoitors and potential depositors require that such powers are exercised, it will move to revoke or restrict authorisation."

In its statement the Bank commented in some detail on the minimum criteria for authorisation set out in Schedule 3 of the Act. Attention was drawn among other things to the need for prudence, integrity (requiring an institution to observe high ethical standards in carrying on its business), professional banking skills and probity. The Bank's general approach to revocation under section 11 was set out in paragraph 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."

In Part 5 the Bank laid out the principles it applied to revocation and restriction:

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

[100] Banking Act 1987 Section 16: Statement of Principles, May 1988

[101] Bank of England Banking Act Reports for 1988/89, 1989/90 and 1990/91 at pages 25, 25 and 23 respectively

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 interest 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.

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.

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."

In paragraph 4.12 of the statement reference had been made to situations in which revocation is mandatory: where an institution has its principal place of business in another member state of the European Community where its authorisation has been withdrawn; and where a winding-up order has been made or a resolution for voluntary winding-up passed in the UK.

14 Statement of principles on money-laundering

1.68 Money-laundering means transmitting illicit funds through the banking system in such a way as to disguise the origin or ownership of the funds. In December 1988 the Basle Committee adopted a statement of principles to counter this growing menace. These principles called on banks to introduce effective procedures to ensure that bank customers were properly identified, that questionable transactions were discouraged and that banks fully co-operated with law enforcement agencies. The first and most important safeguard against money-laundering was said to be the integrity of banks' own managements and their vigilant determination to prevent their institutions becoming associated with criminals or being used as a channel for money-laundering. The Bank circulated this statement of principles to authorised institutions in January 1989 and reminded institutions of their duty in a detailed letter of 10 November 1989.

1.69 At the Economic Summit held in Paris in June 1989 a Financial Action Task Force was established which has since then been the main focus for international discussions of measures to combat money-laundering. The Task Force has 28 members (including the European Commission) and brings together representatives of supervisory authorities, policy departments and enforcement agencies. Its report in February 1990 set out 40 recommendations and it has since established an evaluation procedure for checking that they are being implemented. This includes a system of peer group review under which each country in turn is examined by a group of experts which produces a report for discussion by the Task Force. The Task Force recommendations go well beyond the Basle principles.

1.70 In December 1990 the British Bankers' Association and others issued Guidance Notes on Money Laundering for Banks and Building Societies.

1.71 On 10 June 1991 the Council of the European Communities adopted a Directive on prevention of the use of the financial system for the purpose of money-laundering: this reflected both the Basle principles and the Task Force recommendations and of course had legal force as between member states.[102]

1.72 The Basle Committee's statement of principles and the European Community Directive represented a step forward in international thinking and practice. In most countries, banking supervisors had not had a role in detecting money-laundering. It was during the 1980s, and against a background of growing concern about drug-trafficking, that it became accepted that bank supervisors should contribute to its prevention, although the supervisors' primary concern remained to maintain the financial stability and soundness of banks.

[102] 91/308/EEC. Offic. Jo. 28/6/91

15 The Second Banking Coordination Directive

1.73 On 15 December 1989 the Council of the European Communities adopted the Second Banking Co-ordination Directive,[103] which is currently in the process of being implemented. Its main effect is to give a passport to a bank authorised in one member state to open a branch or do banking business on a services basis in another member state without further authorisation.[104] This is associated with a tightening of the supervisory system and harmonisation of minimum standards, particularly by means of two sister directives.[105] Article 13 provides that the prudential supervision of a credit institution (such as a bank) including its activities in another member state shall be the responsibility of the competent authorities of the home member state. Attention should be drawn to the eighth recital to the Directive:

> "Whereas the principles of mutual recognition and of home Member State control require the competent authorities of each Member State not to grant authorisation or to withdraw it where factors such as the activities programme, the geographical distribution or the activities actually carried on make it quite clear that a credit institution has opted for the legal system of one Member State for the purpose of evading the stricter standards in force in another Member State in which it intends to carry on or carries on the greater part of its activities; whereas, for the purposes of this Directive, a credit institution shall be deemed to be situated in the Member State in which it has its registered office; whereas the Member States must require that the head office be situated in the same Member State as the registered office".

In the French language text of this Directive, the expression rendered in English as "head office" is *"l'administration centrale"*.

[103] 89/646/EEC. Offic. Jo. 30/12/89

[104] See particularly Articles 6 and 18

[105] The Own Funds Directive (89/299/EEC) Offic. Jo. 5/5/89 and the Solvency Ratio Directive (89/647/EEC) Offic. Jo. 30/12/89

16 The Second Consolidated Supervision Directive

1.74 The Second Consolidated Supervision Directive was adopted by the Council of the European Community on 6 April 1992. It is due to be implemented by 1 January 1993 and replaces the Consolidated Supervision Directive of 13 June 1983 (paragraph 1.33 above). The new Directive does two things. First, it extends the range of institutions subject to the requirement of consolidated supervision. A non-bank holding company such as BCCI Holdings, not previously subject to consolidated supervision, would now be covered. Second, it extends the range of activities covered by the consolidated supervision so as to include all activities listed in the annex to the Second Banking Co-ordination Directive, a wide if not exhaustive list of banking activities. There are additional provisions providing for the exchange of information between group companies and between member states.

1.75 Other legislative initiatives within the Community have reached a less advanced stage, but very substantial progress has been made towards a Large Exposures Directive and the Commission has approved a proposal for a Deposit Guarantee Directive.

17 Supplements to the Basle Concordat 1983

1.76 The Basle Concordat of 1983 (see section (7) above) was supplemented in April 1990 by a paper on information flows between banking supervisory authorities. This provided a statement of good practice in relation to authorisation, the information needs of parent and host authorities, the removal of secrecy constraints and external audit.

1.77 In the aftermath of the BCCI closure the Basle Committee reviewed the existing statements of good supervisory practice with a view to closing loopholes and raising standards of supervision and co-operation internationally. This review culminated in the issue, on 6 July 1992, of a further supplement to the 1983 Concordat. This paper, now in the course of distribution to banking supervision authorities worldwide, sets out the minimum standards to be observed by supervisory authorities. These are four-fold:

(i) All international banking groups and international banks should be supervised by a home-country authority that capably performs consolidated supervision.

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

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

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

The effect and intent of these standards are elaborated in the text of the Committee's statement. Standards (ii) and (iv) will not apply within the European Community under the regime established by the Second Banking Coordination Directive (see section (15) above), and the Committee has emphasised that no precautions can provide a cast-iron guarantee against the existence of fraud within banks and banking groups. But these standards should, if generally observed, further reduce the risk that fraud will flourish undetected and unchecked.

Chapter 2
Report and Conclusions

2.1 The history of BCCI's supervision by all the UK authorities is a long story, extending over 19 years. It is also a complex story, involving a number of different authorities and parties in the UK and abroad. And it is a very dense story, because the supervisory attention paid to BCCI over the years was very great. It is not a story which readily lends itself to simple and categorical judgements.

2.2 No one reading the history of BCCI and its supervision today can do so without knowledge of what happened in the end. But that is knowledge which no one had until the last week or so of the bank's active existence. It would not be fair to judge the actions or decisions of supervisors involved at any particular time on the basis of knowledge which they did not then have and could not reasonably have had. Nor would it be fair to judge the actions or decisions of supervisors on the basis of supervisory principles or practices which had yet to take shape or gain acceptance at the relevant time. For these reasons I have attached particular importance to views expressed at the time by informed participants in the events under review.

2.3 Two other general points are worthy of note at the outset. First, the supervisory problems which BCCI presented were tackled by busy men and women, often over-stretched and with other problems competing for their attention. Reading the story of BCCI alone may give a misleading impression that these events occurred in isolation. Of course they did not: they were to the supervisors part of an often very considerable workload. No UK supervisor ever enjoyed the luxury of devoting himself or herself single-mindedly to the supervision of BCCI. Secondly, the systematic frauds now thought to have been practised in BCCI were on a scale which had never been known before. It would, until the later stages of the story, have required considerable imagination to suppose that fraud was being practised on anything approaching the scale which has now been revealed.

A The Bank

1 The establishment of BCCI in the UK

2.4 When, in the summer of 1972, Mr Agha Hasan Abedi told the Bank of his plan to open a London branch of his new Luxembourg bank, the Bank gave the plan a cautious welcome. Formally, the Bank had no power to block entry. It could withhold exchange control authorisation, and it was indeed indicated that the new branch would have to earn such authorisation on its track record. But the Bank could, had it wished, have used its great moral authority to try to discourage entry. It did not do so. Its reaction cannot, in my view, be fairly criticised. Abedi himself appeared to be an experienced and successful banker. If doubts then existed about his integrity, they were not widely known, and certainly not known to the Bank. The proposed manager of the new branch was known to the Bank, and had proved himself reliable and trustworthy. A modest operation, with perhaps a branch or two in addition to the City branch, was envisaged; there was no thought of a large retail network. Above all, Abedi came with the Bank of America, one of the largest banks in the world, regarded as a model of sound and conservative banking, as a 25 per cent shareholder. It would not have been consistent with the City's role as a dynamic financial centre to have resisted entry by this apparently promising newcomer.

2.5 I am inclined to accept an assertion, made more than once by Abedi, that before ever incorporating BCCI in Luxembourg he sought to incorporate it in the UK, but was rebuffed when the Bank called for capitalisation of a new UK bank in a sum he could not then raise. In retrospect it can be seen that a different decision would have saved much time and effort over the years ahead, and perhaps led to a different outcome. But the Bank was clearly seeking to prevent the establishment of a weak, under-capitalised bank, and on that basis its decision cannot, save in hindsight, be faulted.

2.6 In 1975 parties financed by, and perhaps more closely associated with, BCCI sought to establish a UK branch of a Luxembourg insurance company. The Department of Trade objected and insisted that the business should be done through a company incorporated here. In the result the business was done through Credit & Commerce Insurance Company (UK) Limited. The Department of Trade's response may be partly explained by the fact that it had at the time a statutory duty to supervise insurance companies and the Bank had none to supervise banks. But the facts also were different. Even if the Department of Trade's decision is to be commended, it does not follow that the Bank's approach at that time is to be criticised.

2 1974-1976

2.7 Concern about BCCI's speed of growth first surfaced in the summer of 1974. This concern was at first modest, since inspections made by the Luxembourg Banking Commission ("the LBC") and reports made by the Bank of America and others were favourable. The first criticisms of BCCI's business practices came to the Bank's notice in 1975, but these were at that stage isolated and insubstantial criticisms.

2.8 It seems likely that it was pressure by the LBC to restrict the speed of BCCI SA's expansion which prompted, at least in part, Abedi's decision to restructure the group by forming a non-bank holding company in Luxembourg (BCCI Holdings Luxembourg SA) to become the parent of SA and a second banking subsidiary in the Caymans, BCCI Overseas. The Bank did not learn of these changes until March 1976 and was not at first concerned, even though the reasons given for the choice of a Cayman base were not very convincing and even though the opening of Overseas branches in the UK was expressly mentioned. But as the first UK branch of Overseas opened in June 1976, the Bank's attitude to Overseas changed, primarily because of the confusion which branches of SA and Overseas, operating together, were liable to cause. Any request for interim exchange control permissions for Overseas was firmly discouraged, although hope of full exchange control authorisation within the foreseeable future was held out to SA, which already enjoyed some interim permissions. There were in 1976 some rumours, apparently of little or no substance, about BCCI's business integrity, but the Bank of America's support was continuing and it was proposing to be represented at board level. The concern of the Bank and the LBC about the speed of BCCI's growth was shared by some other bankers, but the contemporary evidence does not suggest that up to this time (1976) market opinion in the UK was strongly hostile.

2.9 A contrast has been drawn between the Bank's cautious welcome of BCCI in the UK and the rebuff administered by Mr John Heimann, the New York Superintendent of Banks, to two attempts by parties financed and advised by BCCI to acquire New York banks in 1976-77. The Superintendent's reason for rebuffing these attempts was that BCCI had no single regulator responsible for overseeing its worldwide operations. The two situations are not closely comparable. The Superintendent's approval was a formal requirement; the Bank's was not. In 1976 BCCI had no presence in New York; in the UK it had. The Superintendent had personal experience of problems caused by lack of a single regulator; the Bank, up to then, had not. But the Superintendent's decisions were, particularly by the standards of the day, wise and farsighted decisions. The Bank was aware of his thinking, but when the licensing stage in the UK came it did not (perhaps because it felt it could not) apply it.

3 1977-1979

2.10 In the course of 1977 a number of themes became more dominant. First, it became clear that Abedi's ambitions for the expansion of the group continued unabated. Secondly, it was evident that much of the expansion was taking place through Overseas, which was subject to little or no supervision. There was concern that parts of SA's business might be hived off into Overseas and other subsidiaries and concern that attempts to curb further expansion of SA might prompt the further growth of Overseas and other subsidiaries. Thirdly, there was a concern that in the drive for expansion such mundane prudential matters as ratios and bad debt provisions were somewhat neglected. Fourthly, certain features of the group's business attracted critical attention: the UK branches were thought to be over-trading and trading at a loss; to be over-lent in certain areas and to certain borrowers, of which the Gokals' Gulf shipping group was one; to be doing too little business with other banks. Fifthly, attention was drawn for the first time to the facts that BCCI did no sizeable banking business in Luxembourg or the Caymans, whereas the bank had more branches in the UK than in any other country, and that the London office appeared to play a central role in the group. Sixthly, there was a discernible increase in the volume of critical comment by bankers and others.

2.11 The Bank asks that such critical comment, at this stage and later, should be put in context. Much of it was hearsay. Little or none of it was substantiated. Some emanated from disgruntled customers, a phenomenon common to all banks, or arose out of commercial disputes where the Bank could not know (let alone decide) which side was right. Some, it was thought, was the product of cultural differences between BCCI and more familiar Western banks, or racial prejudice, or the resentment of banks discomforted by the operations of a young, aggressive and apparently successful newcomer.

2.12 As against these somewhat nebulous criticisms and concerns, the Bank had more solid material telling in BCCI's favour. The Bank of America, represented in the London office and on the board, reported nothing amiss. The LBC continued to inspect the UK branches and continued to give SA a clean bill of health. The auditors gave an unqualified opinion on the group's accounts. There was no concrete evidence of malpractice. But some doubts were raised as to how closely the Bank of America was in touch with the business of the group, and representatives of the LBC said it was impossible to supervise SA effectively from Luxembourg, suggesting that they would be much happier if the Bank was responsible for supervising the UK branches.

2.13 It was against this background, which was one of uneasiness, not apprehension of imminent catastrophe, that a scheme was proposed for combining the UK business of SA and Overseas in a single UK subsidiary directly subject to the supervision of the Bank: the true quality of the business could then be investigated and appropriate ratios imposed, in the expectation that in due course and if all went well exchange control authorisation would be granted. Neither at this time, nor on the later occasions when local incorporation was considered, did any supervisor suppose that incorporation could wholly insulate the local company against the effects of disaster afflicting the rest of the group, and there were those even in 1977 who felt that the responsibility of supervising a local subsidiary was one which the Bank could not adequately discharge and should therefore not undertake. But the balance of opinion among Bank supervisors was in

favour of the scheme, and BCCI's application to the Department of Trade for approval of a new company with a banking name received the Bank's blessing.

2.14 In early 1978 this proposal foundered. There were three main reasons for this. The first was that the Bank, in accordance with its then current practice, thought it desirable to obtain letters of comfort from the ultimate owners of the proposed subsidiary's share capital, affirming their support of it. In the case of BCCI it was recognised that the only comfort letter of real value would come from the Bank of America. But when the Bank of America was approached for a comfort letter it revealed its intention, over a period, to withdraw from BCCI. The reasons it gave were commercial, and it was at pains to disavow concern about BCCI's business as a cause. But the loss of this prestigious backer significantly undermined the Bank's confidence in BCCI, and Abedi's failure to reveal this important development to the Bank (or the LBC) confirmed the Bank in its suspicion that he was a man whose frankness could not be relied on.

2.15 The second reason why the proposal foundered was because of reservations expressed by the LBC. While middle-ranking officials had been inclined to welcome the proposal, the Director-General (Mr Pierre Jaans) was apprehensive that withdrawal of the UK branches from SA might so weaken it as to jeopardise renewal of its Luxembourg licence. He acknowledged that Luxembourg was not an appropriate base for a bank with retail branches in other countries, and favoured removal of the whole group, including the holding company, to the UK; but he was unhappy at a simple hiving off of the UK branches.

2.16 The third reason concerned the proposed legislation which became the Banking Act 1979: unless a UK subsidiary of BCCI were recognised as a bank in the UK, it could not use a banking name under the proposed legislation, and recognition was (at best) uncertain. It was therefore felt to be potentially disadvantageous to BCCI to encourage a UK subsidiary, which might then be denied use of the name under which SA's business in the UK was already being done.

2.17 A fourth reason for rejecting the proposal has been suggested in evidence: that the Bank did not wish to give BCCI the seal of approval which establishment of a UK subsidiary might be understood internationally to confer. I can find no trace of this reason in the papers circulated at the time, but it may well have had an effect on the minds of supervisors.

2.18 I do not find the other reasons very persuasive. The Bank of America's proposed withdrawal naturally weakened the Bank's confidence in BCCI, but the more vulnerable BCCI became the more important it was to achieve such additional protection as the Bank's direct supervision of a UK company might give. Equally, the more it appeared that Abedi would not voluntarily share unwelcome news with the Bank, the more important it was for the Bank to be in a position to discover such news for itself. As for the LBC, there was as in any organisation (including the Bank) some variation of view between individuals, those lower in the hierarchy being more conscious of practical problems, those higher up inclining to a broader and perhaps more political view. But no real attempt was made to persuade Jaans of the proposal's merits and one can only speculate whether such an attempt, if made, would have succeeded. The third reason was not a good one since, on a correct construction of the legislation as enacted, BCCI should not have been permitted to use a banking name in the UK whether it traded through a subsidiary or through branches of SA (paragraph 2.33 below). But these were early days. The 1979 Act was not yet in force and the Bank lacked formal powers. Internationally accepted principles of supervision were only

beginning to take shape. BCCI was still a little-known entity. Adoption of this proposal, if practicable, would in my view have been an advance, but it is understandable that it was not at that stage adopted.

2.19 The Bank was still concerned to curb BCCI's over-rapid growth in the UK and end the confusing dichotomy between SA and Overseas. A scheme was accordingly devised by the Bank and put to Abedi, the essence of which was a freeze in the overall number of UK branches and a transfer of all UK branches of Overseas into SA. The LBC was content that all the UK branches, as part of SA, would be its responsibility. The Bank arranged to receive information on the UK branches as if they were part of a UK bank and established a pattern of routine prudential meetings. The Bank had no power to compel Abedi's acceptance of this scheme, but he did accept it (if reluctantly) and he did what was asked of him. The transfer of the branches was completed with effect from 1 January 1979 and represented an undoubted improvement, both because a source of confusion was removed and because retail business was no longer done in the UK through unsupervised branches of a Cayman bank. The episode is significant on two counts: first, as a timely and well-judged exercise of the Bank's informal supervisory authority; secondly, as illustrating how anxious Abedi usually was to earn the approbation of the Bank.

4 The licensing of BCCI in the UK

2.20 The Banking Act 1979 received the royal assent in April 1979 and came into effect for the most part in October 1979. For the first time bodies such as SA required authorisation (either recognition as a bank or licensing as a deposit-taking institution) to carry on deposit-taking business in the UK. For the first time formal statutory responsibility for supervising banks was imposed on the Bank and powers were conferred to enable it to discharge that responsibility.

2.21 From the contemporary documents and from the oral evidence it is possible to discern the picture which SA and the group presented to the Bank as the authorisation period under the Act approached. On the positive side, both SA and the group appeared to be profitable. The shareholders appeared to be supportive and willing to supply more capital when asked. The auditors were giving unqualified opinions on the accounts. The LBC as primary supervisor under the Basle Concordat continued to give favourable opinions. The Bank of America indicated no ground for concern (although inability to discover what was really going on was widely thought to underlie, in part, its decision to withdraw). Other favourable opinions were expressed. No concrete evidence of malpractice had been established. There were, however, a number of negative factors known to or appreciated by the Bank:

(i) The Group's structure prevented any supervisor seeing the whole of its operations. Holdings, as a non-bank holding company, was subject to no supervision. The LBC was the primary regulator of SA, but acknowledged the difficulty of supervising a worldwide group from Luxembourg. Overseas was effectively unsupervised. The risk that substandard loans might be switched around the group to places where they were least likely to be questioned was expressly recognised, and suspected of having been done.

(ii) The ownership of the group was not clear. The largest bloc of shares was owned by a Cayman company, ICIC Overseas, owned by another Cayman company, ICIC Holdings. But despite considerable probing by the Bank, satisfactory details of the ownership of ICIC Holdings were never forthcoming. It was suspected that BCCI was financing the purchase of a considerable tranche of its own shares. The business rationale of these ICIC entities was far from clear, although they were thought to hold management's interest in BCCI.

(iii) The ramifications of the BCCI group were not understood. An insurance company (CCI UK) was thought to be part of the group but how it fitted in was never clarified.

(iv) The group lacked a lender of last resort, that is, a party who would provide liquidity in time of crisis if all other sources of funds failed.

(v) With largely Arab ownership, largely Pakistani senior management, Luxembourg and Cayman incorporation and senior management based in London, the group lacked a natural home.

(vi) The group did much business in parts of the world where supervision was rudimentary or non-existent.

(vii) The speed of the group's growth raised doubts about its profitability and the soundness of its business. Its exposure to the Gulf/Gokal group had been

reported by the US authorities in February 1978 to be twice the capital of the bank. It was this exposure which, the Bank suspected, had been transferred from SA to other members of the group.

(viii) By its involvement, in collusion with Mr T Bertram Lance (formerly Director of the US Office of Management and the Budget), in an attempted takeover of Financial General Bankshares (which owned First American Bank), BCCI had antagonised the US authorities.

(ix) The general balance of market opinion, at home and abroad, was adverse, ranging from wariness of the unknown through unease to outright (but unsubstantiated) hostility.

(x) The group was dominated by and excessively dependent upon the personality and skills of a single man, Abedi. He could not be trusted to disclose unwelcome news to the Bank or any other supervisor.

(xi) The group's operations were characterised by ostentatious expenditure and lavish entertainment.

2.22 As explained in Chapter 1 paragraphs 1.16-1.19 above, the 1979 Act drew a distinction between institutions whose principal place of business was in the UK and institutions whose principal place of business was overseas. In the first case the Bank had to make an independent judgment whether the statutory criteria necessary for recognition as a bank or licensing as a deposit-taking institution, as the case might be, were fulfilled. In the second case the Bank could, if it thought right, rely on the judgement of the overseas supervisor with responsibility in the principal place of business in relation to certain of the criteria, if the Bank was satisfied as to the nature and scope of the supervision exercised by that authority. That was the effect of section 3(5). If recognition were refused, but a licence granted, the institution's right to use a banking name also varied, depending on whether the institution's principal place of business was in the UK or overseas. That was the effect of section 36.

2.23 In applying this new and unfamiliar statutory regime to BCCI SA, it was necessary for the Bank, first of all, to understand what was meant by "principal place of business". That was a legal question. Those who handled this matter in the Bank had many applications to process in a very limited time, and did not recognise this as a question to be asked. So legal advice was not sought. Had advice been sought, the Bank would have been advised (as it was when it did seek advice ten years later) that the expression did not relate to the place of incorporation or the statutory or registered office but to the place where the mind and management of the company, its central direction, resided. The Bank has not suggested that it was misled by any disparity between the language of the First Banking Coordination Directive (see Chapter 1 section (4) above) and sections 3(5) and 36 of the UK Act; in any event its duty was to comply with the UK Act unless and until that was held to be inconsistent with the Directive. The question was simply never addressed.

2.24 Having established the meaning of the expression, the Bank's next step should have been to address a factual question, namely where the principal place of business of SA was. This also was an enquiry which the Bank never made. Had it done so, it would have been bound to conclude that SA's mind, management and central direction resided in London and certainly not in Luxembourg. While some Bank witnesses questioned the London residence, suggesting that the mind and management of the group were in Abedi's briefcase or wherever he happened to be, none contended for a Luxembourg base. In my view the evidence is clear that London was by 1979-80, if not much earlier, the effective head office of SA and the group. Perhaps significantly, when

filling in the Bank's application form which contained a rubric "Principal place of business", SA did not answer "Luxembourg" but gave an evasive, although honest, answer.

2.25 The Bank treated section 3(5) as applicable and applied it. This was in my view erroneous. Whether it would have made any difference had a correct legal approach been followed is an issue to which I turn below. I read nothing sinister into this error of approach: in making the change from an informal system of supervision to a new, statutory regime, the Bank was slow to appreciate that the new provisions had to be fully understood before they could be literally observed.

2.26 SA applied for recognition as a bank. The Bank accepted that it provided a wide range of banking services, which was one of the criteria to be fulfilled. It also found that the "four eyes" criterion ("At least two individuals effectively direct the business of the institution") was fulfilled. But it rejected the application for recognition because it was not satisfied that "the institution enjoys, and has for a reasonable time enjoyed, a high reputation and standing in the financial community". In reaching this conclusion the Bank relied not on gossip but on the outcome of a careful and well-devised consultation exercise. Its conclusion on this point, evidenced in particular by the paucity of BCCI's business with other banks, was plainly correct. No other conclusion would have been sustainable. When communicating the Bank's reasons for refusing recognition, however, this was not the only reason given. Reference was also made in writing to concerns about the structure of the group, the shareholding of ICIC and yet unformed trusts, and the lack of a single supervisor able to take an overall view of the group's total operation. When Abedi called at the Bank to complain of the refusal of recognition he was told that the fundamental bar to recognition was the opacity of the group structure and the lack of a single supervisory authority. Another main cause of unease was the consequence if he fell under a bus. There is no reason to doubt that these reasons, given at the time, underlay the Bank's decision.

2.27 The Bank decided to license SA as a deposit-taking institution. In making this decision it was required to be, and was, satisfied that the four eyes criterion was fulfilled. For the fitness and properness criterion, and for the prudence criterion, it relied on the judgment of the LBC. This, I have concluded, it was not entitled to do. But the Bank also relied on its own enquiries, and even if section 3(5) did not apply it was entitled to give appropriate weight to the opinion of the LBC as the primary regulator most closely in touch with the business. The Bank witnesses involved at the time are emphatic that had the Bank recognised the need to make an independent judgement, without reliance on section 3(5), the decision would have been the same. While the decision whether or not to grant recognition was at first thought difficult, the decision to grant a licence was regarded as relatively straightforward. The Act was not, a Bank witness said, intended to put apparently thriving companies out of business, and the denial of a licence would have caused astonishment.

2.28 Section 3(3)(b) of the Act provided that "the Bank shall not grant a full licence to an institution unless it is satisfied that the criteria in Part II of [Schedule 2 to the Act] are fulfilled with respect to the institution". The first criterion on which the Bank was required to be satisfied was that every person who was a director, controller or manager of the institution was a fit and proper person to hold that position. Had the Bank exercised an independent judgement, it would have been satisfied of the fitness and properness of the directors and, in all probability, of the managers as defined in the Act (see Chapter 1 paragraph 1.18 above) and most of the controllers (as also defined). But to be satisfied that all the controllers were fit and proper it would have had to know who all the controllers were, and that would have required an understanding, which the Bank did not in fact achieve, of the ICIC shareholding. Whether the Bank would ever have obtained full disclosure of the shareholding structure and, if so, what such disclosure would have shown, must now be speculative.

2.29 The second criterion on which the Bank was required to be satisfied was the four eyes criterion. The Bank was entitled to conclude, despite the pre-eminence of Abedi, that at least two individuals effectively directed the business of SA.

2.30 The third criterion on which the Bank was required to be satisfied was that SA conducted its business in a prudent manner, both generally and in certain particular respects. It is hard to see how the Bank could be so satisfied unless it had or could acquire an adequate knowledge of how its business was conducted. If, for example, SA was making bad loans and transferring them to Overseas when their badness became apparent, that could reflect adversely on the prudence with which SA conducted its business (and also on the fitness of those responsible for such transfers). The Bank points out that the 1979 Act (and its successor) did not empower the Bank to impose a structure on a banking group. I agree. But if a group was so structured that the Bank was unable to ascertain how the business was done, and so to satisfy itself that the business was conducted prudently, then the Bank was not only entitled but obliged to refuse a licence. Even the retrospective judgment of responsible and experienced Bank officials as to what they would have done is deserving of great weight, but it is never easy to be sure what answer would have been given to a question which was never asked. Had the officials posed the stark question "Are we satisfied that BCCI SA conducts its business in a prudent manner?" I am not sure a positive answer would have been given. A negative answer would not, of course, have meant that the Bank was satisfied of imprudence. That was not the test. It would only have meant that the Bank was not, as matters stood, sure that it was prudent.

2.31 Refusal of a licence would, in all probability, have caused loss to depositors and other creditors and exposed the Bank to accusations of racial prejudice, xenophobia and so on. In the real world such considerations are bound to intrude. But in the real world the choice did not lie simply between the grant and refusal of a licence. If (always assuming complete good faith) the Bank had indicated that it was not satisfied that the prudence criterion was fulfilled, Abedi would in my opinion have done all that he could (to the length of making structural changes) to alleviate the Bank's concerns and enable it to be satisfied. On more than one occasion during this period BCCI representatives (including Abedi) discussed the possibility of structural change, which the LBC would also have welcomed. In suggesting that Abedi would have been willing to make structural changes, I am assuming that it was practicable for him to make such changes: it may be, in the light of what is now known, that the group's exposure to Gulf and the Gokals was already such by 1980 that he could not afford to let the truth appear without jeopardising the future of the group.

2.32 The refusal of recognition under the Act, formally notified to BCCI in June 1980, was not accepted without demur. Abedi made clear his extreme unhappiness at the decision and would probably have appealed had he not been told that he could apply again in due course. Dr Ghaith Pharaon inspired a protest through diplomatic channels in Saudi Arabia. Pharaon had attracted the attention of the US authorities in the Financial General Bankshares episode and his role had been discussed between the Bank and the LBC in April 1978. Neither knew very much about him. In August 1980 the Bank learned that Pharaon had, since June 1980, been a controller of BCCI, although the Bank had not been notified as it should have been. The fitness and properness of Pharaon, as a controller, then became germane. Knowledge of him and his activities was scant.

2.33 If I am right that SA's principal place of business in 1979-80 was in the UK, not Luxembourg, it was not under section 36 of the Act entitled as a deposit-taking institution to use a banking name. This is a point which the Bank recognised very shortly after the grant of the licence, but not before, and it was not acted on. Had Abedi been denied the use of a banking name, as he should have been, it would have been a bitter blow and would have been a strong additional inducement to do all in his power to meet the Bank's supervisory requirements with a view to obtaining recognition, if not at once, at least in the foreseeable future.

5 1980 – April 1984

2.34 The Bank's consideration of BCCI's 1979 accounts caused it serious concern, particularly about certain UK loans for which provision had been made. At the Bank's instigation, the UK management of SA were prevailed upon to commission Ernst & Whinney ("E&W") (SA's auditors) to review SA's UK loan book and report to the Bank. This was done, and E&W's report (delivered in March 1981) was generally reassuring and earned the LBC's general endorsement. It was one of the Bank's continuing problems that, as a Bank witness put it, the words never matched the music: critical comment was widely made in professional banking circles, but when specific tests were conducted no substantial basis of criticism was found. Despite this reassuring report, however, the Bank's concerns came to the surface again in 1982, concerns which discussion with the management did something to relieve but did not dispel.

2.35 A series of minutes, beginning as early as September 1980, drew attention to the role of London as the administrative nerve centre of the BCCI group. The implications of this for the supervision of BCCI were directly addressed in May 1981, when it was questioned whether London was not BCCI's principal place of business. Abedi himself was talking of restructuring the group so as to move the two main banking arms from Luxembourg and the Caymans to the UK and the US. He spoke (in May 1981) of acquiring an American bank and merging Overseas into it.

2.36 BCCI never formally re-applied for recognition under the Banking Act, but the Bank repeated its consultation exercise in 1981 and 1982. On the first occasion there was a detectable, but still relatively minor, improvement in the market's opinion of BCCI. On the second, the improvement was more marked although BCCI's level of business with other banks was still well below the level to be expected of a bank of its size. But despite some sharply critical comments from a number of sources, it began to look to the Bank in 1982-1984 as if BCCI was starting to live down its poor reputation of earlier days and advance towards a position in which recognition could not be properly withheld.

2.37 This growing view prompted a careful review within the Bank of BCCI and its appropriate supervisory regime. Mr Brian Gent, a deputy head of Banking Supervision, wrote a long and thoughtful paper in June 1982. In this he pointed to the favourable picture presented by the 1981 accounts but also to the persisting (although diminishing) caution of the market, continuing prudential concerns, the risks inherent in the structure of the group, the crying need for a single overall supervisor, the fiction of the group's Luxembourg location and the arguable anomaly of the Bank's reliance on Luxembourg assurances when the group's principal place of business was in the UK. The thrust of his argument was that no supervisory authority other than the Bank could reasonably be expected to take on the supervision of BCCI and that the Bank should do so, rather than let a large international group continue in business on a largely unsupervised basis.

2.38 This paper provoked no action. But over the months which followed Gent's conviction did not weaken. It was, indeed, strengthened by the report of a visit made by Bank officials to BCCI's premises at 100 Leadenhall Street. This visit left the officials in no doubt that London was the head office of the group. It also revealed that the group's Central Treasury, which managed the liquid funds made available to it by the whole group, was an office of Overseas. His conviction was strengthened further by

renewed concern about the UK loan book and by indications from Luxembourg that recent attempts to conduct consolidated supervision had been thwarted by lack of information from BCCI and the IML's own lack of resources. So Gent wrote a further paper dated 15 July 1983 addressed to his immediate superior, Mr Peter Cooke, Head of Banking Supervision, and the Governors.

2.39 Gent's argument was the same as before. The IML (as the LBC had by now become) had admitted its inability to supervise BCCI on a consolidated basis. Luxembourg was not, anyway, BCCI's principal place of business. Either BCCI's UK licence should be revoked or it should be properly supervised. Despite private reservations, Gent dismissed revocation as a practicable option. Consolidated supervision could only, realistically, be undertaken by the Bank. This paper, here very briefly summarised, was (as it seems to me) clear in its argument and compelling in its conclusions.

2.40 The paper was not, as drafted, forwarded to the Governors. Three events intervened. One of these was an intimation by the IML that it proposed, in agreement with the board of BCCI, to make a fresh attempt to conduct effective consolidated supervision. But the Bank had considerable doubts how effective this attempt was likely to be, given the IML's limited resources and the group's modest presence in Luxembourg. The second was a meeting between the Bank and the board of BCCI, the only such meeting ever held, in September 1983. Intended to bring home to the board the need, in the Bank's view, for a group structure lending itself to effective consolidated supervision, the meeting proved unproductive, the board arguing that the group was effectively run as a single entity and questioning the value of supervision. The third intervening event was a paper written by an analyst in October 1983, raising two legal objections to the status quo: since the principal place of business of SA was in the UK, he suggested, it was not entitled under section 36 of the Act (unless recognised) to use a banking name; and since Overseas held no UK licence at all, it was not entitled to conduct any deposit-taking business here, including the Central Treasury operation. Cooke and Gent regarded the first of these breaches as more tolerable than the second, but no immediate action was taken on either, doubtless because a comprehensive review of BCCI's position was in the offing.

2.41 In January 1984 a final version of Gent's paper, revised by the Banking Supervision Division, was forwarded to the Governor over Cooke's signature. The thrust of the argument was repeated. The structure of the group was highly unsatisfactory. Luxembourg lacked the resources to supervise the group effectively, and SA had little more than a nominal head office in Luxembourg anyway. It was essential that there should be consolidated supervision of the group's worldwide activities. This could most effectively be achieved by moving the incorporation of the holding company to the UK, so that consolidated supervision could be conducted by the Bank. But before this a comprehensive review of BCCI's worldwide business should be undertaken, at BCCI's expense, by a major firm of accountants. The hope of achieving recognition would, it was hoped, secure BCCI's co-operation. The Governor's approval of this overall strategy was sought before any approach was made to BCCI. That approval was given.

2.42 The Bank disclosed its intentions to the IML before approaching BCCI. The IML raised no objection: although the IML was itself embarking on a new attempt at consolidated supervision, the prospect of losing responsibility for the supervision of BCCI seemed (not surprisingly) to be rather welcome. So in April 1984 Abedi called on Cooke, who intended to broach the Bank's plan with him. Cooke began to do so, describing the Bank's unease at the existing structure and recommending the integration of SA and Overseas. Abedi was resistant. He spoke again of his eventual plans to move Overseas into the US, but he would not contemplate a merger with SA.

Cooke's message was couched in oblique terms, but (as he felt) conveyed to Abedi both the Bank's willingness to accept the group into the UK, on appropriate conditions, and also that there could be no recognition without acceptable reorganisation. Abedi, usually compliant (at least overtly) and ingratiating, was on this occasion truculent and angry. The Bank's initiative, under consideration for nearly two years, thus fell at the first fence. There can be no doubt that the result the Bank set out to achieve was that favoured by the consensus of informed opinion.

2.43 Since the strategy which Cooke tried to commend to Abedi in April 1984 had the support not only of the Governor and himself but also the Banking Supervision Division, there can be no hindsight in the judgement that this represented a bold and constructive, if potentially expensive, response to a problem which had become increasingly obvious with the passage of time. It is true that there were no grounds for fearing imminent catastrophe. There were, indeed, no substantiated grounds for immediate apprehension. But it was appreciated that no one had a clear overall view of the group's operations. There was concern about what might be happening out of sight. And it was understood that if the worst were to happen it would be citizens of the UK and elsewhere, not Luxembourg, who would be the biggest losers. If a sail has to be changed, it is better to change it before, not after, a storm has blown up. It is unfortunate that this promising initiative was so quickly snuffed out.

2.44 There were two main reasons for this. The first was that Abedi was, for the time being, riding high, finding lack of recognition less of a drawback than he had expected and seeing no need to fall in with the Bank's wishes. The Bank for its part had no immediate ground for taking action against SA under the Banking Act and thus lacked formal means of exerting leverage on it.

2.45 The second reason was that with the IML, as primary supervisor of SA, seeking to undertake consolidated supervision, the Bank felt it should not obstruct the IML's performance of that role. But there is little force in this . The IML had shown no desire to cling to the role of consolidated supervisor and had the Bank sought its agreement to intensified effort by the Bank to secure BCCI's acceptance of the Bank's strategy there is every reason to think such agreement would have been forthcoming. As it was, the IML's agreement was not sought.

2.46 There was still the first reason, which cannot be so easily discounted. Given the potential importance of the end in view, I find it surprising that no effort was made to bring the Bank's traditional authority to bear on Abedi to seek to secure his compliance. It seems possible that the introduction of formal legal powers led officials to lose sight of the Bank's informal authority, which had proved efficacious in the past. Abedi's truculence when meeting Cooke would have made clear that the authority of the Deputy Governor, or even the Governor, would have had to be brought to bear. This is not to say that even this would have been effective. Hindsight prompts one to doubt whether, in 1984, Abedi could have agreed to bring the group to the UK, merge SA and Overseas, and expose the group to consolidated supervision without its insolvency and much malpractice becoming apparent. But as matters appeared at the time, the Bank was, I think, rather easily deterred.

6 1984 - 1985

2.47 Despite satisfactory visits to two commercial branches, the Bank's concern about lending by the group and the UK Region continued. There were very substantial losses and supervisory worries in Hong Kong. There were critical comments nearer home.

2.48 An anonymous, not very expertly typewritten, complaint in December 1985 deserves mention. It was sent to the IML, copied to the Bank and signed "Shareholder". Apparently writing from the Middle East, the correspondent suggested that 70 per cent of BCCI's shareholders were nominees, funded through different names in different group companies, and he raised the suspicion that there were bad loans amounting to 15-20 per cent or more of the group loan portfolio. He asked that the "speculative mysterious profitability" of BCCI be investigated. The letter was earmarked for the Bank's BCCI files but never reached them. Its contents were never investigated, at any rate by the Bank. In writing to the Inquiry the Bank described this letter as "of apparent significance with the benefit of hindsight". That is an appropriate caution. Many documents may be seen in retrospect to have a significance which could not reasonably have been recognised at the time. But I do not place this document in that category. Given the suspicions widely voiced about BCCI, the opacity of its structure and the doubt about its ownership, an alert supervisor would in my view have wished to see these issues investigated, unless he regarded it as a matter for the IML to pursue, in which case I would expect him to have been interested in the outcome of the IML's investigation.

2.49 By early 1985 the IML was becoming restive. Jaans first indicated an intention, unless the group structure were changed, to announce publicly that he could not supervise the activities of Overseas. Later he told Abedi to remove the anomaly of a bank headquartered in Luxembourg and operating from the UK. It appeared to the Bank that the IML had found the consolidated supervision of the BCCI group to be beyond it.

2.50 In June 1985 Abedi exposed to the Bank alternative schemes: a three bank scheme based on banks in the UK, the Caymans (Overseas) and the US (First American), with the prospect of merger between Overseas and First American after a period; and a two bank scheme based on banks in the US and the UAE. Since both schemes depended on the approval of the US authorities Cooke urged Abedi to consult them, advice which he was to give again but which Abedi never followed.

2.51 Before and after this meeting there was a vigorous debate within the Banking Supervision Division. There was support for a UK subsidiary embracing the Central Treasury and all the assets and liabilities of SA and Overseas, and for the incorporation of the Central Treasury alone into a UK subsidiary. But there was also a body of opinion which resisted acceptance of any increased supervisory role for the Bank. Gent himself, formerly a powerful advocate of consolidated supervision by the Bank, was now concerned primarily to emphasise the size of the resources such consolidated supervision would demand, not so much because he had lost faith in the principle as because he was sceptical whether the resources would be forthcoming. The IML had not (in July 1985) given up thought of conducting consolidated supervision itself but regarded a move of the effective head office from London to Luxembourg as a necessary precondition: it had found that no one in BCCI's Luxembourg office ever knew the answer to any question without reference to London.

2.52 In a letter of 21 August 1985 Cooke gave the Bank's answer to Abedi's alternative plans. This letter rejected the suggestion of a UK subsidiary. It also ruled out consolidated supervision of the group by the Bank. Cooke did not in evidence accept that the letter had this second effect, which indeed was inconsistent with his persuasive advocacy of consolidated supervision as chairman of the Basle committee. But I cannot read the letter in any other way, and that was how Abedi understood it. He, having entertained rather unpromising notions of incorporation in Abu Dhabi, Pakistan and Hong Kong, returned to his earliest ambition of incorporation in the UK, this time with the difference that the company was to be a subsidiary of SA, not Holdings, and that the Central Treasury was to be moved to Abu Dhabi as part of a new headquarters. The Bank undertook to respond to this proposal.

2.53 It did so in a letter of 22 November 1985, signed by Mr Rodney Galpin the executive director responsible for banking supervision. The response was affirmative but conditional. Affirmatively, the Bank saw no reason why BCCI should not proceed with plans for a UK incorporated entity. But the Bank's blessing was conditional on the outcome of a visit to the Central Treasury, on discussions with the Central Bank of the UAE concerning supervision of the new headquarters and Central Treasury after their move to Abu Dhabi, and on detailed examination of SA's business in the UK to ensure the Banking Act criteria were fulfilled. A number of other conditions were indicated.

2.54 BCCI welcomed this initiative and a programme of action quickly followed. Officials of the Bank paid an extended visit to the Central Treasury in London and made a report criticising BCCI's procedures in a number of respects. E&W were commissioned to review the control systems for certain UK operations to be included in the UK company and reported in generally favourable terms in December 1986. A commercial banker seconded to the Bank investigated the UK Region's loan book: his interim report in May 1986 and his final report in December 1986 were also generally favourable.

2.55 The most serious weakness of the BCCI group was recognised to lie in its structure, which precluded effective consolidated supervision. This scheme for UK incorporation, even if all the Bank's conditions had been fulfilled, did not address that weakness. It was not thought that the UAE Central Bank then had the experience and capacity to discharge that task. Nor, as already observed, was it thought that incorporation of a UK subsidiary would insulate the UK business against disasters afflicting other significant parts of the group. But it was seen as a means of achieving closer and more direct supervision of the UK operation and so of providing an imperfect but valuable measure of protection for UK depositors. This was, I think, a correct judgement. The advance was worth making, even if the potential gain was relatively small. I find it harder to understand why consolidated supervision by the Bank, endorsed at the highest levels of the Bank not so long before, was now so firmly rejected. The answer is perhaps to be found in Johnson Matthey Bankers. In the aftermath of that episode substantial additional demands were made on the Bank's supervisory resources and the Bank may well have been wary of undertaking new and risky assignments which, if the worst happened, would expose it to renewed criticism.

7 Central Treasury losses 1984 – 1986

2.56 Between September 1983 and January 1985 the Bank received eight reports of BCCI's activity in the financial and commodity markets. One of the reports suggested that BCCI was also dealing through Capital Commodity Dealers Limited ("Capcom"), a company with which it appeared to have close links. There was nothing extraordinary in a bank such as BCCI dealing in these markets and none of the reports contained any suspicion of fraud, malpractice or default by BCCI. But the scale of BCCI's activity had attracted the attention of seasoned market professionals, some of whom were sufficiently puzzled or concerned to feel that the Bank should know; one commodity broker and trader had given up doing options business for BCCI because it felt BCCI was taking too many risks. This activity was carried out through the Central Treasury in London, which was part of Overseas.

2.57 The Bank passed on the information it received to the IML. There is no evidence that the Bank raised the reports with BCCI management, or caused any investigation or enquiry to be made. Nor did it know of any enquiry by the IML, although it did learn in September 1985 that the IML suspected (without being able to prove) that BCCI had made substantial losses dealing in fixed rate instruments. The Bank adopted this passive role because it regarded the IML as the primary supervisor of SA and the group and did not regard itself as being responsible for the supervision of Overseas. Given that the Central Treasury was based in and operated from 100 Leadenhall Street (although a part of Overseas, with transactions booked in the Caymans), this was a highly unsatisfactory supervisory situation, as should have been obvious at the time.

2.58 In October 1985 the IML (unknown, it appears, to the Bank) caused BCCI to commission Price Waterhouse ("PW") to review the Central Treasury's investment activities. PW were at the time the auditors of Overseas. PW found that Overseas had made and were making substantial losses on option contracts, the extent of which had not been revealed by the accounting methods used. PW quantified these losses at the time at $285 million (attributed as to $75 million to 1984, $150 million to 1985 and $60 million to 1986). It is important to emphasise that PW attributed these losses at the time to incompetence, errors made by unsophisticated amateurs venturing into a highly technical and sophisticated market. PW similarly attributed BCCI's accounting treatment of these transactions to lack of expertise; the appropriate accounting treatment was, indeed, a matter of some considerable complexity.

2.59 PW reported the existence of these losses to BCCI and E&W, the group auditors, in February 1986 and to the IML in March. Abedi himself told E&W in February, just before PW did so. Despite PW's advice to BCCI that the Bank should be told, and the IML's belief that BCCI proposed to do so and (later) had done so, BCCI never volunteered information of the losses to the Bank, which learned of them for the first time in mid-May 1986. The first indication came in a conversation which Gent had with the IML in Brussels, the second when the Bank telephoned BCCI to ask about a (false) rumour circulating in the City that BCCI had lost $200 million in a computer fraud.

2.60 The Bank's immediate reaction to the news was twofold. First, it was concerned at the size of the loss, which it understood to be $400 million (a figure greater than PW calculated at the time but much smaller than is now thought to have been the true figure). This was understood to be nearly half BCCI's net worth. The second reaction was one of extreme displeasure that the Bank had not been promptly informed of this

significant development. At a meeting on 22 May 1986 Gent conveyed the Bank's concern and displeasure to Abedi, Mr Swaleh Naqvi and the UK General Manager Mr Abidi. They explained the loss as a failure of BCCI to apply its own stop-loss policies, the failure to report as a desire to rectify the problem before doing so. The loss was to be made good by a capital injection and a contribution of $150 million by the ICIC Staff Benefit Fund, a Cayman charity which held a large tranche of BCCI shares. At a meeting with Abedi and Naqvi a month later, Galpin reinforced Gent's message to the management. He made plain the Bank's understanding, which Abedi did not challenge, that management had deliberately overriden the stop-loss safeguards it had established to avoid losses on this scale.

2.61 This development naturally caused the Bank to review the position of SA and the Bank's relationship with it. The officials who had visited the Central Treasury in December 1985 and had received no inkling of the losses then being made felt a particular sense of betrayal. One of them expressed three conclusions: first, that the Central Treasury should not be part of a UK subsidiary; second, that it was difficult to contemplate BCCI incorporating in the UK at all, since there was no basis of trust on which to base the Bank's supervision and the management had shown itself to be reckless; and third, that BCCI's continuing presence in the UK called for consideration. Galpin, to whom these conclusions were expressed, endorsed the first two and thought that the third required examination. While some Bank witnesses to the Inquiry thought "reckless" a bit strong, none thought the BCCI management had been other than seriously imprudent.

2.62 In early June 1986 a small group of officials met under the chairmanship of Mr Brian Quinn, Head of Banking Supervision, to consider whether SA's licence should be considered by the Bank's Assessment and Review Committees in advance of any application to incorporate in the UK. It decided against, because there appeared to be no immediate danger to depositors, because it seemed unlikely that there were grounds for revoking SA's licence outright and because the closure of 45 UK branches would cause substantial political and diplomatic problems. It is true that the financial loss had been made good and the group's controls were under review by PW. But even so, and making, as I hope, appropriate allowance for the benefit of hindsight, I cannot regard this as an adequate supervisory response.

2.63 The lack of an immediate threat to depositors was not a reason why the longer-term interests of depositors and the interests of potential future depositors did not call for the most careful consideration.

2.64 Since one of the Banking Act criteria was that the business should be conducted prudently, and since the business had on any showing been conducted with serious imprudence (even if the losses were attributed to incompetence and lack of sophistication, since management had overridden the intended safeguards), it is not easy to understand how grounds to revoke were thought unlikely to exist. It was true that the authorised institution was SA and the company making the losses was Overseas. But the top management of both companies was the same and SA made its liquid funds available to Overseas, which was an imprudent thing to do if Overseas was going to lose them; and this technical point (on which no legal advice was sought or given) did not occur to the supervisors or influence their decision.

2.65 The potential loss which would be caused to existing depositors, creditors, employees and shareholders by closing 45 retail branches is not something a conscientious supervisor could or should ignore. This consequence does not appear to have been uppermost in the supervisors' minds, although it may have been too obvious to need stating and even those Bank witnesses who accept, in retrospect, that grounds for revocation did exist are insistent that exercise of the power to revoke would in all

the circumstances have been inappropriate. Such a judgment by experienced supervisors is not to be lightly discounted. But if I am right that the Bank's power to revoke was exercisable, the choice was not between maintaining the licence and simply revoking it. The imposition of conditions was a third option to be considered. It was only an option which arose if the power to revoke was exercisable, and the Bank's error (as I consider it) on that score precluded consideration of conditions.

2.66 That was unfortunate. The statutory power to impose conditions was designed to cover cases where the drastic power of revocation was judged inappropriate but where it was necessary to exert some formal control over the way a business was run. If revocation was inappropriate, it is hard to think that SA in the summer of 1986 was not such a case. To the extent that the Bank's supervisory plans had been thwarted in April 1984 by lack of leverage on BCCI, such leverage now existed. In this highly judgemental field, it cannot fairly be said that there is any single solution which the Bank should have adopted. The imposition of conditions undoubtedly raised practical and legal problems. But given the formal sanctions now available, it may very well be that agreement on changes acceptable to the Bank could have been reached.

2.67 However, even if the Bank had recognised this as an opportunity to impose on BCCI a solution to the group's structural and supervisory problem, it would not at this time (1986-7) have known what solution it wanted to impose. Its earlier aim that the group should move to the UK (with a merger of SA and Overseas) and become subject to the Bank's consolidated supervision, although still favoured by some junior officials, no longer commanded general support. The Central Treasury losses also caused the Bank to back away from the scheme for local incorporation. That was an understandable decision, but I think a questionable one. It was understandable, because the Central Treasury losses episode underlined the difficulty of supervising BCCI and reinforced the Bank's distrust of the management's willingness to disclose bad news. It was questionable, because supervision is not a reward for good behaviour but a safeguard against bad, and this episode should have strengthened the Bank's existing view that closer and better supervision was called for. The episode may have caused the Bank to wonder whether the business of a future UK subsidiary would be prudently conducted (a criterion to be fulfilled before it could be licensed), but if so that was a consideration pointing towards revocation; it was certainly not an argument in favour of the status quo. The problems and cost for the Bank in effectively supervising BCCI, or a UK subsidiary, were indeed formidable, so formidable that I think the supervisors tended to lose sight of their primary duty to protect the bank's UK depositors. I do not think that in this instance the Bank measured up to its task.

2.68 A lull of some months in discussions about the future of BCCI came to an end in October 1986 when BCCI told the Bank that the Central Treasury was to be relocated to Abu Dhabi in ten days' time. The move was being made for tax reasons, and the Bank was critical of BCCI's failure to inform it in advance, since the move had of course been planned for months. But the Bank raised no opposition to the move itself. An official of the Bank in June 1987, indeed, described the move as "helpful", no doubt because it distanced this part of BCCI's operation from the UK and the responsibility of the Bank. But this does not seem to me, again, to be an adequate supervisory response. The place for a refractory pupil is in the front row, not in a dark corner at the back. The Central Treasury's recent history did not suggest that supervision was unnecessary, and the UAE Central Bank (which only heard of the move some time later) was not, as yet, well-equipped to provide it.

8 December 1986 – February 1987

2.69 Abedi remained a fertile source of plans. In December 1986 he discussed a two-bank scheme based on companies in the UK and the US, but he accepted that the US would not be open to the group for some years. Alternatively, since the group had been asked to leave Luxembourg, SA could be relocated in Abu Dhabi or Pakistan, the UK operations incorporated and other free-standing companies formed elsewhere. It was pointed out that this scheme would make for a worse, and not a better, supervisory regime. It found no support in the Banking Supervision Division.

2.70 During an interval in a discussion in Brussels in January 1987, Jaans of the IML made a direct appeal to the Governor. The preponderance of BCCI's presence was in the UK, he argued, Luxembourg was not much more than a statutory headquarters, and the worldwide group was anyway too much for Luxembourg to supervise: what was the prospect of consolidated supervision by the Bank of a group incorporated in the UK? The Governor gave no immediate answer, and invited the advice of the Banking Supervision Division on a suitable reply. Within the Division the issue was carefully considered. It was learned from the IML that Abedi was willing to accept consolidated supervision by the Bank on any terms it might impose, including the winding-up of Overseas. But the clear balance of opinion in the Bank, particularly among the most senior supervisors, was strongly against the Bank undertaking this responsibility. The view was put that it was Luxembourg's problem and Luxembourg had to solve it. That was only partly true. Certainly Luxembourg had a problem, because SA was registered and licensed there and the IML was the lead supervisor under the Concordat. But it was also the Bank's problem because BCCI's effective base (apart from the Central Treasury) was in the UK, it was widely perceived as a British bank and UK depositors stood to lose much more than those of Luxembourg if things went wrong. In February 1987 the Governor replied to Jaans, saying that the Bank would not undertake the worldwide consolidated supervision of the group but would be very ready to attend a meeting of international supervisors.

2.71 Within the Bank, Gent argued that BCCI's continued worldwide operation without consolidated supervision was the worst of all worlds. Orderly run-down of the group was preferable. But Gent's preferred solution, incorporation in and supervision by the UAE, did not command general confidence. Abedi asked the Bank in March 1987 if it would act as consolidated supervisor and was told it would not. In the same month the IML repeated that it lacked the ability to monitor the activities of BCCI on a consolidated basis.

2.72 Had the Bank accepted the burden of supervising the worldwide operations of a BCCI incorporated and based in the UK, its task would indeed have been formidable. The group traded in over 70 countries, in many of which supervision was weak or non-existent. In the absence of trust, a more intrusive style of supervision than the Bank ordinarily practised would have been needed. The cost would have been great. The demands on trained supervisory personnel would have been very difficult to meet. But this was by far the most hopeful solution, possibly the only hopeful solution. If it could not be undertaken, urgent steps were needed to reduce the group to a shape and size where supervision could be and would be effectively undertaken by someone, or the group had to be run-down. For the group's worldwide operations to continue under the existing structure and without consolidated supervision was surely, as Gent argued, the worst of all worlds. Had the Bank decided in 1986-87 to undertake the consolidated

supervision of the group, the likely course of events is doubtful. It would, without doubt, have required a very detailed independent examination of the group's worldwide business, particularly in the major centres. What might have been discovered is speculative. But again I think that the Bank failed to measure up to the task.

9 Mr Sedgemore MP and Mr Hussein

2.73 In a speech in the House of Commons in November 1985 and again (as I conclude) on a visit to the Bank in June 1986 Mr Brian Sedgemore MP suggested that BCCI were involved in fraudulent transactions affecting Nigeria and West Africa. He was relying on information received from an informant, Mr S A Hussein. Relations between the Bank and Sedgemore were at the time strained, as a result of accusations made by Sedgemore in the wake of the Johnson Matthey Bankers affair. Sedgemore criticises the Bank for failing to follow up his allegations about BCCI with him. The Bank replies that the allegations were of a most general nature, and Sedgemore offered no details or substantiation. I find a measure of truth in both points. I am doubtful how much substantiation Sedgemore would, at the time, have been free to offer, but some enquiry by the Bank would have been appropriate. It seems likely that, in the context of other allegations Sedgemore was making at the time, this one received less attention than it is now known to have deserved.

2.74 Hussein says that he wrote five letters to the Governor. Only the last mentioned BCCI and the Bank can trace receipt of none of the letters. He also was in acrimonious dispute with the Bank at the time. It may well be that the relevant letter never reached the Bank. If it did, his allegations were probably discounted.

2.75 Hussein also says he sent three letters to the Chancellor of the Exchequer. He certainly sent one, which was answered. It did not refer to BCCI. Only the first of the letters referred to BCCI. The Treasury cannot trace receipt of it. Had the Treasury received it, I would expect the letter to have been copied to the Bank, which did not occur.

10 The appointment of Price Waterhouse as group auditors

2.76 Until 1987 the responsibility for auditing the accounts of BCCI was divided. E&W firms were group auditors, responsible for auditing the consolidated accounts of the group, and also auditors of SA. PW firms were auditors of Overseas and BCC Emirates. Other firms carried out relatively minor audit functions, but the major responsibility was shared between these two large international groups of accounting firms. (A PW firm were also auditors of ICIC Overseas, and remained such until the end.)

2.77 This division of responsibility was felt to be unsatisfactory, particularly in the wake of the Central Treasury losses episode. The IML pressed Abedi to appoint a single auditor. In May 1986 E&W told Abedi that they would not accept reappointment as group auditors in 1987 unless they were auditors of all the more significant companies of the group (including, in particular, BCCI Overseas) and agreement was reached on improving financial and managerial controls and enhancing the role of the board. In August 1986 PW advised BCCI that the audit would be more effective and efficient if there were a single firm of auditors. In early 1987 the Bank welcomed the proposal for a single group auditor and welcomed the suggestion that PW might be appointed.

2.78 The directors informally explored PW's willingness to accept appointment as group auditors if invited, and in due course PW formally offered to act if asked. E&W stuck to their first condition (on coverage of the audit) but in April 1987 withdrew their condition on management and board control, feeling that agreement in principle on the changes needed had been reached over the preceding year.

2.79 BCCI offered appointment as group auditors to PW in May 1987 and PW accepted in June.

2.80 As group auditors and auditors of SA, E&W had drawn attention to a number of prudential and management concerns. PW had drawn attention to somewhat similar points arising from their audit of BCCI Overseas. Both firms (or, more accurately, groups of firms, because more than one E&W firm and more than one PW firm were involved) were aware of BCCI's somewhat tarnished reputation in the market. But neither firm entertained the slightest suspicion of the fraud and malpractice which were ultimately revealed. Within PW there were differences of opinion about taking on the audit, but it appears from the evidence given to the Inquiry that these sprang from recognition of the difficulty of the task, not from doubts about the trustworthiness of the client. In deciding to accept appointment PW were influenced by the stature of the directors, the prospect of a constructive relationship with the Bank and a belief that the firm was well-equipped to rise to the challenge of this difficult audit, as well as by legitimate commercial considerations.

11 March 1987-January 1988

2.81 In March 1987 Jaans wrote a long and important letter to the Bank. He accepted (and did not criticise) the Bank's decision not to undertake consolidated supervision of the group but said that Luxembourg lacked the means to undertake it and was in any event an inappropriate supervisor, given its tiny share (1-2 per cent) of the group's business. He proposed a co-operative approach to supervision based on locally-incorporated national subsidiaries.

2.82 Galpin replied for the Bank in early April. While advocating the virtues of consolidated supervision, he acknowledged that this was not feasible in the immediate future. He welcomed a co-operative approach but had difficulty about Jaans' proposal in so far as it envisaged a UK subsidiary. For this he gave two reasons. The first was that supervision of a UK subsidiary was likely to lead the Bank into the role of lead supervisor which it sought to avoid. The second was that the Bank doubted whether it could be satisfied (as required before an institution could be authorised under the 1987 Act) that it would be run prudently and with integrity, although the Bank could continue to rely on the IML's assurances in respect of SA. He offered the Bank's co-operation by intensifying its supervision of UK branches of SA, sharing information and discussing changes in the central role of London in the group.

2.83 Galpin's offer of co-operation was constructive, and the proposal for intensified supervision of the UK branches was valuable. There were good supervisory grounds (already aired in the Bank) for resisting a network of locally-incorporated companies. But even allowing for the fact that Jaans and Galpin were engaged, however politely, in a negotiation, I find Galpin's reply disappointing. There is no doubt of the Bank's intense desire at this time to avoid being drawn into a leading supervisory role. But that risk very largely arose because of the leading position occupied by the UK in the group, however unwelcome that position might be (and was). The commercial realities would not be changed by pretending they did not exist. More seriously, if the Bank doubted whether the business of a UK company would be run with prudence and integrity it was not in my view satisfactory to continue to rely on the IML's assurances when the IML had repeatedly drawn attention to its supervisory limitations. There was, as during much of this history, no evident threat to the immediate interests of depositors, and the Bank was entitled to take comfort from the results of investigations recently conducted, the auditors' clean opinions and the general satisfaction of the IML. But the structure of the group was known to preclude effective supervision. That was a source of concern, because no one could be confident he knew what was going on. Had it not been a source of concern the supervisors would not have been giving the matter so much attention. The Bank's answer to Jaans did little to address that concern. In his reply Jaans showed that he was disappointed. He may or may not have been surprised.

2.84 The later months of 1987 saw two developments. The first, prompted by the Board of Banking Supervision (see section (12) below), was renewed consideration by the Bank of incorporating a UK subsidiary to embrace the UK branches. The second, partly inspired by a distinguished Dutch central banker (Mr Huib Muller), was consideration of a new scheme for supervision of BCCI by a co-operative group of international supervisors. Muller saw dangers in local subsidiarisation, as liable to create a false sense of security without addressing what he saw as the main problem, the absence of widespread information on the risk profile of the group as a whole. A scheme was accordingly devised for twice-yearly meetings of national supervisors

responsible for BCCI. It was envisaged that BCCI management and the auditors would attend part of these meetings, and the auditors would report on the financial condition of the group. This proposal was accepted by the Governors, the Board of Banking Supervision, the IML, the auditors and the management of BCCI. Early in 1988 the Swiss Federal Banking Commission and the Bank of Spain were invited by the IML and the Bank to become members. Both accepted. These invitations were somewhat anomalous, since although both of these were experienced and respected supervisors BCCI had only a relatively minor operation in Switzerland and Spain, whereas the Caymans, the UAE and Hong Kong, where BCCI had much larger operations, were unrepresented. It was thought better to start with a small College and expand the membership later.

2.85 The College was a unique response to a unique problem. No one knew quite what to expect from it. The College was seen by the supervisors and PW as an advance on the clearly unsatisfactory supervisory regime then in force. But it was a second-best solution. No one thought it likely to be as effective as a single, efficient consolidated supervisor, and the establishment of the College did not of itself do anything to tackle the root of the problem, which lay in the structure of the group.

12 The Board of Banking Supervision 1986-1987

2.86 In anticipation of the enactment of the Banking Act 1987, a shadow Board of Banking Supervision (initially with five independent members) was established in June 1986. A paper before the Board at its first meeting reported on BCCI. Mention was made of the very substantial Central Treasury losses, but with no figure given and no indication of how they had arisen. The Board was told of Galpin's indication to Abedi that BCCI's failure to report the problems promptly had implications for the Bank's relationship with BCCI, but no reference was made to the stalled proposal on local incorporation or to the Banking Supervision Division's conclusions on revocation. The paper was not discussed.

2.87 In July 1987 the Division presented a further paper to the Board. This reported the Bank's unwillingness to undertake consolidated supervision of the group and also its recent offer (to Jaans) of intensified supervision of the UK branch network and international discussion. The independent members were unhappy with this paper, and the Division was asked to produce a further paper for the next meeting, covering in particular the pros and cons of local incorporation in the UK.

2.88 The Division duly produced a detailed paper for the August 1987 meeting. This reviewed four options. One of these, removal of all SA's branches from the UK, was rejected because the Bank had no grounds for this action. Two options, consolidated supervision by the Bank and local incorporation, were rejected on their merits. Only the fourth, intensified supervision by the Bank of the UK branches, was supported. In the course of a vigorous discussion it became plain that the Board was unpersuaded by the paper and saw considerable merit in local incorporation of a company to embrace the UK business. The Division was asked to produce a paper on that subject for the September meeting.

2.89 Two papers were prepared for the September meeting. One, representing the considered views of the Division, presented a strong argument against local incorporation on the ground that it would offer no additional reassurance, would distort the Bank's supervisory objectives and relationships, would not isolate the UK from the effects of a collapse of the BCCI group and would lead to the Bank becoming de facto the group supervisor. A supplementary paper by Gent stated the case against local incorporation even more strongly but said that if the existing supervisory regime was unacceptable the Bank should bite the bullet and supervise the whole group.

2.90 There was again a lively discussion, during which the Deputy Governor expressed his disagreement with the main paper which, he felt, was too heavily influenced by concern for the Bank's position and too little by concern for that of UK depositors. Reference to the situation in Abu Dhabi, where BCC Emirates handled the group's domestic business and branches of SA handled the international business, led to a request that the Division prepare a paper examining the merits of such a split in the UK.

2.91 A paper was prepared which suggested that such a split would cause many problems of definition, demarcation, control and management. When the paper was considered at the October 1987 meeting of the Board, the Deputy Governor and one independent member who strongly advocated local incorporation were absent. Opinion at the meeting was divided, although one of the members who shared the Division's doubts about the split-company scheme still favoured local incorporation, as did two

other independent members. By this time Galpin was able to report on the early discussions which led to the establishment of the College, and it was left that he would pursue these while, in the meantime, the Bank's supervision of the UK branches would be intensified. When, in December 1987, Galpin brought the provisional College scheme to the Board for approval, the Board blessed it, although not without an expression of some scepticism and also some impatience for the first meeting to be held.

2.92 In the course of this debate the Division showed itself, as I think, disappointingly negative and there was some truth at least in the Deputy Governor's stricture quoted in paragraph 2.90 above. But the Board itself demonstrated its value as a supervisory instrument, operating just as its progenitors must have intended. The problems at issue were clearly presented, the members were given adequate information and the members brought their professional experience and judgment to bear in an admirable way, challenging the accepted wisdom of officials and causing the issues to be fully and carefully examined. That the discussion led to what, I venture to think, was not the right answer cannot fairly be laid at the door of the Board.

13 Supervision of the UK Region: June 1986 - October 1988

2.93 During the period June 1986 - October 1988 the Bank supervised the UK branches of SA both by receiving and analysing the returns made by the UK Region of SA and by holding periodic meetings (some of them at 100 Leadenhall Street) at which matters of prudential concern were discussed and Bank officials familiarised themselves with the management and business of the UK Region. The steps taken by the Region to implement the recommendations of E&W's December 1986 report were monitored. At the end of the period, in October 1988, there was discussion with management and PW of a report shortly to be commissioned from PW under section 39 of the 1987 Act as part of a rolling programme intended, over a three to four year period, to cover all areas of the Region's business. This supervision of the UK Region was in my opinion carried out in a commendably careful, conscientious and professional manner which reflects credit on those who conducted it.

14 Reports and complaints to the Bank: January-February 1988

2.94 The Bank continued to receive critical reports on BCCI's operations from a number of quarters. Some of these it was entitled to dismiss or discount. Others, particularly those from foreign bankers and supervisors, were more disturbing, although they were usually unspecific. But there were two reports which reached the Bank in early 1988 which were serious and specific.

2.95 The first came from the City of London Fraud Squad. The facts which were disclosed suggested, at best for BCCI, a disturbing departure from standard banking practice. More probably, BCCI management appeared to have colluded with a customer (who was suspected of perjury) to defeat by deception the enforcement of a judgment. The police were contemplating contempt proceedings against BCCI on the ground that it had obstructed their investigations and suggested a meeting, which the Bank agreed to attend. But despite several reminders by the Bank no meeting was held and the Bank heard no more. No contempt proceedings were begun against BCCI, although the customer was eventually convicted of perjury.

2.96 The second report reached the Bank through British diplomatic sources in the Gulf and recorded information supplied by a British chartered accountant working there. As a result of work recently done for a BCCI shareholder (who although indebted to BCCI had been bought out by BCCI for the local equivalent of £1 million), the accountant claimed to have unearthed evidence of fraud and manipulation in BCCI on a substantial scale. The Bank official to whom the report was referred discussed it with a colleague and they agreed that no follow-up was possible.

2.97 Both these incidents, in my opinion, point to a weakness in the Bank's supervisory approach. In the first case, I think the Bank felt that it should not tread on the toes of the police, who could be relied on to tell the Bank anything it needed to know. That approach was, as I think, unsound. The concern of the police is with the investigation and prosecution of crime. The Bank is of course concerned with crimes committed by the directors, controllers, managers or staff of a bank. But it is also concerned with conduct which is not criminal but may reflect on the integrity, fitness or competence of a bank's management. In view of the critical opinions widely held about BCCI and the considerable detail which the police supplied, I find it hard to understand the Bank's apparent lack of interest in establishing the truth. In the second case, the incident occurred outside the UK and had nothing to do with the UK branches of SA. But it appeared to have a direct bearing on the ownership of the group and the integrity of its management. It may be that the Bank discounted the reliability of this report because of other suggestions it contained. If so, I think, its source justified more serious treatment, and it is indisputable that follow-up was possible. In this instance also I find it hard to understand how any supervisory official could think it right to leave such allegations unexplored.

2.98 In supervising an individual bank, supervisors are ordinarily concerned to assess and base judgments on the management and financial information which it supplies (supplemented, where appropriate, by information from auditors, reporting accountants and other supervisors). This is a task demanding professional skills appropriate to a banker. It is understandable that officials of a central bank should view with some distaste what might appear a less professional role, of receiving (perhaps from unsavoury

sources), and causing to be investigated, allegations of impropriety, malpractice or fraud. This cannot very often be called for. But one of the virtues claimed for the Bank's style of supervision is its flexibility. That must mean that its supervisory approach can be adapted to the task in hand so that different methods are applied to (at one extreme) an ultra-conservative merchant or clearing bank and (at the other) a bank suspected of operating at the margins of legality. In 1988 neither the Bank, nor the IML, nor the auditors suspected BCCI senior management of fraud. But the Bank did not feel it could trust the management and it was well aware of the distrust the group aroused elsewhere. Galpin and the Banking Supervision Division had given doubt about the management's integrity as a reason for reluctance to contemplate a UK subsidiary. In that situation it was in my view incumbent on the Bank to see that serious and apparently credible allegations capable of investigation (other than customer complaints suitable for resolution in the civil courts) were fully investigated. As it was, the police complaint petered out and the report from the Gulf was neither investigated nor passed to any other authority.

15 Mr Abedi

2.99 On 9 February 1988, while in Pakistan, Abedi had a heart attack. Two weeks later he suffered a second, more serious attack. A heart specialist flew out to examine him and diagnosed serious damage. Shortly afterwards he was flown to the UK and a heart transplant operation was performed at Harefield Hospital on 9 March 1988. After a long stay in hospital he was followed up as an out-patient until December 1990, when he moved to Pakistan. There he remains.

2.100 With the consent of Mrs Abedi the Inquiry obtained a report from Abedi's UK surgeons. This disclosed severe neurological damage sustained before the operation. Abedi was said to have a profound motor disability and a marked speech impairment and there was evidence of significant cognitive dysfunction. Although this report was based on an examination about a year earlier, the surgeons did not expect major improvement and their report is consistent with accounts given by those who have seen him recently.

2.101 Abedi has consistently denied any wrongdoing in the management of BCCI and offered to speak to me if I visited Pakistan. Having regard to my terms of reference and his condition, I did not think this journey would be justified or useful. His denial of responsibility should, however, be recorded.

2.102 After February 1988 Abedi played no more than an occasional part in the affairs of BCCI. His departure was much more significant than the retirement of a bank president would ordinarily be, because BCCI had been very largely his conception and his creation. He aimed to create an international bank which would not simply be a national bank expanded overseas but a worldwide organisation, at home everywhere and bringing its services in particular to the less developed countries of the world where such facilities were least readily available. There was nobility in this ideal which, by his ambition, energy and flair, he did much to realise. The vices which brought BCCI down should not obscure the virtues which it showed in some places and which, perhaps, inspired its creation.

2.103 While my impressions of Abedi are inevitably second-hand, I have had the opportunity of speaking to many who knew him well and had dealings with him. He remains something of an enigma. His hold over the staff, particularly the Pakistani staff, of BCCI was almost mesmeric, and he very favourably impressed a number of seasoned politicians. But there were others who recoiled. His oft-expounded and much-publicised semi-mystical philosophy, seen by many in BCCI as an inspiration, was viewed by others as tedious rubbish. While preaching the need for humility, he was thought by some who knew him well to be a man of overweening arrogance and considerable personal vanity. He combined his advocacy of the poor and oppressed with a personal life of flamboyant opulence and a driving ambition for power. If he is to be given credit for his ideals, he is to be debited with an inordinate endowment of low cunning, manifested in many ways and not least in his assiduous cultivation of those who by virtue of their wealth or position could be used to his advantage.

2.104 The departure of Abedi introduced a new phase in the history of BCCI.

16 April-September 1988

2.105 The period from April to September 1988 saw four significant developments.

2.106 The first was the emergence of Naqvi, who had always been Abedi's number two, as his successor. He became a director of Holdings and SA and chief executive officer of the group, none of which he had been before, and over this period he established himself as the dominant figure in the group.

2.107 The second was the publication of the 1987 accounts, the first audited by PW as group auditors. On their face these accounts showed a small profit of $37 million for the year. But on reappraisal of provisions made in previous years an additional provision of $100 million was made, covered by direct transfer of that sum from the reserves.

2.108 The third development was a very substantial report made by PW for the College in May 1988. This reviewed the business of BCCI and the results for the year in considerable detail. It drew attention to a heavy concentration of lending to certain customer groups. It also drew attention to substantial lending to a group of customers (several of them BCCI shareholders) secured on shares in Credit and Commerce American Holdings, the parent company of First American Bank. The Bank had learned in 1982 that CCAH had acquired control of First American, and was well aware of BCCI's fraught relations with the US authorities following its involvement in an earlier, abortive investment (paragraph 2.21(viii) above). PW pointed out that any direct involvement by BCCI in CCAH would be precluded by regulatory constraints, but the Bank did not in 1988 (or for some time afterwards) suspect any involvement by BCCI in CCAH otherwise than as bona fide lenders to its shareholders, who had given the shares as security. Nor, it seems clear, did the US authorities have any suspicions at that time. But the US authorities had, when the acquisition had been approved in 1981-82, been assured that BCCI had no involvement in financing the acquisition, and they did not know of BCCI's lending to its own shareholders secured on CCAH shares. When speaking to the Bank of his plans for establishing BCCI in the US through First American, Abedi had always stressed its independent ownership and management. But he had always spoken of it as a vehicle available for his use. Given the similarity of name and the previous history it is possibly surprising that suspicions about the relationship of BCCI and CCAH were not aroused, but plainly they were not and it was over a year before the US authorities began to show interest in the subject.

2.109 PW included in their report a short section on the various ICIC entities, which then held over 11 per cent of the group shares, and mentioned a put option enjoyed by a BCCI shareholder entitling him to sell 7.5 per cent of BCCI's share capital to ICIC. PW included this section in their report, despite some reluctance by management and some of the directors, because they felt concern about the relationship between BCCI and ICIC. A PW firm was (and had for years past been) the audition of ICIC Overseas, and there is no reason to doubt that PW had real grounds for concern. But the reasons for their concern were not spelled out in the report, or even flagged, unless the inclusion of the section was itself such a flag. PW faced, now as later, the dilemma of seeking to reconcile their duty to make appropriate disclosure to the supervisors with the need to retain the confidence of their client. An acute supervisor might perhaps have wondered what, if anything, lay behind this section, but it was one brief section in a long report, and it cannot be said that any note of warning was sounded.

2.110 Nor can it be said that the report as a whole sounded a note of warning, although it did identify prudential concerns. PW's broad-brush estimate of BCCI's risk

asset ratio as at the end of December 1987 put it comfortably above the Basle minimum.

2.111 The fourth development was the first College meeting held in Luxembourg in June 1988. At the first session, attended by supervisors only, with Jaans in the chair, it was made plain what the meetings were and were not intended to achieve. They were not intended to be a long-term substitute for consolidated supervision nor a long-term endorsement of the BCCI group's existing structure (which needed to be changed), nor were they intended to water down each supervisor's local responsibilities. Instead, they were intended to be an organised forum for the exchange of information between national supervisors and an opportunity to meet BCCI management and the auditors in order to gather information and make recommendations. A number of prudential matters were then discussed. At the afternoon session there was discussion of some features of PW's report. Reference was made to the large exposures, the ICIC put option and CCAH lending, but none of these was explored in detail and BCCI's relationship with ICIC was not raised.

2.112 This first meeting of the College, although necessarily exploratory, was generally thought to be useful and constructive. Through the medium of PW's report it certainly increased the body of information available to the participating supervisors. But the College did not attempt to take a firm supervisory grip on the group nor did it offer any prospect of advance in solving its basic structural problem. It was Naqvi, arguing against an enlargement of the College on the ground that it would be unmanageable, who expressed a wish that the group should be supervised on a consolidated basis by one supervisor and that the group should be restructured with that end in view.

17 The Tampa indictment

2.113 In 1983 BCCI acquired a minority interest in an existing Colombian bank with 24 retail branches there. It increased its stake to 99 per cent in 1985 and the number of branches rose. By the early 1980s Colombia was prominently associated in the public mind with trafficking in cocaine. Overseas had two branches in Panama and three agencies in Florida. SA had agencies in New York, Los Angeles and San Francisco and representative offices in Chicago and Houston. One of BCCI's customers was General Noriega.

2.114 Perhaps because of the US authorities' interest in General Noriega, perhaps for other reasons, they began to take an interest in BCCI's business in the US, Panama, Colombia and elsewhere, and in May 1986 launched an operation code-named "Operation C-Chase" by which US undercover agents interposed themselves between the point at which the proceeds of Colombian cocaine sales on the streets of US cities were collected and the point at which those proceeds were remitted to the Colombian traffickers. A BCCI account in Florida was used for holding cash before its transfer to a BCCI account in Panama. In due course local BCCI officials suggested to the undercover agents that very much more sophisticated procedures should be used to launder these funds, and BCCI accounts in Paris, Luxembourg and London were used for the purpose. Among those who agreed to co-operate in this exercise, with knowledge of what the funds represented, were Mr Asif Baakza, manager of the corporate unit of SA's UK Region at 100 Leadenhall Street, and Mr Ziauddin Akbar, manager of BCCI's Central Treasury at the time of the 1984-86 losses and now the moving spirit in Capcom, a company thought in 1985 to have been involved in BCCI's speculative trading activities (paragraph 2.56 above).

2.115 The involvement of branches in Paris and London led the US Customs to brief and seek the co-operation of the Customs authorities in France and the UK in the summer of 1988 and in September 1988 HM Customs alerted the Bank to what was in train.

2.116 Between 8-10 October 1988 seven BCCI officials were arrested in Tampa on drug-trafficking and money-laundering charges. Mr Nazir Chinoy, Overseas' Regional Manager for Europe and francophone Africa, based in Paris, who happened to be in London at the time, surrendered to the UK authorities and was arrested. (He was later extradited to the US, tried and sentenced.) Baakza also was arrested in London. So was Akbar. These arrests led to much sensational publicity both in the US and the UK.

2.117 Both publicly and privately BCCI denied that its management or its employees were in any way involved in drug-trafficking or money-laundering. It suggested that it had been set up and picked on, perhaps for political reasons in the run-up to a presidential election, perhaps because its lack of a home base deprived it of a national protector and made it an easy target. Later, when it began to look as if the employees probably had committed the acts alleged, the innocence of senior management was still maintained and it was claimed that the employees had been enticed or entrapped by the undercover agents into acting as they had. These protestations were on the whole sympathetically received by the Bank and the IML, as also by PW who judged Naqvi to be genuinely shocked by what had happened.

2.118 The immediate concern of the Bank was not, however, with the truth of the US accusations (of which, indeed, it had little knowledge) but with the risk that the widespread adverse publicity would prompt a run on deposits which might jeopardise the existence of the group. The Bank accordingly established, promptly and efficiently, arrangements to monitor closely the liquidity and fortunes of the UK Region of SA. It received a daily statement of liquidity and a weekly analysis of deposits and advances. It also held weekly meetings with the management of the UK Region and imposed caps (progressively reduced over the coming months) on the Region's funding of the rest of the group. Although, in the immediate aftermath of the arrests, the level of deposits fell, the threat of a serious run on deposits quickly receded (unless or until there was further bad publicity) and by the end of the year the business of the Region was beginning to pick up.

2.119 BCCI for its part reacted to the arrests by strengthening and reviewing its compliance procedures in the UK, the US and elsewhere. In the UK the review was conducted by independent lawyers and suspect accounts were reported to the National Drugs Intelligence Unit. Similar due diligence reviews were conducted in the US. The management of BCCI were of course aware that the facts revealed at Tampa could lead to revocation or non-renewal of the group's licences in Luxembourg, the UK, the US and elsewhere. They were therefore understandably anxious to persuade the supervisors that, whatever might have happened in the past, the group's operations were now above suspicion. Whatever the management's motivation, the evidence strongly suggests that in the aftermath of Tampa the group made a genuine and determined effort to ensure future compliance with rules intended to prevent money-laundering.

2.120 In mid-November 1988 the British managing director of a small Muslim bank with a presence in the UK telephoned the Bank. He said his bank employed some junior staff who had formerly worked for BCCI. To his horror, they had told one of his colleagues that they were not at all surprised by recent revelations and that there was certainly justification for them. The managing director offered to interview these staff members on a confidential basis if the Bank thought it might serve any useful purpose. The Bank's response, given after internal consideration, was that he should contact the enforcement authorities, such as the police, if he considered he had information suggesting malfeasance. The Bank took no action, made no enquiry and heard no more. I repeat, in relation to this episode, the criticisms made in paragraphs 2.97-2.98 above. In mid-November 1988 any alert supervisor was bound to wonder whether the Tampa allegations were true and, if so, whether they represented an isolated aberration by some local, relatively junior employees or whether they represented the tip of a far more sinister iceberg. Information on such questions is of its nature hard to come by. Here were informants apparently able to throw light on both questions. There were various ways in which the Bank could have responded constructively to the managing director's enquiry. It was of course important not to compromise investigations by the police or HM Customs and it may very well be that the informants, if approached, would have been found to have nothing of value to say. It does nonetheless seem to me that the Bank's response was so off-hand as to suggest a lack of interest in whether they had or not.

18 The second College meeting: November 1988

2.121 The Bank favoured enlargement of the College by inclusion of the UAE for the November 1988 meeting, but Naqvi opposed this when the proposal was raised with him and so the composition of the College remained unchanged. PW prepared a report on the results and operations of the group for the 9 months to 30 September 1988. This showed static profits for the 9 months and predicted that results for the last quarter would be depressed by the results of the Tampa indictment. The report detailed six customer groups with loans exceeding 10 per cent of the capital fund of the group, exposure to most of them having risen (in some cases substantially) over the period. PW advised that the group's policy on unsecured exposures permitted imprudent levels of lending.

2.122 At the supervisors' morning session of the College on 29 November 1988 there was discussion of the Tampa indictment and its effect, and also of the Central Treasury (where the need for adequate supervision was agreed to be fundamental), loans and provisions, the projected year-end results and the composition of the College.

2.123 When the supervisors were joined by BCCI management and PW in the afternoon much of the same ground was covered. PW made known its concern about the very high concentration of lending, which Naqvi explained as historical, indicating that there would be no further lending to this group of customers. These loans were not discussed in detail and the management were not invited to put forward any plan for their reduction or repayment. On provisions, there was some difference between BCCI management and PW. The Bank supported higher country risk provision. PW took exception to a remark by Jaans suggesting that the level of provision was dependent on the existence of profits against which to provide.

2.124 This second meeting of the College was scarcely more effective than the first. PW did not receive the forthright support on provisions for which they could reasonably have hoped. BCCI were not taken to task over the abnormal concentrations of lending. After the meeting, PW told the Bank of their hope that the Bank would be tougher with Naqvi than Jaans had been when the Bank chaired the College meetings in 1989.

19 January-July 1989

2.125 The immediate threat of a run on deposits having apparently passed, the Bank was able at the beginning of 1989 to reduce the frequency of the UK Region's liquidity statements from daily to weekly and the frequency of meetings from weekly to monthly. But the Bank successfully maintained its pressure on the Region to reduce its funding of the rest of the group and it kept closely in touch with SA's UK operations both through meetings and through the use of PW as reporting accountants. The Bank discussed with management a *Private Eye* report that the Leadenhall Street branch of SA laundered money for the Abu Nidhal Organisation and was subject to surveillance by the intelligence services, a report taken up by BCCI with the FCO, who declined to comment. The Bank also knew of, but played no part in, an application by the Attorney General (not in the end pursued) to restrain transmission of a television programme *("The BCCI Connection")*, which it was thought might prejudice the forthcoming trials of Baakza and Akbar. While the Tampa prosecution wound its way forward, there was during this period no discussion of restructuring the group (save of a scheme to bring the Central Treasury back to London from Abu Dhabi) or improving the supervisory arrangements.

2.126 On 11 April 1989 PW gave their audit opinion on the group's 1988 accounts. It was a qualified opinion because of uncertainty attaching to the Tampa proceedings and their uncertain effect on the operations of the group. The accounts showed a loss for the year of $49 million after loan loss provisions of $145 million. The Bank received these accounts in May, and in June it received PW's report for the College, like its predecessor of the year before a substantial document. This discussed the year's results, the adverse effects of the Tampa indictment, the poor economic conditions in certain key areas of operation and the requirement for increased loan loss provisions. It drew attention in clear terms to the high concentration of lending to a small number of counterparties (most of the exposures having increased over the year), to large lending secured on CCAH shares, to the ICIC entities and to the ICIC put option. PW's concern about the concentration of lending was clear, but again the report struck no note of alarm. Taking account of a capital injection in April 1989, PW reported that the risk asset ratio at the end of 1988 had been over 1 per cent above the Basle minimum.

2.127 For the third College meeting held at the Bank on 6 July 1989 the membership was enlarged by representation of Hong Kong and the Caymans. An invitation to the Central Bank of the UAE, extended through HE Ghanim Faris Al Mazrui, a director of the Central Bank, had been declined.

2.128 Among the subjects discussed at the supervisors' morning session were the group's large exposures, which caused general concern. These were mostly booked in Overseas, and the Cayman supervisor said attempts to reduce the largest exposures had so far proved unsuccessful: since the Cayman supervisors did not have the resources to monitor these large exposures effectively he felt that this was an area of high concern, particularly because, although the transactions were booked in the Caymans, many of the loan files were held elsewhere. It was agreed that unilateral action to insulate individual BCCI entities could ultimately create problems by leading the group to make other less transparent arrangements. The restructuring of the Central Treasury was considered the most urgent issue to be addressed in the afternoon, with particular reference to its ownership and the ownership of funds placed with it.

2.129 When BCCI management and the auditors joined the meeting in the afternoon there were 19 people present, a sizeable meeting. A number of issues were covered. Mr Roger Barnes, Head of Banking Supervision Division, who was in the chair and had prepared very thoroughly for the meeting, posed a series of well-considered but complex multi-point questions. To these Naqvi gave very long and discursive answers, some of them supplemented by other management representatives. On the large exposures, Naqvi said BCCI wanted to phase them out and was discussing with PW how to do so: they arose from historical relationships and would not increase. PW reported that the 1988 provisions had been realistic and that no new accounts had emerged as doubtful. They also commented favourably on the group's due diligence reviews of its money-laundering precautions. But overall PW played a minor role in the meeting, and no real attempt was made by the supervisors to tax Naqvi on his lengthy answers.

2.130 The evidence satisfies me (although the Bank contests this) that as a result of this meeting PW judged the College meetings to have become too large and too formal to be a very effective supervisory instrument. Although the supervisors' concerns had been expressed more strongly than before, PW questioned whether management had really absorbed their message. In a report to the BCCI audit committee they expressed the view that detailed supervision would have in future to be done on a one-to-one basis with the principal supervisors.

2.131 The Bank took a more sanguine view. In reporting to the Board of Banking Supervision, Barnes found comfort in PW's more open relations with BCCI management, in the absence of developments in the money-laundering affair, in the support of the shareholders, in BCCI's response to pressure from PW to improve their control systems and in their wish to restructure the Central Treasury operation. There was, indeed, no warning of immediate crisis, and the Bank's much intensified supervision of the UK Region had uncovered nothing sinister. But the UK branches of BCCI SA, however well run, could not hope to swim if SA as a whole sank. It was now over three years since the Central Treasury losses had been reported. The group structure had not been altered (save for a move of the Central Treasury to Abu Dhabi which was unsatisfactory both in supervisory and operational terms). The appointment of a single auditor for the group was an undoubted advance, but the supervisors' grip on the group had not been greatly strengthened. The Tampa prosecution was, in the Bank's judgment, just the sort of mishap to which BCCI was prone, given its emphasis on obtaining deposits at almost any price and the places where it chose to do business. Pending the outcome at Tampa, it would no doubt have been wrong for the supervisors to assume the worst against BCCI or its employees. But it is hard to see grounds for much optimism.

20 The Cambridge Crime Symposium

2.132 The Seventh International Symposium on Commercial Crime, organised by the Commonwealth Commercial Crime Unit of the Commonwealth Secretariat and the International Maritime Bureau of the International Chamber of Commerce, was held at Jesus College, Cambridge, from 2-7 July 1989. It was attended by representatives from the UK (including officials of the Home Office and HM Customs) and abroad. The subject was "Dirty Money".

2.133 It was originally intended by the organisers that a talk should be given on BCCI and the television film *"The BCCI Connection"* shown. These agenda items were cancelled on the directions of the Secretary-General's office at the Commonwealth Secretariat. This may well have been a response to representations by HM Customs, who were properly anxious to avoid any risk of prejudice to their forthcoming prosecutions of Baakza and Akbar. Although representatives of BCCI's solicitors attended part of the symposium, they did not attend on behalf of BCCI and made no representations to the organisers. Nor did BCCI itself.

2.134 There was in the event no open discussion of BCCI at the symposium, although it was almost certainly the subject of informal discussion among some of those present.

21 July-December 1989

2.135 The second half of 1989 was a very significant period in the history of BCCI. Partly at least as a result of approaches made to the Bank by Lord Callaghan a little earlier, fresh thought was given to structural and supervisory questions. This led the Bank towards, as an interim solution, incorporation of two UK subsidiaries, one housing the Central Treasury, the other the UK Region's operations, and, as a longer-term solution, the consolidated supervision by the Bank of a group incorporated and based in the UK. During this period also, PW were alerted to grounds for doubting the reliability of certain information provided by the group and the genuineness of certain transactions undertaken by it. At the College meeting held in London in December 1989, by far the most effective in the series so far, the supervisors made clear what they wanted for the immediate future.

2.136 While these developments, more fully summarised below, were in train, however, the Bank did not falter in its supervision of the UK Region. Monthly meetings continued to be held. Reports previously made by PW as reporting accountants were discussed. Further reports (on BCCI's high level procedures and controls, and on its internal audit function) were commissioned, delivered and discussed. Neither of these reports was particularly favourable but neither was particularly unfavourable. The supervision of the UK Region was well conducted and nothing arose to cause undue concern.

2.137 The structural question raised more difficult issues. Lord Callaghan had known Abedi for about 7 years, largely as a result of their joint involvement in the Cambridge Commonwealth Trust, to which BCCI contributed generously, and this association had ripened into warm personal regard. When Abedi was unable, through illness, to continue running the group, he shared his thoughts with Lord Callaghan, who also on occasion acted as an unofficial adviser to the group. Lord Callaghan came to feel that the group had somewhat lost its direction in the absence of Abedi's leadership and that its best future lay (once the Tampa prosecution was completed) in relocation of the group in the UK, subject to the supervision of the Bank. A meeting was arranged with the Governor on 25 May 1989 at which Lord Callaghan advanced this proposal.

2.138 Although, as a matter of courtesy, the Governor agreed to consider the proposal, he outlined at the meeting a number of reasons why the Bank was reluctant to accept it. These included: uncertainty about the identity and nature of the shareholders; the dominant position of Abedi; the Bank's inability to understand BCCI's cultural and managerial approach; the Bank's lack of its normal relationship with the management; the absence of the basis of trust which characterised the Bank's ordinary relationship with those it supervised; the difficulty of achieving necessary communication with the management; the need for an entirely new and exacting style of supervision; and the many enquiries the Bank received from banks and other parties raising questions about BCCI's business practices. In reality, the Bank felt there were fundamental difficulties with the suggestion of BCCI incorporating in the UK and it was reluctant to take on any further responsibilities with regard to it.

2.139 The Deputy Governor demurred at this response when he learned of it. He had previously favoured local incorporation, and still did. When the outcome of the meeting was reported to the Board of Banking Supervision in June 1989, it also demurred. It felt that the matter should be looked at again after the forthcoming College meeting. Additional impetus was given to the reconsideration of structural questions by the knowledge that BCCI in any event intended to restructure its Central Treasury (now inconveniently located in Abu Dhabi): a first draft plan, delivered in May 1989, had been found unsatisfactory; a second draft, to be delivered in September 1989, would be thought little improvement.

2.140 In response to an invitation by Quinn to put his thoughts on paper, Mr John Beverly (a deputy head of Banking Supervision) did so in a paper dated 27 July 1989. His conclusion was that any solution other than consolidated supervision by the Bank of a thoroughly scrutinised and somewhat modified group would involve the "continuance of a fundamentally flawed supervisory construct with the likelihood that, in the event of a major problem, we would attract the blame we seek to avoid". Barnes, to whom this note was addressed, favoured a somewhat different solution: the formation of two UK subsidiaries, one to house the Central Treasury and one to house the UK Region's business.

2.141 On 1 November 1989 the Banking Supervision Division settled a long and important paper for the Board of Banking Supervision. This rehearsed a number of points: the central role of London; the defects in the group's structure and in the existing supervisory regime, including the College; the opacity of much of the group's activity; the highly unsatisfactory operation and supervision of the Central Treasury; and the lack of full consolidated supervision, denying any one supervisor a view of the whole group. The paper recognised that only the Bank could, in reality, undertake the consolidated supervision of the group, and that was regarded as ultimately the only solution. But it had to await major restructuring of the group. As an interim solution, Barnes' suggestion of two UK subsidiaries (to house the Central Treasury and the business of the UK Region) was recommended. The paper recognised that this proposal would increase pressure on the Bank to supervise the whole group, and the thrust of the paper was that the Bank should accept this responsibility. In contrast with the negative approach of the Division two years earlier (paragraphs 2.87-2.92 above), this was a constructive, realistic and forward-looking paper.

2.142 When the paper came before the Board on 9 November 1989 its implications were discussed. There was general agreement that the Bank should proceed on the basis of the recommendations in the paper. The independent members did not appreciate that approval, in principle, had been given by the Bank to local incorporation of the UK business in 1977 and again in 1985, and to the conduct of consolidated supervision in 1984 (paragraphs 2.53 and 2.41 above).

2.143 By this time, PW's audit cycle (which had begun, as usual, in August) was well advanced. This particular audit had one feature which, although by no means unique in an auditor's experience, is unusual: the provision by an employee of the company being audited of information which throws doubt on what the auditors are being told by management. In this instance, the Informant was a senior officer of BCCI outside the UK with access to good information. To protect his personal safety his identity must be withheld, although it has been made known in strict confidence to the Inquiry. He began to give information to a PW partner ("P") in early October 1989. The Informant was not easy to assess. He tended to speak in riddles, to make suggestions about areas to be investigated, to drop hints. P followed up the leads and hints he was given. Some led, or appeared to lead, nowhere. But over a period P increasingly came to regard the Informant as fundamentally honest and accurate. P's partners, who did not enjoy P's

direct relationship with the Informant, were more sceptical, and took longer to be convinced of the Informant's reliability and good faith. There was accordingly a period during which, within PW, there was some doubt about the reliability of the Informant's often rather enigmatic communications.

2.144 Among a number of points raised by the Informant at a series of meetings, some stood out. He questioned the genuineness of certain loans made on the security of CCAH shares, suggesting that some of these borrowers would not confirm their indebtedness for audit purposes and that they had received hold-harmless letters indemnifying them against loss. He questioned certain accounts booked in the Caymans, certain loans made in Bahrain and certain transactions with offshore companies. He suggested the existence of dummy loans, the crediting of funds to non-performing accounts from extraneous sources and the existence of improper transactions between BCCI and entities such as ICIC and Kifco (a Kuwaiti company in which BCCI held a 49 per cent interest). He described BCCI's loans to the Gokals as a joke, and not real loans, and said that certain major customers held CCAH shares as nominees for BCCI.

2.145 However hard to assess, these indications naturally caused PW concern. Their concern was increased when they eventually succeeded in seeing the accounts of ICIC Holdings, an unaudited Cayman company: contrary to management representations that this was an inactive holding company, the accounts showed that it had incurred significant liabilities and expenses.

2.146 In their interim report to the audit committee of BCCI on the results for the 9 months to 30 September 1989, PW did not mention the existence of the Informant or refer to anything he had said. But the report (which the Bank did not see) struck a sombre note. It predicted a loss if substantial provisions were required. It criticised BCCI's accounting practices and one-off deals effected to boost income. It pointed out the increase in major loans since the end of 1988. These included an increase in lending secured on CCAH shares: this increase, coupled with a fall in the basis of valuation of US bank shares, led PW to predict a substantial shortfall in the value of the CCAH shares pledged as security for the lending. Reflecting the Informant's warning, PW indicated a requirement for unusually searching confirmations from the CCAH borrowers. At a meeting with BCCI management to discuss this report in draft, PW were strongly criticised for acting as regulators instead of helping their client. At a meeting with the BCCI audit committee, PW repeated their concerns about CCAH (they wanted to be sure there was no concert party) and BCCI's relationship with ICIC. The Bank did not attend these meetings and was not invited to do so.

2.147 In their interim report on the 9 month period, which was circulated to College members, PW included a section on capital (in which reference was briefly made to ICIC's loans to shareholders secured on BCCI shares) and omitted the emphatic statement on CCAH loan confirmations which had appeared in the earlier report to the audit committee. But the increase in CCAH-related loans was made clear, as was PW's concern about the continued concentration of lending to a small group of counterparties. On some of these loans a detailed commentary was given. Broadly, the report covered the same ground as the report to the audit committee.

2.148 The fourth meeting of the College was held at the Bank on 1 December 1989 under the chairmanship of Barnes. Before it was held, the Bank told the IML of the Bank's proposal to incorporate two UK subsidiaries. The IML representatives welcomed a UK company to house the Central Treasury, but had reservations about a UK company to embrace the operations of the UK Region (unless it included the Middle Eastern branches, or these were transferred to Overseas). The IML did not wish to be left with responsibility for supervising the less viable parts of SA. A suggestion by the IML that the Bank should undertake the consolidated supervision of the group was resisted.

2.149 At the first session of the College, attended by supervisors, it was agreed that PW's report gave grounds for serious concern in a number of areas. There was agreed to be a need for larger provisions against country risk and also against doubtful and non-performing loans. There was concern that large exposures, particularly in relation to CCAH, had grown larger, when reductions had been hoped for. The Bank's plan for a UK subsidiary to house the Central Treasury provoked no objections. The second subsidiary incorporating the UK branches was opposed by Hong Kong, the Caymans and the IML.

2.150 Much of the afternoon session was occupied by a long and polished presentation by BCCI's Washington lawyers, Messrs Clark Clifford and Robert Altman, on the Tampa indictment. It was explained that under US law a corporation is liable for any act of its employees in the course of his duties. Some of the tape-recorded conversations with BCCI employees were exceedingly damaging. It was therefore desirable for BCCI to negotiate terms on which it could plead guilty. Stress was laid on the steps taken by BCCI to avoid repetition.

2.151 For the remainder of the meeting the issues raised by PW were discussed. It was made plain that income was not to be artificially inflated. Provisions and large exposures were considered together and at length. Naqvi was confident that CCAH borrowing would now be reduced, despite past failures. PW indicated that it was the large exposures which caused problems; the rest of the loan portfolio was improving. The supervisors made clear that provisions should be at a higher level than proposed, whatever the effect on profits, and called for progress in reducing the large loans. The Bank disclosed its plans for the two UK subsidiaries, but did not seek an immediate answer.

2.152 After the College meeting, Beverly telephoned PW to make sure that the supervisors' messages had been clear. He wished to stress in particular that proper provision was to be made both against country risk and problem individual exposure, and also that the supervisors wished to be warned in advance if there was any question of PW qualifying their opinion on the accounts, which was the last thing anyone wanted to see. Mr Chris Cowan of PW said that these messages had been particularly clear to them. These were messages which, shortly thereafter, the IML reinforced: Mr Arthur Philippe (of the IML) expressed strong support for PW's efforts to clean up the BCCI loan book; it was time that BCCI tackled the problems which had been identified; the supervisors would not accept a qualified audit opinion because BCCI had failed to tackle the problems, or because inadequate provisions had been made.

2.153 When, following the meeting, Naqvi gave the Bank his considered response to the scheme for two UK subsidiaries, it was one of enthusiastic welcome. It was also welcomed by Lord Callaghan. When the Board of Banking Supervision was informed of recent developments, including the prospective loss in 1989, the Governor pointed to the need for greater urgency in pressing forward the separate incorporation of the UK business in order to build a firewall around the UK depositors.

2.154 The fundamentals of the problem which faced the supervisors in December 1989 had not changed over the preceding decade, although its lines had become more clearly defined. The problem had also become more acute as conviction of money-laundering loomed and the group's vaunted record of profit faced another setback. But the Bank did now have a clear idea of what it wished to achieve and how it planned to achieve it. That was an advance, and the December 1989 meeting of the College was much the most effective there had so far been.

22 The outcome of the Tampa indictment

2.155 The money-laundering trial in Tampa was fixed for January 1990. As the date approached both the Bank and the IML considered whether BCCI's authorisation should be revoked if it was found guilty or pleaded guilty. Both were markedly disinclined to take this action unless the facts or circumstances obliged them to do so. A number of factors contributed to this disinclination. They included the matters mentioned in paragraph 2.117 above. It was by now fairly clear that BCCI employees had played a part in the money-laundering scheme but it was felt that they had been led into doing so by the undercover agents acting as *agents-provocateurs*. It was plain, both from the presentation made by Clifford and Altman at the College meeting in December and from a similar, documented, submission made by BCCI's English lawyers, that the employees' conduct without more would not found a conviction of their corporate employers in English law, the test of corporate criminal liability in US law being significantly lower. It was believed that senior management of the group and the UK Region were innocent of any involvement in the money-laundering scheme, a view unequivocally endorsed (to the Bank's knowledge) by HM Customs. It was believed, in my view quite correctly, that BCCI had made genuine efforts to ensure compliance with international guidelines for the prevention of money-laundering.

2.156 On 16 January 1990 the Bank learned that a plea-bargain agreement had been reached, subject to the agreement of the court which it later received. By this agreement SA and Overseas were to plead guilty to all counts of the substantive offence of money-laundering and to conspiracy and the US Government were to drop charges of cocaine trafficking. Charges against Holdings and BCC Colombia (over which the court had no jurisdiction) were to be dismissed. SA and Overseas were to pay no fine but were to forfeit a sum of $14 million which they had earlier lodged with the court to prevent seizure of their assets. This represented the sum which had been laundered by BCCI with knowledge of what the funds represented. Under the agreement SA and Overseas were placed under the control of the Federal Reserve for five years, and the conditions of their probation were specified in the agreement.

2.157 Following these convictions the Bank's Review Committee formally reviewed SA's authorisation in the UK. For this purpose the Banking Supervision Division prepared a lengthy submission and compiled a substantial dossier for Committee members.

2.158 Both in the submission and in the meetings of the Committee (which met on 29 and 31 January 1990) the criteria in Schedule 3 of the 1987 Act were systematically reviewed. The submission suggested (and the Committee agreed) that the adequacy of capital and provisions could not be determined until the 1989 accounts had been finalised. The submission suggested and the Committee took the view that liquidity of SA and the group appeared adequate. The submission suggested that at the date of the indictment SA's systems and controls had been adequate in the UK, and possibly elsewhere; they were now thought to be adequate everywhere. In considering the requirement of fitness and properness the submission suggested that none of those indicted was sufficiently senior to be a manager within the statutory definition. The Committee accepted this view of Baakza, the only UK employee; it had more doubt about Chinoy, but he was an employee of Overseas. The submission considered whether the directors and senior management had shown unsound judgment or lack of competence or diligence in failing to recognise the risks the group was running, but concluded that "the questions which arise in this context lack sufficient substance to

support the contention that the senior management or directors are not fit and proper". The Committee had some unease about the prudence criterion but concluded that this was not sufficient ground for concluding that it was not fulfilled. The submission referred to the requirement of integrity and skill, suggesting that the offences had been unintentional and unusual and that the management could not have rectified the situation so satisfactorily had they lacked skill. The Committee concluded that there was insufficient evidence to say that the integrity and skill criterion was not met. The submission ended with a strong argument that if (contrary to its contention) the power to revoke was exercisable, it should not be exercised. The Committee did not find it necessary to consider this, since it found no grounds for revocation. Formally, the Committee did not reach a final decision, since the questions on capital adequacy and provisions remained open, but the Committee did not plan a further meeting and did not meet again on this issue. The Committee's conclusions were reported to the Board of Banking Supervision, which did not question them.

2.159 The evidence satisfies me that the Division and the Committee approached this review in a serious manner, intending to do a thorough, professional job. I nonetheless make three criticisms.

2.160 The first criticism is of the Bank's legal approach, and it is a general criticism applicable at various points in this history. Section 11(1)(a) of the 1987 Act provides:

> "The Bank may revoke the authorisation of an institution *if it appears to the Bank that*
>
> (a) *any of the criteria specified in Schedule 3 of this Act* is not or has not been fulfilled, or *may not be or may not have been fulfilled,* in respect of the institution ....." (my emphasis).

This wording, amending the narrower language of the 1979 Act, enlarges the Bank's area of appreciation. It does not have to be satisfied that a criterion has not been fulfilled. It is enough that it (genuinely and not irrationally) appears to the Bank that a criterion may not have been fulfilled. The clear intention of the legislature was, in my opinion, to provide a very low threshold before the Bank's powers to revoke (and restrict) become exercisable. On the question whether the threshold condition is met, as on the question whether the power to revoke or restrict (if exercisable) should be exercised, paramount weight is given to the Bank's experienced and informed judgment. On this occasion the Bank received internal legal advice which was in my view erroneous, but more generally I think it has considerably exaggerated the conditions to be met before it can act. Parliament intended the Bank to back its professional judgement. Provided it does so objectively, fairly, rationally and, preferably, with the benefit of sound legal advice, it need have little to fear. Even if the Bank's decisions were, on occasion, to be successfully challenged, that risk should not deter it from doing what it considers to be right in the circumstances. The fear that an appellate body might disagree with it has in my view loomed much larger than it should in the Bank's mind.

2.161 My second criticism relates only to the Tampa review. The Division's submission was markedly sympathetic to BCCI. This was partly because it relied, almost exclusively, on BCCI's account of the case. Like anyone else in the same position, BCCI put the most favourable construction it could on the matter. The Bank never obtained a comprehensive resume of the facts from HM Customs and never sought to explore the basis of Customs' conclusion that senior management were innocent. There were questions, to which Customs had answers, which the Bank could pertinently have raised: for example, as to the authorisation of a journey made by Baakza to Miami, a journey in fact made to tie up arrangements with the undercover

agents (following an earlier meeting in London) and the BCCI conspirators. Nor was any approach, direct or indirect, made to US Customs or the US prosecuting authorities. Officials of the Federal Reserve were, it appears, asked if they had any information the Bank did not, but the Fed were not the prosecuting authority and these informal communications were unrecorded. On this, as on other, occasions the Bank showed a very marked lack of curiosity.

2.162 My third criticism is more general. It has never (to my knowledge) been suggested that the directors or controllers of SA were party to the money-laundering conspiracy. Nor is there evidence known to me that senior managers were implicated. Those indicted were not managers of SA within the statutory definition, as the Bank rightly held. But the Schedule makes clear that fitness and properness involves, not only probity but also competence, soundness of judgment and diligence. Elsewhere, the requirement of prudence is stated in general terms. There were, as it seems to me, questions to be asked about the judgment and competence of the board and management when BCCI bought its minority interest in BCC Colombia in 1983 and its majority interest in 1985. The likelihood of involvement in handling the proceeds of drug-trafficking could scarcely have eluded a competent and diligent banker contemplating such an investment, particularly if he had branches in Panama and agencies in Florida. While it is true that money-laundering became an increasingly high-profile subject throughout the 1980s, it was not an activity in which a banker of probity would knowingly have engaged in 1983. Whether BCCI failed to recognise the risk, or recognised and discounted it, or recognised and accepted it, or recognised and took what were thought to be adequate precautions, I do not know. This enquiry was never made. I think it was a pertinent enquiry, to which a rigorous supervisor would have wished to know the answer.

23 January-April 1990

2.163 In the early months of 1990 further consideration was given by the Bank and the Board of Banking Supervision to the scheme, already approved in principle, for incorporating two UK subsidiaries with the expectation, in the longer term, that the Bank would undertake consolidated supervision of a group established in the UK. It was felt that in the interests of UK depositors incorporation was a priority, and at the meeting of the Board in March 1990 details were given of possible interim structures. At this meeting Barnes stressed that all these proposals were based on the assumption that Naqvi was a man of integrity, but he gave no grounds for doubting that he was.

2.164 It was thought necessary to win over the IML to support the Bank's proposals, and in March 1990 Quinn made clear to Jaans that the Bank intended the incorporation of the UK companies to be part of a process leading to incorporation of the group headquarters in the UK. The Bank was influenced in its approach by the Tampa case, which (it said) did not come as a surprise to it and might not turn out to be unique. A pressing need was felt for the group to be restructured and its financial position strengthened so that it could be properly supervised on a consolidated basis and the risk of repetition reduced. Jaans welcomed these proposals, appreciating that they would take time to implement fully. It was agreed that the governments of both Luxembourg and the UK should be alerted to this new and significant development.

2.165 While these discussions on the future of the group were in progress, PW were working on their audit of the 1989 accounts. As a result of this work their concern had mounted. A number of factors contributed to their concern. A series of drawdowns had been made on the CCAH accounts for which there appeared to be no authority. It had been suggested that the CCAH borrowers held letters indemnifying them against loss if the value of the shares pledged as security fell below the sum advanced. Two of the CCAH borrowers had expressly refused to confirm their indebtedness, as the Informant had predicted. Five relatively small sums had been drawn down in Bahrain and it appeared that in two of the five cases identical sums had been credited to non-performing loans in the UAE. Loans made to a large borrower in the Gulf appeared questionable. BCCI's relationship with ICIC continued to cause concern. The more senior members of PW's team (Mr Tim Hoult and Cowan) were coming round to P's view that the Informant was probably reliable. Probably in the first week of February 1990 PW decided that the Bank should be alerted to their doubts. Hoult telephoned Barnes and said he wanted to speak to him about the probity of BCCI. Barnes said he should come round at once.

2.166 In communicating with the Bank in this way Hoult and Cowan felt they were taking an exceptional step. They went to the Bank and entered separately to avoid any risk of being seen by any representative of BCCI. They agreed with Barnes, who was alone, that because of the extreme secrecy of the meeting no note should be taken. It was a short meeting and recollections of it differ. I am, however, sure that Hoult communicated PW's doubts about the probity of BCCI, giving some of their grounds. I think it probable he mentioned the Informant, the CCAH loans, the refusals to confirm and the Bahrain transactions. Barnes asked whether they considered Naqvi to be fundamentally honest. Hoult said that Cowan had very serious doubts about Naqvi's honesty but he himself was as yet unconvinced of his dishonesty. Barnes' recollection, that PW came to tell him that the audit was not proceeding too smoothly and that they were having difficulty getting the information they needed from Naqvi, is in my view mistaken, although he thinks that if the Informant had been mentioned he would have remembered it.

2.167 I find it surprising that this meeting made so little impression on Barnes. It is true that PW called to voice doubts, not to present conclusions, and they gave little chapter and verse. But a reputable auditor does not voice doubts about the probity of his client to a regulator unless he has something fairly substantial to go on, and he will understate his concerns to avoid any risk of overstatement. It was reasonable for Barnes to await further developments, but I would expect him to have done so in a state of greatly heightened anxiety. After years of criticism, and after Tampa, here was a suggestion of dishonesty from an unimpeachable source pointing at the chief executive of the group. Barnes' impassivity on receiving this message seems to me to show a rooted unwillingness to believe ill of BCCI.

2.168 The Bank had no knowledge of efforts made by PW during February to investigate further their grounds of concern. These culminated in a long and difficult meeting between PW and Naqvi on 28 February 1990 when the PW partners understood him to make two confessions. One related to false documentation prepared on the Bahrain loans to deceive the auditors, the other to the terms on which money had been lent to the CCAH borrowers who had refused to confirm. At a meeting with Hoult the next day Naqvi spoke of a "bad bank", which he had inherited.

2.169 In the light of these admissions Hoult and Cowan returned to the Bank on 2 March 1990 and saw Barnes and Beverly. On this occasion a note was taken. It was a much longer meeting, in the course of which the matters mentioned on the first occasion were covered again in more detail. The note of the meeting shows that reference was made by Hoult to the refusals of CCAH loan confirmations, the possibility that BCCI had granted indemnities against loss, the possibility that Bahrain advances were being re-cycled as repayments to avoid the need for provisions, the Informant (of whom no details were given), "Guinness-type issues", questions about the integrity, openness and trustworthiness of Naqvi and "a bad bank inside a better bank". PW felt they had to ask how far Naqvi had been frank, not just with regard to the stated instances but more generally. Hoult said Cowan had more concerns on this score, but their confidence had been shaken. Barnes said that Naqvi's integrity was of crucial importance to the Bank.

2.170 This was the same observation Barnes made to the Board of Banking Supervision five days later (paragraph 2.163 above), although he gave the Board no hint of PW's communication. He judged it inappropriate to tell the Board of what were no more than suspicions. While respecting his motives, I consider this a misjudgment. This was, after all, PW's second visit, and no one but he knew of the first. Even unsubstantiated suspicions from such a source are of significance. One of the results was that the Board of Banking Supervision, and the Governors, were not at this point alerted to serious doubts about the integrity of the chief executive of the group.

2.171 PW's private visits to the Bank were not known to BCCI management, the board or the shareholders. But as a result of the interview with Naqvi on 28 February 1990 (paragraph 2.168 above) PW's relations with the management were seriously impaired. To try and repair them, PW advised and BCCI agreed to the setting up of a task force to investigate and report on a series of issues which were causing PW concern. These issues were identified in two briefing papers which PW prepared. The Bank did not see these briefing papers but knew of the task force, knew of difficulties in finalising the audit, knew that substantial provisions would be needed and knew that the accounts were likely to be delayed. PW told the Bank on 30 March 1990 of the task force's slow progress and of their waning confidence in Naqvi.

2.172 The work of the task force broadly confirmed PW's suspicions in the areas investigated, without contributing much new information save in two areas. One of those areas was Kifco: contrary to representations earlier made by Naqvi that Kifco was not of significance to the group, it appeared that Gulf-related loans of $75 million had been made by it. The second area was the Gulf/Gokal lending: the work of the task

force suggested that offshore loans amounting to some $300 million were to be aggregated with the known exposure to the Gulf Group, giving a total exposure of almost $700 million. These findings were discussed at a long and contentious audit committee meeting (not of course attended by the Bank) on 6 April 1990, when PW made clear their lack of confidence in Naqvi. He defended himself and the board members declared their confidence in him.

2.173 Hoult and Mr Tim Charge of PW called on Barnes and Miss Helen Jones at the Bank on 11 April 1990. Although the audit committee meeting of 6 April 1990 was mentioned, no detailed account of it was given. Their message was mainly financial. Loan loss provisions of $500-$650 million were forecast and the survival of BCCI was said to be at stake. Efforts were being made by management to solicit shareholder support and Hoult had told Naqvi that about $2 billion in capital was needed, including the purchase of minority shareholdings. Asked by Barnes whether BCCI was insolvent, Hoult replied that it probably was not. He was uncertain whether, if BCCI were a UK bank, the directors would have to take advice on continued trading. The directors were at this time, very understandably, concerned about their position.

24 PW's report of 18 April 1990

2.174 On 18 April 1990 PW finalised a report to the directors of Holdings. The most striking point in the report was PW's indication that the group required financial support estimated at a minimum of $1.8 billion, with unfunded support for unsecured loans of about $400 million. PW said they could not sign the accounts as they stood. This point therefore went to the survival of the group.

2.175 In their report PW also highlighted uncertainties relating to major loans. The first area of uncertainty related to the Gulf Group. The exposure to this group had been $350 million at the end of 1988, $400 million at the end of 1989. But the task force had now concluded that loans to 71 separate offshore companies totalling $300 million at the end of 1989 were to be treated as part of the total Gulf Group exposure. The Gokals had now accepted responsibility for these accounts so that the total Gulf exposure was currently $700 million.

2.176 Despite management assurances that the CCAH loans would reduce during 1989 they had in fact increased. Interest had not been paid and additional unsupported drawdowns had been debited. There was now an estimated shortfall of $200 million in the value of the security.

2.177 PW reported that their enquiries (confirmed by the task force) had indicated

> "that certain accounting transactions principally booked in Cayman and other offshore centres have been either false or deceitful ...."

A minimum of $50 million was recommended to cover such contingencies.

2.178 PW expressed their opinion that the ICIC entities, although organised as separate legal bodies, were in substance under the control of BCCI management. PW referred to their previous expressions of concern about the dependence of ICIC on loans secured on BCCI shares and the extent to which it could be regarded as independent of BCCI.

2.179 Of two borrowers PW said

> "Despite repeated assurances by management to the contrary and confirmations from the borrowers concerned we now understand that BCCI shares recorded in the names of [these borrowers] may have been owned by BCCI and ICIC."

The figure involved, amounting to some $349 million, was not insignificant.

2.180 On the day the report was finalised, Hoult and Cowan called on Barnes, Beverly and Miss Jones to deliver a copy. Barnes declined to receive a copy because of the Bank's delicate position vis-a-vis the IML. So Hoult went through the salient points in the report. It is, I think, clear from the only note of the meeting (which was made by Miss Jones and which, though not comprehensive, was substantially accurate) that Hoult concentrated on the immediate financial crisis and the need for very substantial shareholder support. He mentioned the CCAH loans, "minor bits and pieces" warranting a provision of $50 million, the two borrowers mentioned above, ICIC and the $300 million of loans to offshore companies for which the Gokals had agreed to accept responsibility. But it seems he made no express reference to fraud or malpractice

of any kind, and he went into little detail save, to some extent, of the Gokal loans. It is surprising, and unfortunate, that the Bank's attention was not expressly drawn to the fitness and properness implications of the report.

2.181 It is eminently understandable that a financial crisis which threatened the survival of the group was the major preoccupation of PW and the Bank. But I do not think any informed reader of the report, which was relatively brief, could have failed to read it as seriously impugning the honesty with which the group had been run.

2.182 The Gulf/Gokal exposure had been a concern for over a decade. There had been considerable pressure on BCCI management to reduce it, and yet it had inexorably increased. It now appeared that the Gokals, who were thought to have owed $400 million, were accepting responsibility for an additional $300 million owed by 71 offshore companies. That would be an astonishing thing for businessmen to do if the debt were not theirs. But if the debt was theirs, why had the 71 companies been introduced and why had the lending not been aggregated when made? It might, of course, be that the Gokals had deceived the management, but a much more likely explanation was that the Gokals and the management were colluding to hide the extent of this lending from the auditors and the supervisors with the object of avoiding provisions and maintaining a false level of profit.

2.183 To anyone who knew (as the Bank did: paragraph 2.169 above) of the two CCAH borrowers' refusals to confirm and PW's suspicions that BCCI had given borrowers an indemnity against loss, the information about CCAH should have raised clear doubts about the genuineness of at least some of those loans.

2.184 The reference to false or deceitful entries was a reference to the Bahrain transactions already mentioned to the Bank. The sum involved was not large. Hoult made little of it when introducing the report to the Bank on 18 April. I do not regard this as of major significance. But $50 million is not a negligible sum even in a large bank and any false entry must be a source of concern unless and until fully explained. It is no doubt possible, but not very likely, that these entries were false although not deceitful.

2.185 More significant, in my opinion, is the suggestion that management and customers had colluded to deceive the auditors about the ownership of a substantial bloc of BCCI shares, in fact thought to be owned by BCCI itself and ICIC. It is hard to see how the management's representations on this point, if misrepresentations, could have been innocent.

2.186 On 19 April 1990 PW handed over two copies of this report to Beverly and Miss Jones. On 20 April 1990, at Beverly's request, they sent copies to Quinn and Barnes at the Bank. They accordingly assumed that the inferences to be drawn from the report, as they thought clearly, would be drawn by the Bank. This was not what happened. Although Beverly read the report and found it a "shock" and a "devastating report to read", it is questionable whether he drew from it any inference of deception or malpractice. Barnes, if he read the report at the time at all, read it briskly and understood it to concentrate on the financial problem outlined by PW on 18 April 1990. Quinn saw the report at the time and appreciated it disclosed a serious financial crisis, but may not have read the whole of the text very carefully and the report raised no real doubt in his mind about the integrity of Naqvi and Abedi. The note of PW's visit on 2 March 1990 (paragraph 2.169 above) was copied to Quinn in early May 1990 as part of a long series of minutes, but he did not then read it, feeling that it had been overtaken by events.

2.187 The Board of Banking Supervision (including the Governors) were in due course told of BCCI's financial problem and the solution found to it. But no mention

was made, formally or informally, of the existence of PW's report of 18 April or its contents. Thus in April 1990 (and for a number of months afterwards) the Governors, the Board of Banking Supervision, Quinn and Barnes were unaware of the serious doubt thrown by PW on the integrity of the bank's most senior management.

2.188 The question has been raised whether the Treasury and Treasury ministers were informed at about this time of the suggestions of deception and malpractice raised by PW in this 18 April 1990 report. I have questioned most of those involved (both in the Treasury and the Bank) and am certain the Treasury and Treasury ministers were not informed. No one suggests they were; and those at senior levels in the Bank who would have given the information could not have done so, since they did not know themselves.

25 Abu Dhabi interests

2.189 When still an officer of the United Bank of Pakistan, and perhaps even earlier, Abedi had earned the respect and support of His Highness Sheikh Zayed Bin Sultan Al Nahyan, President of the United Arab Emirates and Ruler of the Emirate of Abu Dhabi. As a result, the Ruler and his son, the Crown Prince of Abu Dhabi, became early, although minor, shareholders in BCCI at the behest of Abedi. In 1981 the Abu Dhabi Investment Authority, again at Abedi's behest but not without some divergence of opinion in Abu Dhabi, also became minority 10 per cent shareholders. At that point HE Ghanim Faris Al Mazrui became the Abu Dhabi shareholders' representative on the boards of Holdings, SA and Overseas. The Inquiry was told, and accepts, that the Abu Dhabi shareholders had very little involvement in and acquired very little knowledge of the detail of the group's business. Mazrui himself was one of a relatively small group of influential Abu Dhabi citizens who between them held, as they still do, many important offices and discharged many important responsibilities. Mazrui himself had responsibilities for the Central Bank of the UAE, the Department of Private Affairs of the Ruling Family and the Abu Dhabi Investment Authority. He was not a banker, and there is no reason to think that his understanding of BCCI's affairs was other than superficial.

2.190 When, in the spring of 1990, it was plain that BCCI faced financial disaster, Naqvi appealed to the Abu Dhabi shareholders to rescue the group. He admitted to them that the group had made large losses. An attempt to staunch these losses by Central Treasury dealing had, he said, led to even greater losses. To try and prop up the bank he and Abedi had misappropriated funds amounting to $2.2 billion from the Ruling Family's portfolio which they managed. It seems clear that this misappropriation was admitted by Naqvi, and understood by the Abu Dhabi shareholders, to have been dishonest. But Naqvi pleaded that BCCI was basically a sound and profitable enterprise and begged the Abu Dhabi shareholders to support it.

2.191 Naqvi's revelations did not end there. He disclosed a sum of $570 million, which was itemised, as being due to outside parties. This item appears to correspond, at least in part, with what were later described as unrecorded deposits, although they were not so regarded in April 1990. A sum of $130 million was said to be due to two other named banks on account of two BCCI customers as nominees. A list was also given of loans in BCCI in nominee accounts. These amounted to $340 million, and names were given. All these sums were described as payments to be made to sources from which the group's loss had been financed. They amounted in total (including the portfolio claim) to $3.24 billion.

2.192 Reference was also made to payments due to be made from the sale of 20 per cent of BCCI shares. These payments amounted to $800 million, of which (it was said) $295 million had already been paid from a suspense account.

2.193 Naqvi also attributed the losses to various causes, breaking down the cost between principal and interest. In brief summary the effect of his disclosure was as follows:

Cause of loss	*Principal*	*Interest*	*Total*
	(figures in $ million)		
Treasury loss	630	580	1210
Shipping group*	600	730	1330
Adjustment of non performing loans	350	150	500
Carrying cost of nominee shareholdings and maintaining profitability of portfolio	125	75	200
	1705	1535	3240

*excluding proposed provision in 1989 accounts.

Naqvi made plain that these figures were estimates and that a detailed exercise would be needed to achieve more accurate figures.

2.194 It is not the practice in the Gulf to make notes and records of meetings or to record personal exchanges by letter. Reliance is instead placed on oral communication and personal contact. There is thus no record of what Naqvi disclosed beyond a three page handwritten summary said to be in Naqvi's own hand. The effect of that summary has been given above.

2.195 The Abu Dhabi shareholders, in particular Mazrui, have told the Inquiry that all these losses, with the exception of those relating to the Ruling Family's portfolio, were presented to, and understood by, them as the result of unsuccessful banking and not of dishonesty. In the absence of any contemporary record beyond Naqvi's summary, it is hard to evaluate this contention. The summary itself, although strongly suggestive of fraud, is perhaps not conclusive (and it contains no admission of dishonesty). The Inquiry has not gained access to Naqvi, who is under restraint in Abu Dhabi. Mazrui's own understanding is not easy to assess. The Abu Dhabi authorities are not, however, untutored innocents in the world of international finance, and I cannot think they were as greatly deceived as they suggest.

2.196 The Abu Dhabi authorities had very little time to decide whether they would rescue the bank, which they were not obliged to do. There was no time to explore the details underlying Naqvi's estimates. The decision was taken to support the bank to the extent which PW advised to be necessary. The communication of that decision is described in paragraphs 2.199-2.200 below. Unhappily, the Abu Dhabi shareholders did not at the same time communicate to either the supervisors or the auditors even the outline of what Naqvi had revealed to them. It was to be nine months before the misuse of the Ruling Family's portfolio became known to PW and the Bank. I have to regard this as a serious and potentially influential omission, even if the Abu Dhabi shareholders' understanding was as they say. They point out (quite correctly) that Naqvi's estimates were unverified and unsubstantiated, and suggest that they viewed them with some scepticism. I find this unconvincing. The detail was certainly unclear, but it is hard to see why Naqvi, a suppliant for financial help, should have painted the picture as worse than he believed it to be. In any event, there was no good reason for not passing on the effect of what he did say. Had the full facts known to them been communicated to PW and the supervisors in April 1990, it seems likely either that all concerned would have embarked on a group restructuring programme with a much fuller investigation and understanding of the malpractice which had existed in the past and of the level of support required, or that the bank would have been closed or would have collapsed there and then.

26 The finalisation of the 1989 accounts

2.197 The period from 20 to 30 April 1990 was one of intense activity, which will here be briefly summarised.

2.198 On the morning of 20 April a meeting was held in Luxembourg between the board, BCCI management and PW. Among the board members attending was Mazrui. The BCCI management team included, for the first time at this level, Mr Zafar Iqbal, formerly the manager of BCC Emirates and believed to be close to the Abu Dhabi shareholders.

2.199 At this meeting Mazrui produced a letter signed by HE Habroush Al Suwaidi, chairman of the Finance Department of the Abu Dhabi Government. The letter said that the Government would acquire 20 per cent of the shares of Holdings from an existing shareholder and would subscribe $400 million in cash for new shares. It was hoped this support would enable PW to sign the 1989 accounts. This acquisition would give Abu Dhabi interests a 77 per cent stake and steps to reorganise the group were envisaged. There was a lengthy discussion during which PW referred to the areas of continuing uncertainty (particularly about CCAH and Gokal) and Mazrui made clear the Government's intention to support the Bank, while declining any formal, written guarantee.

2.200 In the afternoon the board, the BCCI management and PW were joined by the Bank and the IML. The Government's letter was read again and the morning's discussion summarised. PW referred to the areas of continuing uncertainty and indicated the need for a commitment by the Government that if large provisions were required in future it would ensure that these did not impair the capital of the bank. Mazrui repeated in effect the assurances given in the morning. The supervisors made plain that they wished the accounts to be published with an unqualified opinion as soon as possible. They were, however, well aware that even if the accounts were finalised there were urgent outstanding issues which would have to be resolved. When Beverly and Miss Jones returned to London they briefed Quinn and Barnes on the Luxembourg meetings.

2.201 PW were concerned that the Government should not commit itself to support of BCCI without a full understanding of the unresolved issues about which uncertainty remained. They accordingly drafted a letter outlining all the areas then known to them and showed this draft to Iqbal, who appeared to have superseded Naqvi in the day to day management of the group. Iqbal said the Government were fully aware of all the matters raised in the letter: Naqvi, he said, had been completely forthcoming, both with him and the Ruling Family, and had told the whole story, certainly more than was discussed in the letter. He described how the problems (particularly the Gulf lending) had arisen years earlier, and kept snowballing ever since. PW showed Iqbal their proposed audit opinion but he was anxious that the Abu Dhabi shareholders' support should not be mentioned, even by reference, in the audit opinion. This was a position he maintained with some force over the next few days.

2.202 The Bank wished to be sure that the Abu Dhabi shareholders were aware of all outstanding issues and prepared to rectify them within the year. To this end Habroush invited Bank representatives to visit Abu Dhabi at once, and arrangements were put in train for Beverly and Miss Jones to travel to Abu Dhabi. It was, however, decided that such a visit was inappropriate, and it was decided that a letter should be written instead.

2.203 PW's letter outlining the remaining areas of uncertainty was handed to Iqbal, who delivered it to Habroush with a copy for Mazrui. The letter recorded Mazrui's confirmation that the Government was fully aware of the nature and magnitude of the uncertainties and was prepared to provide the necessary financial support in the event that losses arose from the realisation of the loans referred to. The Bank's letter referred to outstanding issues which could not be resolved before finalisation of the year-end accounts, and asked Habroush to confirm the Government's awareness of all the matters mentioned in the letter and its intention to take the necessary remedial action during 1990. Iqbal delivered this letter to Habroush and returned from Abu Dhabi with a copy endorsed "Received", with the signature of Habroush and the date. Iqbal said Habroush had received both letters but nothing in either of them was new to him. He had agreed that the level of provisions should be raised from $500 million to $600 million.

2.204 Representatives of the Bank and PW returned to Luxembourg on 30 April 1990. Their first meeting was with the IML. The new capital of $400 million had at this time been subscribed and the purchase of the 20 per cent shareholding effected. The implications of the Gokal lending for the control of the group's loan portfolio were considered, but it was felt that the implications were limited because only 5-10 people at most had been involved in successfully disguising the true extent of the lending. PW said they had had no access to Kifco, which they believed to be totally funded by BCCI, and they thought the 51 per cent Kuwaiti shareholding might be a front. PW had had similar difficulty gaining access to the Banque de Commerce et de Placements (BCP), in which BCCI had a minority interest, but understood there was only one common customer. At a later meeting, attended by BCCI management, PW said they would be able to sign the accounts if they received various confirmations from the board and management. Asked about restructuring plans, Naqvi said that a restructuring committee (headed by Iqbal) had been established.

2.205 A board meeting held on 30 April was attended by PW. Mazrui was one of the directors present. A representation letter was adopted by the board and signed by four members of the management including Iqbal and Rahman (but not Naqvi to whom PW objected as a signatory). The letter represented that full disclosure had been made and that loans amounting to nearly $1 billion, although not confirmed, would prove substantially realisable.

2.206 The accounts of Holdings were signed during the board meeting. They showed a loan loss provision of $600 million and a loss for the year of just under $498 million. Note 1 to the accounts read as follows:

> "Basis of Preparation
>
> Since December 31, 1989 the Government of Abu Dhabi has subscribed $400 million for new shares and acquired a major holding from an existing shareholder such that together with related institutions they now hold over 77 per cent of the share capital of the holding company.
>
> They have advised the directors of their intention to maintain the group's capital base whilst the reorganisation and restructuring necessary for its continued development is undertaken."

The audit opinion read:

> "We have audited the consolidated accounts of BCCI Holdings (Luxembourg) SA . . . . in accordance with International Auditing Guidelines. These accounts have been drawn up on the basis described in Note 1.
>
> In our opinion the consolidated accounts give a true and fair view of the financial

position of the group at December 31, 1989 and the results of its operations and changes in financial position for the year then ended in accordance with International Accounting Standards."

As originally drafted, the second paragraph of this audit opinion had begun "On this basis, in our opinion the consolidated accounts . . . .". In order to meet Iqbal's objections, PW agreed to delete the opening phrase "On this basis", which they did not regard as adding anything of significance.

2.207 The period leading up to finalisation of these accounts, as evidence of Naqvi's dishonesty began to emerge and the group's precarious financial position became apparent, was an anxious one for the Bank and PW. The Bank made it clear to PW that it did not want them to resign as auditors (which was not seriously considered at that stage), that it would support them in holding out for proper provisions and that it wanted a clean audit opinion. PW appreciated the strength of these messages but also appreciated that the final decision whether they should qualify their opinion on the accounts, and if so in what terms, was one for them in the exercise of a proper professional judgment. They had specifically identified certain areas of uncertainty to the majority shareholders, who had undertaken to make good any losses arising in those areas. As a result of their investigations they felt they could effectively eliminate the possibility of significant losses arising in other areas, but in any event understood the majority shareholders to have undertaken to cover such losses if they did occur. Given the support of the majority shareholders, they did not doubt that the group was a going concern and did not conceive themselves to be dealing with a case of uncertainty in that respect. They believed that the accounts presented a true and fair view of the group's financial position. They did not regard a more explicit note as being necessary or negotiable: had they insisted on it, the majority shareholders' support would not, as they thought, be forthcoming. If that support were not forthcoming for that reason, of if PW were to qualify their opinion or disclaim an opinion, they regarded the collapse of BCCI as the inevitable result, with the loss to depositors which would necessarily follow. PW felt that they would be open to justified criticism if, in those circumstances, they were seen to frustrate an offer of support which would be of benefit to depositors, creditors and employees.

2.208 This audit opinion of PW, read with the accompanying note, has been the subject of considerable public discussion. That they genuinely considered it (and still consider it) a proper opinion to give I do not doubt. Some of the arguments in support of that view have been mentioned. There are others. Neither the supervisors nor the majority shareholders were in any way misled, since they very well understood the basis on which the accounts were signed off. It cannot be said that the accounts painted a rosy picture, with a loan loss provision of $600 million, a loss of $498 million and a clear reference to the rescue of the group by the Abu Dhabi Government. Since the assets, to the extent they proved to be worth less than their face value, were to be made good by the majority shareholders, the overall net worth or capital base in the accounts was reliable. I take the competing approach to be that a reader of company accounts is not only interested in the capital base. If assets shown at a certain value in the balance sheet are known to be of such uncertain value that their face value may be maintainable only by the provision of funds from an extraneous source, that tells a story about the management of the business to which a reader of the accounts is entitled to be alerted. Bad though the picture painted by the accounts might already be, the picture was in reality even worse, because the management might very well have made substantially greater losses in running the business than the accounts disclosed.

2.209 I see considerable force in this second approach. Anyone who knew of the continuing uncertainty about some of the major loans would have taken a more jaundiced view of the group's performance than someone who did not, however cast-

iron the Government's support. It seems undesirable that information of this kind should not be available to ordinary readers of the accounts (whoever they may be) but only to those who are in the know. The adverse consequences of making a disclosure, otherwise proper, surely cannot be a reason for not making it. But I am not at all sure that this second approach currently commands general support among the accounting profession or the general public. I rather doubt if other auditors, similarly placed, would have acted very differently. It may be that existing principles and practice cover this difficult situation, but I am not persuaded of that.

2.210 The rescue of the group by the Abu Dhabi Government came as a very considerable relief to the Bank, the IML and PW. The danger of imminent, disorderly collapse was averted. The group had gained what it had always lacked, a clear shareholder base and a dominant majority shareholder with resources to act as lender of last resort. There were financial, managerial and structural problems to be resolved, but the immediate future appeared more hopeful. It is, however, unfortunate in retrospect that the supervisors did not, at this critical juncture in BCCI's affairs, seize the opportunity to establish direct personal contact with the top levels of the Abu Dhabi Government: had senior representatives of the Bank and the IML succeeded in discussing the existing situation and the future at this stage, all involved might have had a clearer understanding of the others' position over the months ahead and it is to be hoped that more detail of Naqvi's revelations would have emerged.

2.211 The majority shareholders have criticised the significance attached by the Bank and PW to letters sent to the majority shareholders, one of them marked "Received", the other not acknowledged at all. To an Arab, it is said, no significance is attached to an unanswered letter, let alone any inference that the contents are accepted. I do not doubt that, in ways like this, differences of business practice exist between the West and the Middle East, but I do not think they are of great importance in the present context. PW's letter was largely informative. The Bank's letter was asking the Abu Dhabi shareholders to do what they already intended to do. The Inquiry has not been referred to anything in either letter which the majority shareholders would have wished to challenge.

27 April-June 1990

2.212 The acquisition of majority control by the Abu Dhabi Government had two immediate results. First, it caused the Bank to reconsider its longer term plans for undertaking the consolidated supervision of the group. It now appeared that Abu Dhabi was the natural home of the group. It therefore seemed appropriate that the group should be based, and consolidated supervision conducted, there. But there were two problems. There were doubts about the capacity of the UAE Central Bank to conduct the consolidated supervision of the group. And, more seriously, there were indications that the group would not be permitted to establish itself in Abu Dhabi. Given the identity of the majority shareholders, however, the supervisors were inclined to think that this second problem could be overcome if the will to do so were there. The second immediate result of the acquisition was the implementation by the majority shareholders of a programme to rationalise the operations of the UK Region: this involved large reductions in the number of branches and employees, in order to save costs and put the operations on an efficient, commercial footing.

2.213 While reconsidering its longer term plan to act as consolidated supervisor, the Bank still favoured a UK subsidiary to conduct the business of the UK Region, in order to protect the UK depositors. But the wider structure of the group remained unclear, and became still more so when, in early June 1990, the IML gave BCCI notice that it was to leave Luxembourg within twelve to fifteen months. The Bank then faced a rather confusing impasse: the group had to leave Luxembourg, but could not apparently go to Abu Dhabi. The supervisors appear to have felt that it was for BCCI to produce a solution.

2.214 A College meeting was due on 19 June 1990. In the week before, PW told the Bank of their strong view that Naqvi should not attend it because he was not fit and proper and they urged the Bank to exert its influence to secure a new chief executive and a new board of directors. On the eve of the meeting they repeated their concern at the lack of progress with reorganisation and at the proposed attendance of Naqvi.

2.215 When the College supervisors met on 19 June 1990, the IML announced its twelve month ultimatum to BCCI to leave Luxembourg. The Cayman supervisor said that if SA had to leave Luxembourg, Overseas would not be permitted to stay in the Caymans. The Bank's objectives were stated to be: a clear legal structure reflecting the new principal shareholding; the need for consolidated supervision; and the continuation of the College, to help the UAE Central Bank in supervising an Abu Dhabi registered bank. At the plenary session of the College (not attended by Naqvi), Iqbal outlined the group's plans for reducing its worldwide operations, including withdrawal from Colombia and other Latin American countries. The IML reiterated its twelve month ultimatum. It was agreed that at the next meeting PW should report on the issues left open when the 1989 accounts had been finalised, in particular accounting policies, concentration of risk and shareholder lending.

2.216 Following the meeting a letter was written calling on the group to submit detailed restructuring plans for consideration at the next meeting of the College in October. The College specified the conditions which were to underlie the proposals, in particular a clear and simplified group structure reflecting the principal shareholding of the group and arrangements for practicable and effective consolidated supervision.

2.217 Conditions of this kind were relatively easy to state. They would, as the supervisors knew, be much less easy to meet. More progress might, I think, have been made had senior representatives of the supervisors made personal contact with senior representatives of the Abu Dhabi Government.

28 Mr Ambrose

2.218 Mr Vivian Ambrose was a well-qualified inspector employed by BCCI. In the summer of 1990, when SA's operation in the UK was reduced in size, he was made redundant. He thought he had been singled out for redundancy because, in the course of his job, he had not hesitated to point out abuses and irregularities he had encountered. The redundancy terms BCCI offered were considered by Ambrose and other redundant employees to be very ungenerous.

2.219 On 12 June 1990 Ambrose wrote to the Secretary of State for Employment, complaining of BCCI's redundancy terms and making serious but very general allegations about the conduct of BCCI's business. The Department does not appear to have received this letter.

2.220 Having spoken to the Rt Hon Tony Benn MP, Ambrose wrote to him enclosing a copy of his letter to the Secretary of State. In his letter to Benn, Ambrose criticised BCCI's redundancy package but also criticised the conduct of BCCI's business in strong terms. Benn's office sent both these letters to the Chancellor of the Exchequer. At the Treasury, the Ministerial Correspondence Unit understood the letters to touch on a Department of Employment responsibility, and by arrangement with that department the correspondence was transferred there for an answer.

2.221 The Secretary of State for Employment replied to Benn, regretting that he could not intervene in a redundancy matter where there was no failure to comply with the statute, but saying that the correspondence would be copied to the DTI. It was felt that general allegations of fraud and breach of company law were a matter for the DTI, and it was not noted that the complaint related to an institution which was the supervisory responsibility of the Bank. The correspondence was never sent to the DTI.

2.222 Ambrose wrote letters to a number of other public figures, some of whom replied but none of whom was able to offer him substantial help.

2.223 On 16 July 1990 an anonymous document entitled *"The BCCI Mystery"* was delivered to the Bank. Ambrose knew of the document but was not the author of it. It made serious criticisms of BCCI and PW. The Bank referred the document to PW for investigation. Some of the allegations in the document were familiar to them. Others they regarded as scurrilous. They thought it was the work of a disgruntled redundant employee and its anonymity made it hard to investigate.

2.224 This brief story clearly has some unsatisfactory features. If Ambrose's first letter to the Department of Employment was ever sent, it should have been received. Benn strongly feels that a letter from a Privy Councillor and Member of Parliament to a minister should receive a reply from the minister to whom it is addressed (I understand that decisions on transfer are now made by the appropriate Treasury Division and not by the Ministerial Correspondence Unit). The copies which the Department of Employment intended for the DTI should have been sent (I understand procedures have now been tightened) and the responsibility of the Bank should perhaps have been appreciated or ascertained. It is unfortunate that the serious, although general, allegations made by Ambrose were never investigated. But I very much doubt whether these omissions affected the course of events. When Ambrose was interviewed by HM Customs in July 1990 he could give no specific information about money-laundering. When questioned by the Inquiry he was able to particularise a number of abuses and

irregularities he had encountered as an inspector in the UK, but he had no first-hand knowledge of the frauds which brought down the group. He does, however, illustrate one of the difficulties which the auditors and the supervisors generally faced in dealing with BCCI: the high degree of loyalty it commanded from its staff, particularly those from the Indian sub-continent. Ambrose was critical of BCCI's business methods in a number of ways, but never voiced those criticisms to the auditors or anyone outside the group until after he had become redundant. Nor did his colleagues. The Informant was an exception.

29 The summer of 1990

2.225 In the period between the College meetings in June and October 1990 Hoult and Cowan, the two most senior partners of PW with responsibility for the audit of BCCI, paid three visits to Abu Dhabi. The history can be conveniently summarised in three phases, each culminating in one of these visits.

Phase 1

2.226 After the June College meeting, PW took up with Iqbal their long-standing concern about ICIC and its relationship with BCCI. Iqbal said he had been instructed not to involve himself with ICIC and referred PW to the Crown Prince, Habroush or Mazrui.

2.227 PW wrote to Iqbal on 11 July listing in order of priority the issues to be addressed by the BCCI group: completion of the relocation to Abu Dhabi (the Central Support Organisation being already planned to move); development of a business strategy; and restructuring of the corporate and management organisation. The IML reinforced this message, reminding the group yet again of the twelve month ultimatum. On 18 July 1990 PW wrote to BCCI listing all the matters on which they were required to report to the College in October.

2.228 When the Board of Banking Supervision met on 12 July 1990 there was general concern among officials and independent members at the lack of communication with the shareholders. Doubts were expressed whether they had really understood the College's message. There was felt to be a need for direct communication.

2.229 This was a view which PW very strongly shared. They had been seeking a meeting, unsuccessfully, since April. But learning that Habroush was in London they persuaded him to see them and a meeting was held on 18 July 1990. It was a somewhat difficult meeting. Habroush spoke of BCCI's problems, of which he had been aware in April when the Government (against his wishes) had increased its stake. He said the Gokal account went back to 1975 and had been manipulated ever since. He spoke of CCAH as the American bank partly owned by BCCI; in his view the shares were held by nominees. In reality, he said, BCCI had never made a profit. Habroush was scathing about the board, whom he described as ineffective puppets. He accepted responsibility for the new BCCI management team, but regarded the bank as it stood as unmanageable; it would have to be dismantled by closing down operations or selling them. Habroush expressed criticism of the supervisors' conduct and PW urged him to speak directly to Quinn. According to Habroush, PW asked if the Bank should be told about the problems they had discussed, and he said that it should; the Bank should know everything. When PW raised their concerns about ICIC, Habroush referred them to Mazrui.

2.230 After the meeting with Habroush, Hoult and Cowan flew to Abu Dhabi. They met the chairman of BCC Emirates and also HE Jauan Salem Al Dhaheri, under secretary at the Abu Dhabi Finance Department. On 24 July they wrote to Habroush urging the appointment of a new board and chief executive and recommending discussion with Quinn at the Bank.

2.231 BCCI were meanwhile seeking to promote their plans for a UK banking subsidiary. The Bank found it hard to respond without knowing more of the proposed group structure.

Phase 2

2.232 On their return from the Gulf, Hoult and Cowan called to see Barnes, Mr John Bartlett (who had recently succeeded Beverly as a deputy head of Banking Supervision) and Miss Jones. PW were becoming frustrated at the lack of progress towards restructuring. They were particularly concerned at the lack of a properly constructed board and a firmly appointed chief executive. They thought progress might be made if Habroush and Quinn were to meet, but Barnes referred to the "political" difficulty of a meeting on Habroush's home territory. The Bank envisaged a series of meetings, all of them in London. PW felt (in my view rightly) that questions of protocol were impeding the despatch of business.

2.233 The Bank shared PW's view that a number of questions called for urgent resolution, and when Iqbal and Mr A Chaudhry visited the Bank on 2 August 1990 they had some progress to report in appointing divisional and regional heads and preparing premises in Abu Dhabi for the Central Support Organisation. But no decisions had been made on the board and the chief executive because the Ruler, the Crown Prince and Habroush had been travelling (the latter was still in London) and no decisions had been made on structure or group domicile. Barnes welcomed the limited progress made and reminded Iqbal of the IML ultimatum; he could not hold out hope that the group might migrate to the UK. It was agreed that a meeting with the shareholders would be helpful, and a meeting with Habroush was suggested. That, however, was thwarted by the Gulf War: the Iraqi invasion of Kuwait had taken place that morning. The representatives of the Abu Dhabi shareholders who were engaged in planning the future of BCCI were also heavily involved in co-ordinating the Abu Dhabi contribution to the allied war effort. The multiple demands made on a relatively small group of influential Abu Dhabi citizens (paragraph 2.189 above) were increased still further. It is not altogether surprising that questions of life and death pushed the affairs of BCCI into second place. But that made it the more necessary to exert effective pressure for results.

2.234 PW acted on the suggestion that they take up the question of ICIC with Mazrui. They wrote to him on 31 July, 7 August and, later, on 19 September. They received no direct reply.

2.235 When the Board of Banking Supervision met on 9 August 1990 there was concern that the Gulf War might deflect the attention of the Abu Dhabi Government from BCCI, and a feeling that the Bank should perhaps apply more pressure to BCCI so that relocation was completed within a specified period. Barnes said Habroush was very willing to meet someone from the Bank in Abu Dhabi but there were "presentational difficulties about us going there". The Deputy Governor, who was presiding, discounted these so-called presentational difficulties, but no plan was made to accept Habroush's invitation. I think this was unfortunate. City tradition is that the world attends upon the Bank. This is, no doubt, a beneficial tradition. But the Bank was dealing with a proud and independent Government not reared in this tradition and in the throes of a serious local crisis. There was an urgent need, in the interests of UK and other depositors, to impress on the Government the finality of the IML ultimatum and the necessity to find a solution. As it was, no meeting was achieved between the Bank and Habroush before BCCI was closed, although there were meetings with Mazrui and Salem.

2.236 Cowan returned from holiday in early September 1990 to find little progress in his absence. In the second week of September, Hoult and Cowan returned to Abu Dhabi. They had an easier meeting with Habroush, who was critical of Mazrui's past role as representative of the shareholders and of the existing board. He wanted to keep the Bank as lead supervisor, if possible. Both Habroush and Salem (who was with him) wanted to identify those responsible for the wrongdoing in BCCI but did not want an investigation to result in criminal action damaging to the bank. PW advised that the

shareholders should themselves conduct the investigation. Habroush and Salem were concerned about the uncertain size of BCCI's financial problem, on which PW could offer little comfort. Habroush wound up by saying that the Government were committed to supporting the bank.

2.237 PW also met Salem alone to discuss a letter PW were (at his invitation) to write to Habroush. Hoult advised Salem to arrange a high level meeting with the Bank. They also discussed an investigation of the problem loan accounts, recruitment of a chief executive and a shareholder loan which remained on BCCI's books despite Abu Dhabi's purchase of the shareholder's shares.

2.238 PW's letter of recommendation to Habroush was dated 11 September 1990. It covered directors and management, pointing out that Naqvi would be unacceptable to the supervisors or PW; business strategy; head office location, legal structure and regulation; the investigation of problem accounts, advising the formation of an independent task force including representatives of the shareholders and PW; and profitability, warning that losses for 1990 could (with loan loss provisions of $550 million) amount to around $800 million. In conclusion, PW recommended that the search for a chief executive and the establishment of the task force should be treated as priorities.

Phase 3

2.239 Iqbal and Mr Basheer Chowdry (the UK General Manager) called on Barnes and Miss Jones on 19 September. Iqbal was able to report progress in agreeing priorities with the majority shareholders but no progress towards solutions. In a letter of the same date, PW warned Iqbal that, although the figures were uncertain, they assessed the likely loss for 1990 at $1.255 billion. They also pointed out that the issues left unresolved in their 18 April report were still largely unresolved; in addition, there had since then been additional transactions on which PW had no information.

2.240 A meeting was held on 20 September 1990 to discuss PW's letter to Mazrui of 19 September about ICIC (paragraph 2.234 above). PW then learned that the loans made to minority shareholders had not been paid off when their interests were acquired in April. This was contrary to PW's understanding of what had been intended, although Iqbal challenged any such understanding.

2.241 The Bank's first meeting with a representative of the majority shareholders (save for Mazrui's attendance at the Bank's meeting with the board in September 1983 and at the Luxembourg meeting on 20 April 1990: paragraphs 2.40 and 2.198 above) took place on 24 September 1990, when Salem, accompanied by Hoult and Cowan, called on Barnes, Mr Richard Diggory and Miss Jones. At this meeting Salem revealed, for the first time, a scheme of the majority shareholders for reorganising the group into three banks, a European bank based in the UK, a Middle Eastern bank based in Abu Dhabi and a Far Eastern bank based in Hong Kong. But they did not envisage relocation of the holding company. On the overall structural question the discussion reached an impasse. Barnes argued strongly for an Abu Dhabi home for the group, pointing to the IML's acute awareness of its incapacity to supervise the group. Salem was adamant that the Government had no intention of moving the group's place of incorporation to Abu Dhabi because the Central Bank also lacked the capacity to supervise it. The meeting ended in a polite, but complete, stalemate.

2.242 Iqbal had indicated that he wished to tell PW all he knew about problem loans, and a meeting for that purpose was arranged on 26 September 1990. He then reviewed, in turn, the major areas of concern, painting a very gloomy picture. Gulf, for example, was not in his view viable: it would not survive if PW pressed even for payment of interest, and he thought an extra provision of $370-$380 million was needed. Other

substantial provisions were also required. But the most disturbing revelation was of a loan recently increased to $514 million, nominally to a third party bank, but in truth an indirect loan to certain CCAH shareholders and another. PW were shocked to learn of these new facts, because of the figures involved, because Iqbal had apparently not been free to make the revelations before and because of the deception apparently involved. PW once more feared for the survival of the bank and thought it necessary to see the majority shareholders again urgently. So Hoult and Cowan returned to Abu Dhabi on 29 September 1990. They told the Bank they were going, but not of the reason for the visit beyond referring to financial problems: asked for a ball-park figure, they thought that the shortfall on certain assets might be $1.5 billion, which would be needed in the form of new capital, the take-out of certain loans by the shareholders, provisions and guarantees.

2.243 In Abu Dhabi PW first met Iqbal, to whom they said that there were three critical issues which had to be dealt with before the College meeting on 3 October:

(i) The Government of Abu Dhabi must give a clear and substantial commitment of its support to the Bank.

(ii) The extent of the falsification of the bank's accounting records must be properly established. The regulators would feel bound to investigate if the bank did not.

(iii) Naqvi must be removed as chief executive officer.

Iqbal fully supported (ii) and (iii). The major issue in his view was whether BCCI was viable in the long term: if so, the problems should be resolved; if not, it should be wound down in an organised way and the depositors paid off. There was some discussion of particular problems: Iqbal said he had been aware of most of the problems from Naqvi before 18 April, although there had only been an allusion to the $514 million placement.

2.244 When the PW partners saw Mazrui on 1 October he fully supported PW's three requirements, while saying that he himself was not in a position to take decisions on the way forward. He had become aware of most of the issues facing the bank but was not in a position to know how many of the loans would be recoverable.

2.245 On 2 October PW discussed their draft report of 3 October 1990 with Salem. He wanted management changes at once, but Cowan pointed out the difficulty of attracting suitable people until they could be assured that all the fraudulent and improper transactions within the bank had been dealt with. Salem's priorities were the removal of Naqvi and Abedi, the appointment of Government directors and a chief executive, the initiation of an investigation and CCAH. PW suggested that CCAH was not the only problem: ICIC and other related groups also called for attention. It was agreed that PW should present their views to Habroush, who would arrange with the Crown Prince for the provision of Government support.

2.246 Finally, the PW partners met Habroush, with Mazrui and Salem. PW put forward their three requirements in the same terms as before and there was discussion of the financial implications. PW estimated the need for direct support (by guarantee and funding by means of a bond) at a minimum of $2.5 billion, of which $1 billion was thought to be recoverable. In addition, loans amounting to $600 million were to be taken over for collection by the controlling shareholders, although Mazrui was not sure how much would be recoverable. There was general agreement on the need for an investigation and the removal of Naqvi and Abedi. It appeared that Iqbal would have to be acting chief executive officer *faute de mieux*. Habroush felt that now the size and complexity of BCCI's problems were known, a start could be made on finding a solution, and he saw no alternative to the Government bailing it out.

2.247 PW discussed with Iqbal a draft of their 3 October report, to which he strongly objected, but PW made no substantial change. To the Bank, Iqbal indicated that things were generally "moving satisfactorily". PW took a more serious view. They agreed with Salem that the bank's papers in London should be properly secured and there was discussion of securing Naqvi personally, although Salem thought this unnecessary. But PW did arrange surveillance of Naqvi's London house after the College meeting to detect any improper attempt to remove documents.

2.248 If the generally hopeful developments of April 1990 were to bear fruit, an advance on three fronts had been urgently needed: first, the outstanding financial issues had to be resolved; second, a new board and management untainted by past failures were needed; and third, a new and acceptable structure, permitting consolidated supervision, was called for. Five months (and a quarter of the IML's final year) had now elapsed. The financial problems had not been resolved but had increased in size and gravity. There was virtually no progress on the second issue and none on the third. It was not an encouraging picture.

2.249 Unhappily, both PW and the Bank were restricted in their understanding of the situation, by lack of communication. The majority shareholders had not told PW or the Bank of Naqvi's revelations, even as to the misuse of the Ruling Family's portfolio. PW for their part had not told the Bank of Habroush's remarks about manipulation of Gokal accounts, the ownership of First American by BCCI nominees and the failure of BCCI to make a profit (paragraph 2.229 above) or about Habroush's reference to criminal action against those responsible for wrongdoing (paragraph 2.236 above). Nor had they mentioned Iqbal's remarks on 26 September (paragraph 2.242 above) and the fact that he had not apparently been free to make these revelations before.

30 PW's report of 3 October 1990

2.250 PW's report to the audit committee of 3 October 1990 was, as they made clear, based on discussions with Iqbal and not on fresh audit procedures. In a covering letter they referred to significant transactions which they understood had been authorised by a representative of the majority shareholders. They also expressed their belief

> "that the previous management may have colluded with some of its major customers to misstate or disguise the underlying purpose of significant transactions."

They referred to uncertainties about the recoverability of major accounts and estimated that financial support of $1.5 billion was needed.

2.251 The report showed that certain major loan accounts which had totalled $3.56 billion at 31 December 1989 had by 31 August 1990 increased to $4.233 billion, of which $2.479 billion were thought to be recoverable. Contrary to previous representations to PW, loans to shareholders had not been repaid following the sale of their shares in April 1990. Certain major accounts were reviewed. On Gulf, management's recommendation that $369 million be provided was recorded. Attention was specifically drawn to the $514 million placement, which had reached that figure "by further drawdowns apparently approved by the Board and with the knowledge of the controlling shareholders", although PW had seen no evidence of that. The real purpose of the placement was stated. The shortfall in the value of the CCAH security was now estimated at $300 million, for which PW thought "the recorded shareholders" would be unlikely to accept liability.

2.252 The report dealt separately with loans to four sets of borrowers which the majority shareholders had said they would collect. These amounted (with interest) to $586 million, and were later known as "the $600 million loan portfolio".

2.253 A projected net loss of $311 million was shown for 1990, based on management accounts adjusted by PW but excluding the estimated provisions and the income and funding cost of the major loans. The pro forma financial statements at 31 December 1990 showed a need for additional provisions or financial support of about $1.5 billion. This assumed a transfer of loans amounting to $1.815 billion to the majority shareholders (with an estimated loss of $753 million), guarantees of $738 million being given by them and the $600 million loan portfolio being collected by them (with a need for additional provisions or guarantees to the extent that these loans were not collected).

2.254 PW delivered a copy of the report to the Bank on the morning of 3 October 1990. Later in the day, Hoult and Cowan called on Bartlett, Diggory and Miss Jones to discuss it. Hoult reported on the enormity of the expected loss, but thought the majority shareholders would provide support. The plans to remove Naqvi and Abedi, appoint Iqbal as acting chief executive officer and establish an investigating committee were disclosed. Mention was made of the $514 million placement discovered the week before which was said to have been "nodded through" the board. Hoult thought the financial problems could be tackled but there would be no strategic plans for group operations until a new board and a permanent chief executive had been appointed. He was concerned that the IML might take action which would prejudice the rescue of the bank.

2.255 Bartlett, who read the report, was understandably struck by the serious financial situation it disclosed. He did not at the time read the reference to collusion with major customers to misstate or disguise the underlying purpose of significant transactions as "a very strong suggestion of dishonesty", although with the benefit of hindsight he now does. He did not wonder why the recorded shareholders of CCAH were unlikely to accept liability for any shortfall, nor why the $514 million loan had been placed as reported.

2.256 This report was not widely circulated within the Bank. Neither Barnes nor Quinn saw it until after the closure of the bank in July 1991. The Board of Banking Supervision (including the Governors) learned that PW had reported further problems in the BCCI loan book and the possible need for further provisions, and were told of losses identified in PW's report on BCCI's financial position, but received no indication that PW had made a report which reflected in any way on the honesty of BCCI's business or the integrity of its managers. Of that the Board and Governors were entirely unaware. The Treasury and Treasury ministers received no information that the report had been made or of the financial and other problems it revealed, although the Treasury were told in the following spring of BCCI's need for large financial support.

2.257 I find it hard to understand why the fitness and properness aspects of this report made so little impact on the minds of those who did read it in the Bank. For any bank to be accused of colluding with customers to misstate or disguise the underlying purpose of significant transactions should be a very serious thing to a supervisor responsible for monitoring compliance with the statutory criteria. It is true this accusation was made against former management, the two most prominent members of which were about to be removed. But the increase in the $514 million placement was said to have taken place very recently with the approval of the board and the knowledge of the controlling shareholders. This was, moreover, disguised lending to CCAH borrowers, which was in itself suspect if borrowers were unlikely to "accept liability" for any shortfall in the value of the security. I would have expected an alert supervisor to wonder why these new problems had not been disclosed earlier and had only just come to light. He might also have wondered what other managers were implicated, since although Naqvi had the reputation of being a workaholic he could scarcely have run the bank single-handed. The answer is, I think, in October 1990 as in April, that faced with a financial threat to the survival of BCCI the Bank regarded fitness and properness considerations as secondary, particularly in the context of a group which (if it survived) was to be restructured and run by a new board and management. This is how the majority shareholders understood the Bank's reaction, naturally assuming that the Bank was alive to the implications of the reports. It was because the majority shareholders took this to be the Bank's position that they did not contemplate the possibility of supervisory action by the Bank against BCCI based on the past misconduct of former management, a state of mind which persisted until 5 July 1991.

2.258 In failing to appreciate and react to the implications of this report the Bank was in my view at fault. But it was not solely at fault. The report did not convey, in a blunt and unmistakable way, the full extent of PW's concerns following their conversations with Habroush and Iqbal (paragraphs 2.229, 2.236 and 2.242 above). Nor had the majority shareholders revealed the full effect of Naqvi's revelations in April (paragraph 2.190-2.193 above).

31 October 1990: The sixth College meeting

2.259 At its meeting on 4 October 1990 the Board of Banking Supervision was informed that PW had unearthed further problems in the BCCI loan book which might lead to substantial additional provisions and that the shareholders were understood to have indicated willingness to take these bad loans out of BCCI. No indication of fraud or malpractice was given. The Board did nonetheless consider whether BCCI's UK authorisation should not be reviewed. On the whole, opinion was against doing so since the shareholders had supported the bank in the past, the bad loans recently identified were in the Caymans and not the UK and the group had tightened its precautions against money-laundering. Had the independent members, the Governors and the most senior officials known of the malpractice revealed by PW's report of 3 October, and of the additional remarks made by Habroush and Iqbal (not reported to the Bank), I cannot think the Board's discussion would have ended there. Where it would have ended must now be doubtful.

2.260 I do not think that the Board, properly advised on the material known to the Bank, could have doubted that grounds for revocation (and therefore restriction) existed. But it would have been vividly aware of the hardship which revocation would necessarily cause and would probably have favoured the more constructive approach of procuring a recapitalised, restructured and cleansed group (probably including a UK subsidiary) within an extremely short period. What the Board would have decided must, of necessity, be a highly speculative question. But I question whether it would have been content simply to await the unfolding of events, and I think there would probably have been strong pressure for a very high level, face-to-face meeting with senior members of the Abu Dhabi Government to review the facts so far as known, to set a very clear programme for the future and to agree a timescale for its implementation. Failing a satisfactory outcome of such a meeting, I think the Board would have given very serious consideration, possibly to revocation and certainly to restriction. The Board did not, in my opinion, lack power to impose a solution and I think there would have been a strong view, particularly among the independent members, that the Bank should exert its supervisory muscle. As it was, lacking very significant information, the Board was unable to hold an informed discussion.

2.261 The sixth College meeting, held in Luxembourg on 5 October 1990, was chaired by Mr Jean-Nicolas Schaus of the IML. The sessions were dominated by two major issues: resolution of the financial crisis and the restructuring of the group.

2.262 At the supervisors' session, Bartlett voiced the Bank's concern over the size of the provisions needed (greater than the capital of BCCI) and the lack of control over the past six months, particularly in resolving the loan problems. Even with Naqvi and Abedi replaced, the Bank had worries whether the remaining management were fit and proper. Other supervisors shared these concerns, particularly over the size of the loss and the lack of management control. There was a strong view that cash should be injected, and Schaus insisted that there could be no relaxation of the Luxembourg ultimatum. When BCCI (including Mazrui and Iqbal) and PW joined the supervisors,

Mazrui produced a letter from the Finance Department of the Government offering support to the level indicated in PW's report, subject to a number of specified conditions. One of the conditions (Condition 1) was that the Government's support in respect of any transaction should cease immediately if such transaction had been undertaken in connection with fraudulent or criminal activities. This condition was included to preserve the Government's good name by avoiding its involvement as effective assignee of loans in transactions tainted by money-laundering, the financing of terrorism or illicit arms dealing. It was understood not to apply to the false accounting which was thought to have been perpetrated by Abedi and Naqvi (whose resignations the board had resolved to accept). The supervisors welcomed the Government's support, but in discussion there was emphasis on the need for an injection of cash and doubts were expressed about the effect of Condition 1. PW, asked for their view, said that previous senior management were not acceptable to them, and they emphasised the standing obligation of the Abu Dhabi Government to maintain the capital of BCCI. Mazrui accepted the obligation to put in new capital but said cash was not always available. It was generally agreed that the Government's proposals provided a hopeful way forward, but work was necessary to refine and formalise them.

2.263 When the supervisors, meeting alone, discussed restructuring, they had to acknowledge that they had no firm proposals before them, and the difficulty for BCCI of producing new proposals before a new board and chief executive had been appointed was recognised. This would require more time than the IML was allowing. Schaus pointed out that the structure of BCCI had been under discussion for ten years and he expected no relaxation of the ultimatum. When BCCI joined the supervisors, Iqbal pleaded for more time and flexibility but Schaus was adamant.

2.264 After the plenary session the supervisors discussed and drafted a letter to Mazrui, calling for urgent action to rectify the financial problems and the lapses of control reported by PW. The letter discussed various features of the Government's proposal (objecting to Condition 1) and pointed out the need for 1990 accounts acceptable to the auditors, the supervisors and the market, as well as reorganisation within the timescale stipulated by the Luxembourg authorities. The Holdings board meanwhile wrote to PW, expressing deep concern over the findings in PW's recent report and seeking urgent clarification.

32 October-December 1990

2.265 After the College meeting in October 1990 there were four major issues which called for urgent resolution. These were: finalisation of the package of financial measures by which the Abu Dhabi Government would support the BCCI group; recruitment of new directors and senior management; determination of the group's future structure; and investigation of the problem loans. Although work on all these issues to a large extent proceeded in parallel, it is convenient for purposes of this very brief summary to treat them separately.

The financial package

2.266 The details of this package were the subject of meetings and discussions involving the majority shareholders, PW, the Bank, the IML and Allen & Overy, solicitors whom BCCI instructed to advise on the package and prepare the extensive legal documentation. The Government reaffirmed its intention to provide necessary financial support, but there were problems to be resolved about the supervisors' desire for an injection of cash, and when PW on 3 December 1990 sent the Government a memorandum on the financial support package they warned of a higher operating loss for 1990 than previously estimated and raised doubts about the recoverability of the $600 million loan portfolio.

2.267 The IML, the Bank, BCCI and PW met in Luxembourg on 5 December 1990. It was agreed to commend the package to College members subject to one proviso, that the assignee of the loans secured on CCAH should not have the right to reassign them to BCCI if they turned out to be tainted by fraud or criminality. A letter was sent to College members along those lines. Iqbal meanwhile indicated an intention to try and increase the value of promissory notes to be issued by the Abu Dhabi Government to $2.4 billion to cover the $600 million loan portfolio, and he suggested that the CCAH loans might be covered by a side letter. The majority shareholders, however, had reservations about excluding these loans at all. Other members of the College were broadly content with the financial package, and Iqbal was so informed, although Schaus expressed regret that the losses were not to be made good by cash and said the CCAH loans should be excluded from Condition 1. Schaus also communicated the College view that a risk asset ratio of 8 per cent should be achieved by the end of 1991. Later in December 1990, the majority shareholders agreed on the terms of a side letter confirming that Condition 1 would not be exercised on the basis of any false accounting of which they were then aware.

2.268 This draft side letter was discussed with the Bank on 20 December 1990, when Bartlett expressed concern at the delay in completing the financial support package and wondered if the Government was seriously committed. The Bank was disappointed that no meeting with Habroush had yet been arranged, and would (he said) react most unfavourably if such a visit were not arranged in early January 1991. PW and Allen & Overy pointed to the substantial funds the Government had committed and was proposing to commit. Its reluctance to make an open-ended, legally binding, commitment to BCCI while investigations were still in progress was, they suggested, understandable. The general expectation was, however, that the financial package would be completed very shortly.

Recruitment

2.269 The search for a specialist to handle the recovery of outstanding loans, and for a potential chairman and board members of a new BCCI company in the UK, began at

once. Schaus called for the whole of BCCI's senior management to be changed, but Iqbal considered this unnecessary and unfair since Abedi and Naqvi had kept matters away from other managers and the staff culture was one of unquestioning obedience. In due course a senior recovery specialist was found and appointed. Concern was expressed at the continuing involvement of Naqvi, but his co-operation in unwinding and explaining the transactions he had handled was said to be necessary. Attempts to identify suitable non-executive directors continued, but the task proved very difficult. A distinguished international banker showed interest in appointment as chairman of BCCI UK, but also showed nervousness about the structure of the group, the quality of the balance sheet and the group's reputational problems in the US.

2.270 As 1990 ended, recruitment of new directors and managers (save for the recovery specialist) had advanced very little.

Structure

2.271 The Bank was aware of BCCI's proposal to form three banking subsidiaries based in London, Abu Dhabi and Hong Kong (paragraph 2.241 above), but this left an unanswered question where the holding company (and the consolidated supervisor) should be. The shareholders resisted incorporation in Abu Dhabi and both they and some of the supervisors resisted consolidated supervision by the Central Bank of the UAE. It was expressly recognised by the Bank that if no solution could be found revocation was the almost inevitable consequence.

2.272 On 23 October 1990 Iqbal confirmed that Abu Dhabi had been ruled out as a place of incorporation and raised, yet again, the possibility of incorporation in the UK. When Bartlett said that the holding company structure could not be based in the UK, Iqbal suggested that the three banks (London, Abu Dhabi and Hong Kong) should be free-standing, with no holding company. Bartlett agreed to consider this possibility.

2.273 Although the Bank felt that it was for BCCI to resolve the impasse over structure, and again recognised the possibility that the group might not survive, it did consider the three bank structure (with no holding company) and thought it potentially acceptable if the IML would allow enough time and if other important conditions were satisfied. The Board of Banking Supervision agreed that this possibility should be explored (in the hope that the IML might be persuaded to relax its deadline). Quinn tackled Jaans on this question over dinner on 15 November 1990, urging that relocation to the UAE, however desirable, was not achievable and that the current three bank proposal (subject to conditions) had merit. Jaans relaxed to the length of accepting that, if sufficient concrete progress on all the outstanding issues were demonstrable by June 1991, a short extension might be allowed.

2.274 On 26 November 1990 Barnes told Iqbal that the Bank would like to discuss this three bank proposal with the majority shareholders, suggesting a preliminary meeting with Salem, to be followed by a meeting between Quinn and Habroush. Iqbal was concerned at the constraint imposed by the IML ultimatum, but Barnes said the only answer was to demonstrate real progress.

2.275 On 27 November 1990 the Bank told PW of its agreement in principle to this three bank proposal. Barnes wrote to Salem to the same effect, also suggesting that Habroush, and other shareholder representatives if appropriate, should come to London to meet Quinn.

2.276 Salem called on Barnes on 6 December 1990. Restructuring was discussed. Salem was concerned about the IML deadline and asked whether the UK would accommodate the bank on a short-term basis. Barnes agreed to put the proposition to Quinn, and thought it would be helpful if Habroush were accompanied by other

representatives of the shareholders at the suggested meeting, for which a date in the second week of January 1991 was thought to be possible.

2.277 There had, in this modified three bank proposal, been advance towards a solution of the group's structural problem. But it was by no means an ideal solution because it did not offer the prospect of effective consolidated supervision. Supervisors of the three banks could only be content if satisfied that the three banks would be, in substance as well as in form, truly independent of each other; otherwise, most of the drawbacks of the existing group structure would remain.

Problem loans

2.278 An investigating committee was established in Abu Dhabi by the majority shareholders to unearth the facts about BCCI's problem loans. This was a constructive move, for which full credit should be given. It was to be chaired by Salem and include the recovery specialist plus representatives of the Government, the Abu Dhabi Investment Authority, the Department of Private Affairs and PW. It first met on 4 November 1990. At first the committee's staff was made up of PW members, but they were later joined by staff from Ernst & Whinney and Abu Dhabi interests.

2.279 The majority shareholders insisted that the investigation should be conducted in Abu Dhabi and little progress was made at first because the investigation team had access to no new information. A breakthrough came on 21 November 1990 when PW entered Naqvi's personal filing room. There they found about 6,000 files. Among them were thin clips of papers in plastic folders, many of which were in a fireproof cabinet. These contained evidence of major customers colluding with BCCI in the falsification of accounting through the use of nominee arrangements, hold harmless arrangements and the payment of fees to individuals to buy their co-operation with BCCI. It was evident that a number of old, very large, apparently irrecoverable loans were not simply the result of bad lending but were the result of collusion, through joint venture or nominee arrangements, with BCCI.

2.280 PW drew these discoveries to the attention of Salem on 16 December 1990, expressing disappointment at the level of concealment and deceit which the files were revealing and commenting on the "irrefutable" interdependence of BCCI and ICIC. Salem was pleased at the progress the investigation was making and wondered how the Central Treasury loss (said by BCCI to be $1.2 billion) had been funded. This was a figure very close to what Naqvi had revealed. PW reported two tranches of new lending, of which Salem was aware.

2.281 Both Salem and Habroush agreed that PW could discuss these matters with Iqbal, and they did so on 17 December 1990. He said that his knowledge came from Naqvi and others, and the nature and extent of the problems had only come to his knowledge since 18 April 1990. The information he would divulge, he said, had already been discussed at length with Salem, Mazrui, Habroush and the Crown Prince (a fact which the majority shareholders deny). The current situation arose from the need to solve financial problems within BCCI and to boost income. Iqbal enumerated the means used to solve the problem. These included:

(i) Loans created in the names of individuals who were unaware of the supposed loans. The $600 million loan portfolio was an example.

(ii) Loans made on terms that the borrower would have no obligation to repay.

(iii) Misappropriation of security given to the bank, in order to give an inflated value to investment portfolios managed under power of attorney by Abedi and then Naqvi.

(iv) Non-recording of customer deposits, the largest of these a deposit of $400 million by an Islamic bank.

(vi) Loss of funds placed by the Ruler and the Crown Prince for management on their behalf, estimated at $800 million and substantially all lost.

Iqbal said the Government had undertaken to meet the cost of reinstating customer deposits. The total of funds recycled under loan and deposit manipulation was estimated to be $1.2 billion. It was thought that the deceit was limited to certain accounts and that the shortfall had been identified, but the Government wanted an investigation so as to be sure that only genuine depositors were paid. Reference was made to nominees and fictitious loan accounts. The Government's total financial outlay (including the initial purchase of shares) was estimated at upwards of $4.15 billion. The 1985 Central Treasury losses had been instigated by Ziauddin Akbar to boost income. ICIC, Iqbal explained, was a vehicle used by Abedi for parallel activities. A number of companies such as Credit and Commerce Insurance and Credit and Commerce Life were ICIC investments fronted by Dr Pharaon. Iqbal suggested that the directors, like the auditors, had been duped and misinformed. He was clear that loans to the 71 offshore companies for which the Gokals had accepted responsibility were indeed their responsibility.

2.282 Following this meeting, the investigating team set to work to verify Iqbal's revelations. This was not, of course, the first intimation PW had received of fraud at the heart of BCCI, but it was the most comprehensive and the most far-reaching and it came from a source with no obvious motive to exaggerate the extent of the group's malpractice.

33 Supervision of the UK Region: 1 January 1990 – 5 July 1991

2.283 It is unnecessary to attempt a detailed summary of the Bank's supervision of the UK Region between 1 January 1990 and the closure of the bank. As in the preceding period (paragraphs 2.118, 2.125 and 2.136 above) this was conducted skilfully and professionally.

2.284 The Bank continued to receive statistical and prudential returns from the UK Region, and regular monthly meetings were held with BCCI management, supplemented by six monthly prudential branch interviews. Trilateral meetings between the Bank, PW and BCCI management were held on three occasions, to discuss reports to be commissioned and reports made under section 39 of the 1987 Act. One of these, on criminal misuse of the banking system, involved a searching examination of BCCI's precautions against money-laundering based on surprise visits and tests on sample accounts. The report (delivered in June 1990) made some criticisms of BCCI's procedures, but none of a fundamental nature. Other reports were commissioned on more routine matters, the accuracy of the Region's prudential returns and the Region's accounting and other records. The report on the first was unexceptional. The report on the second was never delivered, being overtaken by the closure of the bank. An increase in the Region's foreign exchange net short positions guideline was agreed by the Bank after a review of the UK Treasury. A breach of the caps imposed on lending by the Region to the rest of the group was quickly corrected, and a further reduction in the caps was agreed in April 1991.

2.285 In its supervision of the UK Region the Bank encountered nothing to cause serious concern.

34 Contacts with the US authorities 1989 - 90

2.286 In August 1989 PW in London received an enquiry about the financial affairs of BCCI from Mr John Moscow, an Assistant District Attorney in the office of the New York District Attorney, Mr Robert Morgenthau. The enquiry was in general terms and it was not clear to PW why the District Attorney was interested. They reported the enquiry to BCCI and the Bank, who were unaware of any investigation by the District Attorney.

2.287 The Bank's relations with the Federal Reserve Board in Washington are traditionally close, cordial and fruitful. There was some discussion between the Bank and the Fed of the likely course of events after BCCI's pleas of guilty at Tampa and about BCCI's UK redundancies in the summer of 1990.

2.288 In June 1990 the Bank learned from the Fed of problems about loans made by BCCI for the purchase of shares in CCAH. In the same month the Bank learned that the New York District Attorney was leading investigations into BCCI.

2.289 A very tangled situation was developing. The Fed were asking the IML questions about the acquisition of Financial General Bankshares. The IML could not answer and was seeking information from Iqbal. He could not answer either and was seeking information from Altman, who represented CCAH. But Altman was declining to give the information, as he had earlier done to the Fed.

2.290 The Fed had meanwhile asked BCCI for a copy of PW's 3 October 1990 report. BCCI sought PW's consent to release it. PW discussed this request with the Bank, who took a neutral position, and PW refused consent to release of the report. The Fed strongly felt that both BCCI and PW were being unreasonably obstructive.

2.291 Moscow was at the same time pursuing links between BCCI and CCAH and also wanted to get hold of a copy of PW's report. The Bank was of opinion that it was not entitled, under the Banking Act, to give information to Moscow; it was also not inclined to do so without a clearer understanding of his enquiry; and the Fed were not encouraging the Bank to do so.

2.292 For some time the Bank was genuinely unclear what the Fed were investigating. But on 16 November 1990 Quinn was told by the Fed of its long-standing suspicion that BCCI had covertly financed the purchase of CCAH shares by BCCI's Middle Eastern shareholders. On 4 December 1990 the Fed told Quinn that they believed the District Attorney wanted to see PW's report in order to show that First American and BCCI were both controlled by the same entity, in contradiction of what BCCI had said before. When Salem visited the Bank on 6 December 1990 Barnes referred to the US authorities' belief that they had been "conned".

2.293 For some time before this, the Bank had known of loans by BCCI to CCAH shareholders (most of them also BCCI shareholders) secured on CCAH shares, but had not known of warranties by BCCI to the US authorities that it was not involved in financing the purchase of Financial General Bankshares. The Fed knew of the warranties given by BCCI on the acquisition of Financial General Bankshares, but did

not know of the loans to BCCI shareholders secured on CCAH shares (paragraph 2.108 above). Both parties were now beginning to see the other half of the picture. The Fed saw it when Iqbal (with the consent, under pressure from the Fed, of PW) showed the Fed a copy of PW's report of 3 October. It immediately decided that there had to be an order of investigation into the CCAH loans on BCCI's balance sheet. The Fed then told the Bank that when Financial General Bankshares had been acquired, various assurances had been given about the financing of the purchase: the Fed had been told that the named investors had substantial private means, that only a small part of the purchase would be financed by borrowing and that BCCI would not be a lender. The Fed now believed that the recorded shareholders were shadows, and envisaged that "things were going to get nasty over CCAH". The Fed was concerned because the earlier takeover had been approved on the basis of assurances which it believed to have been false and dishonest. That was, I think, clear to the Bank. The view expressed in Luxembourg on 5 October 1990 (paragraph 2.262 above) that the assignee of the CCAH loans should not have the right to reassign them if they turned out to be tainted by fraud or criminality can only have rested on a suspicion that the US authorities might turn out to have been misled. The Bank may, however, have thought that the Fed's action might be directed at CCAH rather than BCCI. Observations made by the Fed gave ground for that belief. But there was every reason to expect the Fed to take action and every reason to anticipate resulting publicity.

2.294 On 17 December 1990 Bartlett spoke on the telephone to Hoult of PW. Iqbal had now established a line of communication with the Fed, who took a slightly better view of BCCI as a result, and Bartlett hoped that some of the heat might thereby be taken out of the situation. Hoult was unconvinced: he thought this might not necessarily be so "in view of the lies which have probably been told to the Fed in the past about BCCI". Hoult was not in much doubt by this time that, years earlier, the Fed had been misled by BCCI about the relationship between it and CCAH.

2.295 The Bank's position (like that, for different reasons, of PW and BCCI) was an uncomfortable one. It wanted above all to preserve its good relations with the Fed. It was also reluctant to see the reconstruction of BCCI, which it believed to be in train and to be beneficial to depositors, jeopardised by highly publicised and damaging proceedings in the US. Over the remaining months of BCCI's active existence the role of the US authorities was to be an increasingly significant one.

35 January 1991: unrecorded deposits

2.296 There was a delay in completion of the financial package. It had become clear that the loans making up the $600 million loan portfolio were irrecoverable. They were to be covered by an additional issue of Abu Dhabi Government promissory notes. But formal approval of this increase in the Government's support had not been obtained. There was to be a delay in completion of the package while approval was obtained. Cowan explained this to the Bank on the telephone on 3 January 1991 and Iqbal repeated the explanation at a meeting on 4 January.

2.297 The real purpose of the meeting with the Bank on 4 January 1991, however, was so that Iqbal could tell the Bank of the unrecorded customer deposits of which he had told PW on 17 December 1990 (paragraph 2.281 above). The meeting was attended by Barnes and Miss Jones. Iqbal said that the bank's deposits might be understated by some $580 million. The Government would make good the shortfall once it was satisfied that the customers had a genuine claim. There were believed to be seven customers involved, the largest of whom (later code-named "Tumbleweed") was thought to have deposited $350-575 million. The deposits had been made for the purpose of Islamic commodity transactions. Cowan's provisional view was that there was a contingent liability in the bank. Iqbal asked if a meeting could be arranged with Salem, Habroush being unable to visit because of events in the Gulf.

2.298 Barnes appreciated the probability that the deposits had been misappropriated and appreciated the implications this might have, if true, on the fitness and properness of management. But his main concerns expressed at the meeting were that the deposits should be investigated to see if they were true liabilities and that, if so, they should be covered by the Government's support.

2.299 Both PW and Allen & Overy were extremely disturbed that Iqbal, knowing of these unrecorded deposits earlier, had not disclosed them. He had assured Cowan in September 1990 that he had disclosed everything but had chosen not to mention them. This had caused what Cowan described as "a major row" before the meeting with the Bank on 4 January. Both PW and Allen & Overy seriously considered resignation, but appreciated this would be very damaging to the group. PW decided to defer their decision until finalisation of the 1990 accounts. In the meantime they wrote a strong letter complaining that Iqbal had not disclosed these deposits when he had known of them (if not of the sums involved) in April 1990. They also asked about other matters which Iqbal had said he was unable to discuss. Iqbal denied in his reply that he had known of the unrecorded deposits in April 1990. He promised to revert about the other outstanding matters. Allen & Overy wrote a similar letter.

2.300 It was undoubtedly right to inform the Bank promptly of the unrecorded deposits and PW acted correctly in prompting Iqbal himself to make the disclosure. I am puzzled (because PW had no wish or motive to withhold information from the Bank) that they did not prompt him to tell the Bank of the other matters disclosed by him on 17 December 1990 (paragraph 2.281 above) and why they did not, if he proved obdurate, tell the Bank themselves. I am also puzzled that they did not ensure disclosure of the matters learned on perusing Naqvi's files (paragraph 2.279 above). The Bank knew that recoverability of the $600 million loan portfolio was dubious, but did not know that the loans were fictitious. It did not know of the evidence of collusion unearthed in Naqvi's files. It was not fully alive to PW's concerns about ICIC. It did

not know that Iqbal had been subject to any constraint on making full disclosure, or of the displeasure felt by PW and Allen & Overy at Iqbal's failure to be forthcoming with them, or of the fact that there were still matters Iqbal felt unable to discuss. I think there may have been a number of reasons for PW's reticence. First, the unrecorded deposits were causing a delay in completing the financial package and there was therefore a specific reason to mention them. Unlike most of the other matters, they directly and immediately affected the quantum of the Government's support. Secondly, most of the other points had not been verified. The unrecorded deposits had not been fully verified either, but PW knew enough to form a provisional view. Thirdly, the unrecorded deposits were a new discovery to PW. Several of the other matters had, in some form and to some extent, been known by and mentioned to the Bank before, although PW may have felt they had passed on more than they actually had. Fourthly, the Bank's muted reactions to PW's disclosures of early February 1990 (paragraph 2.166 above), and 2 March 1990 (paragraph 2.169 above), and to their reports of 18 April and 3 October 1990, probably led PW to feel that the Bank was not greatly concerned about the misdeeds of former management. They could scarcely have appreciated the extent to which their earlier signals had not been received. But even taking account of these four reasons, I think it was very unfortunate that the opportunity was not taken to put the Bank as fully in the picture as the known and suspected facts then permitted. Whether, if this had been done, the supervisors would have seen the problem very differently, I find it hard to judge, but I think the Board of Banking Supervision (had it been told) might well have pressed for the course of action described in paragraph 2.260 above.

2.301 Salem called at the Bank on 8 January 1991 and saw Barnes and Miss Jones. He referred to the potential losses from unrecorded deposits and expected more such problems to arise out of the investigation. He listed the losses which the shareholders had suffered over the preceding twelve months and reached a total of $7.5 billion, although this was a figure some $2.2 billion higher than the items specifically mentioned and the Bank did not then understand how the difference was made up. Salem's real worry was that this might not be the end. It was agreed that the three bank scheme might be a way of limiting the damage and making a fresh start, but Barnes cautioned that the 1990 accounts had to be produced and drew attention to the risk of preferring some creditors over others (an issue which caused some trouble over the next few days). Barnes expressed pleasure that Habroush would be coming to London to meet Quinn, which he said was important, since it was not yet certain the Bank would accept BCCI's three bank scheme. In a letter written after the meeting Barnes said the group's first priority was to be in a position to publish its 1990 accounts, which could not avoid reference to the new disclosures but in which it was important to avoid a qualification. He thought the three bank scheme offered a hopeful means of protecting the group's viable business. A meeting between Habroush and Quinn was described as "vital" to the proposal for a UK company.

2.302 The unrecorded deposits were reported to the Board of Banking Supervision on 10 January 1991 although it was said, for reasons which are unclear, that they did not affect the UK operation. (At the same meeting the Board was also told of the US authorities' concern about CCAH and First American: the assurance that the shareholders had had their own funds to make the investment had turned out to be a "fabrication", since the shareholders had been lent monies by BCCI).

2.303 On 14 January 1991 Cowan told the Bank of a conversation he had recently had with Habroush in Abu Dhabi. Habroush was doubtful whether BCCI was liable for the alleged unrecorded deposits (which he suspected of being a fraudulent scheme concocted between existing management and the alleged depositors) and was concerned that if the Government's intention to support these claims became known it would prompt bogus claims. He was anxious that the outcome of the investigation into these

claims, which was bound to take some time, should not become public. Cowan mentioned that some of the missing deposits or alleged deposits related to the UK Region, an assertion which he elaborated when telephoned by Miss Jones the following day.

2.304 The Bank took the information of these unrecorded deposits seriously and wished the issue to be fully investigated. But there were three problems. The first was to ensure the confidentiality of the outcome of the investigation. It was thought that this problem might be solved if PW made a report to Allen & Overy in order to obtain legal advice on the alleged depositors' claims. The second was that if the Bank caused BCCI to commission or itself commissioned a report under sections 39 or 41 of the Banking Act, notice would have to be given to Chowdry as General Manager of the UK Region, but the Bank did not wish to alert Chowdry to the investigation since his own conduct would be in question. Legal advice was sought, internally and externally, and section 41 was recommended as the more appropriate section to use: notice would have to be served on SA in the UK, but the terms of the notice need not be too explicit. The third problem was a College meeting fixed for 11 February 1991. If the Bank had commissioned a report by then, it felt it would have to mention the fact. But it did not wish to disclose the report for fear that its contents might leak and was reluctant to announce the commissioning of the report and then later deny access to the document.

2.305 Cowan advised that these problems could be overcome. While he welcomed a vague commissioning letter, he was not concerned that Chowdry might be alerted to the fact that an investigation was in train, since he already knew that. PW were already, as members of the investigating team, engaged in investigation of the facts. Issue of a formal commissioning letter was not therefore necessary to authorise the work but only to authorise disclosure of the findings to the Bank. It would not delay the investigation if the commissioning letter were not issued until after the College meeting since PW could not report before then anyway. But Cowan strongly suspected that the UK Region transactions would be traced back to Chowdry, whose conduct he described as being "at the least, naive". (On 25 January 1991 Chowdry admitted to PW that there had been unrecorded deposits and fictitious loans in the UK Region. He had wished to disclose the unrecorded deposits to PW before, he said, but had been told not to do so.) Iqbal and Allen & Overy knew that the Bank was considering how to procure an investigation into and report on the unrecorded deposits but the majority shareholders did not know of this.

2.306 The investigating team was hard at work in Abu Dhabi. Two PW partners interviewed Naqvi on 19 January 1991. It was the first of many such interviews during the investigation. His line was that everything which had been done in BCCI was his personal responsibility. He spoke generally of the Central Treasury activities, the Gulf Group, nominee accounts, movement of funds to avoid the need for loan loss provisions and refresh delinquent loans and payments to various ex-employees (including a payment of $15 million to Ziauddin Akbar, the former Central Treasury dealer and manager of Capcom). He also gave considerable detail of certain accounts, mentioning (for example) that almost all the CCAH shareholders held wholly or partly as nominees, that the Gulf account had been moved to the Caymans in the late 1970s when the Bank had complained of the group's excessively concentrated lending, that BCCI had had to pay off Gulf's other creditors because the collapse of Gulf would bring in its train the collapse of BCCI and that ICIC had been used for funding BCCI requirements.

2.307 PW were conscious that Naqvi's revelations had not been verified by detailed investigation and they were sceptical of his assumption of sole responsibility. But they could see no reason why he should make damaging admissions which were untrue and much of what he said corroborated what Iqbal had said earlier. They were inclined to regard Naqvi's disclosures as, in all probability, a fairly comprehensive account of the fraud practised in the bank. They did not report this conversation to the Bank, perhaps for some of the reasons given in paragraph 2.300 above. Again, I find this puzzling and think the omission was very unfortunate.

36 1 February-5 March 1991

2.308 Of the issues which remained to be resolved following the October 1990 meeting of the College, some (structure and recruitment) received little supervisory attention between 1 February and 5 March 1991. The interest of the US authorities and the US press continued and increased, and new evidence of major fraud in the running of BCCI came to light. The period was, however, dominated by doubt whether the Abu Dhabi Government would support BCCI at the level now required and consideration of what should be done if it did not.

Restructuring

2.309 In early February 1991 PW and Allen & Overy discussed the new UK company with the Bank. There was a question whether certain branches outside the UK could form part of it and the possibility of a holding company was considered, the Bank having no objection provided it were in the UAE. PW wrote to Habroush urging that restructuring be given urgent attention so as to meet the IML deadline, but they were still working on the basis that BCCI UK might be established by the end of June 1991 and Bartlett contemplated taking an outline proposal to the Assessment and Review Committees fairly soon. It did not, however, appear that BCCI had made very detailed plans for the bank to be based in Abu Dhabi: in a conversation with the responsible supervisor in the UAE Central Bank on 11 February 1991 the Bank learned that BCCI still had to discuss their plans with him.

2.310 When the Board of Banking Supervision met on 14 February 1991 concern was expressed at the lack of progress on restructuring. It was suggested that even if the IML deadline expired with no overall agreement on restructuring, it might still be possible to incorporate a UK company and so protect UK depositors. On 20 February Bartlett informed the Fed that the shareholders had still not agreed on a proposal to put to the supervisors and it was becoming increasingly urgent for this to be done.

2.311 With the Gulf crisis at its height, the pressures on the majority shareholders at this time were undoubtedly intense, but plainly they were not addressing this issue with the urgency which the IML deadline required. The supervisors for their part took little positive action to procure a solution.

Recruitment

2.312 PW reminded Habroush on 11 February 1991 of the need to take urgent action to recruit directors and management. It does not appear that any progress was made during this period.

The US authorities

2.313 The Fed had made formal orders of investigation into the relationship between CCAH and BCCI, and in mid-February 1991 two US lawyers visited the UK in pursuit of this investigation. They were Mr Richard Small, Special Counsel in the Division of Banking Supervision and Regulation of the Fed in Washington, and Mr Thomas Baxter, Counsel in the Legal Department of the New York Fed. They visited the SIB, the Bank and PW, seeking information about not only CCAH and First American but also ICIC, Independence Bank (in California) and Credit and Finance Corporation (in the Caymans). Subpoenas had been issued in New York against BCCI and PW's World Firm, and a grand jury investigation was in progress there.

2.314 There had, earlier in the month, been considerable concern about a forthcoming article in the Wall Street Journal: it was expected to report serious losses and shortage of capital in BCCI and to criticise the Bank for failing to keep the Fed

fully informed. The Fed did not itself make this criticism, but there was consideration of the need for common action to counter any adverse reaction to the article. In the event, several articles were published, but they proved to be less damaging and critical than expected.

Financial package

2.315 Both the Bank and PW were concerned at the majority shareholders' delay in approving the financial package. PW wrote to Habroush on 7 February and again on 11 February, but in the middle of the month it became clear that such approval was problematical. Salem himself was inclined to think approval might not be forthcoming (a result he himself favoured). The Bank prepared plans for the contingency that approval was not given, and PW advised the Abu Dhabi Government on the comparative costs of supporting and not supporting the bank. Cowan, telephoning the Bank on 18 February 1991, passed on Iqbal's view that it would be very valuable if a senior Bank supervisor were to visit Abu Dhabi to make the supervisors' voice heard at first hand. This was a move which Bartlett tentatively favoured at the end of the month, when another ten days had passed and the majority shareholders' decision was still uncertain. It was also favoured by the Hong Kong supervisor. It was not strongly favoured by Quinn: on the first occasion the matter was raised, he thought a visit might be helpful but wished to await the outcome of a visit to Abu Dhabi which PW were about to undertake (by which time it could have been too late); on the second, he wondered how a decision could be forced short of a face to face meeting and whether a further effort should be made to get Habroush to London.

2.316 It was fairly clear by this time that Habroush would not come to London, at any rate until a decision had been made. Had the outcome of the shareholders' decision been a matter of indifference to the Bank, its inaction would be understandable. But the Bank wished the support to be provided and judged that UK depositors would suffer serious loss if it were not. It is of course unusual, perhaps even unprecedented, for a supervisor such as the Bank to have to seek out an institution subject to its supervision in this way, but I am surprised that this exceptional course was not more urgently considered to avert what was regarded as a potential catastrophe. Senior Bank supervisors were, it must be remembered, busy men, with many responsibilities other than BCCI, but it is hard to think they faced very many problems of comparable omplexity and threatening imminent loss on a comparable scale.

2.317 The Bank's approach was, I think, strongly influenced by its recognition of the IML as primary supervisor. Following a conversation on 20 February, the IML drafted a letter to the majority shareholders, which the Bank amended, but which the IML did not in the end dispatch. It asked for confirmation that the majority shareholders ontinued to extend their full support to the BCCI group, in accordance with undertakings previously given to the supervisors, and that they were committed to executing the necessary financial arrangements without further delay.

2.318 At a meeting in Abu Dhabi on 24 February 1991 attended by Mazrui, Salem and Iqbal, as well as representatives of PW and Allen & Overy, there was a vigorous discussion of PW's estimated costs of supporting and not supporting the group. In the course of the discussion Salem denied that he had known about the unrecorded deposits in the spring of 1990, a denial which Iqbal challenged and Salem eventually retracted. Mazrui did not deny his own knowledge. This account of the meeting is strongly challenged by the majority shareholders; Allen & Overy did not record, and do not recall, Salem's retraction.

2.319 On 25 February 1991 PW signed a report, addressed to Mazrui and prepared at his request, which came to be known as "the Doomsday Report". It was intended to enable the majority shareholders to decide whether to continue their support of the bank. PW estimated the cost of support at $4.4/5.6 billion, depending on various

contingencies, but assuming there were no further unrecorded liabilities and assuming there were no claims arising out of the operations of ICIC. The cost to the majority shareholders of abandoning the bank was assessed at a higher figure.

2.320 On 26 February 1991 the Bank learned from Cowan (in Abu Dhabi) that a decision on the financial package was imminent. He was hopeful of a positive outcome but would not say he expected it, although he was continuing to plan on the assumption that support would be continued. Hoult (also in Abu Dhabi) could add nothing when he telephoned the Bank the next day. On his return to London, Cowan visited the Bank on 28 February 1991. He reported that no decision had yet been made. Mazrui was urging support; Salem was arguing that BCCI was a bottomless pit. A decision was expected at the weekend. Cowan put the total cost of support at $4.4-5.6 billion. Many of these costs had been known in April 1990 when the majority shareholders decided to support the bank, but some of them had arisen since then. Bartlett was concerned about the sheer size of the financial support package and ondered what action the majority shareholders would take if they decided not to support the bank, but Cowan thought they had little choice but to do so. This meeting also covered other matters of great significance: paragraph 2.323 below.

2.321 On 1 March 1991 PW were called to the Bank at short notice to discuss what should be done if the majority shareholders decided not to support the bank, which was thought to be a possible but unlikely event. Arrangements were made to keep in touch over the weekend. There were communications, but no news of a decision, over the weekend. The uncertainty came to an end on Monday 4 March 1991 at 9.00 am, when the Bank was told of the majority shareholders' decision to provide continued support by endorsing the financial support package. It was hoped that the documents (which required some amendment) could be signed within about 10 days.

Financial problems

2.322 The investigating team continued to investigate the problem loans and other financial issues. PW obtained some limited access to the ICIC files, which provided further evidence that BCCI and ICIC were interdependent and confirmed them in their view that a full investigation was needed. The Board of Banking Supervision was told, on 14 February 1991, that the unrecorded deposits reported at the previous meeting were being investigated to establish whether there was a genuine liability but that, contrary to previous information, the UK Region might be implicated in the problem to a significant extent. The Board was told that PW were passing information to the Bank as it emerged, and that the Bank intended to commission a section 41 investigation into UK Region involvement.

2.323 In their Doomsday Report (paragraph 2.319 above) PW made reference to losses of $2.2 billion believed to have been suffered by the Ruler and the Crown Prince on investments managed on their behalf by Abedi and then Naqvi. This was the item which Naqvi had revealed to the Abu Dhabi shareholders before finalisation of the 1989 accounts (paragraph 2.190 above). Cowan told the Bank of this new discovery when he called at the Bank on 28 February 1991 on his return from Abu Dhabi (paragraph 2.320 above). He said that Abedi and Naqvi had managed the Ruling Family's investments under powers of attorney. It was now apparent that they had misused this portfolio, investing it through ICIC companies to fabricate repayments of loans in BCCI's books. In theory, therefore, the Ruling Family had claims on BCCI in respect of misappropriated funds. It does not appear that the figure of $2 billion was mentioned at this meeting but the sums involved were plainly very large. Cowan gave an example (based on information from Naqvi): some $700 million belonging to the Ruling Family had been paid into Gokal accounts to make it appear that the Gokal loans were performing when they were not. He said PW would require a waiver of their claims by the Ruling Family. He also said that Naqvi had apparently written a full confession in April 1990, when the majority shareholders had resolved to rescue the

bank, and Mazrui had promised Cowan a copy. Cowan also mentioned Independence Bank, supposedly owned by Dr Pharaon as a nominee (as to 85 per cent) for BCCI. In the course of discussion, reference was made to payments to staff and former staff to keep them quiet.

2.324 Although, as already noted (paragraph 2.320 above), Bartlett was much concerned at the size of the financial support which this conversation showed to be necessary, the reported theft of very large sums by Abedi and Naqvi from the Ruling Family of Abu Dhabi caused remarkably little stir in the Bank. Barnes, to whom the note of this meeting was copied, did not attach great importance to this aspect of it because it related to past events and former management who, however disgracefully they had behaved, had no place in the future plans of the group. It was a matter between the shareholders and the former management. Quinn confirmed that no thought was given to revocation at this time since SA was regarded as effectively dead anyway. It was doubtless for reasons of this kind that no indication of this sizeable theft was made to the Board of Banking Supervision and the Governors until after the closure of the bank.

2.325 I consider this reaction strange. The victims, it is true, were the Ruling Family and not BCCI. But it was at least arguable that the Ruling Family had claims against the group, and even if (as was likely) they chose not to pursue them the misuse of these funds cast a fresh shadow over the recorded business of the group. Men capable of acting in this way to the detriment of the group's longest-standing backers might, moreover, be thought capable of anything, so new vistas of potential fraud were opened up, of unquantified significance. At the very least, I would have expected the supervisors to be acutely concerned to know who other than Abedi and Naqvi was involved. I have no doubt the explanation given by Barnes is correct: the report was not treated as significant because it related to past events and discredited former management. This lack of reaction does, however, help to explain why the majority shareholders were so surprised and shocked when the Bank moved to close SA in July 1991.

2.326 On 1 March 1991 four partners of PW (Hoult, Mr Andrew Burnett, Cowan and Charge) met Mr Yves Lamarche, Dr Alfred Hartmann and Mr J D Van Oenen (directors of BCCI). It was a highly-charged meeting. PW had in recent months been working in close collaboration with the majority shareholders on the refinancing and restructuring of the group. It had been made quite clear that the directors had no part to play in the shareholders' plans, and that they would be ousted when the restructured group took shape. PW had accordingly had little recent contact with the board, which was no longer (if it ever had been) the focus of decision-making in the group. But the new structure was slower to take shape than had been hoped, and PW were conscious that in the meantime the board continued to carry certain important legal responsibilities. They were also keen to obtain access to BCP, which required Hartmann's consent. The directors for their part were angry that they (as members of the audit committee and appointors of the investigating committee) had been excluded from participation in and knowledge of the group's affairs and the restructuring. For this they were inclined to blame PW, unfairly in PW's view since they did not regard it as the auditors' responsibility to inform the board about the conduct of the group's business. PW were also resentful that their strenuous efforts to rescue the group were accompanied by complaints by the directors that they were not being kept informed. Cowan had attended a meeting of the investigating committee (chaired by Salem) in Abu Dhabi on 26 February 1991, at which the extent of the fraud so far discovered had been very fully reported and discussed. He resolved to give the directors a clear picture of how matters stood at the meeting on 1 March 1991, which had been arranged at the board's request some time before.

2.327 In the course of a long meeting PW gave the directors a very comprehensive account of the various frauds and malpractices which had been found by the investigating team to exist in BCCI. No compendious account is needed here. Treasury losses, nominee shareholdings, falsification of accounts, regulatory breaches, pay-offs to employees, fictitious transactions, misuse of deposits, deceptive routing of funds, hold-harmless letters, false confirmations, ICIC and a number of other matters were mentioned. So were doubts about the integrity of Chowdry, the UK General Manager. Although most of these matters were described in general terms, the allegations covered a very great deal of the ground which was later to be covered by PW's draft section 41 report. When PW visited the Bank later on 1 March 1991 it was for another purpose (paragraph 2.321 above) and PW did not report the effect of this meeting with the directors. Nor did they do so on any later occasion.

2.328 Many of the matters canvassed at this meeting with the directors on 1 March 1991 had, in one form or another and to a greater or lesser extent, been mentioned to the Bank before. The involvement of the UK Region had been suggested, doubts raised about Chowdry and attention drawn to the majority shareholders' knowledge of certain recent and impliedly questionable transactions (paragraph 3.251 above). But points of this kind make a greater impact when they are all gathered together, and the Bank had never up to this point received a briefing as comprehensive as the directors received on this occasion. Had it done so, and had the information been passed to the most senior supervisors, the Bank could not have been surprised as it was when it received the draft section 41 report. There was, I am sure, no conscious decision by PW to withhold this information. PW felt, rightly, that much of the information had already been given to the Bank, which did not seem concerned about what had happened in the past if BCCI could be recapitalised, restructured and differently managed for the future. This was, nonetheless, an opportunity, in retrospect probably the last opportunity, for a clear and comprehensive understanding to be reached by the Bank with the majority shareholders on the future of the bank (whether that involved recapitalisation and restructuring or orderly run-down), and the opportunity was lost. I feel bound to conclude that full disclosure to the Bank should have been made.

Section 41

2.329 The College meeting originally fixed for 11 February 1991 was postponed, but for the same reasons as before (paragraph 2.305 above) the Bank saw no urgency in formally commissioning a report under section 41. The letter commissioning the report existed in draft before the theft from the Ruling Family was reported on 28 February 1991 (paragraph 2.323 above) and its terms were not altered. The commissioning letter referred to certain irregularities drawn to the attention of PW and the Bank in connection with the 1990 audit and to the Bank's belief in consequence of these disclosures that

> "significant accounting transactions undertaken by the Company, or other companies within the same group, may have been either false or deceitful, or that their underlying purpose may have been disguised or otherwise misstated".

This was wide language and PW took it as a formal instruction to investigate and report on all the malpractice in the group. I very much doubt if the Bank so intended or understood it. The Bank's decision to commission the report had been prompted by the report of about $600 million unrecorded deposits. There had been doubts whether these were genuine liabilities and about the UK Region's involvement. It was a report on these matters which the Bank, as I think, expected. It did not regard the investigation and the report as matters of major strategic significance which is why, in the weeks ahead, internally and externally, they were scarcely ever mentioned (although the formal commissioning of the investigation was reported to the Board of Banking Supervision on 14 March 1991). It did not in my judgment cross the mind of anyone

in the Bank that the outcome of the investigation or the terms of the report were likely to have a crucial bearing on the survival of the group.

2.330 The commissioning letter was signed by Barnes on 4 March 1991 and addressed to Cowan in terms settled by the Bank and approved by him. Notice of the appointment was at once given to Chowdry, as the Act required, and it came to the immediate notice of Iqbal. Allen & Overy learned of the appointment the same day. Neither the Bank nor PW nor Allen & Overy informed the majority shareholders, who did not know of the appointment until Mazrui learned of it on 27 May 1991.

2.331 The majority shareholders have made five major complaints arising out of the Bank's appointment of PW under section 41 and PW's acceptance of that appointment. They complain, first, that they were not told of this appointment. Secondly, they accuse the Bank of duplicity by encouraging the majority shareholders to pursue the restructuring and refinancing of the group, while secretly harbouring the thought or intention of using PW's report under section 41 as a pretext for closing the bank. Thirdly, they contend that PW's acceptance of this appointment involved an inevitable conflict with PW's duty as advisers to the majority shareholders on the restructuring and refinancing of the group. Fourthly, they say that PW's ability to make a fair and objective report under section 41 was compromised by their knowledge that if the group were to collapse or be closed their own record as auditors would be called in question. It is accordingly said that accountants other than PW should have been appointed to report under section 41. Fifthly, they complain that the Bank waited until the majority shareholders had indicated their intention to support the bank before formally commissioning the report.

2.332 As to the first of these complaints, I can find no evidence that information of the appointment was deliberately withheld from the majority shareholders. The chief executive officer of the group, who had close relations with the majority shareholders, knew of it, and the probability must have appeared to be that he would pass the information on if he thought it significant. The Bank had, up to this time, no distrust of Iqbal. Given the Bank's desire for good relations with the majority shareholders it might have been politic to tell them of the appointment, but the Bank was in breach of no duty in failing to do so and in my judgment harboured no sinister motive.

2.333 For reasons given more fully in paragraph 2.426 below, the Bank was not guilty of duplicity, as the majority shareholders believe, although I find their belief understandable. The Bank was moved to commission the report when it learned that the UK Region, for which alone it regarded itself as directly responsible, might be implicated in the failure to record customers' deposits. Nowhere, even in the Bank's internal papers, can one trace any expectation that the report, when received, might cover the ground it did or might lead to closure of the group.

2.334 In their role as auditors, PW's clients were Holdings and other group companies. When they accepted appointment under section 41, PW's client was the Bank. In advising on restructuring and refinancing PW's clients may well have been the majority shareholders, as they contend, although PW were formally retained by Holdings. Whatever the legal relationship, I do not think that either the Bank or PW perceived any conflict between PW's duty to the Bank and any duty owed to the majority shareholders, whose declared intention was to investigate the abuses which had existed in BCCI and to establish three new, clean banks acceptable to the relevant supervisors, including the Bank. Together, the majority shareholders and PW were working towards that end. It is, however, possible that this issue will be the subject of litigation hereafter, and it is preferable that I express no opinion on it.

2.335 The complaint that PW's ability to make a fair and objective report under section

41 was compromised by their knowledge that if the group were to collapse or be closed their own record as auditors would be called in question is, again, one that may well be the subject of litigation hereafter. Much may depend on the quality of the audits conducted by PW, in the Caymans and elsewhere, and involving ICIC Overseas as well as BCCI SA and BCCI Overseas, and PW's own perception of those audits. These are matters the Inquiry has not investigated, and it is preferable that I express no opinion on this complaint.

2.336 The Bank could, of course, have appointed another firm. But any other firm would have lacked PW's familiarity with the problems and would have been bound to seek information from PW, which PW would under the Act have been obliged to provide. Another firm might also have found difficulty obtaining access to all the relevant material. The main results of appointing another firm would in my opinion have been to increase the length and cost of the investigation and weaken the reliability of the outcome.

2.337 The fifth complaint, that the Bank waited until the majority shareholders had indicated their intention to support the bank, has a measure of factual truth. Initially, the Bank delayed in commissioning the report for other reasons (paragraph 2.304-2.305 above). But after postponement of the College, doubt arose about the majority shareholders' willingness to support the bank. If they had decided not to do so it would have collapsed. The Bank only wanted the report if the bank was to continue. So it waited for the majority shareholders' decision, and when it turned out to be in favour of support the report was commissioned. I do not think this was sinister for the reason already given, that the Bank did not at that stage contemplate using the report as a ground for closing the bank.

2.338 A further complaint, that PW breached the duty of confidence which they accepted as members of the investigating team by reporting under section 41 without first notifying and seeking the consent of the majority shareholders, is not in my opinion sound. PW had expressly reserved a right to give the College such information as they were in their judgment obliged to give "under the banking regulations". They would in my opinion have been entitled, probably bound, to give the Bank this information even if not formally instructed under section 41 and whether or not the majority shareholders consented. Had the majority shareholders given their consent the position would have been little different. Had they refused consent, and had PW accepted that constraint, the Bank would have been bound to draw adverse inferences from the refusal. This breach of confidence by PW, as the majority shareholders see it, very greatly rankles with them, but I do not think the complaint is justified.

37 5 March-4 April 1991: the seventh College meeting

2.339 The College held its seventh meeting at the Bank on 4 April 1991. The month which preceded it had not lacked incident.

Financial package

2.340 The main focus of attention during the month was on the financial package, approved by the majority shareholders but not yet signed. Work on preparation of the documentation was known to be in hand, but Bartlett wrote to Iqbal about the delay in signing the package, appreciating that BCCI was technically insolvent until the agreement had been signed. At the suggestion of PW, Quinn wrote to Habroush on 13 March 1991 calling for signature of the package (and also calling for progress on restructuring: paragraph 2.343 below). The delay in signature and Quinn's letter were reported to the Board of Banking Supervision on 14 March: concern was then expressed that the agreement might not be signed within the Bank's time-frame.

2.341 PW urged the majority shareholders to reply to Quinn's letter, suggesting that failure to do so would be viewed most unfavourably by the Bank. Mazrui, however, saw no point in trying to respond until the financial package had been fully signed, although he thought Salem should visit the Bank to try to explain the majority shareholders' position on support.

2.342 On 20 March 1991 the Bank learned that the financial package was to be signed by the majority shareholders the next morning. But there was a last-minute problem. Quinn had referred in his letter to the IML deadline. The majority shareholders regarded that as impossible to meet. They did not want to commit themselves to support the bank, only to learn in June that Luxembourg had withdrawn SA's licence. A series of telephone calls initiated by Quinn overcame this problem (paragraph 2.346 below) and Mazrui confirmed that the documents would be signed the following day. On 25 March 1991 Salem told the Bank that the Abu Dhabi Government had now signed the financial package. Of the sixty signatures required, fifteen were still outstanding, although these were confidently expected. But the agreement would not be binding until those signatories also had signed. That was to take another two months.

Restructuring

2.343 In the early part of March 1991 there was little progress on restructuring. PW met the Bank on 12 March to discuss BCCI's preliminary restructuring plan, which was regarded as an unusually specific, detailed and practical document. But although it was thought to reflect the majority shareholders' intentions, they had not yet approved it or taken any of the necessary strategic decisions. Neither Chowdry nor the directors were as yet aware of the three bank scheme and it had not been decided whether there should be a holding company or, if so, where. Both the Bank and PW were concerned about the IML deadline and in PW were concerned about the IML deadline and in his letter to Habroush of 13 March (paragraph 2.340 above) Quinn called for a decision on restructuring as a matter of urgency, expressing a strong desire, now that the Gulf War was over, to meet a senior representative of the principal shareholders such as Habroush himself.

2.344 At its meeting on 14 March 1991 the Board of Banking Supervision was given to understand that BCCI's restructuring plans would be considered at the College

meeting on 4 April. If the College then approved BCCI's plans, it was hoped that the incorporation of the UK branches could proceed fairly shortly thereafter.

2.345 PW called on the Bank on 20 March to discuss a revised draft paper on BCCI's restructuring and there was a wide-ranging discussion, although it was recognised that decisions had yet to be made on such matters as the ownership structure and the possible creation of a management services company (a possibility earlier raised by PW). By this time PW regarded the IML's deadline as almost impossible to meet.

2.346 The last-minute hitch in signature by the Government of the financial support package (paragraph 2.342 above) was intimately linked with the timetable for restructuring and the IML deadline. Quinn accordingly telephoned Jaans on 20 March 1991 to ascertain what the IML required from BCCI to allow more time for restructuring. The answer was, in effect: a detailed and complete plan for the group's future by early June, agreed by all the relevant authorities, accompanied by a clear timetable for the restructuring which should not stretch beyond the end of 1991. Quinn and Jaans agreed on a timetable for Quinn to suggest to Mazrui, providing, by late May, for a detailed plan with a timetable to which the shareholders were committed in writing. In a further conversation with Mazrui, Quinn put forward this timetable and suggested that if it were met the IML might allow a further six months beyond 30 June 1991 for final completion and implementation. When PW told the Bank on 22 March that despite all the work being done it was unrealistic to think that restructuring proposals could be in place by the end of June, the Bank replied that if the shareholders produced a well-conceived plan the IML might extend the deadline to the end of December 1991.

2.347 On 25 March 1991 Salem told the Bank (at a meeting with Barnes) that the majority shareholders had engaged Booz Allen & Hamilton, management consultants, who were working on a strategic review to enable decisions to be made on the shape of the business. The majority shareholders would have a clearer idea how to proceed by August or September, but they had not yet addressed questions such as the number of new banks and their places of incorporation. Salem argued that the shareholders could not be in a position to provide firm proposals for the College at its meeting in a week's time. Barnes suggested that, given the IML deadline and the absence of any supervisory authority willing to take responsibility for the group in its existing form, the shareholders had two effective options: to call a halt to the bank's operations, run it down and recover what they could; or to remain committed to the bank as an ongoing business, which could be developed through the right management and structure. If the shareholders chose the second option, the point had been reached where reasonably firm proposals and a detailed timetable for implementation were essential. They should accept now the need for restructuring into more than one unit and should provide a blueprint even if final details were lacking. Salem wondered if the Bank would consider a bridging authorisation, so that the whole of SA could be transferred to the UK until more permanent plans could be implemented; Barnes said the Bank would consider short-term proposals if the longer-term objects were clear. Salem eventually agreed that the revised restructuring plan, with some amendments which Cowan would make, could go forward to the College. Barnes was sympathetic to the suggestion that another bank or financial institution might take a small interest in the UK bank to provide management advice and help to establish a good market image.

2.348 PW visited the Bank on 26 March 1991 and handed over a draft of what became PW's discussion paper on Preliminary Restructuring Proposals. This set out proposals for successor banks to take over the core businesses of the BCCI group based on PW's assessment of the majority shareholders' likely intentions. Both the Bank and PW expressed irritation that neither the majority shareholders nor BCCI had as yet

approached the UAE Central Bank. PW discussed their paper on 3 April with the Hong Kong supervisors, who had some reservations but generally felt that it provided a sensible framework from which to develop detailed plans.

2.349 On the eve of the College meeting, Mr Khalid Kalban of the UAE Central Bank called at the Bank, as it had suggested, to discuss the proposed restructuring plan. Kalban himself favoured the plan but saw great difficulties in the Central Bank giving a firm answer on the Middle Eastern bank within a short period and foresaw a number of problems, some of a supervisory nature, some arising from lack of contact with BCCI senior management and the majority shareholders and some within the Central Bank itself (there had not been a board meeting for eighteen months, when the terms of office of the Governor and directors had expired).

Recruitment

2.350 The month saw little progress towards the appointment of a new board and new management, although PW discussed names of possible appointees with the Bank on 25 March 1991 and on the same day the Bank first met Mr Khalifa Nasser, who had recently been appointed Iqbal's second-in-command with responsibility for handling the restructuring. On 26 March 1991 the Banking Supervision Division discussed the names of possible UK senior directors.

The US authorities

2.351 The board of BCCI had signed a cease and desist order in the US, which provided for BCCI to sell CCAH but committed the Abu Dhabi Government to support First American. Meanwhile, Small and Baxter were continuing to pursue their enquiries into BCCI's loans to CCAH shareholders. The Bank said that it had known of these loans since 1988, but had not known there was anything odd about them until 1990. The names of some of the shareholders with BCCI/CCAH loans had been familiar to the Bank for some time as long-term customers of BCCI and sometime shareholders, but knowledge of their involvement in CCAH was more recent. The New York District Attorney was also pursuing his investigation, seeking from PW all the information PW had supplied to the Fed, and more. He was threatening to indict PW for false accounting and the pressure on PW was intense. Subpoenas served on PW's World Firm and New York partners had proved unavailing, since none of them had any relevant documents, but a number of PW's reports (including those of 18 April and 3 October 1990 and PW's briefing paper for the task force) were being sought, and PW were concerned at becoming a target of the investigation. A visit to the Bank by representatives of the District Attorney and the New York State Banking Department revealed the breadth of the District Attorney's investigation, which was by no means limited to CCAH and First American.

The board

2.352 Relations between PW and the directors were continuing to deteriorate. The directors, shocked by what they had learned on 1 March 1991 (paragraph 2.326 above), felt that PW had wrongly withheld vital information from them and delayed in completing their audit work. PW felt that it was the duty of the management and majority shareholders to keep the directors informed, that the circumstances of the audit were exceptional and that their task of investigating the past and preparing for the future was not assisted by carping criticism from the directors.

Financial problems

2.353 PW's investigative work was in large part directed towards ICIC, about which PW had written a detailed letter to Mazrui on 2 March 1991, urging the need for full and urgent investigation. Mazrui agreed to an investigation on 14 March 1991, but he

did not agree to the suspension of Mr H M Kazmi, the effective manager of ICIC, and he later decided that the ICIC files should be collected from the Caymans by Mr David Youngman, a former senior partner of Ernst & Whinney in the Middle East, now advising the Ruling Family. Arrangements were made for finalising PW's terms of reference and bringing the documents to Abu Dhabi. In their report of 28 March 1991 prepared for the College, PW explained that the audit had been delayed for a number of reasons, one of which was the need to investigate ICIC.

2.354 PW also questioned Chowdry about the operations of the Islamic Banking Unit in London and unrecorded deposits. He said that acting on instructions from Naqvi he had placed funds with ICIC, which had defaulted in making repayment. To conceal this, he had used deposits not recorded in the books to cover up the amounts supposedly due from ICIC. He had prepared a statement of outstanding funds in April 1990, which he had telexed to Naqvi so that he could brief the shareholders. Iqbal had also been involved in the presentation to the shareholders in April 1990, and he had been aware of these facts. Kazmi, when questioned, gave a different explanation, but said Chowdry would have known the detail of these transactions.

The College meeting

2.355 When the College met at the Bank on 4 April 1991 a report by PW dated 28 March 1991 had been circulated. It said that the audit had been delayed and was not expected to be completed until May. There was thus likely to be a delay in publication of the accounts. The unaudited results for the year suggested a loss of about $700 million. The problem loans (which were to be taken over or supported by the Government) were still estimated to amount to about $4.1 billion, but whereas the 3 October report had estimated $2.527 billion to be recoverable and $1.491 billion to be a loss, the recoverable sum was now estimated to be $1.186 billion, leaving an estimated loss of $2.891 billion. The report drew attention to two risks remaining with BCCI: the risk that the Government would reassign loans back to BCCI if they were found to involve illegal or criminal activity going beyond false accounting; and the risk of losses beyond the $750 million guarantee given by the Government to one of the two companies established to realise group loans.

2.356 At the College meeting, supervisory bodies of the UAE and France were represented in addition to those of the UK, Luxembourg, Switzerland, Spain, Hong Kong and the Caymans. Losses were reported or predicted in the UK, Luxembourg, Hong Kong, the Caymans and Spain. Hong Kong had discovered the routing of funds to the Central Treasury through third party banks, to evade local funding caps. France, having discovered breaches of local regulations, had placed formal restrictions on BCCI's activities. The supervisors discussed recent bad publicity the group had received. They also discussed the forthcoming 1990 accounts: since these were to be the last annual accounts of Holdings and SA, the IML wanted full disclosure of the restructuring, unrecorded liabilities and contingent liabilities, even if this meant (temporarily) a low risk asset ratio.

2.357 The supervisors considered PW's paper on restructuring to be a basis for continuing discussion but to require substantial further work. Problems were envisaged in Hong Kong and the Caymans, and the UAE wanted time to look at the proposals. No decision on a holding company had yet been taken: neither the UK nor Hong Kong was prepared to receive one, being unwilling to undertake consolidated supervision; the UAE had no legislation or precedent for coping with such a structure. Most of those present agreed that a structure with no holding company was to be preferred, although consolidated supervision (if achievable) would have been better still and the Swiss representative thought consolidated supervision essential. The IML's position remained that complete, detailed, definitive and workable plans were required by 30 June 1991 if the deadline was to be extended.

2.358 The supervisors were joined in the afternoon by Salem (Abu Dhabi Government), Iqbal and Nasser (BCCI) and PW (Cowan, Charge and Mr Robert Brown). Cowan mentioned that three investigations (including that into ICIC) were proceeding to establish whether there were any further material undisclosed liabilities of BCCI as a result of the activities of former management, and if any accounts were issued before the results of these investigations were known any audit opinion would have to be heavily qualified. A delay in publication of the accounts until May, or beyond, was envisaged.

2.359 Bartlett, in the chair, said that overall the supervisors considered the restructuring proposals a workable framework but Salem emphasised that much work remained to be done. The IML repeated its deadline, but Salem said Booz Allen's report would not be ready until July or August. Bartlett expressed surprise that work had only just begun. Salem said that no decision had yet been made about a holding company; such issues would be discussed with supervisors bilaterally.

2.360 After the College, Barnes wrote to Salem on 11 April 1991, on its behalf, in terms agreed with the other members. He recorded the College view that the restructuring proposals provided an acceptable framework, but emphasised the need for early bilateral contacts with all the principal supervisors involved. A fully articulated restructuring plan was required by the end of June 1991, to be implemented by the end of the year. The College position was restated on early publication of the accounts; the difficulty of agreeing to a holding company; the need for final plans to cover relations between the three banks and the shareholders and the supervisors; and other issues.

2.361 On the day after the College meeting PW and the Bank met. Bartlett considered the supervisors' morning session constructive and Cowan said PW and BCCI were delighted by how the afternoon session had gone. BCCI had been interviewing potential senior staff and Cowan's concern was to keep the impetus of the College meeting going. Iqbal had been told he was not to continue as chief executive officer. The shareholders were sceptical about the need for three separate management and board structures, and as to whether a UK bank was necessary at all. Cowan felt that a holding company would make commercial sense, but understood the supervisors' concern about the burden of consolidated supervision which would be placed on the supervisor in its place of incorporation. He indicated that an interim section 41 report would be issued shortly, before finalisation of the accounts, to outline the main issues. There were now several strands of the investigation which needed pulling together, and PW were having problems in inducing Kazmi (of ICIC) to talk.

2.362 It is not easy in retrospect to understand how the Bank and PW could in early April 1991 have been other than pessimistic about the future. The IML deadline had three months to run. The financial package had not been finally signed, so the group was still technically insolvent. The accounts, already overdue, would be still further delayed and would show huge losses. The final outcome of the various investigations in progress was not known but must on past experience have appeared likely (particularly to PW) to produce disturbing revelations. The prospect of hostile proceedings and adverse publicity in the US had not receded. Even the basic decisions on the future structure of the group had not been taken, and there was no realistic possibility that a detailed structural plan, approved by the shareholders and the relevant supervisors, would be available by the end of June. The directors and managers of the new banks (wherever they might be) had not for the most part been appointed. I find it surprising that there was not a sense of impending crisis, and that the Bank did not judge this College meeting (attended by Salem for the shareholders and Kalban of the UAE Central Bank) to merit the personal attendance of one of its most senior supervisors. But it must be very doubtful whether anything the Bank could reasonably have done at this stage would have averted the ultimate collapse of the group.

38 5 April-30 April 1991

Financial package

2.363 In a paper dated 5 April 1991 the Board of Banking Supervision was told that only one signature remained outstanding to complete the financial package, but the month ended with this signature still outstanding. The group was meanwhile suffering liquidity problems, partly caused by the nervousness of correspondent banks and partly by supervisory action to reduce intra-group lending. These problems were exacerbated when, as Iqbal told PW on 25 April 1991, the Abu Dhabi Investment Authority withdrew $250 million, at the instigation (as Iqbal thought) of Salem, who had always opposed the Government's investment. Iqbal was confused whether the Government wanted to save the bank or not. It appeared that the final signature was held up by the absence of Mazrui, from whom the final signatory wanted certain explanations before signing.

Restructuring

2.364 PW discussed restructuring with the Bank on 10 April 1991, in particular the procedure for authorising a new UK company. It was envisaged that authorisation in the UK should be obtained by 30 June 1991, in Hong Kong by 30 September 1991 and in the UAE by 31 December 1991. The Bank's procedural requirements were made clear. There were further meetings with the Bank on 17 April and 22 April 1991, when restructuring was discussed. But Mazrui was still away, and several major decisions had yet to be made (such as who would be running the banks and whether there should be a holding company). There had been no answer to Quinn's letter of 13 March or the College letter of 11 April 1991 (paragraphs 2.340 and 2.360 above).

2.365 PW met the IML in Luxembourg on 23 April, at PW's suggestion, to ensure that they fully understood the IML's requirements on the June deadline. The IML made plain yet again that if no concrete restructuring plan was in place by 30 June 1991 SA's banking licence in Luxembourg would be withdrawn. In particular the IML required firm agreements of principle from host authorities and a detailed plan for implementation. The shareholders had to demonstrate clear commitment and support for the plan including detailed implementation within the deadlines. The IML would countenance no delay due to commercial considerations. The IML envisaged a residual non-bank company in Luxembourg to handle transitional problems. The final restructuring plan would have to be ready for the next College meeting in June.

2.366 On 30 April 1991 PW told the Bank that Nasser, Habroush and Salem were all taking a responsible attitude towards restructuring, and were planning to consult with the UAE Central Bank.

Recruitment

2.367 When PW met the Bank on 22 April 1991, it was agreed that the most crucial need in the UK was a manager to handle restructuring. PW were inclined to favour Chaudhry: he had been general manager of BCP between 1986 and 1989 and might be implicated in certain irregular transactions during that period, but he came well out of the task force report. PW had reservations about Chowdry, particularly in relation to the unrecorded deposit issues which would be covered by the section 41 report. The Bank indicated a slight preference for Chowdry, who knew the UK Region and whose compliance officer knew the Bank's requirements, but it was willing to accept Chaudhry if he were chosen. The IML, on 23 April 1991, questioned whether the proposed structural changes could be pushed through by the existing board and considered that the composition of the board and senior executive management needed attention. Iqbal, on 25 April 1991, told PW that prospective appointees approached to

join the new bank were asking for very large remuneration. But Iqbal himself was known to be the subject of suspicion by the US authorities, and PW were aware that in 1987 he had signed an arrangement for a loan to someone who was not responsible for repaying it. However, he would not be involved in the new bank. Cowan confirmed that, although it was probably not appropriate to list the individuals, BCCI was aware of the need to consider who would be acceptable in the new banks.

Financial problems

2.368 PW's investigation into ICIC was not proving straightforward. Although about 180 files were removed from the offices of ICIC in the Caymans and taken to Abu Dhabi, most of these were said to relate to the Ruler's affairs and were not made available to the investigating team. PW had understood that when the files had been collected they would be able to conduct a full investigation into ICIC, but there was great difficulty obtaining agreement on their terms of reference and strong opposition by Youngman to the conduct of any investigation of ICIC by PW otherwise than as members of the investigating team. The Cayman supervisors shared PW's concerns about ICIC but the directors of BCCI did not. At an audit committee meeting on 11 April 1991, when PW reported on current investigations into problem loans, BCP, ICIC and under section 41, they were asked why ICIC was so important, since it was an entirely separate entity and not part of BCCI. PW reminded the directors of their earlier references to this topic and took the opportunity to explain the scope of the section 41 investigation.

2.369 On 22 April 1991 PW told the Bank that the group accounts would not be out before 30 June 1991: they would be qualified, but not very seriously. If published at once, they would be heavily qualified in relation to the ICIC investigation and potential unrecorded liabilities. The Bank appreciated that the ICIC investigation, in particular, was delaying finalisation of the accounts. When PW visited the Bank on 30 April 1991, it was two days after the second meeting of the investigating committee in Abu Dhabi. No detailed reference was made to this.

The US authorities

2.370 Although completion of the financial package, restructuring, recruitment and PW's investigation of outstanding financial problems were all crucial to the future of the group, and on 11 April 1991 the Board of Banking Supervision viewed the situation with concern, the attention of Bank supervisors was dominated during April 1991 not by any of these issues but by the activities and reports of various US authorities.

2.371 The New York District Attorney continued to apply strong pressure on PW to produce College reports, and PW were expecting to be subpoenaed to do so. Both PW and the Bank were concerned as to how they should react.

2.372 The Bank received from BCCI a copy of a letter dated 12 April 1991 from Senator John Kerry to Mr Alan Greenspan, chairman of the Federal Reserve Board. Senator Kerry was chairman of the Senate Foreign Relations Committee's Sub Committee on Terrorism, Narcotics and International Operations which had, since a date before the Tampa indictment, been investigating BCCI. In his letter, written in strong terms, the Senator drew attention to BCCI's lack of a consolidated supervisor and to the fact that the proposed scheme for reorganisation of the group into three banks would still provide for no consolidated supervisor. He called on the Fed not to approve any transfer of the assets of BCCI or CCAH until the Fed was satisfied that all the assets would be subject to the oversight of a single, consolidated supervisor. This letter was plainly intended to thwart BCCI's proposed restructuring plan.

2.373 In Abu Dhabi, Small and Baxter had identified a number of documents originating in London and bearing on BCCI's relationship with CCAH. They were not

allowed to take the documents, or copies, to the US, but did persuade the Abu Dhabi authorities to allow copies to be sent to Allen & Overy in London. Once the documents were in London, it was proposed that the Bank should obtain the documents under section 39 of the Banking Act and, subject to satisfying itself that the Fed was conducting an enquiry relevant to the supervision of BCCI and that the documents were relevant to that enquiry, make the documents available to the Fed. This proposal gave rise to considerable discussion. The legal implications were explored. Iqbal was consulted and did not object. The Fed gave details of its enquiry. It was decided to adopt the proposal, and two notices under section 39 were formally served on Chowdry on 26 April 1991. The situation was complicated by an injunction previously granted to one customer to restrain BCCI from disclosing matters relating to his account. The Bank's intention was, however, to disclose to the Fed such documents as it properly could.

2.374 On 16 April 1991 US Customs told the Bank of significant intelligence being gained from those convicted at Tampa. Warning was given that BCCI was likely to "blow up" again soon in the US and become very political.

2.375 The Governor was representing the Bank in Basle in early April 1991 when he was approached by Greenspan and also by Mr Gerald Corrigan, president of the New York Fed. Both were highly respected and influential US central bankers, and they warned the Governor that BCCI was about to be prosecuted in New York for breach of security laws and, probably, fraud. They thought it would be a big case, involving the indictment of BCCI as well as individuals. There was mention of New York gossip that BCCI's London arm was involved in drugs money-laundering. Corrigan wanted someone to visit the New York Fed. The Governor said the Bank was considering the possibility of ring-fencing the UK operations, in order to protect depositors. No objection was raised. The Governor felt it desirable that a senior Bank supervisor should discuss the case with Corrigan. Bartlett happened to be in New York at the time, and it was arranged that he should call on the New York Fed.

2.376 He did so on 15 April 1991. He learned that both the Fed and the District Attorney expected to complete their investigations in upwards of two months. The Department of Justice was also conducting an investigation, into drug money-laundering. Bartlett gathered that the Fed wanted BCCI out of the US altogether, and the New York Fed was resentful that other supervisors had not kept it informed. While in the US Bartlett also spoke to other supervisors, who mentioned their belief that Independence Bank in California was owned by BCCI through a customer nominee. This was not news to the Bank, since PW had mentioned it on 28 February 1991 (paragraph 2.323 above).

2.377 It was felt desirable that Barnes should himself visit the US, in particular to learn how the activities of BCCI in the US impacted on the group's UK business. Before he did so, Corrigan again told the Bank of his concerns about money-laundering, counterfeit currency activities in South America and possible links with Middle Eastern groups. He described BCCI as a "cesspool" and spoke of possible serious consequences for the Bank.

2.378 Barnes visited the US on 29-30 April 1991, spending time in New York and Washington. In New York, Corrigan made plain that the Fed were determined to proceed swiftly and actively against BCCI; their action would be public and everything would come out; there would be criticism of other authorities, including the Bank, on whom the effect would be "as bad as Johnson Matthey". He regarded BCCI as "all bad" and thought that the Bank would be unwise to press ahead with any reconstruction until the US developments were clearer, perhaps in the next two weeks.

A similar line was taken by Moscow, the Assistant New York District Attorney. In Washington, Barnes received the same message, although it was delivered in a lower key. The Fed were determined to press ahead with the main case against BCCI, which rested on the lies told about the true control situation in First American. They advised that Senator Kerry's letter had to be taken seriously, warned of impending publicity, questioned the majority shareholders' commitment and speculated on the risks of letting the group disintegrate.

2.379 In his note on his visit, Barnes identified three main areas the US authorities were investigating. The first was whether BCCI had consistently lied to the Fed for ten years about its control of First American, Independence Bank and the National Bank of Georgia. He regarded the evidence he had seen as "pretty conclusive". But no involvement had been traced to the Abu Dhabi shareholders or the non-executive directors of BCCI. Abedi, Naqvi and several of their group support staff based at 100 Leadenhall Street were closely implicated, but no links to the UK Region had been identified to him. The absence of involvement by the majority shareholders and non-executive directors and of links to the UK Region was something Barnes had specifically asked about and regarded as important.

2.380 The other two areas of investigation concerned the BCCI accounts and miscellaneous suspicions of money-laundering, financing arms shipments, counterfeiting US currency, improper loans to politicians and intimidation. In neither of these areas did Barnes find the evidence hard or persuasive, and there were no identified links into the UK Region. Barnes did, however, learn that the District Attorney had evidence from Mr Masihur Rahman, formerly the chief financial officer of the group, of which he obtained a copy.

2.381 Barnes' visit raised what he felt to be worrying issues about the reliability of the group balance sheet, the position of PW, the involvement of the Abedi/Navqi clan at 100 Leadenhall Street and the viability of the proposed reconstruction. Within the Bank, it was thought that Corrigan's reaction was slightly exaggerated but there was concern about the grounds of any criticism to be made of the Bank.

39 1 May-22 May 1991

The US authorities

2.382 The relations of the Bank and PW with the US authorities, which had claimed much time and attention during April, continued to do so in May. But some of the issues were relatively quickly resolved.

2.383 BCCI complied with both of the Bank's section 39 notices to produce the copy documents which Small and Baxter had caused to be sent to London from Abu Dhabi. Following the grant of further injunctions in favour of BCCI customers, it was necessary for BCCI to obtain rulings from the court in its favour which, supported by the Bank, it did. These proceedings were expeditiously and efficiently handled and the relevant documents were handed over to the Fed.

2.384 The New York District Attorney's threat to indict PW and the expected subpoena to produce College and other reports continued to cause concern. The Bank was urged by the Fed to help the District Attorney if it could. Up to this time, the Bank had not been keen to supply material to him and had in any event been advised that, since he was not a UK prosecutor, it was not legally entitled to do so. But the Fed's representations, coupled with criticisms which were beginning to surface in the US press, caused the Deputy Governor to ask for legal advice on how the Bank might assist the District Attorney by providing documents. Advice was given that the Bank could make disclosure if to do so would help it to discharge its own supervisory functions under the Act. PW's own position was discussed with the Bank on several occasions. Eventually, on 22 May, PW formally wrote to the Bank seeking its permission to make full disclosure to the District Attorney of matters relating to its audit of BCCI, the group's 1990 accounts and matters related to CCAH.

2.385 In a paper dated 7 May 1991 Barnes addressed himself to the criticisms likely to be made of the Bank in the US. In summary, he judged these to be that the European supervisors had not inspected BCCI sufficiently rigorously, that they had enabled BCCI to exploit the fragmented structure of the group so as to indulge in intra-group transactions designed to deceive the US authorities, that they had taken too narrow a view of their local responsibilities, that they had failed to keep the US authorities informed, that they had been insufficiently ruthless in pursuing the truth and that they had placed too much reliance on the auditors. Barnes felt that the Fed were embarrassed because they, like the European supervisors, had been misled. He also felt that these criticisms (if applied to the Bank) were unreasonable because

(i) the Bank's formal responsibility was limited to supervision of the UK branches, together with the fitness and properness of the shareholders and senior management;

(ii) no links had been found into the UK Region which would have merited action by the Bank, (or where they had, as with the section 41 investigation into the "lost" deposits, the Bank had taken action);

(iii) the Bank had kept the fitness and properness of senior management under continuous review (Naqvi had been trusted until 1990 and then he was sacked);

(iv) beyond the call of its formal responsibilities, the Bank had taken the initiative in forming the College and working, with the auditors, to penetrate the opacity of the balance sheet and to clarify the true asset quality of the bank;

(v) that process had been maintained at a pace which had kept the financial soundness of the group and the financial commitment of the Abu Dhabi shareholders intact, to the benefit of creditors; and

(vi) arguably, the Americans would not have obtained the evidence they were now assessing without this relentless pressure.

2.386 Barnes went on to identify what he felt to be the "weaker parts of the UK position". These were: possible slowness (but greater speed might have lost the shareholder commitment); the continuing preference of the Naqvi clan in senior group positions; the US evidence showing most of them to be tarnished; and the College's preoccupation with financial soundness, rather than hunting down the guilty men (partly because of jurisdictional limitations). But he felt the Bank had given all possible assistance to the Fed. Finally, Barnes reviewed the suggestion made by Corrigan (sharply contradicted by other sources in the Fed) that the proposed restructuring should be stalled. Having stated the pros and cons of that course, he concluded that the US authorities had not so conclusively proved their case that the Bank should unilaterally abort the reconstruction at that stage. That was a view which the Board of Banking Supervision endorsed on 9 May 1991, having heard an account by Barnes of his visit to the US. The Board thought it desirable to press ahead with the ring-fencing of the UK operations, although "on the assumption that none of the present directors, controllers or managers of BCCI was implicated in the US investigations".

2.387 The suggestion that the Bank had been alerted to fraud and malpractice in BCCI, particularly fraud and malpractice affecting CCAH, and had not alerted the US authorities, was to be made more than once during this period. The Bank took the suggestion very seriously, since it greatly valued its relations with the Fed, and it caused its files to be searched to ascertain whether the suggestion was well-founded. It concluded that it was not, and the Fed ascertained that a communication thought to have been made to the Bank early in 1990 had in fact been made to the IML. In briefing Quinn, Bartlett said that the Bank had, for quite some time, been suspicious of links between BCCI and ICIC, but although there were banks in the ICIC group most of the group fell outside the scope of normal supervisory investigation. He pointed out that ICIC was not owned by BCCI, but there were significant common shareholders and common borrowers and a relatively large shareholding by ICIC in BCCI itself. He could find no other evidence of serious wrongdoing where, with hindsight, the Bank might have reacted in a more positive way, although he mentioned certain anonymous accusations in the files which might now be seen to have an element of truth in them.

2.388 Warnings by the US authorities of damaging revelations likely to erupt in the US did not cease or diminish in intensity. In the second week of May 1991 the Bank learned that BCCI was likely to become an even greater issue in the US, with potentially far-reaching political ramifications. At Basle on 13 May 1991 Corrigan again stressed to the Governor and Quinn the gravity of the offences which BCCI might have committed and the possible implications for the Bank. On the CCAH/First American issue the grounds for prosecution appeared strong. On a range of other offences the evidence was much less solid but a number of transactions appeared questionable. There was likely to be much publicity, which might be enough to bring down the group. On 15 May 1991 the New York Fed wrote to Barnes observing that "every stone we turn over covers up another illegal activity within and without the United States".

Restructuring

2.389 The US authorities' arguments against proceeding with the restructuring of the group did not cause the Bank or PW to slacken their efforts towards that end. BCCI's draft application to incorporate a UK subsidiary was discussed by the Bank and PW on

2 May 1991 and on the same day PW reminded the board that a detailed restructuring plan, and approval by the Bank of an application for full UK authorisation, were required by 30 June 1991. On 16 May Iqbal reported to the Bank that Booz Allen had now made a number of recommendations which would be discussed with supervisors in the ensuing 2-3 weeks. Rapid progress was now being made in resolving the outstanding issues and the shareholders aimed to meet the IML deadline. Later that day, just returned from Abu Dhabi, Cowan told the Bank that the shareholders were happy with the framework proposed by PW and that managers to run the new banks had been identified (although not yet engaged). But no decision had been taken about a holding company. Cowan advised the Bank to work on the assumption that there would be none.

2.390 Having read the note of this conversation, Quinn asked how, in the face of US arguments that BCCI's structure made control by any regulatory authority impossible, the Bank could justify the structure of the new group with no overall holding company. Bartlett replied that ideally the Bank would like a holding company and proper consolidated supervision. But no supervisor was prepared to undertake the task; the UAE Central Bank was not only unwilling but probably also incapable of fulfilling such a role. The next best solution was the three bank scheme, with strict limits on intra-group flows, the continuation of the College and an important continuing role for the auditors in providing relevant information to the College. On 21 May 1991 Quinn noted that he had not yet heard anything which should deter the Bank from continuing with its normal consideration of the restructuring. But a change of procedure was contemplated. It was now unlikely that the College would meet in June; instead, the IML would judge whether the BCCI plan was satisfactory and would seek the views of other supervisors bilaterally. The Bank still considered mid-June a sensible working deadline for completion of the plan.

Recruitment

2.391 Plans for the board and management of the proposed UK company did not advance. Cowan and Bartlett discussed the UK management team on 9 May 1991, but the conversation did not progress beyond the point reached in April.

Financial problems

2.392 PW's investigation of ICIC continued to meet difficulties. Access to the files was denied. But on 2 May 1991 Salem said PW's terms of reference for the ICIC investigation should be whatever was necessary to satisfy them as auditors. He added that in his view ICIC was owned by BCCI and Mazrui was acting as the controller of ICIC in his capacity as a director of BCCI. He agreed that PW should qualify their audit opinion if they were unable to obtain the necessary audit satisfaction regarding the ICIC group. (The IML later indicated to PW that if they qualified their audit opinion on this ground that might lead the IML to refuse SA a renewal of its licence.) PW told the BCCI directors in their report of 2 May of their urgent need to investigate ICIC to determine whether there were any further material undisclosed liabilities of the BCCI group, but the board maintained its view that it had no concern with the operations of ICIC because ICIC was independent of BCCI.

2.393 At a meeting on 3 May 1991 (not attended by PW) the board had before it a summary report, prepared for a meeting of the investigating committee on 28 April, which described the history and development of the fraud in BCCI. The board was dismayed at some of the contents, which it considered unfair, but were impressed by the scale of the fraud when (after the meeting) they were shown some of the customer reports on which the summary was based. One of the directors told PW that he now distrusted everyone who worked for BCCI.

2.394 But the investigation of ICIC remained an intractable problem. A team, which included representatives of PW, E&W and the Abu Dhabi Investment Authority, was briefed on 8 May to visit the Caymans to make a limited investigation of ICIC, and

arrangements to do so had been put in train. On 16 May 1991 PW reported to the Bank that the team had not as yet made progress and the team had not left Abu Dhabi because of delay in obtaining clearance from the Caymans.

Financial package

2.395 The group meanwhile continued to suffer severe liquidity problems and the final signature on the financial package remained outstanding. On the Bank's calculation, the current cost to the majority shareholders of supporting BCCI (including the cost of its shareholding and its 1990 support) was $10.1 billion. This included the sum of $2 billion misappropriated from the Ruling Family's portfolio, described in a Bank note as "Private subsidy by Abu Dhabi Royal Family". With the financial package still unsigned and the group's liquidity problem exacerbated by the withdrawal of Abu Dhabi funds, Iqbal was in mid-May acknowledging the real possibility that the bank would fail. He thought PW should spend less time trying to assist in the restructuring of BCCI and more in looking after their own position, as the situation could turn extremely nasty if the shareholders finally decided to withdraw their support.

2.396 PW's estimate of the cost of supporting the group had by this time risen above the figures given in the Doomsday Report (paragraph 2.319 above). The 1990 loss was now estimated at $1.2 billion, but even this figure was to be treated with caution and a number of uncertainties remained. An additional $250 million capital subscription was needed to restore the risk asset ratio at 31 December 1990 to 5.2 per cent.

2.397 Iqbal's mood was much more optimistic when he telephoned the Bank on 16 May. He understood the final signature would be obtained shortly; the Government had injected $124 million into the bank; a further $250 million was to be injected in a few days' time. By 20 May $400 million had been received from the Government and the group's liquidity was much improved. Arrangements had been made for a substitute to sign in place of the unwilling signatory, and Mazrui was shortly to visit London, hoping to see Quinn and Barnes. It was made plain, expressly and in writing, that henceforward Mazrui was to be the sole channel of communication between the supervisors and the shareholders. Cowan attributed this move to Mazrui's exasperation at the lack of action by Habroush and Salem in recent weeks. He may have been right. But it may also have reflected the majority shareholders' growing disaffection with PW.

2.398 On 22 May 1991 the Bank and PW learned that the financial support package had been finally signed. It was a long and detailed agreement. It increased the majority shareholders' potential support to about $5.1 billion, made up of promissory notes ($3.061 billion), a guarantee ($750 million), subscription for new shares ($400 million, increased on 7 June 1991 to $650 million) and replacement of unrecorded deposits if the underlying claims were substantiated (up to $600 million). The promissory notes and the guarantee were to take effect as if the agreement had been made on 29 December 1990. A side letter confirmed that the Government would not, on the basis of its existing knowledge, invoke the clause entitling it to reassign loans to BCCI as tainted by criminal or illegal activity. That had been PW's understanding all along. (On 7 June 1991 the Government committed itself to give further support and the Ruling Family waived its claims against BCCI.)

40 Mr Rahman

2.399 Mr Masihur Rahman is a well-qualified chartered accountant who from 1974 until the end of July 1990 was chief financial officer of the BCCI group based (from about 1977 onwards) in London. As chief financial officer, he was an important executive, responsible for consolidating the accounts of the group and liaising with the external auditors. He was a member of several group committees and a director of three group companies. But he was never, despite the importance of his position, a member of the small, inner group which, with Abedi and Naqvi, ran the bank. He was not directly concerned with the affairs of ICIC, but knew of the ICIC Staff Benefit Fund, and as a long-serving and senior member of BCCI management, regarded himself as a potential beneficiary of that Fund.

2.400 In early 1990 Rahman played a prominent role in the task force set up to investigate the financial problems which had come to light (paragraph 2.171 above). Perhaps as a result of what he then learned, perhaps for other reasons, Rahman left the group at the end of July 1990. He had expected to be generously compensated on leaving, and was outraged to be offered a cheque for £26,000, which he rejected with contempt. In early September 1990 he issued a writ against a number of defendants, including ICIC Holdings and ICIC Overseas, but the proceedings were not in the event pursued.

2.401 The US investigators came to know of Rahman's willingness to talk about the affairs of BCCI. They interviewed him in London and believed him to be a potentially important witness, both because of the position he had held and the access to information he had enjoyed in BCCI and also because, on leaving BCCI, he had kept a number of very significant documents. One of these found its way into the press and led to the grant of an injunction to SA and Holdings, restraining Rahman from disclosing their confidential information. But the terms of the injunction permitted disclosure to official authorities, and on 25 and 26 April 1991 he testified at some length to the grand jury empanelled by the New York District Attorney and to the New York Fed.

2.402 When Barnes visited New York at the end of April 1991 he learned of Rahman's testimony (paragraph 2.380 above) but he did not, on returning to London, initiate any approach to Rahman to explore what he had to say. Rahman's solicitors, however, wrote to the Bank offering his co-operation, which the Bank accepted, reluctantly, since Rahman's evidence to the Fed was not judged to be of great value. Rahman and his solicitor accordingly called to see Bartlett at the Bank on 22 May 1991. He then made allegations of fraud against several shareholders and managers of BCCI, contending that the restructuring of the group should not proceed without removal of the executives who had perpetrated the fraud. His major complaint was that the funds of the ICIC Staff Benefit Fund had been misapplied to make good the 1986 Central Treasury losses, but he also alleged that BCCI deposits had been placed with ICIC, that $300 million of BCCI's capital had been effectively loaned to ICIC Overseas, that the Central Treasury losses had been a fraud and not a genuine loss, that there had been a fraud in operation for several years involving 8-10 executives as well as Mazrui and the Crown Prince, and that more than 70 false accounts and shell companies had been established, to which $300 million had been syphoned off in loans which then vanished, save that some had been traced to the Gokals. He regarded the Ruler of Abu Dhabi as one of the group's few genuine shareholders.

2.403 Quinn, Barnes and Bartlett met on 24 May 1991 to discuss (among other things) Rahman's very lengthy evidence to the Fed, with reference in particular to the relationship of BCCI and ICIC. Quinn asked if a series of route maps could be prepared to indicate the flows of funds between the groups but was told that the Bank, and probably PW as well, lacked the information to do this. Quinn noted that as a result of Rahman's deposition a number of questions needed to be asked. Some of these related to the knowledge PW, the IML and the Bank had had of BCCI's activities in relation to CCAH and Independence Bank. One of them was "whether there is any evidence to support the charge that the activities were masterminded out of London". I find this a surprising query, since it had been clear for a long time that all the significant activities of the group had been masterminded out of London.

2.404 On 29 May 1991 Rahman's solicitors sent the Bank his second affidavit sworn in the action against him, which summarised his complaints more intelligibly than his oral evidence to the Fed or his presentation to the Bank, although covering much the same ground. On 6 June 1991, at the request of the Bank, Rahman's solicitors sent it his first affidavit which, although drafted in haste and professedly incomplete, made a number of allegations concerning the ICIC Staff Benefit Fund, the establishment of ICIC Overseas as a secret bank receiving BCCI deposits, loans to fund the purchase of BCCI shares, the use of ICIC to buy shares in First American, the Central Treasury losses, the making of non-performing and undocumented loans, the making of loans to front companies and the use of CCAH to acquire banking interests in the US.

2.405 The Banking Supervision Division reported on Rahman's evidence to the Board of Banking Supervision on 6 June 1991, pointing out that he was a man with a grievance but accepting that some of his allegations needed to be taken seriously. Nothing more was done before the Bank was closed.

2.406 This is a small, but perhaps revealing, episode. Although Rahman lived and worked in the UK, it does not surprise me that it was the US authorities who contacted him and first elicited his evidence, since no comparable search for information was initiated here. When told of his evidence the Bank initiated no approach to him to explore what he had to say and his offer of co-operation was only reluctantly accepted. When it learned of his allegations, the Bank was right to be circumspect: he was an ex-employee who might be motivated by malice, and he might have been using the threat of publicity to try and coerce BCCI into settling with him on his own terms. But some of what he said (for instance, about the use of the ICIC Staff Benefit Fund to help make good the Central Treasury losses, and the creation of the 70 front companies) the Bank knew, or should have known, to be true, and other allegations (for instance, about ICIC, CCAH and non-performing loans) coincided sufficiently closely with what the Bank had heard elsewhere to give them apparent credibility. If the Bank had really wanted to know more of the inner workings of BCCI it would have been bound to pursue Rahman's allegations in order to establish whether, or to what extent, they were soundly based. That it did not do so is, I think, largely because the Bank did not see itself in an investigative role. It may have owed something to the Bank's lack of interest in the past misdeeds of former management, but that does not explain the Bank's failure to pursue the points raised about Mazrui and executives still in office. I can well understand the Bank viewing Rahman and his allegations with scepticism, which may have been to a greater or lesser extent justified; I have much more difficulty, particularly in view of the timing, in understanding the Bank's failure even to try to explore whether the allegations were true or not.

41 The US authorities: 23 May-27 June 1991

2.407 Questions of documentary disclosure to the US authorities continued to occupy much supervisory time and attention between 23 May and 27 June 1991.

2.408 One problem of principle was resolved when the Bank was advised that it could make disclosure to the New York District Attorney if satisfied that this would help the Bank's own task of supervision. It was then a question whether the Bank was so satisfied. Another, more practical, problem was resolved when the Bank, in reply to PW's letter seeking its consent to make disclosure to the District Attorney (paragraph 2.384 above), gave its consent, although this did not absolve PW from the need to obtain other consents. A still more practical problem arose when the New York grand jury and the Department of Justice subpoenaed the Fed to produce the documents it had obtained from the Bank after the Bank's use of section 39 (paragraph 2.383 above): the problem was resolved by an agreement that some documents should be produced and some not. The brevity of this summary gives a misleading impression of the time these questions took to resolve.

2.409 Exchanges with the US authorities did not suggest that their hostility to BCCI was abating, although the Fed made clear that it had not unearthed anything which incriminated Mazrui or the Ruling Family. It was, however, known to the Fed that Abedi had used funds entrusted to him by shareholders on a discretionary basis for funding non-performing accounts and lending against the security of CCAH shares.

2.410 In mid June 1991 the Deputy Governor and Quinn visited the US. They called at the New York Fed where Corrigan, although grateful for the Bank's help in supplying documents, continued to feel that the Bank had not alerted the Fed to indications of malpractice affecting the US when it should have done. He also warned of evidence pointing more strongly to a range of criminal activities and to capital transactions designed to conceal the financial weakness of the group. There were likely to be criminal proceedings in a glare of publicity, and Senator Kerry might bring a number of matters (such as the $600 million unrecorded deposits) out into the open. Quinn said that the Bank did not know what the missing deposits represented and expected to learn more when PW reported back on the matter.

2.411 The Deputy Governor and Quinn also met the New York District Attorney and Moscow, to whom they made clear that the Bank's particular interest was in the owners and directors of the bank; if material was available on these matters, the Bank might be able to give disclosure. Moscow said that he had a very substantial amount of evidence relating to individuals still in senior management positions, and said he had overwhelming evidence that senior management knew of widespread drug money-laundering activities in the group. It was left that the District Attorney would write to the Bank and the Bank would take legal advice on whether it could make disclosure.

2.412 Moscow duly wrote to the Bank, although his letter was largely overtaken by the New York grand jury's subpoena. But it was thought desirable for Bank representatives to inspect the material Moscow had available, and to that end Diggory and Miss Jones visited the US between 23 and 25 June 1991.

2.413 At their first meeting, with the New York Fed on 23 June, they were left in no doubt of the authorities' determination to take action against BCCI. When they called on Moscow on the following day they indicated the Bank's interest in prospective

directors, controllers, managers and officers of the new banks and he commented on a number of individuals in terms which were usually unflattering but generally unspecific. Further meetings with the District Attorney, Small and Baxter followed. It was said that Rahman had produced a list of BCCI malefactors which included a number of those already discussed (such as Iqbal) and also Chowdry.

2.414 Diggory and Miss Jones were much struck by the intensity of the investigations being undertaken in the US and by the volume of material collected. Their unease about BCCI was, as a result, greatly increased. They noted the US authorities' apprehension about the authorisation of new banks and their doubts whether the ghosts of the past could ever be laid to rest. They did not come away with very much usable material, but did feel that very serious questions had been raised about the shareholders which might make it very difficult for the Bank to satisfy itself about their fitness and propriety. At an internal meeting on 27 June Bartlett, reporting on their visit, said they had learned a good deal that was new and disturbing about senior management and shareholders.

2.415 It is impossible to be sure what effect these US disclosures would have had on the Bank's decision-making if they had stood alone. Perhaps none. But I have a very clear impression that when knowledge of the US authorities' beliefs and intentions was added to the contents of PW's draft section 41 report, they helped to weigh the balance decisively in favour of the action which was in the event taken.

42 Restructuring: 23 May-22 June 1991

2.416 The month from 23 May to 22 June 1991 showed some real progress towards formation of a new UK subsidiary and some, although less, progress towards restructuring of the rest of the group.

2.417 PW wrote to Mazrui on 23 May 1991 listing the outstanding restructuring issues on which decisions were required. These included fundamental matters such as the structure of the new group, the management of the new banks, the winding up of ICIC and questions whether the new banks in Hong Kong and Abu Dhabi were to be based on the existing banks or reincorporated as new companies. On the same day PW told the Bank that they hoped to give it a business plan and operational details of the new UK bank on 28 May but in the absence of decisions on outstanding points such as whether there should be a holding company they thought mid-June the earliest practicable date for submission of an application.

2.418 On 28 May 1991 Mazrui and Nasser called at the Bank. They first met Barnes, to whom Mazrui outlined the three bank scheme and stressed the full commitment of the majority shareholders despite what they had recently learned about Abedi's activities and the bank's financial position. He outlined the majority shareholders' intention to remove all current senior management, and outlined a proposed board structure, with certain directors common to each of the three banks but with each board having its own chief executive officer, financial controller and non-executive directors. Names were mentioned for the UK bank, although only one had agreed to serve. Booz Allen were considering a feasible structure for the UK bank and were preparing a business strategy. These proposals would be presented to the Bank by BCCI management and their advisers.

2.419 Mazrui and Nasser then went on to meet Quinn, who alluded to past difficulties and outlined the Bank's wishes for the future (including speedy publication of satisfactory and transparent financial statements and satisfactory supervisory arrangements). Quinn indicated that the Bank would seriously consider a request for additional support by the UAE Central Bank.

2.420 On 29 May 1991 the Bank received BCCI's draft UK application and on 31 May 1991 BCCI's restructuring proposals were presented to the Bank by a team which included representatives of BCCI, PW, Booz Allen and the shareholders. The plan was for a smaller, better focused bank, with some existing operations covered by the UK company and others discontinued. Arrangements were to be put in train for the UK company to begin trading at the beginning of October 1991.

2.421 There was some dissatisfaction in the Bank at the risk asset ratio which BCCI were proposing for the UK company. The Bank favoured a higher figure. But at an internal meeting on 4 June 1991 Quinn observed that the initial American excitement over possible discoveries in the US had appeared to lessen recently and he had not seen anything which led him to believe that the Bank should object to the proposed restructuring.

2.422 Mazrui had meanwhile visited Hong Kong to discuss restructuring with the supervisor there. There had been discussion of the risk asset ratio likely to be required, and it appeared that there was to be no holding company, no management services company and (probably) no reincorporation.

2.423 In early June a British banker approached to act as chief executive of the UK company indicated probable acceptance, and it was indicated that the chairmen and deputy chairmen of all three banks were likely to come from the UAE.

2.424 In its report dated 6 June 1991 to the Board of Banking Supervision, the Banking Supervision Division reported on the draft application which had been received and on the majority shareholders' plans for the UK. Subject to ironing out some existing problems and others that might arise on consideration of the application, the Division envisaged the grant of approval in principle for the new bank before expiry of the IML deadline at the end of June, "provided that the US investigations do not throw up serious problems for the restructuring". No similar caveat was entered in relation to PW's investigation under section 41. Nor was it when the Board discussed the paper at its meeting on 13 June 1991.

2.425 BCCI, PW and Allen & Overy called on the Bank on 13 June 1991 and BCCI's draft business plan and application form were considered in detail. The Bank's required risk asset ratio was stated. The Assessment Committee was to consider the application on 25 June. On 18 June, BCCI sent the Bank 12 copies of its revised draft application and updated business plan and projections. These were substantial documents. They provided for a risk asset ratio at the required level and took account of other comments by the Bank. The only reservation expressed at an internal Bank meeting on 18 June 1991 related to the proposed name, regarded as rather grandiose.

2.426 There is room for very real doubt whether, in view of what it had learned (and should have understood) about the business of BCCI, particularly over the preceding eighteen months, the Bank was well-advised to give even provisional blessing to these restructuring plans until the past had been comprehensively explored or a clear understanding for the future reached with the majority shareholders. But there are two points on which I have no doubt at all. First, by pressing for submission of plans for a UK company, by discussing these plans and by indicating the likelihood of approval if the Bank's points were met, the Bank gave the shareholders every reason to believe that, subject to allaying the Bank's technical concerns (for instance, about the risk asset ratio), it would raise no impediment to implementation of these plans. The majority shareholders received no hint of any kind that these plans were subject to the outcome of PW's section 41 investigation, which indeed the Bank had never on any occasion mentioned to any representative of the majority shareholders. Secondly, in omitting to enter a caveat relating to PW's section 41 investigation, the officials of the Bank were guilty of no deliberate duplicity. It was not that they entertained a mental reservation based on this investigation which they omitted to express. The truth is that they entertained no mental reservation. At internal meetings and in internal papers, just as in meetings with BCCI, PW and (very occasionally) the shareholders, there is scarcely a reference to section 41. In the minds of officials this investigation did not loom as a significant matter. The reason is, I think, that this was regarded as an investigation into whether there were $600 million of unrecorded deposits and whether these were true liabilities. By June 1991 no one really doubted that the answers to both questions would be affirmative. The majority shareholders had already agreed to cover these liabilities, if such they were shown to be, so the outcome of the investigation did not greatly matter. It is easy to understand the majority shareholders' feeling of betrayal when the Bank relied on PW's draft section 41 report to close the bank, since they naturally suspect that this unspoken possibility must have been in the Bank's mind all along. This was not the case.

43 PW, the 1990 financial statements and the draft section 41 report: 23 May-22 June 1991

The 1990 financial statements

2.427 In a letter to Mazrui on 30 May, in a report to the Holdings board on 3 June and at an acrimonious board meeting on 4 June 1991, PW said that they could not complete their audit until they were able to investigate ICIC fully. In the view of Lamarche, no further work on ICIC was likely to be achievable, and PW should consider how best to express their reservations in their audit opinion. On 6 June and again on 11 June PW told the Bank that they would have to refer to ICIC in the accounts and if they could not get the information they required they might have to qualify.

2.428 But despite restrictions on their access to ICIC PW were able, largely as a result of the investigating team's recent visit to the Caymans, to form an opinion on the relationship between ICIC and BCCI. They set out their conclusions in a report to the directors of Holdings dated 17 June 1991 and a covering letter dated 16 June. Their conclusion was that the management and finances of BCCI and ICIC were inextricably linked. Reference was made to circular transactions between BCCI and ICIC amounting to over $1 billion, the principal purpose of which had been to falsify the records of loan activity within BCCI. Although their information was incomplete, PW judged the combined financial position of ICIC Holdings and ICIC Overseas to show net liabilities of $178 million, with additional risks to the BCCI group. PW were unable to conclude that there were no material liabilities of BCCI arising from the activities of former management in relation to ICIC, and suggested a note to be included in the 1990 accounts. But they advised that the note could be amended if an indemnity were given by the majority shareholders against all liabilities arising out of ICIC. At a board meeting in Abu Dhabi on 17 June 1991 the directors at first refused to receive the report, expressing willingness to accept PW's unamended note, without any indemnity, but on legal advice the directors agreed to accept copies of the report.

2.429 In their report of 3 June 1991 to the directors of Holdings, PW presented a provisional estimate of the 1990 results showing a loss of $1.174 billion after a loan loss provision of $650 million. These figures were discussed with the Bank on 11 June, when PW said that they hoped, but did not expect, that the financial statements would be approved. Cowan referred to a number of uncertainties which, if not resolved, would have to be mentioned in the audit report, and to a number of investigations in progress, of which the outcome was uncertain and which would also have to be mentioned. Barnes' view was that these would be the last set of accounts in the existing form and that it was therefore appropriate to include as much detail as possible about potential liabilities, especially since the shareholders were committed to putting the past behind them and looking to the future. He felt it did not matter how awful the accounts were, provided there was a strong statement of support by the shareholders.

2.430 The draft financial statements were the subject of prolonged discussion at the board meeting on 17 June 1991. PW at first tabled an audit report disclaiming an audit opinion, but the directors rejected this, and after a break for consideration PW indicated that a heavily qualified opinion might be possible instead of a disclaimer, provided the bank had unequivocal support from the shareholders in respect of contingencies such as US penalties, ICIC and restructuring costs. A revised draft opinion along these lines was presented. Mazrui emphasised that the majority shareholders' commitments were

binding, but that he could not go to the Ruling Family seeking blanket approval for the advance of unspecified sums of money. Hoult listed some of the potential future costs, and Mazrui said the shareholders had already demonstrated beyond doubt their commitment to support the bank. Hoult said that it would be on the basis of these representations that he felt an opinion on a going concern basis could be given. On the day after the meeting PW wrote to Iqbal summarising the matters to be resolved before the accounts could be signed off: they warned that unless these matters were resolved the accounts could not be signed in time for the AGM on 28 June 1991.

2.431 On 19 June 1991 PW reported to the Bank on the accounts, which they felt the board had come close to agreeing. Several issues were outstanding, but it was hoped that these could be resolved by 28 June. One remaining problem related to the $650 million support awaited from the shareholders: there was a commitment to subscribe for new preference shares, but the subscription had not been completed.

2.432 On 24 June 1991 PW wrote to Habroush. Their letter was intended to ensure that the majority shareholders were fully aware of the continuing uncertainties affecting the financial position of BCCI and to seek written confirmation that the Government intended to continue its support for the foreseeable future so that BCCI could meet its liabilities as they fell due. Reference was made in very explicit terms to manipulation, collusion, nominees, bogus transactions, fraud and deception, and to the possibility of claims for which no provision had been made. A letter confirming the Government's support was attached for signature by Habroush, but it was never signed. By this stage the majority shareholders had lost confidence in PW, and the Bank was told in confidence of their intention to replace them as auditors at the AGM.

2.433 On 18 June 1991, following the board meeting, PW visited Mazrui at the Department of Private Affairs in Abu Dhabi. Hoult said how much he welcomed Mazrui's assurances at the board meeting of the shareholders' continuing support. While not retracting his comments, Mazrui said that he did not wish to be quoted. But he thought the Government would pay because of what it had already invested. PW then broached two matters which were causing them concern.

2.434 One of these concerned share dealings by Mazrui, of which the investigating team had recently learned in the Caymans. They were dealings in BCCI shares between Mazrui and ICIC Overseas, one of which in 1986 had given Mazrui a profit of $4 million on a purchase and resale made on the same day. Mazrui admitted that he had had such dealings, although he questioned whether he had received as much as $8 million (which PW understood to be the total of his receipts), said Abedi had pressed him to hold the shares and claimed that he had given most of the proceeds to charity. PW regarded the transactions as highly questionable, since there was no active market in BCCI shares which could have yielded a genuine profit in such a short time. Mazrui points out that he had not expected this subject to be raised at this meeting, and he was shown no documentation to remind him of the transactions to which PW were referring. He now recalls receiving an unexpected credit to one of his bank accounts, which Abedi explained as the proceeds of a very profitable transaction in BCCI shares carried out on his behalf. He tried to give the money back, but Abedi would not accept it. So he gave the surplus proceeds to charity.

2.435 The second matter concerned a confirmation signed by Mazrui for what had turned out to be a fictitious loan. Mazrui agreed that the signature on the confirmation looked like his, but could not remember signing it and thought it might be a forgery. PW did not find the suggestion of forgery persuasive, although they did accept the possibility that Mazrui had signed a piece of paper put in front of him by Iqbal without reading it. The Inquiry has been supplied with documents by the majority shareholders which leaves the true history of this matter in serious doubt.

2.436 PW mentioned these matters to Salem, who thought the share transactions should be reported to Habroush. PW also mentioned both of these matters to Barnes, whom Hoult met by chance at Basle airport on 20 June 1991. Barnes was leaving on holiday the next day, so on his return to the UK he telephoned Quinn to pass on the substance of the conversation. Barnes regarded this as the first hint of any taint against Mazrui that he had received.

The draft section 41 report

2.437 PW's draft section 41 report was mentioned when PW visited the Bank on 11 June 1991. Cowan said that PW hoped to have a draft in the Bank's hands before it had to reach conclusions about the application to form a UK bank. Barnes thought this would be most helpful, and said he would be particularly interested to know whether the shareholders were involved in any way in the deposit issue. Cowan said there were no indications that they were, but added that they might well be involved in other transactions. This observation was not questioned or elaborated.

2.438 On 19 June 1991 Cowan told the Bank on the telephone that he hoped to get a draft section 41 report to the Bank on 21 June 1991 and stood ready to talk over any issues with the Bank. He said it might contain a few surprises for the Bank, and thought the Bank's reactions might affect the restructuring in some way. Miss Clare Latham asked what areas might cause concern. Cowan said there were implications concerning a number of members of the existing management, and also a shareholder representative whom he did not name. Miss Latham feared that this might prevent the Bank doing more than approve the application in principle.

2.439 Cowan telephoned Miss Latham on 20 June 1991 to say that the draft section 41 report would not be with the Bank until 24 June. Since she understood the contents might have an impact on the UK application to be considered by the Assessment Committee shortly, she asked for a summary. PW had concluded, Cowan said, that there was a reasonable probability of the $600 million missing deposits being liabilities. Chowdry had facilitated the transactions, although it was difficult to know if he had done so knowingly. In the context of the whole group, the investigations had cast doubt on the whole of senior management. In particular, transactions with PW's principal contact with the Abu Dhabi Government (understood to be Mazrui) compromised him. PW were much concerned about his position and were seeking a meeting with Habroush to discuss this. The report would arrive on 24 June: Cowan was anxious to get the Bank's reaction to it as soon as possible.

2.440 Charge took PW's draft section 41 report to the Bank on the night of Saturday 22 June 1991 and handed it, addressed to Bartlett, to a security guard. The report was in draft because it had not been finally completed. It was delivered to the Bank in draft so that the Assessment Committee knew PW's provisional conclusions when considering BCCI's draft application, and so that the scope and contents of the report could be discussed with the Bank before it was finally completed.

2.441 When PW delivered their draft section 41 report, they thought it might affect the shape and detail of the restructuring but did not envisage that it might lead to the closure of the bank. Their main concern, I think, related to the accounts, and in particular the shareholders' willingness to give an expression of unqualified support, although PW were hardening in their view that they would have to disclaim an audit opinion. Reading the Bank's contemporaneous records, I discern no sense of impending crisis. Had any crisis been expected, it would hardly have been thought satisfactory for Barnes, as Head of the Banking Supervision Division, to go on holiday on 21 June without plans for his return or consultation in case of emergency. (As it was, and although he left a telephone number, the Bank did not communicate with him during what turned out to be the crucial fortnight which culminated in the closure of the bank. The first he knew of the closure was when he returned from holiday on 6 July 1991 and read of

it in the newspaper.) With the IML deadline a week away, the overdue 1990 accounts unapproved, the shareholders' support unconfirmed, their global restructuring plans incomplete and the continuing threat of damaging US revelations, it is hard in retrospect to understand why the course ahead did not appear more hazardous.

44 PW's draft section 41 report

2.442 PW's draft section 41 report was in form and content very evidently a draft. It made plain that further verification was needed and that much of the information had been obtained recently. It was closely based on the work of the investigating team.

2.443 On the limited question of the unrecorded deposits, the draft report confirmed that most of these at least were genuine liabilities. But the report ranged very much wider, giving a comprehensive and detailed account of the frauds and deceptions which had been practised in the group over a substantial number of years so far as they were then known. Thus detailed reference was made to

(i) falsification of accounting records;

(ii) external vehicles use to route fund transfers and "park" transactions;

(iii) the use of nominee and hold-harmless arrangements;

(iv) the fraudulent use of the Ruling Family's funds;

(v) the creation of 70 companies to facilitate and disguise lending to the Gulf Group;

(vi) collusion with third party banks to make loans to BCCI customers, so as to avoid disclosure of such lending on BCCI's balance sheet;

(vii) collusion with customers and others to give false confirmations to the auditors of fictitious and non-recourse loans and loans received as nominees;

(viii) Central Treasury losses;

(ix) ICIC.

The history of the Gulf lending was summarised. A number of accounts (including the CCAH lending of $1.45 billion) were reviewed in some detail and said to have been made to nominees, with no liability for repayment. While the strategic decisions to manipulate accounts and make use of ICIC and CCAH were attributed to Abedi and Naqvi, a number of named individuals were said to have falsified documents and manipulated accounts. Among those suspected of questionable conduct were Iqbal, Chaudhry and Chowdry. PW recorded their understanding that Mazrui and the Government had been fully briefed on all the problems in April 1990. Reference was made to Mazrui's share dealings, to his apparent confirmation of a fictitious loan, to the majority shareholders' failure to disclose problems of which they were allegedly aware when the accounts had been finalised in April 1990 and to indications of alleged impropriety (a proposed share transaction on a guaranteed return basis and an "out of book" loan to finance a buy-back of shares) by the Abu Dhabi Investment Authority. Reference was also made to the personal implication of Chowdry in the misuse of unrecorded deposits. In PW's view the falsification and deception had been on such a scale that the true financial history of BCCI was unlikely ever to be recreated.

2.444 This very brief summary fails to convey the powerful cumulative effect made on the mind by a reading of the whole report.

45 The final phase: 24 June-5 July 1991

2.445 Bartlett and Miss Latham received copies of the draft section 41 report on the morning of Monday 24 June 1991. Cowan and Charge of PW called in the afternoon to discuss it. Bartlett was clearly somewhat shaken by the report, both by its strong language and because it went further than earlier reports. Cowan thought there was not very much new in it, and suggested that its impact was the result of including all the various threads in one place. There was discussion of Mazrui's questionable share dealings and of the accounts, but in Cowan's view PW were almost bound to disclaim an opinion given the significant open-ended uncertainties, even with an unequivocal statement of shareholder support. Bartlett said the Bank had some hard, serious thinking to do about the future, and was very nervous of a disclaimed opinion. Cowan asked what the Bank's view of the proposals for the UK would be in the light of the report, and the Bank representatives were unable at that stage to say. His own view was that there would have to be more wholesale management changes than the Bank had previously contemplated, and Mazrui would have to go. Closure of the bank had not crossed his mind as a serious possibility. He expected the draft report to lead to further discussion and consultation.

2.446 This early meeting with the Bank was arranged because Cowan planned to fly to Abu Dhabi that day or the next. In the event, the meeting he hoped for with Habroush proved impossible to arrange. He remained in London for the week and told the Bank of his availability for discussion if wanted. He was not approached.

2.447 On 25 June 1991 Bartlett told the IML that the Bank was not likely to meet the deadline of 28 June for giving approval in principle for the new UK bank. This, he said, was because of new information the Bank was receiving from the US and PW. Internally, the Bank was considering the possible consequences if BCCI were closed or its licence were revoked. Miss Latham calculated the quantum of possible claims on the Deposit Protection Fund on 25 June, and on the next day she prepared a paper on contingency plans. She there listed a number of precipitating factors. First among these was the draft section 41 report (described as "fairly damning"). Also in the list were: the results of Diggory and Miss Jones' recent visit to New York; the lack of a public commitment by the majority shareholders; the 1990 accounts, showing large losses and with a heavily qualified or disclaimed opinion; the possibility of a run on deposits; the risk that a new UK company might be seen as the old BCCI in disguise; inability to present acceptable restructuring plans in time to meet the IML deadline; other investigations which might lead to prosecution, adverse publicity or financial penalties; and the risk that other supervisors might revoke. She set out reasons why the Banking Act criteria were no longer met and reviewed the possible courses of action, which included orderly wind-down and revocation with restrictions.

2.448 Quinn read the draft section 41 report overnight on Wednesday 26 June. He found it devastating. His mind was in no way prepared for it. Had he been fully alive to the story as, in a piecemeal way, it had unfolded to the Bank (from the confidential meetings in early February and on 2 March 1990, through the reports of 18 April and 3 October 1990, the doubts raised about Chowdry and the detailed allegations of Rahman), he would still have been much struck by the comprehensive and cumulative effect of the draft report, but its contents could scarcely have come as quite such a complete surprise.

2.449 When the senior managers met on 27 June, reports were made on the draft

section 41 report ("a devastating criticism of how the bank was run under the management of Abedi and Naqvi"), the visit of Diggory and Miss Jones to New York ("where they had learned a good deal that was new and disturbing about senior management and shareholders") and PW's inability to give an audit opinion. Various options were considered, to be discussed with the Governors shortly.

2.450 Bartlett considered that recent developments raised serious questions about authorising a new UK bank. He reviewed these questions in a paper dated 27 June. The developments he had in mind were: the outcome of Diggory and Miss Jones' visit to New York; the draft section 41 report; and the 1990 accounts. He felt that the balance had now swung against authorising a new bank, and favoured making a visit to the shareholders to agree on a means of winding down the bank in an orderly way. In a telephone conversation on 27 June, Cowan gave Bartlett the impression that he expected the Bank to be having second thoughts about the restructuring in the light of the draft section 41 report.

2.451 At a long meeting chaired by the Deputy Governor on 28 June 1991 the whole situation was discussed and it was concluded, subject to formal consideration by the Review Committee and discussion with the Governor, that the proposed restructuring could not be pursued.

2.452 A meeting chaired by the Governor followed almost at once. The Governor agreed that, in the light of what PW had revealed, the proposed restructuring was no longer appropriate. Rather, the Bank should explore as a matter of great urgency how to protect depositors. It was agreed that the Bank should speak to fellow members of the College, particularly the IML, with a view to convening a College meeting. The Fed should be informed. The possibility of approaching the Abu Dhabi shareholders should be explored. Quinn thought this probably meant a visit to Abu Dhabi by Jaans and himself. The Bank's wish was to co-ordinate action internationally, but it was willing, if necessary, to act independently. Up to this point no clue to the Bank's thinking had been given to BCCI management, the majority shareholders or PW. Nor had the contents of the draft section 41 report been communicated to other supervisors. But the IML were concerned that the accounts were not available and that a restructuring plan had not been submitted; a meeting was to be held in Luxembourg at the end of the forthcoming week; and an extension of one week, until 5 July 1991, had been set for submission of the accounts.

2.453 Following the Governor's meeting, urgent action was taken to call a meeting of the Board of Banking Supervision for Monday 1 July, to inform the IML and the Fed (both in Washington and New York), to alert the Treasury and to initiate arrangements through the FCO for Quinn's proposed mission to the Abu Dhabi.

2.454 Over the weekend there were meetings both in Abu Dhabi and London. In Abu Dhabi, PW met Mazrui, who said the majority shareholders' support could not be open-ended: his people would think it a crime if they knew how much was being paid, BCCI was bleeding too much and no assurance could be given. His own share dealings were raised, and he gave much the same explanation as before. Following the meeting, a draft letter of authorisation was prepared for the Crown Prince to sign, showing financial support requirements of $6.9 billion (a figure which included the support already given by $3.061 billion of Abu Dhabi Government promissory notes and the guarantee of $750 million). PW also met Iqbal, who felt the IML were becoming difficult about the submission of the accounts. In London, the Deputy Governor and Quinn met Mr William Taylor of the Washington Fed, to whom they summarised the Bank's initial thinking: the Bank could not now proceed with restucturing of the group or authorisation of a new UK Bank; action was essential to protect the interests of UK depositors, either by way of a revocation with supporting directions or by a restricted

licence accompanies by supportive action by the Abu Dhabi authorities; a mission to Abu Dhabi was envisaged during the following week to inform the authorities of the Bank's decision and the reasons for it; a College meeting would be held to decide on the course of action to be followed. Taylor was given a copy of the draft section 41 report, and did not rule out US participation in a mission to Abu Dhabi.

2.455 The working week which began on Monday 1 July was one of intense activity. Reference will be made in this account only to those meetings which were of outstanding significance.

2.456 The Board of Banking Supervision met on 1 July 1991. The meeting was of necessity arranged at short notice and two independent members were unable to attend. Those who did attend were able to read the draft section 41 report before the meeting began. It was explained to the Board that the Bank felt unable to proceed with the proposed restructuring of the group and that the IML's deadline would accordingly take effect. Quick and concerted action by the major supervisors was therefore required. A mission to Abu Dhabi was planned. After a very full and wide-ranging discussion the Governor noted that the questions of the size of the delegation and the time it would stay in Abu Dhabi remained open. He asked whether the Board members were content with the proposed course of action. All four of the independent members present fully supported it.

2.457 On the evening of 1 July 1991 Miss Mary Keegan of PW learned that the draft report had been made available to other supervisors. She was concerned, both because the report was still a draft and subject to verification and because neither Hoult nor Cowan (both of whom were in Abu Dhabi) had been able to talk to the Bank about it. On the same evening Corrigan telephoned the Bank from New York: he doubted the value of a mission to Abu Dhabi and felt that the whole exercise was being rushed; he was concerned at the implications for the dollar payments system if action were taken before a thorough analysis had been made of BCCI's worldwide business.

2.458 There were two meetings of particular significance on 2 July. One of them was in Abu Dhabi, when Hoult and Cowan spent 1½ hours alone with Habroush. They told him in detail about Mazrui's share dealings, of which he had some awareness, and also about Mazrui's confirmation of what was thought to be a fictitious loan. They also discussed financial support: Habroush took the line that this was a matter for the Crown Prince and Mazrui; he would follow instructions. But he did not think Abu Dhabi alone should have to support the bank. The supervisors had licensed the bank and they also had obligations. He was not prepared to give an open-ended undertaking of support.

2.459 In London, there was a College meeting at the Bank. Quinn presided. In addition to the Bank, the IML, Spain, Hong Kong, the Caymans and France were represented and there were two US observers. Quinn described the draft section 41 report as a remarkable document, providing the first hard evidence supporting allegations of criminal activities and the first clear indication of such transactions being routed through the UK branches. The Bank's position was explained, and possible courses of action outlined. After a full discussion in which the supervisors supported collaborative action, it was agreed that the best option would be to visit Abu Dhabi and obtain the shareholders' co-operation.

2.460 Although the Board of Banking Supervision and the College favoured a mission to the Gulf, Corrigan was much opposed to this proposal and support for it faded within the Bank. There were, I think, two main reasons for this. One was the fear that if BCCI management, a number of whom were believed to be implicated in past malpractice, were alerted to what was in the wind steps might be taken to withdraw

deposits and take possession of assets in fraud of creditors. The other, and probably more important, reason was the Bank's apprehension that if a mission visited Abu Dhabi, the majority shareholders would be bound to ask for time in order to consider what they should do, and delay was something the supervisors felt unable to contemplate. It was accordingly felt that it would be better to act first and discuss afterwards rather than offer the majority shareholders an opportunity for fruitless dialogue. By the evening of Tuesday 2 July the Bank thought the best course was to give Mazrui an effective choice, at the meeting which he was to attend in Luxembourg on 5 July, between agreeing to voluntary liquidation or facing the prospect of compulsory action.

2.461 Hoult had a last meeting with Habroush on 3 July 1991, when they further discussed Mazrui's share dealings, of which Habroush was very critical. He asked PW for their continued co-operation, and repeated his view that it was unreasonable for Abu Dhabi to support BCCI alone without contribution by the supervisors. Hoult then met Salem, with whom he discussed the make-up of the additional $1.7 billion of support now needed. Asked for written confirmation that he knew of no other matters arising from the investigation process which should be revealed to PW, Salem refused, although in answer to repeated questions he gave such confirmation orally.

2.462 The Bank had asked Cowan to return to London from Abu Dhabi in order to attend a meeting at the Bank on 3 July, which he did, accompanied by Mr Ian Brindle, recently appointed to be senior partner of PW in the UK. They met the Deputy Governor and Quinn. Four points of substance emerged from the meeting. First, PW made clear their extreme unhappiness at the prospect that the contents of their report might leak out or be disseminated. Secondly, reference was made to the possibility of supervisory action, which prompted PW to say that if there was such a prospect they could not sign off the accounts at all. Thirdly, the Deputy Governor indicated that the Bank did not intend to authorise a new UK bank, and there was discussion of the majority shareholders' likely reaction to supervisory action and their likely attitude to a run-down of the group. Cowan thought Habroush might favour a controlled run-down but Mazrui might be less predictable. Fourthly, the Deputy Governor asked for a letter explaining the precise status of the draft report.

2.463 Cowan left this meeting unsure what the Bank intended to do. He asked Bartlett, who said the Banking Act did not allow him to say. But he did not contradict Cowan's suggestion that the only effective alternative to a new UK licence was liquidation. Cowan told Bartlett that he did not think there could be an orderly run-down if the licence was revoked. He was concerned the Bank might have misjudged the position. PW were in the process of finalising the financial support package and had indicated they did not wish to see Mazrui involved with the new companies. The Government had indicated that it was committed to provide financial support of about $7 billion, and although it had said it was not prepared to enter into an open-ended commitment PW were encouraged that, if it was prepared to provide support of that order, it would ultimately have to put in further funds if it wished to safeguard its investment. If agreement could be reached with Abu Dhabi on the amount of financial support required, PW would sign the audit report with a disclaimer of opinion but indicating that the financial position of BCCI was underpinned by the support of the Abu Dhabi Government.

2.464 On the evening of 3 July 1991 Cowan returned to the Bank with Mr Mark Armour, who had just flown in from the Gulf. They met Bartlett, Miss Jones and Miss Latham. Cowan and Armour made clear their strongly held view that closure of the bank was not in the interests of depositors and would infuriate the Abu Dhabi shareholders who had injected large sums of money into the bank and were willing to inject more. Changes of management were already being made. If the draft section 41

report were to leak, the shareholders would withdraw future funding and assets would disappear. PW had considered the implications of liquidation earlier in the year, and had concluded that a liquidation would be anything but orderly; there would be competing claims from different jurisdictions and the ensuing litigation could last for the rest of the century. PW found it paradoxical that this action should be taken when the shareholders were offering their cheque book to support the bank. But PW were not hopeful their arguments would prevail. Bartlett appeared to them to be resigned to the inevitable: he said the decision was out of his hands, but undertook to see that PW's strong concerns were known to those who needed to know.

2.465 On 4 July 1991 PW told the Bank of their great concern on learning that their draft section 41 report was in the hands of the New York District Attorney. They also expressed, both to Mr Alan Hardcastle (in his capacity as a member of the Board of Banking Supervision) and Quinn their strong opposition to the liquidation of the group, which they regarded as "a nightmare scenario".

2.466 The Board of Banking Supervision met again on the morning of 4 July 1991. All six independent members were present. The Governor reported on a meeting with the Prime Minister and other ministers and officials from which he had just returned, and outlined the proposed plan of action: on the following day the IML and the Bank would meet with Mazrui in Luxembourg and seek an orderly winding down of BCCI; following that meeting the IML, the Bank, the College and the US supervisors would take legal and regulatory action to close SA and Overseas, freezing all assets and liabilities. Hardcastle expressed concern that there was to be no supervisory mission to Abu Dhabi, which had been intended when the Board had met on 1 July, but Quinn explained that in the unanimous view of the College the risks of alerting interested parties, and so precipitating withdrawal of funds and disorderly collapse of the bank, were too great. Concern was also expressed at the prospect of, in effect, confronting Mazrui with a fait accompli, since he could not be expected to commit the shareholders immediately to an orderly winding down of the group, having arrived at the meeting wholly unaware that such a proposal was to be made. Quinn answered that it was important for the supervisors to act in a way which would protect creditors, should the shareholders decide to walk away from BCCI. Most of the meeting was devoted to discussion of the procedure best suited to achieve a freeze of assets and liabilities in the UK. The Board favoured liquidation. Hardcastle agreed, but thought it important to ensure that the Ruler was briefed before action was taken. The Governor said it was proposed to tell him through his representative at the Luxembourg meeting. Mr Nigel Robson felt that the priority was for quick, collective supervisory action.

2.467 In response to the Bank's request, PW wrote to confirm the status of the draft section 41 report. They could not, they said, fully support the detailed information provided in the draft report, or confirm its completeness; but they believed that the report reflected the general scale and complexity of the deception and falsification which had undoubtedly taken place over many years.

2.468 PW considered, on the afternoon of 4 July, whether they should seek a meeting with the Governor to express their concerns about what they regarded as precipitate and prejudicial action. They decided against: they had made all the points they could and it seemed clear a decision had been made.

2.469 Representatives of the Bank and PW flew to Luxembourg for their final meetings before action to close BCCI was taken.

2.470 The first meetings held in Luxembourg on the morning of 5 July 1991 were between Quinn and representatives of PW. At these meetings Quinn indicated his intention to give a copy of the draft section 41 report to Mazrui as the shareholders'

representative, an intention which PW vigorously contested. Quinn gave way and agreed not to release the report to Mazrui.

2.471 The first formal meeting of the day was attended by the IML, the Bank and Mazrui, attending as the shareholders' representative. Jaans referred to the long overdue accounts of BCCI, the abnormal draft audit opinion received from PW, the negative capital of the bank at the end of 1990 and additional information held by the Bank, which ruled out any possibility of the proposed reconstruction of BCCI being viable. Quinn then confirmed that the Bank was now in possession of disturbing information which meant it could no longer countenance the establishment of a new bank in the UK. A draft report had been received from PW which contained prima facie evidence of fraud perpetrated over a very long period of time. The Bank regretted what would now happen, but had decided that it should act that day to protect existing and future depositors in the UK by immediately freezing assets and liabilities. Jaans confirmed that since the Bank would not permit a new bank to be established in the UK, he could not allow the Luxembourg headquarters to continue.

2.472 Mazrui had come to this meeting expecting and intending to resolve outstanding questions on financial support, the end-year accounts and the restructuring of the group. He had no inkling of the bombshell which was to be detonated. He expressed the shareholders' surprise at the irregularities brought to their attention and referred to the steps which had been taken to rectify these, suggesting the possibility of exaggeration by PW. But confronted with the announcement of imminent action by the supervisors, he did not think there was much the Abu Dhabi Government could do. It had already done its utmost, particularly in providing new finance. He wished to report to his government, and asked for time to do this. Quinn said the matter was serious and immediate action had to be taken, but he wished to suggest, in a constructive spirit, that co-operative action should be taken to deal with the repercussions. Mazrui said that he had no authority to react to proposals on those lines. He could only report to his government that he had been presented with a fait accompli. After a break in the meeting, Mazrui was given details of the action proposed. He complained strongly that the shareholders should have been told in advance. According to the Bank's note of the meeting, he offered an Abu Dhabi guarantee of all deposits if BCCI's licence were retained, but Quinn pointed out the risk of preferring some creditors to others and of precipitating a scramble for assets. He also wondered (privately) if Mazrui had authority to make such an offer. Mazrui himself says that he had no authority to make such an offer and did not make it. Quinn and Jaans said there was no alternative to the action proposed. Mazrui asked for, and was refused, a copy of the draft report. In answer to Schaus, Quinn confirmed that the Bank's decision to take action was final. The proposed action was, indeed, on the point of being taken.

2.473 PW were not invited to attend the beginning of this meeting and Mazrui twice opposed suggestions in the course of the meeting that they be invited to join it. At about midday (London time, 1.00 pm in Luxembourg) Jaans asked PW to join the meeting, which they did. But as they entered the room Mazrui got up, shook hands with the IML and the Bank, and walked out. Quinn then summarised what he and Jaans had told Mazrui and said that the Bank intended to apply to the UK court for appointment of a provisional liquidator. The IML would take parallel action. Schaus asked PW to confirm that they were unable to give an opinion on the accounts. Hoult said that the effect of the uncertainties was so great that there was some doubt whether SA was a going concern. Undertakings of unequivocal financial support were not available and it was not known what the effect of the uncertainties (in the form of possible claims, fines and penalties in the US and the cost of restructuring) might be. Since the effect of these matters could not be ascertained it could not be said that the accounts gave a true and fair view. In answer to a question by Schaus, Cowan confirmed

that there was no possibility of change in PW's inability to express an opinion on the 1990 accounts, and the directors were not in a position to approve them.

2.474 At 1.00 pm on 5 July 1991, on petition by the Bank, the High Court in London appointed three partners of Touche Ross to be joint provisional liquidators of BCCI SA. At 2.00 pm the Luxembourg court appointed the IML to be interim "commissaire de surveillance" of SA. On the same day the Governor of the Caymans appointed a receiver of Overseas, CFC and ICIC. Parallel action in many other jurisdictions quickly followed.

2.475 The execution of this plan, once decided upon, involved intense activity to prepare the necessary legal proceedings, inform and seek the co-operation of other supervisors, inform other government departments and public bodies, brief diplomatic missions abroad and, once the news had broken, answer enquiries by the media and by depositors and others. It is not necessary to describe these activities in detail. Given the decision to close BCCI without advance notice to the majority shareholders or management, the closure itself was well-planned and very skilfully executed.

2.476 The Bank was the prime mover in deciding to close, and in co-ordinating the closure, of BCCI. In part this reflected the economic realities as they had existed for years. In part it reflected the Bank's chairmanship of the College in 1991. In part also it reflected the diminished supervisory role assumed by the IML following its twelve month ultimatum in June 1990: thereafter the IML's main interest in BCCI was in seeing the back of it. But most of all it was because the Bank had commissioned the section 41 investigation and received the draft report.

2.477 The Bank's decision to apply for appointment of a provisional liquidator on 5 July 1991 instead of revoking SA's authorisation in the UK was based on its understanding that the procedure chosen would most effectively freeze BCCI's assets and liabilities, in the interests, as the Bank believed, of BCCI depositors in the UK and elsewhere. I do not think that the Bank's choice of procedure, if it was thought necessary to bring BCCI's business to an end, can be fairly criticised. The Bank could have revoked SA's UK authorisation, since the power to revoke was plainly exercisable on the material before it (and had been, in my opinion, since the early months of 1990), but the Bank's reasons for preferring the procedure it chose, if closure was the object, were in my view sound.

2.478 A more vexed question is whether, on the material before it and the facts as they were understood to be, the course which the Bank followed in seeking the closure of BCCI was an appropriate one. There was no course open to the Bank which offered a quick and complete solution to all outstanding problems without loss, or the risk of loss. All the courses open were to a greater or lesser extent unattractive as liable to cause loss. But the Bank had a statutory duty to protect the interests of UK depositors. Its judgment that those interests were best served, as matters stood, by closure was strongly supported by the Board of Banking Supervision. And while a judgment based on that ground alone might be open to criticism (the Banking Act 1987 apart) as unacceptably chauvinistic, it was a judgment which commanded very wide assent among other supervisory authorities. It cannot be plausibly argued, in my opinion, that the course which the Bank took was not an appropriate one, even though it was not the only possible course.

2.479 That, however, leaves unanswered an important question, whether PW's draft section 41 report should have come to the Bank as the devastating surprise it did. In my opinion it certainly should not. It would not have done so if the Bank had been more alert in receiving and understanding the messages it was given, if those messages (received and understood) had been more consistently brought to the attention of the

most senior echelons in the Bank and the Board of Banking Supervision and if the Bank had more actively pursued the leads it was given. The draft report would not have come to the Bank as such a surprise either if PW, as the various elements of the fraud became apparent, had more plainly and directly, more consistently, more comprehensively and, if they felt their messages were not being received, more vigorously, brought them to the notice of the Bank. Nor would the surprise have been as great if the majority shareholders had made full disclosure to PW and the Bank of all the facts known to them when and as they became aware of them.

2.480 This history was, in its later stages, a tragedy of errors, misunderstandings and failures of communication. When the majority shareholders resolved on 3-4 March 1991 to sign the financial package, both they and PW as members of the investigating committee knew the broad outline of the fraud which had been practised in BCCI over about 15 years. The detail had yet to be verified, and new facts of significance had yet to emerge, but the main elements of the fraud were visible. Had the majority shareholders contemplated that those facts might be relied on without advance notice to close the bank, they would not have supported the financial package or provided the bank with liquidity in May 1991 (paragraph 2.397 above). Had PW contemplated that those facts might be relied on to close the bank, they would not have worked on the restructuring proposals in the belief that finalisation of the 1990 accounts was the main hurdle to be overcome before the group could be re-launched on the basis of the three bank scheme, and they would have resisted the suggestion of closure much earlier. But the Bank was not party to the proceedings of the investigating committee and did not share the comprehensive view of the fraud which the majority shareholders and PW had acquired. PW thought the Bank was broadly in the picture. The majority shareholders may well have thought as much. But the Bank had not been given all the pieces of the jigsaw. It had also failed to recognise some of the pieces it had been given. Of this latter point PW's report of 3 October 1990 provides an illustration: the reference to collusion with major customers to misstate or disguise the underlying purpose of significant transactions was not, it seems, understood at the time as a strong suggestion of dishonesty and the report was never brought to the notice of the Head of Banking Supervision, the executive director of the Bank with responsibility for banking supervision, the Governors or the Board of Banking Supervision. Had the Bank reacted more positively to the information it was given, it may be that PW would have been more assiduous in ensuring that it was fully informed of all relevant facts as and when they emerged.

2.481 In addition to the comprehensive picture of the fraud which the draft section 41 report gave and which the Bank had not previously seen, the Bank has drawn particular attention to two features of the report which deserve brief mention. The first of these is the serious reflection made in the report on the integrity of Mazrui, attention being drawn to his share dealings and to his confirmation of a fictitious loan, and on the conduct of the majority shareholders (paragraph 2.443 above). All these allegations, in respect of which Mazrui and the majority shareholders strongly deny any impropriety and which remain unverified, had arisen at a late stage and had never previously been brought to the notice of the Bank (save in the casual communication at Basle airport on 20 June: paragraph 2.436). The allegations were very serious, relating as they did to the Abu Dhabi shareholders and their representative on the board of BCCI since 1981, and they were much more specific than anything which had been reported to the Bank before. It was not, however, the first time that an accusatory finger had to the Bank's knowledge been pointed at the Abu Dhabi shareholders' representative: paragraphs 2.251 and 2.402 above.

2.482 The second feature to which the Bank has drawn attention is the implication of the UK Region in the fraud. Earlier incidents such as the 1985 Treasury losses and the Tampa indictment had involved Overseas and foreign branches. The draft report for the

first time implicated the UK Region as a participator in serious fraud. This was important to the Bank since the UK Region was to be the heart of the new UK bank. The Bank had, however, known for some months that the role of Chowdry, as General Manager of the UK Region, in relation to the unrecorded deposits was, at best, questionable. One of the reasons for delay in commissioning the section 41 investigation was to avoid alerting Chowdry to an investigation which would involve him, and PW had not concealed their suspicions (paragraphs 2.304, 2.305 and 2.367 above). Since the UK Region was part of SA, and SA was functionally part of the group, it might also be thought relatively unimportant whether fraudulent transactions were handled by the UK Region or not if the central management of the bank was seriously tainted.

2.483 If, as I accept, closure of the bank was an appropriate course to follow, there yet remains the question whether the Bank was right to follow it without previous notice to the majority shareholders. The proposal that there should be a high-level mission to the Gulf before action was taken was initially favoured by the Banking Supervision Division (paragraph 2.450 above), the Governors (paragraph 2.452 above), the Board of Banking Supervision (paragraph 2.456 above) and the College (paragraph 2.459 above). It continued to have adherents (paragraph 2.466 above). There is no doubt that the decision to act without notice to the majority shareholders aroused deep anger and resentment. They felt, with some reason, that they were major victims of the fraud, not its perpetrators. They read the decision as a direct reflection on their good faith, in their view the more unjustifiable since they had (with no obligation to do so) rescued the bank in April 1990 and thereafter continued to support it, most recently by making liquid funds available in May 1991. They were dismayed that this action should be taken by the Bank, with which they had been constructively engaged for over a year in discussing the future of the group and which they had thought to be committed to the same objectives as themselves. They felt deeply wounded that such action should have been taken in this way by a country with which Abu Dhabi has, over many years, enjoyed close ties of trust and friendship. I am not at all surprised by these reactions, fired as they were by an unjustified but potent suspicion that the Bank was guilty of duplicity, and they must be a matter for deep regret. But I do not think the Bank's decision to give no effective advance notice to the majority shareholders can be criticised as wrong. There was, once again, a choice between unattractive courses, each with an imponderable potential for harm. But the Bank's overriding duty was to the depositors of BCCI and if, in the Bank's judgment, prior consultation with the majority shareholders could involve any risk whatever that deposits might be withdrawn or assets dispersed, perhaps at the instance of BCCI management, the Bank was entitled, if not bound, to conclude that the risk should not be taken. The Bank could not properly allow diplomatic or personal considerations to override what it felt its duty to the depositors required. Whether the Bank would have felt able to act differently had earlier opportunities been made to build a closer rapport with the majority shareholders I am unable to judge.

2.484 Public attention has naturally focused most closely on the last fifteen months of BCCI's active existence, which was indeed a period of crucial significance. But the problems which then came to light, in large measure through the work of PW and the investigating team, had their roots deep in the past. Prime responsibility of course rests with those who devised, directed and implemented the frauds which were practised. Whether the frauds could and should have been discovered by the auditors earlier is an issue I have not been asked to investigate. The history, however, makes clear that fraudulent management were able to exploit the structure of the group to facilitate and disguise the frauds. This might have been in part prevented, or brought to a head, much earlier, had strong and resolute action been taken to insist on structural change as a condition of continued authorisation and to impose on the group the supervisory regime it was known to require. The role of Luxembourg as primary supervisor was

allowed (particularly by the Bank) to continue long after it had ceased to reflect any economic reality, if it had ever done so. The Bank did not pursue the truth about BCCI with the rigour which BCCI's market reputation justified. In the later stages the Bank came to rely to an excessive extent, in my opinion, on the auditors: under the British system of supervision the auditors have a crucial role to play but the duty to supervise is placed on the Bank and it is a duty which cannot be delegated. It is the Bank, not the auditor, which is the supervisor. In these respects the Bank's supervisory approach to BCCI was in my opinion deficient. How different the course of events would have been had these deficiencies not existed, one can only speculate.

B HM Treasury
1 General

2.485 HM Treasury is the department of government primarily responsible for the integrity, stability and efficiency of the financial system in the UK. Since the banking system is a central part of the financial system, it falls within the Treasury's area of overall responsibility. Thus the Treasury is responsible for the legislative provisions which govern the supervision of banks in this country. It is heavily involved in negotiating and implementing international agreements in this field. A number of powers are conferred on it by the Banking Act 1987 (and were previously conferred by the 1979 Act). But, as explained in more detail in Chapter I above, the responsibility for supervising individual banks in the UK is entrusted to the Bank.

2.486 In the conduct of its practical responsibility for supervising banks, the Bank is under no obligation to consult or inform the Treasury about particular institutions. The 1987 Act does not, indeed, entitle it to disclose information protected by the Act unless "disclosure appears to the Bank to be desirable or expedient in the interests of depositors or in the public interest" (section 84(5)). As the Bank discharges its statutory function the Treasury is not entitled, and does not attempt, to look over the Bank's shoulder or second-guess the Bank's decisions.

2.487 This does not, however, mean that the Bank discharges its supervisory function without any communication with the Treasury. Following the support operations in the 1970s and the Johnson Matthey Bankers affair (see Chapter 1 section (8) above) it was agreed that the Bank would not commit its own (Banking Department) resources to a rescue operation, without informing the Treasury in advance. If support was required in excess of the range permitted by the Bank's reserves and involved use of Issue Department funds or a Treasury guarantee or indemnity, the Treasury's express agreement would be required. There are other situations in which Treasury officials or ministers would expect to be alerted in good time to possible problems lying ahead. No exhaustive list of such situations can be given, but they include situations in which

(i) financial difficulties are developing for an institution of sufficient importance that its failure might have implications for the UK financial system or economy as a whole;

(ii) diplomatic or foreign relations problems might arise (as, for instance, if the licence of a foreign publicly-owned institution were in danger of revocation);

(iii) the failure of an institution might cause serious disruption to the markets, either generally or in a specific sector;

(iv) closure would be likely to cause hardship and losses to a significant number of retail customers;

(v) the activities of an individual bank might call into question the position of London as a financial centre or have other systemic implications;

(vi) the ownership of a major bank raises some issue of public interest;

(vii) some possible weakness in the legislative framework of supervision is exposed; or

(viii) a case is likely to provoke questions to ministers in Parliament;

(ix) the Bank wishes to inform or seek the aid of other departments of state since under section 84(5) such disclosure requires the consent of the Treasury.

Although the Treasury is not responsible for making or monitoring supervisory decisions, it prefers, generally speaking, to be told of possible problems lying ahead rather than learn of a problem for the first time when a crisis occurs.

2.488 Communication between the Treasury and the Bank takes place very frequently, at several different levels and on a wide range of topics of which banking supervision is by no means the most important or obtrusive. But it is one of the matters on which exchanges regularly occur. Most routine contacts were at the relevant time conducted by the Treasury at Grade 5 level and below by members of FIM 1 division (Financial Institutions and Markets 1), who would ordinarily speak to Bank officials at deputy head, manager or analyst level in the Banking Supervision Division; exchanges on important supervisory problems were conducted at a higher level. The organisation of the relevant parts of the Treasury has changed on several occasions since 1978, but for the period 1986-1991, FIM 1 was part of the Treasury's Financial Institutions and Markets group, whose head was an Under Secretary at Grade 3. Since this group was established in August 1986 its head made it a practice to preside at regular six-monthly meetings with the Bank's Head of Banking Supervision when policy issues and, where appropriate, individual cases were discussed. Similar meetings between Treasury and Bank officials took place before, but on a less structured basis. These regular six-monthly meetings were supplemented by ad hoc meetings and telephone conversations when and as the need arose. The head of the FIM group answered to the Deputy Secretary (Financial Institutions and Markets), who on banking supervisory matters usually communicated with the Bank's Executive Director responsible for banking supervision. Formally, the Deputy Secretary reported to the Second Permanent Secretary, but on banking matters she more often reported directly to the Permanent Secretary. The Permanent Secretary's role was pivotal. He held regular bilateral meetings with the Chancellor and the Secretary to the Cabinet. He also had contact with the Governor. On all of these occasions matters of current concern would be canvassed. Most importantly for present purposes, the Permanent Secretary and the Deputy Governor met informally, with no secretary and no written agenda, roughly every ten days, to discuss matters of common concern. Lastly, the Chancellor and the Governor met roughly once a month, alone save for a private secretary, to discuss topics (of which there might be a number) of current note. Following these meetings the private secretary would supply both participants with a summary record of the views expressed and information exchanged. These various channels of communication have been described in some detail to the Inquiry: in the banking supervisory field there was (subject to the Banking Acts: see Chapter 1 paragraph 1.64 above) no impediment to the communication of information which the Bank or the Treasury, as the case might be, thought it expedient that the other should have. Although the structure has since been altered, that remains the case and the frequency of routine meetings has been increased.

2 History

2.489 In the late 1970s the Treasury became aware of unease about BCCI from the Bank and other sources, but nothing specific was brought to its attention. It played no part in the Bank's decision to refuse SA recognition but license it as a deposit-taking institution under the Banking Act 1979.

2.490 There is no evidence that the Treasury received any information about BCCI between the end of 1979 and May of 1986.

2.491 The Treasury was informed by the Bank of BCCI's Central Treasury losses in May 1986. The shareholders were said to have reconstituted the bank's capital base, but some liquidity problems were thought to be possible when the losses became publicly known. The Treasury was not alerted to the critical view which this episode caused the Bank to entertain of BCCI management.

2.492 Mr S A Hussein says that he sent two letters concerning BCCI to the Chancellor of the Exchequer in January 1987. The Treasury has no evidence that these were received. A third letter, not concerning BCCI, was also sent in January 1987 and it was answered in February.

2.493 In November 1987 the Bank told the Treasury of the supervisory problems which BCCI presented, and in April 1988 it reported the establishment of the College.

2.494 The Treasury was promptly informed of the Tampa arrests and was kept in touch with developments over the next few days. The Chancellor, to whom these matters were reported, was anxious to avoid any suggestion by the Treasury to the Bank that it should rescue BCCI if it suffered a run on deposits. He was also anxious that the Treasury should not in any way usurp the Bank's supervisory responsibility. He did, however, ask the Bank to keep him fully informed, and the Treasury was told of Capcom's suspected involvement in drug money-laundering.

2.495 The Bank informed the Treasury in very general terms of events during 1989, including the Bank's intention in November 1989 "to persuade BCCI to incorporate in the UK their activities here which comprehended 43 branches and their group treasury operation".

2.496 Publicity in the press both before and after the pleas of guilty by SA and Overseas at Tampa provoked a flurry of parliamentary activity. The Treasury was fully involved in drafting and co-ordinating drafts of ministerial speeches and answers.

2.497 To the Treasury, which had been actively engaged in the Financial Action Task Force established by the 1989 Paris economic summit to counter drug money-laundering, the BCCI convictions at Tampa were a matter of very great concern. The Bank's plan for a restructuring of the group to bring it squarely under the Bank's supervisory control was notified to the Treasury and very carefully considered. The Treasury supported the Bank's plan as the tough but correct course, although it was greatly concerned that there should be no further revelation of money-laundering by BCCI and was anxious that the task of consolidated supervision, if taken on, should be thoroughly and skilfully discharged, with adequate resources devoted to it. In the course

of these exchanges the Treasury went as far as it felt it properly could to alert the Bank to its concerns without trespassing on the Bank's supervisory preserve.

2.498 On 23 April 1990 the Bank told the Treasury of difficulty in signing-off BCCI's 1989 accounts. The only reason given was that PW were "not happy about the amount of provisions that BCCI have made (they have a lot of Nigerian debt)". Earlier in the same month the Governor had informed the Chancellor that in many ways BCCI had proved remarkably successful. The Treasury was also told on 23 April of an indication that the Government of Abu Dhabi would now accept a substantial commitment to the BCCI group. On 26 April the Treasury was told that an unqualified audit opinion would be given, although the accounts would show a very substantial loss because of the level of provisioning. It was also told of the majority shareholders acquisition of control and of their plans for restructuring the group and changing the management.

2.499 At no time before the closure of BCCI was any reference, direct or indirect, made by the Bank to PW's report of 18 April 1990 (see section A(24) above) in any communication with the Treasury at any level. Nor was any reference made to PW's confidential meetings with the Bank in early February and on 2 March 1990 (paragraphs 2.166 and 2.169 above). The Treasury was not told that the Abu Dhabi Government's support had saved the bank from collapse, of the continuing uncertainties or of the fact that Naqvi had been discredited.

2.500 The Treasury was briefed on the changes which followed the majority shareholder's acquisition of control, including the shrinkage of the UK Region, and of the Bank's doubts about accepting the burden of consolidated supervision in the changed situation then existing.

2.501 A letter written by the Rt Hon Tony Benn MP to the Chancellor in June 1990, enclosing a letter from Mr Ambrose, was not seen by the Chancellor but was transferred to the Department of Employment to be answered: paragraph 2.220 above.

2.502 The Bank informed the Treasury of the IML ultimatum (paragraph 2.213 above) and of BCCI's plan to reorganise the group into three banks (paragraph 2.272 above). At no time before the closure of BCCI was any reference, direct or indirect, made by the Bank to PW's report of 3 October 1990 (see section A(30) above) in any communication with the Treasury at any level. The Treasury received no indication of the financial and other problems which that report revealed, although it did learn in the following spring of BCCI's need for large financial support. It was not told of the unrecorded deposits reported to the Bank on 4 January 1991 or the theft from the Ruling Family's investment portfolio (see section A(35) and paragraph 2.323 above).

2.503 On 5 April 1991 the Bank told the Treasury that the main shareholders had signed up to the financial package (which involved very large sums of money from the majority shareholders) and that the Bank was now happy about the financial position of BCCI, although the accounts were likely to be late. An account was given of the three bank restructuring proposal and of hostile articles in the US press relating to money-laundering and First American.

2.504 On 26 April 1991 the Governor told the Chancellor of investigations by the New York Fed but said there was no evidence of money-laundering by the British arm of BCCI, a view which HM Customs fully endorsed. He mentioned the Bank's efforts to ring-fence the UK operation to protect UK depositors from any problems in overseas offices and expressed reasonable confidence that the UK operation was in fairly good shape.

2.505 In April 1991, Mr John Gieve, who had recently become the Under Secretary responsible (among other things) for banking supervision visited the Bank and met a number of Bank supervisors. One of those was Bartlett, who briefed him in general terms on the position of BCCI, mentioning the Abu Dhabi Government's shareholding and its support of $10 billion. Bartlett also mentioned problem loans and an allusion was made to fraud, although not as something of particular significance. Developments in the United States, and investigations proceeding there, were briefly described. The investigation commissioned under section 41 of the Banking Act was not mentioned.

2.506 On 13 May 1991 Gieve spoke to Bartlett again and, basing himself on these conversations and Treasury files, he wrote a minute to the Chancellor, summarising the recent history of BCCI and reporting on the US investigations into it, the results of which were likely to become public in ensuing weeks. The possibility of a large and very public scandal erupting in the US was mentioned to the Treasury by the Bank on several occasions in the second half of May and the first half of June. The Bank's concern related not so much to the restructuring of the group as to the possibility that US investigations might show the existing owners and managers not to be fit and proper, but the Bank said that so far there was nothing to suggest that that was so. On his return from the US, the Deputy Governor (on 19 June 1991) gave the Permanent Secretary a vivid account of the stories circulating about BCCI in the US.

2.507 Gieve telephoned Bartlett on 26 June 1991 to ask how the restructuring proposals were progressing as the IML deadline approached. The Bank had been intending to make a formal approach to the Treasury on Friday 28 June 1991, but since Gieve telephoned Bartlett felt he should put him in the picture. So Bartlett told him of the very broad effect of PW's draft section 41 report and of PW's inability to give an audit opinion on the 1990 accounts. This was the first the Treasury knew of the section 41 investigation or report. Gieve recorded this message (at some length) in a minute to the Chancellor, and the Deputy Governor explained the position to the Permanent Secretary at a meeting on 27 June 1991. The Permanent Secretary at once alerted the Chancellor's principal private secretary.

2.508 The Prime Minister first heard about problems in BCCI when the Secretary to the Cabinet, following a Cabinet meeting on Thursday 27 June 1991, told him of the possibility that a scandal might be about to erupt in the US. The Secretary to the Cabinet had learned of this possibility from the Deputy Governor (who had not at this stage read the draft section 41 report) when they had met at a social function on the evening of Wednesday 26 June 1991. At that stage nothing was said (by the Deputy Governor to the Secretary to the Cabinet or by the Secretary to the Cabinet to the Prime Minister) about the position of BCCI in the UK or elsewhere outside the US.

2.509 Following his meeting with the Deputy Governor on the evening of Thursday 27 June, the Permanent Secretary briefed the Secretary to the Cabinet on the position of BCCI in the UK and the US the next morning, 28 June, and reported to the Chancellor that afternoon. Up to then neither of them had had any knowledge of the fraud in BCCI. At a meeting held at the Treasury at 4.15pm on 28 June 1991 the Bank told the Treasury of its decision that it could not continue to authorise BCCI to operate and could not authorise the restructuring which had been under negotiation. The Bank hoped to arrange an orderly run-down of the group but would, failing that, apply to wind up. A full report of this meeting was made to the Chancellor, and also to the Prime Minister, who read the minute on the night of Saturday 29 June or the morning of Sunday 30 June. It was the first he had heard of the fraud either as Prime Minister or in his previous office as Chancellor.

2.510 During the week leading up to closure of BCCI on 5 July 1991 the Bank kept closely in touch with the Treasury. On 4 July 1991 the Prime Minister presided at a meeting of ministers and officials at which the Governor outlined the Bank's proposed action and the reasons for it. A number of pertinent questions were raised and discussed. The Prime Minister agreed with the action proposed, but the decision had been made and he was being informed of it, not asked to approve it.

2.511 The boundary between the responsibility of the Treasury and that of the Bank in the field of banking supervision was clearly understood and respected by both bodies at all times relevant to this history. When (as occurred following BCCI's convictions of money-laundering in early 1990) the Bank's handling of a particular problem appeared to the Treasury to touch on wider policy issues, the Treasury went as far as it reasonably could to make known its concerns without trespassing on the Bank's area of practical responsibility.

2.512 There was (subject to the Banking Acts) no impediment to free communication between the Bank and the Treasury in the banking supervisory field, and in the later years of this history there were relatively frequent exchanges about BCCI at various levels. The situations in which the Treasury expected to be alerted to possible problems lying ahead, although not formally defined or reduced to writing, were well understood by the Bank. Most of the Treasury witnesses who gave evidence to the Inquiry made no complaint that the Bank had failed to keep them fully informed: since the practical conduct of banking supervision was the responsibility of the Bank, there was in the view of these officials no need for the Treasury to be informed until action was called for or there was an apprehension of immediate problems. On this view the Treasury did not need to know the details of BCCI's position until the end of June 1991, which is when the Bank told them.

2.513 I would find this view more persuasive if the Bank had chosen to tell the Treasury nothing about BCCI. That would have been an understandable, although not very satisfactory, line to take. But it was not the line which the Bank took. Particularly after the Tampa arrests, BCCI was a fairly regular subject of report. While the Bank described the supervisory problems which BCCI presented and its plans for overcoming them, and reported on losses which the group had suffered, it gave the Treasury no hint of the fraud which came to light in a piecemeal way from early 1990 onwards and the gravity of the group's financial position was never conveyed. When, on 4 April 1990, BCCI was described as "in many ways... remarkably successful", the Treasury could scarcely have deduced that a loss of $49 million for 1988 was to be followed by one of $498 million for 1989. When, on 5 April 1991, the Bank was reported to be happy about the financial position of BCCI, the Treasury could scarcely have appreciated that the bank was technically insolvent. The picture of BCCI which the Bank gave the Treasury during this period was in my opinion misleading, both in what was said and, more particularly, in what was not.

2.514 The Bank had no intention to mislead. It had no reason or wish to withhold information, and motives of self-protection would have made for greater disclosure, not less. The fault lay in the Bank's failure to appreciate the import of the messages it was given by PW, in a deep-rooted reluctance to believe ill of BCCI, in a hope that the past abuses in the group would be put behind it and in a failure to ensure that the matters reported by PW were known to and understood by the top echelons in the Bank.

2.515 The result was not satisfactory. The collapse of BCCI was never at all likely to have serious adverse effects on the UK financial system or economy as a whole. But there was from early 1990 onwards an obvious risk that it would cause diplomatic and

foreign relations problems, hardship and loss to a significant number of retail customers and political outcry. If that is so, Treasury officials and ministers should have been alerted, not because any immediate action was called for but because it is preferable for thought to be given to potential problems before they become emergencies. As it was, the conduct of Treasury officials and ministers is not in my view open to criticism in any respect.

C HM Customs and Excise

1 Operation C-Chase

2.516 HM Customs and Excise ("UK Customs") became involved in the affairs of BCCI in three ways.

2.517 UK Customs were briefed on operation C-Chase, the operation mounted by US undercover agents to expose money-laundering by BCCI, in August 1988. They gave the US authorities all the assistance they could, and told the Bank of the operation in general terms (probably mentioning BCCI) in September.

2.518 On 8 October 1988 US Customs arrested seven BCCI employees in Tampa, Florida. On 9 and 10 October UK Customs arrested Baakza, manager of the corporate unit of BCCI's UK Region, and Ziauddin Akbar, formerly manager of BCCI's Central Treasury and now managing director of Capcom Financial Services Limited, respectively. Both were implicated in the money-laundering conspiracy and were in due course prosecuted to conviction in the UK.

2.519 Having investigated the case, UK Customs did not find evidence which implicated the London management of BCCI in the conspiracy or suggested a history of money-laundering. Tampa was seen as a one-off event. These conclusions were made known to the Bank, which accepted them and made no further enquiries beyond unrecorded oral enquiries of the Fed. The files of UK Customs contained very detailed and comprehensive accounts of the conduct giving rise to the prosecutions in the US and the UK. Customs offered to make these details available, but they were not sought by the Bank.

2.520 In February 1990, following BCCI's pleas of guilty at Tampa, the chairman of UK Customs wrote to the Treasury seeking reassurance that the Bank was fully conversant with recent developments and taking account of them in its supervisory role. He expressed the opinion that action against BCCI would deal a severe blow to the international drugs trade. On receipt of the letter, the Treasury spoke to UK Customs, which confirmed that it had no evidence implicating the management of the UK Region and the group. The Treasury also spoke to the Bank, which said that it was doing all it could. This letter did not represent a change in the position of UK Customs, but reflected the chairman's concern that everything possible should be done to counter money-laundering. By February 1991 the chairman recorded his belief that BCCI were acting reasonably to observe the guidelines against money-laundering, at least in the UK.

2.521 Prompted by US Customs, UK Customs interviewed a former director of BCCI in June 1991 and obtained information bearing on the conduct of BCCI's business.

2.522 US Customs recognised the cooperation of UK Customs in Operation C-Chase by allocating to them a substantial part of the sum forfeited by BCCI under the Tampa plea agreement. The exercise was indeed a model of international cooperation. UK Customs' investigation of the involvement of group management and UK Region management in the money-laundering conspiracy appears to have been adequately thorough, and there is no evidence known to the Inquiry which suggests that the conclusion they reached was wrong. They kept the Bank generally informed and responded to the enquiries made of them. The lead given in June 1991 by US Customs was pursued with vigour. I do not think the role of UK Customs in relation to BCCI's involvement in money-laundering is open to criticism.

2 General Noriega

2.523 When UK Customs searched 100 Leadenhall Street for documents relating to Baakza in October 1988, they saw a number of documents relating to accounts held by BCCI in London for Noriega, his family and associates of his. They knew of a US indictment charging Noriega with drugs and other offences, and took steps to obtain production of the documents and authority to pass them to US Customs. UK Customs were unable to do more without evidence that the funds in the Noriega accounts represented the proceeds of drug trafficking. They asked US Customs for such evidence but it was not forthcoming. All the accounts had, in any event, been closed by July 1988.

3 Mr Ambrose

2.524 Following an approach by Mr Larry Gurwin, a journalist on The Economist who was studying BCCI, the chairman of HM Customs caused a meeting to be arranged when Gurwin was next in London. As a result of the meeting UK Customs made contact with Mr Ambrose (see section A(28) above), who was asked about BCCI's involvement in money-laundering. He could give no specific information to identify any tainted accounts or anyone involved. The evidence suggests that UK Customs were active in pursuing the leads they were given, even though (as in this instance) some of them led to nothing.

D The Department of Trade and Industry

2.525 The Companies Division of the Department of Trade was involved, briefly and insignificantly, in the affairs of BCCI in 1977-1979.

2.526 The Insurance Division of the Department had a longer and more significant involvement. This arose out of a company, Credit & Commerce Insurance Company (UK) Limited, which in the period 1977-1983 caused the Department acute supervisory concern. The Department understood CCI to be closely connected with BCCI. For this reason it told the Bank of action it intended to take and communicated its belief (which the Bank appears to have accepted) that there were close links between CCI and both BCCI and ICIC. The Department tried to explore these connections with the Bank, CCI, ICIC, BCCI and the British Embassy in Luxembourg, but without obtaining much hard information.

2.527 From 1983 the fortunes and management of CCI greatly improved and the activity of the DTI (as the Department had now become) correspondingly decreased. But news of the Tampa arrests rekindled the DTI's concern about the fitness of the managers, directors and controllers of CCL (as CCI was now called). It accordingly took the matter up with HM Customs and the Bank. Customs felt unable to help, but a meeting was held at the Bank. At this time the Bank knew nothing of any BCCI insurance subsidiaries, but was interested in the outcome of any researches by the DTI. The DTI gave the Bank such limited information as it had on the CCL group structure, but received no information from the Bank beyond a list of BCCI shareholders and a brief account of the Tampa case. In an attempt to learn more about ICIC the DTI approached the FCO, who passed on some information from a delicate business source, and sought information from CCL on the shareholders in its parent company.

2.528 The DTI and the Bank had no further exchanges relevant to BCCI, ICIC, or CCL until the DTI was told on 1 July 1991 of the action the Bank proposed to take against BCCI at the end of the week. The existence of links between CCI (or CCL) and BCCI was of significance to the Department and the DTI, because if BCCI was a controller of CCI its fitness was a direct concern of the Secretary of State under the Insurance Companies Acts. There was also a risk that serious difficulties afflicting BCCI could damage and perhaps even jeopardise the business of CCI. The Department and the DTI appear to me to have been alert to their responsibility and to this risk. Between 1977-1983 and 1988-1989 a genuine, although unsuccessful, effort was made to identify the links between CCI (or CCL), BCCI and ICIC.

2.529 There was a corresponding risk, depending on the closeness and notoriety of the connection, that difficulties affecting CCI could have an adverse effect on the business of BCCI. In earlier years the Bank appears to have accepted that CCI was part of the BCCI group; by 1988 this supposed connection had been forgotten. Given its concern about the opacity of BCCI's group structure and ownership, the Bank might have been expected to explore the inter-relationship between CCI (or CCL) and BCCI and ICIC with some care, but it did not do so. This may have been because the IML was regarded as the group's primary regulator. Whatever the reason, I find the Bank's lack of curiosity surprising.

E Financial Services

2.530 The DTI, the Securities and Investments Board (SIB), the Investment Management Regulatory Organisation (IMRO) and the Association of Futures Brokers and Dealers (AFBD) all played some part in regulating the investment activities of BCCI and Capcom.

2.531 When the Financial Services Act 1986 came into effect, BCCI became an interim-authorised member of IMRO. But for the absence of an overall supervisory agreement between SIB and the IML, BCCI would have been admitted to membership in 1988, but before an agreement with the IML had been reached the Tampa arrests had been made. An agreement was reached with the IML in December 1988, but IMRO deferred a decision on BCCI's application until after the outcome of the case. When BCCI pleaded guilty, IMRO remained very uneasy about BCCI, and found reasons for deferring a decision on BCCI's application. In the result, BCCI was still interim-authorised when it was closed on 5 July 1991.

2.532 Capcom Financial Services Limited became a member of AFBD in 1986, before AFBD had become a recognised SRO. It applied for its membership to be continued when the Act came into force and its application was accepted on 30 March 1988. Following the arrest of Ziauddin Akbar, managing director of Capcom, on money-laundering charges in October 1988, SIB appointed investigators under sections 105 and 106 of the Financial Services Act to investigate Capcom. The investigators reported in December 1988 and Capcom was expelled from membership of AFBD in July 1989.

2.533 When the news of the Tampa arrests broke, the DTI, SIB, IMRO and AFBD reacted promptly and vigorously. Meetings were held, attended by the Bank, to discuss what, if any, action should be taken, particularly in relation to Capcom. At one of these meetings it was suggested that the Bank should exercise its Banking Act powers to investigate Capcom. The Bank reacted strongly against this suggestion, regarding it as improper to exercise its statutory powers on behalf of another regulator. It would, without doubt, have been improper for the Bank to exercise its powers for such a purpose, but the Bank could have exercised its powers to explore the nature and extent of the linkage between BCCI and Capcom if that appeared relevant to the Bank's supervision of BCCI. Given Akbar's leading role in the Central Treasury losses of 1985, his role as managing director of Capcom and his role in the Tampa money-laundering conspiracy, to which he was introduced by BCCI employees, the Bank could well have regarded the relationship between BCCI and Capcom as relevant to the fitness of BCCI's managers and the prudence and integrity with which its business was conducted.

2.534 In October 1988 AFBD formed the impression (strongly challenged by the Bank) that the Bank was reluctant to take action. In March 1990 IMRO judged the Bank to be sympathetic to BCCI's position. There was in my view a measure of truth in both impressions. But PW as auditors found nothing seriously amiss with BCCI's investment business in 1989 and 1990 and visits made by IMRO to BCCI in November 1988 and February 1989 found no connection between SA and Capcom, no evidence of suspicious business and no very significant lapses in compliance.

2.535 In relation to Capcom, AFBD acted quickly and decisively.

2.536 The investment business of BCCI was a minuscule part of its total business. I nonetheless consider that the response of the financial services regulators to BCCI's application for membership of IMRO and to the Tampa arrests and convictions was in every way alert, vigorous and shrewd.

F The Intelligence Agencies

2.537 For security reasons, the involvement of the intelligence agencies is described in detail in a separate appendix (Appendix 8)* to this report. The conclusions of the report take account of the agencies' evidence.

2.538 Having made detailed enquiry of all the intelligence agencies, the Inquiry has found no evidence to suggest that the management of BCCI at any level above that of branch manager knowingly held or handled accounts of the Abu Nidhal Organisation or its front companies or any other terrorist organisation at any time.

2.539 A possible connection between BCCI and terrorist accounts was first mentioned to the Bank in a very general way in April 1987. The suggestion that BCCI held accounts for the ANO first came to the Bank's notice as a result of an article published in "Private Eye" on 9 December 1988. At no time did the Bank knowingly acquiesce in the holding of terrorist accounts by BCCI.

* Not being published

G Other Government Departments and Public Bodies

1 The Charity Commission

2.540 Two UK charities closely linked with BCCI were registered with the Charity Commission: Third World Foundation for Economic Studies and ICIC Foundation. The Commission launched an enquiry into the first of these in October 1990 when South magazine went into liquidation owing the charity £1.7 million. It began to investigate the second in June 1990, to establish whether the charity had become involved in non-charitable activities and what could be done to reduce its dependence on BCCI. Neither investigation was complete by 5 July 1991. There is, to the knowledge of the Inquiry, no evidence to suggest that the Commission should have acted sooner or differently.

2 City of London Police Fraud Investigation Department

2.541 During 1988 the City of London Police Fraud Investigation Department believed that its investigation of a perjury charge against a BCCI customer named Shamji was being obstructed by BCCI management. Contempt proceedings against BCCI were contemplated, but Shamji was in the end successfully prosecuted and the contempt proceedings were not pursued. The police were rightly concerned with the investigation and prosecution of crime. The possibility of serious misbehaviour by BCCI management was, or should have been, a matter of more direct concern to the Bank.

3 The Crown Prosecution Service

2.542 The involvement of the Crown Prosecution Service in the affairs of BCCI was peripheral. It never prosecuted BCCI for any offence or had grounds for doing so.

4 The Department of Employment

2.543 The Department of Employment had an exchange of correspondence with Mr Ambrose in June and July 1990. The Department failed to appreciate that banking supervision was a matter for the Bank, not the DTI, and failed to send the papers to the DTI as it intended. The first error was understandable, and should only have led to delay. Procedures have been altered to try and prevent errors such as the second. Had these errors not been made the course of events would not have been significantly different.

5 The Department of the Environment

2.544 The Department circulated to local authorities the Bank's current list of institutions included in the banking sector for statistical purposes. The list was taken from the "Bank of England Quarterly Bulletin", which includes some institutions not authorised under the Banking Act 1987. The purpose of circulating the list was to help local authorities in making their borrowing and lending returns to the Department. Nothing in the Department's letter or in the list itself suggested, or could reasonably have been understood to suggest, that the Department exercised its own judgment in relation to any authorised institution.

2.545 For purposes of the Local Government and Housing Act 1989 and the Local Authorities (Capital Finance) (Approved Investments) Regulations 1990, "approved investments" include deposits made with an institution authorised under the Banking Act 1987. The statutory scheme makes it plain that the body responsible for monitoring authorisation is not the Department but the Bank.

2.546 The very substantial losses made by some local authorities have attracted much publicity and aroused widespread concern. These losses are not attributable to any fault on the part of the Department.

6 The Foreign and Commonwealth Office

2.547 The Foreign and Commonwealth office was never on any occasion asked by the Bank for intelligence about BCCI, but did from time to time volunteer to the Bank reports received from British diplomatic posts in the course of their normal duties overseas. The reputation and conduct of BCCI in various parts of the world were a matter of concern to its supervisors over a number of years. I think it surprising that the Bank did not make known its desire for intelligence on these matters.

7 The Home Office

2.548 At the request of the US authorities, the Home Office obtained production orders relating to Noriega accounts held by BCCI and other banks. It was unable to obtain evidence to establish a link between the accounts and the proceeds of drug trafficking.

2.549 The Home Office received no evidence showing that BCCI was involved in drug money-laundering or in the commission of any other criminal offence.

8 The Inland Revenue

2.550 The Inland Revenue never prosecuted BCCI for any revenue offence, nor did it at any time unearth evidence of any non-revenue offence.

2.551 It did (in 1987) initiate enquiries into a number of technical issues on the corporation tax affairs of BCCI's UK branches. These are unresolved. In early 1990 it reviewed the compliance of the UK branches of seven overseas banks with the provisions of the Composite Rate Tax scheme. One of the banks investigated was BCCI. In its case breaches, attributed to laxity of procedure rather than deliberate fraud, were found, and pursuant to a settlement agreed in February 1991 BCCI paid additional CRT of £660,000 and interest of £200,000. The rate of error by BCCI, which was much the largest of the banks reviewed, was lower than in the case of the other banks.

2.552 There is no record of any discussion of BCCI between the Revenue and the Bank at any time. The Revenue regards itself as strictly precluded from discussing a taxpayer's affairs with any third party, save when prosecuting for a revenue offence. I find it surprising and a little unsatisfactory that the Revenue should not be free to inform an appropriate supervisor if it were, in the course of its duties, to unearth evidence of serious malpractice not amounting to a revenue offence, but it has referred the Inquiry to a strong body of authority in support of its position. It must ultimately be a question of political judgment where the priorities of society lie. In the present case, this never became a practical problem.

9 The Metropolitan Police

2.553 The records of the Metropolitan Police contain no evidence which points to the commission of criminal offences by BCCI or its management.

10 The National Drugs Intelligence Unit

2.554 Before the Tampa arrests, BCCI (in common with many other financial institutions in the UK) made no disclosures to the National Drugs Intelligence Unit. Thereafter, following steps to overhaul and tighten compliance with international guidelines on the prevention of money-laundering, many disclosures were made. The opinion of the NDIU is that after a late start BCCI made a positive move in the direction of due compliance.

11 The Office of Fair Trading

2.555 The Office of Fair Trading granted BCCI SA and Overseas consumer credit licences. Overseas surrendered its licence in 1981.

2.556 As a result of press publicity in 1978 and the Tampa indictment in 1988, the OFT seriously considered whether it should revoke SA's licence (and in 1978, Overseas' licence also) on the grounds that they were not fit persons to engage in activities covered by the licence. On the earlier occasion, the OFT waited to see if action was taken by other authorities; when they took no action it took none itself. On the later occasion the OFT took the matter up with the Bank and ultimately concluded that it should take no action since there was apparently nothing to implicate BCCI in the UK or its controllers in the money-laundering activities of the US employees.

2.557 The OFT was responsible for a very minor part of BCCI's activities. The Bank was responsible under the Banking Act 1987 for authorising and supervising SA in the UK. The OFT was properly mindful of its own responsibility, but was in my view entitled to take its cue from the Bank, which in large measure it did.

12 The Overseas Development Administration

2.558 In March 1990 the Overseas Development Administration, having consulted the Bank, declined to be involved in sponsoring, jointly with BCCI, an African United World College devoted to agriculture. This was undoubtedly a wise decision, reflecting the Bank's apprehension that the events which took place at Tampa could recur elsewhere.

13 The Scottish Office

2.559 The Scottish Office had no relevant involvement in the business of BCCI.

14 The Serious Fraud Office

2.560 The Serious Fraud Office became operational on 1 April 1988. No complaint was made to it about BCCI's alleged criminal activities until Quinn visited the Director on 1 July 1991. Although BCCI featured in a number of cases which the SFO handled during that period, there was no evidence in any of those cases that BCCI itself had committed any criminal offence.

15 The Treasury Solicitor

2.561 Acting on behalf of the Attorney General, the Treasury Solicitor in January 1989 instructed counsel to apply to the court to restrain transmission of "The BCCI Connection" by Channel 4 Television. The application was made because the programme was understood to be prejudicial to the forthcoming trials of Baakza and Akbar. It was not pursued because changes were made to the script which removed the risk of prejudice. The Treasury Solicitor had no other relevant involvement in the affairs of BCCI.

16 The Welsh Office

2.559 The Welsh Office had no relevant involvement in the business of BCCI.

H The Isle of Man, Hong Kong and Gibraltar

2.563 BCCI operated in the Isle of Man through a branch of SA. It operated in Hong Kong and Gibraltar through locally incorporated subsidiaries. The Hong Kong supervisor became a member of the College in July 1989. The supervisory authorities in the Isle of Man and Gibraltar did not become members of the College. Between the end of 1989 and the date of closure the Hong Kong supervisor caused the exposure of the Hong Kong subsidiary to the rest of the group to be reduced from HK $757 million to HK $4 million. The Manx supervisor also asked the Manx branch to place a proportion of depositors' funds outside the group. He considered insisting on local incorporation of the Manx branch, but held his hand pending a major restructuring of the group. The Gibraltar did not take steps to restrict the exposure of the local subsidiary to the rest of the group.

2.564 It seems likely that depositors in Hong Kong will recover a higher proportion of their deposits than depositors in most other countries. Both the Isle of Man and Gibraltar complain, with some bitterness, that as non-members of the College, lacking access to the information which College members enjoyed, they were denied the opportunity to take effective and timely measures to protect the interests of their own depositors.

2.565 The contrasting history in these three jurisdictions vividly illustrates the dilemmas which the Bank faced. The effectiveness of the College was already diminished by its size. To have expanded the College to include the Isle of Man, Gibraltar and other supervisors responsible for small, local operations would have reduced its effectiveness still further, perhaps destroyed it altogether. Equally, to voice doubts and apprehensions to friendly supervisors such as those in the Isle of Man and Gibraltar, at a time when the Bank was hoping for the establishment of a restructured and recapitalised group, was liable to stimulate just such a loss of confidence as the Bank wished to prevent. The Bank could not give information to supervisors in the Isle of Man and Gibraltar and ask them not to rely on it; but reliance on it could have led to action which, reproduced in other jurisdictions, could have increased pressure on the group and sent disturbing signals to the market.

2.566 The resentment felt by the supervisors (and depositors) in the Isle of Man and Gibraltar is readily understandable, but there is no easy escape from these dilemmas. Even if there had been a single, effective consolidated supervisor, that supervisor would have enjoyed access to information denied to other supervisors. But one would not expect such a supervisor to insist on measures for the protection of his own local depositors which were not also taken for all group depositors. It seems clear that a consolidated supervisor (or, in the unique situation of the College, its members) who receives privileged information must bear fully in mind the interests of all those who do not have access to that information.

2.567 Most of the reductions in lending by the UK Region to the rest of the group for which the Bank asked were sought in the aftermath of the Tampa indictment, an event of which all supervisors were aware. The Bank did not make use of privileged information to seek special protection for UK depositors. Any attempt to do so would in any event have been futile in the context of potential liquidation; since the UK Region was not legally independent, preservation of its assets was advantageous to all the group creditors and not only those in the UK.

Chapter 3
Recommendations

3.1 BCCI grew up before banking supervision, in the UK or internationally, had come of age. A similar bank established today could scarcely hope to assume the form it did or last so long. Thus the focus of attention in the aftermath of this debacle should not simply be to prevent a second BCCI (although the aim must of course be to achieve that at least). But the aim must also and more importantly be to ensure that supervisory law, principles and practice generally create conditions hostile to the growth of fraud and friendly towards its early detection and eradication.

3.2 I do not for my part think that this end is best achieved by greatly intensified supervision of all banks, the good as well as the suspect, which must impose unnecessary burdens on the former and distract supervisory attention from the latter. Nor, in my opinion, is it likely to be achieved by seeking to substitute a code of detailed rules for the exercise of informed judgment. The overriding need is to ensure that the supervisors' attention is drawn to and concentrated on the suspect banks, that the judgment they exercise truly is informed and that appreciation of a problem is reinforced by willingness, where appropriate, to take decisive action.

3.3 In the period since BCCI was closed, much thought has been given to preventing recurrence of any similar event. Internationally, this has led to promulgation of a statement of minimum standards by the Basle Committee: see Chapter 1 section (17) above. These minimum standards, if observed according to their letter and their spirit should greatly strengthen the international protection afforded to depositors internationally. In the UK, the Bank and others have studied the supervisory lessons to be learned from this history. Recent communications from the Bank reveal, unsurprisingly, that its diagnosis in part coincides with my own and that certain steps which I recommend have already been anticipated and are in course of implementation. I do not recommend any radical recasting of the system of banking supervision which has grown up in the UK and internationally over the last twenty years. I have not identified any crucial deficiencies in the arrangements now in force and due to come into force. I make a number of suggestions which should, if, accepted, strengthen those arrangements, but ultimately supervisory arrangements can be no more effective than those who operate them: it is on the skill, alertness, experience and vigour of the supervisors, in the UK and abroad, that all ultimately depends.

The UK banking supervisor

3.4 In some countries the central bank is not the banking supervisor. The question has been raised whether the Bank of England should continue to perform that role. Arguments have been made in favour of an independent body, concerned solely with banking supervision and so free of the potentially conflicting pressures which may affect a central bank responsible both for supervising banks and for implementing a monetary policy which may bear hardly on them.

3.5 These are not negligible arguments. But they have been advanced to the Inquiry by one source only, although a respected source. And they were considered in 1985 in the wake of the Johnson Matthey Bankers affair, when it was decided to continue to entrust this important task to the Bank. Arrangements of this kind are not immutable, and it is not impossible to conceive the future development of a national or an international supervisory body. But I do not think there is anything in the history of BCCI which invalidates the judgment made in 1985.

3.6 When the Banking Act 1987 was going through the House of Commons, questions were raised about the likely efficacy of the Board of Banking Supervision. The fear was voiced that it might turn out to be a "rather cosy club". The history does not in my view bear out that fear. Particularly during the summer of 1987, the Board played a valuable critical role (see Chapter 2 section A(12) above). But, and this is a vital qualification, the Board cannot advise on facts of which it is unaware, and at crucial stages of this history the Board was not in possession of very important information. It is important that meetings should not be so frequent that able and experienced independent members with other interests cannot attend them, and the volume of papers provided for meetings should not be so large as to be unassimilable. It is, however, essential, if the Board is to fulfil its statutory role, that the members (particularly the independent members) should be alerted to any fact which even *might* cause their antennae to twitch. This was not done in the case of BCCI and very great care should be taken to see that it is done in future.

The Bank's supervision

3.7 A contrast is commonly drawn between the US style of supervision, dependent on inspection of banks by a corps of professional examiners, and the UK approach, depending largely on dialogue with management and prudential returns. The contrast is exaggerated. US supervisors do not depend on inspection alone and in the UK, as this history shows, the Bank relied on site visits, reports by accountants seconded to the Banking Supervision Division and Banking Act reports as well as dialogue with management and prudential returns. But it is true that the Bank does not as a matter of routine inspect banks in the way the US authorities do. The US authorities are inclined to regard this as a defect of the UK system of supervision.

3.8 The Bank's traditional techniques of supervision, based as they are on trust, frankness and a willingness to co-operate, seem to me on the whole to have served the community well. The US record does not of itself demonstrate the superiority of the system employed there, which (quite apart from expense) has its own drawbacks. But one of the virtues claimed for the Bank's supervision is its flexibility. This should mean that a quite different supervisory approach is adopted where trust and frankness are lacking. In such cases also special qualities are required of the supervisor.

3.9 This last point is one which need not, I hope, be laboured since the Bank has acknowledged the need to "develop and maintain a high degree of alertness and inquisitiveness in our staff .... ". The emphasis should be on development, since the degree of alertness and inquisitiveness shown by many of the Bank officials who dealt with BCCI was not high. The matter is well put in the Bank's submission on this aspect:

> "Nevertheless, we plainly can on occasion – either because of warnings or because of information obtained or received in the normal course of supervision – be the first to encounter problems which may be early indications of fraud. We therefore clearly need to be alert to the possible symptoms of fraud (and, indeed, of other criminality or breaches of accepted standards of conduct) and the circumstances in which it is most likely to arise, as well as to be aware of the methods by which it may be committed. The evident sophistication of recent frauds – at least, in terms of the complexity of the transactions and accounting practices involved – and the ability of the fraudsters to disguise their activities for so long, suggest that we must do more to train our staff in the skills necessary to spot the possibility of sophisticated fraud. This will include ensuring that they are kept up to date on known vulnerabilities of current banking systems and practices and, if possible, alerted to any new techniques fraudsters may seek to exploit."

The Bank also acknowledges the need to be more responsive to "the accumulation of information which, while apparently of little significance in itself as a sign of fraud,

may when seen in its proper context point to a deeper malaise which deserves thorough investigation". And the Bank recognises the need to develop "a greater awareness of context, of the history of an institution and its relations with supervisors". These also are points I would endorse. It is very important that those responsible for supervising suspect banks should be alert to the possibility of fraud, astute in recognising signs of it and active in investigating it (or causing it to be investigated).

3.10 The Bank has recently communicated its intention to establish a specially trained and qualified Special Investigations Unit within the Banking Supervision Division to consider all warnings and suspicions of malpractice received by the Bank and determine whether they should be followed up and, if so, how and by whom, so as to ensure an effective investigation. This plan is to be welcomed. It is for consideration whether this unit should not be supported by a small team of specialist examiners, available to act quickly, independently and firmly when occasion demands.

3.11 A significant weakness of the Bank's supervision, exposed by the Inquiry, has been in its internal communication. I understand that steps have been taken to ensure that information reaches senior officials in the Bank who should know of it more quickly and more surely. This again is to be welcomed. Guidelines are to be issued on communication with the Treasury and other public bodies.

3.12 When banking supervision was put on formal statutory basis under the 1979 Act, the Bank took some time to appreciate that this called for a more direct legal input into supervisory decisions. Over the ensuing decade, this weakness was to some considerable extent remedied, but the Bank's recent decision to strengthen the Banking Supervision Division's legal unit will in my opinion help the Division to perform its role in a more effective way. The function of the unit will of course be to give sound and practical legal advice on supervisory questions, but the main value of the unit will lie not in warning the supervisors of what they cannot lawfully do but in making sure the supervisors appreciate the full extent of what they can lawfully do. In supporting the Bank's recent decision, I (like the Bank itself) intend no criticism of the Bank's long-standing solicitors, whose advice when consulted about BCCI was on each occasion impeccable.

Banking Act powers

3.13 In its submission to the Inquiry the Bank argues for amendment of the 1987 Act to confer additional powers upon it.

3.14 First, it seeks explicit power to refuse or revoke authorisation on the grounds that the applicant or bank cannot be effectively supervised, whether on structural or other grounds. Secondly, it seeks power to require banks to locate their effective head office in the country of incorporation, so that the home supervisor is able in practice to discharge the role of lead supervisor.

3.15 I share, unreservedly, the Bank's view that it should have these powers. But I am not persuaded it currently lacks them. If, for whatever reason, a bank cannot be effectively supervised, I do not see how the Bank can be satisfied that all the Schedule 3 criteria are or have been fulfilled with respect to it. In the same circumstances, it must almost inevitably appear to the Bank that all those criteria may not have been fulfilled with respect to such a bank. The same argument, I think, applies in the second case also: the vice (and a very real vice) of divorce between the place of incorporation and the effective head office is that the lead supervisor in the country of incorporation cannot effectively supervise through inability to satisfy himself what is really going on. That leaves the Bank in the same position as in the first case.

3.16 If my analysis does not carry conviction or if the Bank's hand would be significantly strengthened by a more explicit statement of the law, I strongly endorse

the Bank's submission. The structure of the BCCI group and the inability of any supervisor to get to grips with it, made possible the frauds which were practised. The most important single lesson of this debacle is that banking group structures which deny supervisors a clear view of how business is conducted should be outlawed. If there is any continuing doubt about the Bank's power to prevent that situation recurring, such power should be expressly conferred.

3.17 The Bank next submits that the Banking Act should be amended "to make more explicit the circumstances where and extent to which the Bank may rely on overseas supervisors in discharging its supervisory functions". I take this point to be limited to the non-Community sphere, since the new Community regime seems to me to make the division of responsibilities fairly clear. But I am not quite sure that I understand the source of the problem even in the non-Community sphere. In authorising any institution the Bank must itself be satisfied unless section 9(3) of the 1987 Act applies and is relied on. Exercise of the power to revoke or restrict is conditional upon the opinion of the Bank itself, but there is nothing to prevent the Bank relying on the opinion of any other reliable and informed party, as any reasonable person would. The Basle Concordat provides for the sharing of supervisory responsibility on an agreed basis. Difficult borderline questions are bound to arise, but I question whether a statutory formula can provide a satisfactory solution.

3.18 Three other legislative changes which the Bank suggests can be more conveniently considered below. I note, however, that the Bank does not seek a change in the statutory provisions governing appeals against its decisions. This is a significant matter if, as I suggest (Chapter 2 paragraph 2.160 above), the Bank's willingness to act has been inhibited by undue apprehension of reversal on appeal. I do not for my part find that the sections of the Act governing appeals define the available grounds of appeal as clearly as I would wish. It can scarcely have been intended that the appeal tribunal should interfere with any decision of the Bank properly reached, and I would be happier if that had been more clearly stated. There is, however, nothing whatever to suggest that the Bank's decisions have been the subject of mischievous interference by the appeal tribunal, which must anyway be very unlikely. In the absence of any evident problem, there is no pressing case for remedial action.

The European Community

3.19 Brief reference has been made in Chapter 1 sections (15) and (16) above to the Second Banking Coordination Directive and the Second Consolidated Supervision Directive. These are important measures, the first of which in particular radically alters the banking supervisory regime as it at present exists within the Community. The powers of a host supervisor in relation to an institution authorised by its home supervisor in another member state will in future be very limited.

3.20 This new regime has aroused some concern among those who question the underlying premise on which the new regime is based, namely that there is a broad equivalence of supervisory standards and capacity among the member states. The general consensus of opinion (shared by the Bank and the Treasury among others) nonetheless is that a regime such as that established by the Second Banking Coordination Directive is a necessary and desirable step towards the internal market to which member states aspire.

3.21 I am not for my part persuaded that anything in the history of BCCI calls for the new Community regime to be substantially revised. I would, however, make three points, each of them in my view important.

3.22 The first of these points relates to the eighth recital to the Second Banking Coordination Directive, quoted in full in Chapter 1 paragraph 1.73 above. That recital contains three significant principles: the first is that member states should set their faces against supervisory forum-shopping; the second is that its place of incorporation (and

thus its registered office) should be treated as an institution's home; and the third is that an institution's head office should be in the same member state as its registered office. Thus an institution should not be permitted to incorporate and subject itself to supervision in a member state where it judges supervisory standards to be most lax while effectively running its business from another member state where they are thought to be more rigorous. I appreciate that a recital to a Community directive has more effect than a preamble to a UK statute. It nonetheless seems to me that these principles are cardinal to the proper functioning of the new Community regime and it would be very much more satisfactory if they appeared as articles of the Directive and not simply in a recital.

3.23 My second point relates to the fifth recital to the Second Consolidated Supervision Directive. This provides (in part):

> "Whereas the Member States can, furthermore, refuse or withdraw banking authorization in the case of certain group structures considered inappropriate for carrying on banking activities, in particular because such structures could not be supervised effectively; ....."

I have suggested in paragraph 3.15 above that these are powers the Bank already has, but that if there is any doubt they are powers the Bank should have, as an important safeguard against repetition of a structure such as BCCI's. By parity of reasoning, it seems to me that they are powers which all Community supervisors should have. In this case also it seems to me highly desirable that the powers should be expressly conferred and should not simply be the subject of reference in a recital. It would be advantageous if the language used were such as to make clear that the powers are exercisable where the problem arises from a tangled web of domestic companies, or from a complicated and fragmented group such as BCCI, or from the involvement of any centre where secrecy or commercial practice precludes a clear view of a group's affairs, or from a structure which makes a group incapable of being effectively supervised.

3.24 My third point relates to the proposal (briefly mentioned in Chapter 1 paragraph 1.75 above) for a Community Deposit Guarantee Directive. This would not only require all member states to establish deposit guarantee schemes, as all but two already do, but also and more importantly would impose the guarantee obligation on an institution's home member state in respect of qualifying liabilities in host member states as well as in the home member state itself. This seems to me (as, I understand, to the Commission and the member states) to be an important bulwark of the Community regime, providing a sharp practical incentive to supervisory authorities not to authorise or continue to authorise institutions which they cannot effectively supervise. The suggestion that this incentive would be lacking where the guarantee is funded by commercial banks and not by the supervisory authority itself does not impress me. I cannot think supervisors are oblivious to serious criticism by the banking community. But if this point were felt to have force it could be met by requiring supervisors to contribute substantially to the guarantee fund. This ingredient of the Community regime seems to me of such significance that I hope its adoption will follow hard upon the coming into force of the Second Banking Coordination Directive.

International supervision

3.25 In the international field, standards of good practice are laid down by the Basle Committee whose statements, although lacking legal force, command wide respect. The response of the Basle Committee to the BCCI debacle is briefly described in Chapter 1 section (17) above.

3.26 The Treasury and Civil Service Committee of the House of Commons looked into the possibility of according the Basle Concordat legal status and concluded that

such a change would be advantageous although hard to achieve in practice.[1] The practical difficulties of achieving such a change are indeed formidable, but I doubt the desirability of such a change in principle. A statement of good practice or minimum standards, capable of being informally adapted to meet changing circumstances, new problems and new business methods is in my view preferable to a legal code, which is susceptible to over-literal interpretation and which is hard to change even when it has become anachronistic. It is not, in any event, clear to me how or by whom the Concordat would be effectively enforced even if it were legally binding.

3.27 The problem nonetheless remains that it is one thing to preach high supervisory standards and may be another thing to practise them. The Treasury and Civil Service Select Committee has urged that the Bank for International Settlements should expand its role to encompass the monitoring of supervisory standards.[2] This, plainly, is one possibility and other international bodies have been suggested as candidates to perform the task. Another possibility is to institute a system of peer group review, such as has been done, apparently successfully, to monitor compliance with international guidelines for the prevention of money-laundering. I do not feel qualified to judge which of these approaches is likely to prove the more practicable and effective, but the need for some independent monitoring of supervisory standards is in my view clear. It makes very good sense that supervision should be primarily conducted by the home supervisor, who is closest to the bank and best placed to monitor but if host supervisors are increasingly to rely on the home supervisor they must be reassured by some form of independent verification that the home supervisor is really doing his job.

3.28 There is one matter which is already engaging the attention of those concerned internationally with the supervision of banks but which perhaps deserves special mention: the role of certain financial centres which offer impenetrable secrecy and which tend, for that reason, to be favoured by those with something to hide. Supervisors appear up to now to have tolerated the use of such centres, perhaps because they felt unable to do anything else. It seems very highly desirable that a much tougher line should be taken in future: I suggest in paragraph 3.23 above that the involvement of such a centre should itself, in appropriate circumstances, be ground for refusing or revoking authorisation.

Local incorporation

3.29 Under the new Community regime it will not be open to a member state to require that an institution authorised by another member state should operate through a locally incorporated subsidiary. This is, however, a condition which the Bank will remain free to impose, in circumstances which appear to justify it, in cases not governed by the Community regime.

3.30 There are strong arguments against automatic imposition of this condition. A local subsidiary may lose the support which a parent might extend to a branch operation in time of difficulty, even if (as is the Bank's practice) a letter of support is obtained from the parent, and the requirement of separate capitalisation has an economic cost as well as an anti-competitive effect. Nor can a subsidiary be wholly insulated against misfortunes afflicting other parts of its group. There may nevertheless be circumstances, however rare, in which the protection of depositors will be strengthened by establishment of a local subsidiary subject to the direct and strict supervision of the Bank. I think it important that this condition should continue to be seen as a weapon in the Bank's armoury for use where circumstances justify it in non-Community cases.

[1] Four Report, Banking Supervision and BCCI: International and National Regulation (HC Paper 177 1991-92) paragraph 44.

[2] Fourth Report, paragraph 55.

Disclosure and confidentiality

3.31 Problems of disclosure and confidentiality relevant to the supervision of banks can arise between subsidiary and parent company; between regulatory and other bodies within a single country; between regulators internationally; and between regulators and other bodies internationally. These problems raise difficult and intractable problems of law, policy and practice, nationally and internationally.

3.32 It does not seem to me acceptable that group auditors should be denied any information they seek on the affairs of any group company, whether the information is customer-specific or not, provided only that they seek it for purposes of their audit.

3.33 Among regulatory authorities and other bodies discharging public functions in the UK there is a certain tension between two commendable principles. One principle is that information obtained for one purpose should not be used for another. This principle is fortified by the practical consideration that if, as is desirable, members of the public are to be frank and forthcoming with official authorities, they must be reassured that the information they give will go no further. The other principle is that bodies set up to pursue public ends regarded as important should not be required to operate in ignorance of relevant information known to other public bodies but which those bodies are not free to pass on. Evidence given to the Inquiry reveals no uniformity of law or practice in reconciling these principles in the UK, and it would be unrealistic to expect it. There is, I am sure, no simple, universally applicable solution, and national security is bound to raise special considerations. But if (to take an entirely hypothetical example) the Inland Revenue had in 1980 come on evidence not indicating commission of a revenue offence by BCCI but suggestive of significant widespread malpractice, it would seem to me unsatisfactory if it were precluded from drawing this to the attention of the Bank as the body responsible for the supervision of banks in the UK. There may be scope for review and definition of the circumstances in which bodies may and should pass information to each other and I understand that discussion of these issues has begun.

3.34 The principle that international supervisors should exchange information relevant to each other's supervisory concerns appears to be clearly stated and well-understood both within the Community and outside it. But there appears to be less agreement on detailed questions, such as what information should be given and what the recipient may do with it. The position is complicated further by Article 12.3 of the First Banking Coordination Directive (as substituted by Article 16 of the Second Banking Coordination Directive), which provides that information may be exchanged with third countries only if the information is subject to obligations of professional secrecy as stringent as those imposed upon member states. This could well be understood as inhibiting the flow of information from (for example) the UK to the US. It is very highly undesirable that there should be uncertainty in this area: the best solution would be a clear international agreement on what should be disclosed to whom, and when; but if such an international consensus cannot be achieved, it would be an advance if the European Commission were to negotiate agreements with countries outside the Community and supervisors were to enter into bilateral memoranda of understanding.

3.35 It has been suggested that an international database should be established listing those whom any supervisor has found to be not fit and proper to be a director, manager or controller of a bank. This could, I think, be of considerable value.

3.36 The history of BCCI also shows that difficulties may arise where information is sought by a foreign authority who is not a supervisor (for example, a foreign prosecutor) or where information, obtained in confidence and passed in confidence to a foreign supervisor, is introduced into the public domain in the foreign country by means of subpoena.

3.37 The first of these problems would scarcely merit consideration had the question

of disclosure to the New York District Attorney not absorbed an inordinate amount of the Banking Supervision Division's time during the spring of 1991, distracting attention from more substantial matters. The solution eventually reached, that the Bank may make disclosure if satisfied that to do so will assist it to discharge its own task of supervision, may well be satisfactory. If so, it might well shorten future argument if the rule were publicly stated. The Bank suggests that the Banking Act 1987 should be amended to make the position clear. I doubt if this is necessary.

3.38 The second problem touches on constitutional nerves, particularly in the US, and may not be soluble. In its recent report, the New York Superintendent of Banks, Advisory Committee on Transnational Banking Institutions under the chairmanship of Mr John Heimann[3] said:

> "To encourage cooperation, the Committee recommends that New York enact a statute which permits the Superintendent to accord the same standard of confidentiality to information received from foreign bank supervisors that is accorded to examination reports and related materials generated by the Banking Department."

Even if implemented, this recommendation may give little comfort. But not many banks generate as much public and political interest as BCCI, and in the great majority of cases the risk of subpoena will not be a practical problem.

The appointment of auditors

3.39 It has been publicly urged that complex international banking groups should always have a sole auditor. It has also been suggested that they should have joint auditors, and that auditors should change after a specified period, and that staff handling a particular audit within a firm should rotate. There are merits, but also drawbacks, in all these suggestions. I do not think the subject lends itself to the laying down of absolute rules. The object must be to achieve as thorough and reliable an audit as is reasonably practicable, in the interests of the group, its depositors, its shareholders and its employees. Ordinarily, it would seem to me that this object is most likely to be achieved by employing a single well-qualified firm, which would itself deploy staff so as to achieve the optimum blend of continuity and freshness. But cases vary infinitely and uniformity of practice is not in my view a desirable end.

Auditors: a duty to depositors?

3.40 Under the law as recently laid down,[4] auditors owe a duty of care to their client company and the whole body of shareholders but not to individual shareholders and not to non-shareholding depositors. It has been suggested that auditors should report and owe a duty directly to depositors.

3.41 I take the suggestion to be founded on one or other or both of two propositions: first, that auditors would take greater care if such a duty were owed; and second, that a careless auditor should bear the burden of compensating a depositor who has lost money through his carelessness. The first of these propositions is not self-evidently true, given the duties an auditor already owes and the discipline to which he is subject. Nor is it established by the facts of the present case, since no want of care by any auditor has as yet been shown. The second raises questions of policy (for example, the risk of encouraging audit opinions emasculated by qualifications and disclaimers) and practice (for example, the cost and availability of insurance).

3.42 This question may well, at some point in the future, call for consideration in depth. The material submitted to the Inquiry does not lead me now to recommend any change.

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[3] March 1992, page 25.
[4] Caparo Industries plc v Dickman [1990] 2 AC 605.

The auditor's duty to report to the Bank

3.43 The Treasury and Civil Service Committee observed:[5]

> "We conclude that, although the existing permissive nature of Section 47 has worked well and we accept that it caused no problems in the case of BCCI, it seems desirable to tighten the wording of the Act so that there can be no doubt, either from the point of view of the auditor, his client or the regulator, as to an auditor's duty to report. We so recommend."

In making this recommendation, the Committee attached importance to the agreement by a witness testifying on behalf of the Institute of Chartered Accountants of England and Wales that there was a case for amending the legislation to impose a clear duty to report in appropriate circumstances.

3.44 In giving evidence to the Inquiry, after giving the matter further thought, witnesses for the Institute took a somewhat different view. They were emphatic that under the Institute's Auditing Guideline 307 *Banks in the United Kingdom* auditors and reporting accountants are already subject to a clear professional duty to report directly to the Bank in the circumstances specified in the Guideline. They accordingly questioned whether imposition of a statutory duty would add anything of value to that professional duty. I was initially impressed by this argument, feeling that a duty imposed by statute would in practice be hard to enforce, that the existence of a professional duty has (as a result in part of the publicity attracted by this case) become very well known and that a professional guideline could more easily be adapted to meet changing circumstances than a duty enshrined in statute.

3.45 Having considered the matter very carefully I am persuaded that this initial view was wrong and that the Committee's recommendation was a wise one. The arguments which weigh with me are principally these:

(i) It would strengthen the position of the auditor, and clarify his duty, if it were specified in a clear and explicit statutory provision.

(ii) Determination of the correct relationship between client, auditor and supervisor raises an issue of policy more appropriate for decision by parliament than by the Bank and the accounting profession.

(iii) It is desirable that the duty should be

(a) to report to the Bank any information or opinion which the auditor knows or should reasonably know to be relevant to a bank's fulfilment of the criteria in Schedule 3 of the 1987 Act;

(b) to provide information reasonably requested by the Bank for purposes of its supervisory duties.

This is a wider duty than that imposed by the present Guideline. It might be possible to amend the Guideline to similar effect, but a statutory duty could be imposed by regulations made under section 47(5) of the 1987 Act and this would avoid the need for full statutory amendment if changes were thereafter found to be necessary.

(iv) A statutory duty would clarify the position of foreign auditors of UK branches not subject to the Institute's disciplinary jurisdiction.

[5] Fourth Report, paragraph 80.

3.46 It does not appear that any formal or professional impediment to communication between auditors and the Bank had any influence on the course of events in this case, but it is desirable that the position should be made very plain for the future.

3.47 If this recommendation is accepted, I hope that the process of consultation required by section 47(5) may be quickly begun. It will be important, in particular, to consult those professional accounting bodies (for example, in Scotland) which the Inquiry has not itself consulted.

The appointment of auditors under sections 39 and 41

3.48 It has been suggested that the Bank should not appoint (or cause to be appointed) a bank's own auditors under sections 39 and 41 of the 1987 Act. It is said that such auditors will necessarily be subject to a conflict of interest.

3.49 Where either the Bank or the auditors perceive a risk of conflict, such an appointment will of course be inappropriate. So it will where the Bank doubts the independence or competence of the auditors. But these instances do not justify a general prohibition. Auditors are routinely appointed to report under section 39 without problems arising. Appointments under section 41 are much less common, but even then the Bank and the bank under investigation would ordinarily share a mutual interest in the exposure of wrongdoing (and, for that matter, in the elimination of that possibility). In most cases the auditor is best placed to conduct a thorough and expeditious investigation and need not be torn between his duties to two masters.

3.50 I see no reason to recommend any change in the Bank's existing practice under which cases are judged on their merits and appointments made with a view to securing as thorough, expeditious and as fair an investigation as possible. Any accountant who questions whether a conflict may exist is well-advised to heed the detailed guidance given by the Institute on this subject.

Supervisory practice

3.51 The increased emphasis placed on the importance of internal audit and on the role of the audit committee is to be welcomed. The Bank should not hesitate to ask for copies of the audit committee minutes (and of the external auditors' audit letter) if it feels these would be helpful.

3.52 It should be a rule that all companies in a banking group have the same accounting dates.

3.53 The suggestion has been made, and supported by the Treasury and Civil Service Committee,[6] that

> "a report, covering all aspects of the accounting and other controls, is commissioned from the reporting accountant of a bank incorporated outside the UK annually, rather than as at present on a rolling four to five year basis."

The Inquiry has taken the opportunity to discuss this recommendation with representatives of the Institute of Chartered Accountants of England and Wales who expressed the view to us (as they had to the Committee) that smaller institutions, incorporated in the UK or abroad, should be the subject of a full-scope review by reporting accountants every year, but that the four to five year rolling programme should be preserved for larger institutions. I find both these points persuasive. There is much to be said for keeping a close eye on smaller, probably more vulnerable, institutions, but I think it would be unnecessarily burdensome and expensive to make the same requirement of larger institutions whose procedures give the Bank no cause for concern. In such cases the probability is that the reports would not in practice be studied and they would not in my view serve a useful purpose.

[6] Fourth Report, paragraph 68.

3.54 It has been suggested that the Bank's increased attention to systems, controls and records has led to a reduction in the attention paid to fitness and properness. A BCCI witness has observed:

> ".... the Bank of England's regulatory personnel are likely to know more about Directors, Controllers and Managers of banks they believe pose the least regulatory threat, and know least of those personnel of banks they regard with "suspicion"."

Whatever the truth of this remark, it is clearly vital (as the Bank fully recognises) that more formal supervisory procedures should not supersede the Bank's personal contact with bank managements.

3.55 Commission of the fraud within BCCI was undoubtedly facilitated by the use, or misuse, of the ICIC group which, as now appears, was controlled by those who also controlled BCCI itself. I think it important that the regulators should be fully alert to the opportunities for fraud and manipulation which can be provided by other organisations which, although not part of the banking group the subject of supervision, are nevertheless under common control. The existence of such entities may be a factor in deciding whether or not the bank concerned is capable of being adequately supervised. I recommend that the Bank gives special consideration to this aspect, and explores the introduction of possible checks and remedies, such as the imposition of a specific duty on a bank's management to disclose and provide details of any organisation under common control.

3.56 There is at present no requirement that the UK branches of an overbeas bank should be separately audited, although this is often done as it was by BCCI. It might perhaps be unnecessary to require such audit as an invariable practice, but I consider that the Bank should have the power to require separate audit in any case where it thinks fit, at least in respect of banks domiciled outside the European Community.

Banking practice

3.57 It has been suggested that all payment instructions through a correspondent bank should name the originator and the beneficiary. I can see no valid objection to this suggestion and it has much to commend it. The more detailed suggestions made by Price Waterhouse to the Treasury and Civil Service Committee[7] also seem to me to merit very serious consideration.

Insolvency

3.58 The Inquiry has not entered in depth into the large and vexed issue of harmonising the international law and practice in insolvency. I should, however, record a suggestion made to the Inquiry that the administration procedure provided by the Insolvency Act 1986 should be extended to UK branches of overseas banks. This is a change which, if achievable, the Bank would welcome.

Deposit Protection

3.59 The Inquiry has not considered a review of the existing Deposit Protection Scheme to be within its terms of reference, but has nonetheless received a considerable quantity of material on the subject. This shows support

(i) for giving full protection to qualifying deposits up to a certain, relatively modest, level;

(ii) for giving protection above that figure, either as now on a percentage basis or on a sliding scale;

(iii) for raising the current ceiling figure of £20,000 to a figure more closely in line with the limit on other similar UK schemes;

[7] Fourth Report, page 64.

(iv) for altering the law to provide for speedier payment to depositors where a provisional liquidator is appointed, if the court approves;

(v) for requiring banks to notify depositors (perhaps by a notice printed on pass sheets) of the ceiling figure for protected deposits and (if a Community Directive is made) of the Deposit Protection Fund which applies to their deposits.

I understand. that the Bank would favour a change of law or practice to give effect to (iv) and (v).

Annex 1: List of Witnesses

The following is a list of those who gave evidence to, or made observations relevant to the terms of reference of, the Inquiry; or otherwise provided written material to the Inquiry. Those marked with an asterisk also gave oral evidence and those with a cross met the Inquiry informally. No reference is made to those communicating with the Inquiry and who preferred that their names should not be mentioned.

AMBROSE Vivian*	Former BCCI employee
The AMERICAN BANKS AUDIT GROUP	
AMERY The Rt Hon Lord	Former Member of Parliament
ASPDEN John	Former Commissioner of Banking Hong Kong
ATKINSON John	Former Inspector of Banks & Trust Companies Banking Supervision Department, Grand Cayman
AZIZ S M*	Former BCCI employee
BANK OF AMERICA	
BANK OF ENGLAND:	
BARNES Roger*	Head of BSD
BARTLETT John*	A Deputy Head of BSD
BEVERLY John*	A former Deputy Head of BSD
BLUNDEN Sir George	Former Deputy Governor
COOKE Peter*	Former Head of Banking Supervision
GALPIN Rodney*	Former Executive Director
GENT Brian*	A former Deputy Head of BSD
GEORGE Eddie*	Deputy Governor
LEIGH-PEMBERTON The Rt Hon Robin*	Governor
McMAHON Sir Kit	Former Deputy Governor
RICHARDSON The Rt Hon Lord	Former Governor
QUINN Brian*	Executive Director
BANK OF SCOTLAND	
BARCLAYS BANK plc	
BASLE COMMITTEE ON BANKING SUPERVISION	
BENN The Rt Hon Tony MP	Member of Parliament
BENNETT The Rt Hon Sir Frederic	Former Member of Parliament
BLAIR H R A	

BOARD OF BANKING SUPERVISION:

GERRARD Peter*
BARRON Sir Donald
HARDCASTLE Sir Alan*
LESLIE Sir Peter*
ROBSON Nigel*
SWAYTHLING The Rt Hon Lord*
TAYLOR Harry*
WILKINSON Sir Philip

BOLTON B

BRITISH BANKERS' ASSOCIATION

BRITTAN The Rt Hon Sir Leon+	Vice-President of the EC
BUTLER HARLOW UEDA Ltd	International Money Brokers
BUTSCH J-L	Secretaire General, Commission Bancaire France
CALLAGHAN The Rt Hon Lord	Former Prime Minister

CANADIAN BANKERS ASSOCIATION

CARSE David	Commissioner of Banking Hong Kong

CENTRAL BANK OF THE UAE

CHARITY COMMISSION

CLARKE G L

COCKFIELD The Rt Hon Lord+	Former Vice-President of the EC

COMMONWEALTH SECRETARIAT

CONNELL R M A	Hobson Audley, solicitors

COORDINATING COMMITTEE OF BCCI AUTHORITIES

COURTENAY C	Director, Fareham Borough Council

CROWN PROSECUTION SERVICE

DALE Dr Richard	University of Southampton
DE LA CRUZ Javier	Inspector Jefe de Entidades de Credito y Ahorro, Banco de Espana

DOHA S

DYKES Hugh MP+	Member of Parliament

EMPLOYMENT Department of	
ENVIRONMENT Department of the	
ERNST AND YOUNG (UK firm)	
EXCO INTERNATIONAL plc	International Money Brokers
FARUQUI M A	Former BCCI employee
FEDERAL RESERVE BANK OF NEW YORK:	
CORRIGAN Gerald+	President
BAXTER Tom+	Counsel
FEDERAL RESERVE BOARD, WASHINGTON:	
MATTINGLY J Virgil+	General Counsel
SMALL Richard+	Special Counsel
FORDHAM J M	Stephenson Harwood, solicitors
FOREIGN AND COMMONWEALTH OFFICE	
GIBRALTAR, Government of	
GILLARD Michael+	Journalist
HALL Dr Maximilian	Loughborough University of Technology
HARRIS of Greenwich The Rt Hon Lord+	
HARTMANN Dr Alfred	Former director of BCCI
HASHIM Dr J	
HEIMANN John+	Former Comptroller of the Currency
HM CUSTOMS AND EXCISE:	
UNWIN Sir Brian*	Chairman
COONEY John*	
POULTER Carl*	
TRIGG Michael*	
HM TREASURY:	
DAVIES The Rt Hon Denzil MP	Former Minister of State
HEALEY The Rt Hon Lord	Former Chancellor of the Exchequer
HOWE The Rt Hon Lord	Former Chancellor of the Exchequer
LAMONT The Rt Hon Norman MP*	Chancellor of the Exchequer
LAWSON The Rt Hon Lord*	Former Chancellor of the Exchequer
LILLEY The Rt Hon Peter MP	Former Economic Secretary
MAJOR The Rt Hon John MP*	Prime Minister and former Chancellor of the Exchequer

MAPLES John*	Former Economic Secretary
MOORE The Rt Hon Lord	Former Economic Secretary
RYDER The Rt Hon Richard MP	Former Economic Secretary
STEWARTBY The Rt Hon Lord*	Former Economic Secretary
AIREY Sir Lawrence	Former 2nd Permanent Secretary
BRIDGEMAN Michael	Former Head of FIM Group
BURNS Sir Terence*	Permanent Secretary
CASSELL Frank	Former Head of Public Finance
GIEVE John*	Head of FIM Group
GILMORE Mrs Rosalind*	Former Head of Banking Division FIM Group
HALL Martin	Former Head Banking Division FIM Group
LANKESTER Timothy	Former Head of FIM Group
LITTLER Sir Geoffrey	Former 2nd Permanent Secretary
LOMAX Mrs Rachel*	Former Head of FIM Group
MIDDLETON Sir Peter*	Former Permanent Secretary
MONCK Nicholas	Former Head of FIM Group
NOBLE Miss Gillian*	Head of Banking Division FIM Group
ODLING-SMEE John	Former Head of FIM Group
PERETZ David	Former Head of FIM Group
PIRIE Alastair	Former Head of Banking Division FIM Group
RYRIE Sir William	Former 2nd Permanent Secretary
SCHOLAR Michael*	Head of Public Finance
WALSH Harry*	Former Head of FIM Group
WASS Sir Douglas	Former Permanent Secretary
WICKS Sir Nigel	2nd Permanent Secretary

NB: FIM Group is used throughout above for convenience

HILLBERY John*	Former BCCI employee

HODGES N

HOLLISTON J

HOME OFFICE

HUSSEIN S A*	Accountant

IMAM IMRAN*

INLAND REVENUE+

INSTITUT MONETAIRE LUXEMBOURGEOIS

INSTITUTE OF CHARTERED ACCOUNTANTS of England and Wales:

PLAISTOWE Ian*	President
CHAPMAN Peter*	
NELSON Brendan*	

INSTITUTE OF INTERNAL AUDITORS

INTELLIGENCE AGENCIES*	
INVESTMENT MANAGEMENT REGULATORY ORGANISATION Ltd (IMRO)	
ISLE OF MAN GOVERNMENT, FINANCIAL SUPERVISION COMMISSION	
J P MORGAN & Co Inc+	
KAZMI A	
KENDALL Roger*	Former BCCI employee
KEYES of Zeebrugge and of Dover The Rt Hon Lord	Chairman CCL Financial Group plc
KHAN Mrs R (on behalf of a number of depositors, creditors and employees of BCCI)	
KNAPTON G A B	
LAMARCHE Yves	Former director of BCCI
LIQUIDATORS OF BCCI SA+	
LLOYD'S BANK plc	
LLOYD'S OF LONDON+	
MAJORITY SHAREHOLDERS OF BCCI:	
MAZRUI HE Ghanim Faris Al+ **DHAHERI** HE Jauan Salem Al +	
MALIK K	
MARSDEN Mrs S F	
MEIKLE P A	Former BCCI employee
METROPOLITAN POLICE:	
TAYLOR William+	Assistant Commissioner
MIDLAND BANK plc	
MITCHELL Austin MP	Member of Parliament
MONRO-DAVIES Robin	IBCA Ltd
MORGAN David	Former Commerical Relations Office, States of Jersey
MOSCOW NARODNY BANK Ltd	
M W MARSHALL & Co Ltd	International Money Brokers

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NATIONAL WESTMINSTER BANK plc

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NEW YORK COUNTY DISTRICT ATTORNEY:

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MOSCOW John+

NORMAN P A

ODUNAIYA A W

OFFICE OF FAIR TRADING

PASSEY M L S

PATEL S P W

PERIES T C* — Former BCCI employee

PHILLIPS S

PORTER R F

PRICE WATERHOUSE (UK firm):

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CHAPMAN Simon*
CHARGE Tim*
COWAN Chris*
HOULT Tim*
REW Paul*

RAHMAN Masihur* — Former BCCI employee

RATHBONE Tim MP — Member of Parliament

RICE A C — Former Director BCCI (Bank of America)

RIDER Dr Barry — Dean of Jesus College Cambridge

RIDLEY The Rt Hon Lord — Former Secretary of State for Trade and Industry

RIDSDALE Sir Julian — Former Member of Parliament

ROYAL BANK OF SCOTLAND plc

SCOTTISH OFFICE

SECURITIES AND FUTURES AUTHORITY Ltd (SFA)

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SIDDIQUI S H	
SOOMRO A R	
SPENCER Dr M	
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WALKER Sir David	Former Chairman SIB
WELSH OFFICE	
WHITBY R D	
YOUNGMAN David	Former senior partner of Ernst & Whinney
ZULAUF Urs	Swiss Federal Banking Commission

A number of BCCI former employees (not otherwise identifed)

A number of BCCI corporate customers

A number of BCCI depositors

Annex 2: extract from Banking Act 1987

PART V

RESTRICTION ON DISCLOSURE OF INFORMATION

Restricted information.

82.–(1) Except as provided by the subsequent provisions of this Part of this Act–

(a) no person who under or for the purposes of this Act receives information relating to the business or other affairs of any person; and

(b) no person who obtains any such information directly or indirectly from a person who has received it as aforesaid,

shall disclose the information without the consent of the person to whom it relates and (if different) the person from whom it was received as aforesaid.

(2) This section does not apply to information whch at the time of the disclosure is or has already been made available to the public from other sources or to information in the form of a summary or collection of information so framed as not to enable information relating to any particular person to be ascertained from it.

(3) Any person who discloses information in contravention of this section shall be guilty of an offence and liable–

(a) on conviction on indictment, to imprisonment for a term not exceeding two years or to a fine or to both;

(b) on summary conviction, to imprisonment for a term not exceeding three months or to a fine not exceeding the statutory maximum or to both.

Disclosure for facilitating discharge of functions by the Bank.

83.–(1) Section 82 above does not preclude the disclosure of information in any case in which disclosure is for the purpose of enabling or assisting the Bank to discharge its functions under this Act.

(2) Without prejudice to the generality of subsection (1) above, that section does not preclude the disclosure of information by the Bank to the auditor of an authorised institution or former authorised institution if it appears to the Bank that disclosing the information would enable or assist the Bank to discharge the functions mentioned in that subsection or would otherwise be in the interests of depositors.

(3) If, in order to enable or assist the Bank properly to discharge any of its functions under this Act, the Bank considers it necessary to seek advice from any qualified person on any matter of law, accountancy, valuation or other matter requiring the exercise of professional skill, section 82 above does not preclude the disclosure by the Bank to that person of such information as appears to the Bank to be necessary to ensure that he is properly informed with respect to the matters on which his advice is sought.

Disclosure for facilitating discharge of functions by other supervisory authorities.

84.–(1) Section 82 above does not preclude the disclosure by the Bank of information to any person specified in the first column of the following Table if the Bank considers that the disclosure would enable or assist that person to discharge the functions specified in relation to him in the second column of that Table.

TABLE

	Person	*Functions*
1982 c. 50. 1985 c. 6. 1986 c. 45. 1986 c. 60.	The Secretary of State.	Functions under the Insurance Companies Act 1982, Part XIV of the Companies Act 1985, Part XIII of the Insolvency Act 1986 or the Financial Services Act 1986.
	An inspector appointed by the Secretary of State.	Functions under Part XIV of the Companies Act 1985.
	A person authorised by the Secretary of State under section 44 of the Insurance Companies Act 1982.	Functions under that section.
	The Chief Registrar of friendly societies, the Registrar of Friendly Societies for Northern Ireland and the Assistant Registrar of Friendly Societies for Scotland.	Functions under the enactments relating to friendly societies or under the Financial Services Act 1986.
	The Industrial Assurance Commissioner and the Industrial Assurance Commissioner for Northern Ireland.	Functions under the enactments relating to industrial assurance.
1986 c. 53.	The Building Societies Commission.	Functions under the Building Societies Act 1986 and protecting the interests of the shareholders and depositors of building societies.
1974 c. 39.	The Director General of Fair Trading.	Functions under the Consumer Credit Act 1974.
	A designated agency or transferee body or the competent authority (within the meaning of the Financial Services Act 1986).	Functions under the Financial Services Act 1986.
	A recognised self-regulating organisation, recognised professional body, recognised investment exchange, recognised clearing house or recognised self-regulating organisation for friendly societies (within the meaning of the Financial Services Act 1986).	Functions in its capacity as an organisation, body, exchange or clearing house recognised under the Financial Services Act 1986.
	A person appointed under section 94, 106 or 177 of the Financial Services Act 1986.	Functions under the sections mentioned in column 1.

A recognised professional body (within the meaning of section 391 of the Insolvency Act 1986).	Functions in its capacity as such a body under the Insolvency Act 1986.
The Department of Economic Development in Northern Ireland.	Functions under Part XV of the Companies (Northern Ireland) Order 1986.
An inspector appointed by that Department.	Functions under Part XV of that Order.
The Official Receiver or, in Northern Ireland, the Official Assignee for company liquidations or for bankruptcy.	Investigating the cause of the failure of an authorised institution or former authorised institution in respect of which a winding-up order, bankruptcy order or order of adjudication of bankruptcy has been made.

S.I. 1986/1032 (N.I. 6).

(2) The Treasury may after consultation with the Bank by order amend the Table in subsection (1) above by–

(a) adding any person exercising regulatory functions and specifying functions in relation to that person;

(b) removing any person for the time being specified in the Table; or

(c) altering the functions for the time being specified in the Table in relation to any person;

and the Treasury may also after consultation with the Bank by order restrict the circumstances in which, or impose conditions subject to which, disclosure is permitted in the case of any person for the time being specified in the Table.

(3) An order under subsection (2) above shall be subject to annulment in pursuance of a resolution of either House of Parliament.

(4) Section 82 above does not preclude the disclosure by any person specified in the first column of the Table in subsection (1) above of information obtained by him by virtue of that subsection if he makes the disclosure with the consent of the Bank and for the purpose of enabling or assisting him to discharge any functions specified in relation to him in the second column of that Table; and before deciding whether to give its consent to such a disclosure by any person the Bank shall take account of such representations made by him as to the desirability of or the necessity for the disclosure.

(5) Section 82 above does not preclude the disclosure by the Bank of information to the Treasury if disclosure appears to the Bank to be desirable or expedient in the interests of depositors or in the public interest; and that section does not preclude the disclosure by the Bank of information to the Secretary of State for purposes other than those specified in relation to him in subsection (1) above if the disclosure is made with the consent of the Treasury and–

(a) the information relates to an authorised institution or former authorised institution and does not enable the financial affairs of any other identifiable person to be ascertained and disclosure appears to the Bank to be necessary in the interests of depositors or in the public interest, or

(b) in any other case, disclosure appears to the Bank to be necessary in the interests of depositors.

(6) Section 82 above does not preclude the disclosure of information for the purpose of enabling or assisting an authority in a country or territory outside the United Kingdom to exercise–

(a) functions corresponding to those of–

(i) the Bank under this Act;

1982 c. 50. 1986 c. 45. 1986 c. 60.

(ii) the Secretary of State under the Insurance Companies Act 1982, Part XIII of the Insolvency Act 1986 or the Financial Services Act 1986; or

(iii) the competent authority under Part IV of the Financial Services Act 1986;

(b) functions in connection with rules of law corresponding to any of the 1985 c. 8. provisions of the Company Securities (Insider Dealing) Act 1985 or Part VII of 1986 c. 60. the Financial Services Act 1986; or

(c) supervisory functions in respect of bodies carrying on business corresponding to that of building societies.

Other permitted disclosures.

85.–(1) Section 82 above does not preclude the disclosure of information–

(a) for the purpose of enabling or assisting the Board of Banking Supervision or the Deposit Protection Board or any other person to discharge its or his functions under this Act;

(b) for the purpose of enabling or assisting a person to do anything which he is required to do in pursuance of a requirement imposed under section 39(1)(b) above;

(c) with a view to the institution of, or otherwise for the purposes of, any criminal proceedings, whether under this Act or otherwise;

(d) in connection with any other proceedings arising out of this Act;

(e) with a view to the institution of, or otherwise for the purposes of, proceedings 1986 c. 46. under section 7 or 8 of the Company Directors Disqualification Act 1986 in respect of a director or former director of an authorised institution or former authorised institution;

(f) in connection with any proceedings in respect of an authorised institution or 1985 c. 66. former authorised institution under the Bankruptcy (Scotland) Act 1985 or 1986 c. 45. Parts I to VII or IX to XI of the Insolvency Act 1986 which the Bank has instituted or in which it has a right to be heard;

(g) with a view to the institution of, or otherwise for the purposes of, any disciplinary proceedings relating to the exercise of his professional duties by an auditor of an authorised institution or former authorised institution or an accountant or other person nominated or approved for the purposes of section 39(1)(b) above or appointed under section 41 above;

(h) in pursuance of a Community obligation.

(2) Section 82 above does not preclude the disclosure by the Bank to the Director of Public Prosecutions, the Director of Public Prosecutions for Northern Ireland, the Lord Advocate, a procurator fiscal or a constable of information obtained by virtue of section

41, 42 or 43 above or of information in the possession of the Bank as to any suspected contravention in relation to which the powers conferred by those sections are exercisable.

(3) Section 82 above does not preclude the disclosure of information by the Deposit Protection Board to any person or body responsible for a scheme for protecting depositors or investors (whether in the United Kingdom or elsewhere) similar to that for which provision is made by Part II of this Act if it appears to the Board that disclosing the information would enable or assist the recipient of the information or the Board to discharge his or its functions.

Information supplied to Bank by relevant overseas authority.

86. Section 82 above applies also to information which has been supplied to the Bank for the purposes of its functions under this Act by a relevant supervisory authority in a country or territory outside the United Kingdom but no such information shall be disclosed except as provided in that section or for the purpose of enabling or assisting the Bank to discharge those functions or with a view to the institution of, or otherwise for the purposes of, criminal proceedings, whether under this Act or otherwise.

Disclosure of information obtained under other Acts.

87.–(1) After section 174(3) of the Consumer Credit Act 1974 there shall be inserted–

1974 c. 39.

"(3A) Subsections (1) and (2) do not apply to any disclosure of information by the Director to the Bank of England for the purpose of enabling or assisting the Bank to discharge its functions under the Banking Act 1987 or the Director to discharge his functions under this Act."

1985 c. 6.

(2) Information disclosed to the Bank under subsection (1) of section 449 of the Companies Act 1985 for the purpose of enabling or assisting it to discharge its functions under this Act or in its capacity as a competent authority under subsection (3) of that section may be disclosed–

(a) with the consent of the Secretary of State, in any case in which information to which section 82 applies could be disclosed by virtue of section 84(1) or (2) above; and

(b) in any case in which information to which section 82 above applies could be disclosed by virtue of any of the other provisions of this Part of this Act.

S.I. 1986/1032 (N.I. 6).

(3) Information disclosed to the Bank under paragraph (1) of Article 442 of the Companies (Northern Ireland) Order 1986 for the purpose of enabling or assisting it to discharge its functions under this Act or in its capacity as a competent authority under paragraph (3) of that Article may be disclosed–

(a) with the consent of the Secretary of State, in any case in which information to which section 82 above applies could be disclosed by virtue of section 84(1) or (2) above; and

(b) in any case in which information to which section 82 above applies could be disclosed by virtue of any of the other provisions of this Part of this Act.

(4) Any information which has been lawfully disclosed to the Bank may be disclosed by it to the Board of Banking Supervision so far as necessary for enabling or assisting the Board to discharge its functions under this Act.

Index

CHAPTERS 1-3
PERSONAL AND CORPORATE NAMES

Scope Note
Numbers shown refer to paragraphs, for example 2.27 refers to Chapter 2, paragraph 27.

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