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House of Commons  
Treasury Committee

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# Accountability of the Bank of England

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**Twenty-first Report of Session  
2010–12**

*Volume I: Report, together with formal  
minutes, oral and written evidence*

*Additional written evidence is contained in  
Volume II, available on the Committee website  
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## The Treasury Committee

The Treasury Committee is appointed by the House of Commons to examine the expenditure, administration, and policy of HM Treasury, HM Revenue and Customs and associated public bodies.

### Current membership

Mr Andrew Tyrie MP (*Conservative, Chichester*) (Chairman)  
Tom Blenkinsop MP (*Labour, Middlesbrough South and East Cleveland*)  
John Cryer MP (*Labour, Leyton and Wanstead*)  
Michael Fallon MP (*Conservative, Sevenoaks*)  
Mark Garnier MP (*Conservative, Wyre Forest*)  
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Mr George Mudie MP (*Labour, Leeds East*)  
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David Ruffley MP, (*Conservative, Bury St Edmunds*)  
John Thurso MP (*Liberal Democrat, Caithness, Sutherland, and Easter Ross*)

Mr Chuka Umunna MP (*Labour, Streatham*) was also a member of the Committee during the inquiry.

### Powers

The committee is one of the departmental select committees, the powers of which are set out in House of Commons Standing Orders, principally in SO No 152. These are available on the Internet via [www.parliament.uk](http://www.parliament.uk).

### Publication

The Reports and evidence of the Committee are published by The Stationery Office by Order of the House. All publications of the Committee (including press notices) are on the Internet at [www.parliament.uk/treascom](http://www.parliament.uk/treascom).

The Reports of the Committee, the formal minutes relating to that report, oral evidence taken and some or all written evidence are available in printed volume(s). Additional written evidence may be published on the internet only.

### Committee staff

The current staff of the Committee are Chris Stanton (Clerk), Lydia Menzies (Second Clerk), Jay Sheth, Peter Stam, Antonia Brown and Renée Friedman (Committee Specialists), Phil Jones (Senior Committee Assistant), Steven Price and Baris Tufekci (Committee Assistants) and Nick Davies (Media Officer).

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## Summary

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The Bank of England is being given new powers which affect everyone in the country. It will be responsible for preventing another financial crisis. The inquiry has thrown into relief several issues that may require further examination. However, this report is focussed solely on the accountability of the Bank of England. Wider issues in the proposals contained in the Government's Draft Financial Services Bill may be examined in the first instance by the Joint Committee<sup>1</sup>. We may also return to aspects of the Draft Bill in future inquiries.

The evidence that we have received suggests that the governance of the Bank needs strengthening and that it needs to be more open about its work. The Bank must be held more clearly to account than it has been in the past.

In particular we recommend that the role of the Court of the Bank of England should be substantially enhanced. It should be transformed into a leaner and more expert Supervisory Board, with the power to conduct retrospective reviews of Bank policies and conduct. These reviews are not a substitute for oversight by us, the Treasury Committee, but will allow the Supervisory Board of the Bank to ensure that the Bank learns from its own experience, and to provide this Committee with appropriate evidence on the Bank's performance in order to enhance scrutiny of the Bank's actions. The Board would be made responsible for meeting reasonable requests for information by Parliament.

The Bank should publish indicators of financial stability by which its performance to meet the financial stability objectives may be assessed.

The lines of responsibility and accountability between the Chancellor of the Exchequer, HM Treasury, and the Bank of England at times of financial difficulty must be clarified. In a crisis, where public money is at risk, the Chancellor should be given statutory responsibility for the conduct of affairs, including a limited special power to direct the Bank.

The Bank must be suitably staffed to perform the enlarged role proposed for it. It must ensure that it does not deter suitable candidates from joining its Committees by over-rigid rules on conflicts of interest. The Financial Policy Committee and the Monetary Policy Committee should have a majority of external members. The Governor of the Bank should be appointed for a single non-renewable term of eight years.

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<sup>1</sup> Further information about the Joint Select Committee inquiry may be found at: <http://www.parliament.uk/business/committees/committees-a-z/joint-select/draft-financial-services-bill/>



# 1 Introduction

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## The accountability of the Bank of England

1. The financial sector plays a crucial part in the UK economy in terms of employment, exports and its contribution to GDP. However, the financial crisis of 2007–08 exposed flaws in both the management of financial institutions and in regulators’ ability to identify and act on the risks that were emerging from the system. There is a need for an approach to holding regulators to account which can also improve their performance. Hence this inquiry.

2. In February 2011, HM Treasury opened a public consultation on its proposals for “A new approach to financial regulation”.<sup>2</sup> The proposals were for a reform of UK financial regulation to replace the old ‘tripartite’ system comprising the Bank of England, HM Treasury and the Financial Services Authority (FSA). In June 2011, the Treasury published the results of its public consultation alongside a draft Bill with more detailed proposed amendments of the Financial Services and Markets Act 2000 (FSMA).<sup>3</sup> The Treasury proposes that the tripartite system of financial regulation be replaced by the establishment of:

- A macro-prudential regulator within the Bank of England, the Financial Policy Committee (FPC). This Committee will monitor and respond to systemic risks;
- A micro-prudential regulator, the Prudential Regulation Authority (PRA), created as a subsidiary of the Bank of England, and
- An independent conduct of business regulator, the Financial Conduct Authority (FCA), which will ensure that business is conducted in such a way that advances the interests of all users and participants of the UK financial sector.

3. Figure 1 summarises the proposed changes. It is intended that the Bank of England will be given significantly more power and responsibility over monitoring the financial system and preventing any future crisis. The Treasury stated in its consultation document that:

These changes to give the Bank control of macro-prudential regulation and oversight of micro-prudential regulation will mean a much greater and more operational role for the Bank in the financial system. This will have significant implications for the Bank in terms of its staff, resources, governance and transparency.<sup>4</sup>

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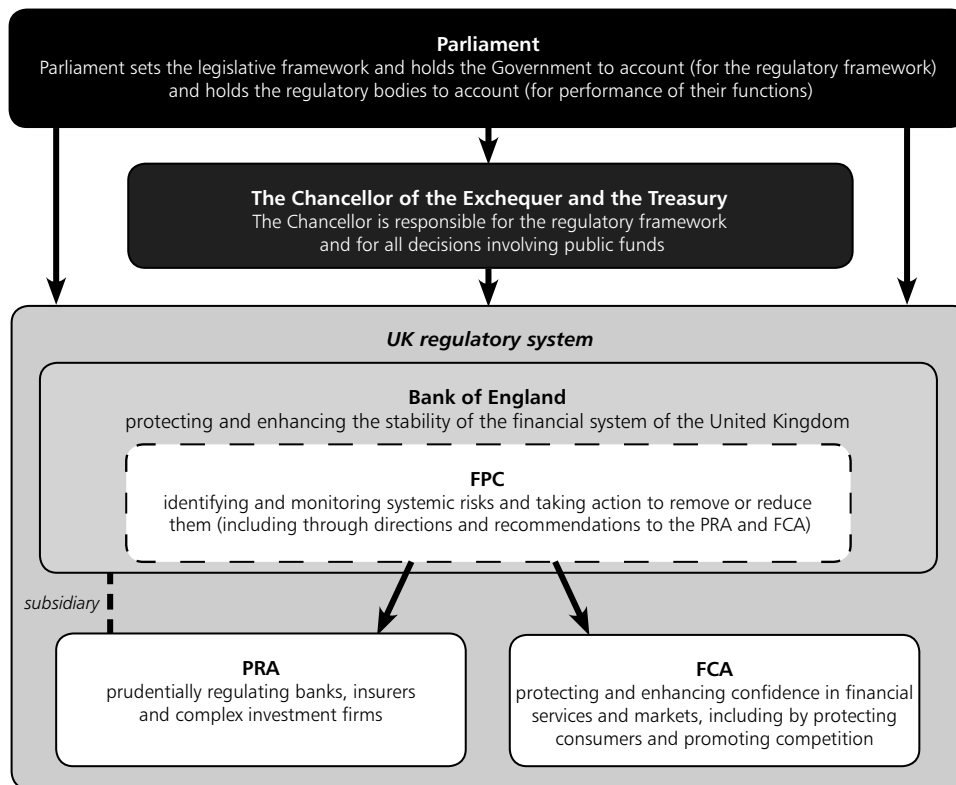
2 HM Treasury, A new approach to financial regulation: building a stronger system, Cm 8012, February 2011

3 HM Treasury, A new approach to financial regulation: the blueprint for reform, Cm 8083, June 2011

4 *Ibid.*, p 8



Figure 1: Summary of proposed new system of UK financial regulation system.<sup>5</sup>



4. With the impending substantial expansion of the Bank's power and responsibilities, the range of policy decisions for which the Bank needs to be held accountable will similarly increase. This will have implications for the post-1997 model of accountability, for the following reasons:

- The responsibilities of the Bank will be much more extensive;
- The Bank's objectives in its new areas of responsibility will be less clearly defined than they are in the case of monetary policy by the inflation target, and
- In some cases, disclosure of the Bank's decisions could frustrate the achievement of their objectives, for example where emergency liquidity is provided to individual banks.

5. In March 2011 we announced an inquiry into the accountability of the Bank of England. Among the important questions for the inquiry were the following:

- What kind of decisions should be made by each body within the Bank?
- To whom should the Bank be accountable?
- Are the responsibilities of the Court of the Bank of England clear and appropriate?
- Are the members of the Court of the Bank and the arrangements for its members' appointment and dismissal appropriate?

- What resources does the Bank of England need to carry out its functions?<sup>6</sup>

6. The substantial reforms to the UK's financial regulatory system are an opportunity—one which occurs at rare intervals—to reopen the balance of relations between the Bank of England, the Government and Parliament which have developed piecemeal since the early 1990s. Accountability of the Bank has developed ad hoc—on the whole successfully in the case of the Monetary Policy Committee. But an opportunity now exists to take stock of the institutional structures in order to bring coherence to relationships and remove anomalies, and to ensure that effective and clear accountability processes are in place.

7. If regulatory bodies are given substantial independent powers, Parliament needs to be able to hold those bodies publically to account for the decisions that they take. HM Treasury, too, as the shareholder of the Bank of England, needs adequate oversight. It is not the intention of this Committee to prevent a regulator taking bold decisions, but to require a high degree of explanation and analysis of the objectives and justification of the decisions they make. The Bank of England is an unelected body with large new areas of responsibility, including over matters of vital concern to everybody in the country. If it gets its decisions wrong, the economy and the country's prosperity could be seriously damaged. As one of our witnesses, Professor Rosa Lastra, has said:

The Bank of England must give account of, explain, and justify the actions, omissions or decisions taken against criteria of some kind, and take responsibility for any fault or damage.<sup>7</sup>

8. We held six evidence sessions in our inquiry. On 15 March we took evidence from four members of the Court of the Bank of England: Sir David Lees, Chairman, and Sir Roger Carr, Lady Rice CBE and Brendan Barber. On 23 May we heard from four former members of the Monetary Policy Committee (MPC): Professor Charles Goodhart CBE, Dr Sushil Wadhvani CBE, Kate Barker CBE and Dr Willem H Buiter. On 20 June we took evidence from academics and experts in corporate governance and financial innovation: Professor Rosa Lastra, Queen Mary, University of London, Professor Bob Garratt, CASS Business School, and Dr Andrew Hilton and Jane Fuller, Centre for the Study of Financial Innovation. On 21 June we heard from Dr Gavin Bingham, Bank for International Settlements. On 28 June we took evidence from five executives of the Bank of England: Sir Mervyn King, Governor, Paul Tucker, Deputy Governor, Financial Stability, Charlie Bean, Deputy Governor, Monetary Policy, Andy Haldane, Executive Director, Financial Stability, and Andrew Bailey, Executive Director. Finally, on 5 July we heard from Rt Hon George Osborne MP, Chancellor of the Exchequer and Sir Nicholas Macpherson, Permanent Secretary, HM Treasury. We are grateful to all witnesses for their contributions to this inquiry and also to all those who submitted written evidence.

9. We would like to thank William A. Allen and Sir Nicholas Monck for their expert advice and assistance in this inquiry.<sup>8</sup>

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6 Treasury Committee Website, <http://www.parliament.uk/business/committees/committees-a-z/commons-select/treasury-committee/news/accountability-of-the-bank-of-england/>

7 Lastra, Rosa, "Keeping tabs on the Bank", *Parliamentary Brief*, July (2011), pp 20-21

8 Relevant interests of specialist advisers are as follows (a complete listing of interests can be found in the Formal Minutes of the Committee available on the Committee's website):

## 2 Historical context

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### Before 1997

10. The Government's proposals represent a major reform to the regulation of the United Kingdom's financial sector. We asked the Bank of England's official historian, Professor Capie, to summarise the Bank's historical role in financial stability to provide a wider context for our inquiry. He told us that:

The Bank has long had a mandate from government to protect the value of the currency. From the eighteenth century when the Bank had become the centre of the monetary/financial system protection of the currency or words to that effect has been its principal function. In the early days that was done by protecting the gold reserves. Later its focus was the exchange rate and most recently has become the inflation rate.<sup>9</sup>

11. In the nineteenth century, economic stability was achieved through a combination of commercial banks learning prudence and the Bank of England taking the role of lender of last resort. However, as Professor Capie went on to explain, the commercial banks were increasingly criticised for being too conservative:

The climate of the times, the age of laissez-faire, meant that an increasingly lightly regulated system emerged.

...

The criticism frequently took the form that [the banks] should become more adventurous in lending to industry and more like their continental European counterparts the universal bank. The Bank of England slowly learned its part, how to behave as a lender of last resort injecting the necessary liquidity into the market as a whole whenever there was a shock and not bailing out individual institutions. And this was all done in a light and informal regulatory environment.<sup>10</sup>

12. The Bank of England Act 1946 provided for the nationalisation of the Bank of England. This legislation led to a transformation: Monetary policy of the UK became the responsibility of the Chancellor of the Exchequer, while the Bank possessed authority over the banking system.

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- William A. Allen: Financial and economic consultant; Two current consultancy contracts. One is with a company called Ad Satis Ltd (their internet site is <http://www.adsatis.com/>). Ad Satis itself provides consultancy services to banks, and the contract is to provide them with pieces of research on bank regulation. The other is with NBNK Investments PLC, which intends to acquire banking assets in the UK and establish a new retail banking company to compete with the established incumbents.

- Sir Nicholas Monck: Non-executive director of UCLH NHS Foundation Trust, a member of the Better Government Initiative; and he has taken part in discussions of an interdisciplinary project, based at Balliol College, on the potential role of a duty of care in financial services. He worked in the Treasury from 1969-92.

9 Ev w24

10 Ev w25

The Treasury, deemed the ultimate authority in matters of monetary policy, could neither issue directives to commercial banks nor direct the Bank to do so.<sup>11</sup>

13. It established that the Court should have sixteen Directors, including four executives. The appointment of the members of Court was by the Crown, rather than being the Governor's decision alone.<sup>12</sup>

14. The Act also contained a reserve power—which is still in force—for the Chancellor to exercise broad and complete control of the Bank in exceptional circumstances:

The Treasury may from time to time give such directions to the Bank as, after consultation with the Governor of the Bank, they think necessary in the public interest.<sup>13</sup>

15. After 1946, the Bank became responsible for, among other things, the currency and the affairs of the City. It was accountable to the Treasury and more generally to government. However there were very few formal accountability mechanisms. The Bank published a Quarterly Bulletin that explained some of its activities to a wider public.

16. As far as financial stability was concerned, Professor Capie says:

It reached a point after the Second World war that financial stability was taken as a given and it was not discussed. ... Within a couple of decades things on both the inflation and the financial stability fronts began to go badly wrong. The 1970s were then the worst decade in Britain's monetary and financial history up to that point.

17. The Bank's involvement in financial crises meant that public awareness of the role of the Bank of England had grown by the 1970s, and the need for public scrutiny with it. A notable episode of parliamentary scrutiny of the Bank occurred in 1970, when the Select Committee on Nationalised Industries conducted an inquiry into the Bank. One of the main criticisms of the Committee was about the lack of published accounts from the Bank. This accompanied a recommendation that the Bank should publish its accounts on a basis which was comparable to that of other nationalised industries. That Committee warned that "any institution which is protected by secrecy and shielded from scrutiny is in danger of becoming unself-critical and complacent".<sup>14</sup>

18. Professor Capie went on to say:

After [the 1970s] crisis more focussed supervision was put in place, and then legislation passed (1979) that regulated some of the activities of banking. That regulation was seen to be faulty within a couple of years as problems arose within the clearing banks. New legislation was prepared and passed (1987) but within a few years fresh problems had blown up in the small banks crisis of 1990–92.<sup>15</sup>

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11 John Fforde, *The Bank of England and Public Policy 1941-1958*, 1992, p 10

12 *Ibid.*, p 12

13 Bank of England Act 1946, Clause 4(1)

14 Select Committee on Nationalised Industries, First Report of Session 1969–70, *Bank of England*, para 267

15 Ev w25

19. The increasing prudential supervisory role of the Bank of England led, in 1987, to the creation of a dedicated Board of Banking Supervision. This was chaired by the Governor, but with a majority of external members. The remit for this Board was to advise the Governor on:

- The general principles and policy of supervision of institutions authorised under banking supervisory legislation;
- The development and evolution of supervisory practice;
- The administration of banking supervisory legislation, including advice on individual cases, and
- The structure, staffing and training of banking supervisors.

20. On 16 September 1992, the United Kingdom was forced to leave the European Exchange Rate Mechanism. In October that year, the United Kingdom adopted a new monetary policy framework with an inflation targeting regime. In this system, the Governor of the Bank of England and the Chancellor of the Exchequer met monthly to discuss monetary policy, but responsibility for setting short-term interest rates remained with the Chancellor of the Exchequer alone. Despite this, the pursuit of an inflation target was “a step on the way to the operational independence, and clearer accountability, that came in 1997”.<sup>16</sup>

### The tripartite system

21. In May 1997, this framework changed. The so-called tripartite system structure was set up under a Memorandum of Understanding (MoU), signed by the Bank of England, the Financial Services Authority (FSA) and HM Treasury. The memorandum was updated in March 2006, and stated that the division of responsibilities was based on four guiding principles:

- Clear accountability—each authority must be accountable for its actions, so each must have unambiguous and well-defined responsibilities;
- Transparency—Parliament, the markets and the public must know who is responsible for what;
- Avoidance of duplication—each authority must have a clearly defined role to avoid second guessing, inefficiency and the unnecessary duplication of effort. This will help ensure proper accountability, and
- Regular information exchange—this helps each authority to discharge its responsibilities as efficiently and effectively as possible.<sup>17</sup>

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16 Ev w25

17 HM Treasury Website, [http://www.hm-treasury.gov.uk/documents/financial\\_services/regulating\\_financial\\_services/fin\\_rfs\\_mou.cfm](http://www.hm-treasury.gov.uk/documents/financial_services/regulating_financial_services/fin_rfs_mou.cfm)

In its report about the Northern Rock crisis the Treasury Committee summarised the responsibilities set out under the tripartite system:

Under the Memorandum of Understanding, the Bank of England's responsibilities are summarised as contributing "to the maintenance of the stability of the financial system as a whole". The FSA's powers and responsibilities stem from the Financial Services and Markets Act 2000, and the FSA has the responsibility of authorising and supervising individual banks. HM Treasury has responsibility for the institutional structure of the financial regulatory system, and the legislation behind it.<sup>18</sup>

22. The division of responsibilities under the Memorandum of Understanding was identified as a weakness even during the passage of the Financial Services and Markets Bill.<sup>19</sup> When Dr Buitter appeared before the Treasury Committee in November 2007, he argued that:

The very structure of the tripartite agreement was flawed so I disagreed with the tripartite agreement before they even started doing anything. The notion that the institution that has the knowledge of the individual banks that may or may not be in trouble would be a different institution from the one that has the money, the resources, to act upon the observation that a particular bank needs lender of last resort support is risky. It is possible, if you are lucky, to manage it, but it is an invitation to disaster, to delay, and to wrong decisions.<sup>20</sup>

23. The Chairman of the Bank's Court, Sir David Lees, said to us, "under the previous arrangements, the Bank had a responsibility only to 'contribute' to financial stability".<sup>21</sup> Focus, therefore, remained on monetary policy: As William A. Allen<sup>22</sup> and Professor Geoffrey Wood found in a recent paper,<sup>23</sup> one reason for this was that the success of monetary policy could be easily measured:

It is clear what the objective of price stability is; and the definitions that different currency areas use are close enough for the policies that they adopt in pursuit of price stability to be recognisably similar ... The definition of something which is a public policy objective is a matter of great importance, since a good definition is a prerequisite for good policy.<sup>24</sup>

24. This sentiment was echoed by Dr Bingham of the Bank of International Settlements (BIS) when he appeared before us:

It is very difficult to measure financial stability and this is something that people are struggling with. How can one come up with suitable metrics? This is one area where

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18 Treasury Committee, Fifth Report of Session 2007–08, *The run on the Rock*, HC 56–I, para 269

19 Official Report, 27 January 2000, col 609

20 Oral evidence taken before the Treasury Committee on 13 November 2007, HC 56–II, Q 854

21 Q 30

22 As disclosed in the introduction to this report, William A. Allen was employed by the Treasury Committee to provide specialist advice for this report.

23 Professor Geoffrey Wood is a Specialist Adviser to the Treasury Committee, although he has not been involved in this inquiry.

24 Allen & Wood, "Defining and achieving financial stability", *Journal of Financial Stability*, Vol 2 (2006), pp 152–172

financial policy, financial stability policy, differs from monetary policy where there are metrics, where inflation is quantifiable.<sup>25</sup>

25. Under the tripartite system, the inflation target was set by the Government, and the Bank of England was given operational independence to set the level of short-term interest rates to achieve that target. Decisions about interest rates are taken by the Monetary Policy Committee (MPC) which is made up of nine members—five bank executives and four external members. This approach seemed successful while the economy enjoyed relative stability. In the Seventh Report of Session 2008–09, our predecessors noted that:

Before the start of the current financial crisis, the UK economy had experienced a sustained period of economic growth. In a speech in 2003 Mervyn King, Governor of the Bank of England, termed the previous years the “nice” (non-inflationary consistently expansionary) decade. In the United States in 2004 Ben S. Bernanke, at the time a member of the Board of Governors of the Federal Reserve, stated that “One of the most striking features of the economic landscape over the past twenty years or so has been a substantial decline in macroeconomic volatility”, noting that other writers had described this period as “The Great Moderation”.<sup>26</sup>

26. The attitude to financial stability at the time was complacent. We now know that, while key macroeconomic indicators such as inflation and growth appeared benign during ‘The Great Moderation’, vulnerabilities were forming in the world economies which have led to the longest and deepest recession since the Second World War. The recent crisis led to the failure of the tripartite system both in supervising and regulating the UK financial system in such a way to prevent the crisis and in ensuring clear accountability and responsibility for the stability of the UK economy.

27. As the Treasury Committee concluded after the Northern Rock crisis:

We cannot accept, as some witnesses have suggested, that the tripartite system operated “well” in this crisis. In terms of information exchange between the tripartite authorities, the system might have ensured that all the tripartite authorities were fully informed. However, for a run on a bank to have occurred in the United Kingdom is unacceptable, and represents a significant failure of the tripartite system. If the system worked so “well”, the tripartite authorities should take a closer look at the people side of the operation.<sup>27</sup>

The Committee went on to criticise the lack of leadership within the tripartite during the crisis:

While we welcome the Chancellor’s admission that he was ultimately in charge of the decision making process relating to Northern Rock, we are concerned that, to outside observers, the tripartite authorities did not seem to have a clear leadership

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25 Q 350

26 Treasury Committee, Seventh Report of Session 2008–09, *Banking Crisis: dealing with the failure of UK banks*, HC 416, para 14

27 Treasury Committee, Fifth Report of Session 2007–08, *The Run on the Rock*, HC 56–I, para 276

structure. We recommend that the creation of such an authoritative structure must be part of the reforms for handling future financial crises.<sup>28</sup>

In 2009, the Treasury Committee said that “where responsibility lies for strategic decision and executive action was, and remains, a muddle”.<sup>29</sup>

28. One of the most important defects of the tripartite structure was that the Bank of England essentially had a veto over HM Treasury on proposed actions. The Chancellor of the Exchequer at the time of the last crisis, Rt Hon Alistair Darling MP, said of his experience of trying to use the tripartite structure during a crisis:

My frustration was that I could not in practice order the Bank to do what I wanted. Only the Bank of England can put the necessary funds into the banking system; indeed that is one of the core purposes of a central bank. The Bank was independent and the Governor knew it. We did not agree on what to do.<sup>30</sup>

29. It is generally agreed that the accountability processes for monetary policy have been effective since 1997. These processes include the publication of the minutes of the MPC meetings two weeks after the interest rate decision. The minutes include a record of the votes of the individual members of the MPC. The MPC explains its actions regularly to the Treasury Committee, and the appointment of external MPC members is followed by an appointment hearing by us which focuses on the appointee’s professional competence and personal independence. The system of accountability of the MPC shows that it is possible to create effective accountability structures while at the same time removing politicians from day-to-day decisions. To that end, this report makes few recommendations about the present accountability structure of the MPC.

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28 HC (2007–08) 56–I, para 280

29 Treasury Committee, Fourteenth Report of Session 2008–09, *Banking Crisis: regulation and supervision*, HC 767, para 114

30 Rt Hon Alistair Darling MP, *Back from the Brink*, 2011, p 23



## 3 The Court of the Bank of England

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### The origins and role of the Court

30. The Court is the governing body of the Bank of England. In this respect, it is the board of the Bank. The Court was established in 1694. The functions of this early Court were essentially to declare the dividend and conduct elections. The Court has endured until now, while its role has changed. The Bank of England Act 1946 set out the duties of the Court as the Governing Board of the Bank of England. Later, the Bank of England Act 1998 strengthened the governance of the Bank and the role of the Court further. Most recently, the Banking Act 2009 introduced a number of reforms to the governance of the Bank of England.

31. From an accountability point of view, it is useful to compare the Court to a typical corporate Board of Directors. In the corporate world, there are broadly two types of board: the unitary board, which is normally employed in the UK, and the two-tier (supervisory or dual) board, which is more typical in continental Europe. The unitary board is characterised by having one board of directors. Some internal members of a corporation (executives) will typically also be directors on its board, provided they are registered as statutory directors. External members (non-executives) also sit on the board, subject to the same registration. The dual board consists of a supervisory board and an executive board of management where there is a clear distinction between the functions of supervision and management. The supervisory board is very unusual in the UK.

32. Professor Garratt told us that the Court is similar to a unitary board:

The Court is the Board under Company Law. The Court is directly accountable to the Owner. It is currently a unitary board and I can see no reason to change this.<sup>31</sup>

Similarities between the Court and a corporate unitary board include that the Court is a single body with both externals and internal Bank executives as members, who have equal standing on the board in terms of responsibility and liability. The Court is responsible for ensuring that the committees of the Bank are properly resourced and that its proceedings are properly conducted. For example, its task includes ensuring that MPC members are satisfied that they are able to express their views freely. It did intervene, in 1999, in a dispute—upon which our predecessors reported at the time—between the external MPC members and the Bank about the resources available external members for research purposes.<sup>32</sup>

33. Like a corporate board, the Court of the Bank represents the interests of the shareholders. The Treasury is the only shareholder of the Bank and accordingly one of the Court's functions is to ensure that the Bank uses resources efficiently and sparingly and that it manages financial risk prudently, so as to protect the interests of the Treasury in the

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31 Ev 134

32 Q 161; see also First Report of Session 1999–2000, HC 43, *Research Assistance for Monetary Policy Committee members*

Bank. However, it should do this while at all times protecting the Bank's reputation for political neutrality and objectivity.

34. The Treasury, as the only shareholder of the Bank, appoints external members of the Court. Certain supervisory functions of the Court are then delegated to a sub-committee of the external members of the Court.<sup>33</sup> These include reviewing the Bank's performance in relation to its objectives and strategy. This system is analogous to a two-tier board structure.

35. The Court has neither direct executive responsibility nor immediate influence on many of the most important decisions made by the Bank, namely those on monetary policy. Professor Garratt told us "that is a very odd structure and I find it quite alarming".<sup>34</sup> Furthermore, the Governor of the Bank is appointed by the Crown. The Court is unable to dismiss him, except in case of dereliction of duty, personal financial distress, or incapacity. This would be considered unusual on a corporate board, and is discussed further later in this Report.

36. The Court has changed recently and, while it does not directly resemble either a unitary or supervisory corporate board, the Court has sought to build on aspects of good corporate governance. As Professor Capie told us:

After Nationalisation the Court was asked to look after the 'affairs of the Bank', again interpreted to be the day-to-day running of the organisation. There were frequent complaints from members of Court that they had no role and were simply observers or rubber stampers. I believe this has changed somewhat in the last decade and they have had work to do.

37. Sir David Lees agreed that the role of Court had changed:

... on a personal note the Court of which I am now a Member is essentially unrecognisable from the one I served on in the nineties. The name is the same but most of the rest is very different and for the better.<sup>35</sup>

38. It has been argued, however, that the Government's proposed changes to the structure of the Bank of England do not go far enough. For example, in his memoirs, Rt Hon Alistair Darling MP said:

If responsibility for supervision of the banking system, as well as responsibility for monetary policy, and for smoothing the economic cycle, lies with the Bank of England, then the governance of the Bank must change ... The Court of the Bank of England, to whom the Governor is in theory answerable, is an anachronism. I tried to reform it, but I now believe that what is needed is a proper board of directors, both executive and non-executive, who will help the Governor form his or her view. He or she should be like the Prime Minister, first among equals.<sup>36</sup>

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33 Bank of England website, <http://www.bankofengland.co.uk/about/people/court.htm>

34 Q 274

35 Ev 86

36 Rt Hon Alistair Darling MP, *Back from the Brink*, 2011, p 319

39. When we asked the Governor about the Court, he said:

I think the Court, therefore, needs to be appointed by politicians, by the Government, but to be an independent body with the responsibility for oversight of how the Bank uses its resources and for how the processes of those three boards work, so that if any member of the MPC, FPC or PRA board feels unhappy with the way the process is operating they can go to Court and say, “This is not working and we want you to step in and find out why”.<sup>37</sup>

40. This inquiry has been about the accountability of the Bank of England. It has however prompted comment about a range of related issues, including more radical reform of the structure of the Bank. We are alert to these, but given our inquiry’s particular focus we have not pursued them. We may wish to return to them in the future.

41. Given that the Court has changed recently, its name is outdated and does not give a clear picture of what the Court actually does. In terms of corporate governance the Court is the Board of the Bank and its name should change to reflect that. **To reflect the shift of emphasis in its role, we recommend that the governing body of the Bank (Court) change its name to the ‘Supervisory Board of the Bank of England’.** References below to the Board of the Bank of England in this report use this term. Whatever name is ultimately chosen, we strongly recommend that the term “Court” is abolished.

42. In the Bank’s paper ‘Governance of the Bank including Matters reserved to Court’, it states that the matters reserved to Court include “approval of the Bank’s annual operating and capital expenditure budgets and any material changes to them.”<sup>38</sup> The Governor confirmed that “one [of the major roles of the Court] is to ensure that there is proper stewardship of the resources of the Bank, the remuneration, the budgets”.<sup>39</sup> He went on to tell us, however, that he was responsible for the allocation of the Bank’s budget. When talking about switching resources away from the Financial Stability function of the Bank he told us:

I take responsibility for that switch of resources. We put it to Court and Court accepted that recommendation. I think it is very important that all organisations ask themselves, “Do you need the resources to carry out this function?”.<sup>40</sup>

When we asked the Governor if this was a function for Court, he told us that the role of the Court is to make judgements about decisions already made on the budget:

They are clearly interrelated, but I don’t believe that the oversight you need to make decisions on that kind of issue is related to the technical expertise of the people you need on the policymaking committees. So what you need on Court to handle that are people who are able to make judgements about representations put to them about budgets: we need more resources for this area rather than that area.<sup>41</sup>

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37 Q 378

38 Matters reserved to Court, March 2011, p 13

39 Q 378

40 Q 386

41 Q 388

43. Dr Gavin Bingham however told us that:

The essential role of modern central bank oversight boards relates to ensuring the operational effectiveness of the institution. This has several dimensions, including approving bylaws and codes of conduct and overseeing compliance with them, reviewing and approving risk management policies, making decisions on major organisational changes, approving the operational budget and the financial accounts, deciding on the allocation of the surplus and administering the audits.<sup>42</sup>

44. The Bank must be allowed to manage its own resources without interference from the Government. However, it is equally important that the management functions of the Bank be conducted by the appropriate body. In the instance of the Bank's budget, this should be a role for the new Supervisory Board. It is important that, when the Board is presented with a budget, or shift of allocation within a budget, it is able to consider and approve/decline such changes without undue interference from the executives of the Bank. **We recommend that when the Supervisory Board considers the annual budget, it should be responsible for coming to an explicit view about both the level of, and changes to the allocation of, resources for all areas of activity, including the macro-prudential and monetary areas of work. It should provide public explanations of those decisions.**

### Make-up of the new Supervisory Board

45. The Government's proposals will give the existing Court a much enlarged role as a consequence of the Bank's increased responsibilities. With a changing and more prominent role, the appointment of people with suitable experience and expertise is particularly important. The Chairman of the Court told us that:

I am very confident in the competency of Court and its present membership; I believe that it is qualified to take forward the significantly enhanced responsibilities that will be falling to it.<sup>43</sup>

46. This confidence, however, is not universal. For example, when we asked Dr Hilton whether the Court of the Bank of England, as currently composed, was a body fit for purpose to scrutinise the work of the FPC, he was very clear:

I think I can summarise for all four of us [Dr Hilton, Ms Fuller, Professor Garratt and Professor Lastra]: the answer is no, but we do not necessarily think that the Court is the appropriate body to do that. If you take the decision that, regardless of whether it is in a perfect world, it will be the body, then the Court has to be re-engineered and re-staffed.<sup>44</sup>

47. Indeed, some ex-MPC members expressed stronger views on the subject. Dr Buiters stated that:

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42 Ev 124–125

43 Q 66

44 Q 302

The Court of the Bank of England does not have the expertise nor the resources (full-time staff, part-time experts, financial resources) to be able to vet the Bank for good housekeeping. Historically, members of Court have been selected from four categories:

- Representatives of special interests. There always is a trade unionist, a nonfinancial industrialist and, under the old, larger pre-2009 Court, a representative of consumer interests. Court or Board members should, in my view, be selected for their expertise and independence, not to achieve some representative mix, be it as regards industrial/occupational background, political party affiliation, religion, gender, race or ethnicity, class or age.
- The Great and the Good. These are mainly superannuated bankers and other financial sector former heavyweights. This type of member was well-represented on the old, larger Court. Unfortunately, many of these members were semi-retired extinct volcanoes, no longer willing or able to expend the considerable effort and energy required to vet the Bank's procedures, processes and practices. My own experience of the Court as mediator between the Executive Members of the MPC and the external members during the conflict about ring-fenced research support for external members was not a positive one. When the Executive Members refused to budge, the Chair of the Court was approached by the External members. Nothing happened. It was only when the conflict was leaked to the media that pressure was put on the Executive by the Treasury Committee and the Treasury and the dispute was resolved to the satisfaction of the External members.
- Active bankers and other senior executives from the (private) financial sector. This category of members has the relevant expertise. Because they are still active in full-time pursuits in the financial sector, however, they will not be able to give their Court membership the time and energy it requires. They are also, of course, inherently at risk of being conflicted. Regulatory capture (cognitive or direct) of the central bank by financial sector interests becomes institutionalised when the financial sector itself has representatives on Court.
- Other independent experts. It is always useful to have a few of these around, but they cannot have the legitimacy to hold the Bank to account.<sup>45</sup>

48. The Association for Financial Markets in Europe highlighted the importance of ensuring the skill mix within the Court was appropriate to the committees that they were overseeing:

We note that as a result of the changes introduced by the Banking Act 2009, in particular, the Bank's new financial stability objective, five non-executive directors (including the Chairman) were appointed to the Court to, inter alia, provide the right mix of skills to enable the Court to: "determine and review the Bank's strategy in relation to the [Bank's] Financial Stability Objective." If the Court assumes

responsibility for the FPC—and the nature of this responsibility would, as noted above, benefit from further clarification—it will be important to ensure that the Court has the appropriate macro-prudential expertise to carry out this oversight role effectively.<sup>46</sup>

49. Dr Bingham summarised how some other central banks ensured that their Boards have the appropriate expertise:

In a number of cases, the law sets out qualifications for board members. In fact the legislation governing the qualification of oversight board members tends to be stricter for members of oversight boards than for members of policy boards. In two thirds [of] the 30 central banks covered in a survey of central bank boards, there are explicit professional qualifications set out in the legislation or bylaws.

The bylaws of the Hong Kong Monetary Authority stipulate that the members of the oversight board should have expertise and experience that includes knowledge of monetary, financial and economic affairs, and of investment issues as well as of accounting, management, business and legal matters.

In Ireland the list of relevant knowledge is even longer. It includes accountancy, actuarial science, banking, consumer interests, corporate governance, economics, financial control, financial regulation, financial services, insurance, law, social policy and systems control.

Formal procedures to identify suitable candidates are set down in Israel and Australia, where the Minister of Finance and the Governor began in 2007 to compile and maintain a list of eminent, impartial and qualified persons suitable for membership in the Board.<sup>47</sup>

**50. The new responsibilities of the Bank will require its governing body to have an enhanced mix of skills. The Bank will have responsibility for macro and micro-prudential regulation and financial stability. As well as management skills, the new Supervisory Board needs sufficient expertise in macro-economics and finance to enable it to perform its expanded oversight role effectively. We therefore recommend that, in addition to experience in running large organisations and financial institutions, membership of the new Supervisory Board have expertise in prudential policy.**

## The Chairman of the new Supervisory Board

51. Dr Hilton referred to the Chairman of the Court's background in the manufacturing sector, and that he did "not know that much about financial stability". He did not think he needed to at present, though, because the current role of the Court and its Chairman was the management of the Bank.<sup>48</sup>

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46 Ev w23

47 Ev 126

48 Q 285

52. The enhanced responsibilities of the new Supervisory Board, however, will inevitably mean that the Chairman will become a position of considerably more power and responsibility. The knowledge and experience required by the Chairman will also need to change to reflect the altered duties. **We draw attention to the increased importance of the role of the Chairman of the new Supervisory Board. We recommend that the Chairman in the future have considerable experience of prudential or financial issues.**

### Size of the new Supervisory Board

53. The size and make-up of the Court has changed in recent years. The Banking Act 2009 reduced the Court's size from nineteen to twelve members, of whom a majority must now be non-executive. We note Dr Bingham's evidence that the typical size of a central bank's Board is smaller still:

Virtually all central bank oversight boards have a majority of non-executive directors. In some cases (e.g. Sweden, Switzerland), they consist entirely of non-executive directors. The changes made to the size and composition of Court in 2009 have brought Court closer to the median of ten for central banks.<sup>49</sup>

He went on to say that “smaller boards consisting of a clear majority of qualified non-executives are widely viewed as more effective”.<sup>50</sup> The proposals will make the Court more than “simply observers or rubber-stampers”, as Professor Capie told us that their historic role had been.<sup>51</sup> It is, therefore, crucial that the Court is an effective decision-making body while maintaining a sufficient range of expertise and experience within the members of the Board.

**54. The current arrangements are that non-executives are in the majority on the Court and that the Chairman of the Court is external. These should remain in place. We propose, in addition, that the new Supervisory Board should be reduced to a size which allows a diversity of views and expertise but is small enough to be an efficient decision-making body. Although the Court has recently been reduced in size, it is still too large. We recommend that the new Supervisory Board be reduced from a membership of twelve to one of eight, comprising the Governor, the two Deputy Governors, an external Chairman, and four other external members.**

### Appointment and review of members of the new Supervisory Board

55. Professor Bob Garratt told us that he was concerned with the Court's ethos, that the oversight of financial stability was likely to involve a lot more commitment from its members and would involve a culture shift:

As statutory directors of the Bank of England, they have a 24/7 responsibility and I think their commitment to that is as important as some of the technical skills. I am not saying that technical skills are not important, but it is the whole ethos that is

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49 Ev 126

50 *Ibid.*

51 Ev w25

created around that Court and the whole way in which you fight that was mentioned in the papers—the groupthink and all those elements—that is so important. ... In my limited experience of central banking, the most extreme was in Saudi Arabia but there it was wonderful. They simply said, “We will choose the best people in the country and it will be an honour for them to be invited to join in this activity. They will be heavily monitored.” They also had some sense of being able to say, “And money is no object”. It was key to getting really motivated people into those roles, then to get those folk excited about the development of the banking supervisors and then below them the banking inspectors, so that the whole thing began to work as a hugely proud and committed organisation.<sup>52</sup>

56. Currently, members of the Court of the Bank of England are appointed under the Banking Act 2009. The Court told us that it struggles to appoint external members because of potential conflicts of interest:

Membership of Court currently comprises the Governor, two Deputy Governors and nine Non-Executive Directors, one of whom is appointed Chairman of Court by the Chancellor of the Exchequer. ... A particular issue with the appointment of Non-Executive Directors, especially in the light of the new responsibilities that are likely to fall to the Bank, is attracting expertise but avoiding conflicts of interest.<sup>53</sup>

57. Dr Bingham believed that the current arrangements might not promote those most qualified for the Court:

The expansion of the Bank’s mandate could make it increasingly difficult to find members of Court who are qualified, independent and prepared to devote sufficient time to their tasks. Members of the Bank of England’s Court are paid £15,000 per annum, Chairmen of subcommittees £20,000 and the Chair £30,000. The pool of potential candidates who will be prepared to devote sufficient time to a wider oversight function is limited. Many of those with the relevant expertise are likely to have a conflict of interest while those devoid of a conflict of interest may not have the relevant expertise. “Grey eminences” may be one source of qualified and impartial candidates, but it will still be necessary to have effective conflict of interest provisions.<sup>54</sup>

58. We have already discussed the importance of having the correct expertise on the Court. It is crucial that the best people for the job are not prevented from membership as a result of too narrow an interpretation of what constitutes a conflict of interest. We were encouraged by Mr Cohrs’ appointment to the Court of the Bank of England, given his relevant experience as a financial practitioner.

59. The International Finance Corporation (part of the World Bank Group) states that the existence of conflict of interests on corporate boards is common, and it gives examples of how they are dealt with in practice:

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52 Q 301

53 Ev 85

54 Ev 126



Depending upon the law or rules related to a particular organization, the existence of a conflict of interest may not, in and of itself, be evidence of wrongdoing. In fact, for many professionals, it is virtually impossible to avoid having conflicts of interest from time to time.

...

Corporate codes of ethics often provide procedures for managing conflicts of interest. Commonly, the individual is required, in good faith, to disclose any material transaction or relationship that can reasonably be expected to give rise to such a conflict to the board (or to the board's ethics, governance or audit committee). Directors are expected to recuse themselves from voting on any issue before the board in which they have a conflict of interest.<sup>55</sup>

60. Professor Garratt has written that it is the role of the Chairman of a corporate board to keep watch over the conflicts of interest:

The chairman is also responsible for the board dynamics so will ensure open debate around the boardroom table, the declaration of any conflict of interest, and the timely running and recording of meetings.<sup>56</sup>

61. The existence of a potential conflict of interest is not on its own a strong enough reason for the non-appointment of a member of the new Supervisory Board. It is likely that many of the best qualified candidates will have some potential of conflict of interest, given their professional background. It is important that this does not exclude them from being considered for the role. Proper processes must, however, exist to deal with any conflicts as they arise. Normal practice on a board is for a register of director's interests to be held which is updated before every meeting. Once a director makes a declaration of interest, the chairman and company secretary must record it immediately. If it is relevant to the business of the board, the board must vote on what the declaring director can do. Possible courses of action are: for the director to continue to participate as usual; for the director to be allowed to talk on the relevant topic but not to be permitted to vote on it; or for the director to leave the meeting and re-enter only when the board has made its decision and the vote has been recorded.

**62. The membership of the new Supervisory Board of the Bank of England must consist of eminent and professionally experienced individuals. The interpretation of what constitutes a conflict of interest needs to be assessed on a case-by-case basis when external members of the Board are appointed. When a conflict arises in relation to a member of the Board, the rest of the Board, led by the Chairman, should exercise its judgement as to how to deal with it, as is standard practice on the boards of major public companies.**

63. In his submission to us, Professor Garratt expressed concern that the members of the Court themselves were not appraised properly:

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55 International Finance Corporation website:  
[http://www.ifc.org/ifcext/corporategovernance.nsf/Content/matrices\\_terms\\_fi\\_listed](http://www.ifc.org/ifcext/corporategovernance.nsf/Content/matrices_terms_fi_listed)

56 Bob Garratt, *The fish rots from the head*, 2010 (3<sup>rd</sup> ed), p 19

If the Court is to behave as a board under the best practices of the Companies Act 2006, then it is important that they have robust induction, development, annual evaluation and dismissal processes for the board, its committees and individual directors so that they follow the Seven Non-Exhaustive Duties of directors set out in the Act:

- To act within their powers – i.e. the company’s constitution
- To promote the success of the company
- To exercise independent judgement
- To exercise reasonable care, skill and diligence
- To avoid conflicts of interest
- Not to accept benefits from third parties
- To declare interests in third party transactions.

These are based on the judicial experience of corporate governance generally over the last two hundred years. I believe that the Court does have already grounds for dismissing a director concerning unreasonable absence, bankruptcy and unfitness for the post. But does it have robust induction, development and appraisal processes?<sup>57</sup>

64. Professor Garratt went further when he appeared before us, recommending that it the appraisal of all senior members of the Bank be covered by legislation:

... the notion of the annual appraisal of both the board and the Court, each of its committees and any subsets that it has, is very important indeed. It is built into the secondary legislation. Most people don’t bother with it, but it is there. I think the Bank could be a very interesting exemplar in future as to how that might work.<sup>58</sup>

65. The Court told us that the effectiveness of the Court is reviewed annually within the Bank. One of the ways that the Court told us that they can bring influence to bear on the Bank is:

Conducting the annual Court Effectiveness Review by the Chairman of Court with each individual Member to ensure that Court is operating as effectively as possible and to surface any particular concerns of Members.<sup>59</sup>

66. The British Bankers’ Association told us that this was not sufficient, and that an external, public review of the entire governance of the Bank should be conducted periodically:

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57 Ev 117–118

58 Q 306

59 Ev 86

A specific recommendation would be that the Treasury Committee request that the governance arrangements for the Bank and the other authorities be set out in terms fully consistent with the UK Code on Corporate Governance. This would include their being subject to the type of external performance review provided for by the Code and reported upon publicly on a periodic basis.<sup>60</sup>

67. We have already discussed how the size and composition of the new Supervisory Board are crucial, given the important role that the Board will have in the future financial stability of the UK economy. Their performance also needs to be monitored closely. **It is important that those overseeing financial stability are publicly accountable for their performance. We will invite members of the new Supervisory Board before the Treasury Committee regularly in the future and we will seek to ensure that its members remain committed and effective in fulfilling their role. We recommend that the new Supervisory Board's minutes be published to a timetable similar to that of the MPC, subject to any specific concerns of confidentiality which the Chairman of the Supervisory Board should raise with the Chairman of the Treasury Committee.**

### Staff available to the Court

68. The Court of the Bank of England currently have no dedicated specialist or policy staff working to it. We were interested to learn from Dr Bingham's submission that the staff resources available to the Court of the Bank of England are relatively low from an international perspective:

The amount of support given to the board and the degree of independence of the mechanisms for providing it vary across central banks. Support is typically provided by central bank staff. For example, at the Reserve Bank of Australia, the Board Secretariat operates under the direction of the Secretary and Deputy Secretary of the institution, who both report to a Deputy Governor. The number of staff supporting the board ranges from just a couple to up to more than 40 in the case of Singapore (where, however, the mandate of the board's subcommittees is particularly wide).<sup>61</sup>

69. Dr Buiters told us that the Court needed more resources simply to meet its current management function:

Anything that creates the appearance of accountability without adding its substance is likely to end up hurting accountability. The Court of the Bank of England does not have the expertise nor the resources (full-time staff, part-time experts, financial resources) to be able to vet the Bank for good housekeeping.<sup>62</sup>

70. We have already recommended that the expertise on the new Supervisory Board be reviewed to reflect the enhanced responsibilities and committees that report to it. Similarly, we recommend the role of the new Supervisory Board be expanded include oversight and review. Given the complex nature of financial stability and financial regulation, the current

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60 Ev w9

61 Ev 127

62 Ev 110–111

lack of dedicated specialist staff to support the Court is not appropriate for the new Supervisory Board.

**71. We propose that the staff support for the new Supervisory Board be strengthened. It requires a dedicated, and high quality staff containing the skills and experience needed to fulfil its oversight functions. We expect that many staff would be drawn from the Bank, as one stage in their career. While serving the Supervisory Board they would be accountable to the Chairman of the Board, including for performance management purposes. External staff should be considered, at the discretion of the Board.**

### Ex-post review of policy performance

72. We raised the extent of the future oversight function of the Court with witnesses. The Deputy Governor of the Bank of England, Charlie Bean, argued that the Court should not be involved in policy at all:

It seems to me there ought to be clarity in principle, which is that on anything to do with policy-related decisions it is you [the Treasury Committee] to whom we are accountable, and there should be complete clarity on that. As far as Court is concerned, it is management of the Bank's resources, the processes that support the policy-making decisions, that they have purview over.<sup>63</sup>

73. The Governor told us that he thought the Bank had a good track record on accountability, which would be continued when the reforms come into effect with no need for change to the reviewing process. He too told us that he did not think this should be a role for the Court:

I think you would recognise—as you did in your report earlier this year—that we have a very good track record of transparency on the MPC and we fully intend to carry that over to the FPC and the PRA, so on policy that is not Court's role.<sup>64</sup>

74. When we asked the Court about the Bank's performance during the 2008 crisis, however, we were concerned that no transparent and public review had been done. Sir Roger Carr told us that “it was not necessary to call for a review. A review was done as part of normal Court business”.<sup>65</sup> However, he went on to tell us that this was not a formal review but merely a discussion with the Governor:

It was not done on a question and answer basis; it was a question of reviewing the strengths and weaknesses of the system we had.<sup>66</sup>

When we asked the Court why no record of this review had been made public he told us that the minutes of the Court's meetings are limited to summaries of broad discussions:

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63 Q 389

64 Q 378

65 Q 18

66 Q 19

I believe they are minuted, certainly in the broad. ... The dialogue that took place in the courtroom was much more interactive because we were all in a learning situation.<sup>67</sup>

75. Other witnesses were less convinced that the Bank's past record on transparency and accountability was sufficient to allow the Bank to simply "carry that over". In particular, referring to the Bank's performance during the crisis, and the fact that the Court had not published any review, Dr Wadhvani said:

I too was astonished by the minutes of that hearing [the Court's appearance before the Treasury Committee]. It seems to me that the narrative that they offered you about the crisis was potentially too simple.<sup>68</sup>

He went on to say:

It seems to me, especially in a situation where the Bank is going to be made much more powerful and where it seems that the Bank has not really properly accounted for some of the things that people regard as errors over this period, imperative that either you yourselves launch a fully fledged inquiry or the Court or both. It is very important that the lessons from this crisis are fully absorbed before the Bank is given all this extra power.<sup>69</sup>

76. Professor Garratt agreed that a public review should have been done:

I am amazed—and a lot of my work is international and overseas folk I know are just astonished—that we have never had a proper investigation as to what went wrong.<sup>70</sup>

77. We have since received a Bank report to the Chancellor with a review of the Northern Rock crisis,<sup>71</sup> but there has never been a public review of the Northern Rock crisis, nor the wider banking crisis that followed it in 2008 and subsequently. Dr Buiters told us that the "[truth and reconciliation process] hasn't started yet, really".<sup>72</sup>

78. From a corporate governance point of view, Professor Garratt told us that the Court should be involved in holding the decisions made by the Bank's committees to account:

All committees are subsets of the board. ... There is a great fight over the accountability of the Financial Policy Committee. Yet it is spelt out that their accountability is to the Court. What is the problem? This is normal practice and I can see no argument for deviating. Second, all seem happy with the accountability of the Monetary Policy Committee to the Treasury Committee. I am not, as it seems curiously to be based in The Bank but accountable directly to the Treasury Committee under the Bank of England Act. To me this seems nonsensical, highly undesirable and liable to end in tears just like the NHS Foundation Trusts. Surely, if

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67 Q 20 and Q 22

68 Q 146

69 Q 147

70 Q 256

71 See press release which is available on the Committee's website at [www.parliament.uk/treascom](http://www.parliament.uk/treascom)

72 Q 233

it is a Committee of the Bank, then it must report to the Court and the Court reports to Parliament?<sup>73</sup>

79. Dr Bingham told us that, while rare, there is precedent for the Boards of central banks to review policy decisions:

There are one or two cases where there is some evaluation. In New Zealand, there is a process whereby the board evaluates policy decisions. It receives the same information that the Bank itself received and its remit is to assess, given the information that the Bank had at the time the decision was made, whether that decision was correct. Similarly, in Hong Kong there is a review of decisions, but on the whole reviews of policy decisions by oversight boards are quite rare.<sup>74</sup>

80. The Governor stressed to us that “the decisions that the PRA, FPC and MPC make on policy are not decisions that the Court needs to second guess”.<sup>75</sup> We agree. The Bank’s governing body should place more emphasis on oversight and ex-post scrutiny. This does not require or authorise it to become involved in second guessing immediate policy decisions. But there is a need to analyse and learn lessons from the actions of the Bank on a routine and consistent basis, drawing on expertise from within the Bank. Ex-post review of the Bank’s decisions would, we believe, be in the interests of good governance of the Bank. It would not be a substitute for oversight by the Treasury Committee itself, but it would enable the governing body to provide this Committee with appropriate evidence on the Bank’s performance. In addition, it would provide a measure of accountability for decisions which cannot immediately be made public.

**81. We recommend that the new Supervisory Board conduct ex-post reviews of the Bank’s performance in the prudential and monetary policy fields normally not less than a year after the period to be reviewed. This would be consistent with avoiding second guessing at the time of the policy decision. The reviews should among other things enable lessons for the future to be learnt. They should strengthen the Bank’s collective memory. There should be no presumption that the commissioning of a review implied that the episode or function in question had been badly managed: successes and failures should be reviewed alike. It would be a matter for the Board itself to determine when and how such reviews would be conducted, and into which issues.**

**82. There should be the presumption that ex-post reviews would be published, except where confidentiality needed to be maintained, in which case it might be desirable for either a redacted version to be published or for publication to be delayed. On such occasions, the Chairman of the Treasury Committee should be shown an unredacted version of the findings with an explanation of the reasons for non-publication. The date of publication should then be reviewed periodically until such a time as full publication would not endanger confidentiality or financial stability.**

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73 Ev 118

74 Q 333

75 Q 388

## The availability of information to the new Supervisory Board

83. We have proposed that the role of the Court should be extended beyond its current responsibilities of overseeing processes and management within the Bank. The ex-post review of the decisions made by the Bank's Financial Policy Committee means that it is even more important for the Court to have access to the relevant information in order to make informed judgements about the decisions made. Dr Bingham told us that this is often specified as an explicit right of a central bank's Board:

In order to perform their oversight functions, board members need access to relevant information and support in analysing it. Many central bank oversight boards and their subcommittees have an explicit right to all relevant information pertaining to their institutions' activities. In Norway, for example, the Permanent Committee of the Supervisory Council has the right of access to all matters pertaining to the Norges Bank. In Malaysia, legislation passed in 2009 empowers the Board of Directors to require the Bank to produce any document or information necessary for the carrying out of its functions. Furthermore, board committees can call upon any person to provide any information or document which is relevant to their functions.<sup>76</sup>

84. If the Court is to become the Supervisory Board of the Bank of England it is important that it performs its tasks on the basis of possession of all the facts. **In addition to the present monthly reports to the Board on monetary policy and similar papers on prudential matters and actions, we recommend that Board members be authorised to see all of the papers considered by the MPC and FPC, to ensure informed monitoring of processes and management is possible by the Supervisory Board.**

## Provision of information by the new Supervisory Board

85. The Bank's shareholder, the Treasury, needs to have access to high quality and timely information to information from the Bank. Unless the Treasury creates its own team to shadow the Bank, this will mean the employment of Bank resources to supply the Treasury with the information it requires.

86. The same applies to Parliament. The House of Commons and, on its behalf, the Treasury Committee will scrutinise the policy and processes of the Bank of England. To that end, it is important that requests for information and data from this Committee to the Bank are met. This issue was exemplified in recent correspondence that we have had with the Court. We asked the Court to provide the minutes of the Court during the financial crisis. Despite the exceptional nature of the crisis period, the Court has been unwilling to make available to us the minutes of its meetings. It has, despite our suggestion that it provide us with a redacted version, said that giving us copies of its minutes would provide the Court with no private space for deliberation. It has also relied on the provisions of the Freedom of Information (FoI) Act as a basis for denying the Committee access to the information. The Chairman of the Court's letter to the Committee Chairman said that:

The FoI Act expressly excludes certain of the Bank's functions altogether from the ambit of the Act. These include its functions with respect to monetary policy and

with respect to financial operations intended to support financial institutions for the purposes of maintaining stability. A very great proportion of the discussions recorded in the minutes relate to one or other of these functions.<sup>77</sup>

87. While we respect the need for private deliberation within the Bank, we have been disappointed by the Court's approach, especially given the exceptional nature of the period of the financial crisis covered by our request. The fact that the Freedom of Information Act excludes such functions is irrelevant: Parliament should receive material from the institutions it holds to account well beyond that which would be available under FoI. The Court should be willing to provide all information required by this Committee to meet the requirements of parliamentary accountability, not hide behind Freedom of Information provisions. The fact that a reasonable request to the Court to scrutinise the functioning of the Bank during a time of exceptional crisis has been declined is a reflection of the problem with the accountability of the Bank of England that our inquiry has sought to address. The new Supervisory Board should be required to ensure that the requests for information are met, as long as they are not unreasonable. An unreasonable request might be one which was untimely, vexatious or disproportionately costly.

**88. We recommend that the new Supervisory Board be responsible for responding to requests to the Bank for factual information from the Treasury Committee and the Treasury. It should also monitor the regular disclosure and publication of statistics and information relevant to the monetary, financial stability and prudential fields, though such decisions should, in the first instance, be a matter for the Bank executives.**

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<sup>77</sup> Letter from the Chairman of the Court of the Bank of England to the Chairman of the Treasury Committee, 21 July 2011. Available on the Committee's website.



## 4 Committees of the Bank of England

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### Membership and appointments

89. The MPC and FPC are composed of a mix of Bank and external members. They therefore depend to a large degree on the mix of skills and qualifications of the external members. By the very nature of what is desired, external candidates are likely to have close links with the financial industry. The Bank of England has sent us the proposed code of conduct for FPC members. This document has the potential to prevent desirable external individuals from being eligible from joining the FPC:

Appointment to the FPC presupposes that the member has no financial or other interests that could substantially restrict his/her ability to discharge the functions required of a member of the Committee. These include financial interests significant enough to conflict with the member's duty to the FPC, and conflicts of duty and other relationships (including employment and advisory positions in regulated firms) that could give rise to a perception that the individual concerned could not be wholly independent, disinterested and impartial as a member of the Committee.

The acceptability of particular appointments and interests will be assessed on a case-by-case basis prior to appointment, when members will be asked to disclose all relevant commitments and interests to the Governor and to the Chancellor. The Chancellor will decide whether the continuation of any commitment or interest is incompatible with membership of the committee; the Governor may offer advice in this regard. Members should also notify the Governor—who will consult the Chancellor as appropriate—in advance if they are planning to take on any new outside commitment or interest which might be seen as in any way in conflict with membership of the FPC, or if a potential conflict arises in respect of any existing commitment or interest.<sup>78</sup>

90. When we took evidence from Michael Cohrs following his appointment to the FPC, we asked him about possible conflicts of interest arising from his shareholdings in Deutsche Bank. We note the flexible approach that the Bank appeared to have taken when considering Mr Cohrs:

What I discussed with the Governor was that when these vesting periods come up, which I have shown the bank, I will consult him in the first instance about whether I am allowed to sell. There are certainly periods when I know that I will not be able to sell. For instance, I am allowed to go to pre-MPC briefings, which I did on Friday. Having been to a pre-MPC briefing on Friday, I am now in a period when I would not make any financial transactions until the MPC meets and publishes its report. The same will be true in the FPC. We will have pre-FPC meetings that will then go into FPC meetings, which will be minuted. During those periods I would not be free to transact.

This is not dissimilar to what I did when I was at the bank. When I was at the bank I tended to try to transact only once a year in January, after year-end results came out and before we got too far into the year. That was the one time that I would transact for my personal account, and I would want to do the same thing here. I am very mindful of conflicts and I am very mindful of doing the right thing vis-à-vis my personal investments.<sup>79</sup>

91. There is a risk that the code of conduct for members of the FPC may prevent or discourage the appointment of experienced industry practitioners whose membership would be of benefit. We have heard evidence that the interpretation of the FPC code of conduct has, to date, been flexible. We welcome this, but fear that there is still a risk that the rules are too tight and may prevent suitable candidates even being considered for appointment. The same concerns apply in the case of the MPC. **We recommend that the Bank change its emphasis so that the appointment of industry practitioners becomes easier. This will put more onus on the committees, led by their chairmen, themselves to deal with any conflicts of interest as they arise. In order to do so they should follow best practice of private sector boards.**

92. Hearings are held by this Committee which give us the opportunity to scrutinise the appointments of external members of both the MPC and the FPC and to comment on their independence and professional competence. However, the hearings that we hold follow the appointment of candidates. While this provides a level of parliamentary scrutiny and accountability, improvements can be made. Pre-appointment hearings have been undertaken by the relevant select committees for a number of sensitive public appointments in recent years.<sup>80</sup> They enhance parliamentary scrutiny by allowing committees to assess candidate's suitability at a time when the committee's views can have an influence on whether they are appointed.

93. **The expertise and independence of external MPC and FPC members are of the highest importance. Their appointment requires greater accountability to Parliament. We recommend that the Treasury enable the appointment hearings we hold with the selected external candidates for the MPC and FPC to take place before their appointment to these committees.**

### The risk of groupthink

94. Under the Government's proposals, the Governor, as well as performing the role of Chief Executive of the Bank and a member of the Court, will be the Chair of the PRA, MPC and FPC. He will be ultimately responsible for decisions on emergency financial assistance provided by the Bank. He is also vice-chair of the European Systemic Risks Board. Some witnesses were concerned that this represented too much power for an unelected official to hold, as well as too much responsibility for one person to bear.

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79 Oral evidence taken before the Treasury Committee on 7 June 2011, HC 1125, Q 3

80 Cabinet Office, "Pre-appointment hearings by Select Committees", 2009

95. Dr Gavin Bingham explained that the dangers of having a single Chairman of these committees might be balanced by the effective use of other members. He also told us that it was more or less standard practice in a central bank to have a single chair:

In central banks that do have multiple committees, it is quite common—I would say almost universal—for the Governor or Deputy Governor to chair the committees.

One way to address the risk of concentration of power would be to permit the Chancellor to select the Chair of the committee from among the members, rather than setting out the chairmanship in the legislation. The chairmanship could then be changed if there were signs of inefficiencies or the undue concentration of power.<sup>81</sup>

96. Dr Buitter told us about his experience of the Governor when he was on the MPC:

The Chair is not a dictator. On the MPC, the Governor has been outvoted a number of times. I would expect that the make-up of this FPC would include enough people of sufficient self-confidence and independence who would be willing and able to outvote the Chancellor. He is the Chair, he is central to it but he can't dictate.<sup>82</sup>

97. We asked the Governor whether his future responsibilities were simply too much for one person. He told us that if the Bank was going to fulfil the expanded objectives it was being given, it must do so under a single Governor Chairman:

So the question is: why should the Governor chair all these bodies? I think the answer is: do you want these functions in the Bank? If they are in the Bank, and they are major policy-making functions, the Governor really has to chair that body. I am not the only member of the Bank who is sitting on all of these bodies; several other people are as well. So you may ask whether these functions are too much in total for the institution.<sup>83</sup>

98. This may be so from a corporate governance point of view, but the concern remains that the Governor of the Bank of England may have disproportionate influence over the Bank's committees. Dr Willem Buitter said to us that:

Groupthink is a problem at the Bank of England, as it is for any organisation with a strong 'esprit the corps' and long-serving executives. Its incidence and severity can be minimised by having the majority of the voting members of the MPC and the FPC consist of independent external experts, that is, persons who are not executives of the Bank of England. These external members should serve a single, non-renewable term of 5 to 7 years.<sup>84</sup>

99. When we asked where the Bank had failed in the past Professor Lastra said "The Bank of England was influenced by groupthink with regard to monetary theory".<sup>85</sup> She considered that there was now an opportunity to get the balance right and make use of the

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81 Q 358

82 Q 249

83 Q 411

84 Ev 109

85 Q 260

positive synergies that came from having a combination of internals and externals in committee work:

On your question of the composition of external/internal, I think it should be finely balanced. I think the externals are very important to avoid the groupthink. At the same time, you need the internals because you need intimate knowledge of monetary policy. There are synergies between monetary policy and financial stability that perhaps were missed before the crisis—let us make sure that we do not miss them again.<sup>86</sup>

100. Professor Bob Garratt told us that the culture at the Bank of England must encourage diversity and independence of thought:

So the ‘tone at the top’, as the current phrase has it, is determined by the quality of the Chairman in understanding their role and ensuring the best use of the diversity, independence of thought and intelligent naivety around their boardroom table. The shadow side of this is the tendency for one or two powerful personalities to dominate the discussions and decisions, to block out different opinions and information and to create an emotional climate where acquiescence and yielding are dominant.

...

It may be worth the Treasury Committee ensuring that it [the avoidance of groupthink] is built into an aspect of the annual reviews of the Court, its Committees and individual directors.<sup>87</sup>

101. The role of external members on the Bank’s Committees will be crucial to the success of the proposals. Jane Fuller told us that “there should be at least as many, if not more, externals as internals [on the MPC and FPC]”,<sup>88</sup> and Dr Hilton told us that the current arrangements of the interim FPC had “not enough externals”.<sup>89</sup> In our preliminary consideration of the Government’s proposals in January 2011, we recommended to the Government that the mix of externals to internals should be changed so that the number of externals on the FPC was increased to six.<sup>90</sup> The Government chose not to adopt our recommendation:

The Government agrees that it is important to strike the right balance between Bank and non-Bank membership. The proposed membership format for the FPC closely mirrors that of the MPC, whose membership also includes two Executive Directors. On the FPC, alongside the four independent members, there will be an additional non-Bank member: the Chief Executive of the independent Financial Conduct Authority (FCA). This means that the balance currently proposed within the FPC—

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86 Q 301

87 Ev 119

88 Q 311

89 Q 299

90 Treasury Committee, Seventh Report of Session 2010–2012, *Financial Regulation: a preliminary consideration of the Government’s proposals*, HC 430–I, para 44

six Bank members and five members from outside the Bank—is similar to that of the MPC, where the ratio is five to four.<sup>91</sup>

This may explain the Chancellor’s answer when we asked him about the role of externals in reducing groupthink:

I don’t think that is the only check. I think it is partly the job of Parliament to challenge group-think; it is partly the job of the Chancellor to challenge group-think; I think we have all learnt a lot from what happened over the recent years. But I think the presence of external members is an important check on group-think.<sup>92</sup>

102. Groupthink will inevitably remain a potential risk in the Bank’s committees. Exclusive reliance on Parliament and the Chancellor to challenge the proceedings in the committees and ensure the external members of committees are able to challenge the executives of the Bank is inappropriate. The FPC and MPC have one non-voting Treasury representative in the committee meetings. We do not consider this to be a sufficient check or tool to allow the effective challenge of groupthink. **The avoidance of groupthink is the responsibility of the Bank of England, and therefore should be monitored by the new Supervisory Board of the Bank. This Board will be well placed to conduct reviews of committee processes and build relationships with the members of committees.**

103. **We repeat our previous recommendation that a better balance between internal and external members of the FPC and MPC be found. We propose that the ratio of internal to external members move from 5:4 to 4:5. We would expect that external members will not always agree with the internal Bank executives, but we believe that there should be room for such creative tension. Whatever the precise numbers, the external members of both the FPC and MPC should be in the majority.**

104. **The Court already has meetings with individual members on the adequacy of information and any concerns about governance matters. As part of its process and management overview function, the new Supervisory Board must ensure not only that internal and external members (and the Treasury observers) of the Bank’s committees have the information they need, but also seek confirmation that all members feel free to express their views and do not perceive themselves constrained by groupthink or by the dominance of internal Bank members.**

## The financial stability objective

105. Under the tripartite system, responsibility for financial stability was, at best, unclear. The Treasury’s proposals make responsibility clearer. At present, the Bank has an objective “to contribute to protecting and enhancing the stability of the financial system of the United Kingdom”.<sup>93</sup> The draft Bill proposes that it have a new objective “to protect and

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91 Treasury Committee, Fifth Special Report of Session 2010–12, *Financial Regulation: a preliminary consideration of the Government’s proposals: Government Response to the Seventh Report from the Committee*, HC 958, para 9

92 Q 456

93 Banking Act, 2009, Clause 238

enhance the stability of the financial system of the United Kingdom”.<sup>94</sup> As the Chairman of the Bank’s Court, Sir David Lees, said to us:

Under the proposed new arrangements that word “contribute” falls away, so that the Bank will be responsible for the financial stability objective. I think that is a significant difference, in the sense that the buck stops with the Bank now, whereas previously it was only a contributory.<sup>95</sup>

106. The Court of the Bank of England will be responsible for setting the Bank’s strategy to fulfil this objective. It is proposed that the FPC will be a committee of the Court established to contribute to the new financial stability objective. For the Bank to be accountable for protecting and enhancing financial stability, however, it is necessary to know what the objective means. There was considerable discussion during the course of our inquiry about how financial stability should be defined. Professor Goodhart explained some of the difficulties with the objective:

The problem at the moment is that there is nothing more concrete. One of the aspects of the work that I have been trying to do is to find mechanisms for making it more concrete, but at the moment there are none. There is nothing that you can fully rely on and it is just the possibility of the varying indicators on which you can put more or less weight. I don’t want to try and tie the Bank of England or the FPC down too rigidly because this is an area where there is great uncertainty, very little quantification and not enough analysis.<sup>96</sup>

107. Despite this, Professor Goodhart argued that the FPC should have quantifiable indicators against which to measure performance. He suggested three specific indicators that he argued the FPC should be using as a ‘dashboard’ to monitor financial stability:

- (a) A rate of growth of (bank) credit which is significantly faster than average, and above its normal trend relationship to nominal incomes.
- (b) A rate of growth of housing (and property) prices which is significantly faster than normal and above its normal trend relationship with incomes.
- (c) A rate of growth of leverage, among the various sectors of the economy which is significantly faster than usual and above its normal trend relationship with incomes.

I would not be dogmatic about the choice and formulation of such indicators, but I would like to suggest that you require the FSC to choose somewhere between two to four such presumptive indicators. The idea is that when at least two of these indicators are showing a danger signal, that the expectation would be that the FSC should take action to counter such developments or else be prepared to explain in public to yourselves at the TSC why they have not done so.<sup>97</sup>

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94 Draft Financial Services Bill, Part 1 – Amendments of Bank of England Act 1998, Clause 2, Cm 8083

95 Q 30

96 Q 211

97 Ev 104

108. The Governor wrote to us agreeing that “the idea of identifying a set of simple indicators [...] might form a useful starting point for our discussions at future hearings on financial stability policy”. He identified four possible financial stability indicators:

- Aggregate leverage ratio of major UK banks:
- Total peer group assets (adjusted for cash items, tax assets, goodwill and intangibles and with derivatives netted according to US GAAP rules) divided by total peer group capital (including shareholders’ equity adjusted for minority interest, preference shares, goodwill and intangibles).

- Household debt to income ratio:

Households’ gross debt as a percentage of a four quarter moving sum of their disposable income.

- 12[month] growth in lending to UK non-financial sector:

UK resident monetary financial institutions’ sterling lending to UK households and private non-financial corporates (excluding the effect of securitisation and loan transfers).

- UK long term real interest rate:

5[year] real interest rates 5[years] forward, derived from the Bank’s index-linked government liabilities curve.<sup>98</sup>

109. When he gave evidence to us, the Chancellor of the Exchequer provided his own definition of financial stability:

I would define financial stability as a financial services industry that is serving the broader interests of the economy, that is not requiring taxpayers’ money to support it, that is not contributing to excessive leverage nor to excessive credit contraction.<sup>99</sup>

110. The White Paper proposals contain no such definition. However, the introduction to the draft Bill describes a role for the Treasury in providing a remit to the FPC in order to provide guidance to “help shape its pursuit of financial stability”:<sup>100</sup>

Unlike the Treasury’s remit for the MPC, where the role of the Treasury is to complete the objective by defining a specific inflation target, the Treasury’s remit for the FPC will take the form of recommendations around how the FPC should in general interpret and pursue its objective.<sup>101</sup>

111. The Chancellor told us that:

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98 Letter from the Governor of the Bank of England to the Chairman of the Treasury Select Committee, 10 August 2011

99 Q 468

100 HM Treasury, A new approach to financial regulation: the blueprint for reform, Cm 8083, June 2011, para 2.10

101 *Ibid.*, para 2.11

I want the Bank of England to be in day-to-day operational charge of financial stability, identifying risks in the financial system, which was not being done, and also the macro-prudential regulation of institutions. I don't want the Chancellor of the day second guessing. I am trying to get away from the confusion of responsibilities that was the case under the tripartite regime.<sup>102</sup>

112. The remit will be reviewed annually, and the FPC will be required to respond to it. The White Paper says that the power to set a remit will provide “continuing input from the Treasury into the framework for the FPC’s work ... At the same time, the remit is designed to safeguard the FPC’s independence from political influence by building in the ability for the FPC to reject any recommendations with which it does not agree”.<sup>103</sup>

**113. In order to maintain the independence of the Bank, we support the ability of the FPC to reject any guidance which it regards as inappropriate. However, the ability for the Treasury to influence the interpretation of the financial stability objective is an important one, given the present lack of a definition of financial stability, and therefore if the FPC rejects guidance it should have the opportunity to explain its reasoning in writing to both the Treasury and the Treasury Committee.**

114. While we note that measures of financial stability are untested, we endorse the use of indicators so that the FPC uses some measure of stability of the financial system and place this in the public domain. There is a need for clear transparency in this area both in the publication of the remit and the response of the FPC, although exclusive reliance on such measures would be as inappropriate as neglecting to have any. **We recommend that HMT give guidance under Clause 3 of the draft Bill to the Bank of England to adopt indicators for gauging financial stability. The selected range of indicators must be flexible and under constant challenge and review, not only by Parliament, Government and the Bank of England, but also by others such as financial industry practitioners, the media, academia and the public. The indicators should be published so that the performance in maintaining financial stability may be monitored and so that it can be held accountable for that performance. The FPC should report against these criteria at regular intervals.**

115. **Clause 2 of the draft Bill should be amended so that the reference to the stability of the UK financial system takes account of the Chancellor’s proviso about not requiring the support of taxpayers’ money. The use of public funds will usually represent a failure by the regulatory authority to identify problems early enough. We recommend that the clause also place a duty on the Bank of England to minimise, as far as possible, the use of public funds.**

116. **There is some concern that the position of the FPC within the Bank may appear anomalous with regard to the MPC. We request the Governor to review the status of the two institutions and we may return to this matter in further work.**

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102 Q 426

103 HM Treasury, A new approach to financial regulation: the blueprint for reform, Cm 8083, June 2011, para 2.12



## Macro-prudential measures

117. The Government's consultation in February 2011 proposed that the FPC would have access to the following levers:

- public pronouncements and warnings;
- influencing macro-prudential policy in Europe and internationally;
- making recommendations to bodies other than the PRA and the FCA, including perimeter recommendations to the Treasury;
- the ability to make recommendations to the PRA and FCA, supported where appropriate by a comply-or-explain mechanism, and
- the power to direct the two regulators where explicitly provided for by macro-prudential tools set out by the Treasury in secondary legislation and subject to parliamentary approval via the affirmative procedure.<sup>104</sup>

118. Inserted Section 9K within Clause 3 of the draft Bill provides for the Treasury to make orders prescribing macro-prudential measures. These measures may include the power to direct the PRA or the FCA. Except in cases of urgency, in which case the order lasts only 28 days, the Treasury may not make an order prescribing a macro-prudential measure unless a draft of the order has been approved by resolution of each House of Parliament.

119. **The macro-prudential measures set out in secondary legislation will be of great importance and potential scope, and will give the FPC great powers. Parliamentary control and scrutiny of these measures are vital before such powers are granted. As the legislation stands, their approval by the House of Commons requires only a 90 minute debate in a General Committee and a decision without debate in the House. We recommend that the Government amend the draft legislation to require that debates on orders prescribing macro-prudential measures be held on the floor of the House and not be subject to the 90 minute restriction. Furthermore, the House would benefit from prior scrutiny of such orders by this Committee. We recommend that the Government provide us with the proposed text of the draft orders at least two months before they are laid before the House in order to allow us to report to the House on their merits.**

## Duty of the Bank to explain its decisions

120. The Bank's new powers to maintain financial stability are substantial in their potential scope and impact. As we have said, we support the Bank's independence in reaching judgements and implementing measures to maintain financial stability. We are concerned, though, that this untrammelled power leaves an accountability gap. **The Bank is a democratically accountable institution and it is inevitable that Parliament will wish to express views and, on occasion, concerns about its decisions. Our recommendation that the new Supervisory Board have the authority to conduct retrospective reviews of the macro-prudential performance of the Bank should, if operating successfully, provide**

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104 HM Treasury, *A new approach to financial regulation: the blueprint for reform*, Cm 8083, June 2011, para 2.13

**the tools for proper scrutiny. However, the Bank will need to explain its decisions more fully to Parliament than has been the case on occasion with some regulators, for example the Financial Services Authority. If these measures we propose prove inadequate, we will have to return to this issue.**

## Handling conflicts between policy areas

121. A frequent area of discussion in our inquiry was the potential for conflict between the decisions of the MPC and FPC. We raised this in our preliminary consideration of the Government's proposals in April, to which the Government responded:

The objectives of price stability and financial stability are sufficiently distinct that they should be managed separately, with different tools used to pursue the two objectives. It is important to prevent any dilution or confusion of the MPC's inflation remit; the MPC's role does not include financial stability, and the Government does not propose giving the MPC any responsibilities in this area. It would therefore be inappropriate for the MPC and FPC to meet together to consider financial stability. Of course, the MPC and FPC cannot exist in a vacuum: the decisions and actions of one will clearly affect the other. The cross-membership of the two committees will ensure that each committee is fully aware of the work of the other and able to take it into account in its analysis.<sup>105</sup>

122. Dr Wadhvani outlined the possibility that having separate committees for monetary and financial stability might lead to them pursuing contradictory policies:

The Bank has argued that the MPC needs to focus exclusively on price stability or inflation expectations may be de-anchored. They appear to believe that the FPC will use its instruments to affect, for example, a housing price boom without perturbing consumer price inflation because the MPC would set interest rates appropriately. Is this sensible?

Suppose we have an emerging house price bubble and the FPC increases capital requirements which, through widening lending margins, slows the economy, and this leads the MPC to expect inflation to undershoot its target over the next two or three years. Does the Bank then expect the MPC to lower interest rates in order to keep inflation at target to prevent expectations being de-anchored? If so, would this not largely offset the actions of the FPC and keep the house price boom going? Would the FPC then argue that it had not been able to deal with the house price bubble because of the actions of the MPC? Who would be held responsible for policy failure in this case?

Of course, if the MPC were to sensibly coordinate policy with the FPC in the above example (as some members are common to both committees, and the MPC meets more frequently) and not cut interest rates, then inflation would probably undershoot the target for some time. This would have to be explained in terms of

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<sup>105</sup> Treasury Committee, Fifth Special Report of Session 2010–12, *Financial Regulation: a preliminary consideration of the Government's proposals: Government Response to the Seventh Report from the Committee*, HC 958, para 21

financial stability considerations, but would this not be better and more safely ensured by having a single committee?<sup>106</sup>

Dr Wadhvani did say in oral evidence, however, that:

In the vast majority of instances they [the objectives of the MPC and FPC] are inherently complementary.<sup>107</sup>

123. Professor Goodhart did not think that the lack of co-ordination should be of concern:

I do not actually agree with my colleague on this point because his point about co-ordination could be made exactly the same way with fiscal policy. If the Government decides to tighten taxes, then it could be that that will slow the economy and then the MPC would respond. If you don't worry about co-ordination problems between fiscal policy and monetary policy, I don't see why you should worry about co-ordination problems between the Financial Policy Committee, which is a different set of instruments, and the Monetary Policy Committee.<sup>108</sup>

He went on to say:

I am a two-committee man and I think that the co-ordination issues can be exaggerated.<sup>109</sup>

124. Kate Barker had concerns about the conflicts between the committees' objectives:

One issue which has already arisen is the potential for conflicts and trade-offs with monetary policy. Here, I don't agree with Professor Goodhart that these trade-offs are no worse than those with fiscal policy. ... The problem arises at a deeper level. Fiscal policy decisions are, nowadays, chiefly about keeping the public finances on a sound medium-term course, and only occasionally about seeking to affect the growth of the economy. (During the financial crisis, however, fiscal policy and monetary policy worked for a time together towards support of the economy). Tensions can nevertheless arise—it could be argued at the moment that a slightly less aggressive course of fiscal tightening would be preferable at a time when monetary policy has little scope to boost the economy.<sup>110</sup>

125. Dr Gavin Bingham submitted a summary of the potential conflicts between prudential and monetary objectives:

In principle, conflicts can emerge between any of the three sets of policies: monetary, micro-prudential and macro-prudential. The experience of central banks that have long had both monetary policy and micro-prudential (i.e. regulation and supervision

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106 Ev 102

107 Q 216

108 Q 145

109 Q 215

110 Ev 113

of specific institutions) mandates is that significant conflicts between these two types of policy are rare in practice though they may arise in theory.<sup>111</sup>

He went on to offer examples of how other central banks resolved this issue:

One of the advantages of multiple committees is that they permit more specialised expertise to be brought to bear—thereby contributing to better decisions. They also help to deal with concentration of power and introduce internal checks and balances to the policymaking process, particularly if there are external members (ex officio or appointed). Multiple committees also make it more likely that conflicts between objectives and actions will be recognised. The main disadvantages of multiple committees are that extraction of potential synergies is more difficult, that more time is spent in meetings and that there is no mechanism for ensuring the coherence of multiple sets of policies. ... Having one and the same person chair the committees is a common mechanism used to try to foster coherence among policy decisions. ... Having overlapping membership in policy committees is another common way to deal with the challenges of coordination.<sup>112</sup>

126. We also took evidence on the newly formed PRA, which will be responsible for micro-prudential regulation. Several witnesses and written submissions highlighted concerns about potential conflicts of policy. The Financial Services Practitioner Panel and Smaller Business Practitioner Panel wrote:

Although we appreciate the desire for coordination through this model, we question the potential conflicting objectives and other conflicts of interest inherent in this structure. One particular example is the concept of the Governor chairing the PRA when deciding if a firm should go into the Special Resolution Regime, as well as chairing the Bank, FPC and acting as Governor of the Bank which will take on this responsibility. Not only are we concerned about conflicts, but also the capacity for a single person to hold so many significant roles effectively.<sup>113</sup>

127. The British Bankers' Association told us:

It may also be arguable that there may be a conflict of interest between some of the component parts and that how to address these needs to be considered more fully. This would include the Governor's chairmanship of the PRA in instances where the issue in hand concerned the PRA determining how to act upon a recommendation from the FPC within the PRA's statutory framework, and the PRA making an assessment of whether to trigger the special resolution regime (as opposed to the Bank's determination of which of the resolution tools to use).<sup>114</sup>

128. Although conflicts between the MPC and FPC (and to some extent the PRA) are unlikely to be common, they may well occur. The Government proposes the creation of two separate committees with related objectives and overlapping membership. The

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111 Ev 122

112 *Ibid.*

113 Ev w20

114 Ev w9

problem of managing conflicts between the committees might be averted if there was one single committee, but we do not recommend this because the wide skill set, and large size, such a committee would imply would risk undermining the monetary and prudential specialisation required for each objective. Having separate committees is not without problems, however. There remains the risk that a clash would be institutionally divisive and unconstructively played out in public. This is an area which the Joint Committee may wish to consider. The purpose of this report is to recommend accountability amendments to the proposals as they are given.

**129. We recommend the introduction of a statutory duty for the Governor to raise such a conflict with the new Supervisory Board (or its Chairman) if it occurs or is suspected. The Chairman’s role should be to ensure proper consideration and that correct process is followed, not to challenge policy. The Governor should, in addition, explain how he proposes to handle it, including by means of a public statement. We recommend that the legislation should provide for a joint meeting of the MPC and the FPC to take place if that is deemed by the Governor, after discussion with the Chairman of the Supervisory Board, to be the best way to resolve a significant conflict. The existence of the arrangement for notifying the Chairman is likely to diminish the need for its use.**

130. The Chairman of the Court saw Court representation on Bank Committees as important, although at the time Sir David Lees was discussing the FPC and PRA only:

What I’ve urged on the Treasury is that we should have representation from the Court as nonexecutive directors. There should be one or two members of Court sitting on the FPC and another one or perhaps the same person, if he has got time, sitting on the PRA, because that more closely locks in the governance arrangements for the PRA, the FPC and the Court.<sup>115</sup>

131. We have heard evidence that the Court should be responsible for policing groupthink, monitoring conflicts of interest and mediating potential policy conflicts between Bank committees. In order to fulfil any of these roles, the Court would need to be represented at committee meetings. However, the Court should not intervene in these meetings—it should not stray into the executive role of the committees, for whose governance it is responsible.

**132. We recommend that the Chairman of the new Supervisory Board sit as a silent observer on all of the Bank’s committees, a role which could be delegated by the Chairman to other members of the board. Since appearing before us, the current Chairman of Court, Sir David Lees, has told us that he can see the advantages of such a recommendation and agreed that it could be made to work in practice, with elements of discretion as to which meetings are attended and flexibility over which member of Court sits as the observer. A Board presence on Bank Committees will enable the Board better to handle many of the problems outlined above. It will become aware of, for example, potential conflicts of policy between the committees, potential problems of groupthink, and will be able better to monitor the implementation of the respective codes of conduct.**

## The Financial Operations Committee

133. The Bank has had an objective related to financial stability since it was made independent in 1998. Following the passage of the Banking Act 2009, the Financial Stability Committee (FSC) was created. The FSC consists of the Governors, four members of the Court nominated by the Chairman of the Court, and a Treasury observer.<sup>116</sup> Among the FSC's functions are:

To make recommendations to the Court of Directors, which they shall consider, about the nature and implementation of the Bank's strategy in relation to the financial stability objective;

To give advice about whether and how the Bank should act in respect of an institution, where the issue appears to the Committee to be relevant to the financial stability objective.<sup>117</sup>

134. The Bank told us that, in order to reflect the changed objectives in the Government proposals, the FSC will be transformed into the new Financial Operations Committee (FOC). The Court has resolved to:

delegate powers and responsibilities to the Financial Operations Committee ... in substitution for all powers, responsibilities and terms of reference of the Financial Stability Committee and the Transactions Committee.<sup>118</sup>

135. The responsibilities of the Financial Operations Committee are as follows:

To give advice about whether and how the Bank should act in respect of an institution, where the issue appears to the Committee to be relevant to the Financial Stability Objective

In particular, to give advice about whether and how the Bank should use stabilisation powers under Part 1 of the Banking Act 2009 in particular cases

To monitor the Bank's use of the stabilisation powers

To monitor the Bank's exercise of its functions under Part 5 of the Banking Act 2009 (inter-bank payment systems)

To monitor the Bank's exercise of its functions under Part 6 of the Banking Act 2009 (Scottish and Northern Ireland banknotes)

To monitor the Bank's exercise of its functions under the Financial Services and Markets Act 2000 as amended by the Financial Services Act 2012 (regulation of Central Counterparties and Settlement Systems)

To advise the Governor about any loan, commitment or other transaction which it is proposed that the Bank should make or enter into for the purpose of pursuing the

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116 Bank of England website: <http://www.bankofengland.co.uk/about/governance/>

117 *Ibid.*

118 Ev 97

Financial Stability Objective, (other than in relation to participation in any of the Bank's published arrangements, access to which is generally available subject to the applicable terms and conditions) or which is not in the ordinary course of the Bank's business. The Committee is also to advise the Governor about the formation, acquisition or disposal of a subsidiary of the Bank and the appointment of directors and officers to any such subsidiary in connection with the exercise of the Bank's powers and functions under Part 1 of the 2009 Act or for any other purpose.<sup>119</sup>

136. The advice provided by the FOC to the Governor on how to act in pursuit of the Bank's financial stability objective will relate to highly important decisions. He will be accountable to Parliament for those decisions, but for accountability reasons it is also desirable for the advice he receives on his decision to be known. **We recommend that the minutes of meetings of the FOC be published within two weeks, or, if publication would threaten financial stability, as soon as it is safe to do so. If publication of minutes is delayed, the Chancellor of the Exchequer and the Chairman of the Treasury Committee should be informed of the delay, and told of the nature of the discussion and the decisions reached.**

### The monetary policy objective of the Bank

137. The Bank of England has two core objectives: monetary stability and financial stability. The Bank's monetary policy objective is to deliver price stability and, subject to that, to support the Government's economic objectives including those for growth and employment. Price stability is defined by the Government's inflation target of 2%.<sup>120</sup> Some other central banks, such as that of Canada and Japan, have mandates which similarly focus on price stability. But both the US Federal Reserve System and the European Central Bank have mandates to achieve price stability and sustainable growth.

138. **The mandate of the Bank of England is of the highest importance, but has not been a focus of the Committee in this inquiry. The new powers that the Bank has been given will allow it to take steps to meet its financial stability objective. But these powers could also potentially allow it to act to achieve wider economic objectives. Whether these new powers should also mean that the Bank should have an amended mandate, for example to promote sustainable growth, is something that we may wish to return to in a subsequent inquiry given the likely public debate about this important issue.**

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119 Ev 98

120 <http://www.bankofengland.co.uk/monetarypolicy/framework.htm>

## 5 The office of Governor of the Bank of England

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### Appointment and dismissal

139. Under the Bank of England Act 1998, the Governor of the Bank of England is appointed by the Government for a period of five years. The Banking Act 2009 amended this to stipulate that a person may not be appointed as Governor more than twice, so the maximum term that may be served by any individual is ten years. The same rules apply in respect of Deputy Governors.<sup>121</sup> The Court may, with the consent of the Chancellor of the Exchequer, remove a person from office as Governor, Deputy Governor or director of the Bank if it is satisfied that he has been absent from meetings of the Court for more than three months without the consent of the Court, that he has become bankrupt, that his estate has been sequestrated or that he has made an arrangement with or granted a trust deed for his creditors, or that he is unable or unfit to discharge his functions as a member. Sir David Lees, Chairman of the Court, told us that the significance of these arrangements was that “they cannot be removed simply because the government of the day dislikes what they are doing or saying—not at least until their terms expire”.<sup>122</sup>

### Term length and reappointment

140. The Governor, once appointed, needs the renewed approval of the Government of the day in order to serve the second five year term. As the former Chancellor of the Exchequer, the Rt Hon Alistair Darling MP, said in his memoirs of the arrangement:

The thinking is that this gives them long enough to take decisions independent of government interference, but avoids the problem that occurred in the 1920s and 1930s when Governors seemed to go on and on, to the chagrin of Chancellors of whatever political hue. Not to appoint a Governor to a second term would be seen as remarkable, since the assumption is that he or she will serve two terms.<sup>123</sup>

But he added that:

Once a Governor has been appointed for a second and final term he or she is in a much stronger position, more or less untouchable.<sup>124</sup>

141. While the failure to renew a Governor’s appointment might be remarkable, the very fact that Government has the power not to renew the appointment may give rise to two problems. First, it has the potential to create instability towards the end of the first term, as

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<sup>121</sup> Bank of England Act, Schedule 1

<sup>122</sup> Letter from the Chairman of the Court of the Bank of England to the Chairman of the Treasury Select Committee, 25 March 2011

<sup>123</sup> Rt Hon Alistair Darling MP, *Back from the Brink*, 2011, pp. 68–69

<sup>124</sup> *Ibid.*, p 69



until the decision is made, speculation will surround the office of the Governor. It is not reasonable to expect this, and the inevitable uncertainty over his or her own future, not to have an effect on the Governor. Second, the fact that the decision is in the hands of the Government means that the independence of the Bank may be perceived as being compromised. It also distorts the perception of any decisions or public statements of the Governor or the Bank in the period up to the decision on reappointment—people will look for whether they may have been affected by the views of the Government.

142. In 2008, the then Leader of the Opposition, Rt Hon David Cameron MP, suggested a single term for the Governor:

The problem is that people think that now the Bank of England is independent, the argument's done and dusted. It isn't. I would argue that decisions that are crucial to the running of the British economy, too many of them are still made by politicians behind closed doors. For example, the Chancellor has the right to re-appoint the Governor of the Bank of England, and we've seen in recent weeks and months, that creates instability. I believe it's time to have a single, non-renewable term for the Governor to insulate him, or her, from political pressure.<sup>125</sup>

143. The independence of the Governor from political control must be upheld. This independence requires that, following his or her appointment, the Governor should not require the further approval of the Government for his or her performance in order to remain in post. The present provision for the renewal of the term of office after five years could cause instability and at least the perception of political interference in the Bank. The only potential benefit, of preventing a Governor serving too long, is nullified if, as the previous Chancellor says, the assumption is in any case that the Governor will serve two terms. There is a need for a maximum limit on the term of the Governor, and if there is no option of renewal it should, so as to promote stability, be longer than the present single five year term. It should be shorter than the present maximum of ten years, however, so that there is less risk of a Governor remaining in office past the point when his or her effectiveness is diminishing. **We recommend that the draft Financial Services Bill amend the Bank of England Act to state that the Governor may serve a single, non-renewable term of eight years.**

### Parliamentary involvement in appointment and dismissal

144. The Governor of the Bank of England has responsibility for an organisation whose actions affect the welfare of everyone in the country. He is appointed by the Government and may only be dismissed with the consent of the Government. At present there is no involvement of Parliament in the Governor's appointment.

145. This is in contrast to the Office of Budget Responsibility (OBR), where, uniquely for a select committee, the Treasury Committee has a statutory power of both the appointment and dismissal of the Chair of the OBR and members of the Budget Responsibility Committee (BRC). When proposing this power over the Chair of the OBR, the Chancellor told us that:

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<sup>125</sup> David Cameron, Speech to British Chambers of Commerce, February 2008

Parliament will play a prominent role in preserving the independence and accountability of the OBR. As I told the Committee on Thursday, I intend to provide in the legislation for the TSC to have the power of veto over the appointment of the Chair of the OBR. A statutory veto bestows upon the TSC more power over the appointment than they currently have over any public appointment. I propose to take this unprecedented step because I want there to be absolutely no doubt that the individual leading the OBR is independent and has the support and approval of the TSC.<sup>126</sup>

146. Given the range and importance of his and the Bank's responsibilities, the independence of the Governor of the Bank of England, and the confidence of Parliament in the choice of Governor, is even more important than is the case with the Chair and other leaders of the OBR. We were disappointed, therefore, that the Chancellor believed that the OBR was a different case:

I think the OBR is materially different. The OBR is providing an independent audit, in effect, of the Government's numbers and there is a crucial tool for Parliament to scrutinise the executive, and I think that is different. ... I would be against giving the Treasury Select Committee a veto on the appointment of the Governor of the Bank, for the reason that the Governor of the Bank is carrying out executive functions on behalf of the State; the setting of monetary policy, monitoring financial stability.<sup>127</sup>

He went on to say:

When it comes to the Bank Governor and the Bank of England, this is a body that sets interest rates, that will be given significant tools on macro policy, and I think it is proper that the Government of the day chooses the Bank Governor, is held accountable for that choice, but also that the Governor is given some protection, some independence, so it is quite difficult, to put it mildly, or extremely difficult, to get rid of them.<sup>128</sup>

147. Recently the Institute for Government published a report on the role of Parliament in public appointments. It recommended that the importance of the independence from Government of the Governor of the Bank of England was such that Parliament should be granted an effective veto over the appointment.<sup>129</sup> Recently, the Liaison Committee has recommended that significant public appointments should be confirmed by a vote on the floor of the House of Commons, and the dismissal of a post-holder before the expiry of his or her term of office should also require ratification by the House if a select committee so recommends.<sup>130</sup>

**148. The Chancellor argued that because the OBR performs what is essentially an auditing function for the Government, and the Bank of England carries out executive**

126 Fourth Report from the Committee, Session 2010–12, *Office for Budget Responsibility*, HC 385, Ev 30

127 Q 448

128 Q 511

129 Institute for Government, 2011, *Balancing Act: The Right Role for Parliament in Public Appointments*, p 27

130 First Report from the Liaison Committee, Session 2010–12, *Select Committees and Public Appointments*, HC 1230, paras 61 and Annex 3

functions, the two institutions are materially different. He used this distinction to argue that the Treasury Committee's power of veto over the appointment or dismissal of the leaders of the OBR should not apply to the position of the Governor of the Bank. We are not persuaded by this line of argument. The power of veto with respect to the OBR was given to ensure the independence and accountability of that body. The Governor of the Bank's independence from Government is crucial for his or her credibility. Given the vast responsibilities of the Governor, the case for this Committee to have a power of veto over the appointment or dismissal of the Governor is even stronger than it is with respect to the OBR. We therefore recommend that, in order to safeguard his or her independence, the Treasury Committee is given a statutory power of veto over the appointment and dismissal of the Governor of the Bank of England.

## 6 Crisis management and the role of the Chancellor

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### Responsibility in a financial crisis

149. The financial crisis of 2007–08 required the commitment of very substantial sums of public money to avert the catastrophic effects of the failure of any of the major banks and in order bring stability to the UK's economic and financial structures. In the crisis, decisions to make vast sums of public money available had to be made at short notice and at high speed.

150. The Governor of the Bank of England saw a clear allocation of responsibilities when public funds were at stake:

There is now a very clear arrangement under which any lender of last resort operation, which by the way has to have the approval of the Chancellor, cannot be done just by the Bank. Any risk of public money always has to be approved by the Chancellor.<sup>131</sup>

The Chancellor agreed on the latter point:

In a crisis, if there is the requirement that public money is put to use, that is a decision of the Chancellor of the Exchequer, accountable to Parliament.<sup>132</sup>

In the actual crisis, the tools available to the Government and the Bank of England are things like nationalisation, putting it into the resolution mechanism, recapitalising the banks. ... They would be decisions for the bank Governor ... and for the Chancellor of the Exchequer in terms of the use of public money or the nationalisation of a bank.

The Government's White Paper states that:

The fundamental responsibilities of the authorities in a crisis are clear. The Bank of England will be responsible for identifying potential crises, developing contingency plans, and implementing them where necessary, including through the special resolution regime. The Chancellor of the Exchequer will be responsible for all decisions in a crisis involving public funds or liabilities.<sup>133</sup>

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131 Q 406

132 Q 422

133 A new approach to financial regulation: a blueprint for reform, Cm 8083, p 22

151. The Bank of England Act 1946 states that the Treasury “may from time to time give such directions to the Bank as, after consultation with the Governor of the Bank, they think necessary in the public interest.”<sup>134</sup>

152. The Chancellor of the Exchequer at the time of the recent financial crisis, Rt Hon Alistair Darling MP, recently published his reflections. He expressed frustration that he had been unable, in practice, to direct the Bank because of the negative effect it could have on the Bank’s independence:

My frustration was that I could not in practice order the Bank to do what I wanted. Only the Bank of England can put the necessary funds into the banking system; indeed that is one of the core purposes of a central bank. The Bank was independent and the Governor knew it.<sup>135</sup>

I was so desperate that I asked the Treasury to advise me as to whether or not we could order the Bank to take action. The answer was that it might be legally possible, but that there would be wider implications of such an action. We had set great store by making the Bank independent and a public row between myself and Mervyn would have been disastrous, particularly at this time.<sup>136</sup>

153. The present Chancellor told us that he would not want to use the power of direction in the 1946 Act because the action could cause a loss of confidence on the market:

They [previous Chancellors] have never used that power and that is because, of course, the use of a power of direction can itself cause all sorts of problems and give rise to all sorts of confidence issues, so I have been careful about trying to avoid that.<sup>137</sup>

The Chancellor considered the use of this power to be a “nuclear option”,<sup>138</sup> and that:

My judgement, but this is only with hindsight, I think overruling the central bank Governor in the middle of a financial crisis would have added to the sense of chaos rather than diminished the sense of chaos.<sup>139</sup>

154. Sir Roger Carr of the Court of the Bank of England told us that in the 2007–08 crisis:

There were certainly challenges in the information flow in the tripartite structure and uncertainty as to whose finger was on the trigger for some of the action that needed to be taken. ... There was no question of lack of commitment, lack of concern or lack of action, but there were questions on the system in which we were operating.<sup>140</sup>

134 Bank of England Act, 1946 Clause 4

135 Alistair Darling, *Back from the Brink*, 2011, p 23

136 *Ibid.*, pp. 57–58

137 Q 427

138 Q 503

139 Q 501

140 Q 25

155. The Governor argued that the crisis demonstrated a lack of powers sufficient to deal with an unfolding crisis:

Only after the crisis, did we start meeting as a tripartite. Many people feel that that wasn't terribly satisfactory as an arrangement, in large part because the tripartite had no direct responsibilities. Each of the players had their own responsibilities. I don't think co-ordination was ever an issue in the crisis, to be honest. What there was was a lack of powers for anyone to deal with particular situations as they arose.<sup>141</sup>

156. The Chancellor at the time of the last crisis noted in his memoirs that the tripartite did not operate under an air of cooperation:

The system depended on a strong working relationship between the FSA and the Bank of England. ... There is no doubt in my mind that their [Callum McCarthy (FSA) and Mervyn King's] difficult relationship contributed to the fact that our response to the crisis was not as sharp and decisive as it might have been. ... The strains and stresses that had been there all along, but had not been evident, suddenly became very apparent. The whole system depended on the Chairman of the FSA, the Governor of the Bank and the Chancellor seeing things in exactly the same way. The problem was, in September 2007, we simply did not see things the same way.<sup>142</sup>

He went on to say that the Chancellor should be in charge of a financial crisis:

It is necessary to decide who will call the shots in a crisis. That should be decided now. Even if the two principals charged with making the ultimate decisions were the Governor and the Chancellor, what happens if they disagree, as was the case in 2007, over whether to inject liquidity into the economy? The Chancellor might decide, as I did, that this is what the system needs; while the Governor might reach the conclusion that the matter is one of solvency and that more capital is required. The only way in which liquidity can be provided is through the Bank. But with recapitalisation, only the Chancellor can give the go-ahead because the Bank does not have the resources to do it. The only way to ensure that a crisis can be adequately dealt with is to make explicit that the ultimate decision-making authority lies with the Chancellor.<sup>143</sup>

157. Dr Willem Buiter agreed that at all times the Chancellor should be in charge and responsible for all financial stability decisions:

The Treasury should be at the centre of financial stability. This ought to be obvious from the experience of the years since the financial crisis started in August 2007. Instead the proposed new arrangement places the Treasury on the sidelines.<sup>144</sup>

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141 Q 400

142 Rt Hon Alistair Darling MP, *Back from the Brink*, 2011, pp. 20–21

143 *Ibid.*, pp. 318–319

144 Ev 105

158. We asked the Chancellor whether he thought the Treasury should have some power of override to prevent institutional differences ending up getting in the way of handling the crisis:

In the end, yes, we can prescribe the lines of responsibility, the lines of accountability, who is in charge of what, and I have been clear that the big tools available in a crisis are ones that the Chancellor has at his disposal or her disposal. But I would hope that we would conduct the whole thing in the spirit of co-operation between the Bank Governor and the Chancellor. I think if the Chancellor and the Bank Governor are at war with each other in the crisis they are taking a bad situation and making it worse, so there is also an obligation on whoever is the Chancellor and whoever is the Bank Governor at the time to work together and co-operate and that is their obligation.<sup>145</sup>

### The Chancellor and crisis management

159. Clause 42 of the Government's draft Bill places a statutory duty on the Governor of the Bank to notify the Chancellor as soon as it becomes clear that there is a "material risk" to public funds, whether through assistance to a financial institution or a loan to the Financial Services Compensation Scheme, or where an institution is going into the Special Resolution Regime.<sup>146</sup>

160. Clause 43 of the draft Bill requires the Treasury on the one hand, and the Bank of England and the Prudential Regulation Authority on the other, to prepare a Memorandum of Understanding as to how they intend to co-ordinate their functions which relate to the steps to be taken when the Bank has given a notification under Clause 42. The Memorandum must also include provision as to what the parties consider to be a material risk for the purposes of Clause 42, the roles of the Treasury, Bank and PRA in taking steps to resolve or reduce the threats to financial stability which prompted a notification, and the sharing of information. A draft of the MOU is to be published during pre-legislative scrutiny of the draft Bill.<sup>147</sup>

161. Dr Willem Buiter was not satisfied with the proposed arrangements for Treasury involvement. He feared that in a future crisis the Treasury could be called to provide public money too late to address the situation or consider viable alternatives:

... this concoction that you are headed for at the moment, which has the Chancellor standing on the sidelines, expected to be invited in as soon as public money is at stake but not being there while the preconditions are being created under which the money might be required. I think this is the wrong time for the taxpayer to come in.<sup>148</sup>

162. During the Johnson Matthey crisis in 1984 the then Chancellor was notified of a risk to public funds by the Governor only hours before the crisis struck. As the former non-executive director of the Bank of England, Sir Martin Jacomb, has written:

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145 Q 483

146 A new approach to financial regulation: a blueprint for reform, Cm 8083, p 115; Q 420

147 *Ibid.*, p 22

148 Q 251

Some of this awkward relationship [between the Bank of England and Treasury] comes, perhaps justifiably, from the experience of events such as the Johnson Matthey affair in 1984. ... The Bank of England considered that the failure of this subsidiary bank, although not very important in itself, could throw Johnson Matthey as a whole into jeopardy and that for this reason the bank had to be rescued. ... However, this rescue was going to cost a significant amount of public money. The then Chancellor, Nigel Lawson, was only told about the emergency early in the morning of the crucial day, and was thus faced with an unattractive *fait accompli* for which he would have to take responsibility. His angry reaction was not surprising, especially as he was misinformed about the amount of public money involved.<sup>149</sup>

163. The current Chancellor said that he would want to receive the statutory notification from the Bank “when there was the possibility of any use of public money down the track”, and went on:

I think, of course, we have also built into the arrangements here formal statutory meetings between the Governor and the Chancellor of the day on financial stability where a high-level minute is produced of that meeting. On top of that—and in a way this is something you can’t legislate for but depends on the people doing the jobs at the time and the goodwill of the institutions involved—I meet, as indeed did my predecessor, the Governor of the Bank very, very regularly, not just because it is prescribed by legislation, just because it is prescribed by good governance.<sup>150</sup>

He added that “if a crisis is identified on the horizon, the Governor of the Bank informs the Government”.<sup>151</sup> He would also expect to be “round the table” in the build up to a crisis.<sup>152</sup> Clause 3 of the draft Bill establishes a statutory six-month update meeting between the Governor and Chancellor on financial stability matters.<sup>153</sup>

164. In normal times the Bank is responsible for financial stability and the Treasury should not be formally involved in any of the decisions, although the Treasury and the Bank will have regular contact to exchange information. At such times the Bank must be able to fulfil its objectives without political or operational interference, confident of its independence. Exceptional circumstances will from time to time arise when this approach is inadequate. These exceptional circumstances can be defined by reference to the provisions of the draft Bill as existing when the Bank has formally notified the Treasury of a material risk to public funds. In such circumstances, the White Paper states that the Chancellor will be in charge:

The fundamental responsibilities of the authorities in a crisis are clear. The Bank of England will be responsible for identifying potential crises, developing contingency plans, and implementing them where necessary, including through the special

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149 Sir Martin Jacomb, “Re-empower the Bank of England”, *Centre for Policy Studies*, June 2009

150 Q 421

151 Qq 421–2

152 Q 423

153 A new approach to financial regulation: a blueprint for reform, Cm 8083, p 70



resolution regime. The Chancellor of the Exchequer will be responsible for all decisions in a crisis involving public funds or liabilities.<sup>154</sup>

165. Clause 42 of the draft Bill refers to the requirement of the Bank to inform the Treasury of a “material risk” to public funds. The draft Bill requires the proposed Memorandum of Understanding to state what the Bank and Treasury regard as a “material risk”. The definition is crucial; it determines what notice the Treasury will receive and therefore how much time it will have to prepare for a crisis and consider alternative causes of action. It is too important to be merely a provision in a Memorandum of Understanding. **We strongly recommend that the definition of what constitutes a “material risk” for the purposes of Clause 42 of the draft Bill be contained in the forthcoming legislation. This definition should also take account of the fact that major liquidity operations by the Bank require Treasury approval—the material risk of these too must require notification to the Treasury.**

166. **We are concerned that the formal notification of a material risk to public funds may still not give the Chancellor enough time to consider other policy options. The Treasury needs to know as early as reasonably possible when it might receive a notification. We therefore recommend that the forthcoming legislation also require the Bank to give the Chancellor an early warning of the possibility that a notification of a material risk to public funds may need to be given, and full information about the circumstances. We further recommend that the Draft Bill be amended so that this early warning triggers a discretionary power for the Chancellor to be able to direct the Bank if he or she so chooses. The Bank should be required to provide such an early warning to the Chancellor as soon as the FPC becomes aware of a possibility of a material risk to public funds. Subsequently, until either the possibility has disappeared or a formal notification has indeed been made, the Bank should be required to keep the Chancellor fully informed.**

167. Constitutional practice means that only the Government can ask Parliament to approve the spending of public money. The responsibility of the Chancellor, rather than the Bank, for all decisions in a crisis involving public funds or liabilities is stated in the White Paper and is generally agreed. However this responsibility appears to be being left, once again, to the Memorandum of Understanding. This is unsatisfactory. **To ensure proper accountability to Parliament, the responsibility of the Chancellor for all decisions involving public funds or liabilities in a time of crisis should be stated in the draft Bill. A crisis should be deemed to have begun from the moment when the Bank formally notifies the Chancellor of a material risk to public funds.**

168. The Chancellor believes that using the general power of direction of the Bank of England in the 1946 Act to override the Governor would add to what he called the “sense of chaos” in a crisis. The evidence of the financial crisis of 2007–08 supports this view on the difficulty of deploying it, although in that case it appears that the fear in the Treasury was that its use would undermine the independence of the Bank. It is clear from the then Chancellor’s memoirs that he wanted the power to direct the Bank in the midst of crisis, the conduct of which the Treasury and the Government were responsible and accountable

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154 A new approach to financial regulation: a blueprint for reform, Cm 8083, p 22

to Parliament and the public. The Chancellor should be granted a power to direct the Bank in a crisis which is free of the problems associated with the power under the 1946 Act.

**169. We recommend that the Chancellor be given statutory responsibility for a crisis after the formal notification by the Bank of a material risk to public funds. This should automatically trigger a discrete power for the Chancellor to direct the Bank, separate from the general power under the 1946 Act. The Chancellor might choose not to direct the Bank in such a crisis, but once the notification of material risk had been given, the Chancellor should be regarded as fully responsible and accountable to Parliament for its handling. Any use by the Chancellor of the power of direction should be made public unless the Chancellor considers it against the public interest to disclose it. Notification of such an event should be made to the Chairman of the Treasury Committee.**

**170. If the Chancellor chose not to direct the Bank after a notification of a material risk to public funds had been made by the Bank, this would represent a delegation of the function of operational decision making to the Governor, but with the Chancellor remaining responsible and accountable for the decisions made. The Chancellor's assumption of responsibility and his power to direct the Bank are consequences of his responsibility for public funds and liabilities, and his accountability to Parliament for them. The Bill should therefore specify that the period of the Chancellor's sole responsibility expires when the Chancellor decides that the risk to public funds has ended. Its termination should be made public.**

171. There is the possibility of moral hazard operating in these circumstances. The Bank might be deterred from notifying the Chancellor for fear of losing control over its normal areas of responsibility, and the Treasury might wish the Bank to take action on its own to sort a problem out without recourse to public funds. To some extent the Bank's interest in retaining control may be balanced by the Bank's incentive to notify the Chancellor in order to protect its balance sheet. Such problems will arise in any regulatory system where there is a separation of responsibilities. Our recommendations seek as far as possible to address the potential problem of moral hazard in crisis management.

**172. Decisions to issue either the early warning that we have recommended, or the formal notification set out in the draft Bill, should be a matter for the executives of the Bank. In both cases, prompt communication with the Treasury will be vital in order to give the Chancellor time adequately to consider options. We therefore recommend that the Court should have a duty to monitor the fulfilment of these warning and notification requirements.**

### **A wider role for the Chancellor?**

173. In the United States, a new Financial Stability Oversight Council has been provided for under the Dodd-Frank Act. It has a monitoring role designed to ensure the stability of the US financial system, and comprises the heads of the main regulatory agencies and the Chairman of the Board of Governors of the Federal Reserve System. It is chaired by the Secretary of the Treasury. Citing this example, Professor Lastra told us that:

Financial stability is not only a central banking goal. I agree that it is also a political goal. Through the crisis we saw the importance of financial stability for peace in

society and the economic situation. So, financial stability is a goal that transcends institutional mandates. It is also for the Financial Services Authority—the FSA—for the central bank and for the Treasury. It even traverses geographic boundaries, which brings it into the international dimension. Nothing that is done in this country alone would be sufficient to control systemic risk unless we have a view of how much leverage is developing in the financial system generally, given its interconnectedness. So now there is the model that has been followed in the United States with the Financial Stability Oversight Council, which includes the Treasury but also includes the regulatory authorities, including the federal regulation system, the central bank.<sup>155</sup>

174. Dr Buiters told us that the Treasury should be responsible for financial stability at all times:

Treasury should be at the centre of financial stability; it is now on the sidelines. In my view, the FPC should be chaired by the Chancellor. Consider the way the United States has approached this problem: their Financial Stability Oversight Council is chaired by the Secretary of the Treasury, although the regulators and the Fed are on it.<sup>156</sup>

175. Ms Barker agreed that macro-prudential policy should lie within the Treasury:

These arguments would support setting up a decision-making structure along the lines suggested by Willem Buiters, chaired by the Treasury but with strong representation from the Bank, the FSA and possibly also external members. Since the purpose of setting it up in this way would be to enable Government to take its own view about the right balance of taxpayer risk and other policies, the decisions should lie with the Chancellor. But in order to avoid the risk that decisions were driven by short-term political considerations, the Bank and the external members should be able to publish the advice being given to the committee.

In summary, I would argue that macro-prudential policy does not meet the tests for being set up independently from Government, and that there are risks to the structural management of the economy from moving in this direction. A final point is that, although ministers might see the setting up of an independent body as in some sense removing them from criticism if policies were unpopular, experience with bodies such as NICE suggests that in the end ministers are not able to escape criticism for the actions and decisions of the independent bodies which they choose to establish.<sup>157</sup>

**176. The proposals we have made give the Chancellor power to direct the Bank when there is a material risk to public funds. We have further recommended that he or she have a discretionary power to direct the Bank following early warning from the Bank that such a material risk is a possibility. It may be that Chancellors will decide not to use that discretionary power after an early warning, but the fact that he or she would**

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155 Q 277

156 Q 221

157 Ev 114

have the statutory ability to assume that power would create a clear line of accountability for decisions taken through the Chancellor to Parliament. A Chancellor can be expected to take responsibility in times of turbulence. We regard it as essential that the Chancellor should have this discretionary power to allow him or her to be responsible to Parliament for decisions that may lead to a claim on the public purse.

177. A broader enduring discretionary power could be considered. However, given the powers for the Chancellor that we have recommended, it is not clear what further would be gained by giving the Chancellor an enduring discretionary power to chair the FPC. In normal times we would expect any such power to be delegated to the Governor, and the lion's share of the occasions when he or she would be likely to wish to chair the Committee are covered by the recommendations we have made. However, there could be occasions when the Chancellor might wish to take responsibility for decisions by the FPC of great economic or public importance where public funds were not potentially at risk. Since that the powers of the FPC are novel, this is something on which, given the likely public discussion, we and Parliament may wish to express a view.

# Conclusions and recommendations

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## The Court of the Bank of England

1. To reflect the shift of emphasis in its role, we recommend that the governing body of the Bank (Court) change its name to the ‘Supervisory Board of the Bank of England’. References below to the Board of the Bank of England in this report use this term. Whatever name is ultimately chosen, we strongly recommend that the term “Court” is abolished. (Paragraph 41)
2. We recommend that when the Supervisory Board considers the annual budget, it should be responsible for coming to an explicit view about both the level of, and changes to the allocation of, resources for all areas of activity, including the macro-prudential and monetary areas of work. It should provide public explanations of those decisions. (Paragraph 44)
3. The new responsibilities of the Bank will require its governing body to have an enhanced mix of skills. The Bank will have responsibility for macro and micro-prudential regulation and financial stability. As well as management skills, the new Supervisory Board needs sufficient expertise in macro-economics and finance to enable it to perform its expanded oversight role effectively. We therefore recommend that, in addition to experience in running large organisations and financial institutions, membership of the new Supervisory Board have expertise in prudential policy. (Paragraph 50)
4. We draw attention to the increased importance of the role of the Chairman of the new Supervisory Board. We recommend that the Chairman in the future have considerable experience of prudential or financial issues. (Paragraph 52)
5. The current arrangements are that non-executives are in the majority on the Court and that the Chairman of the Court is external. These should remain in place. We propose, in addition, that the new Supervisory Board should be reduced to a size which allows a diversity of views and expertise but is small enough to be an efficient decision-making body. Although the Court has recently been reduced in size, it is still too large. We recommend that the new Supervisory Board be reduced from a membership of twelve to one of eight, comprising the Governor, the two Deputy Governors, an external Chairman, and four other external members. (Paragraph 54)
6. The membership of the new Supervisory Board of the Bank of England must consist of eminent and professionally experienced individuals. The interpretation of what constitutes a conflict of interest needs to be assessed on a case-by-case basis when external members of the Board are appointed. When a conflict arises in relation to a member of the Board, the rest of the Board, led by the Chairman, should exercise its judgement as to how to deal with it, as is standard practice on the boards of major public companies. (Paragraph 62)
7. It is important that those overseeing financial stability are publicly accountable for their performance. We will invite members of the new Supervisory Board before the Treasury Committee regularly in the future and we will seek to ensure that its

members remain committed and effective in fulfilling their role. We recommend that the new Supervisory Board's minutes be published to a timetable similar to that of the MPC, subject to any specific concerns of confidentiality which the Chairman of the Supervisory Board should raise with the Chairman of the Treasury Committee. (Paragraph 67)

8. We propose that the staff support for the new Supervisory Board be strengthened. It requires a dedicated, and high quality staff containing the skills and experience needed to fulfil its oversight functions. We expect that many staff would be drawn from the Bank, as one stage in their career. While serving the Supervisory Board they would be accountable to the Chairman of the Board, including for performance management purposes. External staff should be considered, at the discretion of the Board. (Paragraph 71)
9. We recommend that the new Supervisory Board conduct ex-post reviews of the Bank's performance in the prudential and monetary policy fields normally not less than a year after the period to be reviewed. This would be consistent with avoiding second guessing at the time of the policy decision. The reviews should among other things enable lessons for the future to be learnt. They should strengthen the Bank's collective memory. There should be no presumption that the commissioning of a review implied that the episode or function in question had been badly managed: successes and failures should be reviewed alike. It would be a matter for the Board itself to determine when and how such reviews would be conducted, and into which issues. (Paragraph 81)
10. There should be the presumption that ex-post reviews would be published, except where confidentiality needed to be maintained, in which case it might be desirable for either a redacted version to be published or for publication to be delayed. On such occasions, the Chairman of the Treasury Committee should be shown an unredacted version of the findings with an explanation of the reasons for non-publication. The date of publication should then be reviewed periodically until such a time as full publication would not endanger confidentiality or financial stability. (Paragraph 82)
11. In addition to the present monthly reports to the Board on monetary policy and similar papers on prudential matters and actions, we recommend that Board members be authorised to see all of the papers considered by the MPC and FPC, to ensure informed monitoring of processes and management is possible by the Supervisory Board. (Paragraph 84)
12. We recommend that the new Supervisory Board be responsible for responding to requests to the Bank for factual information from the Treasury Committee and the Treasury. It should also monitor the regular disclosure and publication of statistics and information relevant to the monetary, financial stability and prudential fields, though such decisions should, in the first instance, be a matter for the Bank executives. (Paragraph 88)

## Committees of the Bank of England

13. We recommend that the Bank change its emphasis so that the appointment of industry practitioners becomes easier. This will put more onus on the committees, led by their chairmen, themselves to deal with any conflicts of interest as they arise. In order to do so they should follow best practice of private sector boards. (Paragraph 91)
14. The expertise and independence of external MPC and FPC members are of the highest importance. Their appointment requires greater accountability to Parliament. We recommend that the Treasury enable the appointment hearings we hold with the selected external candidates for the MPC and FPC to take place before their appointment to these committees. (Paragraph 93)
15. The avoidance of groupthink is the responsibility of the Bank of England, and therefore should be monitored by the new Supervisory Board of the Bank. This Board will be well placed to conduct reviews of committee processes and build relationships with the members of committees. (Paragraph 102)
16. We repeat our previous recommendation that a better balance between internal and external members of the FPC and MPC be found. We propose that the ratio of internal to external members move from 5:4 to 4:5. We would expect that external members will not always agree with the internal Bank executives, but we believe that there should be room for such creative tension. Whatever the precise numbers, the external members of both the FPC and MPC should be in the majority. (Paragraph 103)
17. The Court already has meetings with individual members on the adequacy of information and any concerns about governance matters. As part of its process and management overview function, the new Supervisory Board must ensure not only that internal and external members (and the Treasury observers) of the Bank's committees have the information they need, but also seek confirmation that all members feel free to express their views and do not perceive themselves constrained by groupthink or by the dominance of internal Bank members. (Paragraph 104)
18. In order to maintain the independence of the Bank, we support the ability of the FPC to reject any guidance which it regards as inappropriate. However, the ability for the Treasury to influence the interpretation of the financial stability objective is an important one, given the present lack of a definition of financial stability, and therefore if the FPC rejects guidance it should have the opportunity to explain its reasoning in writing to both the Treasury and the Treasury Committee. (Paragraph 113)
19. We recommend that HMT give guidance under Clause 3 of the draft Bill to the Bank of England to adopt indicators for gauging financial stability. The selected range of indicators must be flexible and under constant challenge and review, not only by Parliament, Government and the Bank of England, but also by others such as financial industry practitioners, the media, academia and the public. The indicators should be published so that the performance in maintaining financial stability may

be monitored and so that it can be held accountable for that performance. The FPC should report against these criteria at regular intervals. (Paragraph 114)

20. Clause 2 of the draft Bill should be amended so that the reference to the stability of the UK financial system takes account of the Chancellor's proviso about not requiring the support of taxpayers' money. The use of public funds will usually represent a failure by the regulatory authority to identify problems early enough. We recommend that the clause also place a duty on the Bank of England to minimise, as far as possible, the use of public funds. (Paragraph 115)
21. There is some concern that the position of the FPC within the Bank may appear anomalous with regard to the MPC. We request the Governor to review the status of the two institutions and we may return to this matter in further work. (Paragraph 116)
22. The macro-prudential measures set out in secondary legislation will be of great importance and potential scope, and will give the FPC great powers. Parliamentary control and scrutiny of these measures are vital before such powers are granted. As the legislation stands, their approval by the House of Commons requires only a 90 minute debate in a General Committee and a decision without debate in the House. We recommend that the Government amend the draft legislation to require that debates on orders prescribing macro-prudential measures be held on the floor of the House and not be subject to the 90 minute restriction. Furthermore, the House would benefit from prior scrutiny of such orders by this Committee. We recommend that the Government provide us with the proposed text of the draft orders at least two months before they are laid before the House in order to allow us to report to the House on their merits. (Paragraph 119)
23. The Bank is a democratically accountable institution and it is inevitable that Parliament will wish to express views and, on occasion, concerns about its decisions. Our recommendation that the new Supervisory Board have the authority to conduct retrospective reviews of the macro-prudential performance of the Bank should, if operating successfully, provide the tools for proper scrutiny. However, the Bank will need to explain its decisions more fully to Parliament than has been the case on occasion with some regulators, for example the Financial Services Authority. If these measures we propose prove inadequate, we will have to return to this issue. (Paragraph 120)
24. We recommend the introduction of a statutory duty for the Governor to raise such a conflict with the new Supervisory Board (or its Chairman) if it occurs or is suspected. The Chairman's role should be to ensure proper consideration and that correct process is followed, not to challenge policy. The Governor should, in addition, explain how he proposes to handle it, including by means of a public statement. We recommend that the legislation should provide for a joint meeting of the MPC and the FPC to take place if that is deemed by the Governor, after discussion with the Chairman of the Supervisory Board, to be the best way to resolve a significant conflict. The existence of the arrangement for notifying the Chairman is likely to diminish the need for its use. (Paragraph 129)



25. We recommend that the Chairman of the new Supervisory Board sit as a silent observer on all of the Bank's committees, a role which could be delegated by the Chairman to other members of the board. Since appearing before us, the current Chairman of Court, Sir David Lees, has told us that he can see the advantages of such a recommendation and agreed that it could be made to work in practice, with elements of discretion as to which meetings are attended and flexibility over which member of Court sits as the observer. A Board presence on Bank Committees will enable the Board better to handle many of the problems outlined above. It will become aware of, for example, potential conflicts of policy between the committees, potential problems of groupthink, and will be able better to monitor the implementation of the respective codes of conduct. (Paragraph 132)
26. We recommend that the minutes of meetings of the FOC be published within two weeks, or, if publication would threaten financial stability, as soon as it is safe to do so. If publication of minutes is delayed, the Chancellor of the Exchequer and the Chairman of the Treasury Committee should be informed of the delay, and told of the nature of the discussion and the decisions reached. (Paragraph 136)
27. The mandate of the Bank of England is of the highest importance, but has not been a focus of the Committee in this inquiry. The new powers that the Bank has been given will allow it to take steps to meet its financial stability objective. But these powers could also potentially allow it to act to achieve wider economic objectives. Whether these new powers should also mean that the Bank should have an amended mandate, for example to promote sustainable growth, is something that we may wish to return to in a subsequent inquiry given the likely public debate about this important issue. (Paragraph 138)

### Office of the Governor of the Bank of England

28. We recommend that the draft Financial Services Bill amend the Bank of England Act to state that the Governor may serve a single, non-renewable term of eight years. (Paragraph 143)
29. The Chancellor argued that because the OBR performs what is essentially an auditing function for the Government, and the Bank of England carries out executive functions, the two institutions are materially different. He used this distinction to argue that the Treasury Committee's power of veto over the appointment or dismissal of the leaders of the OBR should not apply to the position of the Governor of the Bank. We are not persuaded by this line of argument. The power of veto with respect to the OBR was given to ensure the independence and accountability of that body. The Governor of the Bank's independence from Government is crucial for his or her credibility. Given the vast responsibilities of the Governor, the case for this Committee to have a power of veto over the appointment or dismissal of the Governor is even stronger than it is with respect to the OBR. We therefore recommend that, in order to safeguard his or her independence, the Treasury Committee is given a statutory power of veto over the appointment and dismissal of the Governor of the Bank of England. (Paragraph 148)

## Crisis management and the role of the Chancellor

30. We strongly recommend that the definition of what constitutes a “material risk” for the purposes of Clause 42 of the draft Bill be contained in the forthcoming legislation. This definition should also take account of the fact that major liquidity operations by the Bank require Treasury approval—the material risk of these too must require notification to the Treasury. (Paragraph 165)
31. We are concerned that the formal notification of a material risk to public funds may still not give the Chancellor enough time to consider other policy options. The Treasury needs to know as early as reasonably possible when it might receive a notification. We therefore recommend that the forthcoming legislation also require the Bank to give the Chancellor an early warning of the possibility that a notification of a material risk to public funds may need to be given, and full information about the circumstances. We further recommend that the Draft Bill be amended so that this early warning triggers a discretionary power for the Chancellor to be able to direct the Bank if he or she so chooses. The Bank should be required to provide such an early warning to the Chancellor as soon as the FPC becomes aware of a possibility of a material risk to public funds. Subsequently, until either the possibility has disappeared or a formal notification has indeed been made, the Bank should be required to keep the Chancellor fully informed. (Paragraph 166)
32. To ensure proper accountability to Parliament, the responsibility of the Chancellor for all decisions involving public funds or liabilities in a time of crisis should be stated in the draft Bill. A crisis should be deemed to have begun from the moment when the Bank formally notifies the Chancellor of a material risk to public funds. (Paragraph 167)
33. We recommend that the Chancellor be given statutory responsibility for a crisis after the formal notification by the Bank of a material risk to public funds. This should automatically trigger a discrete power for the Chancellor to direct the Bank, separate from the general power under the 1946 Act. The Chancellor might choose not to direct the Bank in such a crisis, but once the notification of material risk had been given, the Chancellor should be regarded as fully responsible and accountable to Parliament for its handling. Any use by the Chancellor of the power of direction should be made public unless the Chancellor considers it against the public interest to disclose it. Notification of such an event should be made to the Chairman of the Treasury Committee. (Paragraph 169)
34. If the Chancellor chose not to direct the Bank after a notification of a material risk to public funds had been made by the Bank, this would represent a delegation of the function of operational decision making to the Governor, but with the Chancellor remaining responsible and accountable for the decisions made. The Chancellor’s assumption of responsibility and his power to direct the Bank are consequences of his responsibility for public funds and liabilities, and his accountability to Parliament for them. The Bill should therefore specify that the period of the Chancellor’s sole responsibility expires when the Chancellor decides that the risk to public funds has ended. Its termination should be made public. (Paragraph 170)

35. Decisions to issue either the early warning that we have recommended, or the formal notification set out in the draft Bill, should be a matter for the executives of the Bank. In both cases, prompt communication with the Treasury will be vital in order to give the Chancellor time adequately to consider options. We therefore recommend that the Court should have a duty to monitor the fulfilment of these warning and notification requirements. (Paragraph 172)
36. The proposals we have made give the Chancellor power to direct the Bank when there is a material risk to public funds. We have further recommended that he or she have a discretionary power to direct the Bank following early warning from the Bank that such a material risk is a possibility. It may be that Chancellors will decide not to use that discretionary power after an early warning, but the fact that he or she would have the statutory ability to assume that power would create a clear line of accountability for decisions taken through the Chancellor to Parliament. A Chancellor can be expected to take responsibility in times of turbulence. We regard it as essential that the Chancellor should have this discretionary power to allow him or her to be responsible to Parliament for decisions that may lead to a claim on the public purse. (Paragraph 176)
37. A broader enduring discretionary power could be considered. However, given the powers for the Chancellor that we have recommended, it is not clear what further would be gained by giving the Chancellor an enduring discretionary power to chair the FPC. In normal times we would expect any such power to be delegated to the Governor, and the lion's share of the occasions when he or she would be likely to wish to chair the Committee are covered by the recommendations we have made. However, there could be occasions when the Chancellor might wish to take responsibility for decisions by the FPC of great economic or public importance where public funds were not potentially at risk. Since that the powers of the FPC are novel, this is something on which, given the likely public discussion, we and Parliament may wish to express a view. (Paragraph 177)

# Formal Minutes

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**Wednesday 19 October 2011**

Members present:

Mr Andrew Tyrie, in the Chair

Michael Fallon	Mr Andrew Love
Mark Garnier	Mr George Mudie
Stewart Hosie	Jesse Norman
Andrea Leadsom	David Ruffley

Draft Report (*Accountability of the Bank of England*), proposed by the Chair, brought up and read.

*Ordered*, That the draft Report be read a second time, paragraph by paragraph.

Paragraphs 1 to 177 read and agreed to.

*Resolved*, That the Report be the Twenty-first Report of the Committee to the House.

*Ordered*, That the Chair make the Report to the House.

*Ordered*, That embargoed copies of the Report be made available, in accordance with the provisions of Standing Order No. 134.

Written evidence was ordered to be reported to the House for publishing with the Report on 17 May and 20 June.

[Adjourned till Tuesday 25 October at 9.30 a.m.]

## Witnesses

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### Tuesday 15 March 2011

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**Sir David Lees**, Chairman, and **Sir Roger Carr**, **Lady Rice CBE** and **Brendan Barber**, Members, Court of the Bank of England Ev 1

### Monday 23 May 2011

**Dr Sushil Wadhvani CBE**, and **Professor Charles Goodhart CBE**, former Monetary Policy Committee members Ev 17

**Kate Barker CBE**, and **Dr Willem H Buiter**, former Monetary Policy Committee members Ev 25

### Monday 20 June 2011

**Professor Rosa Lastra**, Professor in International Finance and Monetary Law, Queen Mary, University of London, **Professor Bob Garratt**, Cass Business School, **Dr Andrew Hilton**, Director, Centre for the Study of Financial Innovation, and **Jane Fuller**, Co-Director, Centre for the Study of Financial Innovation Ev 33

### Tuesday 21 June 2011

**Dr Gavin Bingham**, Secretary General, Central Bank Governance Forum, Bank for International Settlements Ev 44

### Tuesday 28 June 2011

**Sir Mervyn King**, Governor, **Paul Tucker**, Deputy Governor, Financial Stability, **Charlie Bean**, Deputy Governor, Monetary Policy, **Andy Haldane**, Executive Director, Financial Stability, and **Andrew Bailey**, Executive Director, Bank of England Ev 54

### Tuesday 5 July 2011

**Rt Hon George Osborne MP**, Chancellor of the Exchequer, and **Sir Nicholas Macpherson**, Permanent Secretary to the Treasury Ev 68

## List of printed written evidence

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1	Court of the Bank of England	Ev w85, w101, w135
2	Dr Sushil B Wadhvani CBE	Ev w102
3	Professor Charles Goodhart CBE	Ev w104
4	Dr Willem H Buiters	Ev w104
5	Kate Barker CBE	Ev w113
6	Professor R Bob Garrett	Ev w115, w133
7	Dr Gavin Bingham, Secretary General, Central Bank Governance Forum	Ev w120
8	Letter from the Governor of the Bank of England to the Chairman of the Committee	Ev w137

## List of additional written evidence

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(published in Volume II on the Committee's website [www.parliament.uk/treascom](http://www.parliament.uk/treascom))

1	Intellect	Ev w1
2	Aviva	Ev w5
3	British Bankers' Association	Ev w6
4	Forum for Stable Currencies	Ev w10
5	Building Societies Association	Ev w14
6	Financial Services Consumer Panel	Ev w17
7	Financial Services Practitioner Panel and Smaller Businesses Practitioner Panel	Ev w20
8	Association for Financial Markets in Europe	Ev w22
9	Professor Forrest Capie, Official Historian, Bank of England	Ev w24

## List of Reports from the Committee during the current Parliament

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### Session 2010–12

First Report	June 2010 Budget	HC 350
Second Report	Appointment of Dr Martin Weale to the Monetary Policy Committee of the Bank of England	HC 195
Third Report	Appointment of Robert Chote as Chair of the Office for Budget Responsibility	HC 476
Fourth Report	Office for Budget Responsibility	HC 385
Fifth Report	Appointments to the Budget Responsibility Committee	HC 545
Sixth Report	Spending Review 2010	HC 544
Seventh Report	Financial Regulation: a preliminary consideration of the Government's proposals	HC 430
Eighth Report	Principles of tax policy	HC 753
Ninth Report	Competition and Choice in Retail Banking	HC 612
Tenth Report	Budget 2011	HC 897
Eleventh Report	Finance (No.3) Bill	HC 497
Twelfth Report	Appointment of Dr Ben Broadbent to the monetary Policy Committee of the Bank of England	HC 1051
Thirteenth Report	Appointment of Dr Donald Kohn to the interim Financial Policy Committee	HC 1052
Fourteenth Report	Appointments of Michael Cohrs and Alastair Clark to the interim Financial Policy Committee	HC 1125
Fifteenth Report	Retail Distribution Review	HC 857
Sixteenth Report	Administration and effectiveness of HM Revenue and Customs	HC 731
Seventeenth Report	Private Finance Initiative	HC 1146
Eighteenth Report	The future of cheques	HC 1147
Nineteenth Report	Independent Commission on Banking	HC 1069
Twentieth Report	Retail Distribution Review: Government and Financial Services Authority Responses to the Fifteenth Report from the Committee	HC 1532

# Oral evidence

## Taken before the Treasury Committee

on Tuesday 15 March 2011

Members present:

Mr Andrew Tyrie (Chair)

Michael Fallon  
Mark Garnier  
Stewart Hosie  
Andrea Leadsom

Mr Andrew Love  
Mr David Ruffley  
Mr Chuka Umunna

### Examination of Witnesses

*Witnesses:* **Sir David Lees**, Chairman, and **Sir Roger Carr**, **Lady Rice CBE** and **Brendan Barber**, Members, Court of the Bank of England, gave evidence.

**Q1 Chair:** Thank you very much for coming before us this morning. This issue, of course, is much bigger than it was prior to the decision of the Government to move a number of very important regulatory and supervisory functions from the FSA to the Bank and to augment the Bank's role. May I begin by asking you, Sir David, to whom you think you are accountable?

**Sir David Lees:** I think I am accountable to Parliament, and through you to Parliament.

**Q2 Chair:** When did you last appear before Parliament?

**Sir David Lees:** I have not had that pleasure yet, so this is my first appearance.

**Q3 Chair:** How long have you been on the board? For how many years in total?

**Sir David Lees:** I have been on the Court now for 20 months. I came in on 1 June 2009. I also served on the Court for eight years in the '90s, and that was a very different Court.

**Q4 Chair:** Okay, so you have quite a bit of experience of the Court over the years, but rather less of the modern Court?

**Sir David Lees:** I have a lot of experience of the present Court.

**Q5 Chair:** Okay. As I mentioned in my opening remarks, financial stability is now very high on the agenda of the Bank. Do you happen to know roughly how much the bank is spending, by function, as a proportion of its total resources on that?

**Sir David Lees:** I could easily reference it from the documents that I have in front of me. If you wish to, I will.

**Q6 Chair:** Do you know roughly? Do you carry that sort of thing in your head?

**Sir David Lees:** I do not carry it in my head but I would say that it was probably something like 100 to 200 people.

**Q7 Chair:** And in resources terms? It is set out in the accounts in resources terms, in cash. Or as a

percentage of total functions? Might that be a way of looking at it?

**Sir David Lees:** I will just ask my colleagues whether they have a view. I would think probably as a percentage of total functions it is something like 20%.

**Q8 Chair:** It is a pretty short list that is provided here. It says "Policy functions" and then it lists two: monetary policy and financial stability. This is on page 29. The figure is 43%. Do you happen to know how that number has varied over the years? Is it an issue that you have taken a look at?

**Sir David Lees:** No. I mean I have certainly taken a view of the total expenditures in the Bank, but not going back over time into the individual functions.<sup>1</sup>

**Q9 Chair:** Given that the Bank has just been given this huge new responsibility and that we have just been through the biggest financial crash since the 1930s, don't you think the amount that the Bank is now devoting to financial stability is something that—as Chairman of the non-executive board, effectively—you will want to keep a very close eye on?

**Sir David Lees:** Absolutely right: that is something that we want to keep a very close eye on.

**Q10 Chair:** But I have just asked you whether you know roughly what has been happening to that percentage number—that key control number—for previous years, and you don't know, Sir David, and as far as I am aware, none of your colleagues is leaping in to help. Is that correct—none of you knows whether this number is higher or lower than it was in 2008, 2007 or 2006?

**Sir David Lees:** I think without a shadow of doubt it would be higher, because the 2009 Act, which created the Financial Stability Committee, will of itself have created a need for more resource, and it is an issue that we on the Court are concerned about—that we have on the Bank's payroll sufficient able and senior

<sup>1</sup> *Note by witness:* In Q7 the Chairman asked what spending on financial stability was as a percentage of total functions. As a percentage of total functions the percentage was 20%. The 43% cited by the Chairman is the percentage of policy functions (actually 44.5%). (The relevant table has been supplied to the Committee as supplementary written evidence and is reproduced later in this volume of evidence)



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15 March 2011 Sir David Lees, Sir Roger Carr, Lady Rice CBE and Brendan Barber

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people to support the financial stability responsibilities.

**Q11 Chair:** Yes, but what I am trying to get at here this morning is whether you are really on top of monitoring that. I am well aware that that is what you should be monitoring; what I am trying to establish is whether you are monitoring it.

**Sir David Lees:** We certainly are.

**Q12 Chair:** Do you know what amounts were being spent on this prior to the crash, roughly?

**Sir David Lees:** I do not know.

**Q13 Chair:** Okay. Do you know what happened in the years prior to the crash, therefore, and know how this percentage varied during the course of the period when we were most at risk of a financial crash?

**Sir David Lees:** I cannot provide you with the detail, partly because I was not there, but I could easily—

**Q14 Chair:** But three of you were. Your colleagues, if they are up to speed on this, please speak up. The correct figures are that in 2005–06, 44% was spent. That figure then dropped to 39% at the very time it was most needed. In other words, cuts to this took place in the Bank, supervised by the Court, and by 2007–08 the figure was only 39%. It has now clawed its way back almost to the level that it was at prior to the crash. I have to say that I am very concerned that you do not seem on top of any of those numbers at all, or indeed even to have a feel for the sense of direction of the numbers.

**Sir David Lees:** I do have a feel for the sense of direction, and I think it is, as you have just said, up, albeit marginally.

**Q15 Chair:** I just asked you whether you knew if it was higher or lower prior to the crash and you said you did not know.

**Sir David Lees:** Well, I correct that answer, if I may, by saying I surmise that it would be higher, and I think it will go higher still as we go forward.

**Q16 Chair:** Has at any time the Court commissioned a review of what went wrong in the Bank during the Northern Rock crisis?

**Sir David Lees:** An external review?

**Chair:** An internal review.

**Sir David Lees:** To my knowledge, no, but again I will ask my colleagues.

**Q17 Chair:** This was the most colossal failure of Bank policy, was it not? This was a period when we were very close to a bankrupt, when the lender of last resort functions, which is the core function of central banks, came into play, and there were very serious problems as a consequence.

**Sir Roger Carr:** I wonder if I may just offer some commentary.

**Chair:** Do.

**Sir Roger Carr:** The whole of the Northern Rock situation was clearly regarded as a crisis. From the Court's perspective, it is something that was discussed in considerable detail in order to try and determine

where we felt the weaknesses of the system were, such that the Court through the Governor could provide commentary as to where improvements could be made in the system. I believe some of those comments were taken into account when the new structure was being evolved. I would be very clear that it was a topic of considerable importance, but it was reviewed by the Court, rather than a specific study commissioned by the Court.

**Q18 Chair:** Okay. Just to be clear, three of you were on the Court at that time and none of you called for a review of the Bank's performance during the financial crisis?

**Sir Roger Carr:** To be clear, it was not necessary to call for a review. A review was done as part of normal Court business, and it was clearly a very important topic.

**Q19 Chair:** You discussed that in detail with the Governor, and the Governor responded in writing to your points made?

**Sir Roger Carr:** Discussion was discussion. It was not done on a question and answer basis; it was a question of reviewing the strengths and weaknesses of the system we had, the points of main failure and where we felt corrective action should be taken.

**Q20 Chair:** Are those points thoroughly recorded?

**Sir Roger Carr:** I believe they are minuted, certainly in the broad.

**Q21 Chair:** Certainly?

**Sir Roger Carr:** In the broad.

**Q22 Chair:** Do you really think that this is a crisis which we can limit conclusions to the broad—discussed in the broad? Really?

**Sir Roger Carr:** I think the minuting, other than line-by-line, is always in summary. The dialogue that took place in the courtroom was much more interactive because we were all in a learning situation. There were no right answers in this period. We were finding the weaknesses of the system that we looked at in hindsight with a view to finding corrective action going forward.

**Q23 Chair:** Okay. The FSA did do an internal review and they published it.

**Sir Roger Carr:** Yes.

**Chair:** Do you think it might be helpful if you publish all the minutes and exchanges of the Court at this time?

**Sir Roger Carr:** I think that is something for the Court to consider and the Governor to comment on.

**Q24 Chair:** I have most, or a good chunk, of the Court here in front of me, so I am asking you to consider it now.

**Sir Roger Carr:** We will give it consideration.

**Chair:** Okay, we are going to park it. Michael Fallon?

**Q25 Michael Fallon:** You are painting a picture, Sir Roger, of the Court really as a kind of commentator on the crisis. The Bank's objective was "To protect

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and enhance the stability of the financial system of the United Kingdom.” Where do you think the Bank went wrong? You were there at the time.

**Sir Roger Carr:** I was. I think the Bank, within the limits of its authority at the time, did a reasonable job. There were certainly challenges in the information flow in the tripartite structure and uncertainty as to whose finger was on the trigger for some of the action that needed to be taken. These were the issues that came out of the review that was undertaken and why the new structure has been evolved. I think the Bank did well, in terms of providing for leadership in finding a way through what was a perilous situation at the time. It did it diligently, it did it with real commitment, and the Court and the executive were very involved and engaged in working through what was a difficult time. There was no question of lack of commitment, lack of concern or lack of action, but there were questions on the system in which we were operating. I think they have now been addressed. I think looking back if you were to comment on where the Bank could have done more running up to the crisis, it may have been able to shout louder. Whether people would have listened is questionable.

**Sir David Lees:** I might just add, although this was before my time, that I think the Governor has said in evidence to you that if he had any regrets, it was that he did not shout louder. I think that would be a pretty accurate quotation.

**Q26 Michael Fallon:** Yes, but I want to know what you were doing on the Court. You were there from June onwards; you were there right through that crisis. What were you doing?

**Sir Roger Carr:** We were participating in the management of the problem as non-executive directors. I mean, this was clearly a level of challenge that those with the executive responsibility were committed to resolving, and they were working literally around the clock to do that. There were no ground rules, there were no absolutes, and there were no certainties. The team had to work through that, and we as the Court were working with them. We were supportive when appropriate, and we were challenging when necessary, within the limits of our own abilities.

**Q27 Michael Fallon:** What did you challenge the Governor on?

**Sir Roger Carr:** At the time? We were challenging I think all the time on whose trigger finger should it be, and where the point of authority was. Those were the sort of challenges we made as observers and outsiders, rather than executives who had the responsibility for delivering.

**Q28 Michael Fallon:** But the net result was a very uncertain period for the Bank. At one point the Governor was telling everybody he should not intervene, and then he did intervene. Do you not think the Court itself did enough to challenge the Bank’s position?

**Sir Roger Carr:** My own view is that given the circumstances that all were facing at that time, all people gave their full commitment to it and made whatever they believed to be an appropriate challenge,

recognising that we were in completely uncharted waters for much of that period.

**Q29 Michael Fallon:** You are now being given quite significant new responsibilities, including the Financial Policy Committee. Do you think the same kind of accountability framework is adequate?

**Sir Roger Carr:** I think what we will have in the future is a new kind of framework, and I think the benefit of the experience that we have all been engaged in is that the learnings of that have been employed in the development of the new structure. With that new structure, with clear accountability and external people being involved in the financial stability area, I think we will have an infrastructure of reporting that will be helpful to decision making.

**Q30 Michael Fallon:** What additional transparency will we have, given we still do not know your internal view in the Court of how the Bank performed? What additional transparency will we have under the new framework?

**Sir David Lees:** If I may just add one thing to what Roger has just said, under the previous arrangements, the Bank had a responsibility only to “contribute” to financial stability. Under the proposed new arrangements that word “contribute” falls away, so that the Bank will be responsible for the financial stability objective. I think that is a significant difference, in the sense that the buck stops with the Bank now, whereas previously it was only a contributory.

**Q31 Michael Fallon:** But how will you be more transparent? How will we know whether you are doing a good enough job?

**Sir David Lees:** I suppose the answer to that is it depends on the outlook and results of financial stability management. I do not know yet what the target or aspirations will be for a successful financial stability regime, but I would have thought that if the economy were to show good growth without the disruptions that we have so recently experienced, that would be a good measure of the success of the regime.

**Q32 Michael Fallon:** But we had plenty of good growth leading up to 2007, did we not, Mr Barber? It was all going very well then. Nobody saw the problems—or did you?

**Brendan Barber:** I think people did see the problems and I think in the financial stability reports published by the Bank in 2006, warning signals were being given about the concerns. The difficulty was that the Bank did not have, as Roger has said, clear authority or a clear toolkit to use to intervene. The change that we are now seeing is, as David has now said, a very clear allocation of responsibility to the Bank, with the responsibilities to develop that toolkit. That is a very changed remit that the Bank has now been given, in recognition of the failures of that period.

**Q33 Michael Fallon:** You have been on the Court since 2003. At what point did you realise the tripartite arrangement was simply inadequate?

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**Brendan Barber:** I think with the benefit of hindsight, in the wake of the crisis, we are all perhaps a lot clearer than we were before the crisis. Certainly, I was part of the discussions in the Court in 2006, where some of these concerns and apprehensions were being voiced. I think it would be true to say that none of us realised quite how cataclysmic the crisis that we ultimately faced might turn out to be.

**Q34 Michael Fallon:** You deal in your other work with this issue of accountability all the time. How do you think the Court's new framework could be more accountable and more transparent?

**Brendan Barber:** I think there is a high degree of transparency, in the sense that of course the Bank produces its annual report. It reports in detail on all the aspects of its work, and in addition it is subject to exposure through this Committee, as this Committee thinks fit to invite the Court to give evidence. You obviously have a regular dialogue with the Governor and the senior executives of the Bank. It seems to me that the implication of the question is perhaps that discussion with the Court might be of value on a more regular basis going forward, and I think that would be seen as a positive thing.

**Q35 Chair:** You kindly said that you were going to consider what you could publish of that crucial period in the wake of the crisis. I would be grateful if you could take a look at that, bearing in mind that huge amounts of public money and enormous public concern—public money at risk and public concern generated—during that period make your response particularly pertinent. I think in order to assess the Court's role we really need to see all the records of the Court's engagement on the issue of the financial crisis, from immediately prior to the crisis to the most recent dates when you think it is possible for us to see it on the grounds of commercial and other confidentiality.

**Sir David Lees:** I have said we will take this back to Court, and we will give it very full consideration.

**Q36 Chair:** As you may imagine, a key question for us would be whether the Court, some other institution, or some beefed-up Court is what is required in order to deal with the FPC scrutiny issue. David Ruffley?

**Q37 Mr Ruffley:** I would like to talk about the history before we get on to the future. This is really for Mr Barber, Sir Roger and Lady Rice. Sir Roger, can you confirm that part of the 1998 Act puts a duty on the Court "to review the bank's strategy in relation to the financial stability objective"? That is very much the Court's role; in fact, Mr Barber talked about a report in 2006. Who were the executives in the Bank who were doing work on financial stability?

**Sir Roger Carr:** Well, there are a group of executives in the Bank.

**Mr Ruffley:** Who were they?

**Sir Roger Carr:** The Deputy Governor.

**Q38 Mr Ruffley:** Just for the record, could you give the names of the people that you were scrutinising?

**Sir Roger Carr:** At the time we had Paul Fisher, Paul Tucker, who was the Deputy Governor responsible—

**Q39 Mr Ruffley:** The other two can chip in to help you with the names. I just want to understand who at the Bank was responsible for doing the work on the financial responsibility objective.

**Sir Roger Carr:** Yes. Andy Haldane was also involved, so these were the people that we had interaction with, from the Court's perspective.

**Q40 Mr Ruffley:** Would you say their work was adequate in doing work on financial stability and making sure bear traps were clearly flagged up before 2007?

**Sir Roger Carr:** I understand bear traps, and the reality is that these people, from our judgment, are very competent and able people who have put a lot of energy and most of their life career into exactly this area of central banking. So they were people of—

**Q41 Mr Ruffley:** The financial stability objective that the executives were doing work on—you think they discharged that work adequately?

**Sir Roger Carr:** I think they did discharge it adequately. As we discovered later, the system and all the difficulties of the financial stability area were not things that were fully understood by all parties, but that is not to say that at the time they were not discharging their obligations correctly, and working hard to do it.

**Q42 Mr Ruffley:** Yes. You see, I have a problem with that answer, compared with the answer you gave some moments ago to Mr Fallon and Mr Tyrie. You said—I wrote it down—that the Bank "could have shouted louder. Whether people would have listened is questionable." That is what you said.

**Sir Roger Carr:** Yes, that is what I said.

**Q43 Mr Ruffley:** On what basis? What evidence do you have for it being questionable that people would have listened, had the Bank done its job of shouting louder? You are implying there was a fault. You said, "We could have shouted louder."

**Sir Roger Carr:** I think in hindsight one could have always shouted louder. On one very notable occasion, I was at the Mansion House where the Governor made a speech that was clearly really forewarning of the difficulties that may result from the way the financial markets were operating. He made a speech which referred to the risk of the champagne cork and, when the bottle was opened, of it being rather flat. He said that people should be careful; there was no new financial paradigm here, and it needed to be monitored. He made that point very clearly—everybody heard it—but it was at a time when the world generally was enjoying this artificial benefit of lots of cheap credit and were developing their businesses accordingly. People did not want to hear the bad news. The bad news was being given, and I think being given with authority. Now, it is a judgment whether if he had shouted more often people would have started to listen, but naturally I think, looking back, people only really listened when it was too late.

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**Q44 Mr Ruffley:** You are painting a picture here of the poor old Bank crying in the wilderness. They were powerless in the face of these events in 2007 and onwards. Is that what you are suggesting?

**Sir Roger Carr:** I am not trying to paint a picture; I am just giving you the facts as I remember them.

**Q45 Mr Ruffley:** You are painting a picture. You are saying, “They could have shouted louder; whether people would have listened is questionable.” I put it to you that there is more that the Bank could have done. That is its job—highly ranking, highly respected professionals in the financial world of this country. You think they did a “reasonable job”—another phrase you used. I have a problem here, because it was a massive screw-up that has affected the lives of our fellow citizens in sometimes quite horrific ways.

**Sir Roger Carr:** Yes. I do not think that emanated from the Bank of England.

**Q46 Mr Ruffley:** You do not think you could have done a better job?

**Sir Roger Carr:** I think everybody can always do a better job in hindsight, but I think the commitment, the vigour and the determination with which the job was being done at the time was very high indeed.

**Q47 Mr Ruffley:** You talk about being in a “learning situation”—I quote from one of your earlier answers. Do you not think it would be a good idea to get more people on the Court who knew about central banking? That is for Sir David and for you. You can go first, but I would like Sir David’s view. Knowing about central banking—don’t you think there should be more people on the Court who are good at that?

**Sir Roger Carr:** I think we need a balance of skills and knowledge on the board. You certainly need a good degree of knowledge about central banking; that is what the executive are primarily for. You then need to add to that through non-executive skills of a mix, some of which are central banking and some of which are not. It is dangerous to have only one skill set in any boardroom.

**Q48 Mr Ruffley:** I think most people listening to this would not particularly want someone talking about being in a learning situation. Let us move on to the future.

**Sir David Lees:** You invited me to—

**Mr Ruffley:** Yes, on that point about banking, and then I will go on to the future, to the.

**Sir David Lees:** Really what you are talking about is the mix of the Court, I think. Whether it is central banking experience or financial services experience or both, and bearing in mind also that we are looking today at the future, we are probably talking about the insurance industry, so I think you really need a blend of skills, but not exclusively financial services or central banking related. I do think that you need on the Court of the Bank of England two or three people—it would always be a minority—who have experience of governance, of running large and complex organisations.

**Q49 Mr Ruffley:** Okay, I’ve got the picture. Sir David, could you just list for me the key changes under the new arrangements to the way the Court will operate now that it will have responsibility for oversight of the Financial Policy Committee and other committees?

**Sir David Lees:** Yes. I think I can. If I start with the Financial Policy Committee, that is a committee of Court. It has a responsibility in the smaller print of contributing to the Bank’s financial stability objective, so there will be a close link between the Financial Policy Committee and the Court. I envisage, and this is looking into the future, the relationships between the FPC and Court to be not dissimilar in certain respects to the MPC. That requires me to say a little bit I think about the MPC, because the responsibilities of Court in relation to the MPC are essentially to make sure that they have the tools of the trade available to them to carry out their responsibilities. How do we do that? We do that in two or three different ways. We attend meetings, called pre-MPC meetings, where they are reviewing the economic developments of the last month. We have external members of the MPC at Court when we are discussing the latest economic situation. I personally interview every single member of the MPC in the first quarter of the year to ensure that they are getting the support that they require and to make sure that there are no governance issues about which they have concerns.

Now I see a similar sort of operation developing also for the FPC, where the Court would invite members of the FPC to attend Court to discuss financial stability matters. We would of course, because it would be our responsibility, initiate the financial stability strategy, of course taking into account the contribution that was being made by the FPC. I would certainly envisage face-to-face interviews with members of the FPC. I hope this gives you a slight picture of how I think it might work as we go forward.

**Q50 Mr Ruffley:** All that would be minuted, would it?

**Sir David Lees:** Certainly. Everything that is said in Court, subject to the generality point that Roger made, is minuted. I think the arrangements for the FPC, as I recall them, are that the Governor and the Chancellor meet twice a year to review financial stability, and I think there is a published record of their conversations. I also understand that the FPC will be fully minuted.

**Q51 Chair:** I am a bit concerned by the reply you have just given, Sir David, to David Ruffley. Have you read the Government’s recent consultation document that it put out in February on this very issue?

**Sir David Lees:** Yes, I have.

**Q52 Chair:** It says something quite different. You, as I understand it, have just said to me that the relationship between the Court and the FPC should be similar to the relationship between the Court and the MPC.

**Sir David Lees:** I think I corrected myself by saying there are similarities. It would not be totally similar.

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**Q53 Chair:** Not totally similar, but not dissimilar—that, in fact, was the phrase you used.

**Sir David Lees:** Not dissimilar in certain respects.

**Q54 Chair:** Okay. I do not know whether you trained as a lawyer but most people here would consider all those phrases to be pretty much in the same ballpark.

**Sir David Lees:** No, I trained as an accountant.

**Q55 Chair:** The MPC's central objective is to set short-term interest rates, to control inflation. You have no oversight of that, do you?

**Sir David Lees:** No, just processes.

**Q56 Chair:** But the central objective of the FPC—

**Sir David Lees:** Is to contribute.

**Chair:** Is to ensure financial stability, and in that document it makes clear that the Bank will be accountable to the Court for the contribution it makes to that central objective, so whereas with the FPC you are on point as the key body to which the Bank is accountable for securing its central objective, with the MPC you are specifically told to keep out of it. That does not sound “not dissimilar” to me. It sounds completely different.

**Sir David Lees:** I was really concentrating on some of the process points. You are absolutely right in defining the financial stability responsibilities to say that the FPC is a contributor, and the Court is ultimately responsible, and that, I think, is what I said.

**Q57 Chair:** Can I go back to another remark that was also made in reply to a question by David Ruffley? “People would only have listened when it was too late.” Was the Court shouting internally?

**Sir Roger Carr:** I think we were all participating—

**Mr Ruffley:** In a learning situation?

**Sir Roger Carr:** With respect, I think the whole of the world was in a learning situation.

**Q58 Chair:** Yes, but was the Court shouting internally? Were you warning internally?

**Sir Roger Carr:** The Court's role is to participate, to support and to challenge, and where it believes things are not being done correctly at the time, to make it clear that it believes more should be done. From memory, I do not believe at the time we felt that more should be being done.

**Q59 Chair:** So when we get these papers we will not find any internal shouting?

**Sir Roger Carr:** I think you will find a record of debate, but there was no question, certainly in my mind—I can only speak from my perspective—that the people engaged in resolving the problem in the midst of the crisis were not fully engaged in so doing.

**Q60 Mark Garnier:** I want to talk about the relationship you have with the Treasury, and my question is directed specifically to all except Mr Barber, because I think all the others of you have been non-executive directors of PLCs. The Bank of England is to all intents and purposes a wholly owned subsidiary of the Treasury. How does your relationship as, if you like, non-executive directors of

the Bank of England, change, or how is it different to your experience of being a non-executive director to a PLC when it comes to dealing with your shareholders?

**Sir David Lees:** Of course, the fundamental difference is that the Bank is not a profit centre, and therefore, I think, in relationships with shareholders in the PLC situation, the profit motive and profit performance and so on is never very far away. That having been said, I think the relationships with our shareholder, the Treasury, are reasonably close. I cannot speak exactly for the Governor, but I know he has a whole series of interfaces, particularly with the Chancellor.

Speaking for myself, I have an interface with the Permanent Secretary, particularly in relation to appointments, and again, particularly in relation to the non-executive directors on the Court. I furnish him with my ideas as to the qualifications that are needed for members of Court. I have given him a performance review of the non-executive directors on Court. I sent the Financial Secretary to the Treasury the large document that I sent the Chairman, which is the forward-looking document dealing with the responsibilities of Court. I sent that to him, so I think our relationships are reasonably close.

**Q61 Mark Garnier:** What has the Permanent Secretary's reaction been to your report about the performance of other non-executive directors?

**Sir David Lees:** Very appreciative.

**Q62 Mark Garnier:** Of the fact that you wrote a report, or of the content of it?

**Sir David Lees:** No, appreciative of receiving it, appreciative of the amount of trouble that I had taken, and appreciative of the quality of the non-executive directors I had been a party to appointing.

**Q63 Mark Garnier:** I do not want to sound patronising, but it is not marking homework. We are talking about the Court of the Bank of England. Clearly there is a big issue about whether you are collectively competent, and what I am really trying to get at is how the Treasury is having an influence on the competency of the Court, and how they are using their influence as, effectively, the single shareholder, in terms of trying to influence that.

**Sir David Lees:** The Treasury has certain ways in which it could measure that, I think. For example, a Treasury representative attends on the Financial Stability Committee, the FSC, on which there are four members of Court, so he would get a reasonable view of at least those four.

**Q64 Mark Garnier:** That is quite a limited view. There are more than four of you on the Court.

**Sir David Lees:** I think it is a limited view, but it is the best that the present circumstances provide.

**Q65 Mark Garnier:** Would you suggest that there should be better scrutiny on the part of the Treasury in terms of the competency of the Court? It is interaction. It is not just what CVs look like, of course; it is how the Court works together and how

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effective it is. Would you like to see increased scrutiny from the Treasury on your competency?

**Sir David Lees:** I would not particularly mind at all.

**Q66 Mark Garnier:** Can I take that as yes, you would like it?

**Sir David Lees:** I repeat, I would not really mind. I am very confident in the competency of Court and its present membership; I believe that it is qualified to take forward the significantly enhanced responsibilities that will be falling to it. As a matter of fact, I asked the Permanent Secretary to give me a comment, if he would, on how he did see the effectiveness of Court.

**Q67 Mark Garnier:** I am delighted to hear that you are happy with the competency, but I think it needs to be more than just one person. Would you not agree with that?

**Sir David Lees:** As I say, the way in which communications with the Treasury have taken place I think should give them some comfort as to our competencies.

**Q68 Mark Garnier:** Okay. Sir Roger or Lady Rice, do you have anything to add?

**Lady Rice:** I would just make two small points, perhaps going back to your original question. We should not forget that the Treasury is involved in the process of appointing non-executive directors to the Court in the first instance. That is a position of tremendous influence from the start and we should not forget that.

The other question you asked was: how does our experience on the Court differ from private sector board experience? I hope this does not seem trivial—it may sound trivial to you—but I have experience of a wholly owned subsidiary of a clearing bank, as both an executive director and then subsequently for a while as chairman, but wholly owned by one shareholder, and the relationship there in a very small way is not all that different. There was one shareholder who would look at what we were doing; one shareholder to whom I would have to make my case on behalf of my board for what we would want to happen; and one shareholder concerned with the appointment of directors to my board. In fact, we ran as a registered bank with a full non-executive board, accountability to a regulator, public accounts and so forth. So to me there is a similarity there.

**Q69 Mark Garnier:** Funnily enough, I think that analogy is extremely important, because you have real direct experience of how a single shareholder can influence an organisation. Do you see that the Treasury is influencing you too much, too little, or just about right?

**Lady Rice:** Gosh. I see the relationship as being perhaps issue-by-issue, so the Treasury might raise an issue, ask us to consider something. I think, from anything I have seen, that there is a healthy dialogue and open doors of communication between the executives, the Bank and senior officials in the Treasury. I think that is really important. Who influences who at the end of the day is a matter of

coming up with what is best in the circumstances, and that should almost always be a matter of dialogue and conversation.

**Q70 Mark Garnier:** If you had a serious worry about the Court, who would you go to, to talk to about it?

**Lady Rice:** If I personally had a serious worry about the Court or how it was operating, I might turn to you Chairman, in a sense, because the Court has a responsibility here. I do not know if the door would be open—

**Chair:** It would, even on a confidential basis, if you want it to be.

**Lady Rice:** Or depending on the issue, I might possibly speak to someone in the Treasury, but I would have to think about this.

**Q71 Mark Garnier:** But there is no formal arrangement for whistleblowing?

**Sir David Lees:** Can I just make a very important point here? Just as in the private sector, all decently run boards do board effectiveness reviews, where the chairman or, occasionally, an outside party takes the views of all the individual directors, both executive and non-executive, as to the effectiveness of the board, so we do exactly the same thing in the Bank of England. It would be very difficult, I think, for any non-executive director to rush off to the Chairman of the Treasury Committee and say he or she was very unhappy about Court without at least having gone through the gamut of the annual effectiveness review. It just could not happen.

**Q72 Mark Garnier:** Okay. You talked a bit earlier about the fact that you did not have the profit motivation, in terms of running it, but you have an arrangement in the amendment of the 1946 Bank of England Act that you pay 50% of your profits to the Treasury by way of a profit split, as opposed to a dividend. Have you had any discussions about that?

**Sir David Lees:** In terms of it being too much, too little or—

**Mark Garnier:** Just in general.

**Sir David Lees:** No, I do not think so. We have accepted it as part of the statute.

**Q73 Mark Garnier:** So you do not feel the dividend cover of two times is too little?

**Sir David Lees:** No, I do not think I see the dividend cover in the Bank quite in the same way as I would in some of the public companies.

**Q74 Mark Garnier:** The Treasury has not said, “Can you help by being a bit more profitable?” No?

**Sir David Lees:** I mean, they could make us much more profitable at the stroke of a pen by changing the customer deposit ratio, but—

**Q75 Mark Garnier:** You have seamlessly come to my next point. One of the main aspects of the Treasury revolves around this money, because you have to look at profitability to make sure you are functioning properly, but you are also taking on a whole lot of new policy functions. Are these new

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policy functions going to be funded from the CRD scheme, or are you going to get help from the Treasury in order to pick up some of these extra costs? Or are they going to change the dividend cover, if you like?

**Sir David Lees:** I think the CRD ratio arrangements come up for review in two years' time. That will certainly be an issue. The ratio up to 2008 was, I think, 0.115, and it has now come down to 0.11. I think there must be an expectation in the light of these increased policy responsibilities that it may need to creep back up again.

**Q76 Andrea Leadsom:** I am still very concerned about this issue of accountability and the level of engagement with the Bank itself of the Court of Directors. In particular, Sir David, both you and Mr Barber made the point that during the financial crisis the Bank had done the best it could within its very limited authority and powers, and you cited the tripartite regime as a reason why it was unable to do more. Yet it is true, is it not, that the MPC had the ability at any time to raise interest rates to try and take the sting out of the credit bubble as it was rising? Did you at any point during that period try and challenge the Bank on what it was doing on the ground, so to speak, rather than just shouting loudly or not loudly enough, to make a difference practically to the credit bubble?

**Sir David Lees:** I cannot answer the question because I was not there, but I am sure Mr Barber can.

**Brendan Barber:** You have to recall that the Court's relationship with the MPC is limited to oversight of the MPC's processes. Although we have a regular dialogue with the MPC on their decisions, we have no authority to challenge the policy decisions they reach month by month.

**Q77 Andrea Leadsom:** That is a very interesting point, because it brings me on to the fundamental issue, which is going forward. You said yourself, Sir David, that the buck now stops with the Bank and that will make things much easier, but is that going to be the case? Of course, now, you will have the very much more hands-on responsibility for ensuring that the Bank meets its objective within the FPC of stability of the financial sector, but on the other hand if you see that it is not meeting its objective, how can you stand back and say, "We have no view on interest rates"? If there were another bubble, for example, and quite clearly raising interest rates would take the heat out of it, and you are required to ensure that the Bank is meeting its stability objective, are you going to stand back and say, "You are failing to meet it, but we are not going to suggest or challenge you on any of the possible remedies"?

**Sir David Lees:** I think that could provoke a very interesting debate in Court. As Brendan has said, we have no direct responsibilities in the monetary policy field. We will have significant responsibility in the financial stability field. To the extent that there is a clash between the priorities of those two different wings of the Bank, if I can describe them as such, I think we would probably have an extremely interesting discussion in Court.

**Q78 Andrea Leadsom:** How are you resolving? Are you looking at some scenarios? Clearly, your role is changing greatly, and the Governor's role is changing greatly. What sort of scenario-testing are you doing? You said, Sir David, that the buck will stop with the Bank, but that is not strictly true, is it? The buck will stop with the Bank, with you clearly accountable for ensuring that it meets its financial stability objective. You also have European regulators that in future will have teeth, whereas previously they were more of a talking shop. What happens when there is a massive risk to financial stability, let us say from a derivative shock or something—something we have not seen before—and your view as the Court is that the Bank is failing to meet its financial stability objective because of something the European regulators are doing, or because of too tight or too easy monetary policy at home. What sort of work are you doing to ensure that you are able to meet those challenges?

**Sir David Lees:** We are not doing any work at this time because the new responsibilities do not even devolve until January 2013, but I think that is exactly the sort of scenario-planning that the Bank will have to engage in as we get nearer the finalisation of the legislation.

**Q79 Andrea Leadsom:** Obviously, right now we are in a massive consultation period. As you know, we have just had a huge inquiry into regulation. Are you contributing to that with your concerns about your ability to hold the Bank accountable?

**Sir David Lees:** We have not contributed yet on that specific point.

**Q80 Andrea Leadsom:** But do you intend to?

**Sir David Lees:** I think we should give it consideration, yes.

**Q81 Andrea Leadsom:** Okay. Turning to another point, it is still a slight mystery to me where the accountability for quantitative easing lay. Clearly, at a time of great flux, when, as you have said yourselves, everybody was learning on the hoof and so on, to what extent is the Court of Directors looking at, or considering, holding the Bank accountable for its policy on quantitative easing—£200 billion of taxpayers' money, for good or ill? You have already said you have no profit motive at all, but to what extent are you accountable for ensuring that taxpayers' money is carefully watched over, that we do not enter into more quantitative easing, or indeed reverse that at a massive loss to the taxpayer? Do you have any responsibility to the taxpayer to look after their interests during this period where quite clearly the Bank of England has operated well outside of its normal remit?

**Sir David Lees:** I would say that the quantitative easing has essentially been part of the monetary policy tools and as such is a responsibility of the MPC, and not the Court.

**Q82 Andrea Leadsom:** So in other words the MPC is not accountable to anyone for the quantitative easing policy? That is how it has always appeared to me, and I think you are now confirming that.

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*Sir David Lees:* I think the MPC is responsible for monetary stability in the round.

**Q83 Andrea Leadsom:** But who is it accountable to?

*Sir David Lees:* To Parliament. To you.

**Q84 Andrea Leadsom:** Accountable directly to Parliament?

*Sir David Lees:* To you. We have not experienced them, but you have frequent hearings with the MPC, don't you?

**Q85 Andrea Leadsom:** It is certainly not clear to me that there is an explicit accountability to, for example, this Committee, which would be the conduit. I am looking to the Chairman here for confirmation, but it is not clear to me that this Committee has ever taken responsibility for the MPC's quantitative easing programme. In fact, it was at our specific request that we were invited into the Bank to hear about it just before Christmas, when all £200 billion of it was already outstanding. It is certainly not clear to me that we had any involvement in that discussion.

*Sir David Lees:* May I respectfully suggest that next time you have an MPC hearing, you put that exact question to them: where does their responsibility for taxpayers' money lie? I see it, frankly, and I think everybody in the Bank sees it, as a monetary policy tool, used particularly when interest rates essentially cannot go much lower, and therefore as a way of fulfilling their monetary policy stability responsibilities.

**Q86 Andrea Leadsom:** One last question, on a slightly different topic. Recently, we have heard the Governor of the Bank of England making a speech saying that we are only a small crisis of confidence away from another financial crisis, that nothing has really changed, and that breaking up the banks is the solution. As the Court of Directors, do you hold him accountable for his personal views? Are you happy that he expressed his personal views at a time when there is a quite significant consultation going on as to what should happen to the banks to try to avert a future financial crisis? What are your views on that?

*Sir David Lees:* I have not heard him specifically say what you have just quoted him as having said. The Vickers Commission is to report, I think, next month on recommendations on the future of banking. I do not doubt that it will have taken evidence from the Governor, but I do not even know that they have.

**Q87 Andrea Leadsom:** But my point, Sir David, is really whether you believe, and consider it to be your role, to hold the Governor of the Bank of England accountable for the opinions he expresses in a public domain in areas that are not strictly speaking within his remit? Is it appropriate, and what are your views on it as a body?

*Sir David Lees:* I think this is a matter of degree, quite honestly. If the Governor, hypothetically, was making statements on taxation policy or public sector borrowing, I think that would worry us quite a lot. I think that hints on how he might like to see the Vickers Commission report would be a lesser matter

of degree, but I would certainly say this: if he was to venture far into fiscal policy in ways that I have just suggested, then I think it would be necessary to have a discussion with the non-executive directors in the first instance to determine what action, if any, we should take.

**Q88 Andrea Leadsom:** Can I just press you slightly on that? Clearly, for the Governor of the Bank of England to say that the banks needed to be broken up is an enormous political statement, as well as having fundamental implications for what is one of our most lucrative industries in this country. It is clearly also not within his brief to express a view, bearing in mind the high-profile nature of his role. I put it to you again: is it not something that the Court of Directors should have a view on—where it is appropriate for the Governor of the Bank of England to be commenting?

*Sir David Lees:* I am not clear about the quotation that you have used to illustrate your point. Is it an absolute quotation, or illustrative?

**Q89 Andrea Leadsom:** It is both. It was a speech that he did three weeks ago. It was very widely reported. I am sorry; I should have brought it. I assumed everybody would have heard the speech and been very familiar with it, so I am slightly surprised that you are not.

*Sir David Lees:* I am afraid we have so many speeches in the Bank that it is almost impossible to keep up with them all, even the Governor's.

**Q90 Andrea Leadsom:** This one is quite exceptional because of the extent to which it was not about monetary policy, financial stability or the future for regulation.

*Sir Roger Carr:* Can I assist the Chairman? I have two points, really. If the Governor strayed into political territory, as a Court, we would find that very difficult to accept and would raise it. If the Governor puts forward options for thought-provoking discussion, we would find that acceptable, because it is his role so to do. If he speaks loudly on issues that he has concerns about that are fact-based and non-political, then I think that is something that we would be very comfortable with, in the sense of the concern of the previous period, where we look back and say, "Could the Bank have shouted louder?" I think if we learned anything from that, it is that when we have a view that is non-political, fact-based and appropriate, it should be said loud and clear.

**Q91 Chair:** Sir David, I think you just said a moment ago that you find it hard to keep up with all the speeches of the Governor.

*Sir David Lees:* Not the Governor.

**Q92 Chair:** You do not mean that, though, do you?

*Sir David Lees:* No, I do not.

**Q93 Chair:** You are telling us that you do not read all the Governor's speeches?

*Sir David Lees:* No, I certainly read all the Governor's speeches.



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**Chair:** Good, I am very pleased to hear that. Chuka Umunna?

**Q94 Mr Umunna:** I must say I do find extraordinary some of the responses you have just given to Andrea. Chair, I notice that in the responsibilities of the Court, you are there partly to ensure the effective discharge of the Bank's functions, and obviously independence is absolutely key to that. I think, Sir David, you just said that if the Governor ventured far into fiscal policy, then you, as non-executive directors, would be looking to have a discussion with him. Have you had a discussion with him, as a result of him having spoken in some detail on fiscal policy?

**Brendan Barber:** There was a discussion in Court after the Governor was reported as having commented on fiscal policy and reported, indeed, to have very explicitly supported the current judgment that has been made by the Coalition Government.

**Q95 Mr Umunna:** Mr Barber, when was that discussion?

**Brendan Barber:** I forget which month it was exactly. It was at the point where—

**Q96 Mr Umunna:** Was it this year or last year?

**Brendan Barber:** This year. It was since the election and it was at the point where—

**Chair:** The election was in the middle of last year.

**Sir David Lees:** I think it was September, if I may.

**Brendan Barber:** Forgive me. It was at the point where the Chancellor was reported as apparently almost in a formal way seeking the view of the Governor and the Bank on the fiscal policy stance that the Government were taking.

**Q97 Mr Umunna:** What was asked of the Governor and what was his response?

**Brendan Barber:** The report suggested that the Governor was giving strong backing to the judgment that the Government had reached. Certainly, I was concerned that the way in which this issue was being reported carried an implication that the Governor, and the Bank indeed, was being asked to take a view on something that was being presented in, if you like, a highly party-political way. I expressed concern at the Bank being put in that position and risking having its political independence being seen to be in some way compromised.

**Q98 Mr Umunna:** What was the Governor's response to this?

**Brendan Barber:** The Governor's response was to explain that he, at an earlier stage, indeed had been widely publicly reported as saying he felt it was important that any Government had a credible strategy for reducing the deficit, and that in his latest remarks, which were being reported at the time, he had simply reaffirmed that stance. He confirmed as well that contrary to the impressions being given by the press reports, he had not taken any view on, for example, the balance of measures to reduce the deficit, decisions on tax as against decisions on spending and so on; that those were matters for entirely legitimate political debate and he had explicitly not been drawn

into commenting on those matters. So the press reporting of his remarks was rather misleading.

**Q99 Mr Umunna:** Were you satisfied with his explanation as a Court, Sir David?

**Sir David Lees:** I think Court was generally satisfied with that explanation.

**Q100 Mr Umunna:** Have you had a discussion with the Governor since this point on the same issue?

**Sir David Lees:** No.

**Q101 Mr Umunna:** The problem with what you are saying is that, as a matter of fact, he has ventured into fiscal policy several times since. He gave a speech in Newcastle on 25 January in which he not only referred to the UK economy and a credible medium-term path of fiscal consolidation being followed but said—this is the last sentence in that speech—that “the right course has been set and it is important that we maintain it.” Earlier on in his speech he talks about one of the conditions necessary for a successful rebalancing of the economy, and refers to the significant fiscal consolidation over the next five years. That is not only commenting on the Government's fiscal policy and approving it, but going into more detail and providing comment on the speed and the time frame within which fiscal consolidation is followed. Are you comfortable with that?

**Sir David Lees:** Let me just report on the discussion in Court. As Brendan has pointed out, the discussion in Court at the time—I think it was September, but it might have been the month after that—was on his comment, his justification if that is the right word, of the need for a credible fiscal deficit.

**Q102 Mr Umunna:** Yes, Sir David, you have already mentioned that, but I have just demonstrated to you and illustrated that in the speech that the Governor gave in Newcastle, he has gone somewhat further than that test. I am asking you whether you are comfortable with that, and what you are going to do about it.

**Sir David Lees:** I am not terribly comfortable with that, because that is moving a bit away from the general into the particular, but I think that the scale of that fiscal intervention, if I may call it that, would not have been so great as to have created a problem with the other members of Court.

**Q103 Mr Umunna:** You see the problem I have with what you are saying, Sir David, is that you have not had a discussion since you had a conversation on this issue in Court in September with the Governor. You have just told me that you are not comfortable with the comments that the Governor made on 25 January in Newcastle, and I also see in the written evidence that you provided to us that you often interview the members of the MPC to ensure that they are receiving the support that they need and that there are no governance issues that are causing concern. I would be quite surprised if you had not seen the reports or even read the evidence that we took from the Governor when he appeared in front of us at the end of last year with Adam Posen and Andrew Sentence, but Adam Posen in evidence to this Committee said

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that some members of the MPC were concerned about the potentially political nature of a paragraph that it was proposed be included in the Inflation Report. I just find it quite strange that in light of all these happenings, you have not had a discussion with the Governor again about him commenting on fiscal policy. Given it is your responsibility to meet with MPC members regularly, did you speak with Adam Posen following his appearance in front of this Committee at the end of last year?

**Sir David Lees:** I have seen all the members of the MPC including Adam, including Andrew Sentence—the whole lot.

**Q104 Mr Umunna:** Have you seen Mr Posen since he appeared in front of this Committee?

**Sir David Lees:** Yes.

**Q105 Mr Umunna:** Did you discuss the issues that he spoke about to us with him?

**Sir David Lees:** No, and nor did he discuss them with me.

**Q106 Mr Umunna:** But why not? Is that not your job—to ensure that the independence of the Bank of England is maintained? You have a member of the MPC appearing in front of this Committee clearly raising concerns about the Governor intervening and interfering in political issues and you did not think it was necessary for you as Chairman of the Court to talk to that MPC member about those concerns he raised in front of us?

**Sir David Lees:** No, I did not, because he did not raise it with me. If he was sufficiently concerned, then I would have expected him, as part of the process, to have raised it with me.

**Q107 Mr Umunna:** You presumably read or watched the evidence that he gave to us. Did you not have concerns? Why do you have to wait for him to initiate that conversation? Is that not one of your duties to raise the issue with him?

**Sir David Lees:** I think that it is my responsibility with individual members of the MPC to listen to what they have to say, to hear their concerns about processes, about the support they are receiving and any other matters, including governance matters.

**Q108 Mr Umunna:** It is interesting that you talk about governance, because I think one of the concerns that many have had is the way in which Ministers have sought to draw the Governor into matters political. You had the former Chief Secretary to the Treasury, David Laws, in his book, “22 Days in May”, very explicitly referring to the Coalition negotiations, the £6 billion-worth of in-year cuts that the Government were going to pursue, and the fact that “Mervyn and Nick”, referencing Nick of the Treasury, “are very supportive of what we want to do.” You have the Deputy Prime Minister explaining his change in position on fiscal consolidation in *The Observer* on 6 June last year, based on a conversation he had with the Governor, and you have the Chancellor explicitly stating, when he appeared in front of us at the end of last year, that his plan B would be looking to the MPC

to further loosen monetary policy. Are you comfortable with Government Ministers involving the Governor in matters political in this way? I address that to each and every member. If we might start with you, Mr Barber.

**Brendan Barber:** I am not comfortable. I was very uncomfortable that the Chancellor chose to pose the issue in that very public way, which then resulted in the Governor’s kind of comment being reported in a certain way. I was reassured by the Governor’s response when I raised this matter in Court, and I was reassured when, in his speech to the TUC in September last year, he made it very clear that matters of judgment on the timing of deficit reduction measures and the balance of measures were issues on which there should be entirely legitimate political debate, and he was offering kind of “no comment” on those issues.

**Q109 Mr Umunna:** But he commented on that in January in Newcastle, when he talked about fiscal consolidation over the next five years being a necessary condition for a rebalancing of the economy. What do you think of that?

**Brendan Barber:** I did not see that as a significant variation from his earlier comment, many months earlier, on the need for a credible strategy for fiscal consolidation. I would draw a very clear distinction between that and the political presentation that was made that his remarks amounted to a clear endorsement of the Coalition Government’s decision to make an early package of cuts, £6 billion or so, and to establish the timetable that we now see being followed through by the Government. They sought to present his remarks as an endorsement of their strategy in all that detail, and I think that was very unfortunate and did risk getting the Bank drawn in, in a rather unhelpful way, to what is clearly a very political debate.

**Lady Rice:** Without repeating and revisiting those specific points, the one thing I would say, because I think this underlies your question to some extent, is that the independence of the Bank is paramount and it is in everything that we do, and the independence of, as has already been stated, monetary policy approach; those are very important matters. In terms of what was stated and how it was interpreted, there are different ways to look at this, but I believe that the Governor made clear where he was coming from. I do not believe he intended to speak with a strongly political voice but one has to be very wary if that is how comments are being interpreted.

**Q110 Mr Umunna:** Lady Rice, this has been a big issue. It has been very widely reported, and it is a huge matter of public interest. Sir David said that you had a discussion with the Governor about these issues back in September. There have been significant developments since then, and it does not seem to me that you as a Court have seen fit to follow up on this and to certainly visibly demonstrate that you are safeguarding the independence of your Bank.

**Lady Rice:** I can probably only repeat what Mr Barber said, which is that the statements more recently were in line with—or at least, I believe, to our ears, very

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similar to—what was stated earlier, which had been discussed with the Governor.

**Q111 Mr Umunna:** So you are comfortable with the Governor expressing a view on the time scale that is pursued for fiscal consolidation by the Government?

**Lady Rice:** Not necessarily comfortable. I think that it may behove us to have a further conversation.

**Q112 Mr Umunna:** Why are you uncomfortable?

**Lady Rice:** I did not say I was uncomfortable; I said I am not necessarily comfortable, and you are raising legitimate questions and it may behove us to have a further conversation. What I am saying is I do not believe there was intent to interfere with a proper political process, and I do believe the Governor understands those distinctions. The way words are stated, the way they are interpreted, is something else, and it matters; interpretation and perception matter, and I think that is something that perhaps needs further discussion.

**Sir Roger Carr:** The integrity and credibility of the Bank is absolutely dependent on it being seen as not having a political axe to grind. That to me is of paramount importance. We have made that very clear to the Governor. The Governor has made it clear to us that he is not expressing a political opinion. Naturally, as the Bank has a greater embrace of all matters of financial stability as well as monetary policy, he will give comment from an objective economic point of view on all aspects. What he must do is stay away from political support, and what the politicians must do is not to seek to draw him in to make it appear as though he is giving political support.

**Q113 Mr Umunna:** Do you think they have done that, Sir Roger?

**Sir Roger Carr:** I think it was unfortunate the way he was commented upon and quoted by the politicians of the time, and I think the newspapers found it very good to publish considerable comment. You should be clear, because we are appearing before you to try and give you confidence in our view, that we are adamant that this Court should make sure that it stays away from any political commitment at all, and that we remain objective and clinical. That is something that we will reinforce in all discussion. I believe the Governor understands that absolutely.

**Q114 Chair:** A moment ago, Lady Rice, you said, “We may have a further conversation about this.” Let us suppose that in that further conversation you conclude that you are not happy. What are the courses of action open to you?

**Lady Rice:** What course is open to us, in terms of taking action? I suppose if the Court concluded that, there would be a conversation specifically between the Chairman and the Governor; the Court delegates responsibilities for management of the Bank to the Governor, who is accountable back to the Court. That is the way our governance works.

**Q115 Chair:** Okay, so you have a further conversation with the Governor; and then what?

**Lady Rice:** It depends on the outcome of the conversation. I am not sure where your question is going, so forgive me.

**Q116 Chair:** I am trying to work out what action the Court may reasonably take in such circumstances. Sir David, you are clearly pregnant with a thought so—

**Sir David Lees:** I am pregnant with a thought, yes. I think that in the circumstances to which you have referred, and partly reflecting the general contributions across this bench, what would have to happen in practice is that the non-executive directors—there is a thing called NedCo which you have probably seen reference to in some of the papers—who, incidentally, would meet in any event to appraise the Governor’s objectives and his performance against his objectives, would need to come to a conclusion as to whether or not the venture into the political world was of such an acute nature or they felt sufficiently strongly about it to require me, as their Chairman, to have a serious conversation with the Governor. I think that would be the process.

**Q117 Chair:** Okay, then you have a serious conversation, and this problem continues. Then what? I am trying to get at what exactly the Court’s line of action and accountability is.

**Sir David Lees:** I think there would have to be another very serious conversation.

**Q118 Chair:** Okay, then we have a very, very, very serious conversation. There is still no progress; then what?

**Sir David Lees:** Then I would need to think very, very hard after the first very serious conversation as to what I was going to do.

**Q119 Chair:** Then what are you going to do? After you have thought very hard, what are you going to do, Sir David?

**Sir David Lees:** By then we are in 2013 and there is a new Governor in place.

**Q120 Chair:** All right. In other words you will spin it out, play for time?

**Sir David Lees:** No, I do not think that is true.

**Q121 Chair:** Okay. What should I conclude from your answer? This is a very serious issue.

**Sir David Lees:** I know it is a serious issue, and I appreciate that it is a serious question. I would have to hope that the situation that you hypothesised upon did not happen, because—

**Q122 Chair:** Okay, well we are past that. We are now at the point where I am discussing with you a circumstance where it has happened and we can move out of the particular into the general. It need not be about fiscal policy; it could be about some other action, any action. It is clear that the fiscal policy issue did not warrant very serious action; it went to discussion and it was settled. That is clear from all your conclusions.

**Sir David Lees:** In the circumstances where the non-executive directors had required me to, or I had

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opined that I should, speak seriously to the Governor about this breach and it had not resulted in a successful outcome, in other words there were repeat—

**Q123 Chair:** Then what do you do?

*Sir David Lees:* I come to you.

**Chair:** Right, okay. Do you think that the—

*Sir David Lees:* Because I don't know who else I can go to.

**Q124 Chair:** Do you think we ought to take a look at the grounds for removal of members from the Court, including conceivably very senior executives including the Governor, as part of our inquiry into the accountability of the Bank of England? At the moment they can only be removed if, I quote, they are “unable or unfit to discharge his”—by the way, it has just got “his” in there—“functions as a member.” Do you think that that is an adequate trigger going forward?

*Sir David Lees:* Three months absence as well, I think, is another condition, isn't it, without consent?

**Q125 Chair:** Yes, it is. Do you think that we should open up that question? While you are reflecting on it, do you think, for example, that the arrangements that have been put in place for the accountability of the OBR and the appointments to the Office for Budget Responsibility might have something to teach us here?

*Sir David Lees:* Yes, I think this is something that I would like to give a lot more thought to than I have.

**Chair:** Okay, you don't have an answer; that is fair enough.

*Sir David Lees:* I don't have an immediate answer to you.

**Chair:** Okay, would you reflect on it and perhaps—

*Sir David Lees:* Drop you a note.

**Chair:** Whatever you prefer. I am sure other people are thinking about this question. Stewart Hosie?

**Q126 Stewart Hosie:** Can I go back to the FPC? That committee will be a committee of your Court, rather than a committee of the Bank, like the MPC. Does that offer them more freedom to comment on non-monetary policy and non-macro-prudential policy than, for example, the MPC has, and would you be comfortable with that?

*Sir David Lees:* Would I be comfortable with—

**Stewart Hosie:** If the FPC were commenting on—

*Sir David Lees:* Monetary policy.

**Stewart Hosie:** Not monetary policy and macro-prudential, but perhaps on fiscal policy and on other areas that weren't necessarily macro-prudential.

*Sir David Lees:* I think we have probably extensively covered comment on fiscal policy. I am not dodging your question, by the way but one of the—

**Stewart Hosie:** It's all right, I wouldn't let you dodge it.

*Sir David Lees:* No, I know you wouldn't. One of the by-products of this year's interviews with the MPC members was a more or less universal view that we could do with a code of conduct in the Bank on speech-making—just the rules of the game—because external members in particular have a pretty fair

degree of freedom but we do need, I think, to be very clear about the rules of the game.

I think the same would probably apply to the FPC. It is, I think, particularly difficult with external members to restrict in any way their right to express an opinion, but one of the things that can happen, particularly with the journalists' fraternity, is that the interpretation of personal views becomes, in some way or other, a Bank view or an FPC view, and that's not right.

**Q127 Stewart Hosie:** Let me come to the external members later, because I do understand what you are saying there about the difference between a personal view and an official view. The responsibility for the FPC will be for considering the macro-economic and financial issues that may threaten financial stability, so one would imagine they would have to range wider than simply money supply, capital ratios, leveraging rules and obvious macro-prudential; they would almost be obliged to look at fiscal matters because of the impact that it could have, is that not the case?

*Sir David Lees:* In a committee, you are absolutely right. I think the extension of our earlier conversation as to members of a committee of the Bank externally expressing views on fiscal policy more or less takes us back to where we were about 15 minutes ago.

**Q128 Stewart Hosie:** Indeed, and I don't really want to get right back there because there is a difference between the MPC as a committee of the Bank and the FPC as a committee of the Court, with different responsibilities and even the powers that are suggested; they can certainly influence macro-prudential policy in Europe and internationally, and they certainly have some powers of the PRA and the FCA—again in relation to macro-prudential tools—but they are also able to make public pronouncements and warnings and make recommendations to bodies other than the PRA and the FCA. If they thought that, for example, debt levels were too high and there was a very real risk of a sovereign debt crisis, that would clearly be significant in terms of their obligations, and they would then therefore have to range more widely than the monetary and the macro-prudential. I'm just trying to understand where the limits on this might be.

*Sir David Lees:* I think this is a question really that the Chairman of the FPC should be addressing. What I would say is that there is the twice-per-annum Financial Stability Review, and that should be a medium for communication about general concerns about some of the things you have just mentioned in the FPC area. I know that one of the areas on which some concentration is now going to be given is the precise format of that Financial Stability Review, because it is a key document of communication.

**Q129 Stewart Hosie:** I want to press this just a little further; there was a lot of talk at the beginning when the FPC was mooted that it would have some kind of role and a system of counter-cyclical economic policy—very sensible. That appears to have gone entirely. I happen to think that it was a good idea that it had some of those responsibilities. Do you think it would be safe to say there is not yet clarity or enough

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clarity about the role, responsibility and remit of the FPC? Would it be fair to say that?

**Sir David Lees:** I don't think that is an unfair comment, and I suspect that that makes the case very strongly for the interim FPC, because I think it's the interim FPC that is going to give considerable attention to many of the things that you've raised.

**Q130 Stewart Hosie:** That's interesting, because I know that one of the roles of interim FPC was to define the tools and levers that it might have.

**Sir David Lees:** Indeed.

**Stewart Hosie:** You did say earlier that the FPC would need the tools for the trade. Would you, or the Court, be prepared to put a little more consideration into what tools and levers the FPC might have, and how widely it might be expected to range to fulfil its obligations and not to enter the world of politics, and to come back to us with some information later as to a more considered view from the Court?

**Sir David Lees:** I think, if I may just say this, that step one in this process is for the FPC to develop what they consider are the appropriate macro-prudential tools to enable them to carry out their work. I suspect, as part of the FPC strategy going forward, that that will be a key issue that will be coming to the Court.

**Q131 Stewart Hosie:** That's helpful. The final question goes back to something you said earlier. Irrespective of how far or how narrowly the FPC can range, what will the relationship be between the external members of the FPC and the Court? How will that work?

**Sir David Lees:** I think I probably answered that question earlier, perhaps not as articulately as I might have done. The MPC external members' relationship with the Court basically comprises first attendance at Court meetings, and secondly an annual interview with myself. Thirdly, a more recent innovation is for the external members of the MPC to have dinner with the non-executive members of the Court, to free up and to get a communication going, so that if they have any concerns they can feel free to communicate it. I see a parallel with the FPC; I think we would invite them to Court, we would wish to do the annual interviews in the same way, and we would want to try and get nearer and closer to them, because it's quite a lonely job being an external member of the MPC, as a matter of fact—not that I've done it, but I imagine it is.

**Stewart Hosie:** Thank you.

**Q132 Mr Love:** I want to come to the design of the new regulatory structure within the Bank, but before I do that, can I go back to comments that Mr Umunna made in relation to being too political? I'm looking at that in terms of the reputation of the Bank. Wouldn't it be right, Sir David, for me to say that at the meeting where you discussed these matters, it was only Mr Barber that raised concerns, or was there widespread concern among the Court about the so-called politics that the Governor was being involved with?

**Sir David Lees:** Mr Barber very properly raised the concern that he has described to you all—

**Q133 Mr Love:** I'm aware of that; what I want to know is whether other people raised similar concerns, or whether he was an isolated member of the Court in relation to that.

**Sir David Lees:** I don't recall—and Susan or Roger may put me right on this—anybody voicing an opinion one way or the other. I do recall the Governor responding in the way that Brendan has just replied.

**Mr Love:** No, I understand that. In relation to—

**Sir Roger Carr:** Can I just intervene and say that I think you shouldn't sort of interpret that as nobody else being concerned. Mr Barber raised the point, which was a very valid point to raise because it is a concern to all, and the response we got to that point was satisfactory at the time.

**Mr Love:** No, I understand that and you've made that clear.

**Sir Roger Carr:** Fine.

**Q134 Mr Love:** What I'm interested in is that the impression you're giving here—not just on this issue but on other issues—is that you have a somewhat standoffish view of your role in relation to some of these matters, but perhaps you will correct that.

**Sir Roger Carr:** No, quite the reverse.

**Q135 Mr Love:** Okay, let me pursue the point I'm trying to make, just for a few seconds. When Mr Posen came before the Committee, he made it clear that while there was a majority on the Monetary Policy Committee for including the paragraph that he objected to, he would have to accept that that was a majority decision, but there was more than him; I think he suggested that there were several members who had similar concerns to him, yet that doesn't seem to have raised any alarm bells with the Court. Was this ever discussed at the Court? You have already indicated you didn't discuss it with Mr Posen; was it not of concern to you, from the reputation of the Bank, that there should even be a discussion of the political nature of a paragraph in their report?

**Sir David Lees:** Yes, I don't honestly think we can say very much more than we've already said. Brendan appropriately raised the point; Roger has said that we shouldn't assume that because nobody said anything else that there wasn't concern. I think we've made it very clear what we would do in circumstances of a repeat or even more serious nature, and I honestly don't think we can say any more. I'm sorry to disappoint you, but—

**Q136 Mr Love:** I don't think it's a matter of disappointment; it's a matter of how you interpret your role that we are concerned about here. I do want to move on, but let me just make one final observation on the role of perception in politics, because it is the perception that is the reality in politics, and the perception among a wide cross-section of the media, and indeed in political circles, is that the Governor's interpretation of what is the line between fiscal and monetary policy may differ from that of many others. I would have thought, in terms of the reputation of issues that the Court would be concerned about, that they would want to raise that issue with him to ensure that he took a conservative view of those perception

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issues and made sure that on no occasions did he stray into what could, by perception, be considered to be a political sphere.

**Sir David Lees:** We absolutely note your concerns, and I think we are concerned about perceptions because, as I think Susan or Roger just said, the independence of the Bank is one of the principal flags that we fly, and anything that does damage to that has got to be bad news.

**Q137 Mr Love:** Okay, I think we've exhausted that today. Let me move on to the new regulatory structures. Did the Court have any input whatever in the design of the new arrangements that you will have to oversee at the Bank?

**Sir David Lees:** The process that we have followed is—

**Q138 Mr Love:** I'm not really interested in the process; I'm asking you whether anyone from the Treasury, or indeed any other aspect of Government, consulted at any stage with the Court on what the design arrangements should be?

**Sir David Lees:** Not with the Court as such, but—

**Q139 Mr Love:** Don't you find that surprising since you will have a much more important role in terms of regulation than perhaps you have had in terms of monetary policy?

**Sir David Lees:** If I can just make the point that when the first ConDoc came out, the Court looked at the implications of the consultative document on the assumption that it would come into law, and we published internally a document very like the one that I sent your Chairman, which he may or may not have circulated to you. The purpose of that was to demonstrate to the Minister in question what the new responsibilities of that regulation would mean for the Bank and for the role of the Court. He and I entered into some correspondence on the basis of that document. We have done exactly the same thing for the second ConDoc, so to that extent we have been proactive. There has not been, apart from an interchange of correspondence, a direct consultation with the Court.

**Brendan Barber:** Would it be fair to add, Sir David, that there has been very, very heavy contact between the officials of the Bank—

**Sir David Lees:** Oh, absolutely.

**Brendan Barber**—and the Treasury officials working on the consultative documents, which has been very fully reported to the Court, enabling us to comment on the issues that were being considered as the drafting work was being done. Certainly, there was very heavy engagement in that form.

**Q140 Mr Love:** The impression you give, Mr Barber, is that they came in and reported to you, and you had a discussion, but at no stage did you either give a lead to the officials of the Bank in their negotiations; nor did the Treasury deem it appropriate to consult with you at an early stage, so that the outlines of the new structure were in place before you got involved.

**Sir David Lees:** Except that by identifying from the proposed new structure what the responsibilities of the

Court would be and having that approved in Court did actually mean that the Court had taken a very active interest and was reflecting a lot of work that was going on at official level between members of the Bank staff and Treasury officials. Had there been any major issues, as the Bill was being developed, with which there was discomfort from Bank staff, that would have been reported to the Court straight away.

**Q141 Mr Love:** Let me take an example: your role vis-à-vis the FPC and your role vis-à-vis the Prudential Regulation Authority seem to be somewhat different. Are you at ease, relaxed, and satisfied that your role in relation to both of them will be one that secures for the Bank overall control of regulations as we go forward?

**Sir David Lees:** Our responsibilities, as the Court, as you know, with regard to the PRA, is essentially to look at their costs, to look at their remuneration policies, and to review their strategy, and I think that gives the Court a reasonable handle on the PRA, particularly the last bit—the bit about reviewing the strategy—because that will be very important and it would of course be a precursor to anything that happens on the budgets and so on of that organisation. I am comfortable, but there is one thing I would like to say, if I may, which concerns both the setting up of the new FPC and the PRA.

There is an overlap, as you will understand, of the executive in those bodies; the Governor and the two Deputy Governors are common to both the FPC and the PRA. What I've urged on the Treasury is that we should have representation from the Court as non-executive directors. There should be one or two members of Court sitting on the FPC and another one or perhaps the same person, if he has got time, sitting on the PRA, because that more closely locks in the governance arrangements for the PRA, the FPC and the Court. The reception I have had to that proposal has been encouraging, but anything you can do, if you believe it, to support that would also I think be helpful.

**Chair:** Perhaps you could set out for us the proposal in just a tiny bit more detail with your justifications for it, and we would like to take a look.

**Mr Love:** That would be interesting.

**Sir David Lees:** I would like to do that.

**Q142 Mr Love:** I will ask two questions, because I'm being pressed by the Chairman to come to—

**Chair:** Two quick last questions and two quick last answers.

**Mr Love:** I wanted to ask about the role that the National Audit Office and, through it, the Public Accounts Committee will have within the regulatory structure, but the question I want you to focus on is this overall question that really is at the source of much of what we are looking at in relation to the Court. The Bank is now being placed at the centre of regulatory activity, yet if one looks back to previous days, when the Bank was at the centre of regulatory activity, its, shall we say, experience and expertise was called into question on many occasions. What we're looking to do is reassure ourselves that the new arrangements will address both the shortcomings that

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have endured in the credit crunch and any shortcomings from the previous regime when it was located in the Bank. Are you satisfied that the arrangements that are being put in place will allow the Court to be contented that they will be adequate to the task being set for them?

**Chair:** Please don't use that as an assessment of what constitutes a short answer.

**Sir David Lees:** Very briefly, I think the Court of today and the Court that was deployed back at the time when supervision was removed from the Bank are just so different as to make them not comparable. I am confident that the Court of today will be easily

able and capable of giving you the assurances that you are looking for; I sincerely believe that.

**Chair:** Thank you very much for coming to give evidence today. It has been something of a bumpy session at times; that is to be expected at a time when there is so much widespread public disquiet about this whole area of public policy. Your role is going to become much more prominent, and the question is: how should that accountability be structured in the future? We have only touched on a number of the big questions in the field, and if you have further ideas, we are very happy to see them, and are receptive to thinking about them. Thanks for coming today.

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**Monday 23 May 2011**

Members present:

Mr Andrew Tyrie (Chair)

Michael Fallon  
Andrea Leadsom  
Mr George Mudie

Jesse Norman  
Mr David Ruffley  
John Thurso

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**Examination of Witnesses**

*Witnesses:* **Dr Sushil Wadhvani**, former Monetary Policy Committee member, and **Professor Charles Goodhart**, former Monetary Policy Committee member, gave evidence.

**Q143 Chair:** Good afternoon. Thank you very much for finding the time to give evidence today and thank you both very much for your notes, both of which are full of interesting material. If I may start with Dr Wadhvani, can you explain to us why it is you think we should have one committee rather than two doing this work?

**Dr Wadhvani:** Good afternoon. It is a pleasure to be here; thank you for inviting me. I worry a lot about splitting the committee in two because of the co-ordination issues. If, for example, it turns out that we get another housing boom and the FPC wants to tighten lending requirements and it essentially increases capital requirements, which then widens lending margins and it puts rates up, that will then slow the economy and by slowing the economy might then lead the MPC to expect inflation to undershoot the target. There is then a risk that the MPC responds to this by cutting interest rates, and you then get into this unproductive game.

The other issue that this raises is related to accountability, because the FPC might come here and say to you that we did increase capital requirements but we were not successful because the MPC actually cut interest rates. The response I think you will get in relation to this critique is that there is overlapping membership and that the MPC meets more frequently than the FPC. I think that certainly would alleviate the problem to some extent. However, it would be much neater to have them all in as one committee because there is still the risk of co-ordination failure and there is still the risk—

**Q144 Chair:** What do the Americans do, the Fed?

**Dr Wadhvani:** In terms of the Fed, ultimately it is all under one roof and ultimately, as I understand it, the chairman has sign-off on all these sorts of decisions.

**Q145 Chair:** Do you want to add anything, Professor Goodhart?

**Professor Goodhart:** I do not actually agree with my colleague on this point because his point about co-ordination could be made exactly the same way with fiscal policy. If the Government decides to tighten taxes, then it could be that that will slow the economy and then the MPC would respond. If you don't worry about co-ordination problems between fiscal policy and monetary policy, I don't see why you should worry about co-ordination problems between the Financial Policy Committee, which is a different set of instruments, and the Monetary Policy Committee.

**Chair:** I think people do worry a lot about fiscal and monetary co-ordination, but we will come back to that in a moment. I know that Andrea Leadsom wants to come in.

**Q146 Andrea Leadsom:** First, I must apologise because I have to go in literally five minutes, but I wanted to particularly ask Dr Wadhvani a question about what the Court Directors told us when we had them in, namely that they had not carried out a full investigation into the financial crisis. The Committee was quite astonished, and I wondered if you could give us your own thoughts on that.

**Dr Wadhvani:** I too was astonished by the minutes of that hearing. It seems to me that the narrative that they offered you about the crisis was potentially too simple because, to paraphrase, what they said to you was that essentially the problem was that the Bank did not shout loud enough or that where the Bank wanted to do something, they were limited by the lack of instruments. That is certainly one possible interpretation of the Bank's role but I think many independent observers would regard that as being rather charitable to the Bank.

It seems to me there were a whole host of issues that certainly deserve further investigation. One is the whole Northern Rock episode where the Bank has pointed to the absence of a special resolution regime, but others might point to the possibility that the Bank should have been more aggressive in terms of liquidity injections, like the ECB. Another is this whole issue of the fact that the Bank did not use monetary policy to lean against the emerging bubbles. The Bank says, "We didn't have the macro-prudential instruments", but when you do not have all the instruments available to you, you can still use what you have.

**Q147 Andrea Leadsom:** Why do you think the Court of Directors did not hold an inquiry?

**Dr Wadhvani:** I am really not qualified to comment on their motivation, but it seems to me, especially in a situation where the Bank is going to be made much more powerful and where it seems that the Bank has not really properly accounted for some of the things that people regard as errors over this period, imperative that either you yourselves launch a fully fledged inquiry or the Court or both. It is very important that the lessons from this crisis are fully absorbed before the Bank is given all this extra power.



**Q148 Andrea Leadsom:** Thank you. Professor Goodhart, would you add anything to that?

**Professor Goodhart:** I think it is mistaken to think that the Court is either an appropriate body to run any sort of exercise about what went wrong or that it should be accountable with respect to policy issues. The Court has several important roles, looking at business efficiency and dealing, for example, with cases where there might be disagreements between the Governor and other important players in the exercise, but I do not think that dealing with policy either is or should be part of their role.

I go back to the Bank Rate Tribunal where it was alleged that the Court had been involved in discussions about changing the interest rate. There were concerns that that had led to conflicts of interest and people knowing in advance, and that kind of concern would be even greater with respect to financial stability issues because you are then dealing with individual institutions. The Court is a fine collection of eminent people, but policy is the role, on the one hand, of the Bank and its executives and the members of the Policy Committee and also of the Government, which should act as oversight, and yourselves. It is you, not the Court, that should be providing the accountability.

**Q149 Andrea Leadsom:** So you are saying that the Bank of England is accountable to the Treasury Select Committee and the Treasury, not to the Court of Directors?

**Professor Goodhart:** Yes. As I say, the Court has roles, and important roles, and again the Governor is concerned with policy, not necessarily with business efficiency.

**Q150 Chair:** I do not think I have ever come across damning with faint praise more perfectly illustrated than, "They are a fine collection of eminent people". Your suggestion that the Court is not an appropriate body leaves the question begging that somebody has got to do this and be in a position to do this and we need a pretty concrete proposal on how that is accomplished, Professor Goodhart.

**Professor Goodhart:** Both yourselves and the Government.

**Q151 Chair:** Those are big, general responses.

**Professor Goodhart:** Why would you expect a body like the Court to be an appropriate body to carry out a technical discussion on policy issues? That is not what they are appointed for and, moreover, because of conflicts of interest and all that, they really are not involved with policy discussions and cannot be.

**Q152 Michael Fallon:** I am still not sure what the Court was appointed for. It is one of the things we are trying to establish. Dr Wadhvani, could I come back to you? You said in your paper any attempt in your time with the MPC to question the efficient markets theory was strongly resisted. How did that happen? How did somebody of your intellectual calibre get intimidated?

**Dr Wadhvani:** I hope I didn't imply I was intimidated. I can only speak about my own personal

experience, but there was a prevailing ethos, there was a prevailing sort of way of looking at things, and the vast majority of the staff who produced the research and analysis for us essentially adhered to that mode of analysis. One of the rules, if you like, was that you generally believed in the efficiency of financial markets. Certainly, again only in my experience, I found that if you raised issues that essentially in part assumed that markets were not efficient, this was often used as an argument against what you were saying. You would occasionally get disparaging remarks of the kind, "You don't understand modern economics".

**Q153 Michael Fallon:** Disparaging remarks were made by other members of the committee?

**Dr Wadhvani:** Sometimes.

**Michael Fallon:** At the water cooler or—

**Dr Wadhvani:** Although I should say that we have two honourable exceptions in this room: my esteemed colleague here, who often supported me and Willem Buiter, who often supported me.

**Q154 Michael Fallon:** Your answer to that is to increase the number of externals. In your paper, you said one answer is to have a majority of externals.

**Dr Wadhvani:** Yes.

**Q155 Michael Fallon:** There would be some safety in numbers. Again, you would not feel bullied.

**Dr Wadhvani:** I didn't use the word "bullied" but certainly I think the way to avoid group-think is indeed to have more externals, because unfortunately the way the organisation is structured means there is always the risk that the view that is held at the centre percolates right through the organisation and right through all the analysis.

**Q156 Michael Fallon:** Yes. You then very specifically say in this regard that you worry that the Governor would be even more powerful under the new arrangements. Do you attribute some of the responsibility for this group-think to the Governor, to his position, to his status? Is that the problem?

**Dr Wadhvani:** I think it is in the nature of any organisation that the chief executive is disproportionately important. I was not singling out any particular personality but talking much more generally about the risks, because this is a system that is supposed to endure for many years and is supposed to serve the country well over the coming years. Given how much more power we are giving them, given that despite the fact that many people think some serious mistakes were made in the past, very little has happened to them, I worry that in a democratic country we are giving them even more power without enough checks and balances.

**Q157 Michael Fallon:** If you don't get your way and the Government sticks with its two committees, let me cut to the chase: do you, therefore, think it is right the Governor should chair both?

**Dr Wadhvani:** Certainly, if you want to improve the problem that I think arises from the lack of co-ordination then it is helpful to have some common

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membership. As to whether the Governor needs to chair both, I am less clear.

**Q158 Michael Fallon:** You are less clear. How can the Governor be truly accountable if he is chairing both ends of the operation? To whom is he really accountable?

**Dr Wadhvani:** He is ultimately accountable to you. He is ultimately accountable to you and arguably—I don't often disagree with Charles, who I have learnt from over 30 years, but certainly in terms of improving accountability and improving checks and balances, I think there may well be a role that an enhanced Court can play. It may well be that Court can get more independent advice and quiz the executive more.

**Q159 Michael Fallon:** Yes. We are trying to draw out here, given your experience from the MPC, how we can improve the operation and accountability of the FPC. You have given us some suggestions, but I am still not quite clear how the executive position of the Governor is made truly accountable.

**Dr Wadhvani:** Well, I think the key thing is to make sure that independent thinking pervades that building, because economics is a pretty uncertain business. There are lots of known unknowns and unknown unknowns and it is very important that we don't find that we wake up in a few years and the Bank of England has followed a particular economic dogma and has ended up in the wrong place at considerable cost to the country.

**Q160 Chair:** I did find it perplexing that you thought that the Governor should not chair both committees, given that you want one committee. Presumably, if you want one committee, the bigger the overlap between the two committees that are presently proposed the better, and it should start with the chairmanship.

**Dr Wadhvani:** I can see the force in your argument and perhaps I answered too hastily, so I take it back.

**Chair:** You are taking back that one.

**Q161 Jesse Norman:** Professor Goodhart, can I come back to your remarks about the Court? It seemed to me you were running, if I may say so, two things together. One was the Court as a potential source of policy advice, which I don't think anyone thinks it should be. The second is the Court as the safeguarder of the well-being and reputation of the Bank of England, which I think people do feel it should have at least some role in discharging. The question is, first of all, do you disagree that that is part of the role of Court?

**Professor Goodhart:** No, I do not with some respects. For example, if there was some personal misdemeanour or problem at a high level in the Bank of England, I would expect the Court to be the place where that was sorted out. The Court, for example, played a role when there was a disagreement between the external members of the MPC and the Governor and some of the internal members of the MPC about the amount of resources that should be made available to the external members, and I think it was helpful on

that front. The point is that what we are talking about here is about policy.

**Q162 Jesse Norman:** Hold on a second, let me just ask you a question. If the Court is not responsible for safeguarding the reputation and well-being of the Bank of England, which independent entity, or at least semi-independent entity should be?

**Professor Goodhart:** Do please let me go on. The thing is that if you are talking about policy, if you are talking about whether the interest rate should be raised or not, if you are talking about whether a time-varying capital requirement should be raised or not, that is a technical policy issue for which these ladies and gentlemen, eminent though they are and good though they are, are not necessarily best suited. In any case, it is second-guessing on a technical policy issue.

**Q163 Jesse Norman:** Forgive me, we have very little time. No one disagrees with that, as I have already said. The question is this: should the Court not be concerned, in its role as an entity that has some responsibility for safeguarding the reputation and well-being of the Bank, about the lack of self-scrutiny that the Bank may have undertaken over its own failures, eloquently identified by Dr Wadhvani earlier? It would be perfectly appropriate for it to look into that issue and have a concern about it.

**Professor Goodhart:** Let me give you a case immediately at hand. A lot of people criticise the Bank for having allowed inflation to run over its target rate now for most months over the last three years. Should the Court take a role in deciding whether the interest rate decisions of the Bank are sensible on that front? My answer would be no. Equally, if the housing market was going up, prices were going up, and it decided, say, not to change a loan-to-value or a loan-to-income ratio, should the Court be involved? My answer is no.

**Q164 Jesse Norman:** No, but what we are looking at is the question of whether the Bank was insufficiently tough on itself through the failure of the Court to undertake any investigation into its own behaviour in the run-up to the crash. We have seen in other cases, for example, the colossal failure of the Royal Bank of Scotland, that there has been an enormous further investigation as to why that took place. It seems not inappropriate that the Bank of England, which was responsible for a large part of the tripartite system, should have had some self-scrutiny as to its own failings in that period.

**Professor Goodhart:** If you are going to ask should the Bank of England have set up a special committee of experts to consider whether its policies could have been better, the answer that I would give is very likely yes. Should the Bank of England and maybe the—well, the FSA did set up a study, but should the Bank of England have set up an inquiry? Yes. Should it have been done by the Court? No.

**Q165 Jesse Norman:** I am grateful for that. Could I just ask a question of Dr Wadhvani, which is with that in mind—and I must say I think Professor Goodhart's question does raise a serious point as to what on earth

the point of the Court is if it can't even have the role you have described, that of commissioning an independent inquiry into its own institution—what about the selection of externals? It seems to me that you are not going to get the kind of yeast and independent-mindedness that you seek on either of these committees if the selection of externals is not done in some more independent way.

**Dr Wadhvani:** My understanding was that in fact the selection process had improved and that essentially it is advertised now and the Treasury, in conjunction with an adviser that they appoint, actually constitutes the selection committee. I would have thought that—

**Q166 Jesse Norman:** Are you comfortable that dissident voices are being given a fair hearing in the current selection process?

**Dr Wadhvani:** I think the quality of external members has remained encouragingly high. It is the quantum that I am quarrelling with.

**Q167 Chair:** I just want to come back to this point, Professor Goodhart. Are you saying that the Court should have and should have had no role in suggesting that there be an independent inquiry or some form of special committee to look into the performance of the Bank?

**Professor Goodhart:** Should the Court have suggested to the Governor that the Governor establish an independent inquiry? Maybe, yes. Should the Court have taken it on themselves? I don't think that that is their role.

**Q168 Chair:** None of us is suggesting that it should have done that. We are suggesting that they should perform the role that non-execs perform in private sector institutions of ensuring good corporate governance, not challenging the policy.

**Professor Goodhart:** Well, they do look at corporate governance and they should do in terms of: is the Bank sufficiently well resourced to undertake these kinds of exercises; will the Bank have a sufficient number of experts to do this job efficiently?

**Q169 Chair:** If we got rid of the Court altogether and replaced it with a body that was capable of doing the sorts of things that Jesse Norman has just been describing, you would see that as a step forward, would you?

**Professor Goodhart:** I think that they would primarily be doing the job that you ought to be doing: keeping the Bank accountable. The Bank is dealing with policy. The overall strategy of policy is set by the Government. It is watched by yourselves and you and the Government are the bodies to which a policy-making institution like the Bank ought to be reporting.

**Chair:** Well, we note the empowerment. We are interested in how to give it effect.

**Q170 Mr Mudie:** Just following on from that, the thing that concerns me is the accountability to Parliament. You have just finished up by saying we should watch them. Is that what you mean by accountability? With regulators taking more and more policy decisions that affect our constituents, should

we be content with just watching these policies being implemented? Where is the line? What part should we play? Apart from having a two-hour session every three months with the Governor of the Bank of England, listening to him for two hours, we have no input into policy. I am not even sure in terms of the consultation paper that the Chancellor has any input into policy.

**Professor Goodhart:** Well, in terms of the Monetary Policy Committee, the inflation target was set by the Chancellor.

**Q171 Mr Mudie:** No, I am speaking about the new arrangements, the wider arrangements, leaning into the wind.

**Professor Goodhart:** The difficulty with the arrangements is that there is no framework that is exactly the same as the inflation target plus the letters that have to be written when the bands are broken. In the note that I sent you, what I was trying to do was to provide some alternative framework that would have some kind of structure that could provide a degree of accountability of the same kind as the Monetary Policy Committee has.

**Q172 Mr Mudie:** Yes, I read that with interest. I thought that was pretty useful. Is that the extent you would allow us politicians to play in the whole exercise, to set some parameters? It is a fair enough point, but I just wonder if it is the extent. Let me just bowl this to you: from outside, are you content with the role we play in accountability and as Treasury Committee?

**Professor Goodhart:** I think that the job you do is an important and useful one and will need to be expanded to cover the Financial Policy Committee as well as the Monetary Policy Committee, and it will be much more difficult for you to maintain accountability on the financial stability side because it is much more amorphous. There is much less in the way of quantitative triggers that you can use to require the Governor and the other policy makers to come before you and explain why they have done what they have done and for you, if you are unsatisfied with those explanations, to say so to the House of Commons and for them to take whatever action ensues as a result of what you have then said.

**Q173 Mr Mudie:** Just following that through, what action can we take? They decide to do the leaning against the wind and they stop more houses being sold and so on, and our constituents cannot get a house. What would we do? You see, I think accountability is very retrospective from our point of view and I am not sure I see the machinery, the way we can intervene into the policy making that seems to be going to be taken within the Bank in the future.

**Professor Goodhart:** That is what the Financial Policy Committee does, but in my note what I was suggesting was that there are certain, what I would describe as, presumptive indicators that, when they are moving, should suggest that the Financial Policy Committee should be taking action and if they don't, they would have to explain to you why they have not done so.

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**Q174 Mr Mudie:** You see, again you are saying that the Financial Policy Committee will make the policy. What part does the Chancellor play in it and what part does the House of Commons play in that?

**Professor Goodhart:** Well, the House of Commons has set it up and I think that the House of Commons should be concerned, as you should be, that you have sufficient means to make the Bank of England and the Financial Policy Committee explain to you clearly the actions it has taken, the reasons for them and—

**Q175 Mr Mudie:** No, you were going very well, that was very useful, and then you went off back to the woolly stuff, “Make them explain to you”. I don’t want them to explain it to me. I am saying what part should we have in the formulation of policy on very important matters? At the moment, with this consultation document we are going to have the participants in the Bank explain to us—very nice—why they arrived at that policy, why they are doing certain things. Should a politician be satisfied with that? Should the Chancellor just be allowed to say, “I hear what you say” and maybe say, “You’re wrong” or “You’re right”? Is that the end of it?

**Professor Goodhart:** That goes back to the argument of why the Bank of England should be independent in its abilities to set the operating instruments for monetary policy and for financial stability, which was a huge argument that we had in the last 20 years and in which it was generally agreed that if there is a clear objective that can be delegated by the House of Commons, with the overall strategy clearly delineated, then it is a good idea to let the experts in that field go ahead to achieve that particular policy.

**Q176 Mr Mudie:** The sort of experts who delivered us the crisis you mean, to pay deference to them?

**Professor Goodhart:** We were all guilty in our ways: the regulators were guilty; the politicians were particularly guilty. I am not speaking about you, I might add. I am speaking about the Americans, where the insistence, for example, that Fanny Mae and Freddie Mac should increasingly provide subprime mortgages, or guarantee subprime mortgages, was a key element in the whole process.

**Q177 Mr Mudie:** It is interesting that you mention that just in passing, because Dr Wadhvani was asked about the Fed. We discovered when we were across there a couple of months back that, following the reorganisation, the Fed have got one of their more senior people to chair one of the regulatory committees that they have set up. They have decided that they can’t leave it to the experts, that a combination of the experts plus a hard-headed politician might be more useful. We are keeping a clear line where the experts run and we listen. It is very interesting.

**Professor Goodhart:** Yes, but if they don’t run rightly or correctly, you can recommend changes.

**Q178 Mr Mudie:** What changes, for example?

**Professor Goodhart:** You could recommend that certain personnel get changed.

**Mr Mudie:** Personnel, yes.

**Q179 Chair:** The Monetary Policy Committee can be readily scrutinised, not only because some of its targets, or indeed principal target, is a number but also because the lion’s share of its work can be put in the public domain in a short period of time, but that is not the case with the FPC, is it?

**Professor Goodhart:** In some cases it is. If you are dealing with a macro-prudential instrument like changing the capital requirements or the liquidity requirements or changing margins or changing LTVs or LTIs, that can be in the public domain just as quick as a change in interest rates and the argumentation for and against can, too.

**Q180 Chair:** No, but when it is collecting information on a bank or group of banks that may be acquiring vulnerability?

**Professor Goodhart:** That cannot, that is indeed right, but the micro—

**Q181 Chair:** In the structure that you have proposed in your note, how do you propose that Parliament address that?

**Professor Goodhart:** On the micro side that is very difficult, that is a difficulty, but remember, the FPC on the whole—

**Q182 Chair:** But I am asking you for the solution. We have got this far in our thinking, but it is at this point you come in.

**Professor Goodhart:** This is a difficulty because there is, clearly, a need for confidentiality about individual institutions and that need has to be maintained. You certainly cannot have public events like this one to discuss confidential considerations relating to individual institutions. What is new about the FPC is actually their utilisation of macro-prudential instruments. On the concerns about how do you make the FSA responsible, they have been dealing with micro-prudential issues, and the Bank of England before 1997 dealt with micro-prudential issues relating to individual banks for donkey’s years.

**Q183 Chair:** The Bank was accountable to the Chancellor and the Chancellor was accountable to the House of Commons. The FSA, arguably, was not adequately scrutinised through this period. The question we are now addressing is, given that that system has been torn up and replaced with a new system of macro-prudential supervision, what we should have in place to deal with exactly that kind of issue.

**Professor Goodhart:** Well, on the macro-prudential, I think the problem is not so difficult. I do think that—

**Q184 Chair:** Well, okay, on the micro as you are describing it?

**Professor Goodhart:** Well, the micro, I have no—

**Q185 Chair:** You haven’t got any ideas?

**Professor Goodhart:** I have no good ideas beyond—

**Q186 Chair:** Well, we are in the market for them. Have you got one, Dr Wadhvani?

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**Dr Wadhvani:** I am afraid I can't offer you any good idea. The only thing I would say—

**Chair:** We have a couple more witnesses coming up in a moment. We will ask them.

**Q187 Mr Ruffley:** Dr Wadhvani, good to see you again. When you had disagreements, if I can call them that, with the Governor of the Bank of England, when you served on the Monetary Policy Committee, about the access to staff that you wanted and so forth, who did you complain to?

**Dr Wadhvani:** Essentially, it was not just me having a disagreement, there were four of us together, and Charles was certainly one of the others. I am now relying on memory, but essentially my—

**Q188 Mr Ruffley:** Where I wanted to go with this is, did you complain to the Court?

**Dr Wadhvani:** Yes.

**Q189 Mr Ruffley:** You did?

**Dr Wadhvani:** Yes. We first went to Court. We first essentially exhausted our options in terms of discussion with the internals. Having done that, we did actually take it to Court. Court then raised it with the senior internal members and then at some point in this process it leaked and it made it into the press. We were then coming in front of you. You also played a very important role in resolving this. We were due to come in front of yourselves and it was essential for the credibility of the whole process that it all be sorted before we made our public appearance. That, essentially, provided a deadline for all the negotiations between Court, the internals and the externals to be resolved.

**Q190 Mr Ruffley:** That was an example of the Court doing something useful, was it?

**Dr Wadhvani:** Yes.

**Q191 Mr Ruffley:** May I ask you why you do not think the Court has asked for a piece of work to be done, not by the Court itself, because it would, I would guess, lack the necessary expertise? Why do you think the Court has not called for an independent inquiry, scrutiny, into the conduct of Bank policy in the run-up to the banking crisis?

**Dr Wadhvani:** I am not close enough to the process now, but certainly soon after I left, Court did commission an inquiry into the forecasting process of the Bank. So there is certainly precedent for them—

**Q192 Mr Ruffley:** Sorry, the forecasting in the run-up to the banking crisis or—

**Dr Wadhvani:** Yes. I may have the date slightly wrong, but I left in 2002 and it is my belief there was an inquiry into the forecasting model in 2003, which was set up by Court, and Court essentially invited an external expert.

**Q193 Mr Ruffley:** Who was that, do you know?

**Dr Wadhvani:** Someone will help me. Was it Professor Adrian Pagan?

**Professor Goodhart:** I think he was, from Australia.

**Q194 Mr Ruffley:** You see, what is interesting is that there was a precedent for the Court commissioning some work. Given that precedent, why do you think that precedent was not followed? I know you were not there at the time, but why do you think the Court neglected to do that?

**Dr Wadhvani:** I have to say I am far removed from the process but I find it very, very surprising. I find it very surprising.

**Mr Ruffley:** Well, I share your surprise.

**Dr Wadhvani:** The only other thing I wanted to add is that I think if Court were to set up such an inquiry, it is very important that Court itself chooses these experts and doesn't allow the Bank executive to choose these experts. I think it is very important that the process be seen to be entirely independent and above board.

**Q195 Mr Ruffley:** Yes. Professor Goodhart has been at pains to stress that the Court does not get involved in policy matters. To paraphrase, he talked about making sure business efficiency is what it should be and resolving perhaps disputes between members of the Monetary Policy Committee. I understand that, but don't you think there is a case for the Court to have beefed-up powers, to have an express power to commission the kind of work that you cited as a precedent and which I think this Committee would have liked to have seen the Bank call for in the light of the banking crisis? In other words, for the Court to take directly on board the responsibility for scrutinising policy decisions and, indeed, policy mistakes. Do you think there should be a rewriting of the Court's remit?

**Dr Wadhvani:** I certainly think that Court should be given enhanced powers. I worry that with the Bank becoming so much more powerful, there is going to be an accountability deficit. We should do everything we can to increase the checks and balances in this whole process through yourselves, Court, more externals; everything we can do.

**Q196 Mr Ruffley:** Following on from stronger, tougher powers, if you like, to scrutinise and to challenge the policy choices and decisions of the rest of the Bank, do you think the personnel on the Court of the Bank of England, given that I think we are arguing for newer powers, should be improved? I would just say a comment that the one thing that many of the former Court Directors had in common was trusteeship of either the Royal Ballet or the Royal Opera House in London or, indeed, the National Ballet in Scotland. It does seem to be the great and the good, sometimes a bit past it, to be quite frank. Do you think the personnel should be improved?

**Dr Wadhvani:** I should say right away that the members of Court that helped us through the resources dispute were unquestionably independent, very clued up and they knew exactly what they were doing. The sorts of people I am thinking about included a very nice lady from the Consumers' Association, a trade unionist, and they were incredibly helpful to us throughout the process.

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**Q197 Mr Ruffley:** Yes, but on the point about new powers, if you wanted to construct from scratch a body that was going to commission a piece of work to work out what went wrong in the Bank in the run-up to the banking crisis, would you be content with the cast list of the Court that you have at the moment or would you want people with more expertise? Yes or no?

**Dr Wadhvani:** I think it is always helpful to essentially have greater heterogeneity and certainly I think some members of Court should have significant expertise in this area because I think they can help other Court members a lot.

**Q198 Mr Ruffley:** Professor Goodhart is smiling; I don't know whether it is knowingly or not. Professor Goodhart, would you like to comment on this?

**Professor Goodhart:** To your yes or no question, I would answer no because I think that what worries me is what you seem to be asking to be set up is a body related to the Bank that has the role of continuously second-guessing the Bank.

**Mr Ruffley:** No, I—

**Professor Goodhart:** When you ask for one of these expert committees to be set up, it is almost always going to be when something has gone wrong. That is going to mean that you are getting the Court, or requiring the Court to be passing what is an implied judgement of no confidence in the Bank's policies.

**Q199 Mr Ruffley:** What, in the very act of commissioning an independent report?

**Professor Goodhart:** Yes. If you are going to ask the Court to set up a body to say what were the mistakes undertaken in the run-up to the crisis, you are more or less saying they made a lot of mistakes. Now, you are established by Parliament to do that second-guessing. I think to have a body connected with the Bank, in a sense over the Bank, in a position of responsibility that is also going to be second-guessing the Bank would be a recipe for problems.

**Q200 Mr Ruffley:** You are actually over-interpreting what I said. Following the precedent in 2002 you referred to, it would be the Court or a reconstituted Court commissioning work to scrutinise what had gone wrong.

**Professor Goodhart:** But setting up the body to look at the forecasting is an implied judgment that there is something wrong with the forecasting, it needs to be improved.

**Q201 Mr Ruffley:** But they did it.

**Professor Goodhart:** Sure they did it, but forecasting is about as technical as you can get and I think that you would always find that setting up committees to study this, that and the other is always going to be done when there is a clear assumption that something has gone wrong.

**Q202 Mr Ruffley:** You don't think there was a clear assumption that something has gone wrong with the banking crisis?

**Professor Goodhart:** It went wrong everywhere. As I say, it went wrong with every central bank in the world; it went wrong with virtually every regulator; it went wrong with virtually all political institutions; it went wrong with economics. We were all guilty.

**Dr Wadhvani:** Some central banks are better than others and maybe there are lessons to be learnt from that. For example, the Reserve Bank of Australia did lean against the wind in terms of the emerging house price bubble and they did do a better job. Maybe there were some lessons for us to learn from that.

**Q203 Mr Ruffley:** Final question for you, Dr Wadhvani. The Financial Policy Committee will be a committee of the Court rather than a committee of the Bank of England, which is what the MPC is. What conceivable justification is there for that difference? I think what I am saying here is that this Committee as a whole is not desperately impressed with what the Court has done in recent times and for the new FPC, a very important body, to be accountable because it is a committee of the Court, which is different from the MPC, it is rather worrying to me. Is it worrying to you?

**Dr Wadhvani:** I don't know enough about why they have structured it this way, so it is possible that I am missing the argument, but I would agree with you that, given my current level of ignorance about the reasons for having structured it that way, it does seem odd.

**Q204 Mr Ruffley:** Professor Goodhart, could you help us?

**Professor Goodhart:** I do not understand what lies behind it.

**Q205 Mr Ruffley:** Do you think there is anything fishy going on? Why the distinction? Well, we will have to ask other witnesses.

**Professor Goodhart:** I am afraid I am ignorant.

**Q206 Jesse Norman:** Very quickly, just a supplementary to the line of thought that has been explored. If I have understood you correctly, Dr Wadhvani, in 2003 the Court called for an independent assessment of the Bank's ability at forecasting. Yet allegedly at the moment there is a view that somehow it would be wrong for the Court to call for an independent investigation of the Bank's performance in the face of the greatest financial crash for 70 years. What would your recommendation be to us that we should ask for in terms of the areas that such an inquiry would cover if we were making a recommendation in relation to the Court?

**Dr Wadhvani:** I certainly think it should be an all-encompassing inquiry. It would be odd if it didn't cover the Northern Rock episode. I know you went through it very thoroughly, but the whole issue of liquidity injections should be covered. I think the issue of should monetary policy have leaned against the wind should certainly be there because that is potentially critically important. Actually, the forecasting model comes up again. As my colleague Charles Goodhart has pointed out before, it was very odd that they were running a forecasting model with no role for bankruptcy and no role for credit

constraints. So that certainly belongs there. I think their whole sort of knowledge base in terms of what was going on in the financial sector and why occasionally they seemed to know so little certainly will belong to that inquiry.

**Q207 Jesse Norman:** You mentioned lack of a resolution regime. Would that be part of the inquiry as well?

**Dr Wadhvani:** I think that has been offered as the reason they could not do more about Northern Rock, but the issue is, given the absence, what else could they have done to avoid that huge failure?

**Q208 Jesse Norman:** But you would take it it would not be an unfit subject to ask why there was not such a resolution regime?

**Dr Wadhvani:** That would go well beyond the Bank, so maybe it would not be for Court to ask that question.

**Q209 Jesse Norman:** That is very helpful. Do you think that as part of your point about the knowledge base, it would be helpful for the Bank to look at its own vulnerability and the vulnerability of the financial sector to herd effects and the lack of variegation within the way in which different financial institutions addressed crisis? There was a tacit assumption, it seems to me, behind regulation that essentially a portfolio effect would occur that would minimise the impact.

**Dr Wadhvani:** Yes, but as Charles points out, we have all learned from the crisis. We all made mistakes. The key thing is not that the Bank made mistakes. The key thing to me is, having potentially made mistakes, they are not willing to own up to them and to learn from them. It seems to me if you are going to learn from your mistakes, step one is to own up to them and then say what you are doing to learn from them. We have not seen them go through that process, which I find very disappointing.

**Jesse Norman:** A little truth and reconciliation for the Bank of England is I think what you are suggesting. Thank you very much indeed.

**Q210 John Thurso:** Professor Goodhart, can I come to you, because it is something covered in your note? I have difficulty in understanding how the FPC will operate. The MPC has a clear objective defined by a measurable target. The FPC at the moment is charged with delivering an unquantifiable state of being. How can we make the FPC more objective and less subjective, more criteria based and less motherhood and apple pie?

**Professor Goodhart:** Well, that I think is the main difficulty, and what I was trying to suggest in my note was that there are some indicators that generally—not necessarily always but generally—show warning signs during the boom and the bubble before you get into the bust. What I would like you to do is to try and get the Bank of England to say what it thinks the key warning signs are, with the corollary that when the warning signs are flashing amber or red, they should be expected to take some action and, if they don't, to explain why not to you. The main problem

in the last crisis was that some of these warning signs were disregarded and they didn't take any action, whether by leaning into the wind through interest rates or by using these other specific macro-prudential measures, which at that time they couldn't use but in future hopefully they will be able to use.

**Q211 John Thurso:** Do we need to start by trying to work towards a definition of stability? At the moment it seems stability is defined as being an absence of instability. Do we need something more concrete to be able to have sounder judgment?

**Professor Goodhart:** Well, the problem at the moment is that there is nothing more concrete. One of the aspects of the work that I have been trying to do is to find mechanisms for making it more concrete, but at the moment there are none. There is nothing that you can fully rely on and it is just the possibility of the varying indicators on which you can put more or less weight. I don't want to try and tie the Bank of England or the FPC down too rigidly because this is an area where there is great uncertainty, very little quantification and not enough analysis. But there does need to be some mechanism for getting the Bank of England or the FPC to appreciate that some action is necessary if you are going to stop a boom or bubble getting out of hand.

**Q212 John Thurso:** Our first task, fulfilling the role of scrutiny that you pointed out is ours, is at a very early stage to ensure that the FPC has set out at least how they are going to arrive at criteria, what indicators will be on their dashboard, as it were, and how they would seek to use those as they develop knowledge and expertise. That is the first thing we need to get them to do?

**Professor Goodhart:** Exactly, and I am delighted to hear you saying that because that is exactly what I am hoping you will do.

**Q213 John Thurso:** Well, now you have told me to do it, I shall undoubtedly do it, unless Jesse does it for me first, which I am sure he will do. Can I then come back to the question of FPC/MPC as two committees? It seems to me that certainly at the outset—and perhaps this is more a question for you, Dr Wadhvani—that where you have one committee with a pretty clear idea of what it is doing, whether it is doing it right or wrong is another matter, but a pretty clear idea, we are all pretty signed up to what it is supposed to achieve and the report and so on, and another committee with an objective that we don't quite understand—we all know it is a good thing but we have not quite worked out what it is—that it is actually important to keep them apart at least until that work has been done, so that you don't end up with the unclear one muddying the waters of the clearer one.

**Dr Wadhvani:** I am not so sure about that because, of course, financial stability feeds back into price stability in the sense that if you take your eye off financial stability then you make it much more difficult to achieve price stability, as Japan has found in the last two decades. In some sense, these things do go together. The other point, which I did make earlier and which is very important, especially in the

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light of some of the discussion we have had, is that we are very uncertain about how these new instruments are going to work. There is very little agreement about how important these instruments are. Yes, we have a little bit of econometric evidence to go on, but a long time ago I learnt about Goodhart's Law, which told me that essentially once you use something for policy purposes then its effectiveness might change and the response coefficient might change. Therefore, I think it is very important that the FPC proceed cautiously in the early days as it learns how powerful its tools are. While doing that, it would be helpful to have a tried and trusted weapon on their side like the interest rate, because the interest rate can also lean in the direction of similar objectives. I think it is important that the stuff be co-ordinated because otherwise you could end up with a big policy error.

**Q214 John Thurso:** I think in your opening answers you talked about co-ordination failure or co-ordination deficit. So, it is not really a question of whether there should be two committees or one committee, it is not really whether either of those are better, it is the interface between the two sets of objectives that we need to be looking at. Would that be right? Is that what we are after?

**Dr Wadhvani:** Yes.

**Q215 John Thurso:** Would you agree with that, Professor Goodhart?

**Professor Goodhart:** Yes, but I also agree with the general thrust of your opening comment. I am a two-committee man and I think that the co-ordination issues can be exaggerated.

**Q216 John Thurso:** Let me ask my last question. Is there an inherent conflict and tension between the two objectives or are they inherently complementary?

**Dr Wadhvani:** I would have thought in the vast majority of instances they are inherently complementary.

**Professor Goodhart:** I agree.

**Q217 Chair:** I just want to take you back to your earlier evidence, Professor Goodhart, about social judgments, the judgments that you feel can't be made

by these bodies but have to be made by politicians, and your view that accountability has to flow through this Committee. Given that you know the way these committees operate very well, you have been before this Committee many times, what we are capable of and the resources that we have at our disposal, do you think it is realistic that we can accomplish the kind of tasks you envisage for us in your description?

**Professor Goodhart:** Well, you have mentioned setting up committees to study, for example, whether the Bank of England made mistakes. I don't see why you could not do that more easily than the Court of the Bank of England. If you think that there is a committee that should be established, I don't see why you should not be in a position to recommend that yourself.

**Q218 Chair:** To the Government?

**Professor Goodhart:** To the Government.

**Q219 Chair:** So, our job is to highlight those crucial issues that may crop up and put pressure on the Government to take action and we should not be trying to think of ways of creating structures within the Bank that can substitute for these functions?

**Professor Goodhart:** I think it would cause trouble.

**Dr Wadhvani:** Is there any reason why this committee could not report to you, this committee of experts? Rather than waiting for the Government to set it up, why couldn't you set it up? I am ignorant.

**Chair:** We need some resources. Supply is the one-word answer.

**Dr Wadhvani:** It is my ignorance, but it sounds to me—

**Q220 Chair:** What you are basically saying is the Committee needs more resources. I have been very reluctant to draw you to that conclusion because I am in the business, as all of us are on this Committee—you can see that that went down well with the staff—of supporting public expenditure retrenchment at the moment.

**Dr Wadhvani:** Yes, understood.

**Chair:** Thank you very much indeed for extremely interesting evidence, both oral and written, particularly written. Thank you.

### Examination of Witnesses

*Witnesses:* **Kate Barker**, former Monetary Policy Committee member, and **Dr Willem H Buiter**, former Monetary Policy Committee member, gave evidence.

**Q221 Chair:** Thank you very much indeed for coming this afternoon. You have heard some interesting evidence and you are both very familiar with the way we operate as well. I would like to start, first of all, with you, Dr Buiter. Is there anything that you have heard that you fundamentally disagree with?

**Dr Buiter:** Perhaps not surprisingly, yes. Let me say before I start, Mr Chairman, that the views I am about to express are strictly my own and should not be identified with those of any organisation I may be associated with, otherwise I will probably get into trouble.

I have just four short points. The reform of the financial stability management in this country is disastrously misconceived. The first mistake is that the Treasury should be at the centre of financial stability; it is now on the sidelines. In my view, the FPC should be chaired by the Chancellor. Consider the way the United States has approached this problem: their Financial Stability Oversight Council is chaired by the Secretary of the Treasury, although the Fed and the other regulators are on it. If we have learned one thing, it is that next to the lender of last resort, you need a recapitaliser of last resort for systemic stability



problems. So to leave the Treasury out of the core of financial stability management is a big mistake. Second, the Bank of England is greatly overburdened and too powerful in this proposed construction, especially the Governor and the two Deputy Governors. The obvious solution is to remove the Prudential Regulation Authority from the Bank of England. Third, it is also not clear who is in charge of the Special Resolution Unit that administers the Special Resolution Regime. Again, this has to be a joint Bank and Treasury activity because there will be public money involved most of the time.

Finally, I think that the Court is essentially irrelevant and should be abolished. It is a historical accident that comes from the historical origins of the Bank as a joint stock company, but the only shareholder now happens to be the Treasury. You have a board to look after the interests of the shareholders and the other stakeholders, to the extent that these are not expressed adequately by the management. In this particular case, although the shareholder technically is the Treasury, the ultimate shareholder is the British people and their board of directors is you, the Treasury Committee. So for political accountability, it has to be Parliament. Of course, Parliament is badly under-resourced and they haven't done a good job in the past; unless they get properly resourced, they won't do a good job, but accountability to the Treasury Committee is the only solution, I think. You can get the National Audit Office to do value-for-money investigations of the Bank on a regular basis and then independent external auditors appointed by the Treasury, including external business efficiency auditors perhaps, to deal with the rest.

So, yes, I do disagree quite a bit with this. The Bank of England should not be independent for financial stability purposes. It is a collective fiscal and monetary affair.

**Q222 Chair:** You are really describing the pre-1997 situation, aren't you, where the Bank did macro-prudential supervision, where the Bank had the responsibility for working closely with the financial sector to keep an eye on risk, but when a crisis occurred the Bank was subordinate to the Treasury?

**Dr Buiter:** Nothing was formalised. The Bank wasn't independent either for monetary policy. I think the Bank's MPC should be independent for the purpose of monetary policy, narrowly defined; that means setting the official policy rate, bank rate, and setting the size of the balance sheet, if you want, and the composition of the liabilities. The composition of the assets inevitably involves the Treasury because anything other than Treasury securities, held outright or as collateral against lending to banks, should be done under a full indemnity or guarantee by the Treasury, lest the central bank end up acting as a quasi-fiscal agent of possibly considerable magnitude, the way it is in the US and in the Euro Area, where the Fed and the ECB are a major affront to accountability for taxpayers' money.

**Q223 Chair:** We have just heard a pretty trenchant critique of the whole of the Government's proposed

supervisory structure. Where do you come down on all this, Kate Barker?

**Kate Barker:** I thought for a moment that I might say that I very much agreed with Willem, but I am not quite sure that I do and I come at it from this direction: if we look back at 1997 there was a view, which at the time was very widely supported, that the way forward in policy was to have rather simple rules. There were some rather simple rules for fiscal policy and the MPC was set up with a very simple objective. I should perhaps hasten to say, since I am the only member of the MPC here who was responsible for monetary policy in the run-up to the crisis, that I fully share the sense of guilt that Charles described. I think we did make errors and didn't handle policy in the right way. But one of the things perhaps we all learned from that period was that the world is a very complicated place in which setting up a set of institutions with very simple and changeless rules doesn't, when push comes to shove, really fit the bill. I have some sympathy with Willem's description that financial stability is properly a matter for the Treasury with this mild proviso, or perhaps quite a big proviso. One of the things we all think is important about the way in which the Bank is independent on monetary policy is a sort of general belief that politicians, worthy as they are, are not always so strong when you are thinking about policy that has long-term outcomes, which are different from short-term outcomes. For example, the very obvious point that you think you can trust the MPC to raise interest rates ahead of an election but you are not entirely sure you can always trust an incumbent Chancellor to do so and that, of course, is what we think strengthens credibility.

So I would add to Willem's proposal that the responsibility is not to move it away from the Treasury as much as today; that you would want, perhaps rather as you have with the OBR, to have an independent voice that can offer an effective criticism of policy, independently as you go along, to ensure that the short versus long-term consideration doesn't come into play too much around election times. I hope I have made that reasonably clear. I should say, another thing I do somewhat disagree with Willem on—

**Q224 Chair:** Sorry, before you get on to this other thing, I haven't understood that first proposal.

**Kate Barker:** Okay. Well, my proposal is that you would put a lot of the onus for financial policy decision making, things such as changing capital requirements, perhaps back towards the Treasury, but you would have a group at the Bank, rather as you have a group with the OBR, that was able to offer some independent challenge and commentary on it in order to ensure that the very natural temptation for politicians to fall into things that they perceive as being short-term advantage was protected against. That is a way in which I would propose you might possibly go forward.

**Q225 Chair:** So you would have a small, independent systemic risk quango?

**Kate Barker:** You could ask the Bank to perform that role. They seem to me very well placed to perform

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the role, rather in the way, if you think back on it, that the *Inflation Report*, at the time when interest rates were still set by the Chancellor, was seen as an independent commentary on whether or not the Chancellor was doing the right thing. Perhaps it wasn't very effective though and you might want to beef this up, but I don't see why it shouldn't work.

**Q226 Chair:** You had a second point you were going to make before I asked you—

**Kate Barker:** I wanted, if I may, to make a quick point about Court, which I observe has had a rather hard time. I do think that Court has a genuine function, inasmuch as it is good for the Bank to have people who look into the way in which the Bank works and its processes and questions of resources, and it does that rather well. I agree with the general view that is emerging here that the role of the Court is not really in looking into policy. I have to say that I was slightly puzzled by some of your questioning, because when I look at accountability, the fact that the FPC is a committee of Court, as opposed to the MPC which is not, does seem to me to open up a potential for an interest in policy. I agree very much with the comments made by Charles Goodhart that that is not a proper role of the Court.

**Q227 Jesse Norman:** I am very glad you raised that. I was going to put the question myself as to how it could be contemplated that the Court could be entirely divorced from policy when the FPC was supposed to be responsible to it. That seems to me a genuine problem in the current structure as it is set up, as well as raising a question about whether the Court's own role is undefined and compromised. I'd like to ask Professor Buiter a question, if I may. There are two positions one might take, broadly speaking, with regard to these proposed reforms. One is, "Well, yes, but these two committees should be the same or they should be tweaked in various other ways". The second is, "No". It seems to me you are coming out with "no", rather than "yes, but". Would that be a fair assessment?

**Dr Buiter:** Would be separate you mean?

**Jesse Norman:** The discussion as to whether it should be one committee of the FPC—

**Dr Buiter:** No, it couldn't be one committee, I think, since I do want monetary policy, narrowly defined—interest rates and the size of the balance sheet basically—to be made independently. But financial stability can never be done independently, so we should not mix the two up in one big institution.

**Q228 Jesse Norman:** That is helpful. So you come out on the two separate committees?

**Dr Buiter:** Yes.

**Q229 Jesse Norman:** That is helpful. Do you not think that, by suggesting the FPC should be chaired by the Chancellor, the PRA should be moved and these various other changes, these are pretty fundamental changes to the structure of the accountability that has been set up?

**Dr Buiter:** Yes, absolutely. I think the structure that is proposed is a complete mess and it is likely to have very bad operating characteristics.

**Q230 Jesse Norman:** Good, thank you. So you are in the "no" category rather than the "yes, but" category?

**Dr Buiter:** Yes.

**Q231 Jesse Norman:** Can I just ask you another question, and Ms Barker if you just tell me where you come out on that. Are you comfortable with the overall broad approach or do you share Professor Buiter's view that it needs to be rethought, it is a complete mess?

**Kate Barker:** Given that I commented that there should be greater political involvement perhaps in some of the work of the FPC, I would have thought that it implies that I have some relatively serious reservations about the way it has been set up. Can I say something just about the two committees? I wouldn't come out in favour of one committee but I think the co-ordination problem that was mentioned is one that from time to time would be serious. On the whole, I rather agree with the fact that normally there aren't these problems. The trouble is when these problems arise, it is generally around a time of crisis, which is when it really matters.

One of the issues, when I look back at the way in which we worked with monetary policy, was that although we were aware of these financial stability problems, partly because we looked a lot at where inflation might be on a two or three-year horizon, I don't think we gave them sufficient weight. So a good question for me, a good challenge, is: how would this process have worked in the run-up to the crisis when, as Dr Wadhvani has already indicated, you would probably have had the FPC tightening and reining back, but at the time the big challenge for us was getting inflation up to the target. So how would that have worked? How would you have made these two things consistent? It seems to me that one way in which you might have made it consistent was to say that you were, to some extent, thinking about risks to the inflation target that lay beyond the two-year horizon. Somebody, I think, made the point earlier that if you lose financial stability, you lose the inflation target as well. But this is quite difficult water.

**Q232 Jesse Norman:** Thank you. Professor Buiter, you have made clear your reservations about the role of Court in the Bank of England. Did you agree with the suggestion made by Dr Wadhvani that there should be a proper investigation into different areas of under-performance by the Bank in the course of the financial crisis and beforehand?

**Dr Buiter:** Yes, under-performance by all the responsible parties, not just the Bank, of course. You cannot look at the Bank in isolation in this crisis. You need to look at the other regulator, the FSA, and at the role of the Treasury and at the institutions that weren't there, like the special resolution regime, and a decent deposit insurance scheme. That this country didn't have a deposit insurance scheme that could dispense money within a period of six months was really quite extraordinary; so, yes, there should be a

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broad-ranging inquiry that should be run by this Committee, not by the Court.

**Q233 Jesse Norman:** The point is you feel that what I referred to as the truth and reconciliation process has not been adequately carried out so far?

**Dr Buiter:** It hasn't started yet, really.

**Q234 Jesse Norman:** Good, thank you. What would such a process cover? You have talked about the different parties that would be involved. Dr Wadhvani has described the issue of liquidity in relation to Northern Rock, the issue of forecasting models, knowledge base, leaning against the wind in monetary policy. Are there any other areas you think should be added into it?

**Dr Buiter:** The issue of the incredible leverage that the big banks were able to build up. Financial crises are the result of excessive leverage and mismatch, and we had both. These excesses went unchecked and there is enough blame here to share around quite generously, so I think we should look at all these things. Were the laws wrong? Were the institutions wrong or was the implementation wrong? Were there personal failures or was it all just a lack of instruments? I think we had a bit of everything. The Bank certainly went into the Northern Rock crisis not, I think, having any idea as to what the likely consequences of its actions would be and they only slowly learned the role of lender of last resort and market-maker of last resort when key money markets froze and banks stopped being able to fund themselves.

There was a belief, I think, on the Bank that inflation targeting and independence had solved the central banking problem for all time and we didn't realise—and I was very much part of that same mindset—that we were incredibly lucky, or maybe unlucky, that we had the world's gentlest economic environment ever—the illusion that inflation targeting was enough could establish itself. The Bank was completely unprepared, in terms of the prisms through which it looked at the economy, to respond when the crisis happened; it had to develop from scratch an approach to illiquidity, when to intervene, how to coordinate with the Treasury, whom to bail out. So it was a night at the improv for about three years.

**Q235 Jesse Norman:** It occurs to me that it might be your view that the Bank had unlearned some of the things it knew in 1997 in regards to bank supervision.

**Dr Buiter:** Yes, although the Bank in 1997 was, of course, a massive beast, because it did not just have the monetary policy and macro-prudential stability remit, it also had the micro-prudential regulation remit, as well as market conduct and consumer protection. I would never want to go back to that. But, yes, in terms of macro-stability, there were some things they unlearned. But I don't think that the skills that were appropriate in the pre-1997 world where it was still, to a significant extent, the eyebrows of the Governor that caused banks to resist temptation, would have worked in the environment that we were living in during the first decade of the 21st century. It requires a greater detachment. The risk of capture of

the regulator, when the regulator deals with individual institutions, is massive. That is one reason why you want the micro-prudential regulator to be out of the Bank that does the macro-prudential management, because you are bound to get captured if you get too close to those you may have to hit macro-prudentially.

**Q236 Jesse Norman:** A final quick question if I may. If the country ends up going down the FPC route, as it is presently contemplated, do you think that committee should adopt the kind of approach that was suggested by Professor Goodhart in his previous testimony to this Committee; that is to say there should be some relatively clear, well-defined new instruments or old instruments against which they could vote, having deliberated?

**Dr Buiter:** It would be nice but, first of all, that only deals with the prevention part. The other half of the FPC's job is to cure, to clean up the mess when a crisis does happen despite everything—and there will be crises again. By all means, let 100 flowers bloom and let us try to write down things like leverage ratio benchmarks or ceilings or counter-cyclical capital requirements or margin requirements that serve as benchmarks. We should recognise, however, that this is very much art rather than science and that this is not something that we should ever put in a law or as a set of numbers but rather a methodology that may be expressed in a number of temporary rules, but is under constant revision. This will be a work in progress that will never be finished.

As such, yes, by all means, more structure is good and it makes answerability easier, but you should be aware of not having “moniterable target disease”. An example is the waiting list at hospitals, things like that. You will end up achieving a target perfectly although it has become completely irrelevant. So we should have something that is forever adapting as the financial system adapts. Then, of course, equally important as prevention is cure and we need a set of instruments and practices. Here especially the role of the Treasury is key because ultimately it is taxpayers' money that is at stake and it has to be answered for, even if it is intermediated through the Bank.

**Q237 Chair:** Just on that last point, is there any halfway house between the Government's current proposals and your critique whereby the Governor could run the FPC in peacetime but that as soon as any crisis started to develop the Chancellor could be responsible for chairing it?

**Dr Buiter:** I think that the American Financial Stability Oversight Council is the right mechanism. Sure, if there is no action, the Chancellor can delegate to the Governor, but it has to be clear that financial stability, when it gets to the cure stage, involves almost invariably putting at risk public sector resources and, therefore, it has to involve the Treasury, with it being more or less active depending on the circumstances. During normal times the Treasury need not be very actively involved, but I would argue that the FPC has to be set up in such a way that it is clear that we are talking about not just provision of liquidity. No serious crisis was ever caused by liquidity shortages alone. Every serious crisis always

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involves a significant element of insolvency risk or reality, and whenever the word “insolvency” raises its head, the taxpayer is likely to be in the firing line. That is why the Treasury has to be central to this.

**Q238 Chair:** You are nodding your head and smiling, Kate Barker. Are you agreeing?

**Kate Barker:** Only because I very much agree with that point. I just wanted to come back on a point that was raised earlier about voting on the FPC. I have a feeling that the kind of complexity of instruments and issues the FPC is dealing with is not going to be one where a sort of nice distinct vote, such as the MPC has, is going to be the way forward. As put forward in its present form, if it survives, I would have thought it is much more likely that it will produce more consensual decisions. That shouldn't mean, of course, that there ought not be very vigorous debate within it. It is just that I am not sure that the sort of simple voting mechanism would work so well.

**Q239 Michael Fallon:** Can I just come back to what you said about financial stability, Kate Barker? As I understood it, you were positing some kind of equivalent to the OBR, some kind of watchdog advisory role inside the Bank alongside the Treasury. Is that right?

**Kate Barker:** I was positing in a fairly loose sense. I have a lot of sympathy with the point that Willem made, that in some sense the financial stability job is perhaps done within Government more readily than within a separate institution, or at least a situation where the Government has a much clearer oversight than perhaps is suggested in the FPC. But I also made the point that, of course—I don't want to repeat myself too much—we have these long and short run issues around the operation of politics that means it would be quite important alongside that to have a respected body that was capable of making clear, independent comment on the decisions that were taken. I have to say, it is not a fully thought-out policy but I am simply proposing this as a way forward, which seems to me to overcome some of the worries about the present proposal in terms of the Bank having too much influence without, I hope, losing altogether the idea that it is not necessarily the case that housing it all within the Treasury is the right answer either.

**Q240 Michael Fallon:** Yes, but the Bank already had that function. When you say it should be able to make independent comment on financial stability, the Bank was free to do that during the crisis. The Bank produced twice-yearly financial stability reports. They didn't tell us the crisis was going to happen but they produced these reports twice a year. It already had that function. Why would it be better at it now than it was before?

**Kate Barker:** I was talking here in the context of proposals around the FPC. I am talking in the context of proposals around macro-prudential regulation and also in the context we have all admitted, which is that we have learned a lot from the crisis. It is a perfectly legitimate challenge that the Bank could have said more and different things in the run-up to the crisis, as indeed could many other people, and the truth is

we all failed to do so. Assuming that we have learnt from this and also that, of course, this group, whether it operates independently or two-headedly, performs this function, I would have thought that it would be much more obvious and apparent what the Bank's role was. I should say, by the way, that I think the Bank's role in financial stability in the run-up to the crisis was probably not as clear-cut as perhaps it might have been and would not be quite as clear-cut as the proposal I am making. There was, after all—and we have all talked about this—probably a lack of appreciation of the need for a more active macro-prudential regime.

**Q241 Michael Fallon:** What do you think of Dr Wadhvani's proposal that we tackle group-think, that we have more external members, if we keep two committees we have more external members on both of them?

**Dr Buiter:** I would favour—

**Michael Fallon:** Sorry, would you mind if I just ask Kate Barker first.

**Dr Buiter:** I beg your pardon.

**Kate Barker:** You are asking about my experience on the MPC. I am not convinced, personally, that we needed more external members there. One thing, however, that I thought was incredibly important on the MPC—and, of course, it is the issue that the three other people here fought for, as it were, on my behalf, I benefited from it—was the access to independent resources and independent analysis. I am not quite sure whether the FPC as it is proposed, the external members who I have to say I think might be somewhat greater in number, will have access to any independent resources and analysis. I think that is a question that might usefully be considered.

**Q242 Michael Fallon:** Yes, but should there be more externals?

**Kate Barker:** On the FPC?

**Michael Fallon:** Well, on both.

**Kate Barker:** No, I have said I think the balance on the MPC was about right. The balance on the FPC, depending on how you judge it, looks a bit less favourable to me. I think I might favour more. Perhaps, however, I will rethink slightly on the MPC, although I have been reminded of the need not to add to the costs of the public purse. Because of the fact that some of the MPC will be sitting on two committees, it might perhaps be helpful to have a little bit more external challenge and so perhaps there would be a case for adding an external member to the MPC, but I wouldn't push that very strongly. I think it is much more important that the external people have the ability to undertake their own analysis rather than they are numerically great.

**Q243 Michael Fallon:** Yes. That is the old issue, whether the day boys should use the library, isn't it? We dealt with that years ago.

**Kate Barker:** Not for the FPC we haven't, if I may say so.

**Chair:** I am sorry, I didn't catch your reply.

**Kate Barker:** I said the issue of resources for the MPC is an old issue. The issue of resources for the external members of the FPC, as I understand it, is not.

**Q244 Michael Fallon:** You were on the MPC for an awfully long time. What is your response to this issue of group-think?

**Kate Barker:** I thought that the description we had from Dr Wadhvani was, on the whole, fair. One of the issues at the Bank, very clearly, is that a lot of people at the Bank are Bank employees. They work for the Bank; they work for the Bank system. If there is a perception of a strong view in one direction that comes from the senior management of the Bank, there will be a bit of a tendency of the staff to follow that view. It is very clearly the role of the external members to challenge that actively and I think there are quite a number of examples of people who have done this. Indeed, we have seen some in recent weeks. Although I have just described the Bank staff as though they were all supine, it is fair to say that that is not the case. The other internal members on the MPC certainly frequently challenged the views that the Governor might hold on issues. So I think we went a long way to try and avoid the dangers of group-think but there is a certain inherent group-think that will emerge from the chief executive, as I think has already been said. That is why the issue of the resources, which you rightly say is in the past, was so important.

**Q245 Michael Fallon:** So it is not group-think, it is Governor-think, is it? How do we deal with that? If we proceed to the Government's ideal model of an FPC alongside an MPC, how do we safeguard against Governor-think with all these people employed by the Bank?

**Kate Barker:** This, of course, is one of the reasons why I have just been talking about potentially having more external members. I also think it is important to reflect that personalities change over time. This potentially gives a role for Court. I completely agree with the fact that Court can't inquire into policy. I think Court should inquire into processes and should ensure that people are free to make comment. To be fair, during the time that I was on the Bank, I saw considerable improvements in this regard with the staff being explicitly encouraged to challenge current thinking. So I don't think we should be too depressed about that, but that's something the Court could specifically ask about, "Do staff feel able to challenge?" I think that would be a very good role for them to play.

**Q246 Michael Fallon:** Dr Buiter, you wanted to add to that, did you?

**Dr Buiter:** No.

**Chair:** You have nothing you would want to add to what you have heard from Kate Barker?

**Michael Fallon:** I cut you off earlier.

**Dr Buiter:** No.

**Chair:** I should take no as an answer, I am told.

**Q247 John Thurso:** Kate Barker, can I come to you first? As you have heard from my questions to the

previous witnesses, I am very concerned about working out what financial stability is meant to be and how we measure it so we can act upon it. One of the areas that gives me cause for concern is the size of financial services or the financial sector relative to the UK's economy. It used to be a percentage of it. It is now a multiple of it, whereas in the States it is still very much a percentage of it. That leads to the question of the impact. If you have a financial sector that is a multiple, as we have seen with Ireland and Iceland, if it gets too extreme that in itself will be a huge risk and cause of instability. Do you think that the FPC should look at that and should have an opinion as to whether the sheer size relative to the host economy is part of potential instability?

**Kate Barker:** I need to make sure I understand your question. You are asking me whether I think the scale of the assets of the banking system as a whole, relative to the size of the economy, is one of the things that we should be concerned about?

**John Thurso:** Yes. The other extreme: if, for example, your banking sector is 5%, if it all goes bust, it has an impact but 95% of your economy is still there. If it's 500% and it goes bust, you are in real trouble.

**Kate Barker:** Yes. If it is only 5%, it suggests to me that it has not been doing much of a job, quite frankly, but I will pass over that. I haven't previously considered this question but the issue here is: where does the weight fall if this all unwinds? What is the real issue here? Is the Government or the taxpayer going to be able to cope? We now know, of course, that this was not the case in either Iceland or Ireland where, when the collapse came, the scale was simply too large for the Government to be able to cope with it. So that would indeed be one of the risks I would hope that the FPC would think about, alongside others. But I am relatively sure this is an area where Dr Buiter is better qualified to comment than I am.

**Q248 John Thurso:** Then let me pass it straight on.

**Dr Buiter:** Whether the size of the banking sector itself is of concern?

**John Thurso:** The question is whether the size of the financial sector relative to the host economy, where it is a multiple rather than a percentage, so increases the potential risks that that in itself is a matter for financial stability consideration?

**Dr Buiter:** Yes, it is. The two countries you mentioned, Iceland and Ireland, are clear examples. In Iceland, the banking system that was too big to save was let go at the last minute by the authorities, who almost made the mistake of guaranteeing it. The banking system collapsed, but the sovereign still stands, as long as they don't have to pay the Icesave debt at any rate. In Ireland the insolvent banking system is dragging down the sovereign with it. In both countries, the size of the balance sheet is or was a key factor. In Iceland it was over 1,000% of GDP; in Ireland it is between 500% and 1,200% of annual GDP, depending on what metric you use. There is no single metric of size.

The two things that matter, apart from size relative to GDP, is mismatch: maturity mismatch, currency mismatch, liquidity mismatch. It is also of key

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importance whether the economy in question has a global reserve currency as its domestic currency. If it does, it will be able to provide liquidity support, almost surely on the required scale, should there be a problem. Second, of course, the size relative to the taxpayers' resources is important, because that ultimately determines how much recapitalisation can be done through the taxpayer when all else fails.

From these perspectives, I think the UK clearly compares favourably to both Ireland and Iceland, although in terms of currency it is more vulnerable than Ireland because sterling, unlike the euro, is not a significant global reserve currency. As regards capacity, however, the UK was just about able to carry its defunct banking sector. There are lessons, of course, for Scotland there as well, which would not have been able to keep the Bank of Scotland and RBS standing if they had been dependent on the support of the Scottish taxpayers.

**Q249 John Thurso:** Yes, that is an interesting point. I am sure it will be made quite often in the coming months and years. Can I come back to the point that you made that you felt the Chancellor should be the chair of the FPC, and just test that a little bit? It seems to me that there are a number of competing issues within stability. You might have strong growth, which politicians like, particularly coming up to an election, but you might have some red signs coming up on the stability dial and the proper course of action would be to undertake things that would dampen down growth. Can you really see a situation where an FPC chaired by a Chancellor—take, say, 1996 where a Chancellor had aspirations possibly of becoming a Prime Minister and maybe having an election—would have said, “Right, I am now going to slam the brakes on because this is so overheating”, would the inclination not be, “Let’s just see if this will carry on long enough to get me in and then we’ll worry about it later”?

**Dr Buiter:** The chair is not a dictator. On the MPC, the Governor has been outvoted a number of times. I would expect that the make-up of this FPC would include enough people of sufficient self-confidence and independence who would be willing and able to outvote the Chancellor. He is the chair, he is central to it but he can't dictate. That would be leaving it to the Treasury alone. I don't think that that would be desirable either. You want the Bank of England in there with macro-prudential responsibility, but not micro-prudential responsibility. You also want the micro-prudential entity in there, and probably also the Financial Conduct Authority/Consumer Protection and Markets Authority, because ‘conduct’, for some reason, has ‘markets’ attached to it. I consider markets to be actually a macro-prudential issue to a significant extent so why ‘market’ is stuck there with protecting granny against dishonest sales practices is not entirely clear to me, but that’s where they have put it. I would expect all these agencies to be in there and the Chancellor to be the chair, *primus inter pares*, but not the dictator.

**Q250 John Thurso:** Let me get this straight. The FPC would be pretty much as it has been set out by the Government, but instead of being chaired by and

reporting to the Bank, it would be chaired by the Chancellor and report to the Treasury?

**Dr Buiter:** It would report not to the Treasury, but to the Treasury Committee of the House of Commons. The FPC would be a separate state body, just like the Bank of England is a state body, without a board or anything like that, which reports to Parliament and which would have, under this set-up, at least one voting member from the Treasury, the Chancellor, instead of the arrangement at the moment, when all they have is a non-voting attendee—the Bank of England's Monetary Policy Committee meetings are attended by a Treasury observer.

**Q251 John Thurso:** It is a very interesting model. I am not sure how much we would need in the way of resources to be able to take that on here. What works, it seems to me, with the MPC is you have an entirely independent committee comprised of part of the Bank payroll, part the externals, have an argument, have a vote, arrive at a decision. The perception certainly was, pre-1997, that Chancellors had a slight tendency to set interest rates for more short-term reasons than perhaps the long-term good merited. Do you think that an FPC, chaired by a Chancellor but who just simply had one vote, reporting to a Treasury Select Committee, would actually function?

**Dr Buiter:** Yes. Certainly I would be willing to try it. It has a better chance of functioning than this concoction that you are headed for at the moment, which has the Chancellor standing on the sidelines, expected to be invited in as soon as public money is at stake but not being there while the preconditions are being created under which the money might be required. I think this is the wrong time for the taxpayer to come in.

**John Thurso:** Thank you very much.

**Q252 Mr Ruffley:** Just one question for Professor Buiter. You say in your helpful note that this is the Financial Policy Committee's policy tools, that the FPC should undertake econometric research on the basis of past historical data to work out what they think the optimal response would have been in changing certain macro-prudential instruments, margin requirements, loan to income ratios and so on. Your note is admirably clear but what Dr Wadhvani has said, which I think is equally compelling, is that the FPC is likely to use time-varying capital requirements as a policy tool, and I am quoting him here, “However, the academic literature contains econometric estimates of their effect on GDP, which differ by a factor of 10”. If we follow your prescription, how would we get round the problem that Dr Wadhvani describes?

**Dr Buiter:** You are never going to get around it. We know very little about how macro-prudential instruments work, especially not during times of extreme stress. We haven't had a crisis like the one we have just come through since the 1930s. So we don't have too many data points, unfortunately. We are like the proverbial blind man in a dark room looking for the black cat that isn't there. We know very little about countercyclical capital requirements, of which there are a whole range, specified in terms

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of the levels or the rates of growth of balance sheets. We don't know about the consequences of the widespread use of countercyclical loan-to-value ratios for mortgages, which is another instrument; we don't know about the effectiveness of margin requirements for equity. We have very little hard evidence. The Treasury Committee can't do the research. You have to wait for others to do that. The answer, "This requires further study" will be coming our way for the next 10 years and we may need to use an instrument immediately. In that case you just start using it cautiously. That is all you can do. If you don't know the magnitude of the effect of a particular instrument that you think qualitatively ought to help, then you had better use it gingerly at first and then jiggle it a bit harder and hope that there aren't too many nasty nonlinearities in the relationship to the target, so that when you push it just a bit harder the thing suddenly falls off a cliff.

I think we are going to have to really improvise and not expect that you have a toolkit anything like what the MPC has—and even the MPC toolkit turned out to be not what we thought it was. The reality was much more complex. Look at what is happening now: inflation 4.5%, heading for 5%. Apparently even the old art of inflation targeting is not alive and well, never mind leaning against asset bubbles and excessive credit growth. I think we now know that we know a lot less than we thought we did in the 1990s. When I was on the MPC, I didn't worry about financial stability for more than two weeks through my entire three years on the MPC. That was during the Russian crisis. For the rest it was just 25 basis points up, down or sideways. We have learned a lot and the main thing we have learned is the old wisdom that we know very little.

**Q253 Mr Ruffley:** The final question: monitoring these small changes and learning by trial and error, who do you think would be best placed, what team of experts, to monitor this? Should it be the Bank of England economists or should it be somebody else?

**Dr Buiter:** I think you use the staff that is available. I would expect that I would staff this from where the

bodies are; that means partly the Treasury, partly the Bank of England. That is where the labour is. It probably costs a little more but it would seem that if you can prevent the next crisis from being quite as vicious as the latest one, then it would be money probably reasonably well spent. We can use, to a large extent, the existing resources of the Bank and the Treasury.

**Q254 Chair:** Do you have something you want to add, Kate?

**Kate Barker:** Can I just add something? I realise that I misunderstood Willem's proposal at the beginning in terms of the role of the Treasury, so I may have done him an injustice. I apologise. But I wanted to say that I think we have a common viewpoint in thinking that the Treasury needs to be more active in all of this than presently the FPC gives it the opportunity to be, because there are real trade-offs to be struck between some of these objectives. Provided there are some safeguards to ensure that politicians can't just be short-termist, I think that would be a direction that personally I would want to move in. Can I also say something else because—

**Q255 Chair:** So you are less opposed to Willem's—

**Kate Barker:** No, I wasn't opposed to it in the first place. I am saying I think we have something very strongly in common about the role of elected politicians, as a matter of fact, in this process.

May I say something else? You didn't give me the opportunity, sadly, to say this when I last appeared with the MPC, which was to thank you very much for the opportunities that we had on the MPC to appear before you and the Committee's courtesy during that process. Thank you.

**Chair:** Thanks for coming. It is clear that there are a wide variety of views about exactly how to handle this thorny problem, but everyone is agreed that the Government's proposals are creating an accountability deficit and that we need something to remedy it. Thank you very much, both of you, for coming and giving evidence this afternoon.

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**Monday 20 June 2011**

Members present:

Mr Andrew Tyrie (Chair)

Mr Andrew Love  
Mr George Mudie  
Jesse Norman

Mr David Ruffley  
John Thurso

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**Examination of Witnesses**

*Witnesses:* **Professor Rosa Lastra**, Professor in International Finance and Monetary Law, Queen Mary, University of London, **Professor Bob Garratt**, Cass Business School, **Dr Andrew Hilton**, Director, Centre for the Study of Financial Innovation, and **Jane Fuller**, Co-Director, Centre for the Study of Financial Innovation, gave evidence.

**Q256 Chair:** Thank you very much for coming this afternoon. I am sorry there has been a slight delay—we had some private business which we had to get through. I regret that we are a little depleted today because there is an urgent question in the House on a related matter—the eurozone. As you can imagine, several colleagues have decided that they want to participate in that.

Could I begin perhaps with Professor Garratt, and ask him, given that there has been no satisfactory review of where the Bank went wrong in this crisis, whether it is a good idea to give the bank more powers to try and prevent the next one?

**Professor Garratt:** That is an important question to start with. I am a corporate governance specialist, and in truth I can't answer that question. I have opinions but they are not necessarily worth anything, and I am shocked that there has not been an investigation at national level as to what occurred there. My experience comes mainly out of the banking field in relation to this Committee, and I shall mention briefly that for 10 years I worked with Sir Brian Pitman at Lloyds, and then Lloyds TSB. He took me aside in the very early days when I was going to run their director development programme, and said, "You will never be a banker and you shouldn't be a banker. That is not what you are here for. The only thing you need to know about banking is there are two bits to it. One is called retail, this is the high street stuff, and there you know your customers, you lend them not quite as much as they want and then you track them like hawks. The other side is called investment banking, and it is very simple: you never trade for yourself", and that is all he ever said to me about banking.

**Chair:** Paul Volcker would have been very happy with that.

**Professor Garratt:** In relation to your specific question, I am amazed—and a lot of my work is international and overseas folk I know are just astonished—that we have never had a proper investigation as to what went wrong. I can say a little bit more perhaps later in the session about when I was brought into one of the banks that failed, literally a couple of weeks beforehand.

**Q257 Chair:** Since you are amazed, does that bring anything to bear on your view about whether the Bank should be given more power?

**Professor Garratt:** I think the Bank could fulfil a crucial national role in the way it is proposed to be set up, with a few modifications, particularly around the committee area, but I see no reason why it should not be the major player in that area, provided that it behaves as a properly constituted company and has the checks and balances within it?

**Q258 Chair:** Okay. Does anybody else want to add anything to what has been said?

**Professor Lastra:** Yes, I would like to add something. In the aftermath of the crisis it is clear that there were supervisory failures. There were supervisory failures in this country, in the United States and in other countries. In the United States at the moment there has been a great deal of criticism directed at the Fed, the central banking system in the United States, which leads me to think that the failure was not so much in who was supervising, but in how they were doing it. Supervisory failures stemmed from the fact that supervision was not done correctly. So from that perspective, the view that has now been embraced in different fora of macro-prudential supervision looking at systemic risk is a sound idea, because although supervisors were looking at individual trees—not necessarily always very well—they didn't have a view of the forest. That is the concept of systemic risk control, the concept of macro-prudential supervision. The remit of your inquiry is the accountability of the Bank of England but somehow there are two interconnected issues. One is the issue of governance—on which Professor Garratt is giving evidence—and that is how an institution is governed and directed, and what role the Court of Directors would have and what should be the interaction between the Prudential Regulatory Authority and the Bank of England. The other more pertinent one for the remit of this inquiry is the issue of accountability. That is to whom is the institution accountable; to whom does it have to give an account, to explain and justify its actions, decision or omissions? I think that the Treasury Committee has a very important role. If you look at the accountability from the perspective of agency theory, in fact the Bank of England is much more an agency than a bank these days. Like many other central banks, it fulfils a number of state functions delegated by the Government with a degree of independence. In that sense, it must be accountable. It must be accountable to the Treasury and to a



Treasury committee. So it must be accountable to the Government, to the House of Commons, to Parliament, and also to the National Audit Office and to the judiciary; but the powers, per se, in terms of macro-prudential supervision are all right, as long as there are adequate mechanisms of accountability.

I am much less sure about the powers of the Special Resolution Regime. The Bank of England has a danger of becoming a 'regulatory Leviathan', doing everything, and some things the Bank of England, the Central Bank, is very good at; other things it might not be as good at. That is just the beginning. I do not want to take too much time.

**Chair:** We will come on to that in a moment. Everybody wants to chip in now.

**Dr Hilton:** Two brief points: one is that before the crisis, the Bank did have a responsibility for macro-prudential supervision. It was the financial stability wing of the bank. As one senior bank official said to me, "That is the collapsed left lung of the bank". It simply wasn't of great interest to the Governor at the time. He permitted it to wither, because he was more interested in the monetary policy arm of the bank, and he was more interested generally in monetary policy. So this isn't quite as new a focus on macro-prudential supervision as people suggest. Secondly, while I guess over the last 10 years I have never heard anybody in the City say a good thing about the Financial Services Authority, at the same time I have never heard anybody ask that it should be folded back into the Bank. I had a rather unpleasant vision that putting financial regulation back into the Bank of England was rather like taking a six-month-old baby and trying to stuff it back into the mother. It is not something that would work. They were not happy with the FSA but they had learned to live with it. This is a huge change that was not demanded by the market that it is being regulated or supervised.

**Jane Fuller:** I was just going to make that point, that it is very important to remember that the Bank of England has always been responsible for financial stability, and in that context perhaps there should have been a report, a post-mortem as to why it didn't discharge that duty very well, and the FSA has done better on that count. We have had a report on Northern Rock, and, albeit dragged out kicking and screaming, we are going to see a version of the report on Royal Bank of Scotland and bank silence.

**Q259 Jesse Norman:** So far you have highlighted two failures of the Bank in regard to its dealing with the financial crisis and in the run-up to the crisis. One is a failure of supervision, and I suppose in a sense that is the same as, or similar to, a failure of its own operations in the area of financial stability. Now, can we be clear about if there were any other ways in which you think the Bank failed in its operations in the run-up during and after the crisis? Perhaps we could start with you, Dr Hilton.

**Dr Hilton:** The only point I would make is that an awful lot of the Bank's success over the years has been either informal or semi-formal; people used to talk about the Governor's eyebrows. What the Bank was enormously good at was putting feelers out into the City, and the establishment of the FSA left the

Bank of England with a responsibility for financial stability but took away a lot of these links that it naturally had into the City. There were efforts. I can't remember who the executive was at the bank who instigated these grey panthers. I used to like the idea of people being licensed to lunch: recent retirees in the City, who I always felt ought to be given a lunching budget to report back to the Governor and to the senior executives of the bank heard the rumours—that was a capability that the Bank had in previous years that to a large extent it lost.

I think the Bank was culpable in letting that slide, because after the FSA was established, its focus moved very much to the Monetary Policy Committee. The focus of the Bank is almost exclusively on monetary policy in this country, but if someone were to tell me what the FOMC was doing in America on American foreign policy, and what the ECB was doing on European monetary policy, I would tell you pretty much what the UK ought to be doing on monetary policy here. So we spent an awful lot of time and put an awful lot of effort into something that is largely market determined.

**Q260 Jesse Norman:** Would anyone else like to add their own feelings on the failure of the Bank?

**Professor Lastra:** Yes, I would like to say that—

**Jesse Norman:** Briefly, if you could, because we are a little conscious of the passage of time.

**Professor Lastra:** The Bank of England was influenced by group think with regard to monetary theory, and I think that the narrow focus on inflation control measured by the CPI ignored asset prices, ignored property prices, and I think that that was a failure. In the years of the boom, it was perceived that perhaps the Bank of England was operating with great moderation, but in fact it allowed the bubble to continue and when it burst it was even more severe.

**Jesse Norman:** Thank you for that.

**Professor Garratt:** My feeling from the papers I have read is that the Court wasn't fulfilling its full duty of horizon scanning in this area.

**Q261 Jesse Norman:** The Court? The Court did not discharge its duty of horizon scanning?

**Professor Garratt:** Yes, that is exactly what I feel at the moment, so that builds on what Dr Hilton has said. The only bit I would add to that is for me horizon scanning is much wider than macro-economic policy, and that is why you need some diversity in the Court to bring in some of those other issues, which would include social, economic, environmental, and so on; that element.

**Jesse Norman:** Thank you. Did you want to add anything?

**Jane Fuller:** It was producing financial stability reports, and Mervyn King said it was like preaching from the pulpit and then you lose control of the congregation as soon as they leave, but it was still a very powerful body with this financial stability remit. We are still part of the tripartite arrangement, so I think there were things it could have done and did not and, as usual, it is not just a question of architecture—it is the will to do something about it.

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**Q262 Jesse Norman:** Thank you. So is it your common view that there should have been a report by the Bank of England into its own deficiencies before and during the crisis?

**Jane Fuller:** Yes, or by somebody else about it.

**Q263 Jesse Norman:** Yes, but commissioned by them in some sense?

**Jane Fuller:** Yes, like the FSA.

**Q264 Jesse Norman:** Okay, that is helpful, thank you. Is it your common view that the Bank should not be given more power, given how poorly it has discharged its existing powers?

**Jane Fuller:** That would not be my view, because I think that the twin peaks model does make sense—prudential regulation does sit better within the Bank than alongside consumer protection, so what you are going to discuss in the proposed legislation is how to get that right through the Financial Policy Committee and the Prudential Regulation Authority. I think there are difficulties in splitting them up, but I think it is still the best place to put it.

**Dr Hilton:** I would endorse what Jane says; it is a step too far. There are criticisms to be made of the Bank, there are criticisms to be made of the FSA, and nobody really wanted the disruption, but to a large extent the disruption has already taken place.

**Q265 Jesse Norman:** Historically, has the Bank ever been held properly accountable for its decisions? Was there ever a point in the Bank's history where it could be said to be held genuinely accountable; for example, after the gold crisis in the late 1920s?

**Jane Fuller:** There have been some excoriating reports, for example, after BCCI; I think after that.

**Q266 Jesse Norman:** Does Parliament have adequate resources to hold an enlarged and re-empowered Bank to account, especially if its own self-regulatory institutions are not working?

**Jane Fuller:** Well, why not? It is an interesting question as to how much input the Treasury has into what is happening at the bank. There is obviously a problem, because the Bank of England is supposed to be independent. Having said that, we are all shareholders in what is going on and—

**Q267 Jesse Norman:** I guess I am thinking not of the Treasury but of Parliament itself.

**Dr Hilton:** Certainly, many of the criticisms that have been made are that the new regulatory structure is not directly responsible to Parliament, to the Treasury, the Select Committee, and so on and so forth. There is a wonderful case to be made that our regulatory system is now so big, so complicated, so diverse and so important, that it warrants a special committee of its own to provide oversight on a regular basis. I think the argument for that is pretty overwhelming.

**Jane Fuller:** Isn't that what the Treasury Committee has spent a lot of time doing over the past three years?

**Dr Hilton:** I would assume the Treasury Committee has many other things on its plate. This is financial regulation, financial supervision. It is Brussels, it is IOSCO and it is Basel. It is thousands of interactions

that the regulatory system has internationally. All of those are important enough to warrant their own committee.

**Jesse Norman:** Thank you. Before I close, could I get a view from Professors Garratt and Lastra as to whether or not they share that view: that at the moment Parliament is greatly under-resourced in reviewing these issues?

**Professor Lastra:** I do agree. The main source of accountability in a democracy is parliamentary accountability, and in order for it to be exercised effectively you need proper resources, including dedicated personnel and a dedicated committee, so I would second that. I would also second the view expressed that, although some of the powers that the Bank of England will be given are a step too far, general responsibility for financial stability has a great deal of synergy with monetary policy. Indeed, part of my criticism of the Bank is that had it had a view of the forest, rather than individual trees, with regard to the financial system, it could have maybe acted earlier and better.

**Professor Garratt:** I agree with that. I am not a specialist in this area, but what I see is that, however it does report to Parliament, the actual corporate governance structure at the moment needs a lot of tidying up, and the committee structure especially needs a lot of focus.

**Q268 John Thurso:** Can I pursue the question of accountability to Parliament; and just to let you know that I think my colleague Andy Love is going to ask some questions around the Court, so it is not that particular area I am looking at. To perhaps start with you, Professor Garratt: when Charles Goodhart came before us he made it very clear that, above all else, the FPC needs a very clear dashboard and a set of four or five clear guidelines. This would very much correspond to your comments in May of the dashboard and KPIs, I would think. Are those KPIs the same as targets?

**Professor Garratt:** In the short term, yes, but in the long term—I was looking at the trends coming out of those, and that is why I think the notion of the Court as the key oversight body within the Bank is so important, because it is meant to be looking at those internal and external trend lines that come out of the dashboard.

**John Thurso:** Those dials, I will call them.

**Professor Garratt:** Yes, sure.

**Q269 John Thurso:** Because what one is looking to see is whether it is closer to cold or hot or empty or full—

**Professor Garratt:** Yes, exactly. That is exactly what it is.

**Q270 John Thurso:**—and possibly where several of them are going. I need not ask you, because you have already said that you think this is absolutely vital for the FPC to have these. What is the counter—

**Professor Garratt:** Sorry, could I interrupt just for a second? I think it is vital that the Court has them, and then there are subsets within the committees.

**Q271 John Thurso:** Right, so your point is: all relevant parts of the bank and that that comes together with the Court viewing the whole thing?

**Professor Garratt:** Exactly.

**Q272 John Thurso:** I am particularly interested in the FPC, the reason being that the MPC, it seems to me, is very clear: there is a remit from the Chancellor with an absolutely clear target. They discuss it; they take a decision; they report publicly to us; write to the Chancellor, and everybody knows where they are but, since nobody can define financial stability, at the early part of this is everybody trying to work out what on earth they are doing, how they are going to do it and who is going to take charge?

**Professor Garratt:** Yes.

**Q273 John Thurso:** Therefore my next question is the other side: if a suite of dials on a dashboard for the FPC are put together, is there a danger that they then say, "Right, we have cracked it. We have our four dials. We don't need to worry about anything else" and they take their eyes off the general picture that is so important?

**Professor Garratt:** That is why I was so keen to stress that the Court has the overall view on those trend lines. In a lot of companies now it is called "the PPESTT analysis", and it is: politics, physical environment, economics, social trends, technology. They are doing that stuff at the highest level and then the committee structure within it is doing the checks, through dashboards and other trend lines, and so on, but feeding in. It is the Court in the end that has to take the final judgment on whether they are keeping their eye on the ball or not.

**Q274 John Thurso:** Which is quite different, of course, from the MPC, where the Court is specifically excluded.

**Professor Garratt:** Yes, exactly, and that is a very odd structure and I find it quite alarming, but I will leave that aside.

**Q275 John Thurso:** All right. To what extent is financial stability almost an audit, in the sense that you want somebody almost outwith the day-to-day grind who is saying, "Well, notwithstanding everything you are doing, when I stand above the fray and look at it, there is a real growing systemic danger". If it is of that nature, is it, to a certain extent, to put the auditor into the Executive by putting it into the Court or reporting to the Court?

**Professor Garratt:** Reporting to the Court, yes.

**Q276 John Thurso:** Should it perhaps report more in the way that the auditors report to the Audit Committee, rather than via the Executive?

**Professor Garratt:** I notice that the Audit Committee name and function has changed—so Audit and Risk Committee—and I guess part of what you are talking about is assessments of the macro risk as well as the micro risk within the Committee itself. I do not have a simple answer to that, but I know it is possible to set up systems to do that.

**Q277 John Thurso:** One quick question, if I may, to Professor Lastra. You have said that one of the key things was not so much who but how things should be done, but you then went on to ask the very pertinent question, "To whom should the FPC be accountable?" Is there an argument to say that financial stability is a political rather than a mathematical judgment and it is a prime task of a Government and the head of the money and finance Ministry, whoever that may be, and that the FPC ought to be under the auspices of the Chancellor, rather than the Bank?

**Professor Lastra:** Can I take the two questions on the point that you mention and refer to the point made by Charles Goodhart, a former mentor 20 years ago. I think it is a very important issue, because there are two dimensions to accountability: one is performance and the other is the institution that checks and balances. Necessarily, you need to have some targets, some way of quantifying it, and the point that he made refers to the criteria of assessment and the content of the obligation. So you have the accountable, the accountee and the criteria of assessment. It is true that, with regard to financial stability, we are still trying to define what systemic risk is. So, in the same way as we say that monetary stability is the control of inflation, we say that financial stability is the control of systemic risk, but we still haven't figured it out—although a lot of literature is developing—and that will be a very important element of the obligation, of the criteria of assessment for a Committee like yours and for parliamentary accountability generally.

As for your other question, yes, financial stability is not only a central banking goal. I agree that it is also a political goal. Through the crisis we saw the importance of financial stability for peace in society and the economic situation. So, financial stability is a goal that transcends institutional mandates. It is also for the Financial Services Authority—the FSA—for the central bank and for the Treasury. It even traverses geographic boundaries, which brings it into the international dimension. Nothing that is done in this country alone would be sufficient to control systemic risk unless we have a view of how much leverage is developing in the financial system generally, given its interconnectedness. So now there is the model that has been followed in the United States with the Financial Stability Oversight Council, which includes the Treasury but also includes the regulatory authorities, including the federal regulation system, the central bank, so that would be my answer to your question.

**Q278 John Thurso:** The critics of the American system say that it has one of everything in it. It is like a bag of liquorice allsorts, there is somebody from everything, and therefore it is just becoming a talking shop because nobody is responsible for gripping it, and the argument for the FPC being in the bank is: everything is in there. If it goes wrong, it is your fault, end of story.

**Professor Lastra:** Yes. However, the Treasury still has an important role, because it is the Treasury that will commit public funds, so definitely. In the same way as there were failures in the tripartite arrangement, it was recognised that, at the end of the day, public funds come from the Treasury and therefore any decision

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that involves public funds must take into account the Treasury view.

**John Thurso:** Okay, thank you.

**Q279 Mr Love:** Dr Hilton, can I come back to the responses you gave earlier? I am going to characterise what you said, so you can disagree with it if you so choose. I rather gathered that you had expressed scepticism about the need for all of this change and the uncertainty that is created, recognised the benefits of forming the PRA and the FCA, but I wasn't clear as to how you felt; you expressed some scepticism about the Bank of England's role. Can I just be clear, if you were given the option of putting the structure together, how you would see the Bank of England operating within that structure?

**Dr Hilton:** I suppose, had I been put in the position where I was going to design the architecture, I probably would have said, whatever shortcomings the FSA has, it is better to work within the framework of the existing FSA and make it work better, which is not by any means impossible. I would have accepted that the Bank of England always had a role in financial stability, but it required a shift of attention within the Bank from the monetary policy wing to the financial stability wing, and much closer links between that wing and the FSA.

I accept what my colleague, Jane Fuller, is saying. That there has always been an argument for a twin peaks regulatory structure, where we take prudential and conduct of business rules and we put them in different institutions, or at least in different bodies within perhaps the same institution, but I think there is a huge cost to the kind of disruption that we are going through. The end result may be acceptable—I am sure it will be acceptable, because it is largely going to be the same people—but there is a cost of getting to there from here, and that I think is something that has perhaps been under-costed. At a time when the UK's role as a financial centre is under threat, at a time when European rules and regulations are starting to impact, we needed to have a lot more attention on what was going on in Brussels, and a lot of attention has been looking at our own internal structures and not really at how we are going to be affected by what is in going in Brussels, in Basel and elsewhere.

**Q280 Mr Love:** I could almost characterise that as being the position that was taken up by the last Government, but I shall not pursue that line.

Let me turn to Professor Garratt. You have expressed a view about the role of the Court. Why should the Court be given a role in terms of policy in relation to the Financial Policy Committee?

**Professor Garratt:** That is a very tricky one for me to answer, because in corporate governance terms policy is very clear: it is the highest level at which the directors of the organisation state their political will to go forward, so it is a very high-level concept. One of the problems I have had, in reading the few papers that I have had access to, is that policy seems to be operating at least three different levels, some of them around the committee area, and some at a very high level such as the national policy debate. My concern

is that the Court is the highest level of policy decision-making for the Bank of England. It has three or so committees reporting to it with recommendations on policy, on which it takes the judgment, and then in turn it is accountable and responsible to Parliament, with you, as the Treasury Committee, being the intervening variable and the oversight there. I am arguing very strongly that the Court needs to have a very strong policy role in itself as an organisation, as well as playing it out at the national level.

**Q281 Mr Love:** Is that how it has been envisaged? It is after all termed a supervisory board that manages the Bank of England. It certainly does not have a role in terms of monetary policy, and it hasn't been presumed that its membership would include people who had the relevant skills and expertise to form a financial stability role.

**Professor Garratt:** That has been my puzzle, because you have a unitary board, not a two-tier board. There isn't a supervisory board, and that is why I gave the response I just gave because, at the moment, it is structured under the company law as a company with a unitary board.

**Q282 Mr Love:** Can I ask Ms Fuller, do you think they have the qualities, the experience and the expertise to undertake a policy role under the current construction of the Court?

**Jane Fuller:** In the Court, as you have just described it as a supervisory board, the managerial role has become much more important. So an Audit Committee will put in a report about the Bank's operations and not financial stability. I think there is some confusion here between governance of the Bank of England and how you run financial stability through the Executive. I think the Court is to do with the governance of the Bank of England, in which case the Audit Committee is very important. For example, we now have an enormous balance sheet to look at following QE 1 and 2. It was only reformed a couple of years ago. So I think to push it and to make it a very good supervisory board with the governance committees, like the Audit Committee, the Nomination Committee reporting to it and to make those work really well, with lots of independence, would be what I would be looking for in the Court.

If you let yet another body have its sixpenny-worth on financial stability policy and monetary policy, I think everybody is going to go mad. If there were some sort of dispute—and I suppose the interesting thing, having said that, is that it has been assumed that you can separate monetary policy from financial stability policy, but you can't—and if the problem is too much credit expansion, and for some reason the MPC isn't raising interest rates, then you could look to the Financial Policy Committee for some specific problem; for example, if there was a bubble in the housing market, to impose a loan-to-value cap or something. If it is not being done by interest rates, it could be done by one of the tools of the FPC, but this is going to have to be really well co-ordinated because to some extent they are both going to aim at the same thing.

In terms of the political issues, it is going to be difficult for the FPC because it too—like the MPC—is supposed to take account of the economic situation, and maybe it should not do something if it will suppress economic growth. So I would like to see more clarity in terms of the role of the Court, conventional governance, the FPC and the MPC, how they work together, with awareness of some of the political difficulties that they will be operating under.

**Q283 Mr Love:** I presume you don't subscribe to the view that has been put to us by others that, because of this co-ordinating role, the two committees should in fact be one committee?

**Jane Fuller:** I think they could have been. In Asia, they are not going down this road and they don't seem to have the same trouble curbing credit growth. The Central Bank uses the tools that have traditionally been at any Central Bank's disposal.

**Q284 Mr Love:** I assume you all agree that there is a role for the Court—a supervisory board role to monitor and manage. What I want to be clear about is where you all stand in terms of the policy aspect and stability—which is of course a role for the Bank and, as you indicated earlier, always has been—whether the Court should have any responsibility, as has been suggested.

**Dr Hilton:** I am not sure. I agree entirely with my colleague on the role of the Court: the Chairman of the Court has 35 years in the metal-bashing industry. He does not know that much about financial stability and I don't see why he should. The role of the Court seems to be the management of the bank. Whether we make a mistake by drawing too clear a comparison between the MPC and the FPC, I worry slightly, as they are very different. We have already talked about the fact that monetary policy is much easier to determine: the tools that apply; the indicators that the committee would look at. Financial stability is a much more nebulous concept. However, I do think that crises occur on a Friday and have to be resolved over the weekend, and I think a committee that meets four times a year is probably not best adjusted to meet the crises as they come up, so I worry about that.

There is obviously a lot of overlapping membership, at least as it stands at the present time, with the interim Financial Policy Committee and the MPC. To that extent, there will be shared experience between the two. I think there probably should be because, as Jane points out, the two committees, if they were truly independent of each other, might conceivably, under realistic circumstances, head in different directions. I do worry that the Financial Policy Committee needs to operate almost day-to-day because when crises occur, they occur unpredictably and they require intervention immediately. You cannot say, "Okay. Well, we will put that off for a month". You can conceivably put off interest rates for a few weeks but you can't put off crisis resolution, even for a day.

**Q285 Mr Love:** It sounds like a return to the old days of the Bank of England deciding things over drinks in the Executive suite. How would you answer

that question? How should they be structured at this point?

**Dr Hilton:** That obviously is unacceptable in contemporary regulation, but I think that the Financial Policy Committee has to have continuing resources. It has to have a staff that meets regularly. I think the times that the committee meets formally, is irrelevant. The question is: how quickly can you put the committee together informally? Can you bring it together either in body or virtually? Can you bring it together at a couple of hours' notice? When these crises come up, there has to be the capacity to pull that committee together and to put in front of it all the facts, which means that it has to be resourced with real staff with real information. This is the debate that we have that you have already raised about the equivalent of the American office of financial reporting. Should there be a data-gathering part that has a continuing obligation to put the important facts—the data—in front of committee members, but on a very immediate short-term basis?

**Q286 Mr Love:** Professor Lastra, you wanted to comment?

**Professor Lastra:** Yes. I am not so sure about the role of the Court. I read the testimony that Willem Buiters submitted. From the comparative experience of other central banks around the world, the role of the Court is somewhat odd. It is clear that we need financial stability—that was one of the lessons of the crisis—and the quintessential central banking role is monetary policy. It is also clear to me that if there are going to be two committees, they should have equal weight and they should have close co-ordination. But corporate governance, which is what Professor Garratt was talking about, has a great deal of importance when you are dealing with a company corporation. I think—and I agree with Willem Buiters—that the Bank of England has evolved much more and become a quasi-autonomous agency, so it needs to be accountable to the system of checks and balances, to Parliament, to the Executive. Therefore, I think that the role of the Court sits where it can have a useful role in the supervision of the management of the bank, but not in actual policy making.

**Q287 Mr Love:** You would not abolish it, as Professor Buiters has said, and replace it with some accounting and supervisory—

**Professor Lastra:** I would not go that far, but I can see the point that he makes and, from comparative central banking experience, there is a fair point in what he says. Still, from the point of view of management of the Bank, it can have a useful supervisory role in the management of the Bank itself.

**Q288 Mr Love:** Professor Garratt, accepting what has been said about the critical importance of monetary policy and financial policy, do you stick by your—if I may say so—traditional view that the board of directors of the Court should have responsibility in these areas, when clearly that has not been an aspect of the way in which they have been chosen in the past?

**Professor Garratt:** Yes is the simple answer to that.

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**Q289 Mr Love:** What do you think could go wrong with what is being suggested that would lead you to say, “Please be careful in the way that you structure this, and give responsibility to the Court”?

**Professor Garratt:** The key thing for me—the great puzzle for me—is the fact that the Monetary Policy Committee of the Bank of England doesn’t report to the Court, apparently, according to the paperwork I was sent. I have asked a few people about this and the answer seems to be, “No, it doesn’t”. It reports to you folk is the very clear answer I have had from three people so far, remembering that I only arrived in from France less than 24 hours ago. So I am very worried that you have apparently three committees effectively of a board, namely the Court, one of which does not report to the Court. That alarms me greatly, because you can see all sorts of fun and games, in power politics terms and policy terms, going horribly wrong there.

**Q290 Mr Love:** Let me put to you, as I suspect others would, that the price that had to be paid for giving responsibility for the decision on such an important issue as interest rates to a group of independent people on the Monetary Policy Committee was proper accountability to the people who had taken the decision before the Government and Parliament. That is why it was set up in that way. You are asking us to put in a second lens, not just have a Monetary Policy Committee but have a Court that intervenes before—

**Professor Garratt:** Yes, that is exactly what I am saying.

**Mr Love:** Even in the circumstances where I am—

**Professor Garratt:** Yes.

**Mr Love:** You are indeed a true academic.

**Professor Garratt:** I hope not. I have been a company chairman for years.

**Q291 Chair:** Could I just ask Professor Lastra a question? You said a moment ago that the Court can have a useful role in the management of banking staff. When the Court oversees a reduction in the number of staff responsible for financial stability or international financial issues, as took place in the six years prior to this crash—in the successive years, you can see this from the accounts—are they taking a policy decision or are they taking a staff management decision?

**Professor Lastra:** I think they should not take policy decisions, but whether they have taken them is something that I am not sure about. However, I would think that going forward, given the importance of having proper decision making, both with regard to monetary policy and financial stability, and considering that there are linkages between the two going back to the twin goals of central banking. For instance, Vera Lutz Smith wrote in 1936 that they are stable money and sound banking. For some time in the last two decades, there has been—maybe with the transfer of supervision away from the Bank of England—a loss of attention to financial stability, which is the modern equivalent of sound banking. It is an extension of that.

So I think these decisions are so important, so time-consuming and require so much constant access to

technical data that, to me, the times that the Court meets, the composition of the Court and the commitment in terms of full-time work cannot be policy decisions. The decisions of the Court are like an internal audit, but you still need external audit. That is why I say that the Court sits oddly because it is not a company like any other company—it is much more like an agency. An agency that has delegated powers needs to give an account of those powers to the sources of democratic legitimacy, which is mostly Parliament.

I am not sure that I have answered your question but, as you can see, I am not a great believer in giving more powers to the Court. I think we need clear decision-making, with regard to monetary policy and financial stability, and the arrangement of having the Financial Policy Committee as a committee of the Court is something I don’t believe in.

**Q292 Chair:** It is a very sophisticated reply, but I am not sure that I am any the wiser because they did take that decision. This is not a hypothetical example, and many argue it did have the effect of reducing the Bank’s capability to respond to this crisis.

**Professor Lastra:** They reduced it to nine, but there used to be 12.

**Q293 Chair:** No, that is the number on the Court. I am talking about the number of staff that the Bank itself devoted to the task of monitoring financial stability in international financial issues.

**Professor Lastra:** Well, to financial stability, very little. They dedicated a lot of time and attention to monetary policy but, going back to your question, part of the failure of the Bank of England is that, in the years preceding the crisis—and here I would disagree with my colleague, Dr Andrew Hilton—they did not pay a great deal of attention to some of the financial stability issues that were definitely showing signs of a bubble.

**Dr Hilton:** That would not be a disagreement. That would be in agreement with me.

**Professor Lastra:** Okay, then—

**Dr Hilton:** Normatively, they should have done.

**Jane Fuller:** The short answer is that the supervisory board should make sure that the Bank has the resources to do its job. It will oversee the strategies being implemented, including running financial stability properly, and it has to make sure that the resources are there to do it and it has to accept responsibility if it has had some responsibility in undermining that.

**Dr Hilton:** The Chairman of our little think-tank, Sir Brian Pearce, used to be a member of the Court. In the old days the Court was largely staffed with—not staffed, what is the word?—the members of the Court were former bankers or senior bankers, and they had those networks into the City so that they could indeed make a judgment on systemic threats. I think it is a more recent development with the Court that it has lost that kind of talent and instead taken on people whose skills are really corporate governance skills—the skills of a generic board as opposed to specifically a board made up of people interested and knowledgeable about financial stability issues.

**Q294 Chair:** Before I hand over to David Ruffley, it does sound—listening to you all and picking up on quite a bit of the written evidence we have had—that wherever we place it, a body with a good deal of experience needs either to be created or the Court needs to be buttressed in a form that can play quite a sophisticated supervisory role, and that what we think of as policy, and what we think of as process or resources, inevitably are going to overlap to some degree, and that this body has to be given some discretion to engage with a high level of support in thinking through whether the Bank is doing a proper job. Is there anybody disagreeing with that?

**Professor Lastra:** Not disagreeing, but I would say that the concept of governance and internal governance is different from the concept of accountability: who guards the guardians? So I would still favour giving further resources to Parliament and to a parliamentary Committee, like this Committee, because the accountable and the accountee cannot be the same, and somehow in the Court you also have some of the people who are taking the decisions.

**Q295 Chair:** So you think Parliament should be doing this?

**Professor Lastra:** Definitely.

**Q296 Mr Ruffley:** Dr Hilton, you have painted a picture that really runs like this: financial stability was the collapsed left lung. You think macro-prudential regulation would better sit in an improved FSA. It should not necessarily go back to the Bank, but I think you have nevertheless conceded—I think we all have to concede—that the FPC will sit as a subsidiary or as an entity of the Bank, and then the PRA will be a subsidiary of the FPC. The FPC has to get tooled up properly, doesn't it, and you have given two examples of where best practice might point us in the direction of amendments to the Government proposals. As I understand it, financial crises and unstable events can come at virtually any time, and you have implied there should be more frequent meetings than is perhaps envisaged. Do you think that should be a weekly meeting?

**Dr Hilton:** I think I would like to get away from the idea of separate, discrete meetings. This is a continuing party. I am not sure even if the word "committee" is quite right; it is a body. It should be a continuing body that deals with systemic stability issues going forward. That might mean that it should be staffed almost on a full-time basis. It certainly should have a full-time staff backing up whoever are the key people on that body.

**Q297 Mr Ruffley:** I think you also referenced a US practice where a specific—I forget the name of it now—body is responsible for the data collection.

**Dr Hilton:** The financial reporting office, which is a very interesting initiative. I assume that this has been raised by other people. Nobody quite knows how it is going to operate. It is a creature of the Treasury, but it is independent of the Treasury and it is going to have responsibility for collecting, collating and disseminating data on the stability of the financial system. It will be staffed. The head will probably be

an academic, not a career Treasury official, somebody whose experience is in data collection and data management. Most people in the financial regulatory world are looking at this with great interest to see if it works and whether we should bring it in over here.

**Q298 Mr Ruffley:** Forgive me, but historically the Bank of England has had a very prominent role in financial regulation in this country generally. Why do you think there would not be adequate officials in the Bank of England to do that kind of work on financial data?

**Dr Hilton:** Because there is so much financial data now. It is at a European level; it is at an international level; it is also at a UK level. There are many competing bodies in this space: the National Audit Office is obviously one; the Treasury has a lot of information; there are all the Brussels agencies and IOSCO. There are dozens of acronyms stacked up to the ceiling, all of which have behind them bodies of data. I think certainly we could piggyback on the work of the office of financial reporting in the US. I don't think the intention is that any of this data should be proprietary. It is public data. Some sort of co-operation agreement with the OFR would make a lot of sense for the UK. We are dealing with international banks and international data.

**Q299 Mr Ruffley:** I will get on to the Court in a minute, but could I ask for your views on the composition. The shadow FPC has the Governor, two Deputy Governors and the current Head of the FSA. That is four voting members. The Governor can appoint two executive directors on top of that, who will be bank creatures. So that is six insiders and only four externals who will vote, and I think the 11th man is non-voting, but would be from HM Treasury. Does that seem to you an optimal mix: effectively, six insiders on the FPC plus four externals? One might even argue that one of the externals is a bank insider. I think you know who I am referring to. What are your thoughts on that?

**Dr Hilton:** My thoughts are there are not enough externals, and we have probably at the moment, if the interim FPC is an indicator of what the permanent one will be, probably the wrong outsiders. I think one is an investment banker and one is a former Fed official. So one is a regulator, an American regulator, and one is an American investment banker. I think this is not representative of the kind of skill set that we ought to have from the outsiders on this committee, but I defer to others on this.

**Q300 Mr Ruffley:** It brings me to my final question. Given that all these things need chewing over in some detail—the frequency of the meetings, the adequacy of the resourcing so that good policy decisions are made, whether it is a permanent body following things in real time, or a secretariat at least, how the externals are performing or whether or not there are enough externals—it seems to me that there are a lot of questions that you have referenced today and that this Committee has looked at, and doesn't that argue for a really high-powered technically informed Court? Because the Court is tasked with being the body under

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this regime responsible for the FPC. Doesn't that worry you, because in the Court, as currently comprised, there is a lot of room for improvement when it comes to the technical adequacy of some of the members who will, if nothing else changes, be the body to whom the FPC is accountable? Does that really worry you, because it rather worries me?

**Dr Hilton:** In my opinion, there has to be that body. Whether it should be the Court, I don't know, or whether it should be a parliamentary committee. There are various ways of skinning that particular cat. The Court, as currently constituted, would not be a satisfactory body for that kind of role, but I am inclined to share the view of my colleague that perhaps that is not the role that the Court should really be filling.

**Jane Fuller:** I think you need more external input on two counts. One is to get the right sort of expertise as the external members of the FPC. Arguably, I think that it should be at least as many external members as internal, and that they should be people more from the real world, in terms of spotting credit bubbles. That is the thing we are most worried about.

The second thing is that you do need a counterweight to the bank. Mervyn King chairs virtually every committee. He and his executives dominate, they are in the majority and they have all the resources, and from a governance point of view it looks as though we are lacking challenge and counterweight to the Executive.

**Q301 Mr Ruffley:** I agree but, given that this structure or something very like it will be enacted—let us just assume that—the role of the Court becomes even more important. I wondered what sense any of you on the panel have as to how we could beef up the technical adequacy and proficiency of the overseers of the FPC, monitoring the performance of the externals and the resourcing of the Secretariat that will supply FPC members with data. It seems to me that to understand whether the FPC is doing a job or not—and the Court has been tasked with that—would require the Court members to be technically more adept and competent than certainly we have reason to believe they are at the moment.

**Professor Garratt:** As statutory directors of the Bank of England, they have a 24/7 responsibility and I think their commitment to that is as important as some of the technical skills. I am not saying that technical skills are not important, but it is the whole ethos that is created around that Court and the whole way in which you fight that was mentioned in the papers—the group think and all those elements—that is so important. I can think of many ways in which it is possible to build really effective boards like that. In my limited experience of central banking, the most extreme was in Saudi Arabia but there it was wonderful. They simply said, “We will choose the best people in the country and it will be an honour for them to be invited to join in this activity. They will be heavily monitored.” They also had some sense of being able to say, “And money is no object”. It was key to getting really motivated people into those roles, then to get those folk excited about the development of the banking supervisors and then below them the

banking inspectors, so that the whole thing began to work as a hugely proud and committed organisation.

**Professor Lastra:** On your question of the composition of external/internal, I think it should be finely balanced. I think the externals are very important to avoid the group think. At the same time, you need the internals because you need intimate knowledge of monetary policy. There are synergies between monetary policy and financial stability that perhaps were missed before the crisis—let us make sure that we do not miss them again.

At the same time, the Court needs to be responsible to Parliament. It is like having a layer in between that goes, “Who guards the guardians?” and that is why I keep coming back to what is the standard in other countries, which is to have—particularly in the United States—greater mechanisms of parliamentary accountability through reporting, through witnesses, and sometimes through having a dedicated committee of people who are technically competent to match the expertise of the Bank people who will be coming here to give evidence to you on how well or how badly they have managed to conduct financial stability. I would say that financial stability is as important as monetary stability, and that the neglect of one or the neglect of the other can be very detrimental for the country.

The Banking Act 2009, which gave the Special Resolution pretty much to the Bank of England, is one power too much, because now the Bank of England has four hats: it is the monetary authority; it is the supervisor both of macro-prudential and of oversight of macro-prudential; it is a lender of last resort; and it is in charge of the Special Resolution Regime. I have always worried that if an institution wants liquidity assistance from the Bank of England, it may be wary of doing so if the Bank of England is going to exercise the Special Resolution powers, which were given to it by the Banking Act. I know that the debate is about accountability, but that is what I think, although it goes beyond your question: it is one power too many.

**Q302 Mr Ruffley:** Again, to focus the question, do any of you think that the Court of the Bank of England, as currently composed, is adequate, is up to the job, is a body fit for purpose, to scrutinise the work of the FPC?

**Dr Hilton:** I think I can summarise for all four of us: the answer is no, but we do not necessarily think that the Court is the appropriate body to do that. If you take the decision that, regardless of whether it is in a perfect world, it will be the body, then the Court has to be re-engineered and re-staffed.

**Q303 Chair:** You want us to have a look at this financial reporting office, don't you?

**Dr Hilton:** I am certainly very attracted by it. I know that a lot of hope is being put in better information. Better information produces better decisions, but it has to be better information produced in a timely way that even politicians can understand it.

**Chair:** Oh my goodness gracious me.

**Dr Andrew Hilton:** Sorry.



**Chair:** With that, we are cautious about asking any more questions, but I know Andy Love has one more, and then I have two more quick questions.

**Q304 Mr Love:** I just wanted to follow up on this issue of group think. While I think most people around this table will accept that we don't want to change the Court in the very radical ways that would be necessary if it wanted to indulge in policy issues about stability, it performs a role in relation to the Monetary Policy Committee of ensuring that members can speak openly and honestly, and it provides them with back-up. Are there any additional measures that might be taken in relation to stability, where they can try and ensure that group think doesn't take hold at an early stage?

**Dr Hilton:** When DeAnne Julius was a member of the Monetary Policy Committee, I think she was the first member of the Monetary Policy Committee to effectively demand her own staff, and a staff—

**Q305 Mr Love:** The Court played an honourable role in that process.

**Dr Hilton:** Yes, and I think if the Court could play that sort of role for the independents, to ensure that they were adequately staffed and that if they felt they needed the resources to go to Basel and have a look for themselves, that they would get it. I think the Court there would play an important role on the Policy Committee.

**Q306 Mr Love:** Let me ask you, Ms Fuller, whether there should be a role for members of the Stability Committee to go through the Court if they feel that they are being hemmed in regarding what they can say in relation to the issues that they will discuss?

**Jane Fuller:** Yes is the short answer. They have a supervisory role, and I may have painted a slightly narrow picture of a supervisory role, so yes.

**Dr Hilton:** The key is that the external members of the Financial Policy Committee should be people who are willing to rock the boat.

**Jane Fuller:** Yes, and they need that support from that counterweight-type body, which is what the Court is as well as overseeing the management.

**Professor Garratt:** Then the quality of the chairing becomes absolutely crucial, as a neutral activity—it is fundamental. Behind all that, we find the Court governance codes and so on, but the notion of the annual appraisal of both the board and the Court, each of its committees and any subsets that it has, is very important indeed. It is built into the secondary legislation. Most people don't bother with it, but it is there. I think the Bank could be a very interesting exemplar in future as to how that might work.

**Q307 Chair:** Very helpful. I have a couple of further points I wanted to raise, just to wind up, first of all to Jane Fuller. When you—I think it was you—said that the Governor had all these powers and responsibilities, as he is chairing so many things, have we inadvertently created a single point of systemic risk?

**Jane Fuller:** Possibly, but to be fair, some inactivity on the financial stability part before created systemic

risks, so you certainly need to have some responsibility and you need to have some clear management. However, I think it just looks as though there is dominance by the Executive and dominance by the Governor as the head of Executive.

**Q308 Chair:** Changing the balance of externals to internals might help?

**Jane Fuller:** Yes, and I think it also may mean that Court has to be left out.

**Q309 Chair:** So five/four in favour of external on the MPC; something similar on the FPC?

**Jane Fuller:** Yes, and I suppose it is also in terms of the—sorry.

**Q310 Chair:** Just to be clear for the record, are you agreeing with that?

**Jane Fuller:** Yes, I think it would be better to have—[*Interruption.*]

**Q311 Chair:** I am getting agreement from Professor Lastra.

**Jane Fuller:** Yes, there should be at least as many, if not more, externals as internals.

**Q312 Chair:** Okay. So it is the equal numbers plus one that you see in the corporate governance code that you would like to see replicated.

One last question that we are giving some thought to. We don't have an answer to it, so if you can provide us with one, we are very interested. It is topical in a number of things the Committee has been looking at recently, which is: how should Parliament, and this Committee in particular, scrutinise decisions on the basis of evidence that has been collected confidentially? Take, for example, the work of the FPC. In order to work out whether the FPC is doing a good job, it is necessary to take a look at the evidence base and some of that material is commercially, and in some cases in a sovereign sense, confidential.

**Jane Fuller:** I know that that is part of the argument for the FPC not meeting too often—that you have to see some trends emerging. It is a very important question, but if the Governor of the Bank of England has to write to the Chancellor when inflation goes way over target, then at what point would he as Chairman of the FPC have to write to you or the Chancellor or the Chairman of the Court? It will be important that there are some measures of that, in terms of whether it is, I don't know, credit expansion or—

**Dr Hilton:** I think you have a really important issue, but it must come up with every other Select Committee, with security issues, with other issues. Certain information must be held confidentially, I would have thought, and inherently information on financial stability is going to be potentially dangerous if it got out.

**Jane Fuller:** That is why it is difficult to choose and find external people.

**Dr Hilton:** Right, but there are security committees that deal with this kind of thing all the time.

**Professor Lastra:** I think this is a fundamental issue, because for transparency in this area [financial

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stability] the general principle is the same, but sometimes the untimely release of information can trigger the very negative consequences that you want to avoid. So I agree you are dealing with very sensitive data and I am not surprised that you are struggling with it, because I think the US and most other countries are struggling over these issues: how to balance adequate transparency—a lot of the content of accountability is also transparency—with the need for confidentiality that you need to maintain. Sometimes it is a matter of timing, and sometimes it is a matter of priorities. Sometimes it is like what they did in the US when they wanted to take away the stigma of going to the lender of last resort. Some of the facilities that the Fed created encouraged all institutions to go to the Fed, so that—

**Dr Hilton:** Required.

**Professor Lastra:** Required to go the Fed, otherwise there was the feeling that only the desperate go to the

Fed, as when Northern Rock came to the Bank of England, so it was trying to take away the stigma. I certainly don't have an answer for that one. I think it is one of those issues where you will need to continue to fine-tune because it will be a very important part of any parliamentary inquiry that you hold.

**Dr Hilton:** A super-injunction.

**Professor Lastra:** Certainly to have the press in some of those moments might not be suitable.

**Chair:** Thank you very much, all of you, for giving evidence this afternoon. It has been extremely interesting. I have to say, for the most part, you seem to have confirmed most of our prejudices, but that doesn't always happen when people come to give evidence and thank you very much indeed for coming this afternoon.

Tuesday 21 June 2011

Members present:

Mr Andrew Tyrie (Chair)

Michael Fallon  
Mark Garnier  
Andrea Leadsom

Mr Andrew Love  
Mr David Ruffley  
John Thurso

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**Examination of Witness**

*Witness:* **Dr Gavin Bingham**, Secretary General, Central Bank Governance Forum, Bank for International Settlements, gave evidence.

**Q313 Chair:** Thank you very much for coming to give evidence before us this morning, and for your extremely interesting paper that you submitted. You have seen, no doubt, Willem Buiter's evidence, Goodhart's evidence and others. When we move from peace time to war time, when we move from the point where we are just in the business of monitoring things to the business of possibly providing liquidity or other support to a financial institution or to parts of the system, who do you think needs to be in charge of the FPC, the Bank or the Treasury?

*Dr Bingham:* I think one way to view the question is who should be in control of public money that is put at risk, and I think that the universal experience of central banks in countries around the world is that the Government, the finance ministries, the Chancellor should be in charge of the provision of solvency support.

**Q314 Chair:** Does that mean chairing the FPC, taking over chairmanship of it? Who is going to be chairing the FPC in this crisis phase?

*Dr Bingham:* The FPC is not designed, as I understand it, as a crisis management body. It is designed essentially to identify risks and to propose measures to be taken to deal with risks<sup>1</sup>.

When one moves to the crisis management mode there is something in the proposals that calls for a memorandum of understanding between the Bank and the Chancellor. As I understand that, that is a placeholder and that has not yet been worked out. I can tell you—

**Q315 Chair:** This is exactly where we were over a decade ago, is it not, where we awaited a memo of understanding and then we finally got the memo on the tripartite arrangement and that fell to pieces the first time it was tested. It does not sound a very happy place to be, does it? Do you agree?

*Dr Bingham:* Yes. I agree that this is placeholder and I think one of the duties of this Committee and those who are designing the arrangements is to determine what would be the most appropriate arrangement. I can tell you—

**Q316 Chair:** What is your preferred arrangement? Not what other countries are doing. You know what other countries are doing but what I want know is having looked at all of those what do you think is right for us?

*Dr Bingham:* Let me talk about the pluses and minuses. In the United Kingdom, there is a very special funding arrangement for the central bank that differs from the funding arrangement in central banks around the world. Most central banks have a claim on the income that arises from the issue of bank notes. In the UK this is not the case. Since 1844, the seignorage has been turned over to the Government. The Bank has no resources of its own that it can put at risk; it must seek indemnification from the Government.

**Q317 Chair:** Yes, but in the middle of a crisis we are not going to have a row about seignorage. What we want to know is who is in charge and that is what I am asking you. What is your preference about who we put in charge and how because we are seeking advice from our witnesses on what to recommend.

*Dr Bingham:* I think the distinction we ought to make is between liquidity support and solvency support. Central banks around the world provide liquidity support. That is not putting public money at risk. Solvency support is putting money at risk. The FPC is not designed to be a committee that is making judgements on the provision of solvency support. It is in the business of crisis prevention, to make that less likely. Now there are arguments for having prudential supervision in the central bank and outside. If you look across the world, about half the central banks have it inside, about half have it outside. The trend recently as a result of the crisis has been to move it back in. Experience with macroprudential policy is much more recent. We only have three bodies around the world that have come up with designs: we have the United States; we have the euro system; we have Malaysia. They

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<sup>1</sup> *Note by witness:* It therefore makes sense for the person who chairs the body in peace time to continue to chair it in war time. The proposals call for the Governor to serve as the chair *de jure*. Having the Governor chair a major policy committee is in line with practices elsewhere. However, more degrees of freedom could be introduced if the chair of the FPC were chosen using the procedures now applied to appoint the Chair of Court. These procedures permit the Chancellor to appoint any member as the chair.

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have come up with three different designs.

**Q318 Chair:** Is not the problem with the distinction between liquidity and solvency support that at the time the first liquidity support is discussed or provided there are wide-ranging views about where that is going to end up and nobody knows. Therefore, what value is that distinction in working out who should be in charge?

**Dr Bingham:** I agree entirely with you that the distinction changes rapidly over time and liquidity can be provided to a solvent institution that next week is insolvent. That happens—

**Chair:**—in hours?

**Dr Bingham:** The situation is dynamic.

**Chair:** Hours, not days, is that not the case?

**Dr Bingham:** That is true.<sup>2</sup>

**Q319 Mark Garnier:** The Government last week published its White Paper on financial regulation. How do you think these compare with international financial regulations? Do you think these proposals are particularly groundbreaking?

**Dr Bingham:** My expertise is not in financial regulation; it is in governance and the design of central banks and public policy institutions so I am not qualified to speak.

**Q320 Mark Garnier:** If I could just qualify that: in the context of the Bank of England's role in financial regulation.

**Dr Bingham:** One of the things I have been struck by is at least the quantity of pages devoted to this. The White Paper is 400 pages and I have not yet had a chance to fully digest that. I do note that complexity was one of the causes of the crisis and wonder how much complexity there is in those 400 pages.<sup>3</sup>

**Q321 Mark Garnier:** Absolutely. Looking at the old tripartite system, again in terms of where the Bank of England is involved in that, what do you

<sup>2</sup> *Note by witness:* It is therefore essential to have clearly specified procedures that anticipate the transition from illiquidity to insolvency and permit rapid decision making and immediate action. The proposals call for the Treasury and the Bank to develop a memorandum of understanding. This should be a high priority. The memorandum should specify the role of each party in the decision making process and ensure that the decisions, for example on the provision of indemnities to Bank and other related matters, can be made quickly. This committee might want to review the draft in order to determine whether it allocates responsibility clearly and permits sufficiently rapid decision making.

<sup>3</sup> *Note by witness:* The proposals in the White Paper span more than 400 pages, which implies either complexity or verbosity. Part of the complexity in the current proposal is due to revisions to the FSMA legislation, but another part arises because different decision-making and accountability arrangements are foreseen for monetary policy, macro-prudential policy and micro-prudential policy. Most central banks have simpler legislative frameworks. A simpler framework would make it easier to hold responsible parties to account. High level matters could be set out in legislation, with secondary legislation being used to flesh them out and with Court being given restricted powers to decide on organisational and procedural matters.

think was wrong with the Bank of England's role in accountability in the old tripartite system?

**Dr Bingham:** My speciality is the range of central bank experience. I am not a specialist in the way the Bank of England operates. If you think of the central bank accountability mechanisms that have been set up around the world, there are three types of accountability: accountability for policy, accountability for operations or processes and accountability for resources. Accountability for monetary policy in the UK relies very heavily on transparency. I would say it is at the forefront along with the Nordic countries in providing transparency about objectives, about actions and about outcomes. This permits the public at large and committees like this to hold the central bank to account for policy decisions. I think the question now arises: to what extent can that approach that has been applied successfully in the monetary policy domain be applied in the financial stability domain?

**Q322 Mr Love:** Can I turn to the issue of oversight boards? You mentioned in your paper that most have them but some do not. What is the range of other alternatives if you do not have an oversight board?

**Dr Bingham:** Whether you have them or not is very often a function of history. There are two types of central banks that have them: one, central banks that were originally created as companies and then nationalised so they have had a board; that is the case in the United Kingdom. The other case is that where the boards have been established, essentially as agents of Parliament to exercise oversight on behalf of Parliament, and this you find in the Nordic countries, in Sweden and Finland.

In countries or regions—I am talking about the euro area here—where central banks were set up *ab initio* as public agencies, central banks sometimes do not have oversight boards. In these cases oversight by committees like yours is extremely important. These committees assume some of the functions that would otherwise be exercised by an oversight board. In addition, in these countries, there is often a public auditor which performs some of the functions that otherwise would be performed by a board. The oversight and stewardship of the resources by a board is one of its most important functions so they oversee the audit process but, if you do not have a board, then you have to do it in some alternative way, for example through a public sector auditor.

**Q323 Mr Love:** I am going to come to that issue of not having a board because that has been suggested to us by other participants in this discussion, but perhaps you could just outline for me what the classic oversight board would look like. Do the proposals that are being put to us accord with that classic view of an oversight board?

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**Dr Bingham:** In fact, oversight boards are evolving over the course of time.<sup>4</sup> In one case, where they were set up originally as oversight boards, what I will refer to as the Nordic model, the members tend to be all external members. In this case the board often has an important role in the appointment of the governor and the senior officials. In the case of boards that have evolved out of management boards, they have assumed oversight functions as the management has been given to the executives of the institution and they then become responsible for the oversight.

**Q324 Mr Love:** Would you personally favour that Nordic model or the model that has been proposed here? What are the advantages and disadvantages?

**Dr Bingham:** The advantage of the Nordic model, if you will, is a clear accountability to Parliament because these boards are established by Parliament and appointed through a public process<sup>5</sup>. These boards pay more attention to appointment of senior central bank executives and less attention to the financial integrity of the central bank than oversight boards that have evolved out of management boards. This second type of board often exercises oversight over the financial position of, and use of resources by, the central bank.

**Q325 Chair:** Which do you recommend? Again, we need advice. You understand the system from a lifetime of looking at it. We need to know which is most useful to us in your view.

**Dr Bingham:** My view is that it is very useful to have an oversight board. In the two thirds of the central banks that have them there has never been a case that I know of where such a board has been abolished when there has been a fundamental review of the legislation. The question of how it is constituted, I think, must be embedded in the history of the institution.

**Q326 Chair:** And for us?

<sup>4</sup> *Note by witness:* The paradigmatic central bank oversight committee supervises the operation of the institution on behalf of the stakeholders. It is constituted in a manner that avoids conflicts of interests and institutionalises checks and balances. Its capacity to perform its oversight function is assured by making sure it has the necessary access to information and support. It approves rules of procedure, bylaws and codes of conduct. It determines the allocation of tasks among the executives and the organisation of the central bank. It exercises oversight over the finances of the institution by approving the budget and deciding on the allocation of surplus. It oversees the risk control and audit function. It participates in decisions to appoint, suspend or dismiss senior officials. It evaluates their performance and sets remuneration levels or policy. It also serves to safeguard the central bank from partisan political influence. For central banks that were nationalised or originally set up as public policy institutions, the oversight board acts as an agent of Parliament or the government. With the expansion of central bank balance sheets and the accompanying increase in risks that occurred in the crisis, oversight boards now have the important task of scrutinising risk management and the financial strength of the central bank more closely.

<sup>5</sup> *Note by witness:* In Finland the Constitution states that central bank operates under the guarantee and oversight of Parliament and provides for a Parliamentary oversight board.

**Dr Bingham:** Your history is one that has evolved out of a management board and I would think that the further evolution of such a board in a manner that ensures the professionalism, impartiality of the members would be a serviceable model.<sup>6</sup>

**Q327 Mr Love:** So should all the representatives be from the outside rather than internal as we have at present?

**Dr Bingham:** In cases where you do have all externals on the outside board, there is the question of the acquisition of information. How do they get the information they need about how the central bank operates? In these cases—Norway is an example—the boards have to have a fairly strong secretariat that in some way collects the information that is relevant. The advantage of having some internals present, at least in the discussions or perhaps on the board is—

**Q328 Mr Love:** If I could say what the Chairman said just two seconds ago: you are an expert in this area. Do we strengthen the secretariat and have outsiders or should we have internals as we have at present?

**Dr Bingham:** I think the decision to give the chairmanship to a non-executive was very much in keeping with that being the proper thing to do.<sup>7,8</sup> Before 2009, having the governor chair the board created a clear conflict of interest. I think both can be made to work.<sup>9</sup> I think there is the question of: do you want it to embed it in UK traditions or do you want to move far? Both can work, but there is a case for building on what already exists.

**Q329 Mr Love:** Can I ask you about the policy role? As you know the FPC will report to the Court and there is a whole series of issues around what should be their role in policy in relation to the FPC. What is your view?

**Dr Bingham:** The current arrangements, as I see it, provide great advantages. There is the explicitness of the objectives. There are explicit objectives in the legislation. There is provision for the Chancellor to provide a remit and, moving down the hierarchy, a mechanism by which the Court would set out a strategy within this context. I think that is very much in line with accountability through transparency in conditions where it is not possible to set a quantitative target. You need clarity about overall objectives, about where you are going and how you are going to get there. I think that sort of arrangement helps in the application of

<sup>6</sup> *Note by witness:* The positive features of the Nordic model—clear accountability to Parliament and a clearly specified role in appointment and dismissal of senior central bankers could be adopted in the UK.

<sup>7</sup> *Note by witness:* Having some internals has advantages, as long as they are in a clear minority and precluded from influencing decisions in which there is a conflict of interest.

<sup>8</sup> *Note by witness:* The evolution of Court into an effective oversight board where external members hold sway is the proper thing to do.

<sup>9</sup> *Note by witness:* I think both a board with a clear majority of externals and a board with all externals can both be made to work.

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accountability—accountability to you and to the public at large<sup>10</sup>.

**Q330 Mr Love:** There has been a whole debate in our discussions about whether or not the members of the Court have the expertise or the support necessary for them to involve themselves in a policy role. How do you feel about that? Do you think we would need to change completely the personnel and the support given to the Court if they were going to get directly involved in policy matters?

**Dr Bingham:** I do not know about the skills and the expertise of your oversight board, but certainly over the course of time there has been a change in the composition of oversight boards in other countries. There has been a clear movement towards, if you will, expertise and professionalism. You will find in my written evidence indications of the types of professional qualifications that are required. Formerly, it was often the case that the boards represented different segments of society but now there has been a movement towards the professionalisation of the oversight function. I expect that too would be very natural here as well. However, finding people with relevant expertise who are free of conflict of interest is not trivial at all.

**Q331 Mr Love:** It has been put to us that we should go to the system operated by other countries that do not have supervisory boards—in other words, the link is directly between the FPC and the Treasury Committee—and that we use the National Audit Office as an auditing body to oversee the work of the Bank of England. Do you think there is any merit in that? You seem to be, if I can put it bluntly, somewhat of a traditionalist. You think we should at least evolve out of the existing practice. Are you not sympathetic to a big bang approach to this matter?

**Dr Bingham:** As I said, I think that can be made to work. The question is: is the current system so broken that it needs to be radically overhauled or do changes need to be made in its functioning?

**Q332 Michael Fallon:** At the end, there is a section in your paper on oversight boards. You say, “The assessment of policy decisions themselves is usually outside the board’s purview.” Why is that?

**Dr Bingham:** I think there are two reasons: one, quite appropriately central banks are accountable ultimately to the public at large and to the public through Parliament and Government. So the assessment of the policy decisions is to committees like this, whereas the policy process and the performance of the institution quite properly are subject to the oversight of the boards themselves. There is, if you will, a division of responsibility with the policies themselves and the decisions being subject to oversight by Parliament and Government,

and with the processes and the stewardship of resources being overseen by the oversight board.

**Q333 Michael Fallon:** That implies that the Court under the present model really should not have any role in holding its own committees to account, but should simply focus on housekeeping. Is that right?

**Dr Bingham:** No. If you look at the way such committees operate around the world, they do set operational strategies and examine policy processes and, indeed, the Court itself has on some occasions commissioned studies into the operation of the MPC, even though the MPC is a committee of the Bank, not a committee of Court. So it is certainly possible for an oversight board to ensure the integrity of the process by which policy is made. Indeed, I think that is a very important role. A body should be concerned with things like: is information being used appropriately; are all the options being considered; is there group think present as a result of the design? But the question of whether the right decision was made is something that is beyond the purview of most boards. There are one or two cases where there is some evaluation. In New Zealand, there is a process whereby the board evaluates policy decisions. It receives the same information that the bank itself received and its remit is to assess, given the information that the bank had at the time the decision was made, whether that decision was correct. Similarly, in Hong Kong there is a review of decisions, but on the whole reviews of policy decisions by oversight boards are quite rare.

**Q334 Michael Fallon:** That is more than housekeeping; that is reviewing processes. If the Court of the Bank of England is to review processes, the processes of these three committees now, is it appropriate that members of the committees should go on sitting on the Court?

**Dr Bingham:** Yes.<sup>11</sup> This is the same issue that arises with having the governor chair of the committee. Again, you have the trade-off for the information: how do you get the information; how do you exercise the oversight? It is the same issue.

**Q335 Michael Fallon:** Yes, but what is the answer? Should members of these committees go on sitting on the Court? What is your view?

**Dr Bingham:** At present, if they do continue sitting on the Court, there should be an effective way to ensure that they are not involved in the oversight of their own decisions. There are mechanisms to do this but the most important thing is to ensure the clarity of responsibility for oversight and for the decisions. That can be done even if members of the committee sit on the oversight board—it depends on the process. The other way to do it is to cut them off entirely and then the question is how the oversight body gets the information.

<sup>10</sup> *Note by witness:* However, both the MPC and the FPC could be constituted committees of the Bank, with Court exercising oversight over process and use of resources of both committees, and Parliament exercising oversight over policy decisions.

<sup>11</sup> *Note by witness:* This permits the committee to understand the processes it oversees, but it is essential to have arrangements that effectively address conflicts of interest and segregate overseers from the overseen.

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**Q336 Michael Fallon:** Which of those two do you prefer?

**Dr Bingham:** They can both be made to work.<sup>12</sup> If you go with the one where you have both—those who are subject to oversight present, you need two things. One, you need a clear mechanism or procedure to ensure that the oversight is in no way prejudiced by the presence of such people and you need a mechanism to make sure that the other members have sufficient knowledge and expertise to be able to exercise the oversight.

**Q337 Michael Fallon:** Do you think the Court has been successful in the past in exercising proper oversight over processes?

**Dr Bingham:** I am not familiar enough with what they have done. I do know that on one or two occasions they have commissioned studies.

**Q338 Michael Fallon:** Right, but you do not have sufficient knowledge to form a view as to whether that has been done sufficiently?

**Dr Bingham:** I am afraid I do not.

**Q339 Michael Fallon:** Do you think it is possible for the structure of the Court to be appropriate to supervising the processes of three committees?

**Dr Bingham:** The Bank will become a more powerful institution and it needs effective oversight mechanisms. I think the Court, properly constituted with the appropriate expertise and with proper membership, could be an effective oversight mechanism. Yes, I think it could.

**Michael Fallon:** But it is not at the moment.

**Dr Bingham:** As I say, I am not in a position—I do not think—

**Michael Fallon:** But you use phrases like “properly constituted”, clearly implying that you do not think it is properly constituted at the moment to exercise this much larger oversight function that will be required when the three committees are operating alongside each other.

**Dr Bingham:** When I say “properly constituted”, I mean having a clear majority of non-executive directors who have the time and expertise to exercise oversight. At present, the Court has a clear majority of non-executive members. I know the structure of the Court. I do not know its operation and for that reason I cannot comment on what it has done. The structure—having a clear majority of non-executives—is compatible with an effective oversight role. There is the question of conflicts of interest that will inevitably arise. How can you get members who have sufficient expertise and are free of conflicts of interest?

**Q340 Michael Fallon:** You say somewhere else in this paper, I forget where it is, that all these things are happily bound up in the Fed in the United States, but it is not quite the position, is it? The new

financial policy council is chaired by the Treasury Secretary, is it not?

**Dr Bingham:** Yes, that is right.

**Michael Fallon:** That is very different from the model being proposed here.

**Dr Bingham:** Yes, as I said, we have four models that are out there. You mentioned the Financial Stability Oversight Council (FSOC) arrangement where the Secretary of the Treasury chairs the body. In this case we are talking about a country—the United States—that has quite a number of different regulatory agencies. These are brought together under the roof of this committee, the FSOC. In Europe, a different approach is being taken. The European Systemic Risk Board (ESRB) is chaired by the President of the European Central Bank (ECB) and support for the ESRB is provided by the ECB. The central bank therefore plays a prominent role in it. In Malaysia, there is something similar to what is being considered here. This is a committee within the bank. Again, the same set of issues arises.

**Q341 Michael Fallon:** But here we have this antiquated Court structure and, in essence, we are just proposing to tweak it slightly. The Government think that is sufficient to exercise a much-increased oversight function. That is the position, is it not?

**Dr Bingham:** Again, I know of no instance where an oversight body has been abolished. I know instances where they have been enhanced in terms of structure, in terms of what they look at, and I think that would be a viable model in the case of the UK.

**Q342 Andrea Leadsom:** Dr Bingham, we are very keen to have your advice and we are trying very hard to hold this inquiry so that we can provide the Committee’s advice. It is very difficult because you are not really giving us your opinion. You are just giving us a series of options, which are already quite clearly evaluated elsewhere. It would be very helpful if you would give us your advice.

Very specifically, one question I would like to ask you is: do you find it astonishing that the Court of Directors in the Bank of England never held an investigation into the actions of the Bank of England during the financial crisis?

**Dr Bingham:** I certainly think it is the role of the Court to examine processes and procedures.

**Q343 Andrea Leadsom:** Do you think it is surprising that they have never done such a thing?

**Dr Bingham:** I would have expected some form of evaluation, yes.

**Andrea Leadsom:** Thank you.

**Q344 Chair:** Have you seen one so far?

**Dr Bingham:** No.

**Q345 Andrea Leadsom:** Exactly. I think it is astonishing too; I am glad you agree. So given that the new Financial Policy Committee will be a committee of the Court, do you think that it is

<sup>12</sup> *Note by witness:* Having an oversight board with a few executives who provide information and a clear majority of non-executives who are impartial, experienced and prepared to challenge management is attractive.

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appropriate that the Court will be involved in its decision making?

**Dr Bingham:** This is, again, the question of the hierarchy of responsibilities. The Treasury will give the FPC a remit in the form of recommendations about how the FPC will interpret its statutory objective. The Court will be responsible for setting out a financial stability strategy. The FPC will be able to make recommendations to the Court about this strategy. The FPC is a committee of Court. Court is responsible for the oversight of all of the Bank. In this one particular part of the activities of the Bank, it has a more prominent role.<sup>13</sup>

**Q346 Andrea Leadsom:** Is that appropriate? Are there other precedents elsewhere in your knowledge where the oversight body that you have just been discussing is responsible for procedures and so on? Does it not seem strange that in this case the Court of Directors will be directly involved in the decision making of the FPC? Is that unusual?

**Dr Bingham:** My understanding is that they—rather like the Chancellor setting a remit—help decide the strategy, whereas the policy decisions will be made by the FPC.

**Q347 Andrea Leadsom:** But you said yourself that the role of the oversight is normally the housekeeping and possibly a bit of the evaluation of what has gone well and badly. This is a complete departure from that, is it not?

**Dr Bingham:** Yes, we are in virgin territory here in the design of these macroprudential bodies, and I know of no precedent of the type that you are talking about.

**Q348 Andrea Leadsom:** Yes, thank you. Do you think that, if that is to go ahead, if the Court of Directors is to be closely involved with the setting of the strategy for the FPC and it is to be a committee of the Court, the Government will need to relook at the competences, skills and experience of the members of the Court of Directors?

**Dr Bingham:** The simple answer is yes. If the responsibilities change, you have to make sure that the bodies are manned in the appropriate way.

**Q349 Andrea Leadsom:** Would you extend that to looking again at the remit of that oversight body,

because quite clearly the remit of that oversight body at the moment is not fundamentally being restructured or changed? Do you think that that needs to be considered?

**Dr Bingham:** I think that is precisely the sort of question that you should consider and I hope I can provide information that will help you in your deliberations<sup>14</sup>.

**Q350 Andrea Leadsom:** Thank you. I would just like to also touch on specifically accountability. You have mentioned in your submission that about two-thirds of central banks have financial stability as an objective in their governing legislation. Can you tell us: how do they tend to measure that? Do they have specific yardsticks that we could plagiarise?

**Dr Bingham:** I can answer that simply. The answer is they do not. It is very difficult to measure financial stability and this is something that people are struggling with. How can one come up with suitable metrics? This is one area where financial policy, financial stability policy, differs from monetary policy where there are metrics, where inflation is quantifiable.

**Q351 Andrea Leadsom:** So with that in mind, bearing in mind how very difficult it is to quantitatively measure financial stability, is it not then even higher risk that the FPC becomes a committee of a court where the Court's remit is normally to measure and evaluate against a quantifiable strategy? Does it not make it even more difficult?

**Dr Bingham:** Yes, again it is difficult to evaluate performance. It requires judgement and I would expect that sort of judgement of the types of policy, the adequacy of the policy, to be exercised by a

<sup>13</sup> *Note by witness:* According to the proposals, Court will not make policy decisions. It will play a well-defined role in determining how the FPC acts to achieve its objectives by setting out a strategy. Parliament will establish the statutory financial stability objective. Because it is not possible to set a quantifiable objective for financial stability equivalent to a numerical inflation target, a method is needed to flesh out the legislated financial stability objective. The proposal foresees a hierarchy of steps. The first involves the Chancellor setting a remit for financial stability. The second involves Court spelling out a strategy to achieve the objectives and implement the remit. The FPC would make financial stability decisions in accordance with the legislated objectives, remit and strategy. Parliament would hold the FPC to account for its decisions, using the objectives, remit and strategy as a point of reference. Court would hold the FPC to account for the stewardship of resources and the policy process using the same points of reference.

<sup>14</sup> *Note by witness:* The Court was originally a management committee that has evolved over time into an oversight board. Its current remit reflects this origin. It would be useful to make clear that its basic purpose is the oversight of the operation of the central bank and its stewardship of public resources. It would also be useful to make clear that it does this on behalf of the ultimate stakeholders—the public at large and their representatives in Parliament. The remit to oversee process should cover factors that affect the dynamics of decision-making, including those that influence the emergence of groupthink (relative importance of external members, voting procedures, frequency of meetings, presentation of proposals, etc). It would also be useful to continue the changes initiated in 2009 that made Court a more effective oversight body by permitting the separation of the post of Governor and Chairman of Court. The current legislation allows the Chancellor to designate any member of Court (including the Governor) as the Chair of Court. It is difficult to envisage a situation which would warrant the selection of any executive of the Bank (Governor or Deputy Governor) as the chair of Court. Court evaluates their performance, approves their remuneration and authorises the budget that gives the executives access to resources. The provision in the 2009 legislation should be changed to permit the Chancellor to appoint any *non-executive* member of Court as Chair. The legislation should also require the avoidance of actual and perceived conflicts of interest, and clear and detailed procedures should be put in place to prevent such conflicts. There are numerous examples of such procedures in other jurisdictions. Executive members of Court should be explicitly barred from the oversight of their own performance and of the operation of the committees on which they serve.



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committee like this, whereas the oversight body—court—might be looking at process. I will give you an example. Take for example something as simple as the frequency of meetings. Our work on the frequency of meetings of monetary policy committees showed that early on when they were set up, a higher degree of frequency was useful. These were new bodies. They needed to learn. Once the process was established, the frequency was determined by events and by new information coming in, and that is a simple process. In the case of the United Kingdom, there is not that degree of luxury in deciding on the frequency of the MPC's meetings because it is set out in legislation.<sup>15</sup>

**Q352 Andrea Leadsom:** Right, so flexibility would be an important feature, you feel.

**Dr Bingham:** What I am saying is that the design of process is something that an oversight body could look at. How often should the various committees meet? How long should you meet? Do you need to meet a week in advance to thrash out the issues? How do you make decisions? By voting? If so, is it by secret or open ballot. If it is open, what order do you vote in? Is it a secret ballot? These are the sorts of very concrete, process-oriented features of a committee that fundamentally affect the dynamics of the decision process and those are the sorts of issues that could very usefully be examined by Court.

**Q353 Andrea Leadsom:** Very interesting. Can I ask one other question? Would you have preferred for the FPC to be established on the same basis as the MPC where the oversight body was simply responsible for overseeing policy and perhaps the Treasury was more closely involved in setting the remit of the FPC, so that there was a bigger independence between the oversight body and the FPC itself?

**Dr Bingham:** Yes, I have been struck by the different accountability arrangements for the three policy decision-making arrangements—one, the existing MPC body is a committee of the Bank; another, the FPC or the macroprudential decision making body is a committee of Court and the third, the PRA, will then be a wholly owned subsidiary of the Bank. These are three distinct structures and I have been struck by that. I do not fully understand why there are those differences.<sup>16</sup>

**Q354 Andrea Leadsom:** Can you think of a reason why—I do not want to go into the PRA because I think it is a slightly different issue—the FPC and MPC might be differently constituted? Why

<sup>15</sup> *Note by witness:* It would be sensible to delegate to Court decisions on structure and process of the Bank and its committees, reserving to Parliament the assessment of the Bank's policy decisions.

<sup>16</sup> *Note by witness:* Making both the MPC and the FPC committees of the Bank would provide for greater symmetry in their accountability. Both would be accountable to Parliament for policy decisions and to Court for the use of resources and for process. This would also remove any suspicion that Court was involved in FPC policy decisions.

wouldn't the FPC be set up as a body like the MPC?

**Dr Bingham:** For one thing, the types of expertise that you need are different.

**Andrea Leadsom:** Yes, of course. Notwithstanding that, but in terms of the structure of the committee.

**Dr Bingham:** Yes, I think it may well have to do with the sorts of issues we were talking about before—the extent to which it can set concrete objectives and the extent of the way they can be evaluated. The United Kingdom stands out from other central banks in the way objectives are set.<sup>17</sup> In some senses, the Bank of England is on a very short lead. If you take the ECB or the Fed, the objectives are set out in legislation and these central banks decide how to implement them, how to balance multiple objectives.

The Fed has multiple objectives and it decides what the relationship is between them. In the case of the ECB, there is a hierarchy that is set out in the legislation. There is nothing equivalent to the Chancellor setting an inflation target, or anything equivalent to the Chancellor providing a remit to the FPC. So the Bank of England is, in some sense, as I say, on a very tight rein in what it can and cannot do.

This is pure conjecture on my part, but why should there be this difference? I would think in both cases the Chancellor plays a more concrete role in moving from the high level legislated objective to the actual operational objective. I think this reflects the difference in political traditions and the nature of the two functions—the financial stability and the monetary policy one.

**Andrea Leadsom:** Thank you.

**Q355 John Thurso:** You have touched on the importance of accountability to Parliament in a number of previous answers. Some of the stuff that the FPC is going to get will be pretty confidential; it could move markets. How do you think we should deal with the balance between confidentiality on the one hand and the need for transparency and publication of reports on the other?

**Dr Bingham:** I think you are quite right to say that there will be some instances where there is confidential information. I think, however, the degree to which you can disclose things ex-post is quite substantial. Ex-post disclosure is a very powerful form of accountability. An ex-post appearance before you and your very inquisitive questions is a very effective form, not only ex-post but also in constraining discretion beforehand. So I think it is absolutely essential to maintain this confidentiality of market-moving information. The two are compatible—to observe confidentiality and yet through ex-post disclosure to provide the degree of transparency that ensures accountability.

**Q356 John Thurso:** I think it is very germane to debates that are going on at the moment as to how

<sup>17</sup> *Note by witness:* In both the MPC and FPC cases the Chancellor plays a more concrete role in moving from the high level legislated objective to the actual operational objective.

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this Committee might interact with the FPC. If you look at the MPC, which is all ex-post, when a decision has been made, it is in the public domain and it is very difficult to ask a question that might raise a question of confidentiality. Virtually everything you can think of should be in the public domain. The FPC produces a twice-yearly report. They come before us; we ask questions. I can think of a lot of areas where the ongoing debates that they might have internally could be required to be confidential for many months, if not a year ex-post. How do we as a Committee, if we are not privy to that confidential information, properly hold them to account?

**Dr Bingham:** When you think about the role of the FPC, its role is to look at system-wide vulnerabilities, not to take action that would affect individual institutions. In the course of making these system-wide assessments and system-wide recommendations, they may obtain information on the individual institutions, which could be market-moving. But the essential focus of their activities is on the system as a whole. I think the issue that you are talking about—confidential information—is much more pronounced in the case of the microprudential supervisor, the PRA. The instances FPC, the areas where the market-moving information would be relevant for systemic stability, I think, would be not too frequent. I think you can effectively hold them to account for their decisions on the system.

**Q357 John Thurso:** Let me just press you a little bit on that. Go back to 2007–08 when many who were on the predecessor committee had developed personally some considerable concerns about the risks building up in the system. Supposing the FPC had existed then and we had them before us at that point, would it be possible for us to really have grilled them without having some access to some of the confidential information that they had? If we were unable to see any of the confidential information, could we have come to a balanced judgement on their performance?

**Dr Bingham:** My belief is, given the types of questions you are putting to me, the answer is yes.

**Q358 John Thurso:** Flattery will get you everywhere. Can I turn to a different point, which is that the system as it is designed sees the Governor chairing virtually everything, and that is an immense concentration of power in one individual. What is the balance of risks between having that and having a different system?

**Dr Bingham:** Again, the way I see this particular design issue is that over the course of time you have seen an evolution away from governor-centric central banks. Now, for example, policy decisions are made in committees in about 100 central banks around the world. There is only a handful where the governor makes the decision.

The model that is being proposed here, where you have three distinct decision-making bodies, I think, is a means by which you introduce checks and balances into the system internally within the Bank

of England Group. It is true that you have the same individual chairing the various committees. It is true you do have cross-membership. This is a mechanism to ensure some coherence between the actions of the various committees. There are trade-offs here. The one that is being considered in the case of the UK balances the checks and balances through having multiple committees with external members against the concentration of power of having a single chairman. In central banks that do have multiple committees, it is quite common—I would say almost universal—for the governor or deputy governor to chair the committees.<sup>18</sup>

**Q359 John Thurso:** Your view, in summary, would be that the existence of the committees is the counterbalance to the fact that the governor chairs them all and that the advantages of the common chair for continuity between committees outweighs the potential for a concentration of power in one individual?

**Dr Bingham:** Yes. If you think of some of the alternatives, one would be to have a single decision-making body. Its composition would be much more disparate. You would have people with expertise in monetary policy, people with expertise in microprudential supervision, people with expertise in macroprudential supervision. Its dynamic would be different. You would have a cacophony of voices with people with different expertise challenging the opinions of others. The checks and balances would be built in a different way. The power of the chairman would possibly be greater. It would depend upon the decision-making mechanisms and algorithms that are used, but you have checks and balances here in the proposed arrangements.

**Q360 John Thurso:** It comes back to the point Andrea Leadsom was making about the importance of the Court as the overall check and balance on process of what these committees and their action via the Governor will be.

**Dr Bingham:** Yes, yes, I believe the Court could play such a role.

**Q361 Mr Ruffley:** You have painted an interesting picture—and I agree with it—of English exceptionism, contrasting the Bank of England's position on things like inflation targets compared with the ECB or the Open Market Committee at the Fed. I just wondered, having referenced the February Treasury document, *A New Approach to Financial Regulation*, what you make of the following ways in which it seems to me the Government is made responsible. I will just read out some examples from this report. "There will be a twice-yearly publication that the FPC produces, which will be submitted to the Treasury ministers." "A twice-yearly update from the Governor to the Chancellor of the

<sup>18</sup> *Note by witness:* One way to address the risk of concentration of power would be to permit the Chancellor to select the chair of the committee from among the members, rather than setting out the chairmanship in the legislation. The chairmanship could then be changed if there were signs of inefficiencies or the undue concentration of power.

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Exchequer.” “A flexible mechanism to allow the Treasury to ensure for each macroprudential tool provided to the FPC that the appropriate engagement by the FPC is carried out.” Then we also have, in relation to the PRA, “A power for the Treasury to order an independent inquiry into the PRA’s economy, efficiency and effectiveness.” There are more, but it seems to me there are quite a lot of lines of accountability for the operation of this proposed system to Government Ministers. I wonder if you could tell us: is there anything comparable to that in your experience in other jurisdictions?

**Dr Bingham:** The United Kingdom has a very long shadow. There are many countries that look to the United Kingdom, partly because of their own history, so you can find other countries in the Westminster tradition where the finance minister has a significant say in the operation of the central bank. Outside of this tradition—the presidential system, the ECB, the Nordic tradition—that is less common. There are two things I would say. First of all, it is compatible with a system of checks and balances. The other thing that I think is important to note is financial stability policy, unlike monetary policy, is one that involves a number of different authorities. You will need co-operation with competition authorities, public money might be put at risk so the need for consultation and collaboration in this area is greater than, for example, in the area of monetary policy where the central bank can operate on its own. So having in place mechanisms that very clearly specify who does what and when is—

**Q362 Mr Ruffley:**—desirable, but no one will have quite copied yet the English model because what I read out, of course, are proposals which are new. So it is not part of the British system now. What I am getting at is that, from what you have seen of the proposals in the February Treasury document, and I listed some examples, where the Treasury has its finger in the pie in quite a big way, that implies ministerial accountability when things go wrong. What I was asking you is: are there other examples in the world where the politician, the finance ministers, when things go wrong, take express accountability for any failings in the system. Could you give real live examples of countries or systems?

**Dr Bingham:** Yes, I will give you an example.

**Mr Ruffley:** Because I want to try and test whether anything similar to the proposals in this document, which we are all here to discuss and disinter, has occurred in any jurisdiction. More to the point, do politicians take responsibility by resigning? Are there any examples of that?

**Dr Bingham:** Well, let me cite an example outside, if you will, the Westminster tradition. I will refer to Indonesia. This is, in fact, legislation that was drafted in 2008. As far as I am aware it has not been put in place, but the proposal would provide for a clear transfer of responsibility at the time of a crisis to the Minister of Finance. That is a proposal that is being considered in Indonesia. Obviously, in the situation where public money is being put at risk, this has to be the case. You ask: are there instances of politicians resigning? Well

certainly, there are instances of Governments falling in conditions of failed economic performance and—

**Q363 Mr Ruffley:** Anything on all fours, where there is a financial regime that the Government is responsible for, where it goes wrong? Again what I am driving at is: where is the political accountability? We know this model—it is a stupid question to ask of the Fed or the ECB because there is English exceptionism at work in relation to the Bank of England, I understand that, so forget those countries, but is there anything comparable to the proposals that the Treasury in the UK published this spring in operation? Your answer is no. Is there anything that entrenches political accountability, ministerial accountability? You seem to be saying the answer is no, nowhere in the world, although Indonesia are looking at it.

**Dr Bingham:** This is virgin territory; the arrangements have not been set up. There was a reference to the FSOC arrangement where in fact the Secretary of the Treasury does chair the body. Now, of course, this is a presidential system and the Secretary of the Treasury is a member of the President’s cabinet. The political system is different from a parliamentary one. The Government would not necessarily stand or fall, but the chair would be held to account.

**Q364 Mr Ruffley:** Again, separating out the proposals in the UK from the ECB or the Fed, putting those on side, would you say for those systems that already veer towards more ministerial accountability, i.e. the Anglo-Saxon approach, that the newer proposals in the February document are tough?

**Dr Bingham:** Yes, I would say they are compatible with that provision.

**Q365 Mr Ruffley:** You approve of them? You think that the direct line up to the Chancellor of the Exchequer in fact is implied, or indeed express, in these proposals?

**Dr Bingham:** Yes, it is certainly compatible with ministerial accountability. It is implicit or even explicit in the proposals as they are put forward.

**Q366 Mr Ruffley:** Could I tempt you? Would you say of all the jurisdictions and regimes in all the rest of the industrialised world this entrenches more accountability in respect of finance ministers than anywhere else?

**Dr Bingham:** As I was saying before, the role of the Chancellor is correspondingly greater than in many other countries and the Bank of England’s discretion is therefore constrained. The counterpart of that is a greater role for the Chancellor in accountability. It is very difficult to rank countries in terms of the degree of accountability, but certainly ministerial accountability in the current and proposed UK arrangements is present.

**Q367 Mr Ruffley:** Let us try to measure it. The last Labour Government, as a matter of fact—I am not being party political here—set in place a

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tripartite structure and took away the supervisory banking powers from the Bank of England in 1997–98 and gave it to the Financial Services Authority. Then when everything blew up in the financial crisis, everyone was pointing at everybody else. In the end it was, of course, the FSA, but the Bank of England said that they had a more inchoate responsibility to oversee financial stability. It was a mess, but it seemed to me that no question was ever really asked seriously as to why the Chancellor of the Exchequer did not resign and take responsibility for a fouled up, deficient form of financial regulation and banking regulation. That model failed, did it not? The politicians, the Treasury ministers, in the last Government did not take responsibility as you would rather have expected them to take responsibility. Would you agree with that?

**Dr Bingham:** I would certainly say that analysis goes beyond central bank governance. This is the question of accountability of ministers and governments.

**Q368 Mr Ruffley:** I am not sure that follows from what you were saying. You said something very interesting at the start of your evidence, which was that it is important to discover who is in control when public money is at risk. It seems to me you were pointing in the direction of finance ministers, whatever jurisdiction it is, ultimately being responsible. I agree with that, but it appears to me that even before 2010 in this country there were quite clear lines of accountability leading up to the Chancellor of the Exchequer of the day, under the tripartite system. I am just asking for your view on whether that should have resulted in some mea culpa.

**Dr Bingham:** Yes, that is the way of the UK political system and that is the operation of the UK political system. The Government did change. Perhaps the facts speak for themselves.

**Q369 Mr Ruffley:** Yesterday we took evidence regarding how the FPC should carry out its work,

and you mentioned frequency of meetings. They pointed to what is being put in place in America for an FPC-style secretariat, so the secretariat would be specialists in financial policy and they would be permanent staff and they would be working each day. Could you just confirm what your views are on that, because our understanding is that that is not particularly envisaged under the Government proposals in the February document?

**Dr Bingham:** I agree that the proposals do not foresee the creation of a secretariat for the FPC. This is because the Bank will be providing the support the FPC needs. It goes back to what I was saying before. Where you have a clearly separate body, whether it is an oversight body or a regulatory co-ordination body like FPC or the FSOC, you need some mechanism for providing support, and if it is separated from, for example, the central bank, you need to provide some alternative support arrangement. For example, as I mentioned, in Norway they have a support mechanism for their oversight board. The FSOC will have its support mechanism. In the case of the ESRB, there is a support mechanism embedded within the ECB. In the case of FPC, it will be the Bank of England that provides this.

**Q370 Mr Ruffley:** What do you think of that?

**Dr Bingham:** I think that is a good way to extract synergies. It may be a cost-efficient way too. The Bank will have a spectrum of experience over the macroeconomic and financial system expertise. I can see that being a very viable model.

**Mr Ruffley:** Right, thank you.

**Q371 Chair:** Thank you very much for giving evidence today: very interesting. We understand your reticence given your job on the Central Bank Governance Forum, but if, on reflection, you are able to come off what a number of colleagues might feel is the odd fence here and there in response to questions, we would be particularly interested in that in writing. Thank you very much for coming today.

**Dr Bingham:** Thank you.

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**Tuesday 28 June 2011**

Members present:

Mr Andrew Tyrie (Chair)

Michael Fallon  
Mark Garnier  
Andrea Leadsom  
John Mann

Mr George Mudie  
Jesse Norman  
David Ruffley  
John Thurso

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**Examination of Witnesses**

*Witnesses:* **Sir Mervyn King**, Governor, Bank of England, **Paul Tucker**, Deputy Governor, Financial Stability, Bank of England, **Charlie Bean**, Deputy Governor, Monetary Policy, Bank of England, **Andy Haldane**, Executive Director, Financial Stability, Bank of England, and **Andrew Bailey**, Executive Director, Bank of England, gave evidence.

**Q372 Chair:** We may as well get under way now that you have your new team, your extra players, and we will make sure that Paul Tucker gets more airing in the second session. Governor, the Treasury have now published a pretty thorough document setting out the blueprint for reform of this area of regulation. Is there anything in there that you think probably needs further attention or amendment?

**Sir Mervyn King:** There is a great deal to be looked at. I think, as I explained to you last time, our first preference had been to have a clean, new Bill, spelling out the new system rather than just amend FSMA.

**Chair:** By which you mean fresh draft legislation?

**Sir Mervyn King:** Yes.

**Q373 Chair:** Before we move off that, I am sorry to interrupt, what are we losing by not going down that road?

**Sir Mervyn King:** We are losing the simplicity and the ability to have a cleaner debate about the new framework. Certainly the Government rejected our request to have a new Bill and the argument that they gave, understandably, was that at the cost of some complexity we could ensure that all the provisions that were appropriate could be put into an amended FSMA and it would be a faster way of doing it. I think we have seen the complexity. I am not quite sure whether we have avoided delay. I think what has made me a little concerned is that the nature of the discussion that has taken place has been coloured by the nature of FSMA, which was a Bill put in place specifically to govern an all singing and dancing regulator covering everything. So there are a number of aspects that have coloured all that. There are some specific areas that I would still be a bit concerned about.

I think the FPC, or the Bank itself for that matter, doesn't have an information power. We have to go through the PRA to get data. I don't think that is entirely desirable. The FPC can't give a direction to the PRA as to the timing of a macro-prudential measure. It can recommend and it can direct that the PRA get on with doing something, but the PRA itself decides how long it should take to do it. In the context of trying to deal with a countercyclical problem, that seems a little odd to us.

Obviously I think our first preference would have been not to have had responsibility for insurance companies. I do think insurance companies are

different. We accept that the Government has wanted the PRA to take responsibility for insurance companies, but I do think that has left open some quite tricky aspects about the allocation of responsibilities between the PRA and the new FCA, the Financial Conduct Authority, particularly to deal with with-profit life insurance policies, and this concept that has come in through recent legal cases of policyholders' reasonable expectations. I think this is a mess and it would be very helpful if you, in Parliament, could try to get to grips with this concept of policyholders' reasonable expectations, which seems to me almost impossible to define for the regulator and leaving the regulator open to ex post judgements by others in court as to what it should and should not have done. I think that could have an impact on the way regulation is done.

There are aspects connected with Europe that we are a little worried about. We wanted to be able to impose some more requirements on central counterparties. We think this is very important because there is a tendency now to think that central counterparties are the answer to everything in financial markets; as long as every transaction is with a central counterparty that gets rid of counterparty risk. That is not true. The risk is concentrated in the central counterparty and it is absolutely vital that we don't create new "too important to fail" institutions. There is a debate going on around the world about whether such institutions should have access to Central Bank liquidity. We are not opposed to the possibility that, in a crisis situation, for a very short period, a central counterparty might require liquidity from a Central Bank. But as soon as you start to hardwire that in, you are creating the concern that those central counterparties will behave in a way knowing that they will get bailed out by the Central Bank, and we are going to be creating, all over again, another set of institutions that are too important to fail, which end up as a burden on the taxpayer. The way round that is to make sure that they are very highly capitalised—very highly capitalised—because, if all the risk is concentrated in them, you need to make sure that it would be a very, very, very rare event that means that they would need genuine capitalisation from outside. I think the PRA needs to have the ability with the FPC to impose requirements on some of those central counterparties.

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There is a more general concern I have, which I have expressed before, and it is not particularly to do with the Bill but it is to do with the whole regime of regulation, which is, increasingly, the European not just directives but regulations are constraining the ability of domestic regulators to do what they think is appropriate. This is not all entirely a problem coming from the rest of Europe; this is very much to do with the way in which directives are translated into UK law. Where other countries are prepared to interpret the spirit of the directive when they apply it to their domestic law and in particular cases, here it gets translated literally into words, which then have to be applied in a very literal sense, and that can cause serious difficulties. I am very worried about the way in which we translate directives into UK law, and I am also worried about the scope and the extent to which in Europe there is pressure to have control over national supervisors.

You can see it through the example of the Capital Requirements Directive, where the Commission clearly believes that, in order to impose a single rulebook on the whole of Europe, it must impose not just minimum capital requirements but maximum capital requirements. I think most Central Banks in Europe—we had the discussion recently—feel this is a step too far, that there is a very good case, particularly to support a single market, to have minimum capital requirements. That after all, at the global level, was exactly the rationale of Basel I and the subsequent Basel agreements, but the Basel agreements are very clear that they are there to impose minimum requirements not to harmonise maximum requirements, because that will prevent a country from protecting its own taxpayers.

So there are a number of issues that I think are worth examining and exploring when the Bill comes to the House.

**Chair:** That is a very impressive list and a very thorough answer. I should say, for the sake of the record, that I gave you 90 seconds' notice of that question. I dread to think what would have happened if I had given you half an hour.

**Sir Mervyn King:** We would be delighted to come back at any point of your choosing to expand.

**Q374 Chair:** There were a number of really important points in there, and I hope we will be able to pick up on at least some of them. On this question of the literal translation of directives, it would be extremely helpful if the Bank could provide us with specific examples in writing that we can take up. I have already written on gold plating, as you probably know, to try and get some clarity on that.

In the interests of giving Mr Tucker further work, could you tell me, Mr Tucker, why is the FPC a committee of the Court under the proposals while the MPC is not?

**Paul Tucker:** I think the main difference is that on the monetary policy side everything that matters is done in the MPC—the interest rate decisions, decisions about QE. Whereas on the financial stability side the macro-prudential tools—varying capital requirements over the cycle, perhaps varying margin requirements, giving directions to the FCA and the

PRA about what they should look into and so on that will be located in the FPC.

Decisions about emergency liquidity assistance, lender of last resort, are decisions for the Court of the Bank and the Bank executive. The bog standard liquidity insurance operations, which we do routinely, are matters for the Bank executive and Court. In both cases because they affect the Bank's balance sheet. The oversight of payment systems is in the Bank because it is associated with our operation of payment systems, and the oversight of central counterparties is going to go with that.

What I am doing is painting a picture of the financial stability policy instruments being distributed across the Bank, and the job of the Court is to ensure that we keep this coherent. That is easier for Court to do, frankly, if FPC is a committee of Court than something that was to one side of Court and did not recognise its authority beyond processes. The thing I should emphasise is that this does not take Court into policy, the substance of policy per se. It takes Court into ensuring that we, as an executive, are joined up and ensuring coherence across our responsibilities.

**Q375 Mark Garnier:** Can I carry on with that one? Do you ever envisage that there will be a disagreement of policy between the FPC and the MPC and possibly even the PRA?

**Paul Tucker:** Theoretically this is possible and we may live to see it. It is getting quite a lot of discussion, not only in this country but elsewhere as well. Frankly, I think the concern is exaggerated. So a story is told whereby the FPC raises capital requirements or asks the PRA to raise capital requirements; that slows the economy. The MPC eases interest rates; that fuels the credit boom. The FPC tightens capital requirements again, and so on. But it is much more likely that the MPC are just going to be extremely relieved that there is somebody there that is ensuring that the banking system is safe and sound, so that when bad things happen the banking system does not flake away and the economy with it. So I think first order this is pretty unlikely. Could it happen? I have given you theoretical circumstances where it could.

Because it could happen, it is helpful, not only for us but for the country, that the support for the two committees will be provided by the Bank staff. There is a common Chairman in the Governor. There is overlapping membership. The information base going to the two committees is broadly the same. Something that is no secret, but perhaps we have not said so openly before, is that FPC members are able to sit in on the briefing that the MPC receives on the economy and MPC external members are able to sit in on the briefing for FPC. So we are going to ensure joined-upness. If ever there is tension it is not going to come about by things falling through the cracks.

**Q376 Mark Garnier:** In terms of the Governor—who is looking as if he wants to come in with an answer to this—one thing you did mention, Governor, a bit earlier was that you are unhappy about the way that the PRA can only respond to the FPC on the basis of if it feels like it. Broadly speaking, the FPC—

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**Sir Mervyn King:** No, that is a slight exaggeration. We will make directives under the draft Bill to the FPC. It is just that the PRA will have the timetable of the response under its own control, which is slightly odd because it is quite hard to make a recommendation.

**Mark Garnier:** But here is a prime example of how there could be a need for an arbitrator to resolve problems and conflicts between the three organisations. We already have a situation where the MPC is answerable directly to Parliament. The FPC is answerable directly to the Court of the Bank of England.

**Sir Mervyn King:** And to you.

**Mark Garnier:** The PRA are, yes.

**Sir Mervyn King:** Can I answer this one. I don't think this issue arises between MPC and FPC because the instruments that the two committees will be using are quite distinct. We don't yet know the full set of instruments for the FPC. You and Parliament will determine that, but they clearly will not be the same instruments as are given to the MPC. The link between FPC and PRA is slightly different. The FPC have to take a macro-prudential judgement and then issue directives to the PRA as to how that should be implemented with respect to individual institutions. So there is a closer link in that sense between FPC and PRA. All we are pointing out is that, in that macro-prudential sense, there seems to be some ambiguity about the ability of the FPC to ensure that its recommendation is implemented in a speedy timetable.

**Q377 Mark Garnier:** This is quite a complex area with the different tensions being pulled on it, different terms of accountability and all the rest of it. Do you think the Court, and the individual members of the Court, are equipped to fulfil the role of making sure the FPC is working properly?

**Sir Mervyn King:** I think it depends what you think the role of Court is.

**Mark Garnier:** To be running the Bank of England.

**Sir Mervyn King:** Paul made the point very clearly that Court is not responsible and should not be responsible for policy. There are three separate decision-making bodies.

**Q378 Mark Garnier:** Sorry, if I might just cut across you again, and my apologies for interrupting you. Why is the FPC a committee of the Court and not accountable to Parliament?

**Sir Mervyn King:** The FPC is accountable to Parliament. There is no question about that at all. Indeed, in response to Mr Mudie, I made very clear that the FPC should be appearing before you regularly. Frankly, the question of whether the FPC is or is not a committee of Court I don't think is a major question at all. What does matter is that the three bodies, MPC, FPC and the board of the PRA, for policy decisions should always be accountable directly to you or a Committee of Parliament that you recommend it be accountable to, but it should be accountable to Parliament, full stop. It is accountable to the public as well. The three bodies are all accountable to the public. That is why it is important to have

transparency mandated in the three bodies, and it is, and we fully support that. I think you would recognise—as you did in your report earlier this year—that we have a very good track record of transparency on the MPC and we fully intend to carry that over to the FPC and the PRA, so on policy that is not Court's role. Court has two major roles, I think. One is to ensure that there is proper stewardship of the resources of the Bank, the remuneration, the budgets and so on.

The reason why I think you need an independent body to do that is because the Bank is an independent Central Bank and it would be only too easy—forgive me for putting it this way—for politicians to find a way round the independence of the Bank by interfering with the resources and budgets of the Bank. That is why in most countries round the world those policy areas are ring-fenced from the kind of audit functions that you see in other parts of government. I think the Court, therefore, needs to be appointed by politicians, by the Government, but to be an independent body with the responsibility for oversight of how the Bank uses its resources and for how the processes of those three boards work, so that if any member of the MPC, FPC or PRA board feels unhappy with the way the process is operating they can go to Court and say, "This is not working and we want you to step in and find out why".

I think for that set of functions, first of all Court should be accountable to you, so I think Court ought to come to you on a regular basis and report to you, not on policy, not on whether the Bank took the right decisions on interest rates or made the right kinds of speeches or took the right decisions on the FPC or took various regulatory actions. You should hold the three boards directly accountable for that to you. You should hold Court accountable for its functions in terms of the Budget and stewardship, the remuneration of the senior members of the Bank and also for the way in which the processes of those three boards work.

**Q379 Mark Garnier:** One of the things I am slightly concerned about—and your answer could not have been clearer; I think it is very, very clear indeed—reflecting back what you said in your earlier answer, is that that leads me to think that the Bill is very, very unclear. What slightly concerns me is that as this Bill passes through Parliament people are going to be looking at this and saying, "Well, the FPC is a committee of Court, therefore is the Court going to be expected to be a dispute resolver between these organisations?" While you are being very clear here today, and I think we all understand exactly what you are saying, do you think that the complexity of the way this has been written, and all the various issues that go with it, may mean that by the time we end up getting Royal Assent on this Bill the wrong outcome has happened because of some of the lack of clarity in the way this has been—

**Sir Mervyn King:** If the question of whether the FPC is a committee of the Court or the Bank is a problem, then let's change it. What I want to make sure is that there is a very clear view agreed by you in Parliament. It is very important to me that this happens otherwise

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we will get confusion down the road. The policy responsibility ought to be directly from the three decision-making bodies to you or the relevant Committees in Parliament. That should be crystal clear and nothing should be allowed to confuse that.

**Paul Tucker:** It can't be any other way because the objectives of the three bodies will come from legislation. The instruments and powers of the three bodies will all come from legislation and therefore FPC, MPC and PRA board automatically are directly accountable to you.

**Mark Garnier:** Thank you very much. You have been very helpful.

**Q380 Mr Ruffley:** Mr Tucker, on the question of the FPC—the different parts of the Bank all working together with the FPC—you indicated that the Court would be responsible for making sure there was that co-ordinated work. I think that is the justification you gave for the FPC being a committee of Court. Yes? Who is going to be doing that specifically at Court? Is it going to be a small group? Do you know who the individuals are and do you think they will have the expertise to pull all that together?

**Paul Tucker:** I think the way this will manifest itself is that in the current Bill the Court has a responsibility for ensuring that the Bank as an organisation has a strategy for its financial stability work. This goes exactly with what the Governor was saying about stewardship of resources. Its key responsibility is to ensure that we touch all of the bases. Of course, we, the executive, take a draft to Court and the existing legislation says “consult FPC on that”, “consult the Treasury on that”, but ultimately it is signed off by the Governor and company, which is Court. Whether or not that is done via a subcommittee; at the moment it is. It is done via something called the Financial Stability Committee that was created during the crisis under legislation. That committee will cease to exist as a statutory committee. It will be up to Court whether they want to create a subcommittee of their own to do that.

In terms of the people on Court, I don't think it is for me to comment on that, quite frankly. Like me, these people are appointed by the Chancellor of the Exchequer. I think it is important that there is a blend of skills. I think it is important that some of them are reasonably expert in the financial services industry. I think it is important they don't have conflicts and have a degree of distance from the day-to-day. I think all of that could be set out publicly, but in terms of the individuals that has to be from the Chancellor and the Prime Minister.

**Q381 Mr Ruffley:** There could be a subcommittee constituted from existing Court members but that would be up to the Chancellor? I just want to understand the composition of the oversight body at Court. You are suggesting it is Court or it could be a subcommittee?

**Paul Tucker:** Technically the Court can choose to do it itself entirely or it can itself choose to establish a subcommittee for that purpose.

**Sir Mervyn King:** Can I give an example, which I think illustrates this very clearly? One of the most

important functions of Court, and where I think you do need a body to look at this, is to ensure that the Bank manages the risk on its balance sheet effectively. We have seen an enormous expansion of our balance sheet during this financial crisis, and I hope at some point we will see a contraction. Court was determined to ensure that all the procedures we had put in place for managing the collateral and for managing the risk were done to the highest possible standards. The Audit and Risk Committee of Court is comprised of people with a great deal of experience of both audit and risk management in business and they have gone to great lengths—they meet regularly, they go into enormous detail, and they monitor. The internal auditor of the Bank reports directly to them, to the non-executives, and it is very important that this be done. Although it is not publicised very much, this is an important role of Court. What I would quite like to do if I could, Chairman, is to offer you a short paper spelling out some examples and functions that Court carries out in this process of managing the way the Bank operates.

**Q382 Mr Ruffley:** Yes. Just finally on this point, when would you expect that body to be constituted after Royal Assent?

**Sir Mervyn King:** Well, the Audit and Risk Committee works now.

**Mr Ruffley:** No, the committee that Mr Tucker was referring to that will be overseeing—

**Sir Mervyn King:** The Court only has eight non-executive directors from outside the Bank, if you exclude Lord Turner. But you have eight non-executive directors appointed with their expertise at running businesses. These are serious senior figures. They are not experts in policy, and I think the mistake would be to believe that they should be second guessing or able to comment on the policy decisions.

**Mr Ruffley:** I quite understand we don't want any second guessing.

**Sir Mervyn King:** These eight people can do it in full session of Court, if they want to set up a subcommittee to monitor particular aspects. But one of the things that the Chairman of Court has always done with the Monetary Policy Committee, and I am sure he would do it with respect to the Financial Policy Committee and the PRA board, is to have at least annually, if not more often, private interviews one-on-one between the Chairman of Court and individual external members, and one of the questions he asks them all the time—he has done with all the external MPC members you saw earlier on—“Are you unhappy about any aspect of the processes of the committee? Do you have the resources to do your job properly? Are you worried about how it is working?” If there is any suggestion that they are, he will initially bring it to me and say, “I want you to correct that. I don't want to hear this again” or he will take it to Court for a full discussion if necessary. He always reports back on these interviews to Court. So I think that is another very concrete way in which the Chairman of Court can ensure that these committees can function effectively.

**Q383 Mr Ruffley:** It is a very helpful answer. I think we are all agreed, we don't want anyone at Court



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second guessing on policy. I think we are all agreed on that. I just wanted to understand better than I did how this oversight function is going to be constituted and I think, Chairman, it might be useful if we had that committee in at some stage, whenever it might be constituted.

Could I just move on, Governor, to the first point you made in your very helpful opening remarks, that you didn't have an information power and that you would have to go to the PRA? Could you just flesh out what you meant by that?

**Sir Mervyn King:** I think that one of the things we were concerned about in setting up the FPC was obviously one area the FPC has to look at, which is the boundary of regulation. Indeed, it has the right to recommend to the Treasury whether that boundary should be moved. It will be the case from time-to-time that we will need information on institutions other than regulated institutions. But even where it comes down to regulated institutions, it does seem to me that it would be proper for the FPC to be able to say, "Well, look, we need these data" and be able to go to institutions. We can use the current data collection methods in the Bank in our unit that collects data from banks, but to have to go through the PRA always raises the difficulty that the PRA will say to itself, "This request has come in from the FPC. Is it really within the vires of the PRA to ask for these data?"

It seems to me, the only way to clarify this unambiguously is to give the FPC an information collection power. It may seem a small thing, and in many ways I don't anticipate great practical problems, but it has the potential at some critical point in the future where the PRA hesitates to collect data. We did see this with FSA in 2007—08, where we wanted data and they were reluctant at some point to collect it, under the very reasonable view that they had not seen the need for it and it wasn't clear to them that for their statutory purposes they should be collecting these data. It was just that the Bank wanted the data. I think it helps to have a greater clarification of the specific powers of MPC, FPC and PRA in respect of data gathering.

**Q384 Mr Ruffley:** Yes. The IMF have set up the Independent Evaluation Office to conduct independent and objective evaluations of Fund policies and action and the US Treasury has set up the Office of Financial Research for independent investigation and fact-based policy analysis. Do you see any merit in a similar arrangement being set up to evaluate policy work at the Bank?

**Sir Mervyn King:** To be honest, I think the evaluation of the policies that we carry out should be done by you. The question is whether you need a unit of that kind to help you. The reason the IMF needs such an Independent Evaluation Office is precisely because it isn't accountable to anyone else. It has an executive board but that is not—

**Q385 Mr Ruffley:** What about the US Treasury?

**Sir Mervyn King:** The US Treasury is not an accountability body. The US Treasury is a body to do with collecting information. I think it is very easy to set up committees and say, "Let's collect lots more

data". I honestly don't think that is the solution to better policy. If we felt we needed more data then we would collect it ourselves, but the important thing is that you should feel content that you are able to evaluate the policies of MPC, FPC and PRA, not in a sort of technical second-guessing sense, because there is no point in that. I have always felt that far and away the most effective kind of accountability is when people ask very simple questions, not complicated technical questions but very simple direct questions. The question that came earlier this morning saying, "If your aim is to hit the inflation target, why is inflation so high?" That is not an easy question for us to answer. We have explanations and I think what you should be trying to do is to get us to explain what we are doing and why, in words and terms that everybody can understand. That is what I feel is policy accountability to Parliament.

**Paul Tucker:** Can I just add one thing on this, which is that the US Treasury body created in Dodd-Frank is, I believe, in part a product of just how many agencies there are in the US involved in financial stability. There is a commodities regulator, a securities regulator, three bank regulators, state-wide insurance regulators, and the Financial Stability Oversight Committee embedded in the Treasury is attempting to pull all those together. It is a bit like a tripartite committee for the US with, I think, more than a dozen members. In the UK we are taking a different approach. Other than the use of public money, all of the financial stability tools will exist in the Bank of England group. Therefore, we will produce the data publicly enabling us to be held to account, and if we don't we can be held to account for that.

**Q386 Chair:** Going back to the point you made a moment ago, Governor, about the distinction between processes and policy. I agree that we won't find ways of getting to better policy just by creating extra committees, but you then said, "Of course, if we want to collect more data we will collect more data". It was the case, wasn't it, that the executives of the Bank ran down the resources devoted to financial stability in the years prior to this crisis and that the cash allocated to that function was overseen, because it was a process function, by the Court? Isn't that the sort of issue where process and policy meets where we do need a body that can comment?

**Sir Mervyn King:** I take responsibility for that switch of resources. We put it to Court and Court accepted that recommendation. I think it is very important that all organisations ask themselves, "Do you need the resources to carry out this function?" The reason I did it was when I inherited my position there were 150, 160 people working at financial stability and their only responsibility was to produce a report. That was it. I believe you can produce a report once every three months with fewer than 150, 160 people, and my job is to ensure that taxpayers' money is used wisely. So we cut it from 150, 160 to 120. That was a change. I cannot believe that the reason we had a financial crisis in the UK was because we tried to write a quarterly report with 120 people rather than 150. We may have made mistakes, we may have missed things, but I do not believe it was because we didn't have those 30 or

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40 people. Indeed, I think the great difficulty with what went on in the run-up to the financial crisis was precisely that too many people were focused on details and not on the big picture.

**Chair:** You are answering a question I didn't ask. I didn't say: why on earth did you go and cut all those people, what a terrible mistake it was and what possible justification do you have for it? I said: don't you think that this function of examining decisions like that is something where processes and policy meet and isn't that a function for a body like the Court?

**Sir Mervyn King:** They are clearly interrelated, but I don't believe that the oversight you need to make decisions on that kind of issue is related to the technical expertise of the people you need on the policymaking committees. So what you need on Court to handle that are people who are able to make judgements about representations put to them about budgets: we need more resources for this area rather than that area.

**Q387 Chair:** Let's examine this in relation to the private sector. I have been chairman of audit in a public company. When the head of compliance comes to you, you ask him, "Do you have the resources you need to do your job?" If he says, "No, I haven't and I want more", you don't just say, "Well, here's a cheque", you sit down and have a discussion with him about how he is conducting that job. That means getting involved in finding out how the policy function is being performed in some detail.

**Sir Mervyn King:** That is what Court does.

**Q388 Chair:** Okay. So that is where policy and processes meet and to that extent there is a policy function, there is a policy oversight function?

**Sir Mervyn King:** If you want to define it as such, yes, but what it is is clearly very different.

**Chair:** I am not defining it any particular way. I am taking up exactly the way it is defined in corporate law and corporate practice now.

**Sir Mervyn King:** What Court does in this respect is clearly something that is distinct from the decisions of the FPC, MPC and PRA. Those three bodies do not sit around, nor should they, debating their own budgetary allocations or the resources that are needed. They can make representations but Court has to decide on that. But the decisions that the PRA, FPC and MPC make on policy are not decisions that the Court need to second guess, and therefore they don't need the expertise to do that. What they do need the expertise for is the expertise of someone who is prepared to say, "My job is to probe and challenge the executives of an organisation when they claim they would like more resources". To be honest, the experience of the last 10 years has been mainly that we have been trying to reduce the resources. We have kept, in real terms, the expenditure of the Bank flat over 10 years. I take pride in that achievement. It has not been achieved elsewhere in government but it has been a contribution to the taxpayer and I do believe—and I think Court has been able to probe on all of this all the way through—that our ability to carry out our

policy functions has not been jeopardised by running a careful ship financially, but Court does look into it.

**Q389 Andrea Leadsom:** I am also a big fan of straightforward, simple questions and I think, Governor, you understand we have some very real concerns about the ability of Court to do its job. In particular, from a lot of the evidence that we have taken, it seems that there is some confusion over where we scrutinise the activities of the Bank of England and where the Court scrutinises. I would be interested to know whether any of you gentlemen have any concerns, either about the division of responsibilities where you report to Parliament through this Committee or to the Court on matters of efficient running of the Bank, and whether there are any areas where you think that there needs to be greater clarity. Do you all feel it works perfectly?

**Charlie Bean:** It seems to me there ought to be clarity in principle, which is that on anything to do with policy-related decisions it is you to whom we are accountable, and there should be complete clarity on that. As far as Court is concerned, it is management of the Bank's resources, the processes that support the policy-making decisions, that they have purview over. So that is where I consider—

**Q390 Andrea Leadsom:** Mr Bean, if I can give you a precise example, which is the fact that the Court did not look at a complete review of the Bank's handling of the financial crisis. They have not had an investigation, and there was some surprise from other witnesses on this particular inquiry about that fact. Is that, therefore, something that this Committee should have done, and only this Committee? It would not have been appropriate for the Court to consider the way in which the Bank of England functioned during the financial crisis? Where does that become a matter for the Treasury Committee versus the Court?

**Charlie Bean:** I would certainly have said that, insofar as it relates to policy decisions that were taken, it is clearly this Committee. Indeed, this Committee has undertaken a number of investigations into various aspects of the financial crisis, including our role in it. You had a report on Northern Rock. You had a report on the collapse of the banking system post Lehman's, and so forth.

**Q391 Andrea Leadsom:** But specifically what the Bank did, who did what, when, how many meetings there were, whether they were minuted properly, how decisions were taken? That is a huge grey area, is it not? That is where—

**Sir Mervyn King:** To be perfectly honest, I see this as an important question and you should be concerned about it, but in my view this Committee has played a very important role. It has been a permanent standing public inquiry into the financial crisis. I don't think there is any decision that the Bank made during this crisis that has not been discussed openly at this Committee and that we have not been asked questions and given answers on, and that you have not written about and commented on in your reports. You have written a large number of reports. If you go back and look at the reports of this Committee, I think you will

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see that all the decisions that were taken were discussed and commented on by this Committee in your reports, and this seems to me what accountability is all about.

**Q392 Andrea Leadsom:** But for example, Governor, that would be true about the decisions that were taken, but it would not be true about the individual performance of decision-takers at the Bank of England, nor would it be true of the level of focus of the Bank of England during that period. In other words, the number of meetings and how many people were present and what they were looking at, and that sort of thing. That would not have been considered by this Committee. I wasn't here at the time but I don't—  
**Sir Mervyn King:** It is not true. We were asked about the number of meetings and the way we went about it. You have talked about the performance of individual decision-takers; no one does that in respect of the MPC. You can ask all the members of the MPC what their views are and form your own opinions, but what I am baffled about is what it is about the performance of the Bank that was not covered by your own deliberations. The great thing about your Committee and its reports was that it was done, not by the Bank, but by you. It was an external, independent, highly public inquiry. Within three or four days of the run on Northern Rock, we were in front of this Committee giving evidence to you and this is my twenty-first appearance in a Parliamentary Committee since September 2007.

**Andrea Leadsom:** So you have come of age.

**Sir Mervyn King:** Indeed, and if that is not permanent accountability, I don't know what is.

**Q393 Andrea Leadsom:** Yes. I do agree, but I think you understand that there is still this grave concern that the Bank of England is accountable to the Court and we have concerns—I don't want to speak for my colleagues, but I have concerns—that the Court is not structured in such a way as to provide the level of procedural oversight. It is not a reflection on any of the individuals concerned; I am sure they are absolutely eminent people. But it seems to me that there is a grey area. If you like, it is our own tripartite arrangement: you are doing it, they are overseeing it and we are discussing how you did. There is this issue of who is directing; who is saying, "Well, I am sorry but Mr Tucker was completely useless in this particular area and really he needs to be taken out and dusted down"? Who would be doing that and where does that—

**Sir Mervyn King:** I have regular conversations with Court about the performance and appraisal of individual executives in the Bank, and they have regular meetings with the executive directors where the Governors are not present so they can then ask about the performance of the Governors. What I would like to suggest is two things. One is that we provide you with a short paper spelling out what Court does day-by-day, because I think a lot of the confusion here, and a lot of the evidence you had from people outside, has taken the form, one, the Court should not be doing policy, and I think we all totally agree on that, there is no difference of view, but two, most of

them have no idea what Court does and I don't think they should make sweeping generalisations on the basis of no facts. So I think it is up to us now to provide you with a paper that spells out exactly what Court does, and with real examples. We can give you some examples today of challenge of Court to the executive, if you like, but we can give you that paper.

**Andrea Leadsom:** Thank you.

**Sir Mervyn King:** The second thing, I think, which is worth considering—

**Chair:** I should say we have a rough idea of what Court does. It is fairly well spelt out in a number of public documents already. We went through those with some care before we cross-examined Court, and I think to suggest that this whole debate has arisen as a consequence of a confusion—

**Sir Mervyn King:** Most of the evidence you have had, which dismisses the role of Court, is frankly based on no knowledge at all.

**Chair:** That is a reference to external elements that might have come in.

**Sir Mervyn King:** Indeed.

**Q394 Andrea Leadsom:** If I may say, Governor, when the Court directors came in themselves, it was a lot of their evidence that gave rise to the initial concern. It was what they were telling us, not what third parties were telling us. So that is where it started.

**Sir Mervyn King:** I understand that. I read the transcript of that session. There were very few questions directly about this kind of oversight responsibility. They were mainly about policy.

**Andrea Leadsom:** I think we were really shocked.

**Sir Mervyn King:** What I would like to do is to give you some concrete examples of what Court has done. But I think the second thing that we need to do is to make sure that it is clearly understood that, ultimately, even this function of oversight is accountable to you, but the way that should occur is that you should hold sessions with members of the Court on a regular basis, so that you can hold them accountable for the way they carry out this oversight process.

**Chair:** We note what you say and indeed we just had Court in, so it is not as if we are not active on this front.

**Sir Mervyn King:** Indeed.

**Chair:** I also note your suggestion that you provide some further evidence, which we would certainly like to see. While you are at it, since you have mentioned it, you might also give thought, if I could suggest, to the issue of what kind of support a Committee like this might need in order to perform this enhanced scrutiny function.

**Q395 Mr Mudie:** Governor, I want to move away from the Court and put in place the democratically elected Members of Parliament, as well as the Government. I am not certain we are not exchanging some powers, giving away powers, and all we get is you are going to be accountable to us. Today you have described the kind of accountability you like as, we do not have to second-guess you on policy; secondly, you would prefer us to ask simple questions, and you will give us an explanation and we will be all the wiser. That is a very interesting view of someone, an

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unelected individual, being given vast powers—as you would say—by Parliament, so it is then them to blame. But when something goes wrong, because of your actions, we get the blame, but there is not much we could have done about it because all we can do is ask simple questions and listen to your very erudite explanations. I am not trying to be rude or anything, but that is a simple question, from a simple man. What good is that sort of accountability to elected politicians?

**Sir Mervyn King:** I think it is worth a great deal for the following reason. There are certain functions—but only certain functions—that you in Parliament decide to delegate to a group of people with expertise who are independent of day-to-day politics. You don't have to do that and if you feel that these decisions are better taken by the elected Government, then you should take the powers back from us and give the power to set interest rates to the Chancellor. You could certainly do that and we would not resist it. I think we would point out some of the potential drawbacks, but I think on all sides, and in most countries around the world, people can see the case for certain decisions, but only certain decisions, being delegated to a group like that. The question then is how you hold them accountable. You should be prepared to second-guess our decisions and you are entitled to do so. What I suggested was not that you are not prepared to do that, but that there is little point engaging in a purely technical debate. The way to second-guess us is to say, "The policy you are following is very damaging and wrong. Can you justify it?" It is that kind of accountability.

**Q396 Mr Mudie:** No, but say we do. Let's just take an example from this morning. On your leadership of the Monetary Policy Committee on interest rates, I watched to see if you would buckle to the pressure that you were under and I was glad that you didn't because I thought that was eminently sensible. As you said in an interview, it would have caused great harm to ordinary people, for what? It would not have affected inflation because there were external factors. But then I put to you that there is another instrument that you have that would not affect that inflation rate but could be used, and it would ease the pain on small businesses and individual householders, mortgages and so on, or just people trying to buy a house, if you took that small step. Now I received a reply. I am not satisfied with the reply, not that it was a bad reply, but the frame of mind. Say this Committee said we think quantitative easing on a sensible scale would help small businesses, as we had some members of the Committee say. What is the point of saying it to you, because we are not here to second guess you? We are here to sit at your feet, listen to your words of wisdom and put simple questions to you, as you have said.

**Sir Mervyn King:** But your reports are pretty hard-hitting, and I don't regard your reports as equivalent to sitting at our feet and listening to learned answers. You can be pretty direct in your reports if you are not convinced by the answers. I think that is the only form of accountability you can have once you have decided that you think it is in the long-run interests of this country to delegate these decisions to an independent Central Bank. The most effective constraint on that

independent Central Bank is coming before you. It is not an easy experience to come here and to answer questions in public for which we are accountable in the future. We are reminded of the answers we gave on future occasions and have to justify our actions. I think that is a very powerful weapon in holding us to do what we have been tasked to do by Parliament.

**Q397 Mr Mudie:** I hear that, but let us see how Bob Diamond does it. Bob Diamond gets a big firm to get a group of actors who will study us and each of our weaknesses, how to play us and our background, and so when he comes he only has to face up to a particular individual who might ask the wrong question for 10 minutes. In 10 minutes the Chairman gets restive, and then we will move on to another person who will invariably, because of the agenda, move on to another part of the business. You have done it today. We have moved from one subject to another. So if you are dealing with one part: "Can you not flannel it for 10 minutes, Governor?" "Of course I can". Now you praise us: "Oh you do such a tough task". Do we, hell? We might give you an uncomfortable task, but in terms of influencing you—and remember we are talking about things that affect the people out there on the street. We are giving you great power—

**Sir Mervyn King:** Yes, you are.

**Mr Mudie:**—and we have little power to force you to rethink.

**Sir Mervyn King:** You have the power to take back.

**Q398 Mr Mudie:** Tell us one occasion when we have used it. Right off the top of your head, tell us when you have altered an action because of what this Committee said?

**Sir Mervyn King:** We think very carefully about all the points you raise and it feeds into our discussion and debate later. But if you think our job is just to go away and say, "Gosh, they didn't like what we did. We had better change our mind", you would not respect us for that.

**Mr Mudie:** Come on, you have had time to think though. Give me one time, one action that you have changed because this Committee came across strongly on a given issue.

**Sir Mervyn King:** I would sincerely hope there was no action that we took that was as a direct result of what you have said because that would be to compromise independence. But all our discussions—either you want the Committee to take decisions—

**Q399 Mr Mudie:** That is game, set and match. In other words, if we put such a strong case you dare not change it because that would indicate that we had interfered with your independence. Well, how on earth do we influence you?

**Paul Tucker:** We have changed what we publish about the way we go about our job over the years because of these hearings. If I may say so, Mr Mudie, the way you describe it would be as if we were meeting in closed session with nobody here, but our appearances change the public debate about monetary policy hugely, and the quality of public debate about what we do compared with before 1997 is absolutely

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unrecognisable, and these sessions are the centrepiece of that in any one year. Yes, our minutes matter too and yes the inflation report press conference matters too, but the things that come out of this press conference—some years ago we were asked about the accuracy of the forecasting process, and we have published much more about that as the years have gone by, not always to our credit, but it needs to be out there. You do have an effect on the way we communicate and try to hold ourselves accountable to the public. In the legislation, the Chancellor does have the power to override us if he goes to Parliament.

**Q400 Mr Mudie:** You have just proved my point. You have kept talking and the Chairman said, “George, time”. Do you see? So it works. Let me ask you one last question on accountability. Do you think it is sensible to keep the Chancellor or the Treasury out of this exercise? The Treasury’s input is to have one of their staff at the end of the table without voting rights. The Chancellor only comes in when there is a crisis. The Americans have put the Chancellor or a member of the Government chairing their Committee. Do you think it is sensible to take all this power and keep politicians out? It will be, I would suggest to you, until it blows up and you will take the blame.

**Sir Mervyn King:** If you would prefer the FPC to be a committee of the Treasury or an independent public committee, by all means recommend that. That is not for me to say. What I would say is that if you were to go back to a committee chaired by the Chancellor you would simply recreate the tripartite. Now you may want to do that. I am not arguing against it, but that is what in effect it will mean. With great confidence I predict the following will happen: when it is a generally peaceful time the Chancellor would find that he had more pressing responsibilities than to attend meetings of this committee and deputies would get involved, and there would only be a meeting involving the Chancellor when there was a crisis. The previous tripartite, we managed twice I think to have meetings with principals. We did hold two war games to find out what might go wrong.

**Chair:** Before the crisis?

**Sir Mervyn King:** Before the crisis. Only after the crisis, did we start meeting as a tripartite. Many people feel that that wasn’t terribly satisfactory as an arrangement, in large part because the tripartite had no direct responsibilities. Each of the players had their own responsibilities. I don’t think co-ordination was ever an issue in the crisis, to be honest. What there was was a lack of powers for anyone to deal with particular situations as they arose. But if you want the Chancellor to be in charge of this committee in a crisis, what I would say is you had better make sure he is in charge of it in peacetime too, because one of the problems that we found was that not being involved in these areas in peacetime made it much more difficult for us to get involved when it became wartime.

There are many arrangements for doing this. I have no particular brief for one rather than another. All I would say is: if you want a committee of the Bank, we will run it. If you don’t, fine. Make it a committee of Government or an independent separate public

committee, but just have clarity about where it is and who is on it. But I think you will find that it will be very difficult to get the Chancellor to turn up for meetings in peacetime because other things are always more pressing.

**Chair:** We have listened carefully to that, and there are a range of views around this table, but we will be producing one report.

**Q401 Jesse Norman:** I have a slightly diverse set of questions that I would be grateful, given the time, for short answers if you could. Governor, do you share my view about the affordability of the Private Finance Initiative and the super returns that seem to be made on it to the institutions involved?

**Sir Mervyn King:** I don’t think it is for me to comment on the Private Finance Initiative. I know that many people think I stray too much into political territory. This is one I am happy to leave to you to deal with. It is not my responsibility.

**Q402 Jesse Norman:** Put it this way: does the Bank have a concern about the debt implications of continuing that kind of system when real interest rates are at minus 5%?

**Sir Mervyn King:** I am always in favour of having as much transparency as possible about the implications for the public finances, but I am not going to comment on the PFI.

**Q403 Jesse Norman:** I am grateful for that, thank you. Mr Bailey, could you describe, please, the experience you have had since you have been in the FSA and how it is responding to treatment?

**Andrew Bailey:** I have been there for 12 weeks now. I am still a director of the Bank, which is why I am here today, but I spend most of my time there and I am responsible for bank supervision there. I have learnt a great deal since I have been there. You learn a great deal by being in the FSA. There are changes taking place, and I think that one of the clear changes taking place you saw last week, which is the publication of the *Financial Stability Report*, which has in it direct recommendations to the FSA. I am very pleased to see those recommendations. I think there was a very good process that led up to the FPC agreeing those recommendations and giving them to us. By the way, the point was made about the comparison with the US. Let me say, I don’t think any report of this nature is coming out of the US system, which is a clear assessment of the state of financial stability and very clear transparent recommendations to the supervisory authority on what it should be doing.

You may have seen that we have published two documents in the last three weeks or so: one an outline of our future approach to supervising banks, and the second one last week, an outline of our approach to supervising insurance companies. We would be very happy to come and take your questions on those if you want. That gives you a sense of where we are heading to. Obviously the next big thing is for the legislation to enter Parliament, but we are committed to starting to make those changes to the way supervision is done ahead of the passage of the legislation, and it is not to, in a sense, abuse our role.

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We think there are very real practical things we can do to make the system more judgemental, to make it more focused, and we are starting to do that.

**Q404 Jesse Norman:** So this rather supports the view that has been widely held that it was rather dysfunctional before these changes?

**Andrew Bailey:** I think the FSA has changed a great deal in the last four years. So there is a view of the FSA prior to 2007. The FSA has changed since 2007, as a response to the crisis. My own view is that it needs to further change and I think you wouldn't see any difference between Hector Sants and me on this point. I think it needs to become more focused. It has become more intense in terms of what it is doing. It has become more intrusive. I think it needs to have an appropriate focus and an appropriate framework of risks—of which, by the way, the *Financial Stability Report* is a very big part—for doing that work. Otherwise you are just going into banks and sort of hammering them with questions in the hope that you spot the thing that is wrong but you don't actually know quite where you are going. So it needs to have a very clear focus for the issues that it is taking up with institutions, and that requires judgement. Frankly, that requires a change of style and in some cases a change of skills as well.

**Q405 Jesse Norman:** Thank you for that. Mr Tucker, when I asked the Governor earlier on about contingency arrangements for dealing with contagion in Europe, vis-à-vis Greece and then Ireland, his response, quite properly, was: these are not for public discussion. As a Committee, how are we expected to exercise parliamentary scrutiny and accountability as matters presently stand, given that so many of the most vital decisions are going to be taken, essentially, behind closed doors within the Bank?

**Paul Tucker:** You can see part of what we have done. The Governor has already talked about the liquidity facilities. The terms of those are—

**Jesse Norman:** I am asking you a question about accountability rather than about business arrangements.

**Paul Tucker:** I am going to go onto that because I want to make a point that the Governor did not make earlier. There are a limited number of things that this country can do within its own power to protect itself from a tsunami that may be bred elsewhere. One of the things we can do is say to our banks, "To the extent that you can, build up your capital during the good times when you are making good profits", and the FPC concluded that. It has asked the FSA to pursue that. That is not a sermon, which we were previously restricted to, it is a plan. We could have done that completely privately. We have put it in the public arena. The broader issue about how we can be accountable for invisible things is incredibly hard. In the arena of lender of last resort, I think there are arrangements for very private discussions and maybe they should be extended in some circumstances.

As the *White Paper* makes clear, we will have no responsibility whatsoever for decisions on public money. The Chancellor will retain those responsibilities, obviously. A Memorandum of

Understanding will be required by the draft legislation on how we will give the Treasury the information it needs for its crisis management role. I suggest that when that process has advanced and there is an MOU, that is the time to come back to your question, because the key question then is: how can we and the Treasury officials and the Chancellor, be held accountable for our part in that MOU? This is going to be a very, very important MOU, easily the most important in the whole of the package.

**Q406 Jesse Norman:** Great play has been made today about the accountability of the Bank to this Committee. Indeed, the Governor's previous answer mildly uses a form of exculpation as to why there had been no internal report on the Bank's potential failings in regulation before the crisis. I think if the Bank genuinely believes in accountability to public authorities, you should consider preparing a memo to us about how that accountability could be extended in areas such as these where there are invisible operations taking place, which nevertheless require some genuine public understanding, even if they cannot be made available to markets or to the public in that sense.

**Sir Mervyn King:** We will certainly send you a note where we spell out how we think accountability for those things should be carried out. As Paul mentioned, about lender of last resort, which I think was quite a good example here, we have said in our annual report for many years—we have made this quite clear—that there will be possibly some lender of last resort operations that could not be disclosed at the time, if that disclosure would undermine the purpose of the operation itself, but that we would always disclose ex post once we felt we had reached the point where disclosure would not jeopardise the operation. That commitment was always there. Many people have not noticed it but it was always there. There is now a very clear arrangement under which any lender of last resort operation, which by the way has to have the approval of the Chancellor, cannot be done just by the Bank. Any risk of public money always has to be approved by the Chancellor. If that operation were to take place, the Chancellor and I would jointly brief the Chairman of your Committee and the Chairman of the PAC. I had understood that was going to be the case before. It did not happen but it will from now on.

**Q407 Jesse Norman:** I have one final question, Mr Chairman. I don't know if you want to bring Mr Bailey in on this question first.

**Andrew Bailey:** I want to make one point, which is that there has been a degree of accountability. I have certainly appeared before the PAC on the question of operations undertaken by the Bank. It was another Committee, but that accountability has existed and there are reports on that.

**Q408 Jesse Norman:** Ex post, yes. Thank you very much indeed for that. The final question is probably one for the Governor. The FPC code of conduct is quite clear about the discussion of MPC business and the need to avoid speaking about any aspect of UK monetary policy during the MPC purdah period. Will

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the MPC members' code of conduct be updated to reflect this MPC—

*Sir Mervyn King:* Yes, indeed.

**Jesse Norman:** There will be a standard across the board?

*Sir Mervyn King:* Absolutely.

**Q409 Jesse Norman:** Would it be fair to say that you take a very tough line on public disclosure of information that might unsettle the markets?

*Sir Mervyn King:* Sorry, I missed that last point.

**Jesse Norman:** Would it be fair to say that you take a very tough line on all public disclosures of information that might jeopardise the markets?

*Sir Mervyn King:* Indeed. I think it is one of the most important things to have a set of rules surrounding information that is disclosed, whether it is by us, by institutions themselves. There has to be a very clear framework within which people know what information is or is not available, and any breach of those regulations I would take very seriously.

**Jesse Norman:** I am very grateful for that. Thank you.

**Q410 Chair:** Looking at the code of conduct, of course, I understand the risks that are attached to the non-executives on the FPC commenting on monetary policy, but there is quite an imbalance, isn't there, in the arrangements you are putting in place? You are suggesting that only academic comments can be permitted on the conduct of monetary policy. Paul Tucker, you cited a moment ago an example, which may be more than theoretical, of a potential clash between the exercise of policy by the FPC and the MPC. Why is it not legitimate for a member of the FPC, an external member, to comment on it?

*Paul Tucker:* I think in those circumstances it would be because they would be commenting about the things within their own sphere of responsibility.

**Chair:** Right, but that is certainly not an academic comment, is it? That would be a very policy orientated comment. So this needs some redrafting, doesn't it?

*Paul Tucker:* I think that what you are pointing to is—I can't remember the exact words, but I am confident that it is okay in terms of the words that are there because an MPC member would be talking about influences on MPC decisions. I think the spirit of this is that MPC members, who are not on the FPC or the PRA board, going out and making apparently Bank of England comments on central counterparties, or FPC members ranging off-piste as well could be absolutely confusing to people. I don't think there is a difference between us at all in terms of the spirit.

**Chair:** It is something we might come back to.

**Q411 John Thurso:** I am still trying to get my head round the idea of finding an actor capable of playing George Mudie, but we will let that run.

Governor—I stress this is absolutely nothing personal and I have the utmost confidence in your abilities—the Governor will now chair the Court of the Bank, chair the MPC, chair the FPC, the PRA and will be Vice-Chair of the European Systemic Risk Board. Is that too much for one person?

*Sir Mervyn King:* It depends on how it is done. I correct you: I do not chair Court. One of the things I did when I became Governor was de facto to hand the chair to the senior non-executive director, because I believed that was the right way for Court to operate, and I managed to persuade the Government to put that into legislation when there was an opportunity to do so. So I do not do that, and right through my term of office I have been keener to get rid of responsibilities than to build an empire, and I have a pretty good track record on that.

So the question is: why should the Governor chair all these bodies? I think the answer is: do you want these functions in the Bank? If they are in the Bank, and they are major policy-making functions, the Governor really has to chair that body. I am not the only member of the Bank who is sitting on all of these bodies; several other people are as well. So you may ask whether these functions are too much in total for the institution. Should the PRA be an independent, free-standing body? There are arguments for and against that. We can have that discussion. Once I think you have put them in the Bank, I think the Governor has to take responsibility, but then he has to change the way he does his job.

One of the things that is striking to us is that we have been doing this in practice ever since the crisis began. Andrew Bailey has been in many ways a de facto prudential supervisor for many of our biggest institutions, and I have had to be involved in that, and he has reported to me on that. Financial policy we have been drawn right into the middle of. So these three areas of responsibility have taken up a lot of our time anyway in the last four years, and I think whatever the arrangements for prudential supervision or monetary policy, the Central Bank, in a crisis, is bound to be heavily involved. So to make it feasible, what one has to do is to delegate many of the functions to others, and I have delegated a number of my functions and responsibilities, which I did personally before 2007 in the monetary policy area, to Charlie. In the prudential policy area, Paul and Andy are taking the brunt of the burden of developing the work in that policy area, and in the prudential supervision area, we have a steering committee to design the new functions for the Bank, which meets every six weeks. On that committee are: Hector Sants, Andrew Bailey, Paul Tucker and myself, and we meet every six weeks to oversee that process. Between that, that is delegated to Andrew Bailey to be responsible for. So I think you do have to delegate in order to carry it out, but we have doing this in effect for the last four years.

**Q412 John Thurso:** Can I just check, because I am dying to ask Andy Haldane a question, but I am not sure if he figures in the right place? You are currently Executive Director for financial stability. Will you be on the FPC, working for the FPC? How will you relate to the FPC?

*Andy Haldane:* Yes, I am on the interim FPC, and we met for the first time a couple of weeks ago.

**John Thurso:** In that case, I can ask you the questions I want to. Several of the witnesses we have had—and I have had discussions with them—have raised the

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difficulty confronting the FPC of knowing what it is trying to do, whereas the MPC has a very clear remit. The FPC will have a role in crises, obviously, but its real success will be to help avoid a crisis. That means you need to define financial stability. Can you define it for me?

**Andy Haldane:** Well, I can have a good go, I think, at defining what you would want from the financial system. I think that is pretty well hardwired into the plan, the new legislation, which is a system that is resilient to events, to shocks of various types, by which I mean, when it is shocked by this or that, it is still able to offer confidence to depositors, credit to customers and to other functions in insuring risk of various types. I think that is words rather than a number. I think we are somewhere short of having a quantitative target for this objective, but obviously I think it is pretty clear what failure looks like.

**Q413 John Thurso:** Let me take you back. Let us say the new system was in operation in 2006. Given what we now know happened from 2007 onwards, particularly in 2008, you would expect all the indicators to be at least at the top end of amber, if not creeping into red. What would we have seen, what would we have been looking at, what would be the dials that allowed us to make that judgement?

**Andy Haldane:** I think it is many of the same things that Charles Goodhart mentioned, I think, in his one-page submission to you. So I think that the two key indicators are, I would say, a measure of leverage in the system and measures of mismatch. So looking back historically, it is very difficult to unearth any system-wide crisis event that has not had at its core excessive leverage and/or excessive maturity mismatch within the system. That could be banking, it could be shadow banking. So those two things for me would be at the core of any diagnosis. In truth, if you reran history using only those two or three things, you would have had 90% of what was going wrong. There is no question that augmenting that, whether it is with measures of asset prices, whether it is measures of mispricing of risk, helps to embroider the story, give you a fuller picture of what is going on. Taken together, I think that would be adequate to know when the lights were flashing amber or red. It isn't quite the single summary statistic that monetary policy offers, but I think we know enough already to have a rough idea of what is on the dashboard.

**Q414 John Thurso:** Let me put to you my two concerns. On the monetary side it is a doddle, because the Chancellor writes you a letter saying, "Do this", you produce a great report, and we have a lovely session beating you up because you have not got there, or you have got there or whatever. But it is all out there in the open, and we can have a very adult debate about it and get the issues we got out in the session this morning. As yet, I see no target that you can be given, which would enable you to behave towards us in that way, and the counterpoint is it makes it extraordinarily difficult for us to scrutinise when we don't know what we are scrutinising. That then leads on to the problem—using the phrase the Governor often used a couple of years ago—about

how difficult it is to take the punchbowl away when the party is in full swing. What the FPC does will be judged by our ability to justify the removal of the punchbowl in time. So how do you think you can go about designing those for us?

**Andy Haldane:** I think our report takes us somewhere in that direction. It provides a narrative, backed up by numbers, on where we see the state of the system. Is it warming up? Has it warmed up too far? So I think that is a reasonable starting point, in the same way that the *Inflation Report*, is the best starting point for a conversation about whether our monetary policy is on an even keel. What our report doesn't have, but which the *Inflation Report* does have, is that fan chart, that single measure, that judgement of where things might be one or two years hence.

**John Thurso:** Is there a possibility that a fan chart could be developed that would show an increasing risk of financial instability, or would that just be a rather meaningless toy?

**Andy Haldane:** We should seek to do that, because in some ways the case for a fan chart, a distribution, is even stronger on the financial stability side than it is on the monetary policy side, because all you really care about are those big, fat tails out on the left-hand side of the distribution.

**Paul Tucker:** This is not a completely hopeless endeavour if one has a horizon of, say, five years or so. What matters is the resilience of the financial system and that it can withstand nasty shocks, so the question is how you measure the resilience of the financial system—leverage, capital ratios, and various other things. Then one can say, "Well, what would those capital ratios or liquidity ratios look like if the following nasty things happened?" That is exactly what stress testing is about. Probably the single biggest change in supervision that has come about through the crisis is the idea of doing forward-looking stress tests, and this is not in a completely different universe from doing forecasts of what we think is going to happen to inflation and growth. We are years away from being able to do this scientifically, but this is being employed in real time now. It was employed in the States in 2009 to good effect. It was employed in Europe last year, not to very good effect, and Europe is about to have another go. One of the things that Andy's team is going to do over the next few years, as with the ECB, is to work out to what extent one can do what are called top-down stress tests. Without sending armies of people into the banks, can you take relatively simple scenarios and take publicly available or even privately available data for us from the banks and say how the bank would fare under these stress tests? Over time we could make those things transparent.

**Q415 John Thurso:** It seems to me the challenge you have is more than that, because you and the Governor were making speeches warning us all. Those of us who read those speeches could heed the warning. There were lots of people in the market who said, "This can't last". I can't remember who said, "As long as the music is playing, you have to dance and we're still dancing". How do we get to the point where you can say, "Right, stop the orchestra"?



**Sir Mervyn King:** I don't think it is quite that simple, but I do think there are two things that we could do that will make a big difference. One is that the link between the FPC, with the self-confidence to make judgements about the overall position, can then reinforce the willingness of regulators to take action institution-by-institution. Because one of the things that is so difficult for supervisors is they go in and they say to an institution, "Look, you really ought to have more capital, times are a bit risky now", and they say, "Well, look at all these other institutions". So I think that link is crucial. The second thing we could do is that for each session that the FPC will have with this Committee, we can provide maximum one page—only on one page—some numbers or just one number, on leverage and mismatch, which don't capture the entire picture but are the basis for an initial conversation, which would make it possible for you to say, "Well, look, you have done nothing about this. Why not?" and we could explain why, given everything else that was going on, we felt we should not, or that we had done something and why. That won't capture everything the FPC does, but you will be able to go back to the recommendations and ask us questions on that.

**Paul Tucker:** And don't drive us to over-simplification, because otherwise what will happen is there will be a nice chart of leverage being okay over here, and there will be loads of nasty leverage just outside in the corridor, and so you just have to be patient, as we do, for a number of years. We know a lot more about how to do this than anyone knew 10 years ago, but we are a decade away from meeting your desire for a numerical target that you can hold us to account for, which isn't saying that we can't do a lot now.

**Q416 John Thurso:** Just to be clear, it is not the actual number that interests me; it is to have something that is sufficiently credible that when the then Governor or whoever it is says, "This is it, we are in the danger zone", the markets and the Government don't ignore them and carry on regardless, because they can't afford to stop, but they say, "That has been said. We now have to behave differently". That is the objective.

**Sir Mervyn King:** But I think one of the values—not only of our report but of your reports too—is that they will help to bolster the willingness of non-executive directors, of others working in institutions, to challenge what is going on, and I don't think you should underestimate the impact that these kind of things can have.

**Paul Tucker:** Every board of every bank of any size in this country should go through last Friday's statement and say, "What does this mean for our bank?" Rather than waiting for the FSA supervisors to turn up and ask about it, they themselves should ask about it. We are not going to be in the business in years ahead of saying, "We think there is this risk. We wish you would all calm down, please". If you give us the instruments that the Government is suggesting—you, Parliament—at various points we will be saying, "We think it ought to slow down and here is what is going to happen to the requirements

on you so that it does slow down", and then we will be able to see whether it does or not. We will misfire occasionally, but you will be able to hold us to account for that.

**Chair:** Charlie Bean, you have been very quiet. Have you anything you want to add before we bring this session to a close? In particular, do you agree with Charles Goodhart's three indicators?

**Charlie Bean:** I think the important thing to realise about them is they are indicators, in the same way as, say, on the monetary policy side, things like the rate of monetary growth or the rate of nominal demand growth might also be indicators of inflationary pressure down the road. So think of them in that way, but not as targets. They are reference points to have a discussion around. And certainly for explaining policy they may be very useful to frame an explanation about why we have raised capital requirements, with reference to how those are evolving. For instance, that is exactly what is envisaged in Basel III with the capital buffer, where the Basel Committee particularly referenced it alongside credit growth. But think of them very much just as indicators to help aid the discussion of where the issues are, not as an inflation target, as a hard thing that we are trying to achieve.

**Q417 Chair:** Governor, you have told us that a good number of the people who have given evidence to us have been labouring under various misapprehensions, and you have been kind enough to suggest that you will supply us with more written evidence in order to address those, and set those people straight. I think we could do with that sooner rather than later, because we want to get on with this work, not least because the legislation has just been published. I want to end with one question to you, Governor. I have a fair deal of contact with the City and have done over a number of years. They tell me that when this crisis started, the informal links between the Bank and the financial sector were weak and had been run down, and that this was a severe defect. There was a lack of high-quality intelligence gathering. The MPC, and the Bank on behalf of the MPC, have in place high-quality intelligence gathering about the real economy. Are you now going to—and are you in the process of—reconstructing that intelligence gathering on the financial side, which once was in place in the days when we all relied on your eyebrows?

**Sir Mervyn King:** I don't think that the statement that we did not have an intelligence gathering operation is correct, and I don't think one should confuse lunch or dinner parties with intelligence gathering. When I was appointed Governor, and before I took up the job, I talked to Paul Tucker and I said I wanted him, as Markets Director, to create a new market intelligence function, and that started when I became Governor. It was to build on what we had seen operate successfully at the New York Fed, which used many of the people trading, not to do lots more trading but to use that, to leverage off that and to find a great deal of intelligence based on that. That market intelligence function operated from 2003 onwards and was immensely helpful to us. It was the basis of much of the reporting in the *Financial Stability Report*, which you referred to earlier when commenting on the fact that we had

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made warnings. So I do not think we have a lack of a market intelligence function. It was extremely effective and very good, and I don't think one should confuse the views of people who felt if only they had been able to call in personal favours to get something that they would like to have had in that situation. That is a very different relationship from the one that you need for a market intelligence function. We are beefing up that market intelligence function in order that it will support not just the Monetary Policy Committee in our previous financial stability responsibilities, but the FPC as a whole. Its function is doing that work under Paul Fisher now, with Paul having moved to Deputy Governor, and we are also having a large number of contacts with people in the financial sector, some of which will be done through PRA, some through the financial stability side.

But I will refer you to one example of something that was extremely effective here, which I think belies the assumption behind some of the comments you referred to. In 2008, when we began talking about the Special Liquidity Scheme, this was a proposal of the Bank, and I put it to a private meeting of the chief executives of the big banks. I think they were surprised by the scale and ambition of that plan, but they could see that its virtue was that it was a three-year plan, it was generous, it was big, but it was restricted to the assets that they held when the crisis began, so it wouldn't involve any temptation to create assets and have them financed by the Central Bank. These were the key principles, which are absolutely right, and I think we handled this in the right way. The key thing about that is that we had to have detailed discussions with people in clearing banks in order to make that scheme an operational one. We did that for two weeks. Paul took a major role with Alistair Clark in going round the banks to sort out the details. Nothing leaked at all from that group. We were able to make that a very effective process and it was finally announced. I think that is evidence that the Bank can and does work with the financial sector, not to do them favours, not to give them something that they would

like to have because it makes life easier for them, but in the interests of the financial stability of this country, and we have done it.

**Q418 Chair:** That is a helpful answer, and related criticism of the FSA is that whenever they have any contact with the people they regulate, it is to act as a policeman, and what is required is a much more two-way response. Have you heard that criticism and do you think that is something that needs to be addressed?

**Sir Mervyn King:** I have very much heard the criticism and I know Andrew is dealing with it and changing it, but when senior members of banks met with the FSA, they had too low a level of representation from the FSA. They weren't probed and challenged on the big risks that they might or might not be taking. They were being quizzed about whether they speeded or engaged in a parking offence, rather than something much more serious. That is something that we are adamant we want to change, but I think the way to do it—and I don't blame FSA entirely for this—that approach to banks came out of the attempt to merge prudential supervision into the same operation as conduct of business, enforcement and consumer protection. They are very different kinds of regulation and should be done by different people in different ways. That is why I think the split of FSA into prudential and the Financial Conduct Authority is exactly right. It is a simple question as to whether you want the PRA in the Central Bank. I don't feel strongly about that, and we certainly did not ask for it to be in the Central Bank, but I do think that having a separate prudential regulatory body is the right way to go.

**Chair:** Thank you very much for giving evidence this morning. For two of you, at least, it has been a pretty long couple of sessions, and it has been very illuminating. We are very grateful and looking forward to your written evidence.

**Tuesday 5 July 2011**

Members present:

Mr Andrew Tyrie (Chair)

Michael Fallon  
Stewart Hosie  
Andrea Leadsom  
Mr Andrew Love

Mr George Mudie  
Jesse Norman  
Mr David Ruffley  
John Thurso

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**Examination of Witnesses**

*Witnesses:* **George Osborne MP**, Chancellor of the Exchequer, and **Sir Nicholas Macpherson**, Permanent Secretary to the Treasury, gave evidence.

**Q419 Chair:** Chancellor, thank you very much for coming today. With your agreement we will try and run the session for no more than two hours and for the last part there may well be questions from one or two of us about topics other than accountability of the Bank, but I am sure you would expect that coming before a parliamentary committee. Can I begin by asking you about the MOU, the memorandum of understanding that you intend to prepare, which is designed to set out who is in charge when taxpayers' money comes on the line? Do you really think, given all the experience we have had with the tripartite MOU, we should be relying on such a document for something so important?

**George Osborne:** I certainly don't think we should be relying on an MOU, which is why the MOU that we will produce in the autumn supplements the statutory responsibilities that are on the face of the Bill and, obviously it is up to Parliament, I hope become law. So I would say that the central powers, the central responsibilities are set out in statute and the MOU is simply going to explain how, in practice, the different institutions should go about the exercise of their statutory functions. I would draw a distinction between the MOU, which assumed an enormous importance in the tripartite arrangements, and what I see the memorandum of understanding doing here, which is explaining how very significant statutory powers and responsibilities are to be exercised. If I could just briefly draw your attention, in the draft legislation we have published, to clause 42. There is a very clear statutory duty on the Bank of England to inform the Chancellor when, for example, public money is materially at risk.

**Q420 Chair:** How should a crisis warranting your very direct engagement be defined? Should it be when liquidity support becomes solvency?

**George Osborne:** I would say in a way the crisis is defined by this clause. It is defined by the moment when the Governor has a duty to inform the Chancellor of the day, and he has a duty to inform the Chancellor of the day when public money might be materially at risk, when there potentially needs to be a loan to the Financial Services Compensation Scheme, and also when an institution is going to be put into the Special Resolution Regime. So there are a number of triggers. I think in all those circumstances you are talking about a crisis. Now, it depends what magnitude. It could be a big crisis or a small crisis

but, to answer your question, I think clause 42 establishes what I would define as a crisis.

**Q421 Chair:** You are not going to want to find yourself at the eleventh hour having to take a decision of this magnitude without having been deeply engaged in the run-up to the crisis while it appeared to be a liquidity crisis, are you? You are going to want to be very closely informed, are you not?

**George Osborne:** Well, as I say, first of all the duty on the Governor is when there is a material risk. So obviously that will be for the Governor to decide in the sense that he has to fulfil his statutory obligations, he has to comply with the law, but I would be fairly clear in my conversations with him that that would be when there was the possibility of any use of public money down the track. I think, of course, we have also built into the arrangements here formal statutory meetings between the Governor and the Chancellor of the day on financial stability where a high-level minute is produced of that meeting. On top of that—and in a way this is something you can't legislate for but depends on the people doing the jobs at the time and the goodwill of the institutions involved—I meet, as indeed did my predecessor, the Governor of the Bank very, very regularly, not just because it is prescribed by legislation, just because it is prescribed by good governance.

**Q422 Mr Mudie:** I have listened very carefully to you but, putting aside the statutory meetings, you will be aware that in the crisis over a weekend banks were going down, it was non-stop meetings, which led to the Bank of England Governor being asked by Lord McFall, then Chair of this Committee, who was in charge. That is almost a question in terms of who do you see in a crisis will be in charge? As I read the document, and you have said it, "He will keep me informed". I am really adding to what the Chairman says; will you be involved, not informed?

**George Osborne:** No, I would draw a distinction here between the build-up to a crisis, in which case I would or my successor would hope to be informed, which is the requirement of the legislation, but I am absolutely clear and the legislation is clear that in a crisis, if there is the requirement that public money is put to use, that is a decision of the Chancellor of the Exchequer, accountable to Parliament. So the key decision-maker in a crisis in that sense is the Chancellor and if you look at events over recent years—and the Permanent

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Secretary on my left here was the Permanent Secretary during that period so he could speak in a way I can't for events during that period—during that period in almost every case public money or a public guarantee, the promise of public money, was involved and it is absolutely clear in this legislation that the Chancellor of the Exchequer of the day is the person who takes that decision. I would say if a crisis is identified on the horizon, the Governor of the Bank informs the Government, and then in the crisis itself the key decision-maker—and obviously there are other important decision-makers not least the Governor of the Bank—when it comes to the use of public money is the Chancellor of the Exchequer, accountable to Members of Parliament.

*Sir Nicholas Macpherson:* Can I just add—

**Q423 Mr Mudie:** Sorry, I will let you come in, Sir Nicholas, but just let me keep on track. In the crises, both here and in the States, it is not just a question of saying to the Chancellor that public money is needed. There are some judgements that can be exercised before they hand you a bill in a crisis and they are often hourly judgements, the situation is moving that fast. Will you be round the table?

*George Osborne:* The short answer is yes.

**Q424 Mr Mudie:** The actual Bill suggests, Chancellor, that he will simply keep you informed. The machinery, the FPC—

*George Osborne:* The key decision, Mr Mudie, is the use of public money and that would be my decision or my successor's decision. So in the crisis, as was the case for my predecessor, I suspect it would be a 24 hour, seven day a week job for the Chancellor to be on top of what is going on. I think the key difference, what we are doing here, is looking at the period in the build-up to the crisis and making sure that Government, the British State, has better tools for identifying systemic risks, trying to address them before they become a crisis. If you can call it in peacetime, what this legislation makes absolutely clear is it is the Bank of England that is in charge of the macro and micro-prudential regulation of the financial system. In a crisis when public money is on the line, public guarantees are on the line, it is the Chancellor.

**Q425 Mr Mudie:** Overrides the FPC?

*George Osborne:* In fact, the Financial Policy Committee is not really the crisis body. The Financial Policy Committee is there to identify systemic risks over a long period, spot the build-up of leverage, apply, for example, countercyclical capital requirements. In the actual crisis, the tools available to the Government and the Bank of England are things like nationalisation, putting it into the resolution mechanism, recapitalising the banks. These things would not necessarily go anywhere near the FPC. They would be decisions for the Bank Governor—we will come on to how the Bank Governor is accountable within the Bank to the Court but also to Parliament—and for the Chancellor of the Exchequer in terms of the use of public money or the nationalisation of a bank.

**Q426 Mr Mudie:** That is reassuring. Let us take your peacetime role. Your peacetime role, apart from twice a year, I think it is, meeting the Governor, seems to be that the Treasury can give them a remit, an annual remit of where you would like them to develop or tweak their stability objectives, but you are also putting in the Bill that they will have the ability to reject any recommendations with which they don't agree. Now, let me just add a second question to that. We asked the Governor this and got a dusty response, and I am not sure I don't expect the same but we live in hope. If the Treasury and the Government felt fundamentally strongly about something and put it in the remit and they rejected it, what action could you take?

*George Osborne:* I want the Bank of England to be in day-to-day operational charge of financial stability, identifying risks in the financial system, which was not being done, and also the macro-prudential regulation of institutions. I don't want the Chancellor of the day second guessing. I am trying to get away from the confusion of responsibilities that was the case under the tripartite regime. So the Bank of England Governor is in charge. There is enormous power, if you like, for the Chancellor of the day to appoint the relevant people. All the people we are talking about are people appointed on the recommendation of the Chancellor, from the Governor to the members of the Financial Policy Committee, to the members of the Court. They are all appointed on the recommendation of the Chancellor. The Chancellor of course sets, with Parliament, the overall framework for financial regulation, which we are discussing today. There is a remit that is produced that the Chancellor sets. There is a requirement to inform the Chancellor when things go wrong and the Chancellor has the decision on the use of public money. I don't think there is any shortage of power for the Chancellor but what I don't want is a system where every day people do not know whether to look to the Treasury or the Bank. On a day-to-day basis in peacetime it is the Bank of England that is in charge.

**Q427 Mr Mudie:** No, we are not suggesting that, Chancellor, no, no. I think that is all very sensible, but this is an annual remit. This is your one chance, as you have put it, to tweak or develop their objective, fairly reasonable and sensible to put in but you are giving a right of veto to the Governor. Where does that place you as Chancellor? If you feel something and you put it in print, as you have perfectly entitled yourself to do, and the Governor says no, where does that place you with authority?

*George Osborne:* When you are dealing with an institution like a central bank and a bank governor whose independence, most people accept in most countries, is an important thing to preserve, I have been careful about not inserting powers of direction. There is a general power of direction in the 1946 Act, so Chancellors since then have been able to direct the Bank Governor. They have never used that power and that is because, of course, the use of a power of direction can itself cause all sorts of problems and give rise to all sorts of confidence issues, so I have been careful about trying to avoid that. I think the

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responsibilities are clear. The day-to-day responsibilities, monitoring risks in the system, are not, under these arrangements, the Chancellor of the Exchequer's. They are the Bank Governor's and the Bank of England's and the Financial Policy Committee of the Bank of England.

It is precisely because I don't want to recreate the tripartite system that I have headed in this direction and asked Parliament whether they agree with me. I have read the evidence of previous witnesses before your Committee and I thought the Bank Governor was pretty revealing about the truth of the tripartite system in peacetime. It met twice in 10 years with the principals. The truth is, as the Governor points out—and it is a truth, I can see now doing my job—that if you are relying on the Chancellor to be there day in day out during peacetime financial stability, it is just not going to happen, and it didn't happen, and that is why it is much better to clear the lines of accountability and clear the lines of responsibility. The Bank of England is in charge, but when it comes to a crisis the Chancellor is in charge when public money is at stake.

**Q428 Andrea Leadsom:** Chancellor, this has been something of an extraordinary inquiry into the role of the Court of Directors, and the inquiry has come up with all sorts of odd points. We have established that there are three roles of oversight of the Bank of England in management, processes and policy. Can you tell us what would you see as the lines of accountability between the Bank of England, the Court of Directors, the Treasury Select Committee and the Treasury?

**George Osborne:** I think ultimately where it really counts, that is, the exercise of policy, monetary policy to control inflation and manage demand, financial stability policy, the Bank and its different components, the Financial Policy Committee, the prudential regulator, and the Governor, are accountable to you, Parliament, they are accountable to me as the Chancellor of the Exchequer, appointed to do this job. But within the Bank we also have, like many public organisations, a board—it is called the Court—and that is responsible for the overall internal strategy of the Bank, the resources of the Bank, managing the balance sheet risks to the Bank and so on. When it comes to the big questions as far as members of the public would be concerned, and I suspect Members of Parliament, then I would see those bodies, both through the person of the Governor but also through the individual members of these different bodies, to be directly accountable to you and also, as I say, accountable to me in my meetings with the Governor.

**Q429 Andrea Leadsom:** So do you think that the Court is fit for purpose?

**George Osborne:** Yes I do. I think they clearly had a challenging session with you, and that is not a complaint about the way you asked your questions. I would point out that they are people of very considerable experience. Now you happened to have, and I don't know how you went about choosing the witnesses, the people with the non-financial service expertise and I think it is important to have people,

for example a representative of the trade union movement, on the Court of the Bank, representatives from broader industry, not just financial services, and you met those people and interviewed those people. There are also people with very considerable financial services expertise; people who have run the Pru, Legal & General, Deutsche Bank. I think in your inquiry you have to ask yourself what different group of people would you get in our country to do this sort of job. By all means, you will, of course, make recommendations about whether they have the right tools and whether the Court is the right body to do this, but if you ask yourself who should be doing it and you look at the members of the Court and you look at their very, very considerable expertise—one is the President of the CBI, one is the current head of Legal & General, one ran the Pru, one ran Deutsche Bank—who else in Britain are you going to get to sit on the body that keeps an eye on the central bank? By all means, recommend improvements on how to do it but I don't think questioning the competence of the people, to my mind, is the right line of inquiry because I think those are the sorts of people you would want. Whether you called it a supervisory board, whether you called it a court or whatever, those are going to be the kind of people you would want sitting on it.

**Q430 Andrea Leadsom:** Yes, I agree with you and I think there would be a lot of agreement around the Committee that it is not about the individuals, it is about the structure and whether that is the right structure. You will be aware that we have had some representations, including from Willem Buiters, who say that the Court should be abolished and there should be a new oversight board, perhaps set up within the Bank of England. In other words, it is the structure that is at fault. There have also been a lot of questions over whether the FPC should in fact be a committee of the Court rather than run along the same lines as the MPC. So the issues are around structure rather than the individuals who are involved, and I would appreciate your thoughts on that.

**George Osborne:** I don't personally have a complaint with the way the Court has done its job. I think it has helped manage the Bank of England's resources. It has not allowed a big increase in bank spending. It has dealt with the very significant balance sheet risks, which are almost unique for the Bank in recent years, the scale of the challenge, and so on. So I have confidence in the Court. There is a question you have asked, I can see having read your previous sessions, about whether the structure could be improved in some way. I am very happy to listen to recommendations but I have confidence in the current Court, both in its structure and in the people who do the job. I think the Bank Governor did a good job before this Committee of explaining the difference between the policy functions of the Bank of England, which are the executive responsibilities, and then the role of the Court in managing those resources. Sir Nicholas deals with the Court on a pretty regular basis. I don't know whether you want to say something?

**Sir Nicholas Macpherson:** I think just to come on to your point about the FPC, the fact is that the Bank

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has a range of responsibilities in relation to payment systems, in relation to intervention and so on, and those all are legitimately guarded by the Court so I think it is sensible for the FPC to be anchored within the Court structure. For example, when there was emergency liquidity assistance to Northern Rock, the Court of the Bank did meet to agree that that should take place, and those sort of governance structures, I do think, do create a degree of accountability. So one way or another I think you do need some sort of board structure.

**Q431 Mr Love:** When the Governor of the Bank of England came before the Committee in this inquiry last week he repeated once again that his first preference or the Bank's first preference would be to have a completely new Financial Services and Markets Act. This Committee is on record as saying we should be thorough in whatever we do, yet currently you are not listening to those concerns. Why not?

**George Osborne:** Obviously I have had this discussion with the Bank Governor and he said what he said to your Committee. My judgement was that we could achieve what we needed to achieve by amending FSMA, that it would be an enormous exercise that would take several years to rewrite FSMA. I didn't think that was necessary. Almost all the people who responded to the Treasury consultation from the industry on this point thought it was unnecessary, for example, the ABI, the Association of British Insurers. The final point that draws all this together is that obviously we are undertaking quite a lot of substantial changes to the regulation of financial services. We are changing the way these institutions are regulated, changing the structure of regulation. We have the Independent Commission on Banking due to report in September. These are all big changes and they create, inevitably, some uncertainty around the industry and that is, again, inevitable after what we have been through as a country. I thought rewriting FSMA would be yet another piece of uncertainty; it was not necessary; it would delay the whole process by potentially at least another year. So my judgement was we could achieve what we needed to achieve through amending the existing Act rather than completely rewriting it.

**Q432 Mr Love:** The Governor did say to us that he questioned whether you could avoid the sort of delays that you are concerned about and he said so because he characterised the original FSMA, and I quote, as being, "To create an all singing and dancing regulator covering everything", the FSA. You are moving to a completely different structure, with added complexity. Don't you worry about the possibility of unintended consequences if you just bolt on a quick fix Bill to amend FSMA?

**George Osborne:** I wouldn't describe it as a bolt-on. I would describe it as a pretty substantial rewrite. The reason why this document is so big, by the way, is because all but 50 pages of it are the draft legislation that the Committee asked us to produce in advance and the explanatory notes. As you can see, it is a pretty major rewriting of the legislation and what we

have also produced in the last week is a sort of consolidated version so you can read now the Act as it will look if it is passed by Parliament, and I think it does the job. If people want to go through it and point to specific problems, please do that, that is the whole purpose of the pre-legislative scrutiny, but I have not yet heard a convincing argument of why we should start from scratch. I think this does the job. In terms of the delay, or not, we are completely on course for achieving this change, subject to the view of Parliament, by the end of 2012 and that is quite a significant achievement in a reasonably short period of time.

**Q433 Mr Love:** When the original FSMA was put through the House there was a great deal of comment, discussion, controversy; that is likely to emerge again, even with the amended Bill. Don't you see the force of the argument that rather than end up with huge numbers of amendments coming forward to amend the amended version, it would be more sensible to, as this Committee has suggested, go through in a comprehensive, thorough manner everything related to this particular complex change that you are intending to make?

**George Osborne:** I would hope that ultimately it is judged that we have done this in a comprehensive and thorough way. The facts that I remember as well of FSMA, its original passage—I was working in Parliament but I was not a Member of Parliament at the time—it just showed that even when you start from scratch there are a whole load of amendments and we could try and reduce that this time. That is one of the reasons for undertaking the pre-legislative scrutiny, to try and flush these things out before we get there.

But can I make a general observation? I am also trying to—and I think the Bank Governor is trying to do the same thing here as well—get away from thinking you can prescribe in legislation every scenario and every problem you might encounter in financial services regulation. We are trying to move towards more judgement-based regulation. Let me give you an example of what I think was a shocking failure of regulation. In the end of 2007, there had been a bank run on Northern Rock, after the credit markets had frozen the UK regulators allowed the Royal Bank of Scotland to buy ABN Amro. In other words, this was not at the height of the boom they bought it; they bought this after the run on Northern Rock and it led to the biggest bank failure in the world.

The reason why they allowed that merger to take place was because there was nothing that RBS was doing wrong. It complied with all the regulations, it ticked every box, FSMA was fully complied with, but there didn't seem to be—obviously I was not there at the time—anyone saying, "Hold on, are we really going to allow, in this period of financial uncertainty, the Royal Bank of Scotland to buy this enormous Dutch bank?" What I am trying to do is get to a position where the Bank Governor, or the institution that he heads, exercises that kind of judgement. Yes, we can have a debate, and I will certainly pay close attention to your conclusions on the sort of nature of the legislation, but in the end what we have to do is get

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some judgement, some discretion, some common sense into the system and stop assuming that if you have complied with points 1 to 10 of the law that is it; you want someone also asking the bigger question.

**Q434 Mr Love:** In a sense, the response to that response you have just given is that we need to get the right people; this is a great deal to do with the right people rather than particular structures.

**George Osborne:** That is equally important.

**Mr Love:** But I won't pursue that because I am still on my FSMA point. It is going, as you said, to a Joint Committee for pre-legislative scrutiny. They will, of course, look at the Bill but, as you mentioned, they will undoubtedly, because of all the work that has been done round about this for the last year or so, come up with further amendments. If that Joint Committee recommends that they should look at the whole of FSMA, will you take that into account in your judgements?

**George Osborne:** I will certainly pay attention to, and I mean this seriously, the recommendations of the Committee and, as this hearing has demonstrated, I don't think this is a sort of particularly partisan or heated, in parliamentary terms, discussion. We all want to get this right and we are all trying to learn the lessons of what went wrong. But on FSMA, specifically on your point, it would—and I think the Committee has to ask itself this question now—massively delay this process and I think you have to ask yourselves whether that would be a good thing. Now, you may argue we shouldn't have started from here—I believe we are starting from the right point of amending FSMA—but you have to ask yourself the question whether you are really recommending that I tear all this up and we start again and we presume it will take at least another year, take a couple of years, to come up with a completely new piece of legislation, and that is certainly not where the industry is at. I won't read them all out but we can certainly provide you with some of the comments from people in the industry, like the ABI, like the International Financial Data Services organisation. They have all said it will lead to an easier transition to the new regime and it can be done in a measurable period of time rather than delaying the whole process, but obviously that is a decision for the Committee.

**Q435 Mr Love:** Just one final question, and it relates to this issue about the amount of time that it will take. The Governor has expressed his concern that even under the process that you are instituting there will be considerable delays. If the Joint Committee gets into all sorts of areas that aren't included in the Bill, that will lead to significant delays. There must come a point—even if they don't recommend, even if you don't follow what this Committee is saying—where it would make sense to do the full FSMA again, rather than try to continue to just have some amendments to some parts of the original Bill.

**George Osborne:** I would argue that we are where we are. I think we are in the right place, obviously I think this is the right approach, and the alternative is really saying, "Well, I wouldn't have started from here", but it does mean a very considerable delay and means

going back to the drawing board. I don't think that's good for the financial services industry and, by the way, I want to move to this new system because I think it is the right system, so I want to get the legislation through.

In a way, the pre-legislative scrutiny process, your Committee's hearing, these are all opportunities to raise issues and flush them out before the legislation is produced in final form. If there are specific points that you think would have been better addressed if we had had a brand new piece of legislation, make them and we can make the amendments.

**Q436 Chair:** You have said that the regulators shouldn't have allowed RBS to buy ABN Amro. As you know, the FSA didn't look into that, or if they did they didn't publish anything to give us evidence that they had, and so we have asked for it as a committee and sent in independent assessors to make sure that the job is being done properly before that is published. You presumably agree with what we are doing there.

**George Osborne:** Yes, I think you have undertaken a sensible course of action.

**Q437 Stewart Hosie:** You said, Chancellor, there is a level of accountability to yourself and to Parliament through this Committee and the legislation will provide the mechanisms for Treasury Ministers to satisfy themselves that the regulation is appropriate and the regulatory system is functioning properly. In terms of this Committee first of all, we look at the decisions of the MPC and the FPC in its macro-prudential role, the PRA in its micro-prudential role. I am sure we will also look at the FCA because we know that consumer risk can morph into systemic risk. If this Committee says we need significantly more resources in order to do this job properly, because it is detailed and complicated, I take it you will be happy to sign the cheque.

**George Osborne:** I am generally trying to avoid signing cheques at the moment, which is what I say to almost everybody who asks me for more resources. Ultimately that is a decision, I think, for Parliament, how this Committee is funded. Since I have to take responsibility for how most other things are funded in the broadest sense of the public sector, I think I will not intrude on the privileges of Parliament.

**Q438 Stewart Hosie:** Let me just say that was a little marker. More specifically, you said the Bank is accountable to you through your meetings with the Governor. What role or what additional role, though, do you see the Treasury playing in terms of accountability of the Bank of England and other bodies within the Bank of England?

**George Osborne:** As I say, we are accountable for the overall structure of regulation, obviously, because we have asked Parliament to pass this legislation. We are accountable for the appointments. We are accountable for the remit we set. We are accountable—we haven't discussed it yet—for the tools that are going to be given to the Financial Policy Committee, these new macro-prudential tools, and ultimately I am very aware, as the Chancellor, that the buck stops with me. I think that is all ways in which we are accountable.

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I think there is another thing—I don't know whether I would be intruding on Nicholas's territory here—that it is also true that in the build-up to the financial crisis, certainly my observation then in Opposition was that the Treasury ran down its financial services capability, it wasn't the strongest part of the Treasury, there weren't as many people as were needed. One of the things we have sought to do as an institution—but I will get Nick to say more about this—is learn the lessons of that and make sure that the Treasury retains a strong competence in financial services, partly so that we can deal with a crisis, partly so we get the appointments right and the remit right and so on, partly so that I and other Ministers go into meetings well informed and asking the right questions and demanding the right material, and partly also because, as well as passing legislation through Parliament, we are engaged almost weekly in negotiations on European and international regulation, which is becoming increasingly important in this sphere. Nick, do you want to say something?

**Sir Nicholas Macpherson:** I am very happy to. The Treasury undoubtedly has built up greater expertise in this area. I think it is quite valuable expertise and it has shown on a whole range of issues how we can deliver reasonably quickly. A good example recently was the Irish loan where the expertise we developed during the financial crisis meant that we didn't have to employ investment bankers whereas a few years ago we would have done, thus saving the taxpayer money. I do think we are in a better place there. It is also important that we learn the lessons internally from the crisis and indeed, following a recent PAC recommendation, we are doing work on that.

**Q439 Stewart Hosie:** You are responsible for the appointments, the remit, the tools, competence, the experience within the financial services and you said that this was so that you and others can be informed properly to ask the right questions when you go into the meetings. Is that the way in which you see, in practice then, Treasury Ministers informing themselves or satisfying themselves that the regulatory system as a whole is functioning properly by being informed properly to ask the right questions of the right people?

**George Osborne:** It is both asking the right questions and also coming up with the right suggestions and recommendations and getting the remit right, as I was discussing with Mr Mudie earlier. As I say, I don't want the Treasury to be second guessing every single day the peacetime task of monitoring overall systemic risks and managing individual institutions. I think that is partly what went wrong last time, that no one was clear who was in charge. I am very clear the Bank of England is in charge of that job and they are the people who must take responsibility for that task. But obviously it is my job, and indeed Parliament's job, to make sure they are doing that job properly.

**Q440 Stewart Hosie:** That is where I want to get to, because in the 2007 Financial Stability Report from the Bank it was extremely clear, this is only four months or so before Northern Rock and the start of the crisis, "Weakened credit risk assessments,

impaired risk monitoring, low premia for bearing risk, high and rising leverage in the corporate sector, rising systemic importance of large complex institutions, impaired market liquidity", which was brushed under the carpet by lines like, "Conditions are likely to remain favourable and the UK financial system remains highly resilient", neither of which were true. I am trying to understand how Treasury Ministers, not second guess, will be absolutely satisfied when they get one of these bits of paper they can say, "Yes, we believe it" or "Heavens, that's wrong". Are you satisfied all the tools are in place for your Ministers to be able to understand what is being said?

**George Osborne:** Yes, I am, but I think more to the point, the big difference, once the regime is up and running, is that the Bank of England won't just identify those risks, it will have tools, it will have policies available to it to deal with those risks. This is for them to recommend over the course of the next few months to me, and through me to Parliament, tools that they should be given to deal with things like excessive leverage or maturity mismatch. Let me give you some examples of things that are commonly talked about. It doesn't mean they will necessarily be the tools but they are ones that are commonly talked about; things like loan-to-value caps, countercyclical capital requirements, liquidity tools. They are going to have these tools, stress tests, they can require forward provisioning. These are all talked about as macro-prudential tools.

The Bank of England won't just be producing this report; it will also have a responsibility to do something about it. In a way the biggest innovation we are undertaking with all of this is not to move bank regulation from the FSA into the Bank of England but to create a new task, which is monitoring overall levels of risk in the financial system and creating new macro-prudential tools to deal with those risks. Those tools don't currently exist. The academic literature on this is much less developed than it is on monetary policy. One of the big challenges for the Bank of England is going to be, over the next few months, identifying what those tools are and then the big challenge for me and for Parliament is to decide whether they are the right tools for the FPC to have.

These are very substantial things. These, in the end, come down to questions about whether your constituents or my constituents can get mortgages at certain loan-to-value ratios or what the availability of credit in the economy is. These are very significant issues, but these tools did not exist before in one place. They were spread across the system and most of them had never been identified as tools, and I think this is a big innovation. The Bank of England, I would argue, and the British Government and the British Parliament are at the forefront of developing this in the world. Other systems are trying to develop something similar but we are right at the cutting edge of this. Unfortunately, there is not an off-the-shelf guide to how to do this; it is one of the things we are all seeking to do post the crisis.

**Sir Nicholas Macpherson:** Could I just add to that? I was at the Treasury when that report you read out was produced and it was very striking in those days that the Bank of England could produce reports, it could



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make speeches, and that was it, and sometimes they would get reported and sometimes not. The big difference under the new regime is that these things will be internalised within the Bank of England. If they are going to make recommendations in the report then they have a responsibility to take action, to direct the PRA and so on. I do think this will strengthen the system as a whole because decisions that they could argue were a matter for the FSA will now be their responsibility. It will be internalised within the Bank and the Bank will be accountable for implementing the framework.

**Q441 Stewart Hosie:** Just one final question in terms of the tools then. I know they are being developed and I don't want to get into a debate as to whether or not the FPC will take away some of the fiscal levers the Chancellor might normally have; it is a debate or questions for another time. But when are we likely to see a recommended toolbox this Committee and the public can have a look at and say, "That's an interesting set of levers that are likely to be enough to do the job" or, "The Chancellor is keeping too much power and the FPC is still denuded"? When will we have the toolbox?

**George Osborne:** The interim Financial Policy Committee's—because obviously we haven't set it up yet on a statutory basis because the law has not been passed—first major task is to identify what those tools might be, to make a recommendation to us. We will have to take that to Parliament in secondary legislation, so Parliament ultimately will get a choice about whether it wants to give these tools or not. This is a major innovation in public policymaking in the world and I would venture to suggest it is an important task for this Committee to look at this in the autumn when we get the recommendation. It is certainly an important task for me as Chancellor and for the Treasury.

**Q442 Michael Fallon:** You have decided that both the Financial Policy Committee and the Monetary Policy Committee should be chaired by the same person. Why is that?

**George Osborne:** I don't usually like the word "joined-up" but in this context it is appropriate. It is joined-up, that you don't have different parts of the British State pulling in different directions. The person who is ultimately responsible in peacetime for the systemic risks in the financial system is also the person who is monitoring individual institutions and undertaking monetary policy.

**Q443 Michael Fallon:** So it is to some extent because you think that the macro-prudential tools can't be deployed in isolation from monetary policy?

**George Osborne:** Obviously all these things have an impact on the economy but the inflation target is very, very clear, and that is the task of the Monetary Policy Committee. Of course, in this context the Bank Governor is only one of a number of members and can be outvoted, just has a vote equal to everyone else on it. I am certainly not suggesting a weakening in any respect of the MPC's role on inflation targeting

and, if anything, the other parts of the system have to operate around that central MPC inflation target.

**Q444 Michael Fallon:** The Governor chairs your FPC and he chairs the MPC and he is then accountable for that chairmanship to the Court on which he himself sits. How does that work?

**George Osborne:** He himself, the current Governor, took the decision that the Court was better chaired by David Lees, so he has himself, with the help of the previous Government's Act, I think improved governance in the Bank of England. Ultimately a bank governor is a powerful independent figure in any political system or any state where they have an independent central bank and he is ultimately accountable to Parliament and to the public.

**Q445 Michael Fallon:** But he is also accountable to the Court on which he sits.

**George Osborne:** In many companies the chief executive and the executive chairman sit on the board and are accountable to the board, and I don't think that is a particular problem with these arrangements. He is accountable to the Court for the strategy and the resources and efficiency of the Bank outwith the statutory duties that are imposed on it.

**Q446 Michael Fallon:** One of the other criticisms we have had is that you are heaping quite a lot of responsibility and power on to the Governor; he sits on the Court, he sits on the PRA, he chairs both the FPC and the MPC, he is on the European Systemic Risk Board. It is an awful lot to put on to one person, is it not?

**George Osborne:** Of course the Governor of the Bank of England has an important job to do, but since the recommendation from people who don't want this to happen is normally that they should give this as an additional responsibility to the Chancellor, Chancellors usually cope with the tasks that are heaped upon them; I am sure the Governor of the Bank can cope.

**Q447 Michael Fallon:** A further criticism we have had is that because all this is now being done inside the Bank, and you have just explained how they should have sole responsibility for doing this, there is a danger of kind of group-think or Governor-think within the Bank itself. How do these proposals guard against that?

**George Osborne:** I think the importance is obviously to get the right executive members of the Bank. That is a decision for the Chancellor of the day and a lot of effort should go into getting the right people. I wouldn't say it goes without saying but it is a very key point. The second thing is that we have built into the Financial Policy Committee external members, like with the MPC, and the job of the external members I think is to challenge group-think.

I should say to you, Chair, that today we will be appointing a new member to the FPC, Robert Jenkins, who is someone with enormous experience in markets and investment management, a former Chair of the IMA, a person with enormous experience, and that fills the place that Richard Lambert would have filled.

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Getting the right external members with a lot of experience is crucial and I think the job of the externals—and, by the way, you see them. I would suggest the job of the Committee is to say to these people, “This is not a sinecure. You are there to do a very important job of challenging, if there is a risk of group-think, the group-think”.

**Q448 Michael Fallon:** We do see them and we do have some influence over that; what we don’t do is see the Governor. You have given this Committee a veto over the appointment and dismissal of the Chair of the OBR. Now that the Governor will be even more powerful than he is, is there a role here for Parliament to extend its influence over that appointment?

**George Osborne:** I would be against giving the Treasury Select Committee a veto on the appointment of the Governor of the Bank, for the reason that the Governor of the Bank is carrying out executive functions on behalf of the State; the setting of monetary policy, monitoring financial stability. By all means call him to account, but he is an executive appointment by the Queen on the recommendation of the Prime Minister and the Chancellor. I think the OBR is materially different. The OBR is providing an independent audit, in effect, of the Government’s numbers and there is a crucial tool for Parliament to scrutinise the executive, and I think that is different. The independent audit function is something that is quite legitimate, and that is why I offered the Committee a veto on that appointment. I think the Bank Governor should continue to remain something for which the Government is accountable to Parliament for. If you think I have appointed the wrong Bank Governor by all means hold me to account but I have not yet had a chance to appoint a Bank Governor.

**Q449 Chair:** Are you accepting our recommendation that, although Alastair Clark has a huge contribution to make to the FPC, he shouldn’t score as an independent and therefore for the period of the interim FPC another appointee will be found?

**George Osborne:** I am filling the vacancy that Richard Lambert created by not taking up the post. I know what you say about Alastair Clark, although I think he brings considerable experience.

**Q450 Chair:** 37 years of experience in the Bank of England to be an independent. A bit tricky, isn’t it, Chancellor, don’t you think?

**George Osborne:** He knows all the tricks of the trade and how the institution operates. Sometimes it is good to have someone who knows all that as the watchdog, or here not the watchdog, the external challenge. I have not announced the statutory FPC, although I would certainly hope that some of the members enjoyed being on the interim FPC and agree to serve on the statutory one.

**Q451 Chair:** I am just asking whether you are accepting our recommendation in that report or not.

**George Osborne:** If the recommendation is to appoint an additional external—

**Chair:** It is.

**George Osborne:** I am not accepting that recommendation, although I have moved—

**Q452 Chair:** And to accept with us that Alastair Clark is not an independent external.

**George Osborne:** I think you have made your views fairly clear about whether you think it is appropriate for him to serve on the statutory FPC that will be established at the end of next year.

**Q453 Chair:** So you are ignoring the Committee?

**George Osborne:** No, I have heard those views.

**Q454 Chair:** No, I know you have heard them; I can tell because you are replying to them. What I am asking you is whether you are ignoring the recommendation of the Committee or accepting it?

**George Osborne:** Let me just put it this way, I don’t think it is likely that Alastair Clark is going to be a member of the permanent statutory FPC.

**Chair:** That is helpful. Thank you, Chancellor.

**Q455 Mr Ruffley:** Chancellor, you have accepted that there was evidence of group-think in the run-up to the crisis at the Bank and at the FSA; we can agree on that?

**George Osborne:** Yes.

**Q456 Mr Ruffley:** Do you think that the presence on the FPC, just focus on the FPC, of high quality, independent, external members is the best means of preventing group-think?

**George Osborne:** I think it is one of the—

**Mr Ruffley:** But is it—

**George Osborne:** I don’t think that is the only check. I think it is partly the job of Parliament to challenge group-think; it is partly the job of the Chancellor to challenge group-think; I think we have all learnt a lot from what happened over the recent years. But I think the presence of external members is an important check on group-think.

**Q457 Mr Ruffley:** But externals are on the FPC; Parliament, with respect, is not. So we can make all sorts of noises challenging group-think but we might not always know group-think is going on. It is actually members of the FPC that I think this Committee is most concerned about. Could I just come back to the question of the externals? We have nine members of the MPC, four of whom are externals, yet on the FPC we have 11 members, 10 voting, one not, but we have only four externals. Why the difference?

**George Osborne:** There is also the Chair of the Financial Conduct Authority. Currently that post—

**Mr Ruffley:** No, just on the FPC.

**George Osborne:** Yes, but the head of the Financial Conduct Authority will also be on the FPC. He is not internal to the Bank. The Bank has a narrow majority of one, I think, but that is the case on the MPC as well I think. I would be interested to hear the Committee’s views on this but—

**Q458 Mr Ruffley:** Perhaps if I could reframe it. On the interim committee at the moment we have the Governor, two Deputy Governors, we have the

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Chairman of the FSA at the moment. Then we have two executive directors appointed by the Bank, that gets us to six, and then we have four externals, all those that are voting members. This is on the interim FPC. We have also heard that one of those four, Alastair Clark, has had nearly four decades experience as an insider and yet he is scored as an external, as an independent. I think most people in the City, Chancellor, would say, "We have at the moment now, with the interim, seven out of 10 voting members who are, in some sense, guilty men". These are people who were on the bridge in the run-up to the crisis and I just wonder, having regard to what the Chairman said and having regard to what this Committee has reported on, that you still don't think it sensible to look again at the number of externals on the FPC.

**George Osborne:** First of all, there are actually 11 voting members; there are six from the Bank, five not from the Bank, but the five includes Adair Turner, certainly includes Alastair Clark, then there was a vacancy, which I am filling today. Obviously, it is for you to judge, but I think the quality of the appointments to the FPC has been high. We have people with enormous financial services experience, not insiders, practitioners in the financial services market. We have someone from the Federal Reserve who will be a challenge as well as bringing central bank experience, and there is a new appointment to the Financial Conduct Authority, the markets and consumer regulator, Martin Wheatley, who comes from Hong Kong. I think there will be the quality there to challenge. I completely agree with you that it will be their job to challenge and our job, collectively in our different roles, to make sure they are doing that job.

**Q459 Mr Ruffley:** It is just on the numbers, Chancellor. We have seven people who one way or the other—whether we like it or not it is a fact—were part of the regime that saw the British financial system crash. I wonder whether you still think it is acceptable and whether or not it inspires confidence that seven of those people, as we speak, who were implicated in that disaster are now on your interim FPC. Do you think it inspires confidence?

**George Osborne:** What I would say, and maybe I should have said this right at the beginning, is that I do genuinely want to hear your recommendations. If you have recommendations we will take them very seriously. This is not the last word. This is draft legislation. If you have views, strongly expressed, on the number of external members of the FPC, of course I will look at that. I am not sure I should say this to you, but when you come immediately after you have delivered a Budget, you are not likely to reopen the Budget even on the sage advice of the TSC. I think this is a different kind of hearing and these are a different set of recommendations in the sense that we certainly want to take on board the best ideas that are expressed by you and there is a genuine pre-legislative scrutiny process underway. If the Committee decides that we should look again at the balance and the number of externals, I would be very happy to do that. That is not a promise that I am going to change things,

but it is a promise that I will take a recommendation very seriously.

**Q460 Mr Ruffley:** That is very useful. Final question, it is a question posed by people I speak to in the City, and they say, "How many of the senior officials at the FSA, the Bank and HM Treasury who were making policy decisions in the run-up to the crisis have been fired or have resigned?" Do you know the answer to that question?

**George Osborne:** The short answer is I don't have the answer except that I suspect the answer is—I can't think of anyone who has been fired, so I suspect the answer is zero.

**Q461 Mr Ruffley:** But do you think that answer is surprising? The people I speak to, who are inveterately private sector, say that if they had made the duff judgement calls and the poor decision-making that many in the FSA, Bank and HMT had done in the run-up to the crisis, which contributed to the crisis, they wouldn't be in jobs in the private sector. You are a good free market man and you believe in the importance of the private sector.

**George Osborne:** Well, some of them surprisingly have managed to stay in jobs but—

**Q462 Mr Ruffley:** Don't you think it is unusual that no one in any of those three bodies I have listed—you said so yourself—has either been fired or resigned? Where is the accountability if the answer is zero?

**George Osborne:** First of all, the accountability is through the elected Government of the day, which changed, partly I suspect because of what happened in the financial system. Of course—

**Q463 Mr Ruffley:** I think you are being very diplomatic here, Chancellor. In any other walk of life, people would be fired for those mistakes.

**George Osborne:** I am tempted to ask my Permanent Secretary to answer the question, but that might be a little bit—

**Q464 Mr Ruffley:** I know the Chancellor is being very diplomatic.

**George Osborne:** Permanent Secretary, what is your answer to this?

**Q465 Mr Ruffley:** There is a serious question here, Sir Nicholas, and I think we are in agreement on a lot of things, but don't you hear from people in the City, because I hear it all the time, senior people saying no one seems to have been fired or moved on or resigned from the FSA, the Bank or HM Treasury as a result of poor decision-making? Don't you find that surprising? The private sector does.

**Sir Nicholas Macpherson:** Well, I don't think, strictly speaking, that is accurate.

**Mr Ruffley:** Which bit isn't?

**Sir Nicholas Macpherson:** You will recall a very hard-hitting internal audit report in the FSA, which to their great credit they published, setting out their findings of the collapse on Northern Rock and there were consequences for individuals there. I think it is fair to say there have been changes of personnel at the

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Bank of England and, dare one say it, also at the Treasury. I think the big—

**Q466 Mr Ruffley:** That is encouraging.

**Sir Nicholas Macpherson:** Well, no, Mr Ruffley, the Treasury, as I said, is very keen to learn the lessons of this pretty extraordinary set of events and we need to deploy our resources more effectively. I think there have been consequences, but perhaps the biggest consequences are these changes that we are discussing today. The fact is the FSA as an organisation will cease to exist. The Bank of England, coming back to Mr Hosie's point, is going to be reconstructed to give it responsibility and power in this area.

**Q467 Mr Ruffley:** And thus make it more accountable?

**Sir Nicholas Macpherson:** Indeed, and the Chancellor has set out the accountability that—

**Mr Ruffley:** You gave that in an earlier answer and that was very helpful.

**Q468 John Thurso:** I want to follow up the questions that George Mudie was asking, but can I first just ask, we are legislating to achieve a state of improved financial stability. Does the Treasury have a definition of financial stability other than the lack of instability?

**George Osborne:** I guess I would define financial stability as a financial services industry that is serving the broader interests of the economy, that is not requiring taxpayers' money to support it, that is not contributing to excessive leverage nor to excessive credit contraction.

**Q469 John Thurso:** Are those not all areas that are a fine balance of part fact and part political judgement?

**George Osborne:** I am not sure I would use the word "political" judgement, but I think they are areas of judgement. One of the challenges here is that with inflation targeting and monetary policy we reached a point in the academic literature and in political thinking across the world that enabled us to set a number of an inflation target, which the MPC is asked to hit. We have not been able to do that with financial stability; we don't have a number; there is not a simple target. I thought it was quite interesting evidence you had from Paul Tucker saying that maybe over the next 10 years or more thinking will develop and we will be able to come up with some very specific indicators, but at the moment the world doesn't have the answer to the question of what the number is that you should be targeting. He advised us all to look at leverage and maturity mismatch and so on, but there is not a single target. That is why we have to develop a range of tools and in the end these are judgements about what level of risk you are prepared to tolerate. Obviously, a graveyard is a pretty stable place but it is not necessarily the place you would want to live in.

**Q470 John Thurso:** That leads me on to a question. I think in your answers to George Mudie you pretty well defined that in peacetime it is the job of the FPC and the Bank but in times of crisis that will pretty

automatically revert to the Treasury. Would that be a fair assumption, because public money will be involved?

**George Osborne:** I think the Chancellor of the day will be centrally involved because the biggest tools available to you in a crisis, recapitalisation, public ownership, taxpayer guarantees, are ones that only the Chancellor can take the decision on. Obviously there are other tools that the Bank Governor will also be deploying on liquidity support, use of the Bank's balance sheet and so on, but the big tools available to the Government, or the State rather, in a crisis are ones that the Chancellor would take the decision on within the context of Cabinet Government and accountability to Parliament.

**Q471 John Thurso:** The realistic probability is that in a crisis it will be the Chancellor, the Government, Prime Minister who will de facto be in charge? It would not be a crisis otherwise.

**George Osborne:** Well, as I say, the answer is yes, because these decisions are ones that use public money and ultimately are accountable to you and through you to the public for the use of public money.

**Q472 John Thurso:** Can we come, therefore, to the peacetime scenario? In effect, the legislation proposes to outsource the responsibility to the Bank and the new structures. Is there not some responsibility that should reside within the Treasury and Ministers to at least oversee that that process is operating properly and well?

**George Osborne:** I would certainly think we have that responsibility to make sure the process is, to use your words, proceeding well and according to the legislation and so on, absolutely. That is why, for example, there are these statutory meetings with the Bank Governor twice a year on financial stability where we publish the high-level minutes of that meeting. We certainly accept that. Many, many years ago British Governments accepted that day-to-day financial regulation should be with some other body, so the Bank of England used to regulate the banks, then the FSA and so on. What we are doing here is combining that. We are returning to the Bank of England the power of regulating banks and giving it additional parts of the financial services sector to regulate on a macro-prudential basis, but we are also explicitly giving it the task of monitoring broader systemic risks and holding it accountable for that.

**Q473 John Thurso:** I am assuming that we would not simply be depending on two meetings a year as the control?

**George Osborne:** No.

**Q474 John Thurso:** How would you envisage that control being properly exercised? Would it be by officials reporting to you or would it be a ministerial responsibility?

**George Osborne:** First of all, Treasury officials sit on the FPC, like they sit on the MPC, and they are not voting members but they, of course, report back. Second, I have certainly made it a practice, and I think from my knowledge my predecessor, Alistair Darling,

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made it the practice to see the Bank Governor at least once a month anyway, sometimes more, so there is regular discussion about all sorts of economic issues. There is also then events like the stability report, which of course we will see after it has been decided by the committee, but we are kept informed like that, as you are. I think in all sorts of ways we are going to make sure that the Bank of England fulfils its statutory obligations. That is my responsibility. I or my successors are responsible for the system, the system that I have asked Parliament to legislate for.

**Sir Nicholas Macpherson:** Can I just add quickly—

**Q475 John Thurso:** Can I just—and then you can add away. If you look at, say, America and what they have done, they have set up their financial oversight, whatever it is called, body and they have put Timothy Geithner in charge of it as the chairman on the grounds that the equivalent of a Minister needs to be at the heart of this. We have taken the opposite decision, which is to take all the Ministers right out of it. I think it is a very legitimate area to ask a question as to why we have done that when so much other opinion or some other opinion goes the other way.

**George Osborne:** My observation on the American system, though maybe you should ask Mr Geithner what he thinks, is that they have partly taken this approach because they have so many regulators that their only way of bringing them together, post the crisis, was to create this board. The obvious person to chair a board where there are lots of regulators, all with different jurisdictions, all very jealous of those jurisdictions, might be an appointed Treasury Secretary.

We are in a different situation here. We have the Bank of England as basically the main regulator. There is also a markets and consumer protection regulator, but the main regulator when it comes to financial stability and risk and prudential regulation is the Bank of England. The answer to the question your predecessors asked, and some of you were on the Committee, who is in charge, the answer is the Bank of England in peacetime. Now, when a crisis develops and, of course, the use of public money is at stake then the Chancellor steps in. But what I wanted to get away from, and what this Committee advised us to get away from a couple of years ago, was the tripartite arrangement. The clue is in the title; there were three organisations and three sets of people who thought they were all in different ways responsible or not responsible.

**Q476 John Thurso:** I concur with that in the sense that the actual doing in the ordinary course of events should be divorced, which is what is happening. The thing we observed in 2007, just prior to Northern Rock, this Committee was in Washington and met with Hank Paulson and with Ben Bernanke. I remember well all of us saying how worried we were about the build-up of risk and so on and them all telling us that there was not that much of a problem and we shouldn't worry our pretty little heads, basically, and it is all okay. It was quite clear that there was a serious problem building but it was very

difficult to get a handle on it. If we take that build-up and apply the new mechanisms we are putting in place, the critical test is, will somebody somewhere recognise that build-up and take action, which was missing both in the States and this country before? At what point does it become political and who will have that responsibility?

**George Osborne:** I think in the environment that you are describing, 2005–2006, there is not at that point a material risk that public money is going to be at stake but there is clearly the build-up of broader risk in the system becoming over-leveraged. You would expect the Financial Policy Committee to not just produce the report that Mr Hosie alluded to but then do something about it, have the tools. Instead of just getting up and saying, “Look, there is a problem. Will the Government do something about it?” they are going to have available tools like loan-to-value ratios, potentially countercyclical capital requirements and so on, margin requirements. These are all going to be things they are going to be able to exercise. Parliament will decide what tools to give them but they will then be independent in the exercising of those tools.

I think there is a bit of a parallel here with monetary policy. It has been known to be the case that when Chancellors were in charge of interest rates that they didn't always put interest rates up in the run-up to general elections and sometimes they announced interest rate cuts in their party conference speeches. We moved away from that world. Some of these tools the FPC are going to have are taking away the punchbowl. They are about the availability of mortgages, the availability of credit and so on. Now, I am sure we are immune to these pressures as elected politicians, but many elected politicians are not and will, in other words, succumb to the pressure not to take the punchbowl away, not to try and curb a housing boom or whatever. The Financial Policy Committee is going to have these tools available to it. Of course, we have to get those tools right, that is a big public policy challenge for us all, but the reason we are making this body independent, the reason we are not giving the Chancellor of the Exchequer the power and the responsibility to monitor systemic financial risks and take these actions, is that Chancellors sometimes succumb to electoral temptation.

**Q477 John Thurso:** There is a broad consensus that we don't want inflation. There is a broad consensus now on monetary policy. There is a broad consensus that around 2% CPI is the right target and that the Monetary Policy Committee will use interest rates and QE to eventually achieve their target. There is a quite a lot of academic work around that. It is back to my original question. We can't even define financial stability. We don't have the tools. Is this not automatically going to be political rather than a matter of independent judgement of facts, which is what the MPC is, and how do we get out of that?

**George Osborne:** We are trying to make it a matter of independent judgement, not what tools they have, that will be a matter of political judgement, but how they exercise those tools. I freely accept that we are

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trying something new here. This is not unique to the UK that we are looking at this area. The American arrangements that you referred to are their response to that; the eurozone and, indeed, the European Union has created a Systemic Risk Board of central bank governors. There have been various international responses to the same policy challenge. We are all trying to work out how do you spot the risks developing in the broader system and how you do something about it. I think we can be proud of the arrangements we are proposing to put in place because I think they are at the cutting edge and we are leading the pack, not following it, but it is going to require a lot of work from the Treasury and from Parliament to get this right over the coming months. The big decision we all have to take in the autumn will be what tools to give the Financial Policy Committee. The Monetary Policy Committee has a very big tool; it can raise or cut interest rates. What tools are we going to give the FPC?

**Q478 Chair:** Chancellor, can I take you back to what you were saying a moment ago about your powers in wartime? You said that in wartime—and I am quoting what you said—you would be centrally involved and that the Chancellor would step in. What exactly does this mean? Are you going to be chairing the crisis meetings that are going to be running this crisis?

**George Osborne:** The response to every crisis is not necessarily to set up a committee.

**Q479 Chair:** Someone is going to be deciding whether to—

**George Osborne:** The big decision—

**Chair:** Who are you going to put round the table before you decide to write that cheque?

**George Osborne:** I suspect the Bank Governor and the Chancellor of the day—

**Chair:** You don't have to call it a committee. Call it what you like.

**George Osborne:**—will be in near permanent session, but we do not have to speculate about the future, we can look at the recent past. The decision to recapitalise the Royal Bank of Scotland, the decision to nationalise Northern Rock, the decision to set up the Credit Guarantee Scheme; these decisions were legitimately decisions taken by the Chancellor. That is absolutely clear in the new arrangement. What was not in existence before was a system for identifying risks across the financial services, spotting them develop, doing something about them, taking away the—

**Q480 Chair:** We have just been discussing that. What I am trying to clarify is what happens—I am just going to stick with the Chancellor for a moment, Sir Nicholas, then I will come back to you in a moment if you want. I want to be clear what is going to happen in this crisis. You are going to be in charge, so you are not just stepping in or being centrally involved. You are actually running this; is that correct? You are running the policy to deal with the crisis?

**George Osborne:** Yes, in the sense that the principal tools available in the crisis will be the ones that the Chancellor has to deploy but obviously there are—

**Q481 Chair:** What happens when the Bank differs in its view from yours? Will the Bank have and will you consider it acceptable for the Bank to dissent publicly from the decision that you are taking?

**George Osborne:** The Bank Governor is an independent figure and I certainly am not going to be in a position to muzzle the Bank Governor.

**Q482 Chair:** So the answer is yes?

**George Osborne:** The Bank Governor, whoever the Bank Governor is at the time, will have to make their own decisions about how they conduct themselves within their statutory requirements, but the Chancellor of the day can't impose a speaking ban on the Governor.

**Q483 Chair:** What if there is a package of measures, some of which you have direct control of and some of which you think the Bank should take, which the Bank dissents from taking? Don't you think it is worth at least considering having some much more restrictive power of override to enable you to ensure that that coherent package is implemented rather than have these institutional differences end up getting in the way of handling the crisis?

**George Osborne:** I think the tool that is a classic central bank tool, not a Treasury tool, is liquidity support of the bank's balance sheet. That is an absolutely standard function of central banks since Paget onwards. Obviously, that is a tool available to the Governor. It is worth noting that large-scale liquidity operations need a Treasury guarantee anyway because the Bank's balance sheet will not be large enough to do it by itself. Second, the Treasury, in fact, in the previous crisis did create its own liquidity tools through the Credit Guarantee Scheme. I have already said what I have said to the Committee about powers of direction. There is a general power of direction in the 1946 Act. I will, of course, listen to the recommendations you make. I would just point out that sometimes if you propose some additional powers of direction, the exercise of those powers of direction in a crisis, that is, the Chancellor overruling the Bank Governor, can in itself be a confidence-diminishing moment. We will bear this in mind.

In the end, yes, we can prescribe the lines of responsibility, the lines of accountability, who is in charge of what, and I have been clear that the big tools available in a crisis are ones that the Chancellor has at his disposal or her disposal. But I would hope that we would conduct the whole thing in the spirit of co-operation between the Bank Governor and the Chancellor. I think if the Chancellor and the Bank Governor are at war with each other in the crisis they are taking a bad situation and making it worse, so there is also an obligation on whoever is the Chancellor and whoever is the Bank Governor at the time to work together and co-operate and that is their obligation.

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**Q484 Chair:** Chancellor, you and I have both had enough experience of Government to know that co-operation can often become institutional tension and even rivalry, particularly at times of crisis. What we are trying to do—

**George Osborne:** I have done my best in this job to take classic institutional rivalries between Number 11 and others and reduce them.

**Q485 Chair:** I am sure you have. What we are trying to do here is put in place something that has a chance of coping with those tensions. I don't think it is a good idea to rely on the hope that we will have this full co-operation.

**George Osborne:** Well, it is not hope.

**Chair:** Hope is the word you used.

**George Osborne:** As I said, large-scale liquidity operations require the consent of the Treasury. The Treasury created the Credit Guarantee Scheme off its own balance sheet, but ideally you want a Chancellor and a Governor working together rather than at war. Of course, you are dealing with a situation where they are at war with each other, and I am pointing out there are tools available to Chancellors in that environment. I would just hope you would not have to be in that situation and because you are relying on human nature there is an element of hope involved.

**Q486 Chair:** There is a huge raft of difference between being in full co-operation and being at war, and it is very likely that we will be somewhere in between in these scenarios.

**George Osborne:** You are speaking to a veteran of these encounters.

**Sir Nicholas Macpherson:** Can I just add to this? The thing that you have to understand is that the Bank of England's balance sheet, by central banking standards, is small. That means if they are going to contemplate pretty much any action in a crisis—

**Chair:** The Chancellor has already made that point.

**Sir Nicholas Macpherson:**—they have to get in touch with Treasury. Well, I am just—

**Chair:** Reinforcing.

**Sir Nicholas Macpherson:** My experience through 2007, 2008, 2009 was they were not slow to draw attention to those issues, which means you do get quite early engagement on these matters.

**Chair:** Quite keen to make sure liquidity becomes solvency so that someone else is picking up the tab. We've got the point, Sir Nicholas.

**Q487 Jesse Norman:** I think on the last question the issue is whether the Chancellor can procure the Bank to behave in a certain way rather than merely, as it were, act as underwriter.

**George Osborne:** The Bank is the Government's agent and I think the current Bank Governor has made it clear that he is very happy to act as the Government's agent if the Government or the Treasury stands behind the cost of the policy. What I don't have, unless I were to invoke this power of direction in the 1946 Act, is to force the Bank to use its own balance sheet, but that would be an extraordinary intervention into an independent central bank and it would have its own consequences.

**Q488 Jesse Norman:** Yes. Chancellor, you have been very eloquent about, as it were, sticking with the Court as it presently is. Were you surprised that the Court did not conduct an inquiry into the performance of the Bank during the crisis? There obviously were areas in which its own performance was not ideal.

**George Osborne:** I guess it is easy for me to come in after the event and say something should have happened or should not have happened. I think the way I would put it is I think the FSA did a very good job in conducting its own pretty candid inquiry and publishing that inquiry, and that is a model for all institutions to pay attention to.

**Q489 Jesse Norman:** Sir Nicholas, would that be your view also for HMT since you, as far as I am aware, didn't publish a report?

**Sir Nicholas Macpherson:** HMT have the very good fortune of being audited by the National Audit Office, who did a very thorough report on Northern Rock. But, as I said earlier, we are keen to learn the lessons of the crisis ourselves and we are going to do some work for the PAC on that.

**Q490 Jesse Norman:** That will be published, will it?

**Sir Nicholas Macpherson:** Yes.

**Q491 Jesse Norman:** Thank you. Just to go back to the question that the Chairman raised a moment ago, imagine we are in a situation with Northern Rock, the crisis is starting to escalate; what happens differently now versus what I think the Chancellor referred to as a confusion of responsibilities previously?

**Sir Nicholas Macpherson:** I think I can answer that question very well because I can remember having conversations with the Governor and Chairman of the FSA in late August 2007. What you had at that point were two very differing views on the way forward on Northern Rock, which in some ways it fell to the then Chancellor to seek to internalise and take a view on the way forward. I think one of the real benefits of the proposal set out in this paper is that those debates will be internalised within the Bank. There is lots of governance around them but ultimately it will be for the Governor to come to the Chancellor and say, "This is the way forward". I think that will result in clearer and better decision-making.

**Q492 Jesse Norman:** That was a very elegant high-level view. Was the argument as to whether or not it should be nationalised at the time, the Bank saying yes, the FSA saying no?

**Sir Nicholas Macpherson:** In August 2007 the issues were whether there were liquidity measures that could be taken to support Northern Rock and whether there were measures by which other institutions could be supported in seeking to buy Northern Rock. There was a separate debate through the autumn of 2007 around nationalisation, which was more of an issue in terms of the internal decision-making within Government. It wasn't that the Bank of England and FSA had radically different views on the benefits and the costs of nationalisation.

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**Q493 Jesse Norman:** Thank you for that. You have referred to clause 42, Chancellor. I take it there is nothing to stop you stepping in in advance of a clause 42 activation, the Bank warning you that public money was at risk?

**George Osborne:** Well, no, because there is also the biannual meeting with the Governor explicitly required by statute and minuted and where we discuss financial stability. There will be plenty of other occasions during the year, but that is a kind of fallback in the legislation.

**Q494 Jesse Norman:** But if alarm bells were ringing before any formal notification, the Chancellor could step in or could take action?

**George Osborne:** Yes, of course. The Chancellor would use the channel available through the contact with the Governor to make this clear. The Chancellor also, as we were discussing earlier, sets the remit.

**Q495 Jesse Norman:** An example, I suppose, would be the one you have mentioned of RBS's purchase of ABN because presumably at that time there was no money put at risk, and yet there certainly were plenty of voices who thought this was an extraordinary bridge too far for a cash offer, which it was.

**George Osborne:** I think we have to be careful here. That was a decision by the regulator, a commercial decision by a regulator. Sorry, a decision that had huge commercial implications by the regulator on a company. I don't think you want Chancellors of the day deciding whether one bank can take over another or if one institution can take over another. I think it would be a pretty slippery slope, and we keep Chancellors out of things like people's tax affairs for good reasons as well. The PRA, the prudential regulator, would make those decisions, but I think one of the advantages as well, as Nicholas was just talking about, of what we are doing is all these decisions about systemic risks, regulation of individual firms and so on, they are all brought together in one institution now. We don't have the Chancellor faced with the FSA saying one thing and the Bank of England saying the other and they have to make a decision between the two of them. The Bank is forced to internalise these decisions. The principal reason why we put prudential regulation into the Bank, prudential regulation of individual firms, is precisely so that there is that connectedness. You don't have some separate institution and the Bank Governor saying, "Well, I saw all this happening but unfortunately the regulator refused to listen" and the regulator saying, "We were doing our job but no one was looking at the systemic risk". You will have the Bank of England sitting before you as the institution responsible for all these things.

**Q496 Jesse Norman:** The problem in a way with the point you are making—I had not understood it—with the RBS ABN purchase was that that would have been cut off by the regulator acting on substantive supervisory grounds to look at the implications of—

**George Osborne:** With something as big as that you would expect the Bank Governor—and there will be a Deputy Governor responsible for PI, but the Bank

Governor chairs the board of the PRA and sits on the FPC. The Bank Governor would take a view. The Bank Governor and I both absolutely agree that what is required is judgement. There is plenty of regulation in this area; it just needs to be good regulation. There has to be scope for judgement and discretion by independent regulators. As I say, I would not want an elected politician to get engaged in individual decisions.

**Q497 Jesse Norman:** Whereas just to be clear, as matters actually panned out it was waved through as a matter of box checking, with the Bank of England having no formal role in assessing the wisdom or no of the decision?

**George Osborne:** I was not there at the time so—

**Q498 Jesse Norman:** Sir Nicholas, that wouldn't be an unfair characterisation?

**Sir Nicholas Macpherson:** My recollection is there was some competition to take over this great Dutch bank, which turned out to be a very bad buy indeed. That would have been an issue for the FSA at the time. I think what this legislation is seeking to do is to introduce a different form of regulation as well as rearranging the architecture. I would expect under this regime a different approach to be taken.

**Q499 Jesse Norman:** But the competition would not have been a reason itself to have allowed it to go through. A Governor acting in the way that is contemplated now could perfectly properly have said, "We would permit this share offer but would not permit this cash offer".

**Sir Nicholas Macpherson:** I think that under this regime the Governor will be very much involved and I would expect him to be influencing events both behind the scenes and more visibly.

**George Osborne:** Let me pick up on that point. What you might well have in the situation we are talking about in late 2007, certainly I would hope to have—this is the purpose of this legislation but ultimately, as I say, the actual individual decision must be one for an independent regulator—is the awareness in the Bank that there is a state of heightened financial instability, funding markets have closed, we have had a run on Northern Rock; this is not the moment when we are going to nod through huge takeovers by one UK bank of one foreign bank and that big questions are going to be asked about the funding position of the bank that is doing the taking over. Asking those big questions, informed by a view of the broader financial climate at the time, is what we want to see and that is why we are internalising it in the Bank of England. So you don't have the Bank of England saying, "We are responsible for the overall system but not the individual regulatory judgements" and the FSA saying, "We are responsible for the individual regulatory judgements but we don't have a view on the overall environment".

**Q500 Mr Mudie:** I just want to come back. I think we are trying to do you a favour, which you resolutely appear not to want. There is real worry about the powers you are giving the Bank that can affect



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ordinary people out there. I will give you word for word what the Bank Governor said to me. I said, “We are giving you great powers” and he cut in, “Yes, you are”. I said, “And we have little power to force you to rethink”. His response, and it should make you sit back and just think for a second, is, “You have the power to take back”. That is the second time he has said this here. When you challenge the Governor over his powers, his answer is, “Well, don’t give me them”, not middle way, “Well, we will think about it”, “Well, I hear your pain”, et cetera. From politicians, it is just amazing. The Americans have done it. They put the Secretary of State chairing the board. If you don’t want that—it is just putting a default power in the Act that allows you to have your way. Now, it will be transparent, it will be public, it will be a nuclear act if you wish, but we think you should put it in because the very fact of it being in is a bargaining power when you really feel strongly about things. What is wrong with that?

**George Osborne:** I will listen, of course, to your recommendation, but there is already a power of direction. There is already a power in the 1946 Act for the Chancellor to override the Bank Governor, but there is also a good reason why that has not been exercised since 1946. You could make a bad situation worse.

**Mr Mudie:** Yes, exactly.

**George Osborne:** In a way, we are not dealing with a hypothetical situation because we have just been through the biggest banking crisis in our history. You have to ask yourself, let us ask ourselves a real question, which is if Alistair Darling or Gordon Brown had overruled Mervyn King in 2007 and 2008 would that have improved confidence in our country’s management of the crisis or would it have—

**Q501 Mr Mudie:** Chancellor, the answer is they should have because—

**George Osborne:** But I would daresay, Mr Mudie, I—  
**Mr Mudie:**—Hector and Mervyn should have acted and did not. If the politician had had the power to say to them or used the power it might have improved the situation.

**George Osborne:** I would say, Mr Mudie, they did have a power of direction. My judgement, but this is only with hindsight, I think overruling the central bank governor in the middle of a financial crisis would have added to the sense of chaos rather than diminished the sense of chaos.

**Q502 Mr Mudie:** Are you saying, then, because it is specific, that there is a power that will be unaltered by this legislation in the 1946 Act that will give you and any future Chancellor the ability to actually instruct the Bank of England?

**George Osborne:** Nick will read it out for the Committee.

**Sir Nicholas Macpherson:** Yes, clause 4 of the Act says, “The Treasury may from time to time give such directions to the Bank as, after consultation with the Governor of the Bank, they think necessary in the public interest”.

**Q503 Chair:** That is considered a nuclear option, though, isn’t it?

**George Osborne:** It is considered a nuclear option because, and I guess this is the tension that the Committee has to wrestle with and certainly a Government has to wrestle with, central bank governors are independent. We seek to make them independent. We seek to protect them from elected politicians. On the other hand, we as elected politicians are the people who are ultimately accountable to the public and there is always that tension. I think we have the balance right here. I think we have created a system where the Bank Governor is accountable, where in a crisis and the use of public money the Chancellor is responsible. But we are not trying to second guess the Bank Governor in his day-to-day job of maintaining the stability of the financial system.

**Q504 Chair:** I think you have agreed this area needs some more thought and we are going to do our best to give it some more.

**George Osborne:** I think I agreed that I would listen to the recommendations you make, yes.

**Q505 Mr Mudie:** It is not personal, is it? It is not just mine; it is the Committee.

**George Osborne:** No, I thought you asked some very good questions of the Bank Governor in the previous session.

**Q506 Andrea Leadsom:** Chancellor, thank you for agreeing to talk on slightly wider subjects. Since you were here last, we have had the Vickers Commission in again to talk about their interim review. Specifically, they and this Committee have thought very strongly and very forcefully that competition should be a far more important agenda in the banking sector in the UK than it appears to be in the proposed new legislation so far. Specifically, I wanted to ask you whether you consider that UKFI should be looking at a possible solution that would include breaking up the banks, Northern Rock, RBS, even potentially Lloyds HBOS with the agreement of other shareholders, and parcelling them off and selling them separately in order to create a more competitive environment in the UK?

**George Osborne:** First of all, I would say we have listened to the recommendations of the Treasury Select Committee—and there were other external people who suggested this as well—and given the new Financial Conduct Authority a duty to promote competition, which was not the case before you made your recommendations so we have taken that on board. Second, when it comes to the individual banks—obviously I have to be a little bit careful here because they are commercial institutions with share prices—I would say this. I have always made it clear that I want to see a competitive banking system. I have always made it clear that I think one of the considerations we should have, and sadly we are not at this point yet, when we come to sell bank shares and sell banks is that we want to have a competitive banking system. That should be one consideration we have in mind. We have now put Northern Rock up for

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sale. Lloyds Bank is required to make a divestment by the European Commission and they have issued a market notice on that. At the same time, the Independent Commission on Banking has said they want to see a strong challenger, either a new entrant or a vastly stronger existing bank. I don't want to pre-empt their final report in September, but I am confident that the divesting of the Lloyds branches, which is under way or rather they are seeking a buyer, will help create that strong independent challenger. I certainly hope the sale of Northern Rock will do that as well.

**Q507 Andrea Leadsom:** Thank you. Would you rule out entirely reversing the Lloyds HBOS takeover? Certainly I have heard—I am speaking personally here—that the branches proposed for sale from Lloyds are not necessarily the best, most competitive, inevitably because they get to choose which ones they sell. Do you think that there is any merit in considering reversing the takeover in its entirety?

**George Osborne:** No, I don't and nor do the Independent Commission on Banking. They want a competitive new challenger. They said that either in terms of branches or in terms of the strength of the balance sheet or both we should go beyond what the European Commission were requiring. They have not spelt out in detail what exactly they want to see, but that is because we are awaiting their final report. They are in discussions, they have had a consultation period, and so on. But I don't think it is possible to break apart the Lloyds HBOS deal. I think we now have to implement the European Commission's requirements, which is the divestment of 600 branches, and satisfy the Independent Commission on Banking.

**Q508 Andrea Leadsom:** With that in mind, bearing in mind it is the European Commission who required the 600 branch sell-off, there is, isn't there, an issue now with European regulators having more teeth than ever in the past, that what we have just been talking about, about the co-operation and hope in the relationship between the Governor and the Chancellor, that there is a third person in this marriage, which is the potential impact of a European regulator who might also seek to involve themselves and overrule what British regulators and Chancellors are trying to do?

**George Osborne:** First of all, in respect of competition, of course, the UK authorities at the time explicitly waived their powers to stop this merger. More broadly, it is certainly true that the European Union is developing financial services regulation and, indeed, there are new supervisory agencies, supervisory authorities, one of which is based in London, the European Banking Authority. We have been clear when we have been arguing on behalf of the UK that they should not in any way second guess decisions that require the use of public money, that they should be there to promote the single market so that British firms can operate in Europe and European firms can operate in Britain, and we are, as the home of the largest wholesale financial services centre in Europe, also the voice for making sure the regulation

is competitive vis-à-vis the rest of the world. We bring that wholesale financial services perspective to the table.

**Q509 Andrea Leadsom:** Is Europe listening to the British view on that?

**George Osborne:** I think we have had some good successes, on the hedge fund regulation most recently, on some regulation on short selling. These are not the easiest of issues to get right but what we have achieved, I think, is a more stable financial system but also one where British firms can go and compete in Continental Europe and European firms can compete in Britain. That is to Britain's benefit, I think.

**Q510 Chair:** Chancellor, you said earlier that this Committee should not have a veto on the Governor's appointment and dismissal—and incidentally the Committee has no view on this issue, we haven't discussed it—because, and I more or less quote, the Bank performs an executive function, has executive functions, whereas the OBR does not. But in your own response to our report on the OBR you said exactly the opposite; you said it was the fact that the OBR has an executive function that leads you to feel that that was an important consideration in your decision to give it dual accountability, including the power of appointment and dismissal to us. Perhaps I could just read what it actually says. I quote, "The OBR has been established with dual accountability to both Parliament and the Chancellor. This dual accountability reflects the OBR's executive role in producing the official economic and fiscal forecast for the Government. This is the important consideration, which leads to the new accountability structure."

**George Osborne:** I don't think there is any contradiction. I said that the OBR has a job, I called it an executive job, in producing the independent numbers that Parliament holds me to account for on fiscal policy and, indeed, on the economic forecasts. It is interesting, can I just point out that there is no argument in Britain at the moment about whether the GDP numbers we produce are the right ones, the GDP forecasts, that I have somehow fiddled them. They are the OBR's and that is all accepted now a year on from the event. That is quite a remarkable change. If you mean by, though—

**Q511 Chair:** It is not what I mean, it is what you meant when you responded to our report, Chancellor.

**George Osborne:** The use of the word "executive" in that respect was its executive function in producing independent audited accounts for the British Government. That is something that is not where the Government is using policy instruments to take decisions that materially affect people on the ground. It is about producing things that enable the Government to be held to account. I think they are materially different. When it comes to the Bank Governor and the Bank of England, this is a body that sets interest rates, that will be given significant tools on macro policy, and I think it is proper that the Government of the day chooses the Bank Governor, is held accountable for that choice, but also that the Governor is given some protection, some

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independence, so it is quite difficult, to put it mildly, or extremely difficult, to get rid of them.

**Sir Nicholas Macpherson:** You will, of course, have a—

**Q512 Chair:** Sorry, if I may I will cut you off because I do want the Chancellor to get away on time. There are a couple of other points that I would like to raise with you that are not related to the accountability inquiry. One concerns what is happening to the banks at the moment. The banks are being encouraged to do more lending by you through Merlin, among other things, and by others, by politicians, and at the same time they are being asked to strengthen their balance sheets. Of course, there is a tension, not to say a contradiction, between these two. I just wanted to give you the opportunity to say which of these two you thought at the moment should be their priority.

**George Osborne:** I think they can do both. The banks are strengthening their balance sheets; they are deleveraging. That is happening anyway regardless of any new regulation. The market is demanding that; the funding markets are demanding that. At the same time, of course, new regulation, principally international regulation, is requiring higher capital, or at least higher capital in the future, so the bank balance sheets are shrinking. The purpose of the Merlin lending agreement is to shield in that process small and medium-size business lending in the UK. If you have a big, international, universal bank, based in the UK, that has operations all round the world, lends to all sorts of different customers, I am saying, and the purpose of the Merlin agreement was, as your balance sheet inevitably shrinks post the financial crisis, I want to protect, indeed I want to increase, small and medium-size business lending in the UK.

**Q513 Chair:** The other question I want to ask, which as you can imagine is a considerable cause of public concern, is over Greece. Do you consider the Greek problem to be a liquidity or a solvency crisis?

**George Osborne:** I think it has issues of solvency, obviously, and that is why it has proved so difficult to resolve. The Greeks, to be fair to them, their parliament has just passed a package that improves the solvency position of the sovereign, that is, measures to try and reduce its budget deficit.

**Q514 Chair:** But if it is a solvency crisis, then all these bailouts are just sticking plaster, aren't they? Eventually there is going to have to be restructuring or default—

**George Osborne:** Well, they are sticking plaster if they are not used, if the time bought—after all,

sticking plaster buys you time if it is a wound—is not used, to do something about the fundamental problems. The fundamental problems for Greece are, first of all, it is a very large budget deficit; secondly, the competitiveness of its economy; third, there is the weakness of the European banking system, and we have very important stress tests due to be published later this month across Europe. I think there is a big, big task here that Europe needs to meet and fulfil, which is to make those stress tests credible. They were not too credible last year. Finally, there is a big debate, and we can certainly be here for another two hours, which is how you operate fiscal policy in a single currency. Now, those of us who did not want to join the euro pointed out that if you joined the euro you end up having something akin to a single fiscal policy. Whether the eurozone heads in that direction or not remains to be seen, but what is clear is they need to have much better arrangements than they have had. To be fair, they are trying to develop those.

**Q515 Chair:** I think you are agreeing with the majority view there that the stress tests were not credible and at the moment we are in a position where we don't have credible stress tests.

**George Osborne:** I think the weakness of the stress tests—

**Chair:** Can I just ask the question?

**George Osborne:** Of course.

**Chair:** In which case you must be doing a good deal of contingency work in the Treasury to deal with the eventuality of a possible default?

**George Osborne:** Well, I don't think it is sensible to reveal all our contingency plans in public, but I would certainly be very happy to speak to you privately about those and to discuss how to share that with your Committee. We do a lot of contingency planning for a lot of different events. I would point out that, without returning entirely to our previous discussion, the Financial Stability Report—

**Chair:** There is a very good section on it in there.

**George Osborne:**—produced by the Bank of England warns us all that the greatest risk to the UK banking system comes from the sovereign debt crisis in Europe at the moment. I think it would be somewhat remiss of the Treasury if we were not taking into account some of these recommendations.

**Chair:** We are extremely grateful to you for coming to give evidence to us this afternoon. It has been illuminating and you have left quite a number of doors open on some very important issues. We are grateful to you for that and we will be coming back to you with some recommendations in due course. Thank you.

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# Written evidence

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## Written evidence submitted by the Court of the Bank of England

Membership of Court currently comprises the Governor, two Deputy Governors and nine Non-Executive Directors, one of whom is appointed Chairman of Court by the Chancellor of the Exchequer.

Terms of Appointment of the Non-Executive Directors are normally three years. The years of first appointment of the Non-Executive Directors serving as at 28 February 2011 were:

2003—1            2007—2            2008—1            2009—5

1. A particular issue with the appointment of Non-Executive Directors, especially in the light of the new responsibilities that are likely to fall to the Bank, is attracting expertise but avoiding conflicts of interest.

2. Court is responsible for managing the affairs of the Bank other than the formulation of monetary policy. These responsibilities include:

- (a) determining the Bank's objectives and strategy;
- (b) ensuring the effective discharge of the Bank's functions;
- (c) ensuring the most efficient use of its resources; and
- (d) protecting and enhancing the stability of the financial system of the UK.

Court discharges these responsibilities in a number of ways as set out below.

2.1 Firstly, it makes appropriate use of sub-Committees all of which report back to Court. There are currently four main sub-Committees and three more minor ones. Three of the main sub-Committees comprise the Audit and Risk Committee, the Remuneration Committee, and the Nominations Committee. These are all chaired by Non-Executive Directors and their Terms of Reference are as close as practicable to what would be expected in the best governance systems in the corporate sector.

The Audit and Risk Committee was renamed as such in 2010 to reflect greater emphasis on its responsibility for monitoring the risk management policies of the Bank and their implementation.

The fourth main sub-Committee is the Financial Stability Committee (FSC) which is chaired by the Governor and includes the two Deputy Governors and four Non-Executive Directors nominated by the Chair of Court. It has Terms of Reference as set out in the Bank of England Act 2009. These include:

- (a) making recommendations to Court about the nature and implementation of the Bank's strategy in relation to the Bank's financial stability objective; and
- (b) giving advice about whether and how the Bank should act in respect of an Institution where the issue appears to the Committee to be relevant to the Bank's financial stability objective.

The HMT CONDOC of February 2011 will result in the responsibilities of the FSC being split between a new sub-Committee of Court (the Financial Policy Committee—FPC) and a new sub-Committee of Court to be named the Financial Operating Committee (FOC). The principal Terms of Reference of all these sub-Committees are to be found in the Annexes to the document dated 3 March 2011 sent under cover of my letter to the Chairman of the Treasury Committee of the same date.

2.2 Secondly, although the MPC is a Committee of the Bank and not a Committee of Court, the Non-Executives on Court (NEDCO) have a responsibility for keeping the procedures followed by the MPC under review and for ensuring that the MPC collects relevant information to formulate monetary policy. Court receives monthly reports from the MPC on its activities.

In addition, and to ensure that NEDCO is adequately discharging its responsibilities, the Chairman of Court every year interviews each Member of the MPC to make sure that they are receiving the support they need and that there are no governance issues that are causing concern. A report is made back to NEDCO following those interviews.

2.3 Thirdly, Court plays a similar role to a normal corporate sector Board in approving the Bank's Statement of Accounts, its Letter of Representation to the Auditors, and the Annual Report etc. It is also responsible for approving:

- (a) capital projects in excess of £5 million;
- (b) significant changes to the Bank's operations and organisation and to the management structure of the Bank;
- (c) changes to the Bank's Pension Scheme and Staff benefits; and
- (d) high level succession planning.

2.4 Fourthly, in terms of the Bank's strategy and financial management, Court is responsible for approving and monitoring performance relating to:

- (a) the core purposes strategy and its delivery;

- (b) the annual budget and business plan including capital expenditure projects;
- (c) head count control linked to the budget; and
- (d) the implementation plans and budget for the transition of the Prudential Regulatory Authority (PRA) from the FSA to the Bank.

In the past Court has carried out specific reviews based on securing value for money e.g. procurement and IT operations. Going forward Court will shortly be asked to identify and secure the implementation of at least one value for money study per annum.

3. There are many other ways in which Court or its Members individually can and do bring influence to bear on the Bank. Examples of this are:

- (a) participating in appointment panels and interviews;
- (b) getting to know Executives below Governor level on a one to one basis or in groups to enable better judgements to be made on succession planning and other issues;
- (c) volunteering to act as a Mentor;
- (d) giving advice on a one to one basis to Executives;
- (e) ensuring personal objectives are set for all Senior Executives including the Governors and reviewing performance against these; and
- (f) conducting the annual Court Effectiveness Review by the Chairman of Court with each individual Member to ensure that Court is operating as effectively as possible and to surface any particular concerns of Members.

4. The foregoing is a brief summary of the role that Court plays in the governance of the Bank. Greater detail covering the present and future role of Court following implementation of the February 2011 CONDOC can be found in the attachment to my letter dated 3 March addressed to the Chairman of the Committee (printed below).

5. In conclusion and on a personal note the Court of which I am now a Member is essentially unrecognisable from the one I served on in the 90s. The name is the same but most of the rest is very different and for the better.

*4 March 2011*

On 3 March 2011 the Chairman of the Court sent the following draft document to the Treasury Committee. The Chairman of the Court wishes it to be clear that this document was based on the Consultation document issued by HMT in February 2011, is in draft form for discussion, is subject to change based on the actual legislation when finalised, and has not yet been approved by the Court of the Bank of England. Nor will it be until the legislation is actually finalised.

#### GOVERNANCE OF THE BANK INCLUDING MATTERS RESERVED TO COURT

##### COURT COMMITTEES, COMMITTEE OF THE BANK, EXECUTIVE COMMITTEES AND THE PRUDENTIAL REGULATORY AUTHORITY COURT COMMITTEES

Court has formed a number of Committees to help discharge its responsibilities. Additionally, the 1998 Act created a Committee of the Directors of the Bank (NedCo); and the 2012 Act created the Financial Policy Committee in each case as a Committee of Court.

**Financial Policy Committee (FPC)** has functions which are described below. It is to exercise its functions with a view to contributing to the achievement by the Bank of its Financial Stability Objective primarily through the identification of, monitoring of, and taking action to remove or reduce, systemic risks with a view to protecting and enhancing the resilience of the UK financial system. Its terms of reference are set out in Annex A and in more detail in the Financial Services and Markets Act 2000 as amended by the 2012 Act.

**NedCo** has the principal functions of keeping the procedures followed by the FPC and the MPC under review, and reviewing the Bank's delivery of its strategic and financial objectives. Its membership comprises the Non-Executive Directors of the Bank. Its terms of reference are set out in Annex B.

The other principal Court Committees (each of which reports to Court) are:

**Audit and Risk Committee (ARC)**, which assists Court in meeting its responsibilities for an effective system of financial reporting, internal control and risk management, amongst other duties. Its terms of reference are set out in Annex C.

**Financial Operations Committee (FOC)**, which advises on and monitors the performance of the Bank's financial stability functions which are not within the remit of the FPC. These include Payment System Oversight, the regulation of Central Counterparties and Settlement Systems, the provision of liquidity insurance facilities and bespoke lender of last resort facilities and the Bank's role in relation to the Special Resolution Regime established by the 2009 Act. Its terms of reference are set out in Annex D.

**Nominations Committee** advises Court on appointments to senior positions within the Bank and advises Court on recommendations to be made by Court to HM Treasury as to appointments and reappointments as

members of Court. It also assists Court on the appointment (with the approval of the Chancellor) of members of the board of the Prudential Regulatory Authority (PRA) (other than those who serve in an *ex officio* capacity). Its terms of reference are set out in Annex E.

**Remuneration Committee** advises Court on pay and other remuneration of the Bank's most senior staff including Governors, Executive Directors and Advisers to the Governor. It also advises Court on the remuneration of the external MPC and FPC members and non-executive directors of the PRA (other than those serving in an "*ex officio*" capacity). Its terms of reference are set out in Annex F.

A fuller explanation of the roles played by these Committees is set out in this document. Terms of reference of the two other Court committees, the Governors' Committee on Non-Executive Directors' Remuneration and the Sealing Committee, are set out in the Annexes G and H respectively.

#### THE MONETARY POLICY COMMITTEE—A COMMITTEE OF THE BANK

The MPC is a Committee of the Bank and not a Committee of Court. It is established by the 1998 Act, and consists of the Governor, the Deputy Services Governors for Monetary Policy and Financial Stability, the Executive Directors responsible for market operations and monetary analysis, and four external members appointed by the Chancellor. The MPC has responsibility within the Bank for formulating monetary policy.<sup>1</sup> The 1998 Act requires the Bank to maintain price stability and, subject to that, to support the Government's economic policies, including its policies for growth and employment. At least once a year HM Treasury specifies the price stability target, and the MPC meets each month to set interest rates and other monetary conditions so as to meet that target.

#### EXECUTIVE COMMITTEES

Several high-level committees have been formed by the executive management of the Bank. These include the Executive Team (ET) the members of which are the Governors, the Bank's Executive Directors (who are not members of Court) and the Chief Legal Adviser, which is the most senior management committee; Resolution Committee (ResCo) which considers strategy in relation to individual firms at risk of entering the Special Resolution Regime (SRR) and actions outside the SRR to reduce financial stability risks; Asset and Liability Committee (ALCO) which considers the management of the Bank's balance sheet and associated risks. However Court's delegation is to the Governor, not to any particular structure of executive committees, and within the Bank the Governor delegates to individuals, not committees. The committees inform and advise those responsible for taking decisions, but are not themselves accountable: they are not covered further in this document.

#### THE PRUDENTIAL REGULATORY AUTHORITY

The Prudential Regulatory Authority (PRA) is a subsidiary of the Bank. Its board of directors consists of the Governor (the Chairman), the Deputy Governor for Prudential Regulation (its Chief Executive), the Deputy Governor for Financial Stability, four independent non-executive directors appointed by Court with the approval of the Chancellor of the Exchequer and the chief executive of the Financial Conduct Authority (FCA) who is also deemed to be independent for these purposes. The senior executives with the title of executive director of the PRA are not members of its board, (with the exception of the Deputy Governor for Prudential Regulation).

Its principal role is to authorise, regulate and supervise banks (and other deposit takers), insurers and systemically important investment banks under the Financial Services and Markets Act 2000 as amended by the 2012 Act. Its strategic objective is to contribute to the promotion of the stability of the UK financial system and its operational objective is to promote the safety and soundness of PRA authorised persons, including minimising any adverse impact that the failure of any such person could be expected to have on the UK financial system.

#### COURT PROCEDURES

##### *Chair of Court*

The Chancellor of the Exchequer may appoint a member of Court as Chairman of Court and one or more members of Court as deputies to chair its meetings in the absence of the Chairman.<sup>2</sup>

In the absence of the Chairman and any member so appointed as a deputy, Court may elect a Non-Executive Director to chair a meeting.

##### *Quorum*

Court has determined that its quorum is five members provided that at least three Non-Executive Directors are present.<sup>3</sup> A member who is not present at, but who is in communication with, a meeting is to be treated as present at it.

<sup>1</sup> 1998 Act 813 (1).

<sup>2</sup> 1998 Act Schedule 1 para 3.

<sup>3</sup> Court decision 10 June 2009.

### *Voting*

Each member present, or regarded as being present, at the meeting and entitled to vote shall have one vote and all matters shall be decided on a simple majority vote. In the event of a tie, the chairman of the meeting shall have a second or casting vote.

### *Register of interests*

On appointment, and subsequently at the end of May each year, Non-Executive Directors shall provide to the Secretary details of all their relevant directorships and appointments. The Secretary shall, as soon as practicable after 1 June each year, circulate to Court a full list of all the directorships, and appointments so notified, together with a reminder of the provisions in the Charter of 1946 relating to the interests of the members of Court, and any relevant decisions of Court.

Non-Executive Directors must notify the Secretary at least fourteen days before committing to become a member of the board of any company or to undertake any duty or assume any post or engagement which may affect their position as a member of Court. This would enable the Governor to raise any questions he may have and, if necessary, to consult Court.<sup>4</sup>

### *Conflicts*

The 1998 Act<sup>5</sup> requires that

If a member of Court has any direct or indirect interest in any dealing or business with the Bank—

- (a) he shall disclose the interest to the court at the time of the dealing or business being negotiated or transacted; and
- (b) he shall have no vote in relation to the dealing or business, unless Court has resolved that the interest does not give rise to a conflict of interest.

A member of Court shall have no vote in relation to any question arising which touches or concerns him but shall withdraw and be absent during the debate on any matter in which he is concerned.

### *Removal from office*

The 1998 Act provides that a Non-Executive Director of the Bank must resign on becoming a Minister of the Crown, a civil servant or a “servant of the Bank”. A person who serves on the FPC or on the board of the PRA is not to be regarded as a servant of the Bank by reason only of serving on the FPC or such board. Court may, with the consent of the Chancellor, remove a person from office as a Non-Executive Director if he has been absent from meetings of Court without consent or becomes bankrupt or is “unable or unfit to discharge his functions as a member” of Court.<sup>6</sup>

### *Indemnities for Members of Court*

Members of Court have been indemnified by the Bank against personal civil liability arising out of the carrying out or purported carrying out of their functions, provided they have acted honestly and in good faith and have not acted recklessly. These indemnities were granted in 2000, and approved by HM Treasury in accordance with the practice of the Government in relation to board members of Non-Departmental Public Bodies.

### *Effectiveness of Court*

The Chairman of Court will from time to time undertake a review of Court’s effectiveness, and will commission external advisers as necessary.

## **MATTERS RESERVED TO COURT**

In the following description of how Court operates, matters reserved for Court decision are indicated by a bullet.

### **1. GENERAL DELEGATION**

Subject to the provisions of the 1946 Act, the 1998 Act as amended by the 2009 Act and the 2012 Act and such matters as may now or hereafter be reserved by resolution of Court to itself, the affairs of the Bank shall be managed by the Governor.

The “affairs of the Bank” here include the discharge of any statutory function given to the Bank other than the formulation of monetary policy, which is outside the remit of Court.

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<sup>4</sup> Court Resolution of 19 April 1995.

<sup>5</sup> Schedule 1 paras 4 and 5.

<sup>6</sup> Schedule 1 paras 7 and 8.

- Delegation of powers to a committee of Court and the terms of reference and membership of Court committees (except as specified by statute) are reserved to Court.

## 2. STRATEGY AND MANAGEMENT

The following matters are reserved to Court (with advice from Court committees where appropriate):

- Approval of the Bank's objectives (including its objectives for financial management) and strategy<sup>7</sup>, as reflected in the annual update of the Bank's Core Purposes and the annual review of Strategic Priorities which are published in the Bank's Annual Report.
- Approval of the Bank's financial framework as updated from time to time.
- Approval of the Bank's annual operating and capital expenditure budgets and any material changes to them.
- Approval of the Bank's high-level succession plan including any recommendations in relation to Crown appointments.

The following functions are the responsibility of NedCO<sup>8</sup> but will so far as possible be discharged in Court:

- Reviewing the Bank's performance in relation to the objectives and strategy set by Court.
- Monitoring the delivery of the financial management objectives set by Court.
- Keeping under review the financial controls of the Bank so as to ensure the proper conduct of its financial affairs.

## 3. MONETARY POLICY

The 1998 Act creates the **Monetary Policy Committee** (MPC). The Bank's monetary stability objective is set by the Chancellor and communicated to the MPC under the provisions of the 1998 Act.

- Nedco is responsible for keeping the procedures followed by the Monetary Policy Committee under review,<sup>9</sup> and for ensuring that the MPC collects adequate regional, sectoral and other information to formulate monetary policy. NedCo reports each year on the outcome of this review.

Although Court is not involved in the formulation of monetary policy, the MPC is required<sup>10</sup> to submit a monthly report to Court on its activities (this is circulated in months where there are no meetings). The Governor consults Court about the broad conduct of monetary policy but Court is not informed of the monetary policy decisions in advance.

## 4. FINANCIAL STABILITY

Under the 1998 Act as amended by the 2012 Act, the Bank has as an objective to protect and enhance the stability of the financial system of the United Kingdom.<sup>11</sup> Court, consulting the Treasury, and with advice from the Financial Policy Committee (FPC) is required to determine and review the Bank's strategy in relation to the financial stability objective.

Accordingly:

- Determining and reviewing the Bank's strategy in relation to the financial stability objective is reserved to Court.

The strategy must be published in the Bank's Annual Report

The 2012 Act created the FPC as a Committee of Court. It consists of the Governor, the Deputy Governors, the Chief Executive of the Financial Conduct Authority (FCA), two Executive Directors of the Bank, being those responsible respectively for financial stability and markets, four external members appointed by the Chancellor and a non-voting Treasury representative. The external members may also be Non-Executive Directors of the Bank.

The functions and powers of the Committee are as set out in the Financial Services and Markets Act 2000 (FSMA) as amended by the 2012 Act. The Committee exercises its functions with a view to contributing to the achievement by the Bank of the Financial Stability Objective primarily by identifying, monitoring and taking action to reduce, systemic risks with a view to protecting and enhancing the resilience of the UK financial system in accordance with its remit as set out in FSMA as amended by the 2012 Act.<sup>12</sup>

It delivers that objective by exercising its statutory powers to give advice, make recommendations and make directions. It is responsible for preparing and publishing the Bank's Financial Stability Reports.

<sup>7</sup> 1998 Act 82(2).

<sup>8</sup> 1998 Act Schedule 3 para 2.

<sup>9</sup> 1998 Act S16.

<sup>10</sup> 1998 Act Schedule 3 para14.

<sup>11</sup> 2012 Act section [ ].

<sup>12</sup> Based on draft clauses dated 26 January 2011. Amendments may be required if these provisions are amended as a result of the February ConDoc.



Nedco is responsible for keeping the procedures followed by the FPC under review. NedCo reports each year on the outcome of this review.

The Bank's other financial stability functions are overseen by the Financial Operations Committee (see Annex D).

The Financial Policy Committee's terms of reference are at Annex A.

## 5. PRUDENTIAL REGULATORY AUTHORITY

The PRA is a subsidiary of the Bank responsible for exercising powers and functions set out in FSMA as amended by the 2012 Act to authorise, regulate and supervise certain types of financial institution. Its Board consists of the Governor, the Deputy Governor for Financial Stability, the Deputy Governor for Prudential Regulation, the Chief Executive of FCA and four independent non-executive members appointed by Court with the approval of the Chancellor. In carrying out its statutory responsibilities in relation to prudential regulation, the PRA is operationally independent. However, through matters reserved to its shareholder, the Bank, in its articles of association the PRA is accountable to Court for administrative matters, including its budget and remuneration policy, value for money and performance against objectives, and Court reviews its strategy.

Accordingly:

- approval of the PRA's objectives for funding and financial management;
- approval of the PRA's annual operating and capital expenditure budgets and any material changes to them;
- approval of the PRA's remuneration policies for staff; and
- appointments (on which the Nominations Committee will advise) and remuneration and terms of service of non-executive members (excluding those serving in an ex officio capacity) of the PRA board<sup>13</sup> (on which the Remuneration Committee will advise).

are reserved to Court

## 6. CAPITAL, FINANCIAL REPORTING, CONTROLS AND LITIGATION

The Governor consults Court about the Bank's relations with HM Treasury as sole beneficial shareholder, including financial arrangements.

The following matters are reserved to Court:

- The annual recommendation to HM Treasury about the level of Cash Ratio Deposits.
- The payment in accordance with Section 8 of the 1998 Act of an amount in lieu of dividend (having regard to the provision in the Act contemplating any other amount which might be agreed).
- The appointment of external Auditors.
- Approval of the Bank's statement of accounts and Letter of Representation to its Auditors.
- The adoption of accounting principles; and any proposed exercise of the power contained in S7(4) of the 1998 Act to disregard relevant Companies Act Requirements.
- Approval of the Annual Report.
- The risk management policies adopted by the Bank.

The Governor consults Court about any major litigation affecting the Bank.

The **Audit and Risk Committee** assists Court in meeting its responsibilities for an effective system of financial reporting, internal control and risk management. It receives reports from, and reviews the work of, the internal and external auditors. The Committee also considers and makes recommendations on the appointment of the external auditors, their independence and their fees. It reviews the annual financial statements prior to their submission to Court, including consideration of the appropriateness of the accounting policies and procedures adopted. The Committee reports its conclusions to Court. The Committee normally meets four times a year. Terms of Reference of the Audit and Risk Committee are at Annex C.

## 7. STRUCTURE AND ORGANISATION

The following decisions are reserved to Court:<sup>14</sup>

- Approval of capital projects in excess of £5 million.
- Significant changes in the Bank's operations and organisation, including the opening and closing of Agencies, and the contracting out of significant business functions.

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<sup>13</sup> Section [ ] of the 2012 Act.

<sup>14</sup> It is for consideration which of these items as they relate to the PRA should also be reserved to Court.

- The formation or disposal of a subsidiary company or its business or assets and the appointment of directors of any such company, except for the PRA and in the circumstances where this power is exercised by the Financial Operations Committee.
- Significant changes in the management structure of the Bank, the adoption of schemes of classification of staff, and significant changes to personnel policy.
- Significant changes in the Bank's pension schemes and other staff benefits.
- The agreement to a schedule of contributions to the Bank's Pension Fund.

The Governor informs Court about changes in management structure and accountabilities, and about internal rules or orders on business practice, including policies on gifts, entertainment, the prevention of insider dealing and purdah arrangements.

## 8. APPOINTMENTS

The Governors and the Non-Executive Directors of the Bank are appointed by the Crown. The external MPC members and the external FPC members are appointed by the Chancellor of the Exchequer.

The designation of the Chairman of Court and of one or more members of Court as deputies to chair Court in the absence of the Chairman is a matter for the Chancellor.

The following matters are reserved to Court on the advice of the Nominations Committee:

- Appointment of Executive Directors, the Secretary and the Head of Internal Audit.
- The removal from office of a Member of Court in the circumstances specified in the 1998 Act<sup>15</sup> (which requires the consent of the Chancellor).
- The appointment of independent non-executive members of the PRA board (which requires the consent of the Chancellor).
- The removal from office of a member of the board of the PRA (other than those directors holding office "ex officio") on grounds of incapacity, serious misconduct or material conflict of interest (which requires the consent of the Chancellor).
- The appointment of the Chairman of the Trustees of the Houblon-Norman Fund.
- The appointment by the Bank of the chair of the board of the corporate trustee of the Staff Pension Fund.
- Appointments to Court Committees (except to the extent specified in statute).

Appointment of Governor's Advisers and Heads of Division are reported to Court by the Governor.

## 9. REMUNERATION

The **Remuneration Committee** advises Court and NedCo on the remuneration of the Bank's most senior executives, including the Governors, the Bank's Executive Directors, the Advisers to the Governors, and the external members of the MPC and of the FPC and non-executive directors of the PRA. The Remuneration Committee also advises on other remuneration matters specifically referred to it by the Governor (which may include, for example, remuneration of the executive directors of the PRA). Terms of Reference of the Remuneration Committee are at Annex F.

- The remuneration, pension arrangements and any service contracts of the Governors and the external MPC members are subject to the approval of NedCo.
- The remuneration and terms of service of the external FPC members are subject to the approval of NedCo.
- The remuneration, pension arrangements and any service contracts of the Executive Directors and Advisers to the Governor are subject to the approval of Court.

The remuneration of the Non-Executive Directors of the Bank is subject to the approval of Court, having first obtained the approval of the Chancellor. Court's authority in this respect has been delegated to the Governors' Committee on Non-Executive Directors' Remuneration, and decisions of that Committee are reported to Court. Terms of Reference of the Governors' Committee on Non-Executive Directors' Remuneration are at Annex G.

## 10. TRANSACTIONS OUTSIDE THE NORMAL COURSE OF BUSINESS

The Governor consults Court about any loan, commitment or other transaction which is not in the ordinary course of the Bank's business except for those matters which are otherwise reserved to Court. If the Governor determines that it is not practical to consult Court, he will consult the Financial Operations Committee and report a decision made under this paragraph to Court at its next meeting. The Terms of Reference of the Financial Operations Committee are at Annex D.

<sup>15</sup> Schedule 1 para 8.

## 11. SECRETARIAL

### *Decisions of Court*

Decisions of Court, and delegation by Court, must be recorded by the Secretary and copied to the Auditor.

### *The Seal*

The Bank's Seal may be applied only in accordance with the 1998 Act and subject to the approval of Court. The power to authorise the sealing of documents has been delegated to the Sealing Committee, which makes reports to Court twice a year. Terms of Reference of the Sealing Committee are at Annex H.

### *Annual Review, and Circulation*

This document, and any successor document, is subject to annual review and the approval of Court and must be circulated to senior management and the Auditor.

## 12. POLICIES

The following policies are subject to the approval of Court:

- The Community Involvement Policy

[approved by Court [ ] 2012]

## **Annex A**

### FINANCIAL POLICY COMMITTEE

The Committee is created by the Bank of England Act 1998 (as amended by the Financial Services Act 2012).

The Chair of the Committee is the Governor and the other members are the three Deputy Governors, the Chief Executive of the FCA, two Executive Directors of the Bank being those with responsibility respectively for financial stability and markets, four external members nominated by the Chancellor and a non-voting representative of the Treasury.

The functions and powers of the Committee are as set out in the Financial Services and Markets Act 2000 as amended by the [Financial Services Act 2010].<sup>16</sup>

The Committee exercises its functions with a view to contributing to the achievement by the Bank of the Financial Stability Objective primarily by identifying, monitoring and taking action to reduce, systemic risks with a view to protecting and enhancing the resilience of the UK financial system in accordance with its statutory remit.

Its functions include:

1. Making recommendations to Court about the implementation of the Bank's financial stability strategy.
2. Providing advice within the Bank about the general provision of financial assistance to financial institutions, to the Treasury about the regulatory perimeter and the power of the Treasury to specify macro-prudential measures by order and to the PRA and the FCA about the exercise of their respective functions.
3. Giving directions to the PRA or to the FCA requiring it to exercise its functions so as to ensure the implementation of a macro-prudential measure described in the direction.

The Committee is also responsible for preparing and publishing the Bank's Financial Stability Report prior to publication.

### MEETINGS

The Committee must meet at least 4 times each year. The Governor, or, if he is not present, the Deputy Governor Financial Stability may summon a meeting at any time on giving such notice as in his judgement the circumstances may require.

### QUORUM

The quorum at its meetings is 7, including at least 2 from among the Governors and at least one external member. The non-voting member appointed by the Treasury is not to be taken into account in determining whether or not a quorum is present. A member who is not present at, but is in communication with, a meeting is to be treated as present at it.

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<sup>16</sup> Based on draft clauses dated 26 January 2011. Amendments may be required if these provisions are amended as a result of the February ConDoc.

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**CHAIRMANSHIP**

If the Governor is not present at any meeting for any reason, the Deputy Governor Financial Stability shall chair the meeting.

**MINUTES**

The Committee shall appoint a person as secretary to the Committee. The secretary or his deputy shall be present at, and shall take minutes of, each meeting of the Committee which shall be recorded in a book to be kept for that purpose.

**VOTING**

Each member present, or regarded as being present, at a meeting and entitled to vote shall have one vote and all matters which the Chairman determines should be put to the vote shall be decided on a simple majority vote. In the event of a tie, the Chairman of the meeting shall have a second or casting vote.

**CONFLICTS OF INTEREST**

If any member of the Committee has, or may be perceived to have, any direct or indirect conflict of interest or duty (including any reasonably likely or foreseeable future interest) relevant to anything to be considered by the Committee, he or she may be required to withdraw and be absent during the debate on any such matter if the Chairman of the meeting decides that in the circumstances this is necessary or desirable.

**Annex B****THE COMMITTEE OF NON-EXECUTIVE DIRECTORS (NEDCO)**

The Committee is created by the Bank of England Act 1998 (the Act).

The Chairman of Court is the chairman of the Committee and membership of the Committee consists of all the directors of the Bank.

Under the Act (as amended by the [Financial Services Act 2012]) the Committee has the following functions:

1. To keep under review the Bank's performance in relation to the objectives and strategy for the time being determined by the court of directors of the Bank.
2. To monitor the extent to which the objectives set by the court of directors of the Bank in relation to the Bank's financial management have been met.
3. To keep under review the internal financial controls of the Bank with a view to securing the proper conduct of its financial affairs.
4. To determine how the functions under paragraph 14 of Schedule 1 to the Act (remuneration and pensions etc. of the executive members of the court) should be exercised.
5. To keep the procedures followed by the Monetary Policy Committee under review including determining whether the Monetary Policy Committee has collected the regional, sectoral and other information necessary for the purposes of formulating monetary policy.
6. To keep the procedures followed by the FPC under review.
7. To perform the function of removing a member of the Monetary Policy Committee (other than the Governor or any Deputy Governor) from office, subject to the consent of the Chancellor of the Exchequer, if it is satisfied that any of the conditions of paragraph 9 of Schedule 3 to the Act are satisfied.
8. To perform the function of removing a member of the Financial Policy Committee (other than the Governor or any Deputy Governor) from office, subject to the consent of the Chancellor of the Exchequer, if it is satisfied that any of the conditions of paragraphs 9(1) or (2) of Schedule 2A to the Act are satisfied.
9. To determine the terms and conditions of service of members of the Monetary Policy Committee appointed under section 13(2)(c) of the Act (the external members).
10. To determine the terms and conditions of service of the members of the Financial Policy Committee appointed under section [ ] of the Act (the external members).

**Court delegates to the Committee the following additional function:**

To review the Governor's objectives for each financial year

At its meeting on [ ] the Committee resolved pursuant to section 3(7) of the Act as follows:

#### QUORUM

The quorum is three members. A member who is not present at, but is in communication with, a meeting is to be treated as present at it.

#### MEETINGS

Meetings of the Committee will normally take place on the occasion of, and concurrently with, a meeting of Court. No separate notice need be given of a meeting of the Committee which is to be held on the occasion of a Court meeting. The Chairman of the Committee, or in his absence, the most senior Non-Executive Director judged in terms of length of service, may summon a meeting of the Committee on giving such notice as in his judgement the circumstances may require.

#### CHAIRMANSHIP

If the Chairman of the Committee is not present at any meeting for any reason, a deputy chairman (if appointed pursuant to paragraph 13(3)(b) of the Act) shall chair the meeting, or if no deputy chairman is present, the directors present shall choose one of their number to chair the meeting.

#### VOTING

Each member present, or regarded as being present, at the meeting and entitled to vote shall have one vote and all matters shall be decided on a simple majority vote. In the event of a tie, the chairman of the meeting shall have a second or casting vote.

#### CONFLICTS OF INTEREST

Section 3(5) and (6) of the Act make provision for the circumstances in which a member of the Committee has any conflict of interest.

### Annex C

#### AUDIT AND RISK COMMITTEE

Court resolved on [ ] 2012 to delegate powers and responsibilities to the Audit and Risk Committee and to specify other terms of reference in the terms set out below in substitution for all former powers, responsibilities and terms of reference of the Committee.

##### 1. CONSTITUTION AND RELATION TO COURT AND NEDCo

A sub-committee of Court (to be known as the “Audit and Risk Committee”) is created and constituted and shall comprise at least four non-executive members of Court, one of whom shall be appointed by Court as Chairman of the Committee. Court shall satisfy itself that at least one member of the Audit and Risk Committee has recent and relevant financial experience.

The Committee is to assist Court in meeting its responsibilities for an effective system of financial reporting, internal control and risk management; and to receive reports from, and review the work of, the external and internal auditors. The Committee also considers and makes recommendations on the appointment of the external auditors, their independence and their fees. It reviews the annual financial statements prior to their submission to Court, including consideration of the appropriateness of the accounting policies and procedures adopted. The Committee reports its conclusions to Court.

The Committee also assists NedCo in discharging its responsibilities under the Bank of England Act 1998 for “keeping under review the internal financial controls of the Bank with a view to securing the proper conduct of its financial affairs”.

##### 2. AUDIT AND RISK COMMITTEE’S RESPONSIBILITIES WITHIN THE RISK FRAMEWORK

Court has responsibility for approving the Bank-wide risk framework and for monitoring the overall risk profile of the Bank. References in these terms of reference to the Bank include references to subsidiaries of the Bank for the time being (other than the Prudential Regulatory Authority).<sup>17</sup> It is assisted in this by the receipt of an annual report from the Executive on the effectiveness of the control environment and by independent assurance from the Audit and Risk Committee that the Bank’s risk and control processes are effective. This includes:

- Reviewing the Bank’s risk framework and risk management policies, and recommending the risk management framework to Court for approval.

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<sup>17</sup> On the assumption that the PRA’s accounts will not be consolidated with those of the Bank, it is assumed that the PRA will have its own audit committee.

- Receiving reports on the risk profile of the Bank, including and across all directorates, except insofar as they are:
  - (a) risks considered solely by the Monetary Policy Committee within its statutory responsibilities;
  - (b) details of strategic or policy risks which are identified, in summary reporting to the Audit and Risk Committee, as being considered by the Monetary Policy or Financial Policy Committees; or
  - (c) risks which would ordinarily be discussed by the Audit and Risk Committee but which, in the event that member(s) of the Audit and Risk Committee may have a conflict of interest, are considered by the Financial Operations Committee.
- Evaluating whether risks are within tolerance and the actions being taken or planned by the Executive to bring risks within tolerance.

Requesting reports from the Executive on specific risks or control issues other than those which should be considered by the Monetary Policy and Financial Policy Committees

### 3. AUTHORITY

The Committee is authorised by Court to:

- investigate any activity within its remit and to seek any information that it requires from members of staff. The Committee also has the right to request such regular and ad hoc reports from the external or internal auditors or from management as it sees fit. Where necessary, the Committee is required to make recommendations to Court and/or to the management of the Bank and/or if appropriate to NedCo; and
- engage at the Bank's expense outside legal or other independent professional advice on any matters within its terms of reference (consulting with the Bank's Chief Legal Adviser and Finance Director as appropriate) and if necessary invite external advisers with relevant experience to attend meetings of the Committee.

### 4. MEMBERSHIP

The Committee shall be provided with appropriate and timely training, both in the form of an induction programme for new members and, as may be required, on an ongoing basis for all members.

### 5. FREQUENCY OF, AND ATTENDANCE AT, MEETINGS

The Committee will meet at least four times a year. External or internal auditors or any member of the Committee may request a meeting if they consider it necessary.

A quorum shall be three members present at the meeting. A member who is not present at, but is in communication with a meeting is to be treated as present at it.

One meeting each year will be arranged to tie in with the publication of the Annual Financial Report, allowing a reasonable period prior to a Court Meeting where accounts or financial statements are to be approved.

The Chairman of Court shall be entitled to attend meetings of the Committee at his discretion. The Deputy Governors should attend meetings as required by the Chairman of the Committee. The Finance Director, the Executive Director Markets, the external auditors and the Head of Internal Audit shall have access to the Committee at any time and shall normally attend the meetings. Other persons may be called to attend or be present for particular agenda items as and when required. Once a year the Committee shall meet with the Governor for a bilateral discussion and separately, if required by the Chairman of the Committee, with the Deputy Governors. At least once a year the Committee shall also meet separately with the external auditors and, separately, with the Head of Internal Audit without any executive management present.

In the absence of the Chairman of the Committee and/or an appointed deputy, the remaining members shall elect one of their number to chair the meeting. In the event that any other member of the Committee is unable to attend a regular or ad-hoc meeting of the Committee, the Chairman of the Committee may appoint another director of the Bank to act as an alternate member of the Committee and attend the meeting in his place.

Wherever practicable notice of each meeting together with an agenda and supporting papers shall be given to each member of the Committee at least five working days before the day on which the meeting is to be held, confirming the venue, time and date.

The Deputy Secretary or in his absence the Assistant Secretary of the Bank shall be the Secretary of the Committee.

## 6. RESPONSIBILITIES

Unless provided for otherwise these responsibilities shall apply to the Bank of England, its subsidiaries and any other entities owned and managed by the Bank (other than the Prudential Regulation Authority) as appropriate, as determined by the Chair of the Committee.

The duties of the Committee shall be:

### *In relation to the Annual Financial Report*

To monitor the integrity of the financial statements by:

- reviewing the accounting policies and practices adopted in the preparation of the annual financial statements, including any proposed exercise of the power contained in Section 7(4) of the Bank of England Act 1998 to disregard relevant Companies Act requirements, and to satisfy itself that, where applicable, the appropriate policy has been adopted from the alternatives available so far as they are appropriate to a central bank; and
- reviewing the annual financial statements before submission to Court, with particular attention to: the major judgmental areas and estimates; findings of the external auditors, including significant adjustments resulting from the audit; and the adequacy of the disclosures made.

### *In relation to risk and control processes*

- to keep under review the effectiveness of the Bank's risk framework, risk management policies and systems of internal control and to receive associated executive management attestations prior to their submission to Court;
- to review and report on the risk framework, risk standards and other key risk policies and significant amendments thereto;
- to review regular reports on the risk profile of the Bank, covering strategic and policy, operational and financial risks, and to evaluate the actions being taken by management to bring these risks within tolerance;
- to assess reports from external and internal auditors in order to ensure that necessary standards of risk management are being applied and that appropriate action is being taken in relation to significant incidents. In the context of actions taken the Committee will seek to ensure they a) mitigate against future incidents; and
- impact of that particular risk and (b) where necessary, adjustment is made to the necessary components of the risk management architecture.

### *In relation to the external auditor:*

- To oversee the selection process for new external auditors.
- To consider and make recommendations to Court on the appointment, reappointment, removal, terms of engagement and audit fee of the external auditor.
- To keep under review the relationship with the external auditors including the qualification, expertise, resources, effectiveness, independence and objectivity of the external auditors, ensuring that key partners are rotated at appropriate intervals and taking into account relevant UK professional and regulatory requirements and ethical guidance.
- To agree with Court and monitor the Bank's policy for the employment of former employees of the external auditor.
- To resolve disagreements between management and the external auditors regarding financial reporting.
- To consider and approve the letter of appointment of the external auditor.
- To review and approve the Bank's proposed Letter of Representation to the auditors before final approval by and signature on behalf of Court.
- To discuss with the external auditor, before the audit commences, the nature and scope of the audit and confirm that the scope reflects the terms of the engagement letter.
- To consider the external auditor's quality control procedures and steps taken by the auditor to respond to changes in regulatory and other requirements.
- To review the findings of the audit with the external auditor, in the absence of management where necessary. The review should include:
  - a discussion of any major issues which arose during the audit;
  - any accounting and audit judgements;
  - levels of errors identified during the audit; and
  - any other matters the external auditor may wish to discuss.
- To review the external auditor's management letter and any other findings together with management's response.
- To assess the extent to which non-audit services are provided by the external auditor to the Bank and the associated fees and to judge whether there is an appropriate balance.

- To pre-approve any non-audit services to be delivered by the external auditor (subject to any delegation to the Finance Director) and the related remuneration.
- To consider any appointments which the external audit partner may be invited to take up to ensure that there is no conflict with the Bank.
- To investigate the issues and to recommend to Court appropriate actions in the event that the external auditor resigns.
- To discuss with external auditors the scope and inter-relationships and results of external and internal audit arrangements.

*In relation to the internal auditor:*

- To consider and approve the remit of the internal audit function and ensure that it has adequate resources, standing and access to information to enable it to perform its function effectively and in accordance with the relevant standards.
- To ensure that the Head of Internal Audit has direct access to the Governor and the Audit and Risk Committee.
- To review and assess the annual internal audit plan and any change or delay in the plan.
- To consider any major findings arising from internal audit's work and to review and monitor management's responsiveness to the internal auditor's findings and recommendations.
- To monitor and review the effectiveness of the internal audit function.
- To approve the appointment or dismissal of the Head of Internal Audit.

*In connection with fraud detection and reporting by staff of irregularities:*

- To review the Bank's arrangements for detecting and deterring fraud.
- To review and approve the Bank's arrangements for its employees to raise concerns, in confidence, about possible fraud, danger, malpractice or misconduct in financial reporting or other matters ("whistleblowing") and to ensure that these arrangements allow proportionate and independent investigation of such matters and appropriate follow up action.

## 7. OTHER RESPONSIBILITIES

The Committee shall scrutinise a summary of the annual expenses of the members of Court.

## 8. REPORTING PROCEDURES

All meetings of the Committee shall be minuted unless, or except to the extent that, the Chairman may otherwise decide (in which case a private record of the matters concerned shall be kept). The Committee's conclusions shall be reported to Court and/or to NedCo as appropriate. Its minutes shall be circulated to all members of the Committee and, once agreed, to all members of Court and/or NedCo as appropriate. The Chairman of the Committee shall make such reports and recommendations to Court and to NedCo as the Committee may see fit.

The Committee shall produce an annual report for Court and shall report on its activities in the Audit and Risk Committee section of the Bank's Annual Report and Accounts.

Members of the Committee shall declare to the Committee if the exercise of any of these duties brings them at any time into a conflict of interest.

## 10. ACCOUNTABILITY

The Committee shall be accountable to Court for its actions.

## 11. REVIEWS OF THE COMMITTEE'S TERMS OF REFERENCE AND EFFECTIVENESS

The Committee shall, on at least an annual basis, review its terms of reference and its own effectiveness, recommending any changes it considers necessary to Court for approval.

## Annex D

### FINANCIAL OPERATIONS COMMITTEE

Court resolved on [ ] 2012 to delegate powers and responsibilities to the Financial Operations Committee and to specify other terms of reference in the terms set out below, in substitution for all powers responsibilities and terms of reference of the Financial Stability Committee and the Transactions Committee.

#### 1. CONSTITUTION

A sub-committee of Court to be known as the Financial Operations Committee be created and constituted for the purposes set below.



## 2. RESPONSIBILITIES

- (1) To give advice about whether and how the Bank should act in respect of an institution, where the issue appears to the Committee to be relevant to the Financial Stability Objective.
- (2) In particular, to give advice about whether and how the Bank should use stabilisation powers under Part 1 of the Banking Act 2009 in particular cases.
- (3) To monitor the Bank's use of the stabilisation powers.
- (4) To monitor the Bank's exercise of its functions under Part 5 of the Banking Act 2009 (inter-bank payment systems).
- (5) To monitor the Bank's exercise of its functions under Part 6 of the Banking Act 2009 (Scottish and Northern Ireland Banknotes).
- (6) To monitor the Bank's exercise of its functions under Part [ ] of the Financial Services and Markets Act 2000 as amended by the Financial Services Act 2012 (regulation of Central Counterparties and Settlement Systems).
- (7) To advise the Governor about any loan, commitment or other transaction which it is proposed that the Bank should make or enter into for the purpose of pursuing the Financial Stability Objective, (other than in relation to participation in any of the Bank's published arrangements, access to which is generally available to financial institutions subject to the applicable terms and conditions) or which is not in the ordinary course of the Bank's business. The Committee is also to advise the Governor about the formation, acquisition or disposal of a subsidiary of the Bank and the appointment of directors and officers to any such subsidiary in connection with the exercise of the Bank's powers and functions under Part 1 of the 2009 Act or for any other purpose.

## 3. MEMBERSHIP

The Committee shall comprise [the Governor (as chairman)], the Deputy Governor Financial Stability, the Chairman of Court and two other Non-Executive Directors of the Bank nominated by Court, provided that any Deputy Governor who is not a member of the Committee may attend meetings of the Committee, and any other member of Court may be invited to attend a meeting of the Committee, the business of which is to comprise giving advice in accordance with paragraph 2(7) and any such member who attends a meeting shall be deemed to be a member of the Committee for such meeting.

## 4. QUORUM

The quorum shall be three members present of which two shall be Non-Executive Directors of the Bank. A member who is not present at, but is in communication with a meeting is to be treated as present at it.

## 5. MEETINGS

The Governor, or if he is not present, the Deputy Governor Financial Stability may summon a meeting at any time on giving such notice as in his judgement the circumstances may require.

## 6. CHAIRMANSHIP

If the Governor is not present at any meeting for any reason, the Deputy Governor Financial Stability shall chair meetings of the committee.

## 7. VOTING

Each member present or treated as being present at the meeting shall have one vote and all matters shall be decided on a simple majority vote. In the event of a tie, the chairman of the meeting shall have a second casting vote.

## 8. CONFLICTS OF INTEREST

If any member of the committee has any direct or indirect interest (including any reasonably likely future interest) in any dealing or business which falls to be considered by the committee he or she may be required to withdraw and be absent during the debate on any such dealing or business if the chairman of the meeting decides that in the circumstances this is necessary or desirable.

## 9. MINUTES

The Secretary or his Deputy or Assistant shall be present and take minutes of each meeting of the committee which shall be recorded in such manner as the Secretary may decide.

## 10. REPORTING

The Committee will report on its proceedings at each meeting of Court.

**Annex E**

### NOMINATIONS COMMITTEE

Court resolved on [ 2012] to delegate powers and responsibilities to the Nominations Committee and to specify the constitution, membership, and responsibilities and other terms of reference as set out below in substitution for all such powers and responsibilities previously conferred on the Nominations Committee.

#### 1. CONSTITUTION AND MEMBERSHIP

A sub-Committee of Court (to be known as the “Nominations Committee” shall be created and constituted and shall comprise the Chairman of Court, the Governor, and not less than two other Non-Executive Directors of the Bank. The Chairman of the Committee shall be the Chairman of Court or in his absence a Non-Executive member of the Committee. No member of Court shall attend the Committee when matters for discussion relate to themselves. The quorum shall be two members present. A member who is not present at, but is in communication with, a meeting is to be treated as present at it.

#### 2. FREQUENCY OF AND ATTENDANCE AT MEETINGS

Meetings shall be held as required but at least once a year. The Committee may invite other parties to attend when appropriate. The Bank shall designate a Secretary to the Committee who shall attend its meetings and in consultation with the Chairman be responsible for preparing and circulating Agendas, meeting papers, and Minutes.

#### 3. RESPONSIBILITIES

The responsibilities of the Committee shall be to consider and as appropriate make recommendations to Court on:

- the appointment of Executive Directors of the Bank, the Deputy Chief Executive of the Prudential Regulatory Authority, the Secretary and the Head of Internal Audit, the latter after taking due account of the recommendations of the Chairman of the Audit and Risk Committee;
- the removal from office of a Member of Court (which requires the consent of the Chancellor of the Exchequer);
- whether likely conflicts of interest are sufficiently severe to prevent a member of Court, the FPC or the Board of the PRA continuing to serve as such;
- nominations to HMT of suitable candidates for appointment or reappointment;
- as Members of Court;
- appointment of the chairman of the board of the Corporate Trustees of the Staff Pension Fund;
- appointment of the chairman of the Trustees of the Houblon-Norman Fund;
- any recommendations to be made to the Chancellor as to who should Chair meetings of Court in the absence of the Chairman;
- appointment to Court Committees (except to as specified in statute);
- appointment and re-appointment of the four independent Directors of the PRA (which are subject to the approval of the Chancellor) and their removal from office (which requires the consent of the Chancellor); and
- succession plans prepared by the Bank with particular regard to those appointments for which Court approval is required (see above).

#### 4. REPORTING PROCEDURES

Meetings of the Committee shall be minuted. The Committee’s specific recommendations shall be reported to Court by the Chairman or in his absence by another Committee Member.

**Annex F**

### REMUNERATION COMMITTEE

Court resolved on [ 2012] to delegate powers and responsibilities to the Remuneration Committee and to specify other terms of reference in the terms set out below in substitution for all former powers, responsibilities and terms of reference of the Committee.

### 1. CONSTITUTION AND MEMBERSHIP

A sub-committee of Court (to be known as the “Remuneration Committee”) shall be created and constituted and shall comprise not less than four nonexecutive members of Court, one of whom shall be appointed by Court as Chairman. Two or more members of the Committee shall constitute a quorum.

### 2. FREQUENCY OF AND ATTENDANCE AT MEETINGS

Meetings shall be held as required, but at least once a year. The Chairman of Court, if not a member, shall be invited to attend all meetings. The Committee may invite other parties to attend meetings when appropriate.

The Bank shall designate a Secretary to the Committee who shall attend its meetings and, in consultation with the Chairman, be responsible for preparing and circulating agendas, meeting papers and minutes.

### 3. RESPONSIBILITIES

The responsibilities of the Committee shall be to consider, and—as appropriate—to report its conclusions and recommendations to Court on:

- All matters relating to the remuneration, including pension benefits and costs, of the Governors, Executive Directors, Advisers to the Governor and the Deputy Chief Executive of the PRA and such other senior executives of the Bank or of the PRA as the Governor may propose.
- All matters relating to the remuneration of external members of the Monetary Policy Committee appointed under section 13(2) (c) of the Bank of England Act 1998.
- All matters relating to the remuneration of external members of the Financial Policy Committee appointed under section [ ] of the Bank of England Act 1998 (as amended by the Financial Services and Markets Act 2012).
- All matters relating to the remuneration of the Non-Executive Directors of the PRA (other than the Chief Executive of the FCA, who shall receive no remuneration).
- Other remuneration matters specifically referred to it by the Governor or by Court.

The Committee shall also approve in draft the remuneration report submitted to Court for inclusion in the Bank’s Annual Report.

### 4. REPORTING PROCEDURES

Meetings of the Committee shall be minuted. The Committee’s specific recommendations shall be reported to Court by the Chairman or, in his/her absence, by another Committee member at relevant Court meetings. Its minutes shall be circulated to all Members of Court.

## Annex G

### GOVERNORS’ COMMITTEE ON NON-EXECUTIVE DIRECTORS’ REMUNERATION

Court resolved on [ 2012] to delegate powers and responsibilities to the Governors’ Committee on Non-Executive Directors’ Remuneration and to specify other terms of reference in the terms set out below in substitution for all former powers, responsibilities and terms of reference of the Committee.

### 1. CONSTITUTION AND MEMBERSHIP

A sub-committee of Court (to be known as “The Governors’ Committee on Non-Executive Directors’ Remuneration”) be created and constituted, having the powers and duties set out below, and consisting of the four Governors of the Bank.

### 2. POWERS AND RESPONSIBILITIES

The Committee shall be empowered to determine, with the approval of the Chancellor of the Exchequer, the levels of remuneration of the Bank’s Directors.

### 3. PROCEDURE

The Governor, any Deputy Governor or the Secretary of the Bank may, in writing or by telephone, summon a meeting of the Committee at any time on giving such notice as, in his judgement, the circumstances may require, and the proceedings of any meeting shall be regulated as follows:

- the quorum shall consist of not less than two members;
- the Governor, or in his absence, a Deputy Governor shall take the chair;
- each of the Governor and the Deputy Governors present shall have one vote and all matters shall be decided on a simple majority vote. In the case of a tie, the Chairman of the meeting shall have a second or casting vote except where only two members are present; and

- the Secretary or his Deputy shall be present and shall take minutes of all orders, resolutions and transactions of the Committee which shall be recorded in a book to be kept for that purpose and such book shall be produced to the Court shortly following any meetings of the Committee when changes to remuneration levels have been determined and approved by the Chancellor of the Exchequer.

## Annex H

### SEALING COMMITTEE

Court resolved on [ 2012] to delegate powers and responsibilities to the Sealing Committee and to specify other terms of reference in the terms set out below in substitution for all former powers, responsibilities and terms of reference of the Committee.

#### 1. CONSTITUTION AND MEMBERSHIP

A sub-committee of Court (to be known as the “Sealing Committee”) be created and constituted, having the powers and responsibilities set out below, and consisting of one or more Members of Court and the Secretary of the Bank, or the Deputy Secretary or the Assistant Secretary.

#### 2. POWERS AND RESPONSIBILITIES

The committee shall be empowered to make Orders for the affixing of the Seal of the Corporation of the Governor and Company of the Bank of England to any instrument requiring to be executed under seal which the committee is satisfied should be so executed;

- the affixing of the Seal shall be attested by the signature of:
  - (1) any two Members of Court;
  - (2) any Member of Court and anyone of the Secretary of the Bank, the Chief Legal Adviser, the Deputy Secretary and the Assistant Secretary; or
  - (3) any two of the Secretary, the Chief Legal Adviser, the Deputy Secretary and the Assistant Secretary.
- a record of all Orders of the committee shall be kept in a book which shall be produced to Court at least twice yearly for inspection; and
- responsibility for the safe custody of the Bank’s Seal is delegated to the Secretary of the Bank, who shall keep it in a secure place under lock and key.

#### Supplementary written evidence submitted by the Court of the Bank of England

When I appeared before the Treasury Committee on 15 March 2011 I was asked by the Chairman how much as a proportion of total functions the Bank was spending on financial stability (Q5 of the transcript). I replied “something like 20%” (Q7 of the transcript) which is correct. The Chairman responded that the percentage of financial stability costs was 43% (Q8 of the transcript) which as a percentage of expenditure on policy functions is correct but is not correct as a percentage of expenditure on total functions which was the question I was asked. I also answered correctly the question put to me about the trend of expenditures on financial stability (Q10 of the transcript). This is all demonstrated in the attached schedule extracted from Annual Reports of the Bank.

#### BANK OF ENGLAND—FINANCIAL STABILITY EXPENDITURE

	2006–07	2007–08	2008–09	2009–10
	£m	£m	£m	£m
Financial Stability (F.S) expenditure	41.8	41.9	46.5	54.7
Total expenditure on policy functions	106.0	109.2	113.2	123.0
Percent of F.S. expenditure to expenditure on total policy functions	39.4%	38.4%	41.1%	44.5%
Total expenditure on all functions	231.0	236.4	264.6	271.4
Percent of F.S. expenditure to expenditure on all functions	18.1%	17.7%	17.6%	20.2%

*Sir David Lees*  
Chairman

1 June 2011

### Written evidence submitted by Dr Sushil B Wadhvani CBE

#### 1. IS HAVING SEPARATE COMMITTEES DESIRABLE?

Under the new structure, the pre-existing Monetary Policy Committee (MPC) will continue to set interest rates to achieve the inflation target, while the new Financial Policy Committee (FPC) will use macro-prudential tools to help achieve financial stability. I believe it to be a poor idea to have two one-club golfers. A single player with multiple clubs to choose from would be preferable in terms of likely performance and ease of accountability.

The Bank has argued that the MPC needs to focus exclusively on price stability or inflation expectations may be de-anchored. They appear to believe that the FPC will use its instruments to affect, for example, a housing price boom without perturbing consumer price inflation because the MPC would set interest rates appropriately. Is this sensible?

Suppose we have an emerging house price bubble and the FPC increases capital requirements which, through widening lending margins, slows the economy, and this leads the MPC to expect inflation to undershoot its target over the next two or three years. Does the Bank then expect the MPC to lower interest rates in order to keep inflation at target to prevent expectations being de-anchored? If so, would this not largely offset the actions of the FPC and keep the house price boom going? Would the FPC then argue that it had not been able to deal with the house price bubble because of the actions of the MPC? Who would be held responsible for policy failure in this case?

Of course, if the MPC were to sensibly coordinate policy with the FPC in the above example (as some members are common to both committees, and the MPC meets more frequently) and not cut interest rates, then inflation would probably undershoot the target for some time. This would have to be explained in terms of financial stability considerations, but would this not be better and more safely ensured by having a single committee?

#### 2. THE FPC'S TOOLKIT

We do not know enough about the likely efficacy about the tools assigned to the FPC. This could easily lead to significant policy errors and also make it more difficult to hold them accountable.

For example, the FPC is likely to use time-varying capital requirements (TVCR) as a policy tool. However, the academic literature contains econometric estimates of their effect on GDP which differ by a factor of ten! Moreover, at a theoretical level, we do not even know if TVCR will work. In good times, banks are likely to engage in regulatory arbitrage and might find a way round these requirements. By contrast, in bad times, the markets are likely to hold the banks to higher capital norms than may be imposed by the FPC. Further, in order to be effective, the TVCR will have to be coordinated internationally, which is not easy.

All this is going to bedevil efforts to make the FPC accountable. For example, when setting its policy, the FPC is supposed to take the effects on growth into account. However, if there is little scientific basis on which it can judge the actual effect on growth, then it makes it more challenging to set policy and more difficult for Parliament to hold it accountable.

I believe that it would be far preferable for us to learn about the effectiveness of TVCR by varying them by relatively small amounts (to avoid a large, accidental impact on the economy) for some years while primarily relying on the tried and trusted weapon of interest rates to achieve greater macroeconomic and financial stability as we accumulate knowledge. Similarly, we could spend time learning about other tools. Again, this points to having a single, unified committee.

Further detailed discussion of the arguments made so far, including the academic literature that is relevant may be found in Wadhvani (2010).

#### 3. THE DANGERS ASSOCIATED WITH CONCENTRATING SO MUCH POWER IN ONE ORGANISATION

The Bank of England emerges as a much more powerful organisation as a result of these changes. In an uncertain world, where economists do not understand many important features about the financial system, this could be dangerous. This enhances the importance of making the BOE properly accountable and to build in enough checks and balances within the Bank.

Over the last decade, many of the mistakes made by the BOE stemmed from the prevailing doctrine that financial markets were efficient. In my experience at the Bank, any attempt to question the "efficient markets" theory was strongly resisted. It is very important that we avoid further policy mistakes arising from too much weight being placed by the Bank on some particular theory of how the world is supposed to work.

In this regard, I worry that the Governor will now be even more powerful. History is littered with examples where the personality of a particular head of a central bank had a decisive and sometimes unhelpful impact on how things turned out.

Measures that may be considered include:

- (a) As for the MPC, I believe that members of the FPC should be individually accountable and the minutes should attribute views and votes to specific individuals. It is odd that on current plans the FPC is going to be less transparent and accountable than the MPC.
- (b) It is essential that the external members are able to play a full and effective role. Even on the MPC, external members were sometimes at an informational disadvantage versus the internal members. With different external members on the FPC and the MPC, there is a danger that this disadvantage will be compounded.
- (c) Thought needs to be given to reducing the number of internal members versus external members on the MPC and FPC. I see no reason why the external members should not constitute the majority on both committees.
- (d) I believe that further thought needs to be given to using both Court and the TSC to do more in terms of providing checks and balances. When I was on the MPC, both Court and the TSC played a very important role with respect to ensuring the external members were given the resource necessary to discharge their responsibilities despite significant opposition from some parts of the Bank.

#### 4. THE NEED TO LEARN FROM THE MISTAKES OF THE PAST

When members of Court recently appeared before you, the narrative of what went wrong at the Bank was merely that they should have shouted louder and that, otherwise, the central bank had been constrained by a lack of policy instruments or appropriate laws.

There are those who would question this narrative and they might point to some of the following possible mistakes:

- (a) In the absence of macro-prudential tools, the MPC could have used interest rates instead to “lean against the wind” with respect to the asset bubbles as they were emerging. The BIS was recommending this, as did a group of us (see Cecchetti et al (2000)). At the time, the arguments used against this proposal were either based around the notion that financial markets were efficient or that it was better to “mop up” after the bubble burst.
- (b) The main macroeconomic model used by the Bank did not allow for bankruptcies or credit constraints and was therefore ill-equipped to deal with the emerging financial crisis. They had been warned against the use of such a model by, among others, former MPC member, Professor Charles Goodhart.
- (c) The “Northern Rock” debacle: In the absence of a special resolution regime, the question that needs to be asked is if whether the Bank could have prevented what occurred by the use of ECB-style liquidity injections and by worrying less about “moral hazard” once we were already in the midst of a full-blown crisis?
- (d) Did the Bank devote enough attention to financial market developments? One example of why one might ask this question include the fact that, as late as August 2007, the Governor was asserting that securitisation had made the global banking system safer. At the time, this surprised many market participants as, by then, several banks had already got into trouble because of the securitisation of sub-prime mortgages. This might suggest that the hypothesis that the Bank failed to “shout louder” is oversimplified.
- (e) Was the Bank too slow to recognise the emerging financial crisis and too slow to cut interest rates in 2007–08?

It is essential that the Bank fully incorporates the lessons of any mistakes it might have made in the run-up to the crisis. The TSC has already looked at some of these issues before. However, it is not obvious that the Bank’s narrative of what went wrong is consistent with what many independent observers believe. It may therefore be appropriate for the TSC to launch a full-fledged, comprehensive inquiry into what did go wrong to help ensure that the Bank accepts responsibility more fully and takes active steps to attempt to ensure that the same mistakes are not repeated.

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### Written evidence submitted by Professor Charles Goodhart CBE

The accountability of the MPC is, of course, much enhanced by the quantified nature of the inflation target and the quantified bounds, beyond which the Governor has to write a letter of explanation. In the absence of any similar quantification in the field of financial stability, it is much harder to achieve similar clear accountability.

This is a problem that I have been struggling to resolve, and I believe that I have reached a viable methodology for doing so. It runs as follows:

- (1) Past experience suggests that there are a number of early warning indicators which tend to precede financial crises. These include the following:
  - (a) A rate of growth of (bank) credit which is significantly faster than average, and above its normal trend relationship to nominal incomes.
  - (b) A rate of growth of housing (and property) prices which is significantly faster than normal and above its normal trend relationship with incomes.
  - (c) A rate of growth of leverage, among the various sectors of the economy which is significantly faster than usual and above its normal trend relationship with incomes.

I would not be dogmatic about the choice and formulation of such indicators, but I would like to suggest that you require the FSC to choose somewhere between two to four such presumptive indicators. The idea is that when at least two of these indicators are showing a danger signal, that the expectation would be that the FSC should take action to counter such developments or else be prepared to explain in public to yourselves at the TSC why they have not done so.

- (2) I would then also suggest that you should ask the FSC to undertake (econometric) research on the basis of past historical data to work out what they would think the optimal response would have been in changing certain macro-prudential instruments, such as varying capital ratios, margin requirements, or loan-to-income ratios, etc., so that there can be a prior expectation of the extent that the FSC should vary instruments in response to these presumptive indicators.

The purpose of the exercise is to try and get the FSC to give a prior indication of how they might respond to circumstances which would seem, on past evidence, to suggest increasing financial fragility. The idea is not to constrain the FSC's behaviour, but to put them in a position where they either have to comply with action in such circumstances, or explain to you in public why this is not necessary.

After all, the Governor has already described an Inflation Target regime as one of constrained discretion. The purpose of my proposal is to make the operational regime of achieving financial stability similarly into a regime of constrained discretion.

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### Supplementary written evidence submitted by Dr Willem H Buiter

#### EXPLANATORY NOTE

On Monday 23 May 2011, I gave oral evidence before the Treasury Committee of the House of Commons in connection with the Committee's inquiry into Accountability of the Bank of England. The other witnesses in the same session were Dr Sushil Wadhvani, Professor Charles Goodhart and Kate Barker, like me former external members of the Monetary Policy Committee of the Bank of England. These notes, written in a strictly personal capacity, expand on some of the remarks I made during the evidence session on 23 May.

#### 1. Introduction

On 26 July 2010 the UK government launched a consultation on its proposals to reform the regulatory framework for the UK financial sector. Its current proposals can be found in HM Treasury (2011). Under the proposals the Bank of England's powers are greatly enhanced. The Monetary Policy Committee of the Bank of England (MPC), chaired by the Governor and with the majority of its voting members from the Bank's executive, retains the responsibility for monetary policy. Under "normal" circumstances monetary policy is conventionally defined as setting the official policy rate, called Bank Rate in the UK—the interest rate paid on overnight reserves held by eligible deposit-taking institutions with the Bank of England. When the official policy rate is at the effective lower bound, the instruments of the MPC become instead the size and composition of its assets and liabilities, on- and off-balance sheet. I consider this characterisation of the instrument set of the MPC to be too restrictive. This is briefly discussed in Sections 2, 7 and 8 below.

Under the government's proposals, the Bank of England is also given control of macro-prudential regulation, that is, it is responsible for the proper functioning of systemically important financial institutions, or of clusters/networks of financial institutions and for the orderly functioning of key financial markets. It designs rules and regulations to prevent or mitigate credit and asset market booms, bubbles and busts and it uses the tools of the lender of last resort and market maker of last resort should its preventive efforts fail and funding liquidity and/or market liquidity dry up.

The dominance of the Bank of England in macro-prudential regulation is manifest from the fact that the Governor chairs the proposed new Financial Policy Committee (FPC), which is constituted as a committee of

the Court of the Bank of England (its Board of Directors). The FPC also draws the majority of its voting members from the Bank's Executive and only has a non-voting Treasury member. Finally, the Bank is given oversight of micro-prudential regulation, assuring the liquidity and solvency of individual financial institutions, and preventing them from taking on excessive risk. The Governor is chairman of the Board of the new proposed Prudential Regulation Authority (PRA), which is to be constituted as a subsidiary of the Bank of England. Only in the area of consumer protection and market conduct does the Bank not have a direct role. These tasks are given to the new Consumer Protection and Markets Authority (CPMA), aka Financial Conduct Authority (FCA).

## 2. Recommendations

I consider the government's proposed framework for financial stability to be fatally flawed. What follows are a number of recommendations to remedy the most serious shortcomings.

- (1) The Treasury should be at the centre of financial stability. This ought to be obvious from the experience of the years since the financial crisis started in August 2007. Instead the proposed new arrangement places the Treasury on the sidelines. I propose that the Chancellor of the Exchequer be the chair of the FPC, that the FPC not have a majority of voting members from the Bank's Executive and that the FPC be constituted as an independent state body outside the Bank of England.
- (2) The Special Resolution Unit, in charge of operating the Special Resolution Regime for near-insolvent, systemically important banks and other financial institutions, should be under the joint authority of the Treasury and the Bank of England, with the Treasury, of course, having the sole responsibility for putting public resources at risk.
- (3) The micro-prudential regulator, the PRA, should be outside the Bank of England. It should not have a majority of voting members from the Bank of England's Executive.
- (4) The Court of the Bank of England is a historical legacy institution that now serves no useful purpose and creates the appearance or illusion of accountability or oversight where none exist. The Court should be abolished.
- (5) The Bank of England, the MPC, the FPC, the PRA and the CPMA/FCA should be responsible for policy to Parliament (through the Treasury Committee). In addition there should be an annual external audit of each of these entities by a commercial external auditor selected by the Treasury Committee to verify the accuracy of the annual accounts. There should also be an annual audit by the National Audit Office (NAO) to establish that public funds have been used effectively and efficiently in accordance with the political mandates or priorities established for the Bank, the MPC, the FPC, the PRA and the CPMA/FCA.
- (6) The responsibilities of the MPC and the instruments at its disposal should be clarified. I propose the following:
  - (a) The MPC sets the official policy rate (Bank Rate) and the width and location of the interest rate "corridor" around the official policy rate. The limits of the interest rate corridor in the UK are set by the rates paid or charged on the two Operational Standing Facilities. The official policy rate is the overnight rate the central pays on reserves held with the central bank by eligible counterparties (possibly only up to some finite limit), and at which it lends against high-grade collateral to these same counterparties (again possibly only up to some finite limit). The interest rate defining the upper bound of the interest rate corridor (the Lending Facility Rate in the UK) is the rate at which the central bank lends against high-grade collateral to eligible counterparties that have exceeded their borrowing limits at the official policy rate. Likewise the interest rate defining the lower bound of the interest rate corridor (the Deposit Facility Rate in the UK) is the rate the central bank pays for overnight deposits by eligible counterparties in excess of the limit for reserves that earn the official policy rate. The corridor could have zero width, or it could be one-sided only.

In addition to the Lending Facility, the central bank may have emergency funding facilities with different interest rates and different collateral requirements from the Lending Facility.

In addition to choosing Bank Rate and the width and location of the interest rate corridor, the MPC should decide the size of the aggregate balance sheet of the Bank of England (strictly speaking the size of its assets and liabilities, both on-balance-sheet and off-balance-sheet), and the composition of its liabilities. On the asset side of the Bank of England's balance sheet (and in its off-balance sheet exposure) the Bank should hold only the following: (1) UK sovereign liabilities; (2) loans to eligible counterparties collateralised with UK sovereign liabilities; (3) official foreign exchange reserves; (4) anything else if and only if it is covered by a full UK sovereign guarantee or indemnity.

This fourth category includes private securities held outright or loans to eligible counterparties collateralised with non-sovereign liabilities (including private securities, other private financial instruments or non-UK sovereign liabilities). When the official policy rate is near the zero lower bound (ZLB) or when the Deposit Facility Rate is near the ZLB and the official policy rate at its effective lower bound (ELB), the size and composition of the Bank's assets and liabilities is the only instrument available to the MPC, but even away from the ZLB/ELB, setting the official policy rate does not necessarily fully and uniquely determine either the size or the composition of



the balance sheet of the central bank. Consequently, the MPC should make the appropriate decisions on the size and composition of Bank of England assets and liabilities even during normal times, when the interest rate corridor is not stuck at the ZLB.

- (b) Foreign exchange market intervention should be implemented and decided by the Bank of England. The Treasury decides the nature of the exchange rate regime, including, for instance, whether the UK should adopt a currency peg. The Treasury also decides on capital controls or foreign exchange controls.
- (7) The majority of the voting members of the MPC should be external, that is, non-executive members, appointed for a single non-renewable term. This serves to prevent both groupthink and political capture (carrying favour in hope of re-appointment by the Chancellor).

### 3. *What's wrong with the proposed FPC?*

#### 3.1 Dominance of the Bank of England over financial stability

As currently envisaged, the Financial Policy Committee proposed for the UK will have 11 voting members and one non-voting member. Six of the voting members are executives of the Bank of England: the Governor, the three Deputy Governors (for Financial Stability, for Monetary Policy and for Prudential Regulation—this new Deputy Governor position will be occupied by the Chief Executive of the Prudential Regulation Authority (PRA), a subsidiary of the Bank of England—plus the Bank of England's Executive Directors for Financial Stability and for Markets. The other five voting members are the Chief Executive of the Consumer Protection and Markets Authority (CPMA/FCA), and four external experts appointed by the Chancellor. The non-voting member is a Treasury representative.

The FPC under the government's proposal will be constituted as a committee of the Court of Directors of the Bank of England (its Board of Directors). As I will argue for the abolition of the Court of the Bank of England (see Section 6 below), this feature would obviously disappear in my preferred setup. Even under the proposed set-up, it is hard to see any rationale for putting the FPC under the Court. The MPC is not under the Court, which is just as well if it is to be operationally independent.

Financial policy (policy aimed at maintaining or restoring financial stability) cannot be delegated to an operationally independent entity. Because it inevitably involved the non-inflationary, long-term, solvency-guaranteeing deep fiscal pockets of the Treasury (and not just the potentially inflationary, short-term, liquidity providing or quasi-fiscal deep pockets of the monetary authority), financial policy (and financial stability) cannot be the remit of the central bank alone. The central bank does indeed have access to significant quasi-fiscal, solvency-supporting resources, as I shall argue below, but the use of these resources by the central bank will inevitably undermine its legitimacy and its operational independence even in those areas where such operational independence makes sense—setting interest rates and foreign exchange market intervention.

The government's proposed arrangement is deeply flawed, because it does not put the Treasury at the centre of financial stability. With a single non-voting member, the Treasury will be a bit-player on the FPC, which is dominated by the central bank.

The arrangement I propose instead for the UK's FPC is effectively the arrangement adopted by the U.S. for its Financial Stability Oversight Council (FSOC), the U.S. counterpart, established under the Dodd-Frank Act, of the UK's FPC. Its 10 voting members are the Secretary of the Treasury (who chairs the FSOC), the Chairman of the Federal Reserve Board, the Comptroller of the Currency, the Director of the Consumer Financial Protection Bureau, the Chair of the Securities and Exchange Commission, the Chair of the Federal Deposit Insurance Corporation, the Chair of the Commodity Futures Trading Commission, the Director of the Federal Housing Finance Agency, the Chairman of the National Credit Union Administration Board, and an independent member with insurance expertise that is appointed by the President and confirmed by the Senate. There are also five non-voting members: the Director of the OFR, the Director of the Federal Insurance Office, a state insurance commissioner selected by the state insurance commissioners, a state banking supervisor chosen by the state banking supervisors, and a state securities commissioner designated by the state securities supervisors.

The U.K.'s proposed FPC is similar as regards chairmanship and voting weights (but fortunately not as regards size) to the EU's European Systemic Risk Board (ESRB). This body has 37 voting members: the President of the ECB (who chairs the ESRB), the Vice-President of the ECB, the 27 governors of the national central banks of the EU, one representative of the European Commission, the Chair of the European Banking Authority, the Chair of the European Securities and Markets Authority, the Chair of the European Insurance and Occupational Pensions Authority, the Chair and two Vice-Chairs of the Advisory Scientific Committee and the Chair of the Advisory Technical Committee.

There are also 28 non-voting members. One representative per member state of the competent national supervisory authorities (this is in many cases the national central bank) and the President of the Economic and Financial Committee (EFC) for the Council of the European Union. This last non-voting member of the ESRB is the only one that can be said to represent the EU fiscal authorities, although of the 58 members of the EFC, two each are appointed by the European Commission and the ECB. Each EU member state also appoints two members.

Note that the Eurosystem (the ECB President and Vice-President plus the 17 national central banks of the Euro Area) has 19 of the 37 voting members of the ESRB. The ESRB both in size and in composition is the example not to follow for the FPC.

### 3.2 Only the Treasury can legitimately address insolvency problems of systemically important financial institutions

The Treasury is central to the remedial (mitigating, curative or ex-post) side of financial instability prevention and cure. Its role in the preventive (or ex-ante) side of the financial stability mechanism is derived from this pivotal role in the remedial phase of any financial crisis involving large-scale losses by systemically important institutions—losses that threaten their solvency.

The central bank can provide domestic currency liquidity support to systemically important financial institutions in any amount. If it is to avoid creating a conflict with its macroeconomic stability mandate (price stability in the UK and the Euro Area, a triple mandate—maximum employment, stable prices and moderate long-term interest rates—in the US), it cannot in general use the full measure of the resources it could in principle command through its monopoly of the creation of base money to fill any solvency gap in the financial sector. In the case of the Bank of England, it can, unless it overrides its price stability mandate, at most provide solvency support up to the limits defined by its price stability mandate. I would argue, however, that any solvency support by the central bank to systemically important banks, to other financial institutions, or indeed to any private economic entity is inappropriate and illegitimate, because it involves the central bank usurping the powers of the legitimate fiscal authorities, in the case of the UK the legislature represented by the House of Commons.

Revolutions have been attributed to the violation of the principle of “no taxation without representation”. Whatever the historical accuracy of that attribution, it is clear that under the British constitution, the Bank of England has no authority to put its own resources at risk to support the financial sector. Such quasi-fiscal activities by-pass the need for Parliamentary scrutiny and approval ex-ante and often severely restrict the scope for ex-post accountability as well.

It is worthwhile getting a sense of the magnitude of the resources the central bank can, from a technical economic perspective, command in support of the private financial sector (or indeed in support of any cause or venture it deems worthwhile), even if one holds the view that the central bank should not have the authority or the legitimacy to do anything with those resources except put them at the disposal of the Treasury, under Parliamentary scrutiny. At the very least it should convince Parliament, the media and the public at large, that close scrutiny of the potential quasi-fiscal activities of the central bank is required.

### 3.3 How deep are the non-inflationary pockets of the central bank?

The net present discounted value (NPV) of the solvency support the central bank can provide to other economic entities (systemically important financial institutions, say, plus the tax payer, through the transfer of the central bank’s profits to the Treasury) is the sum of the NPV of its future seigniorage (base money issuance) that can be extracted plus the NPV of the “unanticipated inflation tax”. The unanticipated inflation tax is the reduction in the NPV of future debt service on domestic currency-denominated fixed rate sovereign debt due to unanticipated inflation (that is, inflation unanticipated at the time the nominal fixed rate debt was issued, and therefore not reflected in the nominal interest rate on the debt). Even if higher inflation is expected, it may not be reflected in higher nominal interest rates because of financial repression. This is how much of the post-World War II sovereign debt was amortised in the UK and the US. It is how India today keeps its sovereign debt burden from exploding.

If no limits are imposed on future rates of inflation, the NPV of future seigniorage is unlimited in nominal terms. The NPV of the future real value of seigniorage will be limited by the reduction in the demand for real base money associated with higher anticipated inflation and associated higher nominal interest rates (the real NPV of the anticipated inflation tax is limited (see Buiter (2007))). Assuming that it is not a legitimate job of the central bank to reduce the real value of future nominally denominated, fixed rate sovereign debt service through unanticipated inflation, and assuming that the central bank will, on average, achieve the price stability mandate (2% inflation in the case of the Bank of England), the price-stability-mandate-consistent NPV of future seigniorage is the NPV of future base money issuance assuming a future average rate of inflation of 2% per annum. To get a numerical estimate of the NPV of future price-stability-mandate-consistent or non-inflationary seigniorage, we need in addition an estimate of the future growth of the “scale variable” driving base money demand, an estimate of the responsiveness of base money demand to the scale variable, an estimate of the appropriate nominal discount rate for discounting future base money issuance, and an estimate of the responsiveness of base money demand to the nominal interest rate.

The calculation of the NPV of future seigniorage reported below makes a number of highly conservative assumptions aimed at avoiding an over-estimate. The result is therefore a likely underestimate. I assume, for instance, that the central bank makes no profit from its non-monetary liabilities, nor from the reserves held by eligible deposit-taking institutions with the Bank of England. This is incorrect, even today, and in any case is to a significant extent a choice variable of the Bank, as it can set both reserve requirements and the remuneration of various categories of reserves. The Bank of England, unlike most other central banks, has a voluntary

reserve ratio system, with no minimum reserve requirement. There is a Cash Deposit Ratio (CDR) of 0.11% of eligible deposits for Bank of England income generating purposes, but on 18 May 2011, the CDR stood at just £2.4 billion, compared to £54 billion currency (notes in circulation), £131 billion Reserve Balances and £240 billion total Bank of England liabilities.<sup>18</sup> Reserve balances therefore were about 5.9% of eligible deposits—a very high number because of quantitative easing and the extraordinary continuing liquidity preference of British banks.

The long-run currency demand function on which the seigniorage calculations are based is given below.  $C$  is the nominal value of the stock of currency,  $P$  the GDP deflator,  $Y$  real GDP and  $i$  the short risk-free nominal interest rate;  $k$ ,  $\alpha$  and  $\beta$  are parameters.

$$\frac{C}{P} = kY^\alpha e^{-\beta i}$$

$$k, \alpha, \beta > 0$$

In the calculations reported below, I assume that  $\beta$ , the semi-elasticity of currency demand with respect to the nominal interest rate takes the value 2. For the output elasticity of real currency demand I consider both the case  $\alpha = 1$  (proportionality) and  $\alpha = 0.5$ —the square root rule of Allais, Baumol and Tobin. The inflation rate,  $\pi$ , is assumed to equal the inflation target (ignoring the difference between the CPI and the GDP deflator), that is,  $\pi = 2\%$ . For the growth rate of real GDP,  $\gamma$ , I consider mostly conservative low values of 1.5%, 2.0%, 2.5% and 3.0%. For the discount rate,  $i$ , we assume conservative high values of 4.0%, 4.5% and 5.0%. We cannot take the current value of the stock of currency as the starting point for the calculations, which are based on constant values of all parameters, including the discount rate. Its current value (1.0% if we take Bank Rate as the relevant risk-free benchmark) is much lower than the values for the discount rate assumed in the calculations, so the starting values of the base money stock for our calculations,  $C_0$ , will be lower than the current value of the base money stock.

Some illustrative numbers, taken from Buiter (2010) are shown in Figures 1 and 2 below:

**Figure 1**

PRESENT DISCOUNTED VALUE OF FUTURE SEIGNIORAGE IN THE UK ( $\alpha = 1.0$ )

	$i=4.0\%$	$i=4.5\%$	$i=5.0\%$
$\pi=2.0\%$ ; $\gamma=1.5\%$	£298 bn	£143 bn	£94 bn
$\pi=2.0\%$ ; $\gamma=2.0\%$	£infinite!	£346 bn	£165 bn
$\pi=2.0\%$ ; $\gamma=2.5\%$	£infinite!	£infinite!	£396 bn
$C_0$	£38 bn	£38 bn	£37 bn

Source: Citi Investment Research and Analysis

**Figure 2**

PRESENT DISCOUNTED VALUE OF FUTURE SEIGNIORAGE IN THE UK ( $\alpha = 0.5$ )

	$i=4.0\%$	$i=4.5\%$	$i=5.0\%$
$\pi=2.0\%$ ; $\gamma=1.5\%$	£88 bn	£63 bn	£48 bn
$\pi=2.0\%$ ; $\gamma=2.0\%$	£121 bn	£80 bn	£60 bn
$\pi=2.0\%$ ; $\gamma=2.5\%$	£177 bn	£104 bn	£74 bn
$\pi=2.0\%$ ; $\gamma=3.0\%$	£290 bn	£141 bn	£93 bn
$C_0$	£38 bn	£38 bn	£37 bn

Source: Citi Investment Research and Analysis

When currency demand grows proportionally with GDP ( $\alpha = 1$ ), the NPV of inflation-target-consistent seigniorage of the Bank of England is £396 billion if real GDP grows at the government's assumed potential growth rate of 2.5% per annum, even if we use a very high discount rate of 5%. With 2% real GDP growth, the figure falls to a still impressive £165 billion. If there are strong economies of scale in currency management ( $\alpha = 0.5$ ), the seigniorage numbers go down to £74 billion and £60 billion for real GDP growth rates of 2.5% and 2.0%, respectively.

What this means is that the Bank of England has rather deep, non-inflationary quasi-fiscal pockets. It could use some or all of these quasi-fiscal resources to bail out insolvent banks or other private sector financial entities. The resources spent this way would, of course, not be available for future payment as dividends to the shareholder, the Treasury as agent for the UK tax payer.

<sup>18</sup> Source: Bank of England.

The fact that these resources could be dispensed at the discretion of the central bank does not mean that this would be a legitimate use of what is, after all, tax payers' money. There are no mechanisms for proper Parliamentary scrutiny of such quasi-fiscal transfers and subsidies, *ex-ante* or *ex-post*. Decisions on bail-outs, transfers and subsidies should be made by the fiscal authorities, not by the central bank. In the UK the fiscal authority has the flexibility and power to make the necessary and appropriate decisions about the use of tax payers' money to recapitalise systemically important banks and other financial institutions. This is not the case in the U.S. or in the Euro Area, albeit for different reasons. US Federal fiscal policy is paralysed by the combined effects of the proliferation of constitutional checks and balances and the extreme polarisation of American society and the body politic. In Europe, there is no serious EU-wide fiscal actor. For the Euro Area there is a serious quasi-fiscal actor, the ECB/Eurosystem, whose immediately mobilisable quasi-fiscal resources dwarf those available from the proper fiscal entities: the EFSF, the EFSM and the Greek facility (see Buiter (2010)). This is no doubt the reason why the quasi-fiscal roles played by the Fed and by the ECB/Eurosystem have been so much larger (even relative to the scale of their economies) than that of the Bank of England.

It is key, however, even in the UK, that the Treasury Committee scrutinise carefully the past and future activities of the Bank of England for signs of quasi-fiscal largesse. This requires that Parliament be given detailed information on the management of all the Bank's assets and liabilities, including the prices, terms and conditions for all outright purchases and sales of securities, the terms and conditions for collateralised lending, the valuation of illiquid collateral and all the other information that central banks are reluctant to part with, even when enough time has passed to ensure that commercial confidentiality considerations are no longer relevant. A proposal for limiting the Bank's scope for quasi-fiscal discretion is presented in Section 7.

#### *4. The Bank of England is overburdened with tasks and responsibilities*

Under the arrangements proposed by the government, the Governor of the Bank of England will be chairman of the Monetary Policy Committee, chairman of the FPC and chairman of the board of the PRA. The Bank of England also manages the Special Resolution Unit (SRU), designed to restructure systemically important banks that are deemed to be at risk of failing. This too falls under the responsibility of the Governor. In addition, the Governor of the Bank of England serves as vice-chairman of the European Systemic Risk Board.

This portfolio of responsibilities for the Governor represents an impossibly onerous combination of tasks. No person could possibly discharge all these responsibilities properly.

It is clearly helpful for the Bank of England, the ultimate source of sterling liquidity, to be given serious macro-prudential responsibilities. It is, however, undesirable to grant it in addition responsibility for micro-prudential supervision. The Prudential Regulation Authority (PRA), which will regulate sectors such as deposit-taking High Street banks, insurers and investment banks, should therefore be an independent entity, outside the bank, and it should not have its Board chaired by the Governor or any other Bank executive. This is both so as not to overburden the Governor and his Deputies, but also to prevent regulatory capture. Regular contact with the leadership of banks and other systemically important institutions is a sure road to cognitive regulatory capture or worse.

There is a common instinct among policy makers, and even among some scholars, to conclude, following a crisis during which a lack of coordination, cooperation and information sharing among multiple decision making bodies played a significant role, that centralisation of authority, information and decision making powers is the solution. Generally this is incorrect. If it were correct, central planning would be the dominant mode of economic organisation today. Clearly, the macro-prudential authority will have to work together well with the micro-prudential authority, but to put them all under the same organisational umbrella—the Bank of England—and under the authority of one person—the Governor—would be counterproductive, especially when neither the Bank of England nor its Governor have the legitimacy to fulfil the tasks the government intends to assign to them.

I agree with the decision to assign to the new Consumer Protection and Markets Authority (CPMA/FCA) the FSA's responsibility for consumer protection and conduct regulation.

#### *5. Groupthink*

Groupthink is a problem at the Bank of England, as it is for any organisation with a strong "esprit the corps" and long-serving executives. Its incidence and severity can be minimised by having the majority of the voting members of the MPC and the FPC consist of independent external experts, that is, persons who are not executives of the Bank of England. These external members should serve a single, non-renewable term of five to seven years.

#### *6. The Court*

The Banking Act 2009 reduced the size of the Court of the Bank of England—its Board of Directors—from 19 down to 12, nine of which are non-executive. On the website of the Bank of England, the following brief description of the functions of the Court can be found:

"Court meets a minimum of seven times in a calendar year, and its functions are to manage the Bank's affairs other than the formulation of monetary policy, which is the responsibility of the Monetary Policy

Committee. This includes determining the Bank's objectives and strategy, ensuring the effective discharge of the Bank's functions, ensuring the most efficient use of the Bank's resources and to review the Bank's strategy in relation to the Financial Stability Objective.

Under the Bank of England Act 1998, certain functions of Court are delegated to a sub-committee comprising the nine non-executive Directors of the Bank. This sub-committee is known as NedCo.

The delegated functions are:

- keeping under review the Bank's performance in relation to its objectives and strategy for the time being determined by Court;
- monitoring the extent to which the objectives set in relation to the Bank's financial management have been met;
- keeping under review the internal financial controls of the Bank with a view to securing the proper conduct of its financial affairs;
- determining how the remuneration and pensions of the executive members of Court should be fixed;
- keeping under review the procedures following by the Monetary Policy Committee, including determining whether the Monetary Policy Committee has collected the regional, sectoral and other information necessary for the purposes of formulating monetary policy;
- determining the terms and conditions of the members of the Monetary Policy Committee who are appointed by the Chancellor of the Exchequer."<sup>19</sup>

The existence of the Court of the Bank of England is a historical anomaly. Like many of the older central banks, the Bank of England started life (in 1694) as a privately owned joint stock company. The governance of such limited liability companies typically involves a Board of Directors the majority of whom don't have day-to-day executive or management responsibilities. This majority of non-executive directors are there to ensure that the interests of the shareholders (including minority shareholders) and of other stakeholders are served by the company's executive leadership. Since 1946 the Treasury is the only shareholder of the Bank of England. Indeed the designation of the Bank as a limited liability company is a bit of an affectation. It is a quasi-autonomous state agency. Its true shareholders and stakeholders are the people of the United Kingdom.

The Treasury Committee of the House of Commons is the duly constituted representative body that the Bank of England is accountable and answerable to. To enable it to discharge this responsibility properly, the Treasury Committee needs vastly increased resources. As currently constituted and resourced, the Treasury Committee is no match for the Bank of England (let alone for the vastly enhanced Bank of England envisaged under the government's proposals), just as it is no match for the Treasury, whose legions of highly qualified and well-paid civil servants frequently run rings around it. I don't recommend going to the other extreme represented by the US Congress, which effectively replicates most of the important government departments through a massive and extremely costly parallel structure of committees and subcommittees with vast permanent staffs and countless part-time advisers. However, it is clear that for the Bank to be properly accountable to Parliament, both the permanent support staff for the Treasury Committee and the resources at its disposal for hiring outside expert support must be greatly enhanced.

The Treasury Committee holds the Bank of England accountable for both its internal procedures, processes and practices, including proper financial management and value-for-money, and for its policy performance. This has been true for monetary policy since the Bank gained operational independence for monetary policy in 1997. It will be true for whatever role the Bank ends up playing in the design and implementation of financial stability policy, both macro-prudential and micro-prudential, including its responsibilities in the management of the Special Resolution Regime for systemically important (near-)insolvent banks.

The Treasury Committee should be the sole body to which to Bank of England is answerable for monetary policy and financial stability policy. There can be no role for the Court here. This is recognised in the case of monetary policy. It is not recognised for financial stability policy, because the FPC is set up as a Committee of the Court. This is a mistake that should be rectified even if the Court is not abolished (abolition of the Court is my preferred solution).

As regards the housekeeping aspects of Bank of England governance, the National Audit Office should inspect the Bank on a yearly basis to ensure that the British people get value for money. A private sector accountancy firm selected by the Treasury Committee should also do an annual financial audit of the Bank. The Treasury Committee should also have the right to subject all or part of the Bank to a management consultancy audit from time to time, to ensure operational efficiency.

This construction makes the Court redundant. It therefore ought to be abolished.

Is there a case for keeping the Court on the grounds that, if it does no good, it also does no harm? Even if the Court is removed from the appraisal of policy, could it not play a useful role in vetting the internal procedures and processes of the Bank? I don't think so. Anything that creates the appearance of accountability without adding its substance is likely to end up hurting accountability. The Court of the Bank of England does

<sup>19</sup> <http://www.bankofengland.co.uk/about/people/court.htm>

not have the expertise nor the resources (full-time staff, part-time experts, financial resources) to be able to vet the Bank for good housekeeping. Historically, members of Court have been selected from four categories:

- (1) Representatives of special interests. There always is a trade unionist, a non-financial industrialist and, under the old, larger pre-2009 Court, a representative of consumer interests. Court or Board members should, in my view, be selected for their expertise and independence, not to achieve some representative mix, be it as regards industrial/occupational background, political party affiliation, religion, gender, race or ethnicity, class or age.
- (2) The Great and the Good. These are mainly superannuated bankers and other financial sector former heavyweights. This type of member was well -represented on the old, larger Court. Unfortunately, many of these members were semi-retired extinct volcanoes, no longer willing or able to expend the considerable effort and energy required to vet the Bank's procedures, processes and practices. My own experience of the Court as mediator between the Executive Members of the MPC and the external members during the conflict about ring-fenced research support for external members, was not a positive one. When the Executive Members refused to budge, the Chair of the Court was approached by the External members. Nothing happened. It was only when the conflict was leaked to the media that pressure was put on the Executive by the Treasury Committee and the Treasury and the dispute was resolved to the satisfaction of the external members.
- (3) Active bankers and other senior executives from the (private) financial sector. This category of members has the relevant expertise. Because they are still active in full-time pursuits in the financial sector, however, they will not be able to give their Court membership the time and energy it requires. They are also, of course, inherently at risk of being conflicted. Regulatory capture (cognitive or direct) of the central bank by financial sector interests becomes institutionalised when the financial sector itself has representatives on Court.

This problem is most apparent in the regional Reserve Banks of the Federal Reserve System of the US. Like all 12 regional Reserve Banks, the Fed of New York has a nine member, three-class non-executive board of directors. Three Class A members are elected by member banks to represent member banks. Currently the class A members are the Chief Executive Officer and Chairman of Banco Popular de Puerto Rico, the President, Chief Executive Officer and Chairman of the Board of the Adirondack Trust Company and the Chairman of the Board and Chief Executive Officer of JPMorgan Chase. Three Class B members are elected by member banks "to represent the public" (as seen by the member banks). Two class B member positions are vacant; one of these vacant positions was until recently held by the CEO of General Electric Company, the other by the former Chairman and CEO of Pfizer. The third Class B Director position is held by the President and CEO of Loews Corporation. Finally, three Class C members are appointed by the Board of Governors of the Federal Reserve System to represent the public (as seen by the Board of Governors). Currently, these positions are held by the President of Columbia University, the President and CEO of the Partnership for New York City and the President of the Metropolitan Museum of Art. It is clear that this is not a governance structure the Bank of England would want to emulate. Class A and Class B Directors run afoul of the necessity to avoid both the appearance and the substance of potential conflict of interest. Class C Directors are examples of "the Great and the Good" who are at high risk of not contributing materially to good governance because of lack of relevant expertise.

- (4) Other independent experts. It is always useful to have a few of these around, but they cannot have the legitimacy to hold the Bank to account.

I am convinced that once it is recognised that the Court cannot be the body to which the FPC can be held accountable for policy (just as the MPC is not accountable to Court for policy), the remaining housekeeping governance issues involving the MPC and the FPC (and indeed the PRA and the CPMA/FCA) can be addressed through the Treasury Committee, the NAO and duly appointed external auditors that scrutinize both the financial accounts and the managerial proficiency of these organisations. Neither the Board of Governors of the Federal Reserve System nor the ECB have a non-executive board of directors. Their failures during the past financial crisis (and during the current sovereign debt crisis in the case of the ECB) are not attributable to this feature.

#### 7. Why a "Treasuries only" policy for the Bank of England?

Central banks are agencies of the state. This is true even when they are operationally independent (as in the UK) or even when they are operationally and target independent (as the ECB is for all practical purposes). The financial resources they manage are tax payers' money.

Because the Bank of England is not a body to which fiscal responsibilities have been delegated, the extent to which it acts in a quasi-fiscal capacity has to be kept to the absolute inescapable minimum.

Consider the Bank of England's pursuit of the inflation target—its overriding objective: 2% per annum on the CPI index from now until Kingdom Come. The pursuit of that objective will imply a (contingent) sequence of current and future official policy rates (Bank Rate). Because the monetary liabilities of the Bank of England either pay no interest (in the case of currency) or pay an interest rate that is, in principle, chosen by the Bank of England and therefore need not equal the (non-monetary) opportunity cost of funds to the Bank in the case of required reserves and excess reserves, the Bank of England owns a "money machine"—as does every central

bank. It can use the resources at its disposal for a variety of purposes or quasi-fiscal activities. Quasi-fiscal because, although the actions are from an economic point of view equivalent to taxes, transfers and subsidies, they don't show up as explicit taxes or subsidies in any entity's accounts, budgets or balance sheets. Nor are these redistributive, tax/transfer and subsidy activities voted on and scrutinised by Parliament. The central bank can subsidize different types of lending or borrowing activities or different types of borrowing and lending institutions. Through the interest rates it sets, through the terms on which it buys and sells securities outright, and through the terms on which it accepts securities as collateral for repos or other forms of collateralised lending, the Bank of England, and indeed any central bank, can make large-scale transfers to and among different private, quasi-public or public entities; it can redistribute wealth and income between different private parties in the economy, and it can transfer resources to the Treasury.

As an unelected entity, the Bank of England ought not to engage in quasi-fiscal activities except to the unavoidable minimum degree implied by its proper, politically determined, mandate: price stability (the inflation target) and subject to that, all things bright and beautiful, including economic growth and employment. The pursuit of its financial stability mandate should not involve quasi-fiscal activities at all.

I assume in what follows that the British sovereign is solvent. Provided the fiscal austerity programme (or something equivalent to it as regards the net present value of future primary general government surpluses) is implemented for the next 4 years, this is indeed likely to be the case. We minimize the risk of quasi-fiscal shenanigans on the asset side of the Bank's operations by requiring that the Bank of England's assets consist only of official foreign exchange reserves, UK sovereign securities, loans secured against UK sovereign or sovereign-guaranteed securities, and any other securities only if these are subject to a full guarantee or indemnity by the UK sovereign. Clearly, the liability side is not devoid of quasi-fiscal potential, especially as regards the interest rates paid on reserves or on non-monetary central bank liabilities. But most of the massive quasi-fiscal activities engaged in during the crisis by the ECB and the Fed took place on the asset side of the balance sheet (and through the off-balance sheet assets and exposures taken on by these central banks).

Compared to the ECB and the Fed, which did engage and continue to engage in very significant quasi-fiscal activities, the Bank of England has been a model of quasi-fiscal restraint. For instance under the Term Asset-Backed Securities Loan Facility (TALF), announced on 25 November 2008, the Federal Reserve Bank of New York (FRBNY) was able to lend up to \$200 billion on a non-recourse basis to holders of certain AAA-rated ABS backed by newly and recently originated consumer and small business loans. The U.S. Treasury Department—under the Troubled Assets Relief Program (TARP) of the Emergency Economic Stabilization Act of 2008—provided \$20 billion of credit protection to the FRBNY in connection with the TALF. The FRBNY was therefore potentially on the hook for up to €180 billion—a clear quasi-fiscal exposure. The Fed's Maiden Lane, Maiden Lane II and Maiden Lane III facilities were and are subject to credit risk that is not covered by a Federal Treasury guarantee or indemnity. The ECB has been setting itself up for the role of quasi-fiscal agent of first resort in the coming “transfer Europe”, when sovereign debt restructuring will inflict significant losses on the Eurosystem through its outright holdings of restructured Periphery sovereign debt through the Securities Market Programme (currently about €76 billion worth of exposure) and through the Periphery's sovereign or sovereign-guaranteed debt it has accepted as collateral for loans to zombie banks and undercapitalised banks. In contrast, the Bank of England has insisted on a full sovereign indemnity for all its lending activities against dodgy collateral, including the Special Liquidity Scheme (SLS) introduced in April 2008. It would be desirable to formalise this “Treasures only” requirement.

#### 8. *Why should foreign exchange market intervention be decided by the central bank?*

Either non-sterilised foreign exchange market intervention is effective (has a predictable and material impact on the exchange rate), or it is not. If it is ineffective, it doesn't matter who makes the decisions on foreign exchange market intervention. All that matters is the changes in quasi-fiscal exposure for the central bank potentially involved in foreign exchange market intervention (something considered in the previous subsection). If it is effective, then, in a world with near-perfect capital mobility, the ability to set or steer the exchange rate implies the ability to set or steer the short nominal interest rate. Whoever takes the exchange rate decisions therefore takes the interest rate decisions. If that is not the central bank, the central bank is no longer operationally independent.

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### Supplementary written evidence submitted by Kate Barker

#### GENERAL COMMENTS ON MAKING DECISIONS INDEPENDENTLY OF GOVERNMENT

It is hardly new to have committees and quangos which make decisions about specific issues or projects independently of Government, with authority granted by Government and within a framework set by Parliament. Many bodies operate on that basis, and indeed the recent inquiry “Smaller Government: Shrinking the Quango State” from the Public Administration Select Committee set out a number of possible tests that justified having an independent body taking such decisions, and concluded broadly that the “impartiality” test (politically impartial) was the main distinguishing characteristic. There are many examples, particularly perhaps of grant-giving bodies, whose independence of decisions on the allocation of funding is well-established and widely accepted. The same argument also applies where individual organisations are subject to regulation.

Other reasons for delegating decisions to independent bodies might include the one I mentioned in oral evidence to the Select Committee on 23 May. This is to tackle the problem that politicians may, for electoral reasons, be tempted to take decisions which favour short-term popularity, rather than being in the longer-term interests of the electorate. So a general argument for an independent body to carry out policy is that it can command better public credibility than politicians, whose motives are frequently suspected, however unjustly. In addition, a highly technical decision might be delegated (as NICE was set up to give guidance on treatments and to authorise drugs for use based on careful evaluation).

The arguments for the independence of the Monetary Policy Committee are well-known and sound. It removes (or at least considerably alleviates) suspicions that decisions on interest rates are being taken with an eye to political advantage, especially around elections. This improves the credibility of the inflation target (the fact that inflation expectations in the financial markets, and to a lesser but still noticeable extent among the public, have remained quite well-anchored through the present extended period of CPI inflation well above the 2% target is testimony to this). This brings two main benefits: long-term interest rates are lower as there is less of an inflation risk premium, and short-term interest rates may have to be adjusted by less to keep inflation close to target, in principle reducing economic instability.

The arguments around the macro-prudential regulator are different. Looking at the proposed reasons for independence indicated above:

Is the decision a highly technical one? The decision-maker needs to receive quite technical advice, but is unlikely to require specialist knowledge much greater than that which would normally be required of a Treasury minister or Chancellor.

Does it deal with the affairs of individual businesses? No, unlike the micro-prudential regulator where I would agree that the case for independence is clear.

Are the issues ones where a decision might have a perceived adverse short-term impact on particular groups which would be in the long-term interests of the wider economy? Yes, and this issue would have to be tackled in the detailed arrangements.

Will decisions taken by the regulator have implications for other policies? Are there co-ordination issues and potential trade-offs? One issue which has already arisen is the potential for conflicts and trade-offs with monetary policy. Here, I don't agree with Professor Goodhart that these trade-offs are no worse than those with fiscal policy. Of course, year-by-year fiscal policy decisions are set within a longer-term context, so that to some extent each fiscal event is relatively predictable, and not likely to prompt a monetary policy response or even cause policy to change course. This is also likely to be true for macro-prudential policy, so that monetary policymakers would be able to judge when macroprudential changes were likely, to take that into account, and react, if necessary, to the precise decision when it has been made. In that sense there is not a problem.

The problem arises at a deeper level. Fiscal policy decisions are, nowadays, chiefly about keeping the public finances on a sound medium-term course, and only occasionally about seeking to affect the growth of the economy. (During the financial crisis, however, fiscal policy and monetary policy worked for a time together towards support of the economy). Tensions can nevertheless arise—it could be argued at the moment that a slightly less aggressive course of fiscal tightening would be preferable at a time when monetary policy has little scope to boost the economy.

It is true that macro-prudential policy will also not (usually) be intended to affect the pace of expansion of the economy—but due to the fact that it operates through more similar channels it is more likely to run up against monetary policy. An interesting question is how the economy would have performed in the run-up to the financial crisis if macro-prudential policies had been available and utilised. This would have slowed the growth of credit and probably braked the rise in house prices, dampening the economy. Since inflation was on target given the rate of growth which prevailed in the absence of such macro-prudential policy, Bank Rate would have presumably been lowered to keep demand growing in line with supply. This suggests that the



macro-prudential policy setting would have had to take into account the likely monetary policy reaction in setting their own policy dials (as fiscal policy does at present).

The transmission mechanism of monetary policy in the domestic economy would have been less powerful due to the FPC dampening the response to lower Bank Rate from looser credit conditions. Perhaps helpfully, the UK would have found more of the stimulus came from a decline in the exchange rate. However, as we are presently observing, for quite a lengthy initial period the impact of depreciation can be more on the *price level*, rather than boosting economic growth sufficiently to keep the *inflation rate* close to target over in the medium-term. It could therefore have been more difficult to have achieved the inflation target as the MPC did. On the other hand the economy might have been better balanced. The implications of these issues could benefit from further consideration, including whether there are any implications for how monetary policy is carried out.

Apart from potential tensions with monetary policy, macroprudential policy of course may have other effects—for example adjusting maximum loan-to-value ratios for mortgages would make access to the housing market more difficult for some first-time buyers. Equally restricting the overall growth of credit could reduce the availability of credit for businesses. While changes in interest rates have broadly similar effects, there is also a judgment here about the amount of risk that the average taxpayer might ultimately have to bear if the attempt to achieve financial stability fails. It might be argued that these considerations were more properly the business of government, rather than an independent body.

Against this, it should be noted that the failure to realise the risk being taken on by the banks and the two big US government-backed mortgage enterprises, in an attempt to move home-ownership down the income scale, was one of the prime causes of the financial crisis. However, allowing politicians to make this trade-off would also enable the issues around the role of credit to be considered alongside detailed fiscal judgements about the burden of taxation and the structure of public expenditure. In seeking to understand the tensions and imbalances in the economy, issues around income distribution, including across different generations, are becoming highlighted. Credit availability is one way in which these tensions can be managed, although there are obvious risks. If macro-prudential decisions are taken by an independent body, this may reduce the opportunity to look at issues of trade-offs and distribution in a co-ordinated manner.

These arguments, would support setting up a decision-making structure along the lines suggested by Wilhem Buiter, chaired by the Treasury but with strong representation from the Bank, the FSA and possibly also external members. Since the purpose of setting it up in this way would be to enable Government to take its own view about the right balance of taxpayer risk and other policies, the decisions should lie with the Chancellor. But in order to avoid the risk that decisions were driven by short-term political considerations, the Bank and the external members should be able to publish the advice being given to the committee.

In summary, I would argue that macro-prudential policy does not meet the tests for being set up independently from Government, and that there are risks to the structural management of the economy from moving in this direction. A final point is that, although ministers might see the setting up of an independent body as in some sense removing them from criticism if policies were unpopular, experience with bodies such as NICE suggests that in the end ministers are not able to escape criticism for the actions and decisions of the independent bodies which they choose to establish.

Turning to answer a specific question in the Committee's inquiry, on the assumption that, despite the above, the Financial Policy Committee is established at the Bank as presently proposed:

*To whom should the Bank be accountable?*

The accountability of the Monetary Policy Committee is well-established. The prime accountability to Parliament is through the Treasury Select Committee. In addition the Treasury appoints all four external members, and the Governor and Deputy Governors are also appointed by Government. Together with the commitment to transparency and open communication, this has worked reasonably well, although I have commented before that the Select Committee has tended to concentrate too many questions on the Governor during hearings, and therefore not always managed to shed light on differences of view between MPC members. The role of the Court has been to assure itself that the processes of the MPC are working well and that all MPC members feel they have access to adequate resources in order to carry out their role. The Court also establishes the remuneration of MPC members.

There are different aspects of accountability, and the Court is well-placed to play the role of ensuring that the processes and resourcing of the FPC are both satisfactory. More important of course is accountability in terms of questioning about decisions and their rationale—why and how judgements about policy have been reached and the range of views across the membership of the FPC. The Treasury Select Committee seems better-placed to carry out this function than does Court—not least as its hearings take place in public. As with the MPC, there will of course be considerable discussion and robust challenge in the press, among relevant academics and from the representatives of financial institutions and individuals directly affected by the FPC's decisions. As an MPC member I looked hard at the arguments on monetary policy raised in these wider discussions, and the FPC members will presumably do the same.

However, if the FPC is to be independent, it must also be true that accountability will not include any body—either the Court or the TSC, having the ability to direct the FPC to alter its decisions, or to take any particular decision.

June 2011

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### Written evidence submitted by Professor R Bob Garratt

#### PERSONAL STATEMENT

This submission is entirely personal. It does not represent the position of KPMG LLP to which I am the Advisor on Board Effectiveness and Corporate Governance; nor of Cass Business School where I am a Visiting Professor in Corporate Governance; nor of the University of Stellenbosch where I am Chairman of their Centre for Corporate Governance in Africa.

Moreover, I was asked to appear before you just as I was leaving for three weeks writing in France and I will return just 24 hours before I sit before you. As I had chosen the villa for total quiet—it has no landline, very bad mobile phone connection, no internet connection and intermittent email connection—I have had to rely on those papers that I could hurriedly take with me. These are the uncorrected transcript of the oral evidence of your 24 May meeting and HM Treasury's *A new approach to financial regulation: building a stronger system*. Thus my preparation is not of my usual rigour.

I must rely, therefore, on two things. First, my intelligent naivety—something I develop with the boards to which I consult and of which I have chaired. Second, on my personal experience of *corporate* governance rather than *national* governance. This covers some 30 years across five continents from multinationals to not-for-profits. I was on the international expert panel of the IMF's Independent Office for Evaluation proposing the reform of its corporate governance (sadly now on pause during the Western Economic Credit and Debt Crisis); worked with the Saudi Arabian Monetary Authority on the development of its corporate governance and, especially, the creation of a truly professional regulator through the national development of Banking Supervisors and Inspectors; and am working with the South African Public Investment Corporation on developing a new investment assessment matrix. I must stress also that I am not a macro-economist and have no wish to be.

#### POSITIONING STATEMENT

I have a rant to my students that national governments tend not to want to understand corporate governance. If they did, they would have to work within a carefully-evolved corporate legal framework and this would erode their feeling of absolute power. Having seen the current mess at Network Rail and, especially with the NHS Foundation Trusts, I can only surmise that both ministers and senior civil servants have a vested interest in adopting only those aspects of effective corporate governance which preserve their direct powers, regardless of those accountabilities that the Board of Directors is meant to have. An extreme example are the NHS Foundation Trusts. They now have *two* boards both of which the Chairman chairs thus guaranteeing potential conflicts of interest. Matters are then made worse by the Accounting Officer being the Chief Executive, not the Chairman. Thus the Chief Executive can short-circuit any board decision by going straight to the Department of Health, the regulator or the minister to argue for negating any decision with which they disagree. This is corporate governance nonsense and I hope that your committee will ensure that your work on the Accountability of The Bank of England does not fall into this trap.

There are solutions and, when I did some work with the UK's Shareholder Executive on the corporate governance of State Owned Enterprises, I was delighted that the Financial Services Agency and the Financial Reporting Council were allowed to become Companies Limited By Guarantee thus making themselves legal entities under the Companies Act. The Bank as a legal entity is a banking company with a single shareholder so I recommend strongly that it follows the basics of the 2006 Companies Act and the 2010 Corporate Governance Code to allow it to have well-defined and legally-tested guidelines that will act as comparators for its own corporate governance structure and processes. With the Prudent Regulation Authority morphing from the FSA that has limited liability status I trust that the PRA will have the same legal status, albeit a wholly-owned subsidiary of The Bank.

Legally the Financial Conduct Authority is a puzzle to me. It is said to be an independent body but appears in red in the Treasury Report's drawing as if were part of The Bank. I have been assured that it is not. If so, then the designer of this diagram would be failed if they were a student of mine. I do hope that the FCA is given also the status of a Company Limited By Guarantee.

#### *What is Corporate Governance?*

I have chosen to focus here on the 2006 Companies Act because the UK has now consolidated some four centuries of learning how to run effective and efficient organisations and I see no reason to go against this. My analysis is based, therefore, on the way I would analyse any corporation.

To quote the doyen of UK corporate governance, Sir Adrian Cadbury, *corporate governance is the process by which a company is directed and controlled*. This deceptively simple statement poses the eternal question for a board of directors—how do we drive this company forward whilst keeping it under prudent control? Most boards over-concentrate on the safer world of supervising their executives than the more intellectually challenging world of looking ahead—“horizon-scanning”—and trying to ascertain emerging trends ahead of the competition in the worlds of politics, physical environment, economics, social change, technology, and global trade movements. In a dynamic external environment there is no single answer to these questions. It is the Directors’ Dilemma—which is why we have a board of directors; and in an unstable environment it means that the directors need to meet at least monthly to review these. After all, they are legally bound as statutory directors 24 hours of the day and seven days of the week and so have to do their horizon-scanning “homework”. They are not just directors during board and committee meetings.

We have known the director’s dilemma for at least 3,500 years. “Governance” derives from the Greek *kubernetes* which refers to the steersman of a ship (giving direction) and the feedback in real-time of the consequences of that direction. In modern parlance we use nearly the same word—*cybernetics*—for this feedback.

The Companies Act is based on a four-level hierarchy:

- The Owners.
- The Board of Directors.
- The Executive.
- The Staff.

The Companies Act, and even more clearly the Insolvency Act, hardly ever mentions the Executive and focuses on the accountabilities of the *statutory* directors—not people who dream up the job title of “director” for their convenience. Indeed it is illegal to call yourself “director” of a company if you are not registered personally as a statutory director at Companies House. However, government and civil servants often tend to flout this aspect.

The Owners

I find it hard for me to enter this aspect of your Accountability debate. I assume that the owners are the UK public and that it is to Parliament that The Bank is accountable. The Treasury Committee has an oversight role of The Bank’s behaviours and performance whilst the Treasury comments on this performance and in extreme circumstances can intervene as government. I may be wrong here but I am sitting in the hills of the pre-Alps on the Cote D’Azur without the internet. However, of one thing I am certain, a board of directors must have a single line of accountability to the owner/s and, without it, it is sunk.

#### THE ANALYSIS OF THE BANK’S CORPORATE GOVERNANCE

Any analytical process of corporate governance must follow through a sequence of fundamental questions once the question of ownership is resolved.

*Status as a legal entity?*

As I have said, I believe it is a legal entity with a single share held by government—but I have no access to its constitution.

*The Purpose of The Bank of England?*

The simplest statement I can find at present is that *The Bank is independent in its abilities to set the operating instruments for monetary policy and financial stability*. This is clear but one can see that there will always be fights with the Treasury about the power to set national macro-economic policy especially in relation to short-term political imperatives.

*The Vision and Values of The Bank?*

What would The Bank look like and how will its key performances be measured twenty or thirty years down the track? This question is of national importance and I am unqualified to answer it.

From these fundamental questions flow the following:

*What is the appropriate Culture of The Bank?*

How is emotional climate measured and how is this tracked over time to become The Bank’s culture supporting its Purpose? We know that for some 400 years the values of Accountability, Probity (honest dealing) and Transparency have been proven as the basis for effective and assessable governance. How will such values and behaviours be assessed on a regular basis from the Court down through its organisation?

*What is that appropriate Structure for The Bank?*

I shall attempt to answer this question below.

Beyond that there are other key questions to answer which are beyond the scope of this paper but which I am sure the Treasury Committee is considering:

*What is the appropriate Business Model for The Bank?*

*What is the appropriate Strategy Development process for The Bank?*

*What is the appropriate Executive oversight and control mechanism for The Bank through the Court?*

However, there are some fundamental issues of corporate governance best practice upon which I wish to comment.

#### THE BANK AS A COMPANY

Despite the high status, even grandeur, in which The Bank is held nationally and internationally, I am puzzled that, in the papers I have before me, the mindset of The Bank as an *organisation* seems to be missing. The papers read more like a fight for national macro-economic power when I feel that the Accountability debate needs to address more than the previously mentioned four-level hierarchy which is valid for any organisation. So I have some more corporate governance-focused questions:

*Is The Court a Board of Directors?*

If so, then more attention must be given to the centrality of its role and those of its statutory directors. If not, then does the Governor have absolute power over the Court and the Executive? I find it difficult to determine in the papers I have before me. If the Governor does have absolute power through being both Chairman of the Court and effectively Chief Executive, then this breaks one of the founding tenets of effective corporate governance.

I make the assumption that the reason there is a Court is to ensure two separate outcomes that ensure an effective and efficient organisation. First, that The Bank needs an “horizon-scanning” process that has sufficient diversity within it to ensure that the complex factors affecting the setting of operating instruments for monetary policy and financial stability—in the political, physical environmental, economic, social, technological and global trade trends—are clearly focused to enable The Bank to take wise decisions in times of uncertainty. Second, that the Governor, as Chairman, does not have absolute power that, as under the Companies Act, the Court is collegial with one vote each.

How do the Directors drive The Bank forward whilst ensuring that it is kept under prudent control? In Company Law there are some useful distinctions. A “Chairman” is Chairman of the Board of Directors, not of the Company. A “Chief Executive” is head of the day-to-day operations of the company. Chief Executives do not have to be on the board but, if they are and become, therefore, a registered statutory director, then their correct job title is Managing Director. Companies and governments tend to be very sloppy over their use of such job titles.

I stress again that Boards of Directors are collegial and have one vote each around the boardroom table. The Chairman of the Board may have a casting vote depending on the company’s constitution. The efficient chairing of the board is the responsibility of all the directors, ensuring that sufficient airtime is given to different and diverse views around the table. The chairman’s role in the debate leading to the board’s judgement is essentially neutral during this process. He must not lead the others and should give his opinions last. But he must bring the board to a decision. I shall deal with this aspect in detail later when I consider “groupthink”.

The best explanation I had for the board’s role came from the late lamented Sir Brian Pitman with whom I worked for 10 years on the Lloyds TSB Director Development programme—*the Board’s role is always to take into account the reasonable demands of the owners, the cost of capital, and to ensure the long-term health of the business (the fiduciary duty)*. As someone who doubled Lloyds and then LTSB’s shareholder value every three years for fifteen years no wonder he was so angry with the behaviour of the Banks leading up to the Western Credit and Debt Crisis. He stressed the importance of the board holding together against the unreasonable demands of shareholders, their independence of thought and that they must be prepared to resign rather than bow to unreasonable demands.

If the Court is to behave as a board under the best practices of the Companies Act 2006, then it is important that they have robust induction, development, annual evaluation and dismissal processes for the board, its committees and individual directors so that they follow the Seven Non-Exhaustive Duties of directors set out in the Act:

- To act within their powers—ie the company’s constitution.
- To promote the success of the company.
- To exercise independent judgement.
- To exercise reasonable care, skill and diligence.
- To avoid conflicts of interest.

- Not to accept benefits from third parties.
- To declare interests in third party transactions.

These are based on the judicial experience of corporate governance generally over the last 200 years. I believe that the Court does have already grounds for dismissing a director concerning unreasonable absence, bankruptcy and unfitness for the post. But does it have robust induction, development and appraisal processes?

It should be noted that the Companies Act does not use the nonsensical titles of “executive director” or “non-executive director” but only “statutory” directors. If an executive is promoted to the board and made a statutory director, then they would need both a contract of employment as an executive and, as with all statutory directors, a separate contract for services as a director. In this way all statutory directors enter the boardroom on equal terms and can exercise better their independent judgement as a statutory director. And an effective chairman ensures a board culture where, if a Chief Executive tries to bully an executive who is also a statutory director before or after a board meeting (part of enforcing groupthink), then there is swift retribution on that Chief Executive.

If the Court is to be a working board, then it would need a committee structure, and a crucial officer role—that of the Company Secretary. This is a key role to ensure the board fulfils its legal roles within its constitution but one that reports to and supports the Chairman, not the Chief Executive. The Company Secretary ensures the timely filing of its reports and papers but is also the neutral observer of board process and dynamics, commonly referred to as being “the conscience of the board”.

### *Committees*

All properly constituted boards have a delegation process which ensures that some of the board work is given to smaller work groups—“committees”—although the full accountability for these groups is still the board’s. Here we come to the nub of the immediate problem if the Court is to be a proper board. All committees are subsets of the board. I am struck by three issues:

First, that here is a great fight over the accountability of the Financial Policy Committee. Yet it is spelt out that their accountability is to the Court. What is the problem? This is normal practice and I can see no argument for deviating.

Second, all seem happy with the accountability of the Monetary Policy Committee to the Treasury Committee. I am not, as it seems curiously to be based in The Bank but accountable directly to the Treasury Committee under The Bank of England Act. To me this seems nonsensical, highly undesirable and liable to end in tears just like the NHS Foundation Trusts. Surely, if it is a Committee of The Bank, then it must report to the Court and the Court reports to Parliament?

Third, there seems to be a lack of an Audit Committee which is an essential for any company. My simple assumption is that the Court needs one. I assume also that the National Audit Office has the oversight of the financial probity of The Bank with the Public Accounts Committee as a back stop, but that the usual accountability process for The Bank as a whole lies with Parliament through the oversight of the Treasury Committee.

It should be pointed out that there is a high probability in future of company reporting being on the annual “Triple Bottom Line”—financial, impact on the physical environment, and impact on the communities within which it exists. As this is in part built into the EU Green Paper of May 2011 will this become part of The Bank’s Vision statement?

### *The Accountability of the Executive*

I am puzzled by the seeming lack of interest shown in the papers of the need for the Court both to acknowledge and to ensure the prudent control of the day-to-day executive functions of The Bank. This is a perennial dilemma for any board—how do we ensure a level of certainty over the performance of the executive functions of the business without trying to micro-manage the executive from the boardroom table?

If the Court is to function as a board, then it must address this issue—it is half of the Directors’ Dilemma. There are a number of ways of doing this but the most effective is to have one or two “dashboards” where the key indicators of executive and total performance are flagged up on a regular basis, usually monthly, to enable the board to feel confident that all the varied and linked aspects of the organisation are synchronised. This is usually done in terms of agreed trend lines and ratios. In advanced corporations this can be done in real-time and my colleague, Ram Ramakrishnan in Singapore, could help you with this aspect.

The Bank has many other operations rather than the very publicly debated ones and has also a staff, suppliers, other agents and stakeholders whose performance and rewards need to be kept under prudent control through oversight by the Court.

### *Board Dynamics and Groupthink*

Although boards are often referred to as “top teams”, they are not normal teams. They do not work together continually so they have to be able to build sufficient trust in each other’s care, skill, diligence and probity that they can quickly get up to speed when they do meet. Technically they are “teams apart” rather than “teams

together". Yet they obey the usual dynamics of any working group. Behavioural psychology has progressed so much since the 1940s that we have a vast bank of knowledge on which to draw. Some aspects are basic. For example, we know that any group of less than four people will not have sufficient diversity within it to be able to take a broadly-based decision; and that groups over twelve spend so much time managing themselves that they devote too little time to their primary purpose. My own work shows that most people joining boards have a career in the executive aspects of a business and, unless carefully inducted and developed out of this mindset, tend to try and micro-manage the company from the boardroom table. My researches into the thinking preferences of UK directors show that they tend to value strongly "soft facts" (sensing of the immediate environment backed by a fierce ability to rationalise their position) and value least "hard facts" and the ingenuity to make the future happen. This lack of interest in implementing and having rapid feedback on their strategic decisions (the cybernetic loop) is a worrying factor in over 80% of the hundreds of directors I have assessed.

So the "tone at the top", as the current phrase has it, is determined by the quality of the chairman in understanding their role and ensuring the best use of the diversity, independence of thought and intelligent naivety around their boardroom table. The shadow side of this is the tendency for one or two powerful personalities to dominate the discussions and decisions, to block out different opinions and information and to create an emotional climate where acquiescence and yielding are dominant.

The classic example of this was the youthful John F Kennedy's administration's mishandling of the Bay of Pigs fiasco where at all the crisis meetings the President spoke first and gave his views, so members withheld vital information or differing opinions, there was little debate and fatally flawed decisions were nodded through. Within nine months the same administration was faced with the possibility of global nuclear annihilation with the Cuban Missile Crisis. This time the crisis team never knew if the President would appear at a meeting so they had to get on with it and argue out positions with much more diverse data. If the president was present, he usually listened and encouraged others to ask questions before he disclosed his position. The outcome was more positive and that may be why we all sit in this room today.

There was a young social psychologist present during that 12-month period, Irving Janis, and he was able to conduct a unique piece of field research which became a book—*Groupthink*.

The warning signs of groupthink in a group that sees itself as doing well are:

- **The illusion of invulnerability** (we are on a roll and nothing can touch us).
- **Collective efforts to rationalise** (we've seen this sort of thing before and it will sort itself out).
- **Unquestioning belief in the group's inherent morality** (people like us would never take an unethical decision).
- **Stereotyped views of rivals and enemies** (they are just a bunch of no-hopers who could never affect us).
- **Direct pressure on dissident group members** (listen, we know you have strong views on this but we have debated them before and time is pressing as we have a massive agenda ...).
- **Self-censorship** (gosh! If they are putting pressure on X, then I had better shut up even though I feel that they are missing crucial information).
- **A shared illusion of unanimity (silence is not assent—**the oldest chairman's trick in the book: in times of disunity do not make eye contact with any member of the board and say "well, I feel that we are all agreed on that" and move straight on to the next agenda item. You can always sort out the minutes with the Secretary later).
- **The emergence of self-appointed "mind guards"** (People who are not members of the group but who appear in the corridor just before a meeting and suggest strongly that you drop your line of questioning normally because "the old man is in a filthy mood today and you don't want to make it worse for yourself").

Whilst I would never suggest that such mighty players as the Directors of the Court of The Bank of England would ever fall prey to such groupthink, it may be worth the Treasury Committee ensuring that it is built into an aspect of the annual reviews of the Court, its Committees and individual directors.

## EPILOGUE

I hope that this trawl through the legal aspects of corporate governance, and my varied experiences around the globe seeking to develop more effective and efficient boards and organisations, helps the Treasury Committee in its deliberations. If I have fallen short on my preparation I apologise but do remember the unusual circumstances in which this paper was written.

June 2011

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**Written evidence submitted by Dr Gavin Bingham, Secretary General, Central Bank Governance Forum<sup>20</sup>**

**CENTRAL BANK ACCOUNTABILITY**

**HIGHLIGHTS**

Under the Government's proposals the Bank of England will have a broader mandate than in the past. A wide range of responsibilities is not without precedent. But having *explicit and distinct* mandates for both systemic financial stability and microprudential supervision, in addition to having a mandate for monetary policy, is new.

Wider responsibility will require increased accountability. The strong focus on objectives in the proposals will help in the application of a mechanism now widely used in monetary policy. This consists of requiring transparency about decisions made, actions taken and outcomes achieved with respect to clearly specified objectives and well articulated strategies.

Oversight by Parliament and the Chancellor will be a critical element in accountability arrangements for a more powerful institution. Financial stability objectives cannot be given the same degree of measurable precision as monetary policy objectives, and assessing success or failure in pursuing a strategy and achieving an objective requires a degree of judgement. These reviews will need to cover policy decisions and the consistency among monetary, macroprudential and monetary policies.

A strong, impartial and properly constituted oversight board ("Court") can play an important part in holding the central bank to account for process and the stewardship of resources. This complements the oversight of policy by Parliament and the Chancellor.

The specific issues that deserve close attention by Court are:

- The operation of, and processes used by, the various committees, including appraisal of performance against objectives.
- The question of the financial position of the Bank in the performance of financial stability and other functions.

The challenge will be to constitute Court so that its members have appropriate experience and expertise and are free of conflicts of interest. There are a range of governance procedures that can be used to help ensure that Court operates in this manner.

**INTRODUCTION**

The purpose of this note is to provide information that will help address the Treasury Committee's basic concern: how to make a more powerful institution more accountable? It does so by comparing the proposed new arrangements for the Bank of England with the governance arrangements of other central banks.<sup>21</sup>

It considers the breadth of the Bank's mandate, the use of separate committees for policymaking in different areas and the applicability of different accountability mechanisms to the expanded financial stability mandate. It focuses in particular on the role of oversight boards in the accountability process.

The understanding of financial stability policies and of their interaction with other public policies is developing rapidly. The distinction between micro- and macroprudential policies is sufficiently new that there is not a universally agreed understanding of their components. Nor is the distinction even universally recognised. Hence designing specific governance arrangements for these policy functions involves breaking new ground.

The BIS has just published a report on the implications for central bank governance of financial stability policies. The report was prepared by a Study Group chaired by Stefan Ingves, Governor of the Riksbank. It is entitled *Central Bank Governance and Financial Stability*. This note draws on this report and a previous one prepared under the auspices of the Central Bank Governance Forum, *Issues in Central Bank Governance*.<sup>22</sup>

**MANDATE OF THE BANK OF ENGLAND**

The proposals foresee supplementing the Bank of England's current monetary policy mandate with an expanded financial stability mandate covering both micro- and macroprudential policies. This will give the Bank a wide mandate, but not one without precedent. A number of central banks have as wide or even wider mandates than that proposed for the Bank of England, though there is none that has exactly the same configuration of responsibilities.<sup>23</sup> The Bank of England has, and will continue to have under the new proposals, a fairly narrow range of operational responsibilities. Unlike many other central banks, it has little

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<sup>20</sup> The views expressed do not necessarily reflect those of any of the institutions, bodies or fora with which I am associated. I wish to thank David Archer, Serge Jeanneau and Paul Moser-Boehm for valuable contributions.

<sup>21</sup> The proposals for the reforms at the Bank of England are contained in three consultation documents issued by HM Treasury. See [http://www.hm-treasury.gov.uk/consult\\_financial\\_regulation.htm](http://www.hm-treasury.gov.uk/consult_financial_regulation.htm), [http://www.hm-treasury.gov.uk/consult\\_finreg\\_strong.htm](http://www.hm-treasury.gov.uk/consult_finreg_strong.htm) and [http://www.hm-treasury.gov.uk/consult\\_finreg\\_blueprint.htm](http://www.hm-treasury.gov.uk/consult_finreg_blueprint.htm).

<sup>22</sup> Both reports can be found at <http://www.bis.org/publ/other.htm>.

<sup>23</sup> See Table 2 in *Issues* (op cit).

or no formal role in areas such as infrastructure provision, market development, debt management and general economic advice. It does, however, issue bank notes, collect statistics, act as banker to the Government and manage the Government's foreign exchange reserves. In the area of financial stability, the Bank will have a wide, and most notably, explicit mandate with clearly articulated objectives. There is also a clear distinction between micro- and macroprudential responsibilities.

Most central banks have some form of responsibility for financial stability (see Figure 1). However, the basis for this responsibility varies, as does its character.

- In around two thirds of cases, stability of all or parts of the financial system is mentioned as a central bank objective in the governing legislation, and in most of those cases, the objective relates to the financial system as a whole and appears to be relevant to all of the central bank's activities. In other cases, the financial stability mandate is tied to legislated responsibilities for microprudential supervision and/or for ensuring the soundness of parts of the financial infrastructure (payment and settlement systems, in particular).
- A number of central banks discharge functions that are related to financial stability (such as those mentioned in the preceding point) but there is no explicit objective of financial stability associated with those functions, or for the central bank as a whole. That they discharge related functions may provide a basis for inferring the existence of a financial stability objective. However, as noted in the Ingves Report, other objectives may equally be inferred (eg consumer protection, efficiency, competitiveness). Explicit objectives make it easier to hold a central bank to account.
- Only a small number of central banks have mandates that explicitly cover macroprudential policy, or that make a distinction between microprudential policy and policies oriented to overall systemic stability. By virtue of recent legislation in the European Parliament, the central banks of European Union countries have a specific role in relation to macroprudential policy—via their participation in the European Systemic Risk Board. Some also have microprudential responsibilities. By virtue of the Dodd-Frank Act, the Federal Reserve now has a mandate that has both microprudential and distinct macroprudential elements. Following the passage of a new law in 2009, Bank Negara Malaysia, the central bank of Malaysia, now has explicit authority to take regulatory actions that are motivated by financial system wide considerations, over and above its long-standing authority to take regulatory actions motivated by considerations specific to individual supervised institutions.

In the proposed arrangements for the Bank of England, the differentiation between micro- and macroprudential policies that will be embedded in the powers, objectives, and institutional structures of the Bank is more articulated than in these other cases. The markets for wholesale financial instruments (repos, interbank claims, commercial paper, foreign exchange, etc) in which the Bank conducts its operations are critical for systemic stability. The Board of the Prudential Regulatory Authority (PRA) will be responsible for the supervision of institutions active in these markets, and the Financial Policy Committee (FPC) will be able to require or request action by the market conduct regulator to insure the integrity and continuity of these markets. If these markets are not sufficiently deep, liquid and continuous, the central bank may find itself in a position where it needs to act as market-maker of last resort.<sup>24</sup>

#### *Decision-making*

The most noteworthy feature of the Government's proposal is that decision-making on monetary policy, macroprudential policy and microprudential policy will take place under the roof of a single authority, the Bank of England. In the past, decisions relevant for financial stability were made by the Bank of England, the FSA and the Treasury under the tripartite arrangements. To offset the concentration of power that will result, the proposals limit the scope of the Bank's decision-making power by giving the Chancellor the discretionary power to lay down a remit for financial stability policy. In addition, they foresee internal checks and balances in how policy decisions will be made. Instead of being made by a single board, they will be made by three different committees: the FPC, the PRA and the Monetary Policy Committee (MPC) of the Bank. Each committee will have a separate institutional grounding, a different decision-making procedure and different oversight mechanisms.<sup>25</sup>

The use of multiple committees for decision-making is not new in central banking.<sup>26</sup> They are sometimes found in countries where the central bank has a wide mandate. Malaysia is one of the few countries with a

<sup>24</sup> See Bingham T R G (1990) "Securities Markets, Systemic Stability and Regulation: the Macroprudential Dimension", Journal of International Securities Markets.

<sup>25</sup> The FPC will be a committee of the Bank of England's Court of Directors. The PRA Board will be the board of a wholly owned subsidiary of the Bank. Both of these will operate along the existing MPC which is a committee of the Bank and has a separate statutory basis that would not be altered. Decisions on the specific operational objective for the MPC—the inflation target—will be made by the Chancellor outside the Bank. The decisions of the MPC are explicitly excluded from review by Court and not subject to override by the Chancellor. The Court of Directors will continue to have responsibility for "managing the affairs of the Bank other than the formulation of monetary policy". See "Governance of the Bank" at <http://www.bankofengland.co.uk/about/governance/index.htm>.

<sup>26</sup> See Tables 1 and 2 for information on multiple committees and decision making in central banks that are bank supervisors.



central bank with a separate committee for systemic stability.<sup>27</sup> Assigning responsibility for macroprudential policy decision-making to a specialised committee inside the central bank is one of a number of approaches.<sup>28</sup>

One of the advantages of multiple committees is that they permit more specialised expertise to be brought to bear—thereby contributing to better decisions. They also help to deal with concentration of power and introduce internal checks and balances to the policymaking process, particularly if there are external members (ex officio or appointed).<sup>29</sup> Multiple committees also make it more likely that conflicts between objectives and actions will be recognised. The main disadvantages of multiple committees are that extraction of potential synergies is more difficult, that more time is spent in meetings and that there is no mechanism for ensuring the coherence of multiple sets of policies. A challenge under the new arrangements will be to find some such means.

Having one and the same person chair the committees is a common mechanism used to try to foster coherence among policy decisions. He or she can ensure that matters of concern to one committee are brought to the attention of the other(s). In virtually all central banks that have multiple policy committees, the Governor serves as the chair. This clearly poses challenges in terms of time because in addition to being the chair of the policy committees, the Governor serves as the CEO and chief spokesman.

Having overlapping membership in policy committees is another common way to deal with the challenges of coordination. Examples will be found in Malaysia, Thailand and the United States. The inclusion of individuals other than the Governor in the overlapping membership helps to address the question of the concentration of power that arises when the Governor chairs all the committees. However, if the overlapping membership is confined to internal members who depend in some way on the Governor for appointment, remuneration or advancement, the checks and balances are diluted.

In principle, conflicts can emerge between any of the three sets of policies: monetary, microprudential and macroprudential. The experience of central banks that have long had both monetary policy and microprudential (ie regulation and supervision of specific institutions) mandates is that significant conflicts between these two types of policy are rare in practice though they may arise in theory. Since macroprudential policy is in its infancy, the likelihood of conflicts with other policies is difficult to predict. Still the potential risk of conflict is likely to be greater if only because macroprudential measures can be triggered by macroeconomic or market-wide developments. Clearly monetary policy choices matter for individual institution soundness and the behaviour of the overall financial system. Likewise, choices on regulatory policy, whether with a micro- or macroprudential orientation, matter for monetary policy.<sup>30</sup>

It is useful to have means to ensure coherence among the three sets of policies. The design of mechanisms for achieving this is a challenge. The proposals provide several such mechanisms. The procedures for articulating objectives and the nature of the oversight arrangements imply that Parliament and the Chancellor are ultimately responsible for the resolution of important policy conflicts. The focus of the accountability arrangements is, however, on the operation of the individual policies and the committees that make the policy decisions. The question therefore arises about how to assure accountability for the overall mix of monetary, micro- and macroprudential policies.

#### OVERVIEW OF ACCOUNTABILITY MECHANISMS

In the past two decades a number of concrete statutory and customary procedures have been developed to hold central banks to account for the effective performance of public policy tasks and the responsible stewardship of society's resources.<sup>31</sup>

##### *Transparency about objectives, actions and outcomes*

Accountability mechanisms are particularly well-developed in the area of monetary policy.<sup>32</sup> The procedures consist of setting clear, measurable objectives and employing various mechanisms to shed light on the decisions made, actions taken and the reasons for them. There are differences across countries in how the procedures are applied. For example, in the United Kingdom the Chancellor sets an inflation target whereas in the case of the euro area the ECB announces the outcomes it considers compatible with its statutory mandate. In still other jurisdictions, objectives are set jointly by the central bank and the government. Irrespective of how the objective

<sup>27</sup> The Malaysian case is limited by comparison with the FPC proposed for the Bank of England in that the Financial Stability Executive Committee has a mandate that is limited to considering specific proposals by Bank Negara Malaysia for regulatory actions under certain authorities. It does not have wide-ranging responsibilities to identify threats to financial stability and design policy responses to mitigate those threats.

<sup>28</sup> The recent report *Central Bank Governance and Financial Stability* (op cit) discussed four potential configurations of decision-making arrangements for macroprudential policy that involved the central bank. Under two of these configurations, the central bank had responsibility for both monetary policy and macroprudential policy; the difference between these two hypothetical cases being the location of responsibility for microprudential supervision.

<sup>29</sup> The proposals foresee both ex officio and appointed external members for both the FPC and PRA. The MPC will continue to have appointed external members.

<sup>30</sup> For a discussion of the relationship between monetary and macroprudential policies see "Macroprudential instruments and frameworks: a stocktaking of issues and experiences", CGFS Papers, No 38 May 2010 <http://www.bis.org/publ/cgfs38.htm>.

<sup>31</sup> The mechanisms used to foster accountability are discussed in Chapter 7 of *Issues* (op cit).

<sup>32</sup> Information on the emergence of explicit targets and monitoring ranges for monetary policy can be found in Table 16 of *Issues* (op cit).

is set, the procedure permits the ultimate beneficiaries of the public good of price stability to determine whether the institution is meeting its price stability objective. This is because the objective can be measured and observed by all concerned. Because of this, there is less need for methods of control exercised by those who have different agendas, time horizons or incentives.

Similar procedures can in principle be used in the area of financial stability. The performance of policymakers, their accountability and the management of trade-offs are enhanced by clear objectives. Clarity of responsibilities in the area of financial stability is made all the more important by the need for greater collaboration with other authorities. Knowing who is responsible for what at different stages of a crisis can aid rapid decision-making. And clarity about responsibilities and powers also helps promote accountability.

The Government's proposals pay considerable attention to framing financial stability objectives for the various committees, and this should help those committees understand their respective responsibilities, and help hold them to account. The proposals provide for the establishment of high level objectives that are more fully articulated in published strategy statements. Similar arrangements exist for monetary policy in the United Kingdom. They also exist in the 2009 UK Banking Act for the current financial stability responsibilities of the Bank. The Government's proposal for objective setting for the Bank of England, and the specific committees, is consistent with this approach. The intended remit that the Treasury will publish and periodically update provides a suitable vehicle for publicly articulating a strategy.

But, specifying objectives for financial stability policy is not easy. Turning such objectives into measurable yardsticks against which to assess progress is harder still. Assessing success or failure in pursuing a strategy and achieving an objective requires a degree of judgement. Ex post evaluation of *outcomes* against objectives is difficult, in view of time lags, and difficulties in disentangling the particular contribution of policy actions (or inactions) to such outcomes. An additional challenge in the case of macroprudential policy is that it is likely to meet vigorous resistance during the benign part of the business cycle and that its ultimate success—avoiding financial instability—has to be judged against a counterfactual. Furthermore, when a financial stability objective is added to an existing monetary policy objective, transparency alone will not help to determine which should take precedence if there is a conflict between them. For these reasons, processes of review performed by informed and impartial parties are needed to complement accountability through transparency.

#### *Reviews of performance of public policy tasks and the stewardship of resources*

Reviews of performance are generally conducted or commissioned by parliamentary committees, government ministries, oversight boards, external auditors, public sector auditors, international organisations and panels of experts. By and large, parliamentary committees and government ministries are responsible for the review of policies, whereas oversight boards are responsible for establishing procedures, monitoring processes and overseeing the use of resources.<sup>33</sup> The two forms of review overlap and are complementary.<sup>34</sup> Although most countries make use of a combination of the various review processes, not all processes are used in every country. For example, in Chile the central bank is explicitly exempt from review by the General Comptroller of the Republic and the Superintendent of Bank and Financial Institutions for reasons of autonomy.

The relative importance of different review processes in holding a central bank to account depends on history, the political system and the place of the central bank within it. The central banks in the Nordic countries were made subject to review by Parliament from the outset because of the desire to keep control of money creation separate from the King and the government. In countries where central banks were originally organised as private chartered companies (United Kingdom, France, Netherlands) and subsequently nationalised, the government often assumed the rights of control of the shareholders. Ministerial oversight has correspondingly tended to be greater in these countries. In recent years, however, greater reliance has been placed on parliamentary committees and oversight boards because of concern about time inconsistency associated with oversight of monetary policy by the government of the day.<sup>35</sup>

The review processes need to be designed so that they do not compromise the institution's autonomy. **Financial stability policy needs at least as much independence as monetary policy.** It is subject to the same sort of time inconsistency problems. Moreover, financial stability policy, unlike monetary policy is subject to very strong pressure from vested interests, especially the financial industry, which has effective means to advance its interests. Strong accountability arrangements reinforce independence because they give legitimacy to the institution's actions, address potential conflicts of interest and help safeguard its reputation.

#### *Ex post reports, ad hoc inquiries and other accountability mechanisms*

Ex post reports on actions taken and resources used are essential inputs into the review process, and can be a component in the transparency process if they are made public, as is often the case.<sup>36</sup> In addition to regular

<sup>33</sup> According to *Issues* (op cit), most central banks are accountable *de jure* to Parliament and official reviews occur regularly in about two fifths of the 47 cases surveyed, whereas ad hoc reviews on special request occur in half the cases.

<sup>34</sup> Legal provisions are often framed to ensure that the board oversight will be complementary to that of Parliament and government, for example, by excluding members of Parliament and government from central bank boards, as in France, Ireland, Sweden, the United States and a number of other countries.

<sup>35</sup> See Table 17 of *issues* (op cit) for information on the frequency of reviews by the legislature.

<sup>36</sup> See Table 18 and Figure 41 in *Issues* (op cit) for information on statutorily written reports to the legislature and the actual frequency of such reports.

reports, ad hoc enquiries are commonly used to evaluate the performance of decision-making bodies. These may be commissioned by any of the review bodies. The Bank's Court has used the procedure on occasion to assess performance and process.

A number of other accountability mechanisms are also applied to central banks. They include consultation requirements, legal recourse and veto or override provisions. Rulemaking and enforcement actions are often subject to consultation requirements and the right of appeal. Both serve as checks and balances to prevent abuse of authority and ensure respect for due process.

Legal recourse is a standard and important part of the accountability framework, especially for regulatory and supervisory actions. Central banks and regulatory authorities often enjoy a degree of legal protection so they can perform their functions without facing the encumbrance of nuisance litigation, but this protection is not unlimited. Legal challenge can be made on grounds of gross negligence, misfeasance or action *ultra vires*. It is far more common for supervisory and regulatory decisions than it is for monetary policy actions.<sup>37</sup>

Override provisions exist in some form in about a fifth of all central banks, including the Bank of England. Since they permit the decisions of the central bank to be suspended or reversed, they are more intrusive than a reporting requirement or an ex post review process. Concern about autonomy has meant newer central bank legislation often does not contain such provisions. In the case of the United Kingdom, there is an explicit exemption for monetary policy. The question arises whether there should be a similar one for financial stability decisions, given the equal or stronger arguments for autonomy.

#### OVERSIGHT BOARDS

The Bank of England, in common with about two thirds of world's central banks, has a board consisting of a majority of non-executive directors who perform oversight functions (Tables 1 and 3). Oversight boards tend to be found in older central banks that were originally established as, or modelled on, companies with boards of directors, such as the Bank of England. In the case of the Nordic countries, the oversight boards often serve as agents of the legislature. They consist entirely of non-executive directors and accordingly have a non-executive as chair. They play an important role in the appointment of the Governor and senior policymakers, but their oversight of the day-to-day management of the Bank is not, and never has been, as close as that of oversight boards that evolved out of management boards. Newer central banks that were established *ab initio* as public agencies sometimes do not have oversight boards at all (eg ECB and Bank of Japan).<sup>38</sup> In these cases, the oversight is performed through some combination of the review processes cited above.<sup>39</sup>

Many of the boards that now exercise an oversight function used to make decisions on operational matters such as the interest rates applied to central bank transactions.<sup>40</sup> For example, the Court was involved in setting Bank Rate up till 1957, though in later years its involvement was a formality. In the United States, the boards of the Federal Reserve Banks still formally decide upon the discount rates that each Reserve Bank applies.

The evolution of central bank boards into bodies responsible for oversight rather than for management of the bank or policy decisions is an ongoing process. In recent decades, it has been the consequence of three developments. The first is the creation of distinct monetary policy committees responsible for deciding on key short-term rates. The second is the need for greater accountability as the counterpart for greater autonomy in the pursuit of price stability. Stronger oversight by boards of directors complemented increased parliamentary scrutiny and greater disclosure about decisions and deliberations. The third is the development of more rigorous governance principles and procedures in the wake of a series of corporate scandals and financial crises.

#### *Board functions*

The basic function of a supervisory or oversight board is to hold management to account on behalf of the principals. In the corporate world, a supervisory board acts for shareholders whose ownership rights may be widely spread, reducing the ability and incentive of each principal to monitor and control management. In the central banking world, the motivation for a supervisory board is different. It provides an agency through which the government and legislature, which are themselves agents for principals (the wider public, including future generations), can exercise their oversight responsibilities. Oversight boards may also help shield the institution from short-term political pressures, cronyism or pressure from vested commercial interests.

The essential role of modern central bank oversight boards relates to ensuring the operational effectiveness of the institution (Table 4). This has several dimensions, including approving bylaws and codes of conduct and overseeing compliance with them, reviewing and approving risk management policies, making decisions on major organizational changes, approving the operational budget and the financial accounts, deciding on the

<sup>37</sup> Cases involving monetary policy decisions have been brought to court in Japan, Thailand and Latin America.

<sup>38</sup> The United States constitutes a mixed case. The Board of Governors does not have an oversight board. However, the individual reserve banks do.

<sup>39</sup> Most central banks that do not have oversight boards are subject to audit oversight, often through a public sector auditor, though the remit of the auditor rarely extends to the assessment of policy or the policy process. If a central bank has an oversight board, it is generally oversees the audit process.

<sup>40</sup> The distinction between supervisory and management/policy boards is not always hard and fast. Some central banks, such as the Reserve Bank of Australia, have multifunction boards that are responsible for oversight and for significant management and policy decisions. In others, policy functions have been carved out and assigned to a separate committee, but oversight and management functions are still co-mingled in the board of directors.

allocation of the surplus and administering the audits. Oversight boards may also play a role in the appointment of senior officials not appointed by way of a separate statutory process and they may evaluate performance and decide on remuneration. The role that oversight boards play in ensuring the effective management of the institution can lead to the scrutiny of processes, including policy processes (Table 5).

Oversight boards often play an important role in the introduction of more rigorous governance principles and procedures, in keeping with trends to improve the productive efficiency of agencies of state (and sometimes prompted by corporate scandals and financial crises that elevate attention to good practice). The involvement of oversight boards in the hiring and firing of key policy decision-makers, in reviewing their performance and setting their remuneration, stands—like control over financial resources—at the junction of institutional effectiveness and policy. Selection of key officials and reviews of their performance must necessarily cover policy decision-making aptitude, but the assessment of policy decisions themselves is usually outside the board's purview.<sup>41</sup>

### *The powers of Court*

The powers of the Bank of England's Court of Directors are broad in some respects; narrow in others. They are broad in the sense that the legislation charges it with the management of all of the Bank's affairs other than the formulation of monetary policy. Within the limits set by legislation, Court has the power to determine which matters are reserved for it alone and which ones are delegated. It has decided to delegate all matters not reserved to itself to the Governor. It could revoke this delegation of powers or decide to delegate certain matters to other members of Court or other servants of the Bank. Like the oversight boards of the Federal Reserve and the Hong Kong Monetary Authority (HKMA), the Bank of England's Court has the power to assess the performance of the Governor and Deputy Governors. At the HKMA the oversight board (EFAC) conducts an annual performance appraisal of the Chief Executive that is similar in character to the one applied to HKMA staff members.

Court will play a role in overseeing the performance of the Bank's expanded financial stability functions, primarily by overseeing the use of resources and the processes that are applied. However, its role will vary from committee to committee depending on its institutional grounding. The FPC will be a subcommittee of Court and, in addition to overseeing its use of resources, Court will approve the Financial Stability Strategy and monitor performance against it. Since the PRA will be a wholly owned subsidiary of the Bank, Court will exercise some rights of ownership and control, including oversight of the PRA's financial arrangements and the appointment of Directors. However, its rights are circumscribed by the restrictions set out in the legislation that, for example, establish an *ex officio* chairman (the Governor). The relationship between the PRA and the Bank will be set out in the articles of association, which will be approved by the Bank. Court can help promote coherence of the Bank's policies by ensuring that these policymaking committees are appropriately resourced and adopt processes that foster synergies.

The Bank's—and correspondingly the Court's—mandate is narrow relative to some other central banks in three specific senses:

- First the Chancellor makes decisions that in a number of other jurisdictions would be made by the central bank itself. For example, the Chancellor sets an inflation target in the UK. In other countries, the target, reference level or monitoring range is set by the central bank alone or jointly by the central bank and the government.
- Second, the Bank has no formal role in shaping the legislation affecting the monetary and financial system. The Maastricht treaty provides that the ECB shall be consulted about any community or member state legislation in its field of competence. The ECB has made active use of the advisory powers that this article of the treaty gives it.
- Third, Court's decisions matter less for the financial strength of the Bank than in most other countries with oversight boards. In these countries, the oversight board decides on matters that determine how large the bank's buffer against future losses will be. In the United Kingdom, Court has less discretion. All seigniorage is turned over to the Treasury. The Bank's policy-related expenditures are covered by interest free balances placed by the banks with the Bank. The size of these balances is determined by the Treasury. Other operations such as the provision of banking services are funded with fees and charges. Half of any after-tax profit is paid to the Treasury.

The crisis radically changed the size, composition and risk characteristics of central bank balance sheets. Some of the operations that central banks undertook involved little financial risk, but on the whole the risk exposures of central banks increased. **Oversight bodies such as Court will need to make sure that the risk management procedures of the central bank are sound. They also need to ensure that the financial position of the central bank permits it to perform its monetary and financial stability functions at all times.** Measures taken in the aftermath of a crisis must also be subject to careful oversight arrangements. The authorisation of the Chancellor needs to be sought for exceptional operations that expose the public purse to loss.

<sup>41</sup> The Reserve Bank of New Zealand is one of the few central banks where the board is formally responsible for keeping policy decisions under review. The Board of Directors receives all the information used to make policy decisions and assesses whether the decisions were reasonable in view of the information available at the time they were made.

### *Size and composition*

Smaller boards consisting of a clear majority of qualified non-executives are widely viewed as more effective.<sup>42</sup> Virtually all central bank oversight boards have a majority of non-executive directors. In some cases (eg Sweden, Switzerland), they consist entirely of non-executive directors. The changes made to the size and composition of Court in 2009 have brought Court closer the median of ten for central banks (see Tables 1 and 3). With nine external and three internal members, the former clearly dominate, particularly when a non-executive serves as the chair.<sup>43</sup>

### *Need for impartial members with expertise*

Boards of directors need to challenge management.<sup>44</sup> Members need to be experienced, expert and impartial. In the past, members of central bank boards were often selected to represent different segments of society and in some cases (eg Belgium, Denmark) there are still rules that lay down which industries, regions and interest groups should be represented. The trend however has been towards appointing directors on the basis of expertise rather than sector.

In a number of cases, the law sets out qualifications for board members. In fact the legislation governing the qualification of oversight board members tends to be stricter for members of oversight boards than for members of policy boards. In two thirds the 30 central banks covered in a survey of central bank boards, there are explicit professional qualifications set out in the legislation or bylaws (Table 6). The bylaws of the Hong Kong Monetary Authority stipulate that the members of the oversight board should have expertise and experience that includes knowledge of monetary, financial and economic affairs, and of investment issues as well as of accounting, management, business and legal matters. In Ireland the list of relevant knowledge is even longer. It includes accountancy, actuarial science, banking, consumer interests, corporate governance, economics, financial control, financial regulation, financial services, insurance, law, social policy and systems control. Formal procedures to identify suitable candidates are set down in Israel and Australia, where the Minister of Finance and the Governor began in 2007 to compile and maintain a list of eminent, impartial and qualified persons suitable for membership in the Board.

The expansion of the Bank's mandate could make it increasingly difficult to find members of Court who are qualified, independent and prepared to devote sufficient time to their tasks. Members of the Bank of England's Court are paid GBP 15 000 per annum, chairmen of subcommittees GBP 20 000 and the chair GBP 30 000. The pool of potential candidates who will be prepared to devote sufficient time to a wider oversight function is limited. Many of those with the relevant expertise are likely to have a conflict of interest while those devoid of a conflict of interest may not have the relevant expertise. "Grey eminences" may be one source of qualified and impartial candidates, but it will still be necessary to have effective conflict of interest provisions.

### *Conflicts of interest*

As Court will exercise oversight over a more powerful institution with a wider range of responsibilities, it will be increasingly important to ensure that members are free of conflicts of interest. The relevant statutes in other countries often lay down criteria for impartiality. Although the codes of governance developed for private companies are not suitable in all respects for central banks, they often contain useful guidance on procedures to ensure the directors are independent. The 2010 UK corporate governance code contains such provisions.<sup>45</sup> In the case of South Africa, relevant provisions of the King Code of Corporate Practices are applied to board members of the Reserve Bank.<sup>46</sup>

The need to minimise and manage conflicts of interest has driven many of the changes that have occurred in the structure and operation of oversight boards. The realisation that a separation of functions offers an effective system of checks and balances is a major reason for splitting the post of Governor from that of chairman of the supervisory board and/or creating subcommittees with much clearer remits.<sup>47</sup>

Concern about potential conflicts of interest also increasingly guides the choice of board members and the limitations placed on them. For example, the Dodd-Frank Act stripped the prerogative of class A directors, chosen from banks holding shares in Federal Reserve Banks, to participate in the selection of Reserve Bank Presidents. Similarly, class C directors appointed by the Board of Governors and broadly representing the interests of society are forbidden from owning shares in any bank or bank holding company. Similar restrictions exist in France, where members of the board are permitted to undertake professional activities as long as a majority of members other than the member concerned approve. The board is explicitly enjoined to examine

<sup>42</sup> See eg Agoraki, M-E et al (2009): "The effect of board size and composition on bank efficiency". And Conyon, M J et al (1998): "Board size and corporate performance: evidence from European countries".

<sup>43</sup> Prior to 2009 the Governor was the ex officio chair. Since then, the Chancellor designates the Chair from among the members. In the one instance in which this power has been used, the Chancellor decided to designate a non-executive director as chairman.

<sup>44</sup> Walker, D (2009): "A review of corporate governance in UK banks and other financial industry entities", HM Treasury.

<sup>45</sup> See <http://www.frc.org.uk/corporate/ukcgcode.cfm>.

<sup>46</sup> The Code is named after Mervyn King, the chair of the committee that in 1994 produced a seminal report on corporate governance in South Africa. Mervyn E King is a former Judge of the Supreme Court of South Africa who chaired the committee. Mervyn A King is Governor of the Bank of England.

<sup>47</sup> The Governor still serves as chairman of the board in about half the central banks that have oversight boards. In these cases, explicit use is often made of subcommittees and/or a senior non-executive or lead director to mitigate conflicts of interest.

whether members are free of conflicts of interest. The legislation often precludes officers of financial entities serving as non-executive directors and contains provisions governing ownership or management of personal assets.

Most oversight boards overlay additional procedures and protocols designed to minimise conflicts of interest. Members are frequently required to make declarations of interest, to adhere to codes of conduct and to recuse themselves in matters where a conflict of interest exists. In Spain, for example, members of the Governing Council must place any tradable securities or financial assets which they or their immediate family members own in a blind trust.

#### *Access to information*

In order to perform their oversight functions, board members need access to relevant information and support in analysing it. Many central bank oversight boards and their subcommittees have an explicit right to all relevant information pertaining to their institutions' activities. In Norway, for example, the Permanent Committee of the Supervisory Council has the right of access to all matters pertaining to the Norges Bank. In Malaysia, legislation passed in 2009 empowers the Board of Directors to require the Bank to produce any document or information necessary for the carrying out of its functions. Furthermore, board committees can call upon any person to provide any information or document which is relevant to their functions.

In order to minimise risk of a possible bias in the information provided to the board by management, many central banks have developed mechanisms that allow board members to obtain information through an independent audit or similar process that is controlled by the board. At the South African Reserve Bank, the Board of Directors can obtain any independent advice that it requires at the expense of the Bank.

#### *Resources and support*

The amount of support given to the board and the degree of independence of the mechanisms for providing it vary across central banks. Support is typically provided by central bank staff. For example, at the Reserve Bank of Australia, the Board Secretariat operates under the direction of the Secretary and Deputy Secretary of the institution, who both report to a Deputy Governor. The number of staff supporting the board ranges from just a couple to up to more than 40 in the case of Singapore (where, however, the mandate of the board's subcommittees is particularly wide).

In some cases, the support for the board is provided in an autonomous or semi-autonomous manner. For example, in Finland, Parliament has appointed an independent Economic Adviser who works outside the Bank of Finland and who provides information on request to members of the Parliamentary Supervisory Council (mainly on monetary policy issues). In Norway, the Office of the Supervisory Council of the Central Bank of Norway is subordinated to the Council, and is organisationally and administratively independent of the Bank's Executive Board and Management. The Office's staff members are formally employed by the Central Bank of Norway, but the Office enjoys its own set of administrative rules. The Director of the Office is responsible for appointments, financial terms and working conditions within the framework provided by the Council.

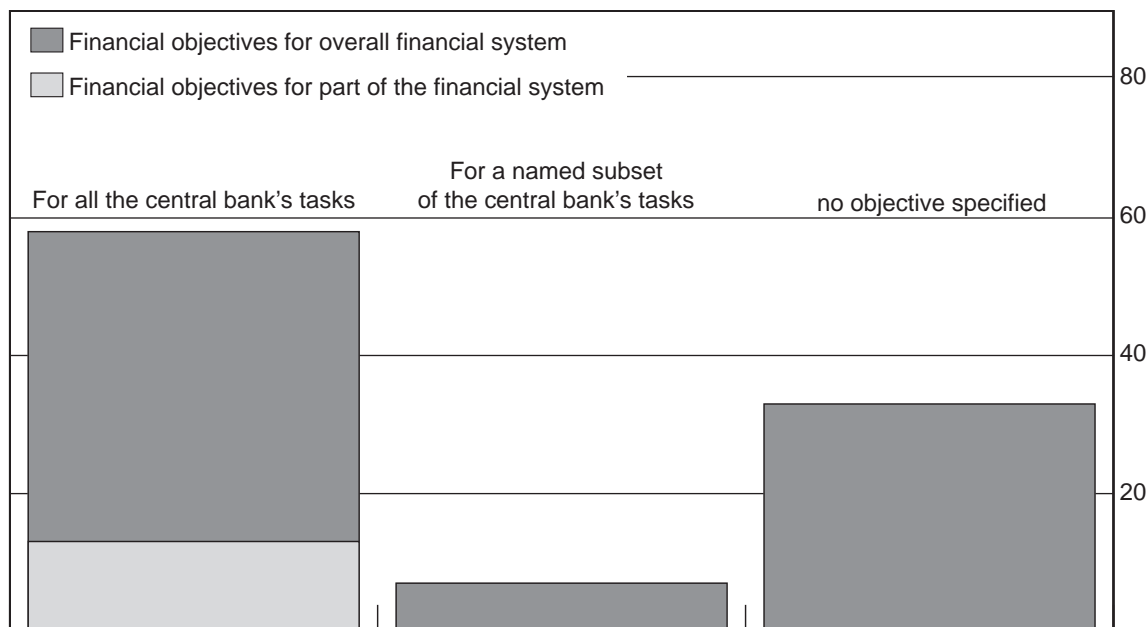
At other institutions, dual reporting arrangements are employed for central bank staff supporting the board. In South Africa, for example, the Secretary of the Bank serves as Secretary of the Board of Directors. The Secretary is appointed by the Board and can only be dismissed by the Board. Moreover, he has free and unrestricted access to the Chairpersons of Board committees. However, he reports to the Governor, who conducts his performance appraisal and reports the results to the Board. Similarly, at the Federal Reserve Bank of New York, the Board appoints the Corporate Secretary (and the Assistant Corporate Secretaries) who support the Board, but the secretaries are directly responsible to the President.

#### CONCLUSIONS

Greater responsibility will require stronger accountability arrangements tailored to the nature of the expanded mandate and increased financial risks revealed by the crisis. Reviews of performance and processes by a Court composed of qualified, impartial members can help in this. It can also help achieve coherence across multiple decision-making bodies and complement the oversight of Parliament and the Chancellor.

*June 2011*

**Figure 1**  
**FINANCIAL STABILITY OBJECTIVES IN CENTRAL BANK LAWS**  
 Percentage of central bank laws that mention “stability” or a synonym  
 At end-2010



**Table 1**  
**SELECTED TYPES OF CENTRAL BANK BOARDS, AND THEIR FREQUENCY**

<i>Board function specified in the law</i>	<i>Per cent of central banks</i>		<i>Median number of board members</i>	<i>Per cent of boards</i>	
	<i>One board of this type</i>	<i>More than one board of this type</i>		<i>Multiple functions</i>	<i>Governor as chair</i>
Oversight	66	2	10	21	39
Monetary policy	64	0	8	83	97
Other policy	43	9	7	82	89
Management	66	4	7	60	97
Advisory	17	2	11	20	30

*Note:* Data are drawn from a survey of the central banks in the Central Bank Governance Network. The 12 national central banks of the Eurosystem which are in the Network are not counted as having monetary policy boards, given the centralised nature of decision-making in the euro area; nor are those 12 central banks counted as having a formal advisory role on monetary policy.

*Source:* BIS (2008b), and BIS analysis of central bank laws and websites.

**Table 2**  
DECISION-MAKING IN CENTRAL BANKS THAT ARE BANK SUPERVISORS

	<i>Industrialised countries</i>	<i>Emerging market economies</i>
Number of central banks in sample <sup>48</sup>	20	21
Central bank is bank supervisor <sup>49</sup>	8	16
Of which:		
— A multipurpose board makes policy decisions in both monetary and microprudential supervision domains	—	10 <sup>50</sup>
— Has both an MPC and a board dedicated to microprudential policy	1 <sup>51</sup>	2 <sup>52</sup>
— Has an MPC; microprudential policy decisions taken by a multifunction board	1	2
— Has a board dedicated to microprudential policy decisions		
— Monetary policy decisions taken by a multifunction board	—	2
— Member of Eurosystem	6	—

<sup>48</sup> From a 2008 BIS survey.

<sup>49</sup> Where the central bank indicates that it has at least a substantial responsibility (shared or solo) for bank supervision.

<sup>50</sup> Includes two cases of currency boards, where monetary policy decisions are typically limited in scope.

<sup>51</sup> The case of New Zealand, where arguably the respective boards are advisory to the Governor rather than decision-making.

<sup>52</sup> Includes the case of Malaysia, where the Financial Stability Executive Committee (FSEC) has limited powers with respect to microprudential policy decision-making. Indeed, the FSEC might better be classed as a macroprudential policy decision-making board.



**Table 3**  
OVERSIGHT BOARDS OF CENTRAL BANKS

Country	Name of Board	Chair	Total	Number of members		Observer	Length of Term (years)	Reappointment	Minimum number of meetings p.a.
				Non-executive	decision making				
Australia	Reserve Bank Board	Governor	9	7		No	5	Yes	11
Austria	General Council	Non-executive	14/16 <sup>1</sup>	14		Yes	5	Yes	12
Belgium (1)	Council of Regency	Governor	16/18	14/16		Yes	3	Yes	24
Belgium (2)	Board of Censors	Non-executive	10	10		Yes	3	Yes	8
Canada	Board of Directors	Governor	15	12		Yes	7	Yes	4
Denmark (1)	Board of Directors	Non-executive	26/29 <sup>2</sup>	26		No	5	No	4
Denmark (2)	Committee of Directors	Non-executive	7/11 <sup>3</sup>	7		Yes	1	Yes	Not specified
Finland	Parliamentary Supervisory Council	Non-executive	9	9		Yes	Parallels term of Parliament	Not specified	Chairman's invitation
Hong Kong	Exchange Fund Advisory Committee	Financial Secretary	19	19		No	Not specified	Not specified	6
Hungary	Supervisory Board	Chairman elected by Parliament	Variable (min 4)	Variable (min 4)		No	Parallels term of Parliament	No	Not specified
Iceland	Supervisory Board	Non-executive	7/10 <sup>4</sup>	7		Yes	Parallels term of Parliament	No	As required
India	Central Board of Directors	Governor	20	14		Yes	4 years, none for ex officio	Elected by new Parliament	As required
Indonesia	Supervisory Body	Non-executive	5	5		No	3	Yes	Not specified
Ireland	Central Bank Commission	Governor	10/12	7/9		No	7 years for Gov, 5 years for non executives	Yes	11
Israel	Administrative Council	Non-executive	7	5		No	4	Yes	6
Italy (1)	Board of Directors	Governor	14	13		Yes	5	Yes	6
Italy (2)	Board of Auditors	Non-executive	5	5		No	3	Yes	Not specified
Malaysia	Board of Directors	Governor	7/12	5/8		No	5 years for Gov and DGovs, 3 years for others	Yes	12
Netherlands	Supervisory Board	Non-executive	9/12	9/12		No	4	Yes	Not specified
New Zealand	Board of Directors	Non-executive	6/8	5/7		No	5	Yes	6
Norway	Supervisory Council	Non-executive	17 <sup>5</sup>	15		Yes	4	Yes	As required
Saudi Arabia	Board of Directors	Governor	5	3		No	5	Not specified	12

Country	Name of Board	Chair	Number of members		Length of Term (years)	Reappointment	Minimum number of meetings p.a.
			Total	Non-executive decision making			
South Africa	Board of Directors	Governor	14	10	5 years for Gov and DGovs; 3 years for others	Yes	4
Spain	Governing Council	Governor	16/18	10	6	Yes	10
Sweden	General Council	Non-executive	11	11	4	Follows a general election	Not specified
Switzerland	Bank Council	Non-executive	11	11	4	Yes	Not specified
Thailand	Bank of Thailand Board	Non-executive	12	8	3	Yes	12
Turkey	Board	Governor	7	6	3	Yes	12
United States (FRBNY)	Board of Directors	Non-executive	9	9	3	No legal limit but rotation practiced	12

*Table Notes:*

- <sup>1</sup> Includes the Governor and State Commissioner as non-voting members.
- <sup>2</sup> The by-laws include as a decision-maker the Minister of Trade, Industry and Shipping in his capacity as Royal Bank Commissioner, and the three members of the Board of Governors as non-voting members.
- <sup>3</sup> The by-laws include as a decision-maker the Minister of Trade, Industry and Shipping in his capacity as Royal Bank Commissioner, and the three members of the Board of Governors as non-voting members.
- <sup>4</sup> The Governors attend the meetings of the Supervisory Board and participate in discussions. They leave, however, if the Supervisory Board decides.
- <sup>5</sup> The Governor and Deputy Governor must attend the meetings of the Supervisory Council and are therefore included as non-voting members.

*Note:* The information contained in this table is drawn primarily from a sample of 47 members of the Central Bank Governance Network with, in some cases, information contained in the bylaws of the central banks. The data were collected in 2011.

**Table 4**  
**FUNCTIONS OF OVERSIGHT BOARD BOARDS—SELECTED EXAMPLES**

*D=active role in decision-making (making decisions, approving proposals, setting rules, exercising responsibilities under double-veto arrangements)  
 A = provide advice  
 R=oversee/review*

Central bank of	Organisation and management				Policy				Senior central bank officials			
	Internal regulation	Org'n & management	Strategy/budget	Financial statements	Distribution of surplus	Audit process	Policy decisions	Policy process	Selection	Dismissal	Performance	Pay
Australia		R	R	D	A	R	D	R				D
Canada	D	D	D	D	D (on provisions)	R		R	D			D
Finland		R	R	D	D	R		R	A		R	D
Malaysia	D	D	D		D (on provisions)	R			A	D (for MPC members)	R	
Netherlands	D	R	D	D	A	R			A			D
New Zealand	R	R	R	R	A	R	R	R	D	A	R	D
Norway	R	R	D	D		D						
South Africa	D	D	D	D				R	A	A		
Sweden	D				A	D			A	A	A	
Switzerland	D	D		D	D (on provisions)				A	A	A	D
Thailand	D	D	R	D	A	D						

**Table 5**

EXPLICIT OVERSIGHT BOARD REVIEWS OF MANAGEMENT AND POLICY PERFORMANCE  
SELECTED EXAMPLES

	<i>Management performance</i>	<i>Policy decisions</i>	<i>Policy process</i>
Bank of Canada	√	–	√
Bank of Finland	√	–	–
Hong Kong Monetary Authority	√	√	√
Reserve Bank of New Zealand	√	√	√
South African Reserve Bank	√	–	√
Sveriges Riksbank	√	–	–
Bank of England	√	–	√
United States—FRBNY	√	–	–

*Note:* Based on an informal and partial survey of central banks in the Central Bank Governance Network conducted in 2010. Coverage focuses on central banks that have dedicated oversight boards. A heavy tick mark indicates evidence of a formal review process, while a light tick mark indicates general oversight.

*Source:* BIS (2010)

**Table 6**

QUALIFICATION CRITERIA FOR OVERSIGHT BOARD MEMBERS  
PER CENT OF OVERSIGHT BOARDS

Educational	13
Individual character or integrity	17
Professional	67
Geographic or sectoral	27

*Note:* Based on the central banks in the Central Bank Governance Network. An entry is recorded for each of the 30 dedicated oversight boards (ie excluding those with mixed functions) in that group. Some central banks do not have dedicated oversight boards (such as the Bank of Japan, the ECB and the Board of Governors of the Federal Reserve Board). Other central banks have more than one. Coverage focuses on external members.

*Source:* BIS (2011) analysis of central bank laws and websites.

**Supplementary written evidence submitted by Professor R Bob Garratt**

CONTEXT

Following my comments to the Treasury Select Committee of 20 June 2011 I feel it necessary to reinforce some of my points. I now better understand some of the major elements of the Committee's debate and, given the not ideal circumstances under which I prepared my initial submission, feel that it is clear the corporate governance issues are crucial to the successful transfer and implementation of the additional powers that are proposed to be granted to The Bank.

OVERALL COMMENT

The Bank is a company under the Companies Act 2006 and should behave as such. That it has a single share, held by The Chancellor on behalf of the nation, should not detract from its duties under the Act, nor best practice as described in the 2010 Corporate Governance Code.

The fact that the Treasury Committee is concerned that the transfer of major powers to The Bank, especially many aspects of the Financial Services Agency's current work, will make a "dysfunctional" corporate governance system worse is of concern to me also; so I have listed below some structural and behavioural processes which from my experience should be addressed to clarify matters.

The Treasury Committee has a golden opportunity for The Bank to be seen as a national corporate governance exemplar from which it would have much greater authority to lead the financial services sector of the UK into the future.

#### SOME PROPOSALS FOR STRENGTHENING THE CORPORATE GOVERNANCE OF THE BANK

1. The Bank is a registered company so treat it as such. It has a hierarchy of:

Owner.

Board or Court.

An Executive function.

Staff.

2. *The Court is the Board* under Company Law. The Court is directly accountable to the Owner. It is currently a unitary board and I can see no reason to change this. It has, therefore, a dual role—to ensure the future direction and long-term health of the organisation whilst keeping it under prudent control. This means that members of the Court must fulfil their seven directoral duties as given in the Companies Act 2006. This will mean giving a personal commitment that they fulfil their accountabilities as directors 24 hours a day, seven days a week. They are not just directors during the Court and Committee meetings and must gear their time to be able to fulfil these important duties on behalf of the nation. This would mean in these uncertain times that the Court would need to meet at least monthly. It would need to select diverse members (beyond macro-economists alone) who can devote the time and have the breadth of experience to ensure the long-term health of The Bank.

All members of the Court are statutory directors in their own right with one vote each. They are not “Non-executive directors” neither “executive directors” and so need to behave in a collegial manner at Court. This will require more rigorous selection, induction, development, annual assessment of the Court, each Committee and each director, and dismissal processes than at present. And it will require a strong Chairman of the Court.

I recommend strongly that you do not install a two-tier board system as experience in the UK and EU has shown that although this is a theoretically elegant design the micro-politics both within and between the two boards often has a debilitating effect on total organisational performance.

#### THE COMMITTEE STRUCTURE

3. This seems to be where much of the current debate is focused. I argue that it can only be resolved fully once the roles, responsibilities and accountabilities of The Court are agreed.

Committees are delegated sub-groups of the Court and report to it, and no-one else. So the present proposed structure is messy on three major dimensions. First, the Financial Policy Committee has a fairly clear role (although more needs to be done on clarifying its strategic role in removing systemic risk). It reports directly to the Court.

Second, the Prudential Regulation Authority’s role seems to be more operational and data-gathering. Yet it is a subsidiary company of The Bank (presumably a company limited by guarantee as the current FSA and FRC are?) so it will need a board of its own to comply with the law. What will be the relationship between this subsidiary board and the Court? And how will it define its roles and liaise with the new FPC?

Third, the role of the Monetary Policy Committee is clear. It is debateable as to whether its having only a single instrument is wise but that is not my concern here. What is clear is that although it is called a “committee” it is not a committee of the Court. It reports to the Treasury Committee. This appears a nonsense and a potentially divisive, even destructive, one to the Court.

I note that there exists an Audit and Risk Committee. Whilst it is essential to have an Audit Committee the role of the Risk aspect of the Committee is puzzling to me. If it is to be a key part of the Court’s horizon-scanning role that helps transform uncertainty into manageable risks, then I would recommend a separate committee.

#### THE EXECUTIVE

4. It is not unusual, but is bad practice, for the Executive to have such a strong influence on a board or Court that it becomes the dominant driving force in an organisation. The Court is where the final *judgements* are made following careful debate on the issues before them. Policy Formulation and Strategy Development and Implementation are the key issues for the measurement of Court performance, not for the Executive.

The role of the Governor needs greater clarification here. Is The Governor the Managing Director of the Bank, with a statutory seat on the Court? Or is he the Chief Executive without such a seat? In day-to-day terms the Managing Director is “the boss of the day-to-day affairs of the company” whilst the Chairman is “the Chairman of the board of directors”. Both are necessary and powerful roles. The Court must have oversight of the prudent control processes of the Executive to fulfil their second key role. This is not to exclude the Executive from the Court. A number of executives will sit on the Court and help develop strategy and the careful monitoring of its implementation. They will also be important in the “horizon-scanning” of the emerging uncertainties in the external environment—political physical, economic, social and technological—for which the Court is ultimately responsible.

But the Executive's main roles are in the design and monitoring of the plans flowing from the Court's policies and strategies. Consideration should be given as to whether the role of Chief Operating Officer is needed to ensure the Governor can concentrate on his inputs into the national strategic debates.

I have tried to be as brief as possible and am happy to expand these ideas and experiences further if the Treasury Committee wishes. I am concerned that the current corporate governance of the Bank seems messy and that the debate seems to be focused on mainly academic macro-economic issues. The narcissism of small differences is always dangerous when one's role is to make difficult judgements across many disciplines. But that is what a board is for.

23 June 2011

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## Supplementary written evidence submitted by the Court of the Bank of England

### CODE OF CONDUCT FOR FPC MEMBERS

#### GENERAL

The FPC is a Committee of the Bank's Court of Directors. Its main objectives are to be set out in statute and it will have statutory powers of direction in relation to the financial regulators. It also carries out functions on behalf of Court.

The Bank's effectiveness depends upon its authority, its reputation for rigorous analysis and its integrity. Members of the FPC have a special responsibility to promote the reputation of the FPC and the Bank and the integrity of its decision making processes. They must at all times avoid statements and conduct that could in any way undermine public trust in the Bank.

#### CONFLICTS OF INTEREST

Appointment to the FPC presupposes that the member has no financial or other interests that could substantially restrict his/her ability to discharge the functions required of a member of the Committee. These include financial interests significant enough to conflict with the member's duty to the FPC, and conflicts of duty and other relationships (including employment and advisory positions in regulated firms) that could give rise to a perception that the individual concerned could not be wholly independent, disinterested and impartial as a member of the Committee.

The acceptability of particular appointments and interests will be assessed on a case-by-case basis prior to appointment, when members will be asked to disclose all relevant commitments and interests to the Governor and to the Chancellor. The Chancellor will decide whether the continuation of any commitment or interest is incompatible with membership of the committee; the Governor may offer advice in this regard. Members should also notify the Governor—who will consult the Chancellor as appropriate—in advance if they are planning to take on any new outside commitment or interest which might be seen as in any way in conflict with membership of the FPC, or if a potential conflict arises in respect of any existing commitment or interest.

The Bank, through its press office, will answer specific factual questions about other commitments and interests held by FPC members and may disclose details of these in its Annual Report. It will also disclose the fees paid by the Bank to FPC members.

#### COMMUNICATIONS

Although to be backed eventually by statutory powers of direction, the FPC's main tool initially will be its ability to make public comment and formal recommendations to regulators. To make this most effective, members should as far as possible take a consensual approach to communication of the Committee's deliberations and decisions. Beyond what appears in the public record, members should not provide details of the FPC's discussions.

Committee members are free to discuss openly their own independent views on issues where FPC does not have a specific public position.

Only the Governor as chairman can speak on behalf of the Committee as a whole. In speaking on policy matters, members of the Committee should make it clear that they speak in a personal capacity, and those who are not part of the Bank executive should make it clear that their connection with the Bank is through the FPC only and does not extend to monetary policy.

#### MONETARY POLICY

Those FPC members who are not members of the MPC should avoid discussing UK monetary policy decisions. This would not preclude more general comments—for example on the design of policy frameworks that might be more academic in nature; but FPC members should in particular avoid speaking publicly about

any aspect of UK monetary policy during the monthly MPC “purdah” period.<sup>53</sup> The purpose of purdah is to avoid comments that feed market speculation about MPC decisions. Publications on issues relating to the Bank’s monetary policy responsibilities should be in non-Bank media, and it should be made clear in both publications and speeches that all such remarks are made in a personal capacity.

#### PURDAH

The FPC “purdah” period will extend from the start of the policy meetings to the day after publication of the record of that meeting. In this period, all FPC members must avoid media comment or speaking engagements related to FPC matters.

Members are also advised not to comment publicly on fiscal policy or tax measures except in the context of their implications for financial stability. Since the FPC may give confidential advice to the Chancellor on fiscal measures ahead of a Budget, members should avoid comments on what should be—or, after the event, should have been—included.

#### SPEECHES

Members must report and discuss their forward speaking and media plans—both formal and informal—with the Bank’s Communications Director when it is likely that an FPC matter may be discussed and provide formal texts of statements or speeches in advance of publication. In the interests of coordination, the Bank’s Press Office maintains a database of all planned speeches and media interviews, and will endeavour to ensure that communications from the FPC and its members are orderly and effective. Where speeches cover issues relevant to the decisions of the FPC, members must give the Governor an opportunity to comment on the content at least 48 hours in advance, along with other members and the Bank’s Press Office. Members should also circulate to the Bank in advance, through the Press Office, speeches relevant to the wider work of the Bank.

#### MEETINGS

FPC members are encouraged to make contact with financial market participants. But in considering invitations to speak at meetings sponsored by profit-making organisations, members should weigh the benefits against the possibility that they are handing the companies concerned a competitive advantage, through the presence of an FPC member. They should weigh particularly carefully the benefits of accepting an invitation from a financial institution to private lunches and dinners with its clients, which may be intended primarily as a promotional event for the institutions concerned.

#### LECTURES AND ACADEMIC JOURNALS

Members of the FPC will treat public lectures and publication of academic research in professional journals in the same way as speeches, and should keep the Press Office informed of all events, whether public or private, where it is likely that FPC matters may be discussed.

#### INFORMATION SERVICES FOR FPC MEMBERS

The Press Office is available for speech distribution, arrangement of contacts with the media, fielding of requests for interviews and training. Archive and Library and Information Services are available to FPC members. The FPC secretariat team has been set up to coordinate briefing for the FPC and requests for briefing should be directed towards it in the first instance.

#### OTHER ISSUES

There are a number of other more specific issues where FPC members will be covered by Bank rules for employees. Copies of the relevant documents are attached.

- (1) The Bank declaration of secrecy for staff which is normally signed every year (modified by the exclusion of the paragraph on public discussions and press contacts, which are covered separately in the above code).
- (2) The Bank’s personal dealing rules as contained in the Code for Conduct of Personal Financial Transactions. (The Secretary of the Bank acts as reporting officer.)
- (3) The Bank’s “Guidelines and Rules on the Acceptance of Entertainment and Gifts”. The Secretary of the Bank acts as reporting officer for FPC members (the same as for Governors and Directors). Item (ii) of “Central Rules: Speaking engagements and other appearances” of the Guidelines for all staff is modified as follows: “Where fees and expenses are offered to FPC members for speaking engagements and other appearances arising from their positions as FPC members, they should be accepted and surrendered to the Bank;” The rest of this paragraph to continue as before.

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<sup>53</sup> A period of eight days from the Friday of the pre-MPC meeting to the Friday after the announcement, inclusive; in the months when the Inflation Report publication and press conference take place, the purdah period extends until the end of the day or the publication of that Report.

## APPLICATION AFTER TERMINATION OF CONTRACT

This Code continues to apply for three months after the end of the FPC member's engagement, either at the expiry of the fixed period, or at any other time. Provided the FPC member continues to comply with this Code, the agreed fee will be payable for the additional period.

14 June 2011

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**Letter from the Governor of the Bank of England to the Chairman of the Committee**

At the Treasury Committee hearing on the accountability of the Bank of England on 28 June, we discussed the idea of identifying a set of simple indicators that might form a useful starting point for our discussions at future hearings on financial stability policy.

I set out in the attachment [below] the short-list of such indicators that I would refer to. Over time, the Financial Policy Committee will develop its own thinking on the appropriate indicators for monitoring financial stability. You will of course understand that there is no small set of indicators that can provide a full picture of the complex range of issues affecting financial stability. That complete picture is reflected in the Bank's *Financial Stability Report*.

TABLE OF FINANCIAL STABILITY INDICATORS

	<i>Latest value</i>	
Aggregate leverage ratio of major UK banks <sup>(1)</sup>	20	(June 2011)
Household debt to income ratio <sup>(2)</sup>	152%	(Q1 2011)
12m growth in lending to UK non-financial sector <sup>(3)</sup>	0.1%	(June 2011)
UK long term real interest rule <sup>(4)</sup>	1.2%	(July 2011)

<sup>(1)</sup> Total peer group assets (adjusted for cash items, tax assets, goodwill and derivatives netted according to US GAAP rules) divided by total peer group capital (including total shareholders' equity adjusted for minority interest, preference shares, goodwill and intangibles).

<sup>(2)</sup> Households' gross debt as a percentage of a four-quarter moving sum of their disposable income.

<sup>(3)</sup> UK resident monetary financial institutions' sterling lending to UK households and private non-financial corporates (excluding the effect of securitisations and loan transfers).

<sup>(4)</sup> 5 year real interest rates 5 years forward, derived from the Bank's index-linked government liabilities curve.

10 August 2011

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