Foreword by the Governor

Mervyn King Governor

The past year has been the most challenging for the Bank of England since it gained independence in 1997. My predecessor, Eddie George, guided the Bank through that transition twelve years ago. It was with deep sadness that the Bank announced his death on 18 April. His memorial service will provide an opportunity for all of us to celebrate Eddie's achievements.

Over the past year, the Bank has responded decisively and comprehensively to the financial crisis that has engulfed the world.

Last summer, rising food and energy prices caused inflation significantly to overshoot its 2% target, peaking at 5.2% in September. That month I wrote a third open letter to the Chancellor. Two more letters were to follow in December and March. However, the Monetary Policy Committee (MPC) judged the pickup to be temporary, with inflation expected to fall back sharply in the medium term as output growth stagnated and the margin of spare capacity in the economy increased. The MPC judged the risks to growth to be on the downside.

Those risks materialised, and on a larger scale than anyone had expected. In September, the American investment bank, Lehman Brothers, collapsed. A panic in financial markets resulted. Our business contacts at home and abroad declared that orders and confidence, in the same telling phrase, 'fell off a cliff'.

The MPC's response was unprecedented. Bank Rate was cut from 5% to 0.5% in just five months. But the Committee judged that further, unconventional, measures were necessary.

In March, the Committee voted to use the new Asset Purchase Facility. It decided to buy £75 billion of assets from the private sector, financed by the issuance of central bank reserves. These unconventional measures were a natural extension of the Committee's usual monetary policy operations.

Changing the price and quantity of money available is, however, only one part of the solution to the ongoing crisis. If the economy is to revive, and inflation to return to target, it is vital that normal lending to both businesses and households is resumed. This means returning banks to health. As I have said many times, this is not to protect the banks as such, but to protect the economy from the banks. That is why the measures the Bank has taken, and continues to take, were extreme and on an extraordinary scale.

In the past year, we have lent the banking sector hundreds of billions of pounds, both via extended open market operations, started in Autumn 2007, and the Bank's Special Liquidity Scheme (SLS). Introduced in April last year, the SLS was designed to finance part of the overhang of illiquid assets on banks' balance sheets by exchanging them temporarily for more easily tradable assets. The Bank lent £185 billion under the scheme against £287 billion of collateral, based on the nominal value at the end of January. It continues to remain in place for three years, thereby providing institutions with continuing liquidity and certainty.

The Bank also implemented comprehensive reforms to its money market operations. In October last year, a new, permanent Discount Window Facility (DWF) was introduced, which allows banks to swap high-quality illiquid assets for gilts, or cash under some circumstances. Initially for a period of 30 days, the DWF was extended to provide a facility for up to twelve months from January 2009. Together with changes to the facilities available for dealing with frictional payments shocks, in the form of new Operational Standing Facilities, the reformed framework puts the Bank at the forefront of global efforts to provide comprehensive liquidity insurance.

The crisis has revealed clear fault lines in the global financial structure. One of the most apparent here was the need for a proper system for resolving stressed banks. When Northern Rock failed in the summer of 2007, it became apparent very quickly that we did not have the tools necessary to effect a rapid resolution. The bank was taken into public ownership only after the Banking (Special Provisions) Act was passed in February 2008. Bradford and Bingley was also resolved under the Act in September, when its retail deposit business along with its branch network was transferred to Abbey-Santander. It was vital that a permanent resolution framework was enacted, and this was done with the passage of the Banking Act 2009, in February.

The Act implies many changes for the Bank. Formally, it gave us a statutory responsibility to contribute to protecting and enhancing the stability of the financial system of the United Kingdom. It created a Financial Stability Committee of the Court to oversee the Bank's delivery of this objective. It also made the Bank responsible for a Special Resolution Regime (SRR) to deal with distressed banks and building societies. Just six weeks after the Banking Act came into force, the SRR was triggered when the FSA determined that the Dunfermline building society no longer met its threshold conditions. Over the course of the last weekend in March, core parts of Dunfermline, including its wholesale and retail deposits and its head office and branch network, were transferred to the Nationwide.

The Act also formalised the Bank's payment system oversight role. Payment and settlement systems are vitally important to the smooth functioning of the economy. They allow financial institutions to settle market transactions, businesses to receive payments for goods and services and the general public to make purchases and receive their salaries. In 2007, the value passing through UK payment systems was around £240 trillion. Later this year, the Bank will have a statutory responsibility for their oversight, ensuring their reliability and so contributing to financial stability.

Banking crises can never be prevented; they are as old as banks themselves. But we can reduce the likelihood of them occurring, and ensure that when they do, they are orderly and contained. The Bank's new statutory responsibility for financial stability is welcome. But, as I have made clear, I regret that the new responsibility has not been accompanied by any new powers to deal with banks before they fail. Responsibilities and powers need to be aligned.

The Bank has always played a vital role at the heart of our economy and financial system. Never has that been more apparent. The significant challenges it has faced in the past year have meant a vast increase in workload for many Bank staff and I am immensely grateful to them all for their extraordinary efforts. Each has played their part, whether it be in supporting the MPC, designing and executing the enhanced liquidity support operations, ensuring the first successful operation under the SRR or assessing the complex risks pervading the global financial sector.

The past year has been one of great change at the top of the Bank. In February, Sir John Gieve stood down as Deputy Governor for Financial Stability. Nigel Jenkinson, after almost 32 years in the Bank, the last six of which as Executive Director for Financial Stability, is retiring. I am grateful to them both for their contributions to the Bank. I am delighted to welcome Andrew Haldane as Nigel Jenkinson's replacement. I am also indebted to Tim Besley and Danny Blanchflower, both of whom leave the MPC at the end of their terms this year. I am grateful for their independent views and their contribution to the policy debate in what has been a challenging period.

I am extremely pleased that the Government has appointed Paul Tucker as Deputy Governor for Financial Stability. Paul's appointment was the first made under the new, transparent appointment process, which I welcome wholeheartedly. I am equally delighted to welcome Paul Fisher to the MPC, as the Bank's new Executive Director for Markets. I am immensely proud of the way the Bank nurtures talent; Paul is just one from a rich pool within the Bank. The Bank has a strong team to take it forward.

Sir John Parker steps down as Chairman of the Bank's Court next month. I would like to extend my warmest thanks for his tireless work and invaluable counsel over the past five years. The Bank has been extremely fortunate to have had such an exceptional Chairman. I look forward to working with Sir John's successor, Sir David Lees, in the years to come.

I have no doubt those years will see their own challenges. It is a great regret that the Bank will have to face them without Lord George. We are a richer, prouder institution because of his contribution over the past four decades. On behalf of the whole Bank, I pay tribute to him and his achievements.

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