A MEETING OF DIRECTORS AT THE BANK

WEDNESDAY 4 JUNE 1997

Present

The Deputy Governor

Mr Plenderleith

Mr Clark

The number of Directors assembled being insufficient to form a quorum, those present proceeded to the business, subject to ratification by the next Court.

The Minutes of the last meeting, having been circulated, were noted.

11 June 1997

COURT OF DIRECTORS

For the period ended 28 February 1998

Declaration Made before	Date	
		Edward Alan John George, Esq, Governor
		Howard John Davies, Esq, Deputy Governor
		Sir David Gerald Scholey, CBE
		Mervyn Allister King, Esq
		Sir David Bryan Lees
		Sir Colin Grieve Southgate
		Mrs Frances Anne Heaton
		Sir John Chippendale Lindley Keswick
		Ian Plenderleith, Esq
		Sir David James Scott Cooksey
		Dame Sheila Valerie Masters, DBE
		Neville Ian Simms, Esq
		Michael David Kenneth Willoughby Foot, Esq
		Sir John Hall
		John Mitchell Neill, Esq CBE
		Andrew Robert Fowell Buxton, Esq
		Thomas Alastair Clark, Esq
The Governor	11.6.97	*Christopher John Allsopp, Esq

* Appointed 2 June 1997

A COURT OF DIRECTORS AT THE BANK

WEDNESDAY 11 JUNE 1997

Present:

Mr George, Governor

Mr Davies, Deputy Governor

Mr Allsopp

Mr Buxton

Mr Clark

Sir David Cooksey

Mr Foot

Mrs Heaton

Sir Chips Keswick

Mr King

Mr Neill

Mr Plenderleith

Sir Colin Southgate

The Governor thanked Members for making space in their diaries, at relatively short notice, to attend the special meeting that afternoon.

He also welcomed Mr Allsopp on the occasion of his first attendance at Court as a Director.

The Minutes of Court of 14 and 20 May and of the Meetings of 28 May and 4 June, having been circulated, were approved.

The Governor asked Mr Plenderleith whether he had anything to report on the markets. Mr Plenderleith said he had nothing to report at this time.

An update on recent developments

The Governor told Members of Court that the Bank would very much like their advice on the attitude the Government was taking and on the Bank's response.

First, he gave Court an update on recent developments. After the Chancellor's first and second announcements in May, the Treasury and Bank officials were asked to draft the Bill, but it became clear in conversations that the Bank and the Treasury were starting from enormously divergent positions. At that time the Governor believed the plan was to instruct Parliamentary Counsel by the end of May. Because of that timetable, he believed it appropriate to raise immediately major questions about both the approach and structure. That was the basis of his letter to the Chancellor on 27 May. The Bank sent separate papers setting out its views on three key issues to the Treasury. The Governor noted that, in his covering letter, he made the general point that the approach signalled to the Bank by the Treasury was minimalist in every area. An underlying feature of all central banks was that it was possible to take apart the functions. But if the process went too far in that direction there would be no central bank left at all.

On 4 June the Bank received the letter from the Chancellor headed Bank of England Bill, which Court had before it. The Governor commented that this letter served only to increase his concerns. The Chancellor had said in his initial letter and subsequent statements to the Governor that the Bank would be responsible for systemic stability. It was clear from the letter of 4 June that that responsibility was being truncated, and brought down to a minimal function of overseeing the payments system and exercising a broad overview of the system - whatever that meant. The Governor noted that Members of Court had seen the letter he had sent to the Chancellor in reply. The letters and annexes had been discussed in the Bank with the Executive and staff, including the Bill Committee. The Governor also noted that he had seen the Chancellor during the morning, and the Chancellor had confirmed that he had received the latest letter. The Governor noted that he had also undertaken to write to the Chancellor during the afternoon on the other two aspects, debt management and the review of the Bank's finances, which had been foreshadowed in the first paragraph of the letter. The Chancellor had agreed to send back a further letter, which would be followed by a meeting with the Governor. The Chancellor had also indicated that it was now unlikely that a Bill would be introduced before the summer recess, and a more likely time was October, which implied enactment in January. The Governor noted that he told the Chancellor that he welcomed that timescale, because these were important issues and it would give time to discuss them properly.

The Governor asked whether Members of Court took the same view as he and the Bank did of the Chancellor's proposals, and were Members content with the position that the Bank was adopting in responding to them?

Sir Chips Keswick commented that his conclusion after reading the papers was that the Government were determined to have a monetary authority, not a central bank. He said he believed that central banking was a skill and a national asset. He did not believe that the skills of a central bank could easily be transferred. Drafting by Treasury solicitors with no knowledge or respect for central banking seemed to him to be a very unbalanced proposition. Sir Chips said he believed that the Bank had been finessed, and had lost the high ground when the proposition was first sprung on it. It was now scrabbling about trying to get back to the high ground. Sir Chips urged the Governor to simplify the debate by asking the Chancellor whether he wanted a monetary authority, or a central bank, or the SIB as a central bank.

The Governor commented that the difficulties were not with the Treasury solicitors. They were with the stage before that, in preparing instructions to the Treasury solicitors, and that was what was being debated. There were some areas where Treasury officials had their own agenda, distinct from that of Gordon Brown. Part of the purpose of elevating the level of the discussion was to be clear about which proposals were from Gordon Brown and which were from Treasury officials. Mr Neill said that, if he understood correctly the Governor's response to Gordon Brown, the Treasury was setting out to diminish the presence, scale and influence of the Bank in the world and in the United Kingdom. He asked who was driving this approach. The Governor said this was a difficult question to answer. The debate had been conducted through correspondence. Where talks took place the Bank felt a totally different sense of what was happening. The Chancellor made clear that it was not part of his objective to diminish the Bank, and it would not be treated as another department of Government in its financing. The Governor commented that he believed that Mr Brown was being driven, entirely legitimately, by the belief that it was necessary to take supervision and surveillance from the Bank of England. Separating the potential conflict of objectives was an entirely sensible and proper approach, though it was possible to solve the practical problems in different ways in order to get the benefit of separation. It was a matter of having clear responsibilities that were not in conflict with other responsibilities.

The Governor said that the difficulty was that, if it went far enough, it would be possible to say that a central bank should be concerned only with monetary policy. The Governor noted that he did not think the Chancellor wanted to go as far as that. In his original statement he had said that the Bank's responsibility for financial stability would continue. This latest letter appeared to have stepped back quite a long way from that. In the meeting during the morning the Chancellor had said he thought a lot of the problem was about language, which should be clarified. The Governor commented to Court that the Bank would have to see what happened.

Sir David Cooksey noted the importance of having accountability and responsibility in the same hands. The correspondence appeared to indicate that the SIB was going to have a responsibility for committing the Bank's balance sheet if things started going wrong. This was pulling apart accountability and responsibility in a very big way. The Governor said he was not sure that Sir David was entirely right. The SIB would decide if a situation was systemic, under the latest proposals. It would go to the Treasury for support. If that was agreed, the Treasury would ask the Bank and guarantee the Bank, which would deliver. The SIB could not come to the Bank and ask it to prop up a bust institution. Sir David replied that the decision-making process was nevertheless still horrendous, and the Governor agreed. The Governor said that the SIB would decide whether a case was systemic. That gave the SIB the cross-eyed focus that the Bank itself had had in recent years. It had, for example, been argued that Johnson Matthey Bankers was not a systemic case, and was propped up because the Bank did not want to be criticised for allowing it to fail. If the two functions were separate, that could not be argued.

Mr Allsopp asked how far the Bank had gone in determining the boundary of systemic risk, and how much activity the Bank should engage in across the board to have an operational capability of performing this function. The Governor noted that immediately the Bank knew about the proposals Mr Foot, as a prospective future executive of the SIB, and Mr Clark, representing Financial Stability in the Bank, began to prepare proposals on what they thought was needed for each institution after independence. The Bank had not finally reviewed the line of separation but it was a line that was fairly easily defined: it was between systemic stability and banking supervision. This gave rise to what could be seen as overlapping capacity, because there were markets both needed to follow. The Bank needed a good deal of information about particular institutions. It would have to get that from the SIB, but would have to have people following the issues in the Bank. The overlap would not be huge and was being debated. It was an entirely justifiable matter. There were aspects where the SIB had to have its own capacity for the protection of depositors and the Bank had to have its own capacity from the systemic stability standpoint. The Governor said there was no disagreement in the Bank about that dividing line. That was why the Deputy Governor had joined in the letter sent to the Chancellor. Both he and the Deputy Governor were at odds with the line taken within the Treasury.

The second question was about how much capacity was required. The Bank would continue to have operational capabilities in the money markets, an extension of its responsibility for monetary policy. It would also have operating capabilities in foreign exchange, because it operated on behalf of the Government. This could be put out to a commercial bank, but in the initial statement by the Chancellor the Bank was allowed to have its own foreign exchange reserves. The Government also accepted that the Bank should maintain a capability for operating - both dealing and back office settlement - in the gilts market, finding its own customers. It had capital and its own central bank customers, though while operating for the UK Government it had not acted for them. Commenting on the numbers of people, the Governor said there were very few involved in dealing with the markets or in gilt settlements. He did not believe that the eventual number would be many fewer than the Bank had now.

Turning to analytical capacity, in relation to the markets, the Governor said that in his view the capacity the Bank now had would be needed for surveillance and for monetary policy purposes. Sir Colin Southgate asked whether the issue was that, when the Bank and the SIB agreed there was a systemic risk, the responsibility had to be handed to the Bank to control it. He commented that he did not like joint responsibilities. It was necessary when a decision was made to be clear about who made it. The Governor agreed, noting that a Memorandum of Understanding was necessary to define responsibilities. He said the Bank recognised that there was a prophylactic supervision role that needed in some circumstances to be carried out to avert a systemic problem. That would be undertaken by the SIB. There would be discussions, and the SIB would keep the Bank informed about how things were going. The reason was because at a certain point, probably in the middle of the night, events had the habit of shifting from prophylactic supervision to direct intervention. That was the operational involvement the Bank would expect to have. Normally both the Bank and the SIB would expect to keep the Treasury informed. But there would be a considerable loss if, in getting ex ante Treasury approval, there would be a slowdown in dealing with the situation, which would lead to a great weakening in the capacity to deal with it.

Sir Chips Keswick likened the risk to a car crash, because it was impossible to plan. Mr Buxton said that he had always thought that the SIB, in its supervisory task, would need a market arm, and he thought that that market arm should be in the Bank. The regulator needed to be close to the market, as the Barings report had demonstrated. He noted that, in the German system, German banks had complained that their regulator was too far away from the market, and did not understand them. Mr Buxton said that one institution had to make the decision about whether something was systemic or not, and it seemed to him that it should be the SIB as the regulator. The Bank of England should be the institution that carried out the decision, using its market arm. But right at the start, it would be necessary to have a very close liaison between the Bank and the SIB, because it would have to be a structure which made use of existing Bank of England market operations to keep the SIB close to the market. The Governor replied that he could not accept that the SIB decided on whether an incident was systemic or not. The reason was that the natural instinct of a supervisor was to protect the depositor, because that was what the supervisor was in business for. The supervisor would know that there was going to be a great fuss if depositors lost money, leading to a moral hazard which the Governor believed was very dangerous. That was why the position of individual institutions should be distinguished from the systemic situation. The Governor believed that it was not acceptable that the SIB should say that it had decided that the Bank should prop up - for example - Barings, and that the Bank should go out and lend the money.

Mr Neill noted that the Chancellor would, in his own interest as well as that of the Government, want the best possible insurance against systemic risk. It would be necessary to have institutions able to predict and to put counter-measures in place, in markets which were changing at an accelerating pace. It would be important to have the ability to deploy counter-measures very quickly and with the authority and resources to act very quickly, in consultation with the Treasury, but with formal approval coming later. Mr Neill said he was also very glad that the Governor and the Deputy Governor were in agreement, and he said that he would strongly support the position taken.

Mrs Heaton asked what were the key differences between what happened now and what would happen in a year's time at a moment of crisis. Using the Barings case as an example, the Governor said that Mr Foot and his staff had all the information about Barings, so when Barings came in to see the Deputy Governor at the time, the first thing Mr Foot did was to give information about balance sheet exposures and other matters. Management of the crisis was at the level of the Bank Executive, with the Governors overseeing the process, and Mr Foot very much involved. Mr Plenderleith also had to be involved in the management of the situation. Once a decision had been taken that Barings could not be rescued, it implied market intervention in order to prevent withdrawal of liquidity from other merchant banks, so that the Barings collapse did not become a systemic problem. Mr Foot was not very much involved in that. The process had worked as the Bank would like to see it in the future. The Bank had summoned Court, in case it needed to commit the Bank's resources, and it had kept the Treasury informed by going to see the Chancellor from time to time.

In response to Mrs Heaton, the Governor said Barings would, in the new circumstances, go to the SIB to say it had a problem. The SIB would come to the Bank and the two would sit down and agree jointly, as they had before. Mrs Heaton commented that the process would be handled very much more through the SIB because they would have the day-to-day contacts. The Governor commented that the question of who called the meeting was not the issue. It would depend very much on the nature of the crisis. If the problem was that someone was short of liquidity in one market and nobody would help, the onus would be on the Bank because it would be talking to other banks about market issues. In the Barings case, one of the things the Bank had explored was how positions could be financed if somebody had bought Barings over the weekend after the problem first came to light. It was not possible to set out hard and fast lines, because both the Bank and the SIB had to be there. Mrs Heaton commented that the Bank had to demonstrate slightly more clearly than in the papers before Court why the Bank was particularly important in this regard. She asked whether it was because the Bank had an existing role and status nationally and internationally, while at the same time everybody was saying that the SIB was going to have a horrendous task in setting itself up. If the Bank of England in the short term handled the crisis, a proven body would be in charge. The Bank should major on the angle that a well tried and tested organisation would be stepping into the crisis. She noted that the Government would not realise that it needed such a structure until it needed it.

Mr Clark commented that it depended on the circumstances of the case. For example, October 1987 and the Mexico crisis were very different from Barings. Their origin was not just in the UK financial system but in the international financial system. Mr Buxton commented that the discussion in Court and the letters went to the heart of what SIB was going to be. If it was going to be a consumer protection agency it would find it extraordinarily difficult to deal with the things that Court had been talking about. It had got to have market knowledge. He believed that the only way it could have that was through the Bank of England, which was why the Bank of England should have a continuing role. He had the impression that this was underestimated in the correspondence. Supposing the SIB was able to make the transition, he did not think there was any reason why the SIB should not make a decision that was going to be carried out by the Bank of England. If he were the Government, he would err on the side of ensuring that the Bank's expertise was continued in some way. The Bank was a highly respected institution and it would be a great pity if, in some way, that were diminished. That respect was due partly to the way the Bank was regulated, partly because it was in the markets and partly because it was situated in the middle of London. It was important to the City that the Bank's role in the world was maintained.

Mr King said there was a more fundamental argument. Even if the SIB had the expertise, it should not make a decision about whether there should be systemic support. One of the strongest arguments for taking supervision away from the Bank was that support could cover up weaknesses in supervision. There was a strong argument for separating the two functions to avoid a conflict of interest. If supervision were taken away from the central bank, systemic risk should not go with it. The Governor commented that otherwise the shift into the SIB would in effect be relabelling the Bank of England as the SIB. What would be left would be a monetary policy institute. He asked whether that was what, as Directors of the Bank, the Court would want the Bank to become. The removal of both supervision and systemic risk to the SIB would just perpetuate in a new body the present confusion of objectives.

Mr Plenderleith noted a question of accountability. If a decision on whether the case was a systemic problem had to be taken by the SIB alone, and if the Bank were allowed to undertake operations with a risk to its balance sheet and made losses, there would be a difficult position. It would not be accountable to Court. Presumably it would be accountable to the SIB. The Bank would have to be part of the decision in order to take responsibility for the risks that were to be borne. Sir Colin Southgate said that the key question was when that responsibility changed hands. The Bank should be responsible for systemic risk. The Governor noted that a problem might start in the Bank's area, but more normally it would start in the SIB's area. Sir Colin Southgate noted that the modest overlap between the two institutions was so irrelevant in the scheme of things that it did not matter.

The Governor replied in the affirmative to a question by Mr Allsopp about whether the Court was all agreed that systemic risk belonged to the Bank. Mr Allsopp said that, as he understood the view from the Treasury and Gordon Brown, it was that they were aiming for transparency and accountability. That raised a question of where misunderstandings were coming from. Was it a conspiracy or a cock-up? If it was a conspiracy, who was messing it up, Mr Allsopp asked? Were there sub-agendas involved and was it about cutting the Bank down to size, or was it a question of people not having thought it through? The Governor replied that the Bank was not wholly confident about the explanations. The Bank did know that a person on the financial stability and regulatory side of the Treasury had never accepted that there was anything that could be called systemic risk. Mr Clark had had long conversations with him over two years and never persuaded him. The Treasury official's view was that, since there were robust payment systems, these things could never be systemic. The Governor believed that a large part of the latest letter from the Chancellor was written from that position. There was also a turf war aspect, but he did not believe that that was shared by others in the Treasury. It happened that the official concerned was driving this particular facet of the negotiations. The Chancellor had said that it was largely a misunderstanding about the language; but until the Bank received his next letter it was difficult to be sure.

Mr King noted that there was one remaining issue that might cause a problem, which was the question of the Bank's capacity to give support without the prior approval of the Treasury. This was more a practical issue than one of principle. Where principle was concerned it was clear that, where public money was involved, there was a need for approval. The real question was one of operational capacity to deal with situations. Mr King drew a parallel with treating the injured in an ambulance. He advised against elevating this to an issue of principle. He noted that, in the case of Johnson Matthey Bankers, the Government had been annoyed about the use of public money when it did not know about it. The Governor said that this was a fundamental question which bore very much on the role of the Court. It was possible to take the view that the central bank was giving a service to the public at large from tax money and that that should lead to control by the Treasury. That had never been the Bank's position and it was not typical of central banks overseas. The Bank had to have its own capital and Court was accountable for its management. That issue was somewhere in the background, and the Governor said that he would be surprised if it did not come up. The issue posed when the review of Bank finances was discussed was whether, if the Bank was not involved in taking risks, it would need capital. If it did not need capital why did it need other income, which in turn raised questions about the role of Court. The Chancellor had said that the role of Court would be to manage, inter alia, the finances of the Bank, which he noted was more restrictive than managing the internal affairs of the Bank, which was the role given by the 1946 Act.

Mr Neill commented that, if he were sitting in government, he would prefer to have the Bank there to take the decisions and to be responsible for them. The Governor commented that if the Treasury had to make a decision every time, the capacity to act would be diminished. The capacity to act without disclosure would also be diminished. Sir David Cooksey said that there was a risk that the City would be seen as very much more bureaucratic as a result of the decision. The Bank's lightness of touch was regarded as a huge asset compared with other European countries. The Governor agreed. He said he did not think that was necessarily going to be lost. It depended how successful the Deputy Governor and Mr Foot were in carrying their work over to the SIB.

He noted that the Bank was now the exception. Only Italy and the Netherlands in Europe had banking supervision within their central bank. In the United States, there was some supervision, but others were also involved. It was necessary to recognise that this was not an issue just relating to the Bank of England. It was possible to supervise with a different institutional structure. The Bank was not arguing that supervision should not go. What it was arguing was that financial stability should not go with it. The Deputy Governor said that, in practice, it was inconceivable that the SIB would wish to mount a case for a systemic rescue without that being supported by the Bank, and inconceivable that the SIB would allow any sizeable institution, or any institution at all, to go down without consulting the Bank as to whether that had systemic consequences. The Treasury letter tended to adopt a definition of systemic without clearly saying what that was. The SIB would be bound to say what it thought the knock-on effect of a prospective failure would be on other institutions it supervised. To some extent that was a systemic judgement, but also a second order impact of a failure. He noted, on the other hand, the confidence impact. That was classic Bank of England territory. He believed that there might be some misunderstanding with the Treasury about that question. On the one hand there was the Bank and market judgement, and on the other was the analysis that the failure of one institution could affect other institutions. Both brought different things to the party.

Sir David Cooksey said that waiting until the autumn for the Bill had a lot of merit. He had visited the Treasury that morning and had learned that the Parliamentary draftsmen were overwhelmed. The Bill would be drafted too quickly if it were done now. It was extraordinarily difficult, without these questions being resolved, to see the way forward for the Bank. The Governor noted that the Bank had no idea of whether eventually there would be a Bank 3,000 or 300 strong.

Sir Colin Southgate asked about morale. The Governor commented that it was rocketing on the monetary policy side, but everywhere else it was going in the opposite direction. Mr Clark noted that it was not too bad, but might deteriorate if the situation persisted for a long time. The Governor said he took it from the discussion that Court was content for the Bank to go on battling in this way. Mr Neill said the Bank should bat very firmly. The Governor said that he would keep Court in touch with what was happening and may have more to report at the long Court the following week.

The Governor also noted that, in the context of the review of Bank finances, the Bank agreed that there needed to be such a review, and it was accepting the terms of reference. It was also accepting that the review should be by Treasury officials in consultation with the Bank, but it was saying to the Treasury that because this was a vital interest of Court, Court would want to be consulted on the conclusions of the review before the Chancellor took any decisions.

Howard J. Davies

18 June 1997

A COURT OF DIRECTORS AT THE BANK

WEDNESDAY 18 JUNE 1997

Present:

Mr George, Governor

Mr Davies, Deputy Governor

Mr Clark

Sir David Cooksey

Mr Foot

Mrs Heaton

Sir Chips Keswick

Mr King

Sir David Lees

Dame Sheila Masters

Mr Neill

Mr Plenderleith

Sir David Scholey

Mr Simms

Sir Colin Southgate

Apologies received from Mr Buxton, Sir John Hall and Mr Allsopp

The Minutes of the Court of 11 June, having been circulated, were approved.

The Governor welcomed two members of the Monetary Policy Committee, Professor Buiter and Professor Goodhart, to the Court meeting.

The Governor said there were two questions which he would wish to bring to Court in one or two months time in relation to the Monetary Policy Committee. The first was whether Court wished to have a discussion with the full MPC every month or whether it thought a discussion every quarter was more sensible, probably after the Inflation Report. Consideration was required in the light of the Chancellor's statement about the role of the Court in overseeing the operation of monetary policy. The second question was the format of discussions, given the purdah period between meetings and the publication of minutes. The Governor proposed that, to begin with, Court should have on the table the last published minutes, which in the case of the current meeting were those of the discussion with the Chancellor at the beginning of May. Court would also know the outcome of the subsequent Monetary Policy Committee meeting. The Governor noted that Professor Buiter and Professor Goodhart were not party to the meeting for which minutes had just been published.

Economic and Monetary Discussion

The Governor asked Mr King to introduce a discussion of the economic and monetary situation.

Mr King said that under the new regime, the papers before Court for the monthly monetary discussion would include the latest published minutes of the Monetary Policy Committee. That would provide the context for Court input into discussions of monetary policy. The other development was the announcement of the new inflation target of 2½% RPIX.

Mr King noted that the minutes of the meeting held on 6 May - "Independence Day" - had been published at 9.30am that morning, and were in Members' folders. For some time the Bank had been recommending a rise in interest rates, advice which had been rejected by the previous Chancellor. At the first and, as it turned out, the last meeting with the new Chancellor, the Governor presented a more detailed background to the current economic situation before focusing on the latest month's data. The picture was one familiar to Court. It was spelled out in paragraphs 13-15 of the minutes, Mr King noted. Higher interest rates were needed to curb the expansion of domestic demand, especially consumption, but the dilemma was that such a rise might push sterling higher and exacerbate the imbalance between the tradable and non-tradable sectors of the economy.

That dilemma had continued, and, if anything, had become more acute. The retail sales figures published on the morning of the Court meeting showed a rise in volumes of 1.1% in May on April, and were 5.3% higher than the level in May of last year. The growth rate in the past three months over the previous three months was now at its highest level since July 1988. Mr King commented that, since the meeting of 6 May, the Bank's estimate of size of windfall gains to households had increased from between £25 and £30 billion to closer to £35 billion. At the same time, the exchange rate was somewhat stronger than it was at the beginning of May - 100.2 on the effective index compared with 99.1 on 6 May.

The growth of earnings had fallen back over the period from 5% to about 4½%, but this was largely anticipated because it reflected the impact of bonuses, especially in the financial sector, dropping out of the underlying earnings figures. The rate of fall in unemployment had come back from the high levels that followed the introduction of the job seekers' allowance. But the unemployment rate itself was down to 5.8%. The labour market had clearly tightened considerably over the past year, and it continued to tighten further.

The Bank's advice on 6 May was that there would need to be an interest rate rise of ¼% before the summer, and there was a case for doing it immediately. But in the light of the announcement which the Chancellor was to make that morning on independence for the Bank, the possibility of an exaggerated market reaction to a full ½ point move suggested that there was little to be lost in moving by a ¼ point then, allowing the new MPC to take account of subsequent developments before its first meeting. The Governor therefore, recommended a ¼ point rise in rates, a move which the Chancellor accepted. At the first MPC on 5 and 6 June a further ¼ point rise to 6½% was decided, and announced at 12 noon on 6 June. Mr King commented that the decision at the last meeting followed very clearly from the advice in the minutes published on the day of the Court meeting.

Mr Plenderleith noted two developments in relation to the markets. The ¼% rise at the beginning of the month was received positively, and that reaction had been maintained, as had the substantial fall in UK bond yields and the narrowing against other bond markets which had occurred in May following the announcement of operational independence for the Bank. The more uncomfortable news was that there were two possible blind spots in the markets. The strains in convergence towards EMU had had very little impact on related exchange rates or bond yields in participant countries. The cracks may have been papered over at the moment, but Mr Plenderleith commented that perhaps the markets had not sufficiently taken on board some of the underlying strains. The second uncomfortable area was equity markets, where the vigorous rise continued in all the main markets apart from Japan. In relation to the United States, there had been a number of expressions of concern that some of the ratios were beginning to look stretched. In relation to the UK, there had been widespread suggestions that the Government might abolish the tax credit on advance corporation tax. That appeared to have had very little impact, Mr Plenderleith noted.

Replying to an invitation from the Governor to comment on the outlook for the construction industry, Mr Simms described the trend as soggy. This was normal about the time of elections, and he said that the trend was still upwards, and it was beginning to create some new job opportunities, after the industry had lost jobs all last year. The improvement in the market was now posing a strong threat to prices, which Mr Simms suggested could exceed the inflation rate by a factor of 2 as the year developed, sucking in more imports. Turning to labour rates, Mr Simms said that pressure was not that strong, and was really occurring in London and the South East, and in particular trades. However, he noted that the unions had refused a four year deal offered by the employers, which looked inflationary to outside eyes, but which in fact would have been a rationalising deal. Mr Simms commented that the expansion of the housing market would be easier to slow down than the main construction market, which in any case he did not believe should be slowed down. It was not a housing boom that was driving forward the industry, but a more solid commercial building programme. Therefore the situation was not as flighty as it had been with commercial property development in the 1980s, and the market was tougher, which was why margins were not moving forward very strongly.

Mr Neill commented that the car industry was still driving prices down in the components sector, at least, and there was no indication that the pressure would reduce. Two years out, the industry would be making components at a lower cost than now. With part of the £35bn building society windfalls going into car sales, it was going to give car makers confidence that they could improve their margins. Mr Neill noted that the April market had risen 12½%, May was up 2½% and the first ten days of the current month were up 12%. The outlook was for a market of 2.15 million vehicles, which was quite a lot up. The question was the percentage of the £35bn which went into savings, or into new cars. He noted that production was up 21% in April and up 10% in the year to date, which was quite a good indication of the underlying strengths of the automotive industry.

Sir David Lees agreed with Mr Neill. The nearer a company was to the consumer, whether directly or indirectly, the greater the degree of underlying activity, he said. He commented, however, that this was a time during which he was glad he was not a major exporter. Sterling had bitten into improved profitability. On the earnings front, Sir David Lees' experience was that there had been stability. The skills pressures were probably going to increase but the general pressure on wage levels was not something he was worrying about. The big issue for manufacturers was exports and the strength of sterling.

Sir Colin Southgate noted that last year his company's profits were hit by 7.5% at the operational level by the strength of the exchange rate. The forecasts were that it would be higher this year, ranging between 8 and 8.5%, which wiped out growth in the industry, which was pretty stagnant at the moment. He noted that his market did not move with the economy in general but with whether there was a hit CD or not. Sir Colin also noted a definite weakness in the rental market for televisions and other equipment. However, one reaction to the windfalls was that some customers were buying TVs rather than renting them. On the pay front, Sir Colin noted that the information technology area was becoming quite difficult, being driven by the Millennium problems, and he thought the issue was going to get worse over the next twelve months. For the rest, he had held the pay round at about 3.2% across the board and did not see any particularly huge pressure in any other areas.

Sir Chips Keswick noted that the second-hand housing market was very good around London and the South East, but elsewhere it was patchy, with fewer sales in May than in April. House building was good in the M25 area, but elsewhere was also patchy. Sir Chips commented that he did not see things going out of control. He took issue with some of the house price forecasts coming out of the building societies.

Sir David Cooksey commented that the textiles and clothing industries had settled at a realistic level with their unions. The venture capital industry, after a hiatus, had opened up again since the election. Another area that he noted could produce interesting problems was the pharmaceutical sector. Some companies were going to find it quite difficult to get their ambitious plans for the future refinanced, because the love affair with the sector was falling away, and it was a sector that was going to need watching.

The Governor commented that Sir David Lees had summed up the problems of the traded sector very well. He noted that he himself had had dinner with industrialists the night before, and all were substantial exporters. They had held on as well as they could by squeezing margins but, at a certain point, there would be review of sources of supply and that point was not far away. The trade figures had held up remarkably well, but the industrialists' comments were consistent with the Bank's view that the traded sector would deteriorate, probably quite rapidly, later in the year.

Mr Neill said that there was still scope for efficiency improvements in British industry, and it was clear that the strength of sterling should provide an incentive to get costs down. The Governor commented that the pressure to do so was there, but it was more easily possible in some sectors than in others, and that left the Bank with its dilemma. But a very relevant point was that the Bank's marching orders were focused on inflation in the economy as a whole. Sir David Scholey endorsed Mr Plenderleith's comments on the equity markets. The UK equity markets were quite fragile. With each passing day, it was a continued surprise that the UK markets were behaving as well as they were, and there would be little surprise if they started to behave very badly. He noted the problem that would pose for counter-inflationary policies, which would be conducted against the background of a sharply adjusting or steadily deteriorating equity market. The underlying market situation in the United States was increasingly different from that in the United Kingdom, but at the moment there was still a linkage. He would not be surprised if there were a sharp adjustment or a tendency to deteriorate steadily in the UK, particularly after the implications of the Budget had been absorbed.

Mrs Heaton asked whether the MPC was going to make representations to the Chancellor about the Budget. The Governor commented that there was an awkwardness because the Bank was in a transition period. It had been agreed that there would be no letter to the Chancellor on behalf of the Bank or the MPC but instead they would satisfy themselves, through Sir Alan Budd, that the Chancellor understood the implications of the current imbalance for budgetary planning. He noted that the current budgetary process was abnormal, because there was no equivalent of Chevening. Another reason for not wanting to write formally to the Chancellor was that the Bank was writing to the Chancellor quite a lot these days about other matters. Mrs Heaton asked whether Sir Alan had sufficient weight in the matter. The Governor said that Sir Alan was the representative of the Treasury on the Monetary Policy Committee.

Sir David Lees asked whether, if the MPC met to discuss the Budget, the proceedings had to be publicly available every time, or whether they were published only for the monthly monetary meetings. The Governor replied that it was his understanding that the minutes were published only for the formal monthly meetings. He envisaged a separate meeting to consider the advice to the Chancellor. He believed that the results of that meeting should be displayed to Court, as they had been in the past. Turning to the inflation target, Mr King noted that it had been set at 2½%, with the words "or less" deleted. The figure was a mid-point at which the MPC would aim over time. The new feature was that if inflation strayed more than 1% either way from 2½% the Governor, on behalf of the MPC, would have to send an open letter to the Chancellor explaining why, setting out what action the MPC would take, and noting the period in which inflation was likely to be outside. There would be another letter three months later if inflation had not come within the band. The Bank would have the opportunity to revive the art of letter writing, Mr King noted. He also commented that, if inflation moved out of the band, it was quite likely that it would be a year before it dropped back, so the letters could accumulate.

Sir David Scholey suggested that the inflation forecast chart in the Inflation Report could include dots to show the levels of inflation at which the writing of letters to the Chancellor would have to start. Mr King noted that it was clear from the Chancellor's remit that 1½% to 3½% was not a target range, in the sense that it would be absolutely desirable for inflation to fall within the range. There were events such as oil price shock where it may be necessary to accept inflation of more than 3½% for a year, rather than screw the economy into the ground. He commented that the procedures were slightly odd in that, though the Bank had to write a letter, it was not necessarily undesirable that inflation went outside the range. The Governor said that he would be disappointed if the letter was not able to say the explanation was published in the previous Inflation Report. He also noted that he had been very anxious to ensure that the letter should be quarterly, and that it would refer, as appropriate, to the Inflation Report. The Bank would also attend the Treasury Select Committee to explain the Inflation Report in a similar procedure. There could be merit in the fact that the Inflation Report was for the cognoscenti; while the open letter might receive wider publicity, the Governor commented. Professor Goodhart and Professor Buiter said they had no comments to add at this first discussion; the Governor thanked them for attending.

The International Economy: Risks to the World Economic Outlook (Mr Allen and Ms Hammond in attendance)

Mr King introduced Mr Allen, who with Ms Hammond, commented on a paper on the international economy. Mr Allen said that over the three years 1994-1996 world output was estimated to have grown at an average of 3.9% a year, compared with 2.5% in the preceding four years, 1990-93. The IMF forecast that output growth would speed up further in 1997 and 1998, to 4.4% a year, partly on account of a pick up in growth in the G7 and partly on account of a projected turnaround in countries in transition. This was a pretty bright picture. In explaining their forecast, the IMF drew attention to subdued inflation, the policy consensus in favour of price stability, the increased commitment to fiscal consolidation, which should contain real long-term interest rates and foster higher investment, and current exchange rates - which the IMF said "appear to be generally consistent with broader policy objectives". The IMF also drew attention to structural reforms, such as liberalisation of external trade and payments, privatisation and deregulation, as factors increasing the potential for economic growth.

Mr Allen said he wanted to talk about possible risks to that outlook, even though that might seem to betray rather a gloomy attitude. There were four particular issues that he wanted to discuss - European Monetary Union, Japan, equity prices and the pattern of world payments balances.

The outlook for EMU had changed over the last month or so as a result of the continuing problems over achieving acceptably low budget deficits in France and Germany, the result of the French elections, and persistently high unemployment in both countries (rising in Germany). It now seemed more likely that, if the project went ahead on schedule in 1999, it would have a fairly wide initial membership, including Italy, Spain and Portugal. At the same time, the likelihood that it would actually go ahead on schedule in 1999 had perhaps decreased. What were the associated risks for the world economy?

Markets seemed to be assuming that a wide monetary union would go ahead in 1999. If EMU were to be postponed, there might well be an initial slowdown in activity in Continental Europe on account of sheer uncertainty as to how economic policy was to be conducted in future. There might well be an appreciation of the DM and a fall in German long-term interest rates if the market thought that "postponement" might really mean "cancellation". What happened thereafter would depend on how policy reacted. Governments would be under great pressure to implement policies designed to stimulate growth and above all employment, and a great deal would depend on how they reacted to that challenge. They were likely to be under pressure of that sort even if EMU did go ahead. One critical question would be whether prospective EMU member countries were able to continue pursuing policies directed at price stability and sustainable public finances, even if not on the original Maastricht timetable. Another critical question would be whether governments could pursue structural reforms and deregulation policies designed to increase the longer run potential for economic growth, or whether there would be a retreat from free market policies. He noted that it would be extremely interesting to see how France's economic policies developed under the new government.

In Japan, there were at last signs of economic recovery in 1996. This came after four years of slow growth, largely the result of financial fragility. The recovery was achieved at the cost of a budget deficit in 1996 of something like 7.5% of GDP on a definition comparable to the UK's, and a ratio of public debt to GDP of approaching 100%. In other words Japan's public finances were nowhere near meeting the Maastricht criteria. And Japan had been running an ultra-easy monetary policy, with short-term interest rates well below 1% and ten year bond yields around 2.5%.

Fiscal consolidation was needed but would restrain domestic demand growth in the near term. Recently, net exports from Japan had picked up, helped by the depreciation of the yen, and that would have sustained Japanese output growth. But Japan still had a big current account surplus, and there were signs of renewed tensions over trade issues between Japan and the United States.

There was a widespread expectation, too, that Japanese interest rates would increase soon. That had caused the earlier depreciation of the yen to be partly reversed and it had caused a back up in Japanese bond yields. If those recent market moves went much further, they could damage the prospects for further economic recovery in Japan. In other words, continued recovery in Japan did not seem assured in the near term.

There had been many reports that ultra-cheap borrowing in the depreciating yen had been widely used by hedge funds and other participants in financial markets as a means of financing asset positions - for example in world equity markets and in emerging markets.

That led to the third risk - the possibility of a fall in equity prices. The strength of world equity markets over the last three years had been remarkable. Since the end of 1994, valued in dollars, the Dow Jones index had gone up by 82%, the FTSE-100 by 62%, the German DAX-30 index by 57% and the French CAC-40 index by 30%. Only Japan had missed out: the Nikkei had risen by only 9%.

There was a widespread view that global equity markets, and particularly the US equity market, were overvalued. The main evidence for that view derived from dividend yields, which in the United States were down to around 2% (on the S&P 500 index) - substantially lower than just before the 1987 crash, and very low by historical standards, both in absolute terms and in relation to bond yields. That evidence provided a reason for thinking that there was a risk of a sharp fall in equity prices: it was conceivable that a rise in US or Japanese interest rates might trigger such a fall. And although the evidence of overvaluation in the UK equity market was much less strong than in the United States, it must be likely that a fall in US equity prices would provoke a price fall in other countries in sympathy.

In the event of a collapse in equity markets like that of 1987, would the economic effects - much smaller then than many people feared - be more serious? A fall in Japanese equity prices certainly had the capacity to aggravate problems of financial fragility and to have knock on effects on the economy. But as regards the UK, Mr Allen believed the direct effects on the UK might not be too serious. Consumer spending could be affected by a fall in wealth arising from lower equity prices. But <u>direct</u> holdings of equities represented only 19% of personal financial wealth in 1995 (up from 12% in 1984). A fall of say 20% in equity prices would therefore translate into a fall of about 4% in the current market value of personal financial wealth. Estimates based on past experience suggested that the effect might be to reduce consumer spending by ¼ - 1¼%. But even that estimate may well be exaggerated.

A decline in equity prices would of course affect the current valuation of pension funds, he said. What however mattered for the economic behaviour of the corporate and personal sectors was not the current valuation of funds but their ability to meet future pension liabilities. The kind of price change involved would be triggered by a correction of "irrational exuberance" rather than one arising from a change in the immediate outlook for corporate profits or dividends.

In principle, lower equity prices could be expected to inhibit investment. The relevant variable was the ratio of the stock market's valuation of a company and the replacement cost of its capital equipment. That ratio had been rising steadily for about the last 15 years, and currently the stock market valuation of industrial and commercial companies in the UK exceeded the replacement value of their capital equipment by over 25%. At least in the UK, the rise had not been accompanied by a parallel rise in investment - and indeed in most countries it had proved difficult to establish any statistical relationship between the valuation ratio and investment.

The fourth and last risk was the pattern of world payments balances. Many countries were in the process of fiscal consolidation. In the long run, budget consolidation should help to stimulate economic growth. The immediate effect, however, was probably to reduce aggregate demand. In a single country, some of the adjustment would normally take the form of lower imports or higher exports, so that the burden would be shared with other countries. When a number of developed countries were cutting their budget deficits simultaneously, there was likely to be some effect on the rest of the world. The IMF forecast substantial increases in the combined current account deficits of developing countries and countries in transition between 1996 and 1998. Thus far adequate financing had generally been available. But it was possible that, in the search for yield, investors were not pricing risks correctly. If that was so, the capital inflows could be vulnerable to sudden interruption. One of the side effects of the rise in US interest rates and bond yields in 1994 was that financing for emerging markets became less readily available, and financial markets became more discriminating. In those conditions, private financing for Mexico suddenly became unavailable in late 1994.

It was possible that an actual or prospective rise in interest rates in industrial countries could have a comparable effect on the market behaviour in the next couple of years. In the last couple of months, both Thailand and the Czech Republic had experienced a sudden reduction in demand for their currencies - which could be interpreted as a demonstration of unwillingness on the part of financial markets to continue financing their current account deficits. This may be a sign that financial markets already had become more discriminating in allocating credit.

The immediate reaction of the Thai and Czech authorities to their recent problems has been to reintroduce controls - in the Thai case on external capital flows and in the Czech case on imports. If problems of this sort were to become sufficiently widespread, there could be a threat of a general retreat to controls as an instrument of economic policy. And even if that threat were to be avoided, it would become more difficult for industrial countries to reconcile fiscal consolidation with faster economic growth in the near term.

In reply to a question from Sir Chips Keswick about whether capital flows about the world were properly understood by economists, Mr Allen said that the flows were difficult to measure and it would not be surprising if there were quite big errors. In a further reply to Sir Chips, Mr Allen said that the impact of exchange rate changes must be proportional to the extent to which investments were hedged. It was difficult to do that with direct investment in developing markets. Mr Neill said that, over the last two years, a major pension fund had been arguing that the past was a guide to the future. He asked whether there was a possibility that the past was not in fact a guide to the future, because of the impact of globalisation, technology and the fact that costs could go down and quality could go up every year. Mr Allen replied that that was entirely possible. The dividend yield at 2% was well below conventional and index linked bonds in the United States. The market was discounting a substantial real increase in future dividends. It was possible that the corporate sector would be able to produce the growth of dividends implied in the prices. He noted that all he had wanted to say to Court was that this was an area of uncertainty.

In reply to a question from Mr Clark about oil and other commodity prices, Mr Allen noted that it had to be assumed that they depended on the outlook for economic growth, and Ms Hammond noted that there also seemed to be quite an increase in supply. Sir David Scholey asked about problems in the international banking system, including Thailand, Korea and one or two Latin American situations. He believed that perhaps 10 or 15 countries were working their way through banking crises. Mr Allen commented that in a stereotype case - a country with a big current account deficit which was importing capital - some of this money came through banks, and they were in effect were taking open positions by borrowing externally and lending in local currency. If the sustainability of the exchange rate came into question it also brought the solvency of the banking system into question, and that was a dilemma for the authorities. That had been the problem in Mexico, and it may be a problem for some emerging markets now.

Mr King, in response to Sir David Scholey, noted that this was where central banks had an interest in systemic stability, and that was important. One of the key points that came out of the Mexican situation was that investors had been gambling in the bond market and had been right, in that they had been bailed out. The issue for G7 was how to give a convincing message to the markets that, if they invested in a developing country, it was on their own account and was not backed by a semi-guarantee by G7 and the International Monetary Fund.

Sir Colin Southgate commented that, if productivity in Japan was measured over the whole of a company, it was extremely inefficient country. He considered his company in Japan to be the most inefficient in his organisation. But when faced down on the issue, the people concerned on the management side were still ducking it. He believed that Japanese manufacturers tried to be efficient by moving inefficient people into subsidiaries in order to hide them. He noted the scale of the Japanese banking and financial crises. Now they had upset the Americans again, with balance of payments problems. It appeared to him to be a serious crisis in the second largest economy in the world. Mr Allen noted that there was a huge cultural difference between Japan and the rest of the world. Japan was embarking on reform but finding it extremely difficult.

Sir David Cooksey said he was concerned about the equity markets. All the froth was in the FTSE 100 companies, and the mid-market companies had hardly moved. He noted comments that the 1987 crash had not had a great effect. But his belief was that it had had an effect further down the tree, bringing the end of the unlisted securities market, and similar events could have the same impact on the AIM market now. Financing smaller companies could become extremely difficult. There had been increases in efficiency and a lot of that had been lubricated by the buy-out and buy-in markets. People depended on the equity market to take them out on a higher price. The Bank was committed to helping finance smaller technology companies, but the markets scenario that had been described would stop this in its tracks.

Turning to monetary union, Sir David Lees asked whether a weaker union meant that inflation would be progressively higher and whether that meant that the subsequent restraining action would be sharper. In reply, Mr Allen said that the Euro area would be quite big and relatively closed, and inflation would be less sensitive to the exchange rate than in the UK. But there could be a situation where the European Central Bank had a dilemma, in which being tough on inflation had implications for the exchange rate. Mr Plenderleith said that there was political momentum for the Euro to start on time, with a less disciplined approach to convergence, implying a weaker Euro. He noted that it was not a foregone conclusion that the European Central Bank would acquiesce in a weaker Euro, and it may lead to a tighter monetary stance. That had considerable implications for the international economy, which was something that the market was ignoring at the moment.

The Governor wondered whether a situation like the trade tension between Japan and the US was developing in Europe itself. Italy and France had enormous and sustained external surpluses. It was difficult to see those going away with a weak monetary union. Germany offset them to a certain extent. He asked whether there was a prospect of this building up to a European - US imbalance. There would then be two imbalances against the US - those of Europe and of Japan - in the scenario of a weak Euro. The Governor further asked if these were the first shock waves from the strength of the Dollar against the rest of the world, and he noted that he found it disconcerting. Mr Allen replied that part of the origin must lie in fiscal consolidation, and the fact that European countries were not easing monetary policy. The Governor noted that pressure for consolidation was being excessively concentrated by the monetary union timetable. Ms Hammond commented that it was not obvious that it was possible to loosen monetary policy more in Japan to stimulate domestic demand.

The Printing Works Annual Report and the Report and Accounts of Debden Security Printing (Mr Jarvis in attendance)

The Deputy Governor, introducing the Printing Works Annual Report, said that the Works was in good shape, progress on the Printing Works 2000 programme was good, and a very large contract had been agreed with India. He noted that there were some tricky decisions coming up on equipment. He asked Mr Jarvis to comment on the Report.

Mr Jarvis said that there had been four challenges over the last year, and indeed over the last ten years. These were a new series of banknotes, a re-equipment programme, the matter of getting a four-building operation retrenched into one building, and introducing a significant cultural change whilst virtually halving the number of staff. Looking forward, the challenges would be repeated.

Referring to new notes, the Printing Works was in the throes of redesigning and modifying contingency versions of the £10 and £20 notes because of the threat of counterfeiting. If Britain were part of the single currency, Printing Works would be involved in the introduction of the Euro. If Britain were out of the single currency, it would want a new series of Bank of England notes because it was desirable to avoid the pound becoming a soft target for counterfeiters.

[redacted]

[redacted]

The final challenge was on the staff front. Printing Works needed to continue to improve efficiency and unit cost performance, which was becoming more difficult given the disadvantage of not having expanding markets for Bank of England notes. It was thus important for the Printing Works to get commercial work whenever possible. He noted the importance of the Indian note contract in this context.

[redacted]

Sir David Scholey commented that he had visited the Printing Works three years before Mr Jarvis had become General Manager, and had visited the Works again recently, and he noted that extraordinary strides had been made in recent years. He thanked Mr Jarvis and

Mr Pen Kent for pushing that change forward. Mr Jarvis said that the Printing Works hoped to end up ultimately with about 550 staff, so that approximately another 100 had to go, but he commented that it became progressively more difficult as the numbers reduced. However, he noted that the Printing Works had reduced to its present complement from over 1200 without compulsory redundancies, and was still hoping to get to its target on the same basis. He also commented that it was necessary to inject new recruits in order to achieve the appropriate levels of skills, at the same time as the general level of staffing was being reduced.

Turning to unit costs, [redacted] However, against that, it was necessary to improve the specification, which made the notes more costly, so the real target was to maintain costs while improving the specification. [redacted]
In general terms, there was a two-phase saving from the introduction of new technology - a large one immediately, through improved productivity, followed by a marginal one year-on-year. There were very few more big hits to come. Moves to new technologies were required for other reasons and would be automatically examined, though the savings would be less.

Mr Neill said he was pleased to see the Printing Works going after external business. He was convinced that there was considerable scope for more efficiency gains. These were very difficult to attain if people saw a threat to their jobs, and he urged the Printing Works to go after new business very strongly. He also asked Mr Jarvis whether the Printing Works had qualified for Investors in People. Mr Jarvis said that the Printing Works hoped to be accredited as an Investor in People in the next twelve months, and would be making an application. Sir Chips Keswick said that the Annual Report of Debden Security Printing was a very dangerous document if it went into Companies House, which Mr Jarvis confirmed it would. Sir Chips said that he would at least wish to say in the filed version that there were a lot of capital commitments coming, up or somebody would want to point to the dividend and claim the Printing Works was a cash cow, and perhaps suggest selling it off.

In a reply to a question from Mrs Heaton, Mr Jarvis said that Portals was the sole supplier of paper, with a contract until 1 March 2000. There was a long lead time involved in changing paper suppliers, and he planned to open negotiations this autumn. The Bank had the option of going out to international tender, and if it was decided to do so it would be this time next year. Because of the Indian contract, the Bank now had a better feel for international paper prices. Mr Neill commented that competition would be good for De La Rue and he believed that the Bank should compete. It would be bad for the country and bad for De La Rue if the Bank had a cosy agreement with them. Sir Colin Southgate commented that there was plenty of competition in the world.

Review of Credit Risk (Miss Hayes in attendance)

In introducing the paper, Mr Plenderleith said it had been brought to Court for information purposes, after the Audit Committee had seen and discussed it. The Bank had a credit risk exposure between £10bn and £15bn in total. That was very material in relation to its capital and reserves and controls were accordingly taken very seriously. The control and monitoring had been stepped up in recent years. Exposures came in a variety of ways, some of which were not on the Bank's balance sheet, for example, foreign exchange for the EEA. Some of the exposures reflected the particular nature of the Bank's central banking activities. In some cases it was not possible to apply conventional banking controls, for example by declining to deal with a counterparty to limit risks.

There were three elements to the Bank's approach. One was to minimise the amount of credit risk exposure it took on. Secondly, for a given quantity of risk the Bank took on, it was important to ensure that that risk was at a minimum; hence paper and counterparties were kept to as high a quality as the Bank could maintain. Thirdly, given that minimum quantity of risk, the Bank took steps to monitor and oversee it. There had been a lot of progress in recent years in improving the Bank's controls in this area but it had more to do, particularly on improving its internal procedures and use of systems.

Miss Hayes said that the paper explained the main sources of credit risk. The Bank took its largest credit exposures through the management of the EEA on behalf of the Government, through sterling market operations and in its core central banking and its limited commercial banking operations. Over recent years the Bank had devoted much effort to credit risk management. In particular, it had established a credit risk advisory committee, which assessed the credit standing of banks and issues of securities. It had also formalised the arrangements for monitoring limits and reporting breaches, and it had taken advantage of market developments to reduce risks, such as the real time gross settlement payment system and gilt repo. However, further work was needed in a number of areas including systems deficiencies, where there were plans to introduce real time monitoring of EEA exposures; adoption of a more formalised approach to credit risks which arose through the banking operations; and measurement and monitoring of the exposure to repo counterparties as the use of repos extended. The Bank also needed to review its policies and procedures after the Chancellor's recent announcements, and EMU would, in addition, have implications for credit risk management.

In response to a question from Sir Chips Keswick, Miss Hayes said that the Bank was looking very hard at netting its foreign exchange exposures. Sir David Scholey commented on paragraph 20 of the report which said that there were no plans to introduce a real time monitoring system for the Bank's aggregate exposure across all operational areas, and he asked whether this was a potential risk. Ms Hayes said that it would be a very major project to introduce real time monitoring across the entire Bank. Sir David asked whether this would happen by evolution, and Miss Hayes replied that it was on the Bank's wish list for each system introduced, but she would not say that it was going to happen across the Bank over the next few years. In response to another question from Sir David Scholey about whether quarterly reporting of exposure to banks across all operations was adequate, Mr Plenderleith said he believed it was not. However, quarterly reporting was a large step forward from three years ago, when there was nothing. He regarded quarterly reporting as only the first step and he wanted more frequent and quicker monitoring of the Bank's risk in this area. But it had to be a progressive process, working through improvements to individual systems a step at a time.

In response to a question from Sir David Scholey on how often the Bank hit limits, Ms Hayes said that it did occasionally have breaches. Sir David Lees noted that the Audit Committee had already had a look at the report on controls before the loss of banking supervision had been announced. It might be difficult to do aggregate exposures across all credit risks every day, but the Bank must have sensitive clients, and could look at them in the aggregate very much more frequently. Ms Hayes confirmed that the Bank did look the following morning at the exposures to banks where it had concerns. Sir David Lees also commented that it was unclear to him how important banking supervision was to the application of credit limits in the Bank and hence whether its departure was going to be a major factor in credit assessment. Miss Hayes said surveillance did a lot of work on the assessment of banks and so the Bank would have to review its credit assessment process in the light of the changes. There was a flow of banking supervision information to the credit area, giving the Bank comfort. There were some groups of institutions where the Bank's stance would be different if it did not have the supervisory information, most notably the smaller UK banks and the Japanese banks. In the latter, the Bank's approach had been influenced by discussions supervisors had had with the Japanese authorities. Dame Sheila Masters asked whether the Bank would have to recreate the capacity, or work through links with the Securities and Investments Board. Mr Plenderleith said that this was part of a larger question, relating to the extent of surveillance work the Bank would take on. For credit risk, the essential need was for the Bank to be satisfied with its exposure to particular counterparties at a particular level. The Bank would have to explore in the new world what sources of information would be available to it. The level of risk it took on would be dependent on what information it could get.

Sir Colin Southgate said that he did not like to read in the document that the Bank was not investing money to take out risk, and he urged the Bank to accelerate the investment required to receive daily information. The technology was easier than it was and there were systems available. The Bank should be moving in that direction. He commented that it was ridiculous for a central bank not to be in the forefront of investments of that type. Mr Plenderleith said that that was the Bank's aim. Sir Colin Southgate asked what the Bank did when it hit a limit. Mr Plenderleith said that the dealers were responsible. If they came to senior executives for a higher limit, it would frequently be turned down. A trickier question was when an existing limit was inappropriate. The Bank recognised that, in reducing exposure to counterparties, it could be very destabilising if a name had been turned down by the Bank of England. In response to another question by Sir Colin, Mr Plenderleith said that this did not happen a great deal, and mostly it had been in relation to Japanese banks. Mrs Heaton said that she shared concerns in that area. She pointed to paragraph 7 of the report which referred to regular breaches being brought to the attention of the Executive Director, who may agree a special concession in certain circumstances. She said that if there were regular breaches, the Bank would not look good, and questions would be asked about why there were regular breaches. Mr Plenderleith said that the passage in the report gave the wrong flavour. There was a daily report to the Deputy Director, copied to himself, and if any questions arose they would be picked up next morning and dealt with by himself and the Deputy Director as part of their daily routine. Mrs Heaton said that maybe the levels needed speedier review, so that the number of breaches was reduced. Mr Plenderleith said that if the levels were exceeded, the Bank investigated why and took immediate steps to ensure controls were observed. The Bank aimed to take action against limit breaches as fast as any bank he knew.

The Executive Report

The Deputy Governor referred to the Officers' pay negotiation and said that there had been a claim across the board for 4.5% and the Bank was offering 2.5%. He noted that this should be seen as coming on the back of rather good bonuses for Officers this year and the proposed restructuring of Officers' pay. So he was quite optimistic that the Bank would be able to agree at about 2.5%.

Turning to Millennium risk, the Deputy Governor said he had been asked a question to which he did not have an answer at a previous Court meeting, which was what had been done at National Mortgage Bank and Minories Finance. The answer was that National Mortgage Bank had introduced new systems which were year 2000 compliant, and in the case of Minories, it was unlikely that it would be an operational entity at the year 2000.

The Deputy Governor asked for Court's approval of the appointment of Christopher Allsopp as a Trustee of the Houblon-Norman Fund. Court agreed.

[redacted]

[redacted]

Ratification of recent appointments to the Monetary Policy Committee

The Governor said that there were two other items to consider on the agenda; these concerned certain members of the Monetary Policy Committee. The first was the ratification of the interim appointments of the new members of the Committee - Professor Charles Goodhart, Professor Willem Buiter, Dr DeAnne Julius and Sir Alan Budd. Court ratified the appointments. The Governor explained that the Chancellor of the Exchequer would reconfirm their appointments when legislation had been passed by Parliament putting the reforms to the Bank on a statutory basis. The Governor said he was thrilled with the four appointments, and they had been very well done.

A Recommendation from the Remuneration Committee

Sir David Scholey, in his capacity as Chairman of the Remuneration Committee, presented to Court a recommendation that following the appointment to the position of Adviser to the Governors with effect from 2 June 1997:

(a) Professor Charles Goodhart's remuneration be [redacted] this representing 2/5 of [redacted] in respect of a two-day working week; and

(b) Professor Willem Buiter's remuneration be [redacted] representing 3/5 of [redacted] in respect of a three day working week.

COURT APPROVED the recommendation.

A further recommendation would be brought to Court later in the year when Dr DeAnne Julius and Sir Alan Budd took up their appointments as Advisers to the Governors.

Howard J. Davies

16 July 1997

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TO MEMBERS OF COURT

COURT 18 JUNE 1997: THE WRITTEN EXECUTIVE REPORT

Conference facility

1 Last year, the Deputy Governor initiated work to explore the possibility of creating a high quality conference facility in the area next to the Bank's museum. This was in response to substantial internal demand: for large meetings (where existing rooms have insufficient capacity and relatively poor quality audio-visual equipment); for press conferences; and for smaller meetings such as those of the new Monetary Policy Committee (where we lack a 'desk style' auditorium). Property Services have now done a substantial amount of work on this project, in collaboration with professional advisers, and - at a recent meeting - GOVCO members decided that they would like to go ahead with the project.

2 Court's views are now sought for two reasons: the project will involve substantial capital expenditure (see below); and it is envisaged that it will become a commercial venture, as the facilities will be designed to allow their hire to external users (so generating income to defray part of the cost).

Design

3 Detailed designs have been drawn up by the architects[1] for a 184 seat auditorium (convertible into 50-60 seat desk-style accommodation) with high quality audio-visual facilities, break-out

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[1] Four firms submitted 'design concepts', following which a panel comprising Messrs Footman, Lywood and Everett chose Wilson Mason and Partners to provide detailed designs.

space and catering. The plans have been discussed with English Heritage who have agreed in principle to the installation of a floor at mezzanine level in the area involved.

<u>Cost and income</u>

4 The quantity surveyors[2] estimate that the total cost of the project would be £3,585,000 (at current prices and excluding VAT, which would be payable on parts of the work). This is based on a timescale which allows for completion in September 1998.

5 On the income side, we have looked at rates charged by comparable conference centres and provisionally estimated that a realistic hire fee would be £2,000-£3,000 a day plus a charge for catering. Assuming 100 lettings annually, which might be achievable, and taking account of running costs, the npv shortfall over a ten year period is therefore likely to be between £800,000 and £1.5 million. This is a substantial sum but needs, of course, to be set against the benefits to us of much improved conference facilities[3].

EMU Developments

<u>Amsterdam Summit</u>

The Amsterdam Summit (16 and 17 June) is intended to see the formal adoption of a number of important pieces of legislation, designed to pave the way for EMU and prepare the EU for future enlargement. However, recent developments in Germany, and particularly in France, have now placed a degree of uncertainty over the summit's potential

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[2] Walfords.

[3] Premises have also established with the help of the Quantity Surveyors that, were we to build a cheaper conference centre for Bank use only (thereby omitting catering etc.), the npv shortfall over ten years would by near to £3million. Finally, they have calculated that if G158 were instead used as offices (so releasing space in BB for rent), the npv shortfall would be £1,237,000.

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success. The main pieces of EMU legislation for formal adoption are the Stability and Growth Pact (designed primarily to enforce budgetary discipline in the future euro zone), the design of euro coins, and the resolution on ERM2.

On the first of these items, the new French Government is insisting that it cannot agree to the Pact texts at Amsterdam, but instead needs more time to consider them. A further stumbling block concerns new French insistence that the Pact makes reference to the importance of economic growth and job creation, as well as fiscal discipline. A compromise has been suggested by the European Commission, which entails a separate EU political declaration on employment and growth, and which is supported by Germany. Agreement on the remaining two items should be assured if the Pact can be agreed.

4 Other outstanding difficulties concern the preparations being made for the future expansion of the EU, where disagreements still exist on the reform of the EU's institutions and the preservation of the balance of power between small and large Member States.

Prospects for the Maastricht Timetable

Doubts regarding Germany's ability to meet the Maastricht Treaty's debt and deficit convergence criteria, coupled with the French Government's new emphasis on promoting economic growth and tackling domestic unemployment, rather than on implementing further austerity measures to ensure qualification for EMU, have raised concerns about whether both countries will be ready to qualify for EMU on time on 1.1.99.

German concerns about qualification were highlighted recently by the Government's plan - subsequently quashed - to re-value the Bundesbank's gold reserves, with a view to the funds generated being used to reduce the government's debt and deficit positions in 1997.

Decisions on first wave entrants will be taken by heads of State and governments in Spring 1998.

Euro banknotes

The re-design of the euro banknotes was approved by the EMI Council at its most recent meeting this month and a number of test banknotes will now be produced over the next couple of weeks for comments from non-banknote experts.

Annual Health and Safety Report

A copy of the latest Health and Safety Report is attached, for information only.

D A Coldwell
Court Post (4236)

Secretary's Department.

A MEETING OF DIRECTORS AT THE BANK

WEDNESDAY 25 JUNE 1997

Present

Mr George, Governor

Mr Davies, Deputy Governor

Mr Clark

Mr Foot

The number of Directors assembled being insufficient to form a quorum, those present proceeded to the business, subject to ratification by the next Court.

The Minutes of the last Court, having been circulated, were noted.

The Governor said that there was nothing to report on the markets.

16 July 1997

A MEETING OF DIRECTORS AT THE BANK

WEDNESDAY 2 JULY 1997

Present

Mr George, Governor

Mr King

Mr Plenderleith

Mr Clark

The number of Directors assembled being insufficient to form a quorum, those present proceeded to the business, subject to ratification by the next Court.

The Minutes of the last Court, having been circulated, were noted.

Mr Plenderleith said that he had nothing to report on the markets or on the Official Reserves figures for June.

16 July 1997

A MEETING OF DIRECTORS AT THE BANK

WEDNESDAY 9 JULY 1997

Present

Mr George, Governor

Mr Davies, Deputy Governor

Mr Clark

Mr Foot

Mr King

Mr Plenderleith

The number of Directors assembled being insufficient to form a quorum, those present proceeded to the business, subject to ratification by the next Court.

The Minutes of the last Court, having been circulated, were noted.

Howard L Laine

Peter D Rodgers

16 July 1997

COURT OF DIRECTORS AT THE BANK

WEDNESDAY 16 JULY 1997

Present:

Mr George, Governor

Mr Davies, Deputy Governor

Mr Allsopp

Mr Buxton

Mr Clark

Sir David Cooksey

Mr Foot

Mrs Heaton

Sir Chips Keswick

Mr King

Sir David Lees

Dame Sheila Masters

Mr Neill

Mr Plenderleith

Mr Simms

Sir Colin Southgate

The Minutes of the Court of 18 June and the Meetings of 25 June, 2 and 9 July were approved.

Economic and Monetary Discussion including Market Charts (Professor Charles Goodhart in attendance)

In introducing the minutes of the MPC meeting of 5/6 June Mr King said that they identified the main issue as the dilemma between the strength of domestic demand and the rise in the exchange rate. The MPC also discussed building society windfalls and the likely effects on consumer demand. He noted that one issue raised was whether more of the windfall gains would be spent than had been suggested in the May Inflation Report, and this was an issue which would have to be thought through before the August Inflation Report. The Committee also discussed the exchange rate and found it surprising that little effect had shown up in the data on imports and exports. The Committee concluded that, despite the fact that there had been no obvious deterioration of net exports yet, it was still expected that an impact would be seen soon. There was no reason to dissent from the view in the May Inflation Report that the deterioration would occur later in 1997, and especially in 1998, and that the impact would be quite large. Mr King reported that, taking all the evidence into account, it had been agreed that there was a need for a tightening of monetary policy and the committee decided that there should be an immediate rise in interest rates of 1/4% to 6 1/2%. He noted that since then there had been a further 1/4% rise, following the July meeting.

Mr King commented that the dilemma between the exchange rate and the strength of domestic demand had, if anything, intensified over the past month. Although there appeared to have been a fall in the growth rate of the economy between the fourth quarter of last year and the first quarter of 1997, the data were volatile and there had also been revisions. He concluded that it would be wrong to put much weight on the apparent slow-down in growth, which was still buoyant at about 4% a year. He noted that the effective exchange rate had been increased by 6.6% since the last meeting and by 24% since last August. The strong part of the picture was the growth in domestic demand and the windfall gains whose impact had still to be seen, and the weak part was the effect of the exchange rate on net trade.

Turning to the Budget, Mr King said that the largest tax change by far was the reduction in tax credits to pension funds. The issue was who bore the ultimate burden. Since these investments were to meet obligations already incurred by companies, the burden in part would fall on shareholders. There would be an increase in the cost of providing pensions to employees. Real wages were going to reflect the fact that pensions would be a more costly way of providing compensation. It would take some time to evaluate that and to see the impact on wage bargaining. It was reasonable to say that, ultimately, the impact would be on the household sector but Mr King commented that he did not think households would be able to see immediately that the measure had the same impact as a rise in taxes. The second aspect of the Budget was public expenditure. The control total was unchanged, and the increase in health and education spending came out of the contingency reserve. But the Treasury believed that the price level was going to be higher. On the face of it that implied a further squeeze on public spending. It was possible that there was a change in the relative prices of public services. So the same level of spending on hospitals and other investments would be achieved for lower expenditure. Mr King noted that the Bank did not know the answer and would have to work it out. He commented that the overall impact of the Budget was likely to be about 1/2% of GDP rather than the higher figure of 1% of GDP that would be implied by a further squeeze on real public spending above that inherited from the Government's predecessors. The Budget had produced some squeeze, but the extent was difficult to assess.

Turning to the labour force statistics, Mr King noted that unemployment was down by 36,500 in the month and the rate of unemployment was down to 5.7%. He commented that the labour market was continuing to tighten. Earnings growth at 4 1/4% was down from April. That was primarily because large bonuses were dropping out of the picture. The Bank did not think earnings growth was falling, and believed that it was steady at about 4 1/4%. The unemployment and hours worked figures were clear evidence of a further tightening of the labour market. Invited to comment by the Governor, Mr Goodhart said that the monetary aggregates had shown a slight fall in April. Mr King noted that the growth in broad money was well into double figures. In the past that was associated with robust growth.

Commenting on market developments, Mr Plenderleith said that the discomfort caused by the rise in the exchange rate had intensified. The main driving force was the continuing rise of the dollar. Other factors were the position of the UK further up the cycle than the major European economies - reflected in interest rate differentials - and the fact that the £ was probably benefiting from the safe haven effect, due to concerns about the possible weakness of the Euro and uncertainty about monetary union. There was also some rebalancing of portfolios generally. Mr Plenderleith noted some concern in the markets that sterling was reaching giddy levels, and some interest in whether the authorities would intervene at about the DM 3 level. Mr Plenderleith also noted a shift in expectations about domestic interest rates over the next few months. There had been an implied expectation that short rates would need to rise as far as 8% next year and the year after. The effect of the increase in rates had been to bring down expectations over that time horizon from 8 to 7 1/2%. Mr Plenderleith said that he could not offer any comfort that sterling was at the top, but he suggested that there would be a topping out and an easing off at some stage in the period ahead.

Sir Chips Keswick commented that the presentation had not mentioned the stock market, which was still being pushed upwards by high levels of liquidity. He observed that investors were beginning to take capital gains and spend the money. Mr King replied that personal sector wealth from the stock market was an order of a magnitude higher than that from the building society windfalls and this had been factored into the Bank's assessment. He also noted that the increase in the stock market in the US and Germany was very much greater than in the UK. If there was irrational exuberance in the markets it was more likely to be in those other countries.

In reply to a question from Mrs Heaton, Mr King said that there would be a vote at each meeting of the MPC, as there had been in June, when it was unanimous. Whenever individuals dissented, their names would be recorded. But the committee had discussed whether to ascribe opinions on particular developments in the economy to individuals and it had concluded that this would lead each member to want to present a coherent view on the economy, leading to nine different essays. The Committee had decided that its practice would be to say that there were, for example, two broad views, and give a coherent explanation of them. He noted that there might be two views but no difference on interest rates among the members. There might be other times when differences of views on the economy would lead to differences of views on interest rates. The main place where names would appear in the minutes would be in the record of the vote, he noted. The Governor said that, if a vote were recorded against the majority view, or if there were an abstention, whoever had taken that view would explain it in the minutes.

Sir David Lees expressed interest in the advance corporation tax changes and the fact that over time the effect would flow into wage rates and arguably into employment. He believed that there was an alternative scenario in which the effect was the reverse of that intended. Companies would instead reduce investment, not necessarily tangibles such as plant and equipment but soft investments such as training and research and development.

In reply to a question from Mr Allsopp, Mr King agreed that the Bank's assumptions about the GDP deflators were more optimistic than those of the Treasury. Mr Allsopp commented that the Bank was assuming that, though output was lower, the inflation forecast would be better. Mr King replied that the crucial issue in assessing the Budget was the difference between 1996 and the latest Budget, in which the Treasury had revised up the price level for the next year or two. What was unclear was whether the Treasury believed that this implied that the price of public services would be revised up or whether it implied a change in relative prices. That would give the answer to whether the Treasury was planning for lower real public expenditure than last November.

Mr Allsopp also asked about the role of Court in relation to the MPC. Was the role of Court to evaluate, think about and supervise the procedures rather than the decisions? If that were the case, when did those aspects get discussed? He also asked what was the role of the MPC in the preparation of the Inflation Report. Was it the MPC's report or was it published by the Bank? The Governor noted that he would go in more detail into these procedural issues immediately after the conclusion of the economic and monetary discussions. He commented that there was not yet available a precise formulation of the role of Court in relation to the MPC. The Governor said that he was clear that Court's role could not be to second guess the decisions of the MPC, but there was clearly going to be a role in terms of the procedures that were adopted by the MPC. Non-Executive Members of Court would be required to make a report on the MPC which would be included in the Bank's report debated by the House of Commons. The Non-Executive Members of Court would need to consider how to fulfil their responsibility, but until the precise terms were given that was slightly difficult. He would ask Mr King to say more after the economic and monetary discussions.

Mr Buxton commented that Mr King was right to say that the export figures were remarkably good, but there had now been quite a substantial deterioration in order books and this was going to come out in the figures over the next couple of months. Companies were having to fight to hold on to orders by cutting prices, but they were still losing orders. However, overall, there was still a lot of optimism in the economy because domestic demand was strong, and total orders were up. Turning to dividend taxation and pensions, Mr Buxton commented that a lot of companies had moved to defined contribution schemes. The tax change was not just going to have an effect on company pension schemes, but was going to come through rather quicker.

Commenting on labour costs in the construction industry, Mr Simms said that the industry was still moving forward. May was almost disastrous for new orders because of the election. That said, the picture was still improving for the next few years. On labour costs, the pressure was growing quite strong, but it was still mainly in London and the South East and among specialist people, though this was beginning to ripple outwards. He expressed confidence that the industry would sign up to a new three-year wage agreement.

Sir David Cooksey said that the group of small high tech companies whose financing he was involved in were very export oriented and beginning to hurt badly. Substantial profits were turning to losses. Another involvement of his, the Wellcome Trust, owned property in the Kensington area of London and had been pressed to grant freeholds at very high prices, indicating that other assets were being cashed in to fund property investment. Turning to tax credits, he said the use of very conservative cash flow models for actuarial valuations hid considerable surpluses if investments were marked to market. He hoped that the Budget would start to move to a more realistic valuation of pension schemes so there was less of an incentive for dividend growth rather than capital growth. Sir Colin Southgate said that before the Budget it would have been 80 years before his companies' funds had to put another penny into pension schemes but this Budget reduced the period to 50 years. Sir Colin described the Budget as wimpish, given that £35bn was going into the economy and people were spending it, for example, on buying out rental contracts for equipment, and on holidays. Domestic consumption was growing fast and there had been an opportunity to do something about it, which had been missed.

The Governor thanked Court for a useful contribution, including the points made about pension funds and the evidence from the retail side. He said that the Bank had real difficulty in making assumptions about the behaviour of companies and consumers. He noted that the Bank was well aware that exporting companies were beginning to be hurt but the question was what could be done about that - that was the dilemma. Court's comments were totally consistent with the assumptions that the Bank had made that there would be quite a sharp deterioration in the external position. It had been cushioned up till now by taking the pressure on margins but companies were coming to the end of that road.

Turning to procedural questions, the Governor asked whether members of Court felt that the monthly procedure, in which outside members of the MPC attended Court for the economic and monetary discussion, allowed them to exercise some degree of oversight over the MPC process. The Governor noted that, in the absence of precise definitions, Court was at the learning stage. The Governor suggested that the present arrangements continue at least until the Bank and the MPC had their full marching orders and outside complement of members.

Sir David Lees asked whether Members could see the minutes of the meeting held six weeks earlier the day before Court. The Governor said that this was a proposal that he would take up with the MPC and he would encourage them to agree with it.

There was a second question which the Governor did not believe could be resolved until it was seen precisely what the government had in mind. This was the question of how Non-Executives should satisfy themselves about procedures and how they report on whether or not they were satisfied with the procedures at the time of the Bank's Annual Report.

One particular question for Court to consider was whether the MPC was taking adequate account of regional interest and representations. The Governor commented that he was very open to suggestions. Non-Executive Members of Court could see presentations by the Bank to the MPC, including the presentations by three regional Agents. Court might also want to consider commissioning a paper from the Secretary or from internal Audit which set out the nature of the process and how the Bank was approaching the new mandate from the MPC.

In response to a question from Dame Sheila Masters, the Governor said it would be wrong if Court were to be put in a position of second guessing the results of the MPC's deliberations. Although it was not possible to say until the legislation was seen, the Governor said his expectation was that the focus would be on procedures. Dame Sheila noted that examining judgements six months or a year ago was not the same as second guessing the judgement in a particular month. The Governor noted the point and said that he believed it would need to be looked at again in the context of the draft legislation. He said his comment about second guessing was not meant to trivialise the issue. The Bank was responsible to the Chancellor and the Treasury Committee. There needed to be clarity on the respective responsibilities of all the oversight bodies.

In response to a question by Sir Chips Keswick about whether the MPC members had enough international experience, the Governor said Mr King, Mr Plenderleith and himself were already familiar with the international aspects of monetary policy and Mr King noted that the MPC was unique in the central banking world in that it would soon have two foreign members, Professor Buiter and Dr Julius.

Mr Allsopp asked what weight was given to different regional views and to different forecasts before the Committee, including those from the Treasury and the City. Mr King noted that a key part of the process was a full-day meeting in which staff presented to the MPC information on the economy. This included monitoring of all surveys, all the information on demand and output and a systematic presentation of information from the regional Agents. The Agents individually wrote a report on the state of trade in their region which was collated at the Bank. There was also a tele-conference with the Agents and each month an issue of the month was chosen, for example growth or export orders, and each time three of the 12 Agents attended the Monetary Policy Committee meeting. These three Agents, on behalf of all the others, presented the results of the month's survey. The difficult task was not to make sure that the information was presented to the MPC, but to know how to weight, absorb and assimilate all the evidence and turn it into a coherent view. Professor Goodhart noted that the meeting was all day, extensive, catholic and ecumenical. It had included everything that could possibly be thought of, and the problem was to assimilate it and come to a judgement about what was likely to happen, which in the case of the exchange rate was exceedingly difficult.

The Governor noted that the reason for the emphasis on the Agents was that the Chancellor had put an emphasis on regional representations. The issue was how Court could satisfy itself. The Bank was trying to find means by which it could expose to Court the way the process worked. It was on that issue that Court would be required to express a view, in the Annual Report and quite possibly to Parliament.

In response to a question from Mr Simms about the timing of the draft legislation, the Governor said that discussions, which had been reported to a special meeting of Court, had come to a halt for the time being and he was hoping that they would be resurrected later in the week or during the next week.

A particular question was the nature of the Bank role in relation to financial stability of the system as a whole. The Bank had developed the bones of a memorandum of understanding with the enhanced Securities and Investments Board and he hoped that would be the basis of the way forward. There had not as yet been an answer on the review of finances, but it would be presented to Court when it arrived.

The Governor noted that draft legislation was unlikely before the resumption of Parliament, though there might be something to look at beforehand, and if so it would be brought to Court. If the legislation were introduced to Parliament in October the Governor hoped that it would be passed by about February.

On the question of the precise role of Court in relation to oversight of the MPC, the language was very much a question for government. It would be necessary to come back more precisely to the question of how Court was going to exercise its responsibilities, and there maybe some feedback into the process itself from those discussions.

Mr Plenderleith, agreeing that it was a learning process, said that he could see that it would not be reasonable to invite Court to second guess the Monetary Policy Committee. But he was nervous about falling back onto a definition related purely to the process. Members of Court would be interrogated on the performance of the MPC in achieving the inflation target. They would be left in a weak position if they had to fall back on saying that they were monitoring the process but not the ex-post results. Mr Plenderleith said that Court should satisfy itself that the process was working properly, that there was adequate input of regional and sectoral information and feedback of Court's experience on parts of the economy, and it should also undertake an ex-post examination of the impact of policy decisions.

The Governor commented that in the Chancellor's letter it was clear that the MPC would be accountable primarily to the Chancellor in the first instance for achieving his inflation objective, and also to the Treasury Select Committee. He said he accepted the way Dame Sheila had put the question, which was whether it made any sense to have the MPC accountable to Court in this respect. The Governor asked what happened if Court said that the MPC had done a good job in achieving the inflation target and the Chancellor and Parliament took a different view. It was important to see what government and Parliament envisaged. It was not possible to carry this much further until the government's intention was seen. The Governor commented that, for the time being, Court's role was in relation to procedures, the effectiveness with which the MPC did its job and whether it was equipped to do it properly, using resources in a sensible way. Court also had the other role, of inputting to the process.

Sir David Lees commented that there was danger in waiting for the government to say what the role of Court should be and that the Bank should consider striking first by putting in its own suggestions. He also saw quite difficult practical problems for Court, particularly given the overlap between the MPC and Members of Court. Members of the MPC on Court had to be separated from the Court view of the MPC. That set up some quite interesting administration problems for the Non-Executive Directors, Sir David noted. The Governor said he was interested to have Court's guidance, but it had to take account of what the Chancellor had said. The Government clearly implied that accountability for the performance of the mandate of the MPC was to the body politic. If Court felt it had to play that role, that was something on which it had to make representations to government. The Governor commented that, in his view, the Court role was to oversee the way the operation was carried out, the use of resources and whether the right skills were employed. This had been the role of Court in relation to most of the Bank's activities. Court had never managed the Bank in terms of the Bank's policy decisions.

Sir David Cooksey said that he believed that there would be merit in the Bank at least tracking how the MPC performed over a two-year horizon. The Governor commented that the Bank could arrange for that to be done. The question was whether the Bank should represent to government that that should be part of Court's responsibilities. The Governor commented that he did not get a sense from the meeting that Court should seek to make representations that it should oversee the outcome of Monetary Policy Committee decisions.

Mr Buxton said that he supported Sir David Lees' suggestion that ideas should be put forward to the Government about the relationship between Court and the MPC, even though they might not be accepted. Once ideas had been put forward by Government it would be extremely difficult for the Bank to alter them. The Governor noted that he was very happy to put forward ideas, and invited Members of Court to write to suggest ideas that they would like the Bank to put forward, and if necessary they would be brought back to Court in August. The Governor said that if Court members wished they could write to him suggesting that Court should take a role, in the sense of monitoring the outcome. But he did not believe that that would be the way the Government saw it. The Governor commented that in his view the Government was right. He did not believe that such a responsibility could be given to the Court.

The Deputy Governor said that the distinction drawn here between substance and process was rather stark, and there might be territory in the middle. One extreme was tackling the question of whether the MPC met the inflation target. There already was a procedure for explaining the reasons, when inflation was more than 1% either side of the target. The other extreme was the minimalist one in which Court could say that the MPC met, there were nine people and the minutes were published. In the middle territory there were questions such as whether the MPC was taking reasonable steps to inform itself on regional developments, on international developments, and on the impact of its decisions on different sectors of the economy. The MPC might, for example, be criticised for meeting the target but leaving no manufacturing company in the UK. That was the middle territory where the questions would be. Mr King commented that it was not such a straightforward issue. There were questions of process and of principle. The comparative advantage of Court was to inform the outside world that the way the MPC went about the monetary decision process took advantage of a wide range of information. The question of hitting the target but leaving only one manufacturing company in the country went to the heart of whether monetary policy was set appropriately. The issue was whether it was right to hit 2 1/2% or whether a slightly higher inflation rate should have been accommodated. That was not a suitable area for Court to venture into. All the information was in the public domain, there was already a shadow MPC, and lots of experts already saw themselves in that role. Court's role was to say that the process was not amateurish - rather it was serious and there were a number of steps in it - and to reassure the outside world.

The Governor commented that the Court role was in a broad sense procedural rather than second guessing. The issue was whether there were points in the language, when it was given by Government, that would enable Court to have that procedural role. The Bank would look and bring the question back to Court. The Governor asked Members of Court who had views on points in the language to let him know outside the meeting.

Foreign Exchange Holdings by the Bank of England
(Mr Smeeton in attendance)

Turning to the Bank's own foreign exchange holdings, the Governor said that the view of the MPC was that standing in the way of the market to determine the exchange rate was pretty much a lost cause. But there was a practical role for intervention which may be to get behind a corrective market movement, and conceivably even to initiate such a market correction. Commenting on the proposed arrangements, the Governor said that decisions would be taken by the Bank executive within a delegated authority from Court in the particular context of a current situation, which would have been discussed with the MPC. The Governor asked Court for its view of the structure of the relationship. He would come back to Court about the delegated authority to take on risks, but he reminded Court that there were ongoing discussions with the Treasury about the way the new arrangements would work.

Mr Plenderleith commented that the proposals were not dissimilar to the way the Bank managed foreign exchange for the Treasury as an agent. Responsibility for the outcome and for the policy was with the Treasury but in both cases there was an agreed framework within which the Bank could operate. The thought was that a similar framework should be developed in relation to the Bank's own reserves.

Dame Sheila Masters said that she was uncomfortable with what was being proposed. How could responsibility be exercised if there was a separation from policy making? Mr Plenderleith said that he accepted the underlying points but the fact was that this was the operation of monetary policy, not a normal business. It was very much an extension to foreign exchange of the process already in place with the Bank's sterling balance sheet. Sir Chips Keswick commented that, with £1bn capital and reserves, there could be little relevance in banking terms in having any foreign exchange activities at all. The Governor noted that it was a question of scale. Even with a capital of £1bn it would be perfectly possible to think of intervention of up to $1bn for tactical purposes. He commented that, in current circumstances, if the Bank displayed the view that sterling was overvalued by undertaking tactical interventions on that scale it could have a significant impact. Furthermore there were other roles that the Bank could engage in. It might want to use foreign exchange swaps in support of its sterling operations. Sir Chips commented that capital of that size would not give the Bank a very powerful presence in the swaps market. The Governor said that it might be significant in terms of the amount of liquidity the Bank had to provide day-to-day. Sir David Lees said that the proposals were acceptable but noted that Government definition of the arrangements for financing the Bank was still awaited. In that context it was not possible to put numbers on the risk, and it was a chicken and egg situation. The Governor agreed that that was exactly the dilemma. In the discussions of financing the Bank it would be necessary to have a view about this. That was why the matter had been brought to Court. The Governor commented that he was not at all clear about the Treasury's position. In the most recent conversation, the Treasury indicated a substantially larger number than $1bn for the Bank's reserves. Another question was whether the amount would be on the Bank's balance sheet or whether the Treasury would share the risk and the Bank would manage it with more discretion than with the foreign exchange reserves. The Bank was seeking to get Court's acceptance of the scale of exposure legitimate for the Bank in this context. The Bank would be guided by the MPC in the way that it used the limits Court set. Any action would have to be by the executives. Exposures would be reported to Court and the Bank would report to the Monetary Policy Committee on the impact of interventions.

Mr Buxton said that the broad structure was reasonable, but when coming to the next stage of deciding the risk management structure it would be very difficult. Central Banks did not have a balance sheet to influence the market. But Central Banks did influence by, their intervention because of the fact that they had the state behind them. The Governor commented that it was possible that by making a statement that sterling was overvalued there could be a market impact, but in practice that was not true. But if the statement was accompanied by intervention, it could have a market impact. That was what the MPC envisaged as the intervention undertaken independently by the Bank.

The Government would have the largest part of the reserves, which it could use typically as part of an international agreement to intervene. It would like to give the Bank the capacity for its own intervention. The role of Court, and particularly its financial Members, was to indicate the scale of risk that it is sensible to undertake in relation to the capital of the Bank.

The Bank's internal preparations for EMU (Mr Kentfield and Ms Gray in attendance)

Introducing a paper on the Bank's own internal preparations for EMU, the Deputy Governor drew Court's attention to a simplified chart of the preparations, noting that there was an even more complicated chart behind this version. Unless entry was ruled out for a decade or so, the difference between the work involved to be in the first wave and the second was not as great as it might appear. He noted the importance of undertaking effective work on EMU as long as there was any prospect of going in.

The Bank's view was that the project was just about on track. There was a problem, he noted, in finding the right people. There were other projects going on, such as the Central Gilts Office and the Millennium Project, that might get in the way. It would take some time before slack appeared. But the Bank would not assess itself as behind the game compared with other central banks in the EMI system. The Bank had also indicated to government that there was a risk that, the longer it went on not knowing where it was going, the more risk would emerge on this front. This had been made clear to the Treasury. A committee would continue in being to ensure that progress continued to be made. It was done in a business-like way bearing in mind the uncertain environment in which the Bank operated.

In response to a question by Sir Colin Southgate about whether the removal of debt management to the Treasury would take a load off the Bank, the Deputy Governor said some load would be removed but not a huge amount. In the critical period the Bank would be helping the Treasury to put together its debt management operation. In response to another question by Sir Colin about the state of preparedness of government departments for EMU, the Deputy Governor said that the Bank's assessment was that they were not very well advanced. A publicity campaign was about to begin, with the Chancellor making a speech indicating that the government would set up a group to look at business preparations, and the Chancellor would also say that the Bank remained in the lead in the financial sector. Areas such as the Inland Revenue and Customs and Excise had not been allowed to do or say very much. Mr Kentfield said that the Inland Revenue and the Customs and Excise have confirmed to the Bank that in fact they were doing nothing. The Deputy Governor noted in response to a question by Mr Simms that on market and gilt conventions the Bank had effectively achieved the target date of July 1997. Commenting on CGOII, Mr Kentfield said that the Bank was conducting dress rehearsals, for the projected start date of late August, but the Bank was not yet in a position to say whether it was in a position to meet that date. He noted that the first dress rehearsal had gone quite well.

It was necessary to get CGOII up and running to handle Euro instruments, and release resources for other projects in the Bank. The Deputy Governor said that the Bank had been a little slow in pulling people into these areas, but not so slow as to

[redacted]

destabilise the Euro project. Commenting on the last paragraph of the paper, which said that many City institutions were less likely than the Bank itself to be preparing assiduously for an in scenario, Mr Buxton said that many City institutions would assume, on the basis of remarks by the Chancellor, that entry was unlikely. They would prepare for EMU on the wholesale front but would not go the whole hog in planning for retail systems. The Governor said that he agreed.

The Executive Report

National Mortgage Bank (Mr Kentfield in attendance)

Turning to the Executive Report, the Governor reported that NMB had requested permission to sell its consumer loan book to

[redacted]

The question for Court was whether the sensitivity was such that the Bank should continue to manage the consumer loan book. The Governor noted that he had asked for an exploration of alternatives and he believed that the answer was that there were none in immediate prospect. Mr Plenderleith reported that the NMB loan book continued to be run off. Business and consumer loans were the two major areas left. The Bank was perfectly content to run the books to maturity if that were the best way of receiving the full current value. For the consumer loan book, that period was ten years. But, equally, NMB was prepared to consider approaches to sell if they were for full value. There had been eight approaches over the last few years and none of those had approached full value. [redacted]

[redacted]

proposition there was a case for authorising the sale. The Bank would receive full value now, and there would be no downside risk that the loan book would deteriorate, although the upside would be lost. In the consumer loan book there was in fact practically no upside, because in many cases they were second or third mortgages with one or two creditors ahead of NMB. Mr Plenderleith noted that administrative costs would be saved and the business case for the sale was fairly cut and dried.

[redacted]

There had not been a full independent trawl for other offers. It had however been confirmed that other potential buyers were not prepared to meet the Bank's full value criterion. Mr Plenderleith recommended that the sale should go ahead, while accepting that there were sensitivities.

[redacted] Dame Sheila Masters asked whether there had been a big loss for the Bank,

[redacted]

and Mr Plenderleith replied that the original funding provided by the Bank was £340 million, and this had now fallen to £155 million. The original loss had been estimated at £113 million, and this had now been reduced to £86 million, all of which had been provided in the Bank's accounts. The Governor noted that the effect of the sale would not be to reduce that further, but it would crystallise the loss. [redacted] The Governor said he accepted that point but the other side of the question was that the deal would fix the Bank's loss and there would be the benefit of getting administrative expenses down.

[redacted] The Governor noted that the share value of NHL fell, but then it attracted new capital. The shares were now well below what they used to be. The Governor commented that there had been great difficulties. There were cross obligations and detaching them had been difficult. The Bank had supported the deposit taking institution in the context of a possible systemic knock on to small banks. The Bank had had to take out a subsidiary from NHL if it was going to stop the whole group going down. The action was not to protect NHL, but the Bank had to do it if it was going to protect NMB. Mr Simms commented that there was a reputational risk both ways. If there was any risk of having to rescue [redacted] the Bank should not contemplate the sale. If not, the Bank should take a commercial deal in today's environment. The Governor said that there was no chance of having to rescue [redacted] was not a deposit taker.

Dame Sheila Masters asked whether it was possible to find a more open process by marketing the business in some way; the Bank would find it very much easier to defend the sale. The Governor said that that had been his reaction, which is why he had said that this had to be the only game in town before there would be agreement on a sale. Sir Chips Keswick said that he felt strongly that if it was seen at the end of the day [redacted] had profited out of this, the Bank would not have a leg to stand on and therefore he would not advise doing it. Sir Colin Southgate agreed with Sir Chips. The only way he could see it happening would be if the sale reduced the Bank's write off. Mr Plenderleith said the Bank had taken additional steps to go back to the areas of possible interest to see if those potential buyers would be interested at a higher price. He was not sure that it would be sensible to go out in a more high-profile way to place the business. However Mr Plenderleith accepted that there was a reputational risk to the Bank. Sir David Lees said that in principle he would be quite supportive because the saving was quite considerable. He asked not whether there was a better offer but what was the next best. If it was only £1-2mn lower, the reputational risk was such that the Bank should accept the next one down.

Mr Plenderleith said that the Bank had historical figures and could go back to those that have shown interest to ask them to put in a new figure. He did not know how close the previous figures were but he believed they were not very close. Whether it was sensible to take the next best offer was another question, because the Bank would be forgoing value. The Governor commented that the sense of the meeting was that there was a nervousness about the reputational risk and a readiness to accept even a worse deal if that risk could be avoided. He

[redacted]

said that Mr Plenderleith and Mr Kentfield should be asked to go back to Mr Hay Davison and say that the Bank would want to be persuaded that there was real additional value before it [redacted]. The matter would be brought back to Court.

The Governor asked the Deputy Governor to comment on the latest state of play on the pay award for the main bargaining units. The Deputy Governor said that the main bargaining unit was the officers of the Bank who had been offered a 2% increase with cash underpinning for junior officers. The union had decided that it did not want to accept this and instead wanted an across the board offer but the Bank was not happy with that. However, the Bank had gone back and said that it was prepared to make an across the board offer, but it would be only 2 1/4%. This had been rejected and a second failure to agree had been registered. The matter would be going to conciliation the following week.

Mr Berkowitz, who was accompanied by Mr Choyce, one of his Senior Legal Advisers, updated Court on the latest situation regarding BCCI litigation. Mr Berkowitz said the last report to Court had been towards the end of 1995 after the Bank had started proceedings to have certain preliminary issues tried on the basis that the allegations in the Plaintiffs' Statement of Claim did not disclose a course of action. Mr Justice Clarke, in delivering judgement in April 1996, concluded that the ingredients of the tort of misfeasance in public office, (the Plaintiffs' primary cause of action) required that the Plaintiffs show firstly that the Bank knew it was acting unlawfully and secondly the Bank knew its acts or omissions would probably cause loss to depositors because the Bank knew that adequate and speedy remedial steps would probably not be

B

taken. He commented that knowledge in this context would be actual knowledge or a belief or suspicion coupled with failure to make the enquiries that a reasonable and honest person would make. The judge found that the allegations made by the plaintiffs on the first leg were sufficient but on the second leg were not. He did however offer the plaintiffs the opportunity to amend their pleadings to remedy this shortfall. He also threw out their secondary claim based on the Bank's breach of European law.

Since then there have been a number of hearings in which the Plaintiffs have sought, ultimately probably successfully, to amend their pleadings to make the required allegations and the Bank has applied to have the proceedings struck out on the basis that they are frivolous and vexatious. This application is made on the grounds that the plaintiffs' claim is based on the Bingham Report and a limited number of other documents from which, on a fair reading, no basis for a misfeasance claim can be discerned. Mr Berkowitz commented that it was a difficult application on which to succeed given that, if wholly successful, it would deprive the plaintiffs of their claim and the remedy was discretionary, but it was considered worth making in the circumstances.

The last hearing was in April and the Bank is waiting for judgement on these issues. In relation to the frivolous and vexatious claim, the court could uphold the Bank's argument in full or in part or not at all. Going forward, the plaintiffs are to appeal and try to have the legal threshold for misfeasance in public office lowered. They have also indicated that they are likely to appeal against the dismissal of their European law claim. The Bank is likely to put in a respondent's notice on the misfeasance claim, arguing that the judge was right but that the threshold should be higher and that the knowledge required should be of inevitable rather than probable loss. It also intends to appeal on one of the preliminary issues on which the judge found against it.

It is likely that the plaintiffs will seek an order that preparations for the trial should commence immediately. This is partly, the Bank believes, because they would like to receive accelerated discovery which they think might help them in the Court of Appeal. Mr Berkowitz said the Bank intended to argue that the preparation should not start because the work which needs to be done would depend very much on whether any claim survives and, if so, whether the Statement of Claim needs to be amended. Moreover, the whole purpose of the trial of preliminary issues was an effort to avoid a lengthy and expensive trial if the matter could be disposed of in a preliminary way. The plaintiffs would seek to criticise the Bank for delaying the matter. The plaintiffs are also likely to seek accelerated discovery of the Appendices to the Bingham Report, which provide in more detail the underlying facts on which the report was based. The Bank will oppose this and it does raise PII issues which are being discussed with HMT.

In response to the Governor, Court indicated it was content with the line to be taken as outlined in relation to appeals and other conduct of the matter.

The Bank's proposed conference facility (Mr Midgley in attendance)

Turning to the conference facility the Deputy Governor said it was a finely-balanced decision made more complicated by recent developments. There was no room in the Bank for large numbers of staff to meet. The Oak Room was not ideal, and it was necessary to go to Livery Halls and other venues to address large numbers of staff. The Bank also had a lot of space that was not well used. It was expensive to convert into offices but could not be used without a conversion. So the Bank had explored the possibility of converting a banking hall to a high-grade conference facility. It was possible to produce this on two floors, seating 180 people, with very good audio visual facilities. It would convert to a desk style facility. It would be used for a number of internal meetings including the pre-MPC meetings, the Bank's own conferences and some staff meetings, though not all. He acknowledged that use by Supervision and Surveillance was an uncertainty because, if the staff were situated in a nearby office, it might be possible to use the new facility but this would not be the case if Supervision and Surveillance was located further away.

The Bank was proposing some commercial use, with links to the Museum. It would provide a very good facility for a conference of 100 to 150 with drinks in the Museum. This would be very attractive for up-market City events. The marketing would have to be outsourced and that would mean giving dates that the facility would not be available for internal use. The best estimate of costs was that, if the facility was used commercially for 100 days a year, there would still be a npv shortfall of £750,000-£1.5mn, which was the cost to the Bank of achieving a better conference facility for internal use. The alternative of an in-house facility with a lower specification was not particularly attractive and neither was it attractive to use the space as offices. The Bank would not be short of office facilities because it was likely that, in future it would fit reasonably comfortably into the Headquarters building, and the space concerned was not worth converting into offices. The choice was between leaving this space in the middle of the City alone or the project to turn it into a conference facility.

The Governor asked whether Court felt comfortable with this kind of investment before the decision was made to go ahead. Sir David Cooksey asked how the project fitted in with the intention to bring the catering back into the Bank. The Deputy Governor said there was not a close relationship. If catering were brought back in, it would probably be on the 7th floor; it would not make much difference to the conference facility. Since the announcement in May, the Bank had not comprehensively redone its building strategy but, over a couple of years, after the departure of Supervision and Surveillance, it would almost certainly be possible to decant all the existing activities of the Bank in the City, though not necessarily Eagle House, into the Head Office building and to have internal catering and a conference facility there.

Mrs Heaton asked whether the Bank had difficulty renting outside when it needed conference accommodation. The Deputy Governor said yes, this was the case in the sense that, for example, with the Bank's EMU work it had to use the Barbican cinema which was not terribly satisfactory. Mr Neill said that with imagination and with involvement of the training activities of the Bank it could produce a very good result. He pointed to the advantages of a similar project at Unipart. Mr Buxton said that he wondered whether the Bank should be going ahead with a facility that appears to be justified by outside letting. Should not the Bank go ahead with the smaller facility? The Deputy Governor said that the proposal was not easily realisable in the space concerned in any other way. Only in that space would it be possible to have a link to the Museum, providing an evening facility. Dame Sheila Masters said that, as an accountant, she did not find the business case well made. The project did appear expensive. Mr King said that when he came to the Bank he was quite surprised at how poor the facilities were for seminars, conferences and presentations. The Bank now had the Oak Room, which was very Heath Robinson with screens and wires all over the place. He believed it very important to have meetings that linked into the Bank's information technology systems. There was no proper place for the Inflation Report press conference. There was no place to get staff together in numbers of 50 to 100. Even internally there was a case for using the space as a conference facility and one that specifically enabled the Bank to have IT in its presentations. This would allow presentations to the MPC to take place in the facility. The capacity could be cut to a 100 but nothing would be gained. It was urgent to have somewhere to conduct meetings of the MPC, press conferences and meetings of staff. Mr Plenderleith said it was equally important to have a venue for meetings with the markets.

Mr Simms said that his instinct was that the time for making this decision was not right. It was preferable to allow issues about Bank staffing to settle down. But he could not argue with the need to have a good facility at the Bank of England. There were three spaces within one mile that took 200 or more people. If the Bank really wanted to do it, he would advise that it should be undertaken in a year or nine months time but if it had to be done he would undertake it under the Private Finance Initiative. He would recommend granting a full concession.

The Governor said it was not right to look on it as a commercial venture. It was a facility the executive would like. Commercial revenues were mentioned on the basis of how much the cost to the Bank could be reduced. Only on that basis did he feel it could be put to the Court. Sir David Lees said that the issue was the size. Either something was built almost entirely for the Bank's use, say for £2.5mn, or one step more was taken and the Bank got some of the costs back by sporadic lettings. He was unclear about whether it was possible to get an effective smaller facility that met the Bank's needs. Sir Chips Keswick said that his building had a conference centre seating 120, with a total staff in the building of 600. The centre was used day and night, five nights a week and he strongly supported the Bank having one. Sir Colin Southgate asked whether the £3.6mn cost was related to the fact that the Bank building was old and was listed. The Deputy Governor agreed. The Banking Hall was an unusual shape with high ceilings. Cutting down on the space would not save very much. There might not be a door through to the Museum and one or two security measures might be saved. Sir Colin Southgate said that he would support a building for the Bank's own use, spending £3mn rather than £3.5mn.

Mrs Heaton said she supported having the facility as a very important instrument for executives for the Bank, particularly with the raised profile of the MPC. There would be criticism, albeit misplaced, if it was done at the moment, with all the staff changes and with possible allegations that the Bank was using up surplus space. She said, however, that she would support going ahead now and not postponing.
The Governor asked whether there was enough support about the table to go ahead and received the agreement of Court. He said that he believed it would prove to be an immensely

valuable facility within the Bank. He was particularly attracted to having tailor-made facilities for the MPC process, tapping into the Bank's database on a live basis. Looking over a long period, he believed it was worth it on those grounds alone.

The Quarterly Financial Report (Mr Midgley in attendance)

The Governor asked Mr Midgley to introduce the quarterly financial report. Mr Midgley apologised for a small error in the report which was corrected with an erratum slip. He commented that, though the manpower shortage looked big relative to the budget number, when the figures had been put in they were on the basis of a net addition, while in practice all that could be done was to use the people on the ground. It had been assumed that S&S was fully staffed, but it was known that it would not be until after the next graduate recruitment round in October. He also noted changes in income. Half were due to changes in interest rates and the other quarter was due to an underestimate of the growth in cash ratio deposits. Sir David Cooksey said it would help Court if it had a quarterly budget and outcome statement. Mr Midgley said that he had shied away from doing this when the reporting system was set up because he had wanted to concentrate on the outturn for the year. The quarter to quarter figures were volatile. If it was found to be helpful, he would introduce more of that into this report. Sir David Cooksey said that it was difficult to make a judgement through the year unless it was known what Court was comparing with. The Governor agreed.

A report of the Trustees of the Court Pension Scheme

The Governor noted that the Executive had an interest in the subject being discussed and he hoped that Court would agree that, it was not appropriate for them to withdraw. Sir Colin Southgate said that the funding was extremely conservative and he expected the changes in taxation in the Budget to have no effect when looked at on a reasonable basis. Mr Buxton said that the costs of the pension fund should be borne by the Pension Fund. Dame Sheila Masters said that in the main scheme half was borne by the Bank. Mrs Heaton said that where the staff scheme was concerned, this had been raised as an issue. The Governor suggested that the matter was raised again at another time, in the context of both the Court Scheme and the Staff Pension Fund. He noted that the Annual Report and Accounts of the Court and Staff Pension Schemes used to be adopted by Court. As a result of the Pensions Act, accountability was now to the Trustees, and Court was no longer required to adopt the Report and Accounts.

The Governor noted that this was the last Court meeting to be attended by the Deputy Governor in that capacity because of his departure to the Securities and Investments Board. He recorded his gratitude, and that of Court and the Deputy Governor's present and past colleagues, for his contribution to the Court's discussions. A dinner would be held for the Deputy Governor and Lord Simon on 29 July.

David Scholey

Assistant Secretary
20 August 1997

TO MEMBERS OF COURT

COURT 16 JULY 1997: THE WRITTEN EXECUTIVE REPORT

National Mortgage Bank (NMB)

Support for National Mortgage Bank (NMB) was originally given in 1991 by way of an indemnity to its bankers; subsequently, in 1994, when the need to avoid disclosure no longer applied, the Bank took NMB over. Ian Hay Davison was appointed by the Bank in February 1992 to run NMB down. The total cost of the Bank's support peaked at £113mn in 1993 and has since been reduced to £86mn.

There are two principal remaining parts of NMB's business: consumer loans (second/third mortgages, mostly now unsecured on account of negative equity) valued at c £37mn net of provisions and a miscellaneous portfolio of business loans valued at c £33mn. No new business is undertaken. There is a running margin for both books, mainly because they are funded by a Bank of England loan at LIBOR, but this will diminish over time as the fixed costs will tend to rise relative to the whole as the books run off. It has therefore been an objective for NMB to look for purchasers of all or parts of the business (and the leasing business was accordingly sold in 1995).

The bulk of the running costs of NMB, in terms of staff etc, arise in relation to the consumer loans business and this is the one which has attracted interest from potential purchasers. NMB have now received an offer to purchase this business from [redacted] It values the consumer loans business at £38.2mn, which is very close to the NPV which NMB believe they could get by running the business down themselves. But, in addition, it would deliver certainty of value now and avoid any risk of future deterioration to the value of the book. It is a better offer than any of the half-dozen or so which have been made previously; although NMB have not specifically commissioned a merchant bank to seek a purchaser, it is Hay Davison's view that the most likely potential purchasers have already had a look. In his view, this is the best offer we are likely to get and he recommends we accept it.

Court Post (4236)

Secretary's Department.

A MEETING OF DIRECTORS AT THE BANK

WEDNESDAY 23 JULY 1997

Present

Mr George, Governor

Mr Davies, Deputy Governor

Mr Clark

Mr Foot

Mr King

Mr Plenderleith

The number of Directors assembled being insufficient to form a quorum, those present proceeded to the business, subject to ratification by the next Court.

The Minutes of the last Court, having been circulated, were noted.

Mr Plenderleith spoke about the foreign exchanges.

David Scholey

Assistant Secretary

20 August 1998

A MEETING OF DIRECTORS AT THE BANK

WEDNESDAY 30 JULY 1997

Present

Mr George, Governor

Mr Davies, Deputy Governor

Mr Foot

Mr Plenderleith

The number of Directors assembled being insufficient to form a quorum, those present proceeded to the business, subject to ratification by the next Court.

The Minutes of the last Meeting, having been circulated, were noted.

The Governor recorded his gratitude to Howard Davies for his contribution during his time as Deputy Governor.

Assistant Secretary
20 August 1997

A MEETING OF DIRECTORS AT THE BANK

WEDNESDAY 6 AUGUST 1997

Present

Mr George, Governor

Mr King

Mr Plenderleith

The number of Directors assembled being insufficient to form a quorum, those present proceeded to the business, subject to ratification by the next Court.

The Minutes of the last Meeting, having been circulated, were noted.

Mr Plenderleith spoke briefly about the Official Reserves figures for July.

David Scholey

Assistant Secretary

10 August 1997

A MEETING OF DIRECTORS AT THE BANK

WEDNESDAY 13 AUGUST 1997

Present

Mr George, Governor

Mr Plenderleith

The number of Directors assembled being insufficient to form a quorum, those present proceeded to the business, subject to ratification by the next Court.

The Minutes of the last Meeting, having been circulated, were noted.

Assistant Secretary

20 August 1997

A COURT OF DIRECTORS AT THE BANK

WEDNESDAY 20 AUGUST 1997

Present

Mr George, The Governor
Sir David Scholey
Mr Allsopp
Mr Clark
Sir David Cooksey
Mrs Heaton
Mr King
Sir David Lees
Dame Sheila Masters
Mr Neill
Mr Plenderleith
Sir Colin Southgate

The Governor explained that, as there were a number of issues relating to the Bank of England Bill which he wished to discuss with Members, it had been necessary to bring forward the start time of Court and he thanked Members for coming in early.

The Minutes of the Court of 16 July and the Meetings of 23 and 30 July and 6 and 13 August, having been circulated, were approved.

A Letter of Resignation and Issues Arising from the Appointment of New Deputy Governors

The Governor laid before Court a letter of 24 July 1997 from Howard Davies, giving notice of his resignation from Court with effect from 31 July 1997, in the office of Deputy Governor.

It was RESOLVED that the Secretary be directed to communicate to the Chancellor of the Exchequer the notice of resignation of Mr Davies from the office of Deputy Governor of the Bank pursuant to Clause 8(e) of the Charter of 1 March 1946.

The Governor then related to Court the steps leading to the announcement of David Clementi as Deputy Governor in succession to Howard Davies. [redacted]

[redacted]

The Governor also regretted that there had been no opportunity to canvass Court's view, in advance of the announcement, of how the structure with two Deputy Governors would work in practice. He did not believe that the situation had been discussed and thought through at the Treasury; and prospectively having two functional heads, one of whom effectively controlled the other's budget, was unusual. But he believed that, in practice, the arrangement could be made to work satisfactorily and he thought that David Clementi would fit in well. He was particularly pleased that, at the same time, the intention to appoint Mervyn King as Deputy Governor, Monetary Stability, had been announced. [redacted]

The Governor noted that, before he had seen David Clementi, the Chancellor had discussed with the latter what his terms of reference would be. This had led to the exchange of letters with David Clementi which Members of Court had now seen. He asked for Members' confirmation - which he wished to pass on to David Clementi - that they were content for him to retain responsibility for the day-to-day running of the Bank, alongside responsibility for financial stability, when the new structure came in to effect.

Sir David Scholey said that, on behalf of all Members of Court, he wished to endorse wholeheartedly the Governor's sentiments [redacted]

Discussion then focused on David Clementi's role. Several Members expressed grave misgivings, both over how the episode had been handled by the Chancellor and over the implication that the role equated to that of Chief Executive. Endorsing comments by Sir Colin Southgate, Sir David Lees said that, given that the Governor was in effect an Executive Chairman, it was a palpable nonsense in governance terms for a Deputy Governor to be seen as Chief Executive: Chief Operating Officer might be a preferable title. Members also had concerns about what would happen should there ever be a divergence of view between the new Deputy Governor and Court about his role and responsibilities.

The Governor said that, in practice, he expected no conflict to arise. His letter to David Clementi had avoided the use of the term Chief Executive and he would convey to him the sensitivities which Members had expressed. In response to Mrs Heaton, he said that the Chancellor was well aware of his views on how matters had been handled and he did not judge that it would be constructive, in the context of the broader on-going debate, to write formally on the point.

Court accepted that the Minute of the discussion would provide a sufficient record of their views, and also agreed that the Governor should confirm to David Clementi that he would continue to have responsibility for the day-to-day running of the Bank when the new structure was implemented.

Recommendations from the Remuneration Committee

Sir David Scholey, in his capacity as Chairman of the Remuneration Committee, presented to Court the following recommendations:

(i) following the appointment of David Clementi to the position of Deputy Governor of the Bank with effect from 1 September 1997, his special remuneration be £190,000 per annum; and

(ii) following her appointment to full time Adviser to the Governors, also with effect from 1 September 1997, Dr DeAnne Julius' remuneration be [redacted] per annum.

Court APPROVED the recommendations.

Bank of England Bill (Messrs A J Bailey and Berkowitz in attendance)

The Governor outlined progress with the Bill. As regards the Bank's monetary stability functions, discussions were well advanced and instructions had been given to Parliamentary Counsel, who had begun the task of drafting the text. Discussions with Treasury Ministers and Officials on financial stability responsibilities, the Bank's finances and other issues (including the future role of Court) were less well advanced, and there was still a lot of work to be done to achieve the aim of instructing Parliamentary Counsel in time for a publishable Bill to be available by late October.

The Governor explained that the questions on the financial stability role, the Bank's finances and the future role of Court were inter-connected. As regards **financial stability**, the special meeting of Court on 11 June had discussed the Chancellor's letter of 4 June and the Governor's reply of 10 June. There had then been a hiatus (largely because of Budget preoccupations at the Treasury) ended by the Chancellor's letter of 22 July, which Members had now seen and which the Governor found to be substantially unsatisfactory. He had subsequently had a series of meetings with the Chancellor in late July. The Governor had felt that little progress was being made and, with the encouragement of the Chancellor, had met the Prime Minister on 29 July to acquaint him with the situation. Mr Blair had shown himself well informed on the substance of the issues but, quite properly, he did not take sides. The main outcome, however, had been the draft Memorandum of Understanding prepared by the Treasury, which was included in the Court papers. Discussions had resumed with a meeting with Alistair Darling held the previous day, to which the Governor's letter of 18 August related. That meeting had been constructive and more encouraging.

The Governor noted that, as set out in his letter, the draft Memorandum of Understanding was, in the Bank's view, deficient in three fundamental respects. First, it confused the lines of responsibility and thus accountability between the Bank and NewRO. The Chancellor's statement of 20 May had drawn a clear line between the overall responsibility of the Bank for the stability of the financial system and that of NewRO for prudential supervision. The distinctive roles were, of course, complementary and mutually reinforcing. But the language of the Memorandum of Understanding was imprecise: it did not reflect the different instruments available to the two institutions - regulatory action to NewRO and financial market operations to the Bank; and it did not adequately recognise that the Bank operated as a bank (ie with a balance sheet).

The Governor continued that the lack of precision flowed into the section of the Memorandum of Understanding dealing with arrangements for handling systemic difficulties, the second area of deficiency. The process as described was cumbersome and militated against the swift decision-making and action which could be critical as and when such situations arose. Thirdly, the Memorandum of Understanding, as drafted, suggested that the Bank would be unable to commit more than 8% of its reserves (currently some £72mn) to support operations without prior authorisation from the Treasury. This seemed unnecessarily restrictive on the Bank's capacity to act, and took no account of the possible spectrum of support operations. At one extreme, the Bank might be providing liquidity against prime assets at minimal risk; at the other, the Bank could be taking over the assets and liabilities of a failing institution where the risk of a loss was real.

In the Governor's view, the starting point for the Chancellor and the Treasury was that any actual or potential public expenditure needed to be authorised by Ministers; this was entirely appropriate for spending departments but not so for a central bank. The Governor understood the public accountability issue which lay behind the Whitehall stance, but believed that the Bank had a well-established line of accountability, running from the Executive to Court and thence to Government, to Parliament and thus ultimately to the public. To circumscribe this in the way the Memorandum of Understanding envisaged would, in effect, give the Bank the status of a Government department. The Bank was not looking for unlimited capacity but for a level consistent with the size of its balance sheet. Court would always - as in the past - be asked to agree any proposed commitment and the Bank would always expect to **inform** HM Treasury (and NewRO) of any unusual action it planned to take. The Treasury's reaction would be reported to Court and taken account of in their decision on the particular case.

In his meeting the previous day, the Governor had sensed that Alistair Darling understood the Bank's real concerns about these issues without, at that stage, being prepared to resolve them. He was more hopeful, without being confident, of achieving progress in the on-going dialogue and was looking for Court's endorsement of the line he was taking on the points at issue.

Dame Sheila Masters asked whether there were any lessons from the situation of other central banks, including in countries where the supervisory responsibility was separate. The Governor said that the almost universal reality was that central banks were, first and foremost, banks with capacity to carry out market operations on the basis of their balance sheets; of the major central banks with which he was familiar, only the Bank of Canada lacked such capacity. He knew of no instance of a separate regulatory authority being empowered to undertake market operations. In response to questions from Sir David Lees, Mr Allsopp and Mrs Heaton, the Governor said he believed that there was no divergence between the Bank and NewRO on their respective responsibilities and accountabilities. The latter saw their role clearly as that of regulator, setting and monitoring standards for individual institutions; they wanted to be involved in discussions, eg about potential systemic threats in the banking system, but recognised that the decision about market operations in response to potential systemic difficulties should be for the Bank alone. He had already described where he thought Ministers were coming from but could not say if Treasury Officials had their own sub-text.

Sir David Cooksey commented that, if the Bank was constrained in conducting market operations, this might reduce its influence on banks in company workouts under the London Approach. The Governor said that this would be so but the issue went broader: if the Bank could not, in effect, act without the Treasury's agreement, this would diminish its contribution to public policy issues in various fora - the BIS, G7, G10 - as well as the catalytic role encompassed in its third core purpose. This was a genuine concern but, in his view, secondary to the implicit inhibition in the proposed mechanism for responding to systemic problems.

Mr Neill said that his views were in harmony with those expressed by other Members. He asked whether examples from past problems could helpfully be adduced to support the Bank's arguments. The Governor rehearsed the circumstances of a number of problem cases but suggested that these were not conclusive. Responding to a question from Dame Sheila Masters as to whether a formula could be constructed covering how Court might address the risk in any problem situation which might arise, the Governor said that this would be difficult: it was of the essence that each situation could only be assessed case by case without circumscription.

Mr Clark noted that the discussion hitherto had focused on crisis management. This was understandable but it was important that the Bank's future financial stability role was not seen as confined solely to this discussion. There was, in addition, a preventative role which extended beyond payment systems (contrary to what the Memorandum of Understanding seemed to imply); and the need for a capacity to spot potential systemic problems before they developed, which would involve collection of at least some market data. These further two aspects needed to be acknowledged in describing the Bank's future role.

Sir David Scholey suggested that functionality could not be split in the way in which the Treasury seemed to think was possible. He also thought that the Bank's ability to act decisively had been important in the past, citing the Johnson Matthey instance and the consequential avoidance of problems in the bullion market. He saw the need for clarity of responsibility and the right institutional interfaces with NewRO. He also had a nagging doubt that the Treasury might be paying lip service to maintaining the Bank's influence -

possibly because of jealousies that central banking co-operation had, in the past, proved more effective than that between finance ministries.

The Governor then moved on to discussion about **the Bank's finances**. Until his meeting with Alistair Darling, this issue had been discussed amongst Officials only. The Treasury's start point had been that the Bank's monetary policy responsibilities should be funded by an allocation, determined by the Chancellor, from the proceeds of the note issue and other activities by income derived from the Bank's capital, with streams of income being used for defined purposes. Alistair Darling had, however, recognised the inappropriateness of this approach. He had also recognised that ending cash ratio deposits would imply handing back some £200mn to the banks at a time of record profits, which would be politically and presentationally awkward. Moreover, the central bank, in its monetary operations, provided liquidity to the banking system as a whole and it was thus not unreasonable that the latter, collectively, should pay for that service. Accordingly, Alistair Darling was disposed to retain and formalise the Bank's capacity to require banks to place cash ratio deposits by including provision in the Bill; it was inappropriate that what was essentially a tax on the banking system should be voluntary. Moreover, the overall burden on the banking system from NewRO charges for regulation and cash ratio deposits with the Bank should not increase from the current level (though there would undoubtedly be winners and losers among the individual institutions). The Governor saw this movement by Alistair Darling as important, because Court would retain control of how income was allocated to streams of expenditure rather than fulfilling a monitoring role in relation to allocation decisions taken by Ministers and officials.

The Governor then moved on to **the role of Court**, and he drew attention to the contents of Tom Scholar's letter of 8 August: this saw the role of Court as setting objectives and strategy for the Bank and suggested a defined role for the Non-Executive Members in overseeing the Bank's discharge of its agreed functions. A senior Non-Executive Member designated by the Chancellor would act as convenor of the Non-Executives and would chair Court in the Governor's absence. The Governor said that he was broadly content with these proposals.

But, reverting to the question of responsibility and accountability, it would be important that Non-Executive Members had a real role to play in oversight of the Executive and were not merely ciphers (as some in Whitehall and Westminster seemed to think had been the case).

Sir David Scholey said that he had a number of questions on points of detail on the Scholar proposals but, more fundamentally, he asked how Court could determine the Bank's objectives: surely only the Government could do this. The Governor responded that the language of the letter was imprecise, but he envisaged that the Bank's statutory responsibilities would encompass the core purposes - for monetary stability, for financial stability as ultimately agreed, and for a continuing catalytic role in respect of the overall efficiency of the financial system. Court would determine and monitor the strategy for implementation of these roles. The issue he saw in the Scholar proposals was over the particular role seen for Non-Executive Members and he invited comments on this.

Sir David Lees said that, while he saw sense in the proposals, they failed to take account of the current work and responsibilities of the Audit Committee and Remuneration Committee; the procedures of these would, at the least, need adaptation in future. Given that the Governor chaired both Court and the MPC, and the proposals envisaged Court overseeing the process of the MPC, defining a particular role for the Non-Executive Members might be helpful; however, oversight of the conduct of the Bank's financial affairs should be for the unified Court and not, as currently suggested, for the Non-Executives alone.

Mr Neill said that, in principle, he was troubled by the idea of a Non-Executive bloc. In practice, it was right that some duties were carried out on behalf of Court by the Audit and Remuneration Committees. He agreed with Sir David Lees that oversight of financial affairs was for the whole of Court, on advice from Audit Committee. Dame Sheila Masters endorsed these sentiments but said that, if accepting the role for Non-Executive Members satisfied the Treasury's concerns about accountability, it should be accepted as a matter of practical politics.

Sir Colin Southgate was concerned how the Non-Executives could take a view on the MPC's operations except on the basis of the results achieved; in any event, an open discussion of these with all three Governors would be essential. He also observed that sixteen Non-Executives was, in his view, far too many.

The Governor said that his own start point had been to favour a unitary board. But, recognising the accountability issue, he now saw merit in the suggested role for non-executives which, in practice, was probably preferable to any alternative and could give the Bank greater capacity to act than might be granted to a unitary Court. He thought that, in practice, Court, as a whole, would be able to carry out the roles envisaged for it in the Scholar proposals except for the remuneration for the Governor and Deputy Governors, which should be decided by the Non-Executive members alone. In essence, he foresaw that Court would agree the strategy for the Executive to implement and that the Non-Executive members would monitor and report on this in the Annual Report.

Sir David Scholey commented that he was broadly content with the proposals though they were based on the model for a 'normal' public company, rather than one with a single or dominant shareholder. It seemed, too, that the Treasury lacked some understanding and experience of how company boards actually worked in practice. He thought that the first designated senior Non-Executive member should be identified as soon as possible and should play an active role in the current discussions.

Mrs Heaton said that she thought that Court would be able to review MPC procedures effectively, but in other regards, that Audit Committee should undertake much of the oversight work. Sir David Cooksey, however, saw a role for an overarching committee which pulled together the work of the Audit and Remuneration Committees, looked at Bank procedures and outcomes, and input into the Annual Report.

Concluding the discussion on these matters, the Governor said that the consensus was that Court was content for him to continue the dialogue with Alistair Darling on the basis that the future roles foreseen for Court and for Non-Executive members were, prima facie, acceptable. But, as he had commented earlier, the question of Court's role was not discrete but had to be viewed as a component of the wider debate about the Bank's financial stability and its finances. He added that the Chief Secretary was anxious that it should be clear to Court that when the Act became law their terms would then end. But, although the Chief Secretary did not want to be firmly committed, it was the broad intention of the Government to reappoint existing Members of Court for the balance of their current terms.

The Governor then briefed Members on his discussion with Alistair Darling over the proposal to give the Bank a pool of foreign exchange to be used for tactical intervention in support of monetary policy objectives. A particular question was how much exposure the Bank should be able to take on its balance sheet (a figure of £2bn had been suggested), but this folded back into the general issue of the Bank's finances. Alistair Darling saw the need for giving an indication to Parliament of how much the Bank would be authorised to commit; but this would, of course, also serve to alert the market to the parameters within which the Bank would be operating. As on other matters, discussions with the Treasury would continue.

The Governor also reported that, at the last MPC, he had been asked to raise with Court the question of an intervention policy to counter the current strength of sterling. He had consulted Sir David Scholey and Sir David Lees, who had agreed that the Bank might commit up to £0.5bn in sales of sterling for foreign currency; however, no such intervention had yet taken place. Court confirmed their agreement to the arrangement on the understanding that any intervention carried out had the endorsement of the Monetary Policy Committee.

Debt and Cash Management

In introducing HMT's consultative - but in practice definitive - document on The Future of UK Government Debt and Cash Management, Mr Plenderleith said that it fleshed out the bones of the Chancellor's announcement in May, describing the rationale for the transfer of responsibilities and how this would be carried out. The new debt management unit, which would be of but not necessarily in the Treasury, would take over responsibility for implementation and tactics and the development of market infrastructure, and would have its own dealing room. The Bank would, for the time being, retain the settlement operation (CGO) and, at least for the five year period previously agreed, the registration function. The Bank would also retain capacity to operate in the gilts market, eg in relation to business for customers, as well as some mechanical functions (eg perhaps conducting auctions). The new debt unit would also take on cash management for the Government: details of this were still being worked out.

Mr Plenderleith said that the aim was to transfer responsibilities at the end of the current financial year. This would entail a lot of work over the next six months and a team from the Treasury was already in the Bank preparing for the handover. There was no doubt that the proposals meant a reduction in the Bank's role, and there had been a loss of morale - and of staff - in Gilt-Edged and Money Markets Division, especially in view of the huge efforts the Bank had devoted in recent years to reforming the structure of the gilt market and the funding programme. But he was confident that those concerned would see the handover through in a professional way.

Quarterly Supervision Report

The Governor said that, in view of the time remaining, this item would be dropped. The documents in Court papers were self-explanatory; if Members had any questions, these could be directed to Michael Foot or Oliver Page.

Arrangements for the transfer of S&S Staff to NewRO (Ms Lowther in attendance)

Ms Lowther drew attention to the Notices to Staff, copies of which were in Members' folders, and outlined the arrangements for the transfer of regulatory staff to NewRO. She said that the task of identifying the jobs which would transfer to NewRO had been completed but the task of identifying the staff was still continuing. Staff had been notified whether their jobs remained in the Bank or transferred to NewRO with the assumption that most staff would remain in their current jobs. But staff who did not want to transfer with their current jobs had been given a deadline of 8 August to apply to remain in the Bank; and the same deadline had been set for staff in the 'remaining' Bank who wanted to transfer to NewRO. There had been 70 requests of which 51 were requests to stay in the Bank and 19 were requests to move to NewRO. Of these, 23 officials had requested to stay in the Bank and this was almost balanced by 16 who wished to transfer. But 28 officers had applied to stay in the Bank while only 3 had applied to transfer. All these applications would be resolved by the end of September after which a Supervision Department would be created and ring-fenced. This Supervision Department would form the undertaking which would subsequently transfer to NewRO.

Staff had been concerned about the terms and conditions they would receive at NewRO. Although the staff were protected because the Bill would transfer them under TUPE terms, the expectation that NewRO would start with a big bang next Spring meant that NewRO would want quickly to put staff on its own terms and conditions but could not yet say what these would be.

Bank staff were also concerned about pension arrangements as these were not covered under TUPE. The Bank was planning to make a bulk transfer from its own pension scheme to NewRO's new pension scheme and this should protect Bank staff's accrued past benefits. The terms of any such bulk transfer would be subject to the agreement of the Bank's Pension Fund Trustees. Although it was expected that NewRO would provide broadly similar core pension benefits to the Bank, the Bank scheme had two provisions which NewRO had indicated it would not replicate: early retirement from 50 with no actuarial reduction of pension and full indexation.

The Governor thanked Ms Lowther for her huge effort in planning for the transfer of staff.

Sir Colin Southgate asked about morale in the rest of the Bank. Ms Lowther said that the changes announced in May created uncertainties for a wider number of staff than just those in supervision. These major changes came on top of a long period of other change and there was some feeling of exhaustion because of the extent of change. There was also concern about the focus of the continuing Bank and whether it would be dominated by the monetary policy role in a way which could have adverse implications for staff's career prospects. Some resignation rates had risen but this had been occurring before the Government's announcements of last May and it was too soon to say how much of an impact these announcements had had. Mr Plenderleith added that although the loss of debt management would remove the need for seven jobs in his area he had in fact faced the prospect of eight departures since May, including expected transfers to the SIB and foreign secondments. Although he could help HMT to undertake this function by seconding some staff he did not have sufficient spare staff to provide for permanent transfers.

Executive Report

(i) **Pay Settlement for the Main Bargaining Unit (Ms Lowther in attendance)**

Ms Lowther advised Court that, in the absence of agreement between the Bank and BIFU at ACAS, the formal negotiating procedures had been exhausted and the Bank had therefore imposed a settlement. There had been a fundamental difference of principle between the Bank and BIFU as the Bank wanted to skew the award towards junior banking staff where it faced problems of recruitment and retention whereas BIFU were adamant that they did not want to discriminate within the Main Bargaining Unit.

Mr Neill referred to the national shortage of IT staff ahead of the millennium and their increasing wage rates and asked if the Bank had sufficient flexibility to keep its IT staff. Ms Lowther said the Bank was very conscious of the issue in the settlement for IT staff, which had been made earlier in the year; significantly more money had been made available than was the case for other staff. There had also been reasonable success in IT recruitment and retention, although she did not feel particularly comfortable given the strong national demand for IT staff.

(ii) **BCCI (Mr Berkowitz in attendance)**

Mr Berkowitz drew Members' attention to an extract from the draft judgement in the litigation case involving BCCI and the Bank, copies of which were in folders, and he explained the summary of conclusions set out in that document and their implications. The Judge had concluded, on his view of the law, that the plaintiffs' action was bound to fail on the basis of the evidence available to them and there was no reasonable prospect of them getting further evidence which could help them make their case. But the plaintiffs had indicated they had grounds for appeal and indeed, if they were to do so, there was one aspect of the judgement which the Bank may wish to cross-appeal in order to revive an argument in the Bank's favour which had previously been rejected. It was unlikely that any appeal would be heard before October 1998.

(iii) **National Debt Office**

In commenting on the National Audit Office's Report on the National Debt Office, Mr Plenderleith explained the role of the National Debt Office and the Bank's relationship to it as its Agent. The Governor and Deputy Governor were amongst the Commissioners for the Reduction of the National Debt who appoint the head of the National Debt Office. The National Audit Office felt that the National Debt Office had not maintained adequate information on the discharge of its functions. The additional information was obtainable from the Bank, who carried out gilt operations for the National Debt

Office as its agent, but the National Debt Office had not previously requested it. Now that the request had been made, all the required information had been made available by the Bank.

Mr Plenderleith pointed out that the National Audit Office had compiled a profit and loss statement of the National Debt Office which appeared to show the Bank's market operations as agent for the National Debt Office, as loss making but their presentation ignored the interest earned on gilts held by the National Debt Office and when that was taken into account, the operations made a profit.

Mr Plenderleith noted that there was the risk of possible reputational damage for the Bank although the matter had attracted little attention so far and it remained to be seen what action the Public Accounts Committee might take.

(iv) **CGO II**

Mr Plenderleith reminded Court that CGO II was proceeding on the basis of using CREST software. But inevitably they had to make changes to reflect gilt market practice and CREST itself was still evolving its own software. He had hoped that CGO II would go live on the coming August bank holiday weekend but a number of further changes to the system had been identified and market operators would benefit from more experience with trialling the system. A further dress rehearsal was therefore planned for September which would show if a two-day cut-over was possible and if this was successful CGO II might go live about a month later.

(v) **Senior Staff Conference**

The Governor advised Members that the Senior Staff Conference this year to discuss the Bank's future strategy had now been deferred to 13 October given that more time was needed to consider the significant changes in the future which will affect the Bank. Following a previous invitation to attend the post-conference dinner which was to have been in September, the Governor apologised for the rescheduling of this event and invited Non-Executive Members to attend the dinner on 13 October. He suggested that those wishing to attend should notify the Secretary so that the necessary arrangements could be made.

Economic and Monetary Discussion including the Inflation Report (Professor Goodhart and Mr Hatch in attendance)

In introducing the Inflation Report which had been published the previous week, Mr King pointed out two changes which had been made to the Report. First, Section 6 was new and drew together the main economic views over the past quarter and related it to the decisions of the Monetary Policy Committee. The Report also included the minutes of the first two meetings of the MPC. Second, the contents of the Report, and its projection for inflation, had been approved by the MPC. The Committee had been involved with the construction of the forecast from the outset, when the initial assumptions were agreed, to the final discussion of both the central projection and to the risks surrounding it.

Mr King reviewed the interest rate decisions of the last three months. He noted that in the final Governor/Chancellor meeting of May it had been acknowledged that there was a case for a

1/2% rise but, given the impending announcement of Bank independence and the likely upward effect this might have on the exchange rate, it was felt that a rise of 1/4% was more prudent. The June meeting of the MPC included two new members who were appointed during the course of its deliberations and so again a rise of 1/4% was agreed rather than a larger change. In July the MPC considered raising rates by 1/2% but settled on a further 1/4% rise, recognising that its August meeting would benefit from additional analysis of the Budget as well as the full Inflation Report forecast. The August meeting of the MPC had agreed a further 1/4% rise, and announced there would be a pause before any further changes to interest rates. The Committee wished to take into account the effects of this cumulative monetary tightening and the fiscal tightening of the last two Budgets, as well as the continued effect of the strong pound.

Mr King referred to the inflation projection in Chart 7.1 and noted that the exchange rate effect would reduce inflation below target over the next few months but that continued credit growth and high domestic demand would take inflation back up to 2 1/2% at the end of the forecast period. The retail sales data published that day were again very strong but were consistent with the Bank's expectations of windfall spending and were expected to tail off next year.

Mr King said that although the effective rate for sterling was now below its peak of 106.6 it remained up 20% over the year. About half the appreciation could be explained in terms of changes in relative yield curves, which we expected to partly unwind over the next two years. Sterling had eased against the dollar and the yen this year; so much of sterling's strength reflected deutschemark weakness which was beyond our control. It was remarkable that the trade figures did not yet show the impact of the high exchange rate although surveys indicated that this effect would soon show through.

Mr King reported that the Bank had commissioned a survey from MORI on how windfall gains had been spent. As 90% of the windfall payouts had now been made this study could look at actual as opposed to expected spending.

A final uncertainly for the MPC concerned the labour markets and the extent to which they could accommodate further tightening without triggering higher wage costs. Thus the Committee would pause and see how these uncertainties began to resolve themselves before taking further judgements on interest rates.

Sir David Lees asked what impact windfalls had over our two year forecast horizon and what reports the Agents made about newly-won export contracts becoming unprofitable because of sterling's appreciation. Mr King said the lasting effect of windfalls depended on the extent to which spending increased domestic demand and thus reduced the output gap still further, whereas spending on imports would have little lasting effect on the UK economy. The increase in consumption over the last 18 months largely reflected a substantial growth in personal wealth which was unrelated to the windfalls. Mr King outlined the Agents' role in reporting to the MPC. The Agents had found that many firms had taken the effect of the higher exchange rate on their margins but that there would be a net trade effect emerging in the third quarter and a reduction of the growth rate in the second half of the year towards a more sustainable trend. In answer to Mr Allsopp, Mr King explained that many firms had reached a point where they could no longer take the effect of the higher exchange rate on margins and were having to raise export prices despite the likely impact on volumes.

Mr Plenderleith said that markets currently faced various uncertainties beyond the current turbulence affecting Asian currencies. Was the dollar topping out? What were the prospects for EMU? Would the volatility in global equity markets continue? How would the problems of financial fragility in countries such as Japan be overcome?

Sir David Cooksey drew attention to the increased number of receiverships in the small companies sector, which reflected in part the strength of sterling and the difficulty of selling into European markets. Mr King promised a note for Court on the differential stock market performance of large as opposed to medium and small companies.

Mr Neill drew attention to the situation in the automobile industry where there had been a trend towards a closer partnership between assemblers and suppliers. In practice this made it harder for suppliers to pass on increased costs for fear of damaging an essentially long-term business relationship.

EMU - The Fifth Broadly Quarterly Paper

The Governor drew the attention of Court to the paper on Practical Issues Arising from the Introduction of the Euro which had been published on 7 August.

[redacted]

National Mortgage Bank Plc (Messrs Hay Davison and Kentfield in attendance)

Further to a Minute of Court of 16 July, Mr Hay Davison gave a short presentation on recent events at NMB and progress on the realisation of its loan book and other non-liquid assets. He drew attention to the data, which had been circulated to Court, on NMB over the five years for which he had been responsible. He pointed to the reduction in the balance sheet size as loans had been recovered and the extent to which it had been possible to reduce provisions for bad loans. Turning to the possibility of the sale of any of the company's operations, Mr Hay Davison [redacted], no bidder had been found who would give as much as the Bank could expect to receive in any case through recovery of debts. As NMB was making a decent profit on its running margin at present it seemed best to continue the process of gradually winding down the company. He told Dame Sheila Masters that NMB had been proactively marketed for two years but no satisfactory bidder had been found. One problem was that it was the nature of the market for this sort of company that bidders might not enjoy good reputations and the Bank might be criticised for putting creditors of NMB into such hands.

The Governor expressed his appreciation for Mr Hay Davison's achievements with NMB over the last five years.

Sealing Committee Minutes for Inspection

In accordance with the terms of reference of the Sealing Committee, the Minute Book of that Committee was laid before Court for inspection.

16.9.97

A MEETING OF DIRECTORS AT THE BANK

WEDNESDAY 27 AUGUST 1997

Present:

Mr Foot

Mr Clark

In the absence of the Governor and Deputy Governor, Mr Foot was appointed Chairman pursuant to the provisions of Clause 6(2) of the Charter of 1 March 1946.

The number of Directors assembled being insufficient to form a quorum, those present proceeded to the business, subject to ratification by the next Court.

The Minutes of the last Court, having been circulated, were noted.

16.9.97

COURT OF DIRECTORS

For the period ended 28 February 1998

Declaration Made before	Date	
		Edward Alan John George, Esq, Governor
The Governor	3. 9.97	*David Cecil Clementi, Esq, Deputy Governor
		Sir David Gerald Scholey, CBE
		Mervyn Allister King, Esq
		Sir David Bryan Lees
		Sir Colin Grieve Southgate
		Mrs Frances Anne Heaton
		Sir John Chippendale Lindley Keswick
		Ian Plenderleith, Esq
		Sir David James Scott Cooksey
		Dame Sheila Valerie Masters, DBE
		Neville Ian Simms, Esq
		Michael David Kenneth Willoughby Foot, Esq
		Sir John Hall
		John Mitchell Neill, Esq CBE
		Andrew Robert Fowell Buxton, Esq
		Thomas Alastair Clark, Esq
		Christopher John Allsopp, Esq

* Appointed 1 September 1997