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**A COURT OF DIRECTORS AT THE BANK**

**WEDNESDAY 7 MAY 1997**

Present:

Mr George, Governor

Mr Davies, Deputy Governor

Mr Clark

Sir David Cooksey

Mr Foot

Sir John Hall

Mrs Heaton

Sir Chips Keswick

Mr King

Sir David Lees

Mr Neill

Mr Plenderleith

Sir David Scholey

Mr Simms

The Governor began the proceedings by wishing the Members of Court a happy Independence Day.

The Minutes of the Court of 16 April and the Meetings of 23 and 30 April, having been circulated, were approved.

**The New Arrangements**

The Governor said he would like to tell Members about the new monetary arrangements. Referring to the Chancellor's letter he said that he hoped the Members of Court would very much welcome

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the general thrust, as he and his executive colleagues had done. He said that the speed of the announcement had been a considerable surprise to him. He had been invited to meet the Chancellor at 9.00am on Monday morning and had thought it was to discuss a range of issues including the interim arrangements for the Monetary Policy Committee. This had been with a view to moving on at some stage to statutory independence, depending on how the interim arrangements went. The Governor said that, when he was told that the Bank would be offered immediate independence, he took a little while to absorb it.

The Chancellor was concerned that there should be no possibility of the information leaking. The Governor said that he needed to inform the Members of Court, which he had done as soon as he was in a position to do so. The Governor noted that it might have appeared that the proposal was made on a take it or leave it basis. However, the Chancellor had in fact taken on board quite a lot of the points that the Bank had put to him in the context of the Monetary Policy Committee discussions. The Governor said he was seeking Court's reaction to the Chancellor's letter on the basis that the next stage was for the letter to be turned into draft legislation.

Commenting on the objectives of the new framework, the Governor said they were precisely as he would have wanted them to be. Some discussion and comment in the morning press had suggested that the Bank was not properly independent under the Chancellor's proposals because it did not have independence in setting targets. However, the Governor said that he thought that the proposals were exactly right in this respect. Setting the target was a political responsibility. The implementation - the operational independence - was the technical part of the arrangement.

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Sir John Hall asked for clarification of the point made in the Chancellor's letter that the Bank was to deliver price stability and, without prejudice to this objective, to support the Government's economic policy. The Governor commented that the objective was to deliver price stability and this overrode the second point about Government policy. That was very much the formula used in the Bundesbank and European Central Bank statutes. The point gave the Governor no difficulty.

Turning to the Government override, the Governor said it was very circumscribed. The Bank could be given instructions on interest rates for a limited period, but only through legislation approved by Parliament. The Governor commented that this was a rather sensible arrangement. If there were a very large external shock, such as the oil price rises in the early 1970s, a sensible approach would be to accommodate the first-round impact and to ensure that it did not feed into the on-going rate of inflation. In such circumstances the Bank would recommend to the Government that such action should be taken.

In response to a question by Sir David Scholey, the Governor said that the Government would have to go to Parliament to seek authority. Sir David asked whether there could be other circumstances, such as a deliberate conflict between the Bank and Government over policy, in which the Government could decide to override the Bank. The Governor commented that it was possible to measure whether the Bank was performing well, and that was by looking at outturn on inflation. If that were satisfactory it would not be easy for the Government to take action. It could re-set the inflation target in the Budget Statement, but he would not expect such a thing to happen.

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Sir David Scholey suggested a hypothetical example in which the Bank Members of the Monetary Policy Committee wanted a 3% rise in interest rates and the Government might say that this was ridiculous, and seek to regain control. The Governor said that, if the increase was justifiable on the basis of the rate of inflation, it was very difficult to see why the Government would want to do that, unless it was because of supply-side shock.

Mr King drew a parallel with the Bundesbank, where a vote of the Bundestag could abolish the independence of the Bundesbank. Sir David Scholey agreed that it seemed to him that having an override available was the least of the precautions that the Government could take. The Governor said that the important point was that the Government would have to explain why it had used the override. If it was because the inflation target was proving too tight, it would have to explain why.

In reply to a question from Mrs Heaton the Governor said that the chances of the override being used were pretty remote. But the principle that the Government should be able to override seemed to him to be unobjectionable.

Mr Plenderleith commented that the essential safeguard that the Bank looked for was transparency, together with parliamentary approval of the override. Sir David Cooksey asked how flexible the legislation would be and whether it could be put before Parliament quickly.

Sir David Lees asked whether the Bank's Inflation Report would have to comment more than in the past on Government fiscal policy, because a loose fiscal policy interacted with monetary policy. The Governor said that he did not think there was

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anything in the new arrangements that required the Bank to do more. Naturally, the Bank would take a view about the fiscal stance - essentially the public sector borrowing requirement - and the question was whether it should give that advice publicly or privately. At this stage it was quite clear that the advice would have more effect if given privately. The Bank would tell the Government privately the implications for monetary policy of its fiscal stance.

Sir David Lees asked whether the Bank would justify a move on monetary policy as a consequence of a loosening of fiscal policy. The Governor replied that that was rarely a direct factor. He would not rule out circumstances in which the Bank would wish to comment more openly, but in general its posture need not change. Mr King commented that the Bank wanted to avoid linking a specific Budget measure to particular interest rate decisions.

Commenting on the paragraphs on exchange rate policy in the Chancellor's letter, the Governor said the proposals were curious but nevertheless welcome to the Bank. The Bank would have its own foreign exchange reserves to use at its discretion to support its monetary policy objective, but the Government would continue to own reserves through the EEA, and would operate for exchange rate reasons as distinct from monetary policy reasons. The Federal Reserve and the US Treasury have a similar arrangement, the Governor noted. However, he could not recall the Fed intervening for an exchange rate reason. He commented that the Bank sometimes used the reserves to influence liquidity in the money market, using foreign exchange swaps, and that would fit in to the proposed category. The Bank would have discussions with the Treasury on exchange rate policy and come back to Court in the light of those

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discussions, because this affected part of the resources of the Bank.

Sir Chips Keswick commented that he did not believe it was possible to manage the exchange rate. The Governor commented that there were points at which it was known the market was long and approaching a chart point. The Bank would see a limited role at that point for tactical intervention.

Turning to the Chancellor's proposal for appointing a second Deputy Governor, the Governor said he could see no objection to the proposal in itself. However, it was necessary to think through the implications for the management structure of the Bank. The question arose of who managed the Bank. One or other of the Deputy Governors would continue to be the Bank chief executive, as Mr Davies was now.

Turning to the Monetary Policy Committee, the Governor said that quite a lot of what was proposed was foreshadowed in earlier discussions, but it was now in the context of immediate statutory change. It was expected that the statute could be law by the end of the calendar year. The fact that the Chancellor appointed the four outside appointees in the same way as the Governor and the two Deputy Governors under the new arrangements did not seem to be something to which the Bank could realistically object. Commenting on the term for which appointments would be made, the Governor said that the Chancellor originally thought that two years would be appropriate. But the Chancellor saw the period of the term as part of the accountability arrangements. The Governor said that this did not seem to him to be a major issue where a point of principle was involved. The arrangements for minuting the meetings of the Monetary Policy Committee and for voting were

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entirely consistent with the statutory arrangement. The Committee would report on a monthly basis to Court.

Responding to a question from Sir David Lees, the Governor said that dates on which the Committee met would be made public. It was expected that the dates of meetings up to the end of the year would be published shortly. Responding to a question from Sir David Scholey on whether a list of proposed names for the Committee's new members had been prepared, the Governor said that it might by now be written but the Chancellor had not given him an indication of the names. The Governor said that he had given the Chancellor an indication of the sort of names that the Bank of England believed would be appropriate.

Turning to the timing of meetings, the Governor said it was currently proposed to meet on Wednesday and announce the result first thing on Thursday. This proposal had to be agreed with the Chancellor.

In discussing the proposals for reform of the Court, the Governor said that the Chancellor's letter said that the Bank would be accountable to the Court for its operations and finances. If the role of the Court was to oversee the effectiveness of the functioning of the Bank, the view was that it would be inappropriate for the Heads of Executive functions in the Bank to be members of the Court. It would be up to the new Court to decide whether Executives would continue to attend Court as now. The Governor said that he would strongly recommend that they did.

The Deputy Governor said that in his discussions with the Treasury he had learned that the Labour Party saw it not as a unitary board but as a supervisory board. Alternatively, it

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could be seen as more like a US company board, where a Chairman and Chief Executive were on the board but nobody else. The Court would hold the rest of the organisation to account.
Mr Simms asked whether the Executives would be seen as members of the top table or the second table and whether that would affect their status in interacting with other organisations.
The Governor replied that the status of the current Executive Directors stemmed from their functions and in that sense they would not be affected. He noted that he had asked that the Chancellor's letter referred to Members not Directors of Court because that left open the possibility of Executive Directors continuing to be called Executive Directors. He commented that, if the concept was that the Bank Executive should be accountable to Court for the way it managed its affairs, it was wrong that there should be seven members of the Executive represented on the body which was there to exercise the oversight. Sir David Scholey commented that he had no doubt that the authority of Executive Directors was enhanced by their status as Executive Directors. He said that the BBC board was the only truly two-tier board he was aware of. The Board was non-executive and the management board had no members on it.
The Governor asked how Court would feel about being Members of Court, not Directors. He noted that GOVCO would fulfil the functions of an executive board. This proposal was one that the Governor would want to go back to Court to discuss again. This was an area where he was particularly looking to Court for advice.

Sir John Hall asked what the role of Court would be if the Monetary Policy Committee had absolute power on interest rates. Did they just report back to Court? The Governor said that it was clear that decisions would be taken by the Monetary Policy Committee. That was why the Government had the power to make

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appointments to it. The Court role would be supervisory, as now. Sir David Lees said he would be very comfortable with the idea of using the term Court Members while leaving the Executives with the title of Director. He would also be comfortable, where appropriate, if some if not all of the Executive Directors were present during Court discussions. The inter-relation between Executive and Non-Executive Members was important. He did not see how Non-Executives could have a very clear view of the performance of the Executives without seeing them. The Governor said he was grateful for the point.

Turning to the appointment on Non-Executive Members, the Governor said that the Chancellor would not have to wait until the legislation went through to appoint his first Director because Sir David Simon was resigning. He was going to be a Minister in the Lords with immediate effect.

Sir David Cooksey asked the Governor whether he would have as much influence in the selection of Court as before. The Governor noted that influence over the process was a recent phenomenon, but he would hope to maintain it in practice. Mrs Heaton said that she felt the shortening of all the terms of appointment was going to make it very much easier for the new Government to change the composition of the Court and Monetary Policy Committee, and make the Bank more open to the government's preferences. To that extent it made it less independent. Most other central banks offered longer appointments. The Governor replied that he had made the point that four year terms were more sensible. But the Chancellor was quite clear on his preference. The Governor said that the Bank could make the point again. However the Chancellor had originally wanted two years and the Governor said he had described this as unsatisfactory. He noted that the Chancellor

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envisaged that there would normally be a renewal of each term of office. But the opportunity for change was seen as being part of the accountability.

Sir John Hall said that a paper by Stuart Bell, published on the subject of New Labour in the financial markets, had said that Court should hold the Monetary Policy Committee to its mandate, and comment publicly upon it. The Governor replied that there had been no suggestion of public comment. Holding the Monetary Policy Committee to its mandate was a part of the supervisory role. Sir David Lees said that the Governor was Chairman of the Court and of the Monetary Policy Committee and asked whether he would in effect be representing his own stewardship to himself. The Governor commented that this was the logical extension of not having the Executive on the Court. Sir David Scholey posed the question of whether there should be a lead Non-Executive Member of Court.

Mrs Heaton noted that the Bank of England, rather than the Court, would make reports to Parliament according to the Chancellor's letter. The Governor said that he did not think that this meant there was any suggestion that there should be a change in the Court's responsibility.

Turning to the financial arrangements the Governor said he did not know the detail and much the same applied to the funding arrangements. Decisions would be taken in the Treasury, but it was possible that the Bank might continue to carry out the operations. On the other hand some at lower levels in the Treasury thought that it was possible that the whole thing could go to the Treasury. This would be extraordinary, and had never been done before. The Bank would have to have further discussion with the Treasury.

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Mr Plenderleith said that, in relation to funding, a central bank with responsibility for interest rates should not perhaps be allowed to be distracted by considerations of selling Government debt. If the Bank was the operator for a Government that took the political decisions that no longer arose. The Governor noted that there was also concern that the Bank would have inside information, though that was not the case. He believed that this particular proposal on debt management was the Treasury's pound of flesh. The Bank would have to see how the discussion went.

Sir John Hall asked whether the Treasury would take a number of staff from the Bank. Mr Plenderleith said that the Bank first needed to clarify what the proposal meant. The Deputy Governor said it was very difficult to give numbers for those affected because the spectrum of activity could be chopped off at different points. Mr Plenderleith believed that the Treasury view of Gloucester was that it had been reviewed recently and it would not want to take on responsibility for it.

Turning to the question of accountability of the Monetary Policy Committee, the Governor said there would be no change except that it would have to account more regularly and on an enhanced basis to the Treasury Select Committee. He envisaged the Bank going to the TSC after each Inflation Report.
Mrs Heaton said that the Bank was accountable to Court and asked whether the part of the Bank that is accountable to Parliament should be the Court. The Governor said the Court was accountable to Parliament through the Annual Report.

On the transition arrangements, the Governor hoped to have four new names for the Monetary Policy Committee whom he would ask

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Court to appoint. He would very much hope to do that by the meeting next week. Mr Neill asked whether there had been discussions about compensation. The Governor said no, but there had been thought given to it. Their status might be as Advisers to the Governors. The Deputy Governor said there was a small category of people employed as Advisers whose salary range was just below that of Executive Director. The Governor said that the new appointees could be either at that or the Executive Director level. Sir David Lees asked whether there was anything that should be done on the Court's terms of reference. The Governor said that perhaps that could be looked at and he could bring it back to Court the following week. Sir David Scholey commented that the way the Governor had responded with a warm welcome in principle was absolutely right, while at the same time not giving hostages to fortune on the detail. The Governor thanked him for his intervention. He said that he thought there were a number of rocks ahead but it was a huge step forward.

**The Report and Accounts of the Bank for the year ended 28 February 1997 - in draft (Messrs Midgley, Chapman and Mr Higgin of Coopers & Lybrand in attendance)**

With reference to a Minute of 16 April, the Deputy Governor presented the draft Accounts for the year ended 28 February 1997.

Sir David Lees said that the Audit Committee had had a remarkably easy ride this time. On the Directors' Report, what was being said on internal controls was new and important, and had occupied the Audit Committee through the year. It had concentrated on the question of the risk matrix of the Bank. He noted that the Audit Committee had done the review, not the

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Court itself. Disclosure of Directors' emoluments was greater than last year and the Note 22 on related parties was more expansive. The Committee had discussed whether the Bank should disclose that the loan to National Mortgage Bank was interest free but had concluded that the general exemption as a central bank had enabled the Bank not to make that disclosure. The Audit Committee had again reviewed its terms of reference to ensure that they were up-to-date and had been complied with and had satisfied itself on both counts. The Governor said he was extremely grateful to Sir David. The work undertaken now, compared with 10 years ago, had risen quite disproportionately. Mr Higgin said that the audit was substantially complete. Points that had arisen had been discussed thoroughly and there were no areas of disagreement. It was expected that the auditors would issue an unqualified report, as in the draft. They would be writing the conclusion of the audit, to set out their main findings. The main conclusion this year was that the Bank faced very substantial systems work over the next two to three years to prepare for monetary union and the year 2000. These fixed deadlines gave the issues a particular character. There had been discussions with the management over measures to help the Bank to meet these deadlines.

Sir John Hall asked how sales of the Branches were going. The Deputy Governor said that note distribution from the branches had not yet stopped and their final closure would be in October. The property sales were not proving easy, as they were rather special premises. However there was strong interest in Birmingham from a bank and there were other tentative expressions of interest elsewhere. Sir David Lees noted that in the April Audit Committee minutes, the Committee strongly supported the Deputy Governor's proposal to bring papers to Court on preparations for EMU and the year 2000. The

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Committee thought it very important in view of the possible risks for the Bank. The Governor said it was a great comfort to him that the Audit Committee was taking an interest in that.

Sir David Lees then explained to Court a number of the Notes to the Accounts. Sir David Scholey asked about Directors' interests, how comprehensively they were disclosed and how they related to the Nolan principles. The Deputy Governor said that the Secretary's Department was responsible for this area and the disclosure to the Bank was comprehensive.

Sir John Hall asked whether the low morale of the Bank had improved. The Deputy Governor commented that there had been an opinion survey 18 months ago which showed poor morale. He noted that recommendations made by the Management Committee had been implemented, Task Forces had been reconvened and there would be a report to the Management Committee next week. The Bank was committed to another opinion survey in due course, in a year to 18 months time.

Mr Chapman said that the Audit Committee had seen an improvement in the control environment. Mr Higgin said there was a high score of 7 or 8 on the control environment. In any business, improvements were possible and there were a number of areas where that was still being addressed. Systems were critical to the control environment. The Deputy Governor said that work on systems and controls should go to the whole Court.

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**Draft Banking Act Report (Mr Page and Ms Robertson in attendance)**

With reference to a Minute of 15 January and in introducing the draft Banking Act Report for 1996/97 the Governor asked whether, because of shortage of time, Members of Court could raise their comments with Michael Foot outside the Court, by tomorrow. The Court agreed to this suggestion.

**Discussion with the independent members of the Board of Banking Supervision (with Sir David Scholey already in attendance, Sir Alan Hardcastle, Sir Andrew Large and Messrs Gerrard and Taylor also attended)**

Introducing his first paper, Mr Foot said it was 10 months since publication of the review of supervision. The Board and the Court had been given regular quarterly updates which showed significant progress in areas such as staffing, which should increase substantially. The Bank was very close to agreeing terms for the appointment of a Head of Quality Assurance. Mr Foot said that, if he had been asked a year ago whether he would be happy to be where he was now, the answer would be yes.

Sir Alan Hardcastle responded that progress had been really quite remarkable, and soundly based. Sir David Scholey asked about the culture of the use of information technology, and how it was changing. Mr Foot said that this remained one of the key challenges. The Bank was rolling out 250 top of the range Pentium personal computers, which many of the younger staff appreciated. Senior management and Heads of Division were being helped to cope, with one-to-one training sessions. The key point was that everybody knew that it would take time. The Head of IT Strategy had set out the general strategic considerations, and they seemed very sound. However there were

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as yet no new tools rolling off the line. When they did, the test would be whether they were user friendly and more adaptable than the material the Bank now had. Sir David Scholey noted that reports to BoBS were now shown to Court and that relevant comments that Court made were fed to BoBS, a logical two-way flow.

Mrs Heaton asked whether there was feedback from customers. Mr Foot said that the Bank had spent a lot of effort on seminars, following the Section 39 and RATE papers, and the supervisors were willing to accept any invitation to talk. One concern of the customers was that all the UK regulators should adopt a consistent framework. Mr Foot said that, if Members of Court came across organisations that wanted further reassurance on this point, he would be very happy to give that.

Sir David Lees asked about the question of bilaterals. Mr Foot said that 120 responses to the paper on Internal Controls had been received and were being summarised. They were not presented to the Board. From the Executive point of view this was a very important issue. Unless there were compelling reasons, he would wish to go ahead. Sir Alan Hardcastle said that BoBS supported the principle.

Replying to a question from Sir Alan on inward secondments from accountancy firms, Mr Foot said that there were currently five or six, but he would like to increase that to eight or nine. From the commercial banks there had been a couple of inward secondments, and he was especially grateful to Barclays. He would wish to push that to seven or eight by the end of the year.

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Introducing his paper on supervisory concerns, Mr Foot said that it had been a busy year. It was extraordinarily important to make sure that, in addition to the daily routine, the Bank tried to stand back and take a wider look. Giving examples, he said that the Bank had been looking at where risks might occur to UK banks, at emerging markets, and issues such as the NatWest securitisation of a large part of its loan portfolio, which was not just important in its own right but raised generic issues.

The Governor asked about the quality of the information provided by the Bank. Sir Alan Hardcastle said that the information requested was delivered promptly and fully. He noted that an advance review of the agenda was a very good thing. Sir Andrew Large said that BoBS received very high quality information. Sir David Scholey said that he could not think of cases where the information or the dialogue were inadequate. He also suggested that it was possible that not every Court member had seen the Bank's Website and said it would be interesting to show it on a personal computer at a Court meeting. The Governor said that the Bank could certainly take that up.

Sir David Lees asked about the interface between S&S and the audit committees of some of the client banks. Mr Foot said that, where there was a formal structure, the supervisors had a direct interface with those responsible for an overview of risk. It had got to the point where some banks were worried that the supervisors were turning their internal auditors into fifth columnists. He noted that, at a number of banks, the audit committee chairman would talk alone, but in others the Chief Executive sat in with the audit committee chairman. The

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piece of the jigsaw missing was a presentation to the whole board.

Mr Simms noted an article in the Financial Times about neural networks, data mining and artificial intelligence, and asked whether this was appropriate for the Bank. Mr Foot noted work in this area at the Bank of France. The Bank of England, in studying this, had come away quite amazed at the level of detail. French supervisors looked at the details of individual bank loans, which we did not consider to be necessary or useful. Mr Foot's view was sceptical, though the Bank was anxious to keep in touch with such developments.

Turning to the future structure of financial regulation, the Governor said it was a fluid scene. The Bank understood that Alastair Darling had gone to the legislative committee of the Government to argue for a financial services bill in the first session. He did not know the outcome. The Governor said he felt he should inform Court and BoBS that the Chancellor had sent a side letter, along with his main letter on the new monetary policy framework. The Chancellor wrote:

> "I have written to you today a separate letter on the operation of monetary policy. This letter focuses on the Bank's responsibilities for banking supervision.
>
> As you know, our Business Manifesto commits us to restructuring the regulation of financial services. It is the Government's intention to introduce the necessary legislation at an early date. I stated that it was the Government's intention to consider transferring part of the Bank of England's responsibility for banking supervision to another statutory body.

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I'm pleased that you agreed that consultation will now start on this basis."

The Governor said he had discussed with the Chancellor whether there was a presumption that part of the supervision function would be removed from the Bank. The Chancellor had replied that there was a commitment to examine the question but it was not being approached with a pre-judgement. The Governor said he had made clear that the Bank would wish to present the arguments against moving part of supervision from the Bank. This would be based in part on the synergy between the monetary and financial stability functions of the Bank. In the light of that the Chancellor had sent the Governor the letter. The Governor's impression was that the more immediate concern was with the financial services regulation, but that the Government would be looking at the Bank's role at least alongside that.

Sir David Scholey enquired whether banking supervision was being regarded separately from the Bill on Monetary Policy. The Governor said that this was the case and, in the technical sense, they were different legislation. Sir David asked when the existence of this side letter would come into the public domain. The Governor said that he assumed that, when the Government knew what it would say, it would make it known. He also noted that he had not discussed what "part" of supervision meant. The Deputy Governor said that he had been told by the Permanent Secretary of the Treasury that that would be between the Treasury, the Bank and conceivably other regulators. The Deputy Governor encouraged the Permanent Secretary to think that this should not be very lengthy. He believed it important to have a decision in principle one way or another, or there would be planning blight not just on the Bank but on the other

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regulators. The Deputy Governor said that the Permanent Secretary was sympathetic but had to put the point to Ministers. The Governor said that Mr Clark had been asked to produce a paper setting out the considerations involved, and it would be sent to the Treasury.

Sir David Scholey asked what the constituencies of the Bank thought about this. The Deputy Governor said that, when Arthur Andersen consulted on the Bank's behalf, that question did arise. His recollection was that, where the point was raised, the response had been that they would rather the devil they knew. There had certainly been no strong sentiment that they wanted to shift from supervision by the Bank. Elsewhere, there had been complaints about forms and about intrusion. But the Bank's constituency would not be agitating for change and had not been agitating. Sir Andrew Large said that in the financial services area he hoped there would be legislation. But he heard with some dismay that the Governor had received such a letter. He hoped it would not interfere with the process of considering the deficiencies in financial services regulation and putting them right. As far as the relationship between securities and banking supervision was concerned, he did not hear complaints but the approach needed to be as seamless as possible. It would be very helpful if there was a rationalisation in the financial services area because there would be fewer interfaces with the Bank. Sir Andrew said there had been no move to promote a super supervisor. It was absolutely not necessary. The Swiss had done it, but it had certainly not been done by countries with the size and variety of financial services that Britain had.

Sir David Cooksey emphasised the importance of taking a very positive attitude at the Bank to welding in new recruits to the

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organisation. Mr Foot said that many of the younger members of staff accepted change enthusiastically, but there were some problems higher up.

The Governor asked for any other comments. There were none.

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A COURT OF DIRECTORS AT THE BANK

WEDNESDAY 14 MAY 1997

Present:

Mr George, Governor

Mr Davies, Deputy Governor

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 7 May, having been circulated, were approved.

**Inflation Report Discussion and Market Charts (Mr Hatch in attendance)**

In introducing the Inflation Report, which had been published the previous day, Mr King said that there had been no changes made to the format of the report following the transfer to the

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Bank of the responsibility for setting interest rates. Some changes would, undoubtedly, be made for the next Report, but the Bank would reflect carefully on how best to meet the remit given by the Chancellor. One thing for certain, however, was that the Inflation Report would become part of the statutory framework for accountability of the Bank. In his letter to the Governor the previous week, the Chancellor said that "the Bank will be required to publish a quarterly Inflation Report in which it will account for its monetary policy actions, set out and justify its analysis of the economy, and explain how it intends to meet the Government's inflation target and support the Government's economic policy". Much of this was covered by the existing format of the Report, but in future the Bank would have to explain why it took certain actions on interest rates in order to hit the Government's target.

Turning to the latest Report, the Bank concluded that despite the previous week's ¼% rise in interest rates, it remained more likely than not that inflation would be above the target two years or so ahead. That was why the Report concluded that, on the present evidence, there was still likely to be a need for some further moderate tightening of policy. By how much and when were questions that the Bank answered month by month, and would do so in future in the Monetary Policy Committee.

Mr King said that although the exchange rate had fallen back a little since the Report was finalised, the effective rate for sterling was 16.5% above its level last August. That would bring inflation down and keep it low through this year and into the early part of next. Goods price inflation had fallen in line with the rise in the exchange rate, but service sector inflation had risen sharply, reflecting faster growth of domestic demand. But the combination of above trend output

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growth and inflation close to the target and falling was not likely to be sustainable. GDP growth reached an annualised rate of about 4% in the first quarter of the year, and domestic demand continued to accelerate. Consumption was growing by about 4% a year, and Bank estimates of the windfall gains accruing to households later this year had risen since the February Report. Broad money growth, which had been above 8% for two years now, rose into double figures to reach a twelve-month growth rate of over 11%, and the short run measures were even higher than that. That suggested domestic demand would continue to grow rapidly.

The dilemma caused by the rise in sterling was that the imbalance between the tradable and non-tradable sectors of the economy meant that a wedge was likely to open up between the growth rates of domestic demand and output. Nevertheless, the strength of consumption, in particular, meant that output growth was likely to remain above trend. That would lead, in due course, to higher capacity utilisation, pressure in the labour market and, ultimately, higher inflation.

Such pressures were already evident in the labour market. Claimant unemployment had fallen by almost half a million since the beginning of last year, and by 400,000 since June, Mr King commented. Short-term unemployment, in particular, was down to the levels seen at the end of the 1980s. Employment, measured by the labour force survey, had risen by over a quarter of a million in the past six months. And earnings growth had also risen. Although the published figures of underlying earnings growth were likely to fall back from 5% in the coming months, when the effect of large bonuses - especially in the financial sector - dropped out of the figures, if productivity growth were to remain in line with its post-war average, then it would

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be difficult to reconcile the inflation target with earnings growth of over 4½%. And earnings growth was above that figure in the private sector.

The rise in sterling over the past six months had improved the short-run outlook for inflation, which now looked likely to fall below 2½% this year. But Mr King said the correlation between changes in the exchange rate and inflation was not strong because domestic demand was much larger than net exports.

Mr King said the current projection was broadly similar to that in February. The rise in interest rates last week lowered the projection, but the extension of the forecasting horizon and a slightly more buoyant outlook for demand offset that. A policy on track to hit the inflation target would imply an inflation rate significantly below 2½% in the second half of this year. What mattered was the outlook two years ahead. There was still likely to be a need for some further tightening of policy in the months ahead.

Turning to the market charts, Mr Plenderleith said that the election, the ¼% rise in interest rates and the announcement of operational independence for the Bank in setting interest rates had had a very significant impact on sterling and the money markets. In the last week or so expectations of short term rates had lessened, the bond market had fallen and the pound had come back from exaggerated previous levels.
Mr Plenderleith commented that these were three rather good pieces of news.

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Sir David Lees said that,since the inflation target was 2½% or less, it could refer to a large range. The word less could mean as low as zero. The Governor commented that he hoped to have an intensive discussion with the Chancellor on the target before the Chancellor made the Mansion House speech in June. Some countries had a point target for inflation but could never hope to achieve that point. Others had a range but experience had been that if there were a range the top of it effectively became the target. The phrase 2½% or less had originally been chosen to reflect the fact that this was not a precise science.

Sir Colin Southgate asked how the Bank responded to 2½ years of failure to hit the target. The Governor said that it was not at all inconceivable that the objective for inflation of the last government would have been achieved. The Governor commented that the Bank would not be at all happy with 1% inflation if the price of achieving that was a consistently - recessed economy. He was not at all sure that, because some countries were achieving better results on inflation, Britain had to try harder. He believed it important to reach the 2½% target before deciding whether the objective should be 2%. He was not at all uncomfortable with the objective that the Bank already had. The Governor said he would expect something comparable to be set by the present government.

In response to a question from Sir David Lees, the Governor said that the target as framed at the moment meant that it was necessary to take risks on the downside rather than the upside with inflation. He noted that when the previous Chancellor set the target of 2½% or less he went on to say that in practice that meant 1% to 4%, which led to total confusion. The Governor said he still met people, who ought to be better - informed, who thought that the target was 1% to 4%. In

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response to a question from Sir Colin Southgate about whether international statistics were comparing like with like, the Governor noted that there was an interesting report on European standard measures of inflation under which UK inflation would be significantly lower. Mr Buxton commented that it was necessary to look at where different economies were in the cycle, which he believed was relevant to inflation. The Governor agreed. In response to a question from Mrs Heaton about whether the Bank should be aiming for 90% probability of being under 2½%, the Governor said that the last government had indicated that it wished a view to be taken on whether achievement of the target was more probable than not. That effectively meant a 51% probability.

Sir David Lees asked whether this was an argument for using a range. The Governor asked Sir David whether he would be content if, with a range of 1% to 3%, a level of 2.9% was achieved. The Governor commented that the Bank had tried very hard over the last 2½ years to explain to the world at large that the numbers were not precise. People had to accept that. They were only persuaded by successive years of delivering low inflation. Trying to redefine the precise specifications implied that the Bank could steer the economy like a machine, and that was not possible.

Mr Buxton asked what might happen if the exchange rate started to go down. Mr King replied that a sharp rise in the short term concealed inflationary pressures but, more important, it had been helping to dampen down prices because of the effect on net trade. If sterling fell to last summer's level it would place much greater pressure on domestic demand. The Bank's projections implied that sterling would come back from its high level. Markets discounted a fall in the sterling/deutschemark

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rate from 2.80 to 2.60 over the next two years. Part of the Bank's projections did assume that sterling would fall back. If there was a very much more rapid fall in sterling than expected, that would cause a revision of the projection and make the Bank a little more concerned.

Mr Neill asked to what extent there was scope for producing productivity gains sufficiently in excess of 2% to avoid higher earnings growth. Mr King said that neither in the UK nor in the US was there solid evidence of a significant increase in the underlying rate of productivity growth.

The Governor paid tribute to the quality of the analysis in the Inflation Report. He did not think there would have been a move to operational independence if it had not been for the huge improvement in the quality of the Bank's analysis and the perception of it outside. He paid tribute to Mr King. Mr King replied that it was his team that had done the work.

**Quarterly Supervision Report - Review of Financial Stability in Japan (Messrs Wright and Dorrington in attendance)**

Mr Foot introduced a paper entitled Review of Financial Stability in Japan. He commented that in the last decade or so the Bank had put enormous effort into understanding the Japanese economy, its banking sector and related areas in the context of a very large Japanese bank involvement in the UK and large Japanese involvement in financial flows in the developed and developing world. The Bank of England was regarded by the Bank of Japan as having more knowledge than any other central bank dealing with this area. Mr Dorrington noted the sheer size of Japanese banks, with the Bank of Tokyo Mitsubishi having assets of almost 70 trillion yen, about the same as

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Barclays and NatWest combined. Nippon Credit Bank was half the size of Barclays. Japanese banks had 27 branches and 10 subsidiaries in London and a UK market share of around 10%. The exposure to Japan of UK banks was over £150bn, and of UK owned banks the total was almost £30bn. Giving the background to the current situation, Mr Dorrington said that in the late 1980s bubble period the focus was on the balance sheet size, and land and equity prices soared. When the bubble burst land and equity prices fell, and GDP growth averaged less that 1% in the four years to 1995. Bankruptcies rose, especially of construction companies. Bank bad debt soared to an estimated 14% of gross domestic product and property collateral values fell. Monetary and fiscal policy was eased and banks benefited from falling rates and an upward sloping yield curve.

Commenting on the current state of the financial sector and its prospects, Mr Dorrington said a moderate economic recovery was underway, with obvious benefits to banks, but bankruptcies were still rising. The Nikkei Index had recovered to 20,000, and property prices appeared to have stopped falling. The focus of the banks in Japan was now not on assets but on return and capital ratios. Operating profits were now good in a historic perspective, but low when compared internationally. In fiscal 1996, after write-offs, the top 20 banks made a pre-tax loss of 2.8 trillion yen. The capital ratios of the top 20 banks had a weighted average of 9.3 at the end of September, giving a limited scope for write-offs, given the need to keep ratios above 8%. It was difficult to raise capital, and one reason was because life companies were an important source. The figures flattered the underlying position compared with measurement of UK banks. Japanese banks' tier 2 capital included 45% of unrealised equity holdings. Cross share-holdings between banks also usually counted as capital,

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and asset and collateral quality were low. The reported bad debt figures were understated, Mr Dorrington noted.

Turning to the Japanese Big Bang, he said this was far reaching, implying cultural as well as economic and financial changes. Currently, there was a consensus for change. He however expected opposition to increase both from potential losers from the changes and from the public and political arenas. The resolution of the changes might not be smooth. Committees working on the details of Big Bang were expected to report in June. Some changes were now clear, including the liberalisation of foreign exchange in April 1998. He noted concern that staff of banks, as well as the Ministry of Finance supervisors, had not got the intellectual infrastructure to deal with Big Bang and its implications. Another risk he noted was the exposure of Japanese banks to South East Asia. In addition there was the probability of an earthquake in Tokyo, a general lack of transparency, a culture of relying on trust, and endemic corruption. The potential for bank failures was clear and this brought with it systemic dangers.

However, Mr Dorrington noted a number of reassurances. The authorities had pledged that internationally active banks would not fail in a disorderly way in the five years to 2001. He saw no question of will on the part of the Japanese authorities. Neither was there a question of their ability to deal with a liquidity crisis, be it in yen or foreign currency. The Nippon Credit Bank case demonstrated their ability to deal with potential failure due to insolvency. It had met resistance and was not yet in the bag, which Mr Dorrington saw as an example of more commercial attitudes. However, he thought it highly probable that the planned rescue would be concluded satisfactorily. The Ministry of Finance and the Bank of Japan

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saw the problem coming and prevented a crisis rather than reacting to one. But they did have time to orchestrate a rescue just before the crisis. A risk he saw was a combination of shocks in a fast-moving situation. Mr Dorrington believed that, in the long run, the use of public money was probably inevitable. He noted public resistance to this, but saw still greater resistance to the prospect of deposit holders losing their money.

Commenting on what the Bank of England was doing, Mr Dorrington said everything was being done to monitor the situation and receive early warning of problems. His area had one Japanese speaker, and was trying to recruit another. He himself was attempting to learn Japanese. There were excellent relations with the Bank of Japan London office and good but less close relations with the Ministry of Finance here, which the Bank was working to improve. He noted annual high-level bilaterals with the Ministry of Finance. There was an effort to build up contacts with other Japan experts in the UK, and visits to Japan. The Japanese speaker was in Tokyo now for two weeks with supervisors at the Bank of Japan, and also for visits with the Ministry of Finance. There was frequent contact with the New York Fed. and contact also with the Hong Kong Monetary Authority. There was increasingly close co-operation with supervisors of Japanese banks, and supervisors endeavoured to make sure that standards were maintained in London. Ministry of Finance and Bank of Japan inspectors visited the Bank of England when they were in London. He noted that other relevant supervisors in the Bank were kept aware of the work done on Japan. The bottom line was that if there were a financial melt-down it would be very serious. Mr Dorrington commented that the probability was low, but it existed. Surveillance

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teams needed to be rigorous in their monitoring, and supervisors needed to be vigilant in monitoring Japanese risk.

The Governor said that the paper illustrated the inextricable connection between monetary and financial stability. It was very difficult to pull these areas apart, and the synergy between them was clear.

Sir Chips Keswick said he had lunched recently with the Bank of Japan Chief Representative in London, who was completely relaxed about the potential for melt-down. The Representative had also noted that, when freed of exchange controls, the yen would weaken and this would allow Japan to put interest rates up to steady the yen.

Mr Neill commented that the report was interesting and well written. He asked whether a reversal in the United States market would have implications for Japanese banking. Mr Dorrington agreed that there were links. If there were a fall in Tokyo as well, it would have adverse effect.

In response to a question from Mr Buxton, Mr Dorrington said there was certainly very strong opposition in Japan to the use of public money. The risk was that it would take time to orchestrate the rescue of one of the biggest banks if there was a crisis that had not been seen coming. However, he noted that the Japanese monitored closely, thus helping them to see things coming, and had a way of keeping the wraps on them for quite a while. He saw an optimistic aspect of the insolvency of Nissan Life (the first life company to be declared insolvent since the war) in that it had been recognised and brought into the open. He also believed that the Japanese had changed from their pursuit of balance sheet size. All the indications he had were

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of a very strong focus on asset quality and profit, at least by comparison with the past, though maybe not to the extent that would have been hoped.

Mr Wright noted that one trend in Japan was that the institutions (particularly insurance companies) had been more willing than for a long time to take unhedged positions in overseas assets in pursuit of yield. This had stopped in the late 80s because of exchange rate losses and started again relatively recently which meant that the institutions were, to some extent, vulnerable to falls in asset prices outside Japan. He also noted that it was very difficult for the Japanese to make a link in the public mind between the use of public money and the necessity to avoid losing depositors' money on a large scale. No Japanese depositor had lost money, Mr Wright noted.

In response to a question from Mr Simms, Mr Dorrington said that deregulation in Japan was far more wide ranging than Big Bang in London. Sir Chips Keswick said if the Japanese promised to pay 6% returns but only had 1% coming in, they had a problem. The Governor commented that that was what had caused the Japanese to go for uncovered investment overseas, where they could earn higher returns. In response to a question from Dame Sheila Masters, Mr Dorrington said if conditions in Japan were better, deregulation would be easier. Without deregulation, he believed that a hollowing-out of the financial services area would happen, as it had in the manufacturing sector. A lot of people in Japan argued that it was a pity that it had to happen now, but they could however see the need for it.

Mr Foot commented that a lot of Japanese had been very affected by the success of Hong Kong and Singapore. He noted that the

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most innovative part of the Japanese financial sector was outside Japan. They were attempting to bring some of that home.

**Sir David Simon - a Ministerial appointment, and succession**

The Governor said that, as Court knew, it was announced from No 10 Downing Street on 7 May that Sir David Simon had been appointed the Minister for Trade and Competitiveness in Europe - a new post attached to the Department of Trade and Industry and the Treasury.

The act of taking up this ministerial appointment technically disqualified Sir David from holding the office of a director at the Bank [in accordance with paragraph 4(a) of the Second Schedule of the Bank of England Act 1946]; he had however written to Court notifying the circumstances of his departure from Court. Given his disqualification, there was no need for him to resign his directorship. The Secretary had written a short confirming note to the Chancellor who, of course, was well aware of the situation.

The Governor said he wished to record for the Minutes his appreciation of Sir David's role. He was very sorry to see him go and he wished him every success in his new role.

His departure meant that the government would have to appoint a new director of the Bank earlier than expected. He invited Court to suggest names to offer to the Chancellor, who may of course have his own ideas. The Governor said that the Bank had wondered whether [redacted] was a possible Member of Court. Sir David Lees said he thought [redacted] was quite a likely nominee.

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Sir Chips Keswick suggested it might be a case for a pre-emptive strike, perhaps by offering the name of a trade unionist. The Governor said that it was exactly in that context that he was inviting the thoughts of Court. He believed that in the government's mind was the question of more representation from the regions. He instanced Scotland, Wales and possibly Northern Ireland. The Governor commented that the trade unionist question was sure to arise, along with other issues relative to the representativeness of Court. He said it would help to have Court's input now or over a longer period.

**The Executive Report**

The Deputy Governor said that the Bank had been looking at the location of the Issue Office, which organises the wholesale issue of notes from the Bank's Head Office. Quite a lot of note traffic was still from Head Office. When the Bank had reviewed note distribution last year, the outstanding issue unresolved after the branch closures was whether it made sense to continue to issue from Head Office. A review had now been completed, and the Bank had concluded that it would make more logistical sense to concentrate distribution on Debden. The cheapest short-term option was to restructure the operation in Head Office but, over a six-year horizon, it was cheaper to re-engineer and locate at Debden. This reduced the journey time, and the cost of security operations and also pay rates were lower in Debden. The capital cost was £2.5mn, and the pay-back period was three to four years compared with what the Bank did now, and six years compared with the option of carrying out the operations at Head Office on a new basis. He said that he would be grateful for Court's approval. He added that the redundancies would be minimal.

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The Governor said that the matter had been brought to Court after the Bank had satisfied itself that the arrangements with the banking community could be managed. The Deputy Governor noted that there had been no overriding objection either to London or to Debden. The Governor commented that the change would also reduce congestion in the City. Sir Colin Southgate noted that some Members of Court had suggested such a move five years ago.

Court gave their approval.

The Deputy Governor notified Court that Lionel Price, the Director of Central Banking Studies, had decided to resign from the Bank to take up a job in the City. Professor Fry would take over responsibility for the Centre in September and would work an average of four days a week, continuing his role as Tokai Bank Professor of International Finance at Birmingham University in his remaining time.

**Report and Accounts of the Bank for the year ended 28 February 1997**

The Deputy Governor said the Report and Accounts now included the Governor's Foreword and a slight rewording of the Directors' Report to reflect the wording in Note 1(a) to the Banking Department Accounts. There were no other significant changes since 7 May, when the draft had been discussed at Court.

He drew Court's attention to the various points in the Accounts where the Directors gave a specific opinion in addition to the overall 'fair presentation of the accounts'. These were mentioned at Court on 7 May.

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- Note 1a included a statement that the Directors considered the Banking Department constituted a single business and that no further analysis into business or geographical segments was necessary to comply with SSAP25.

- Note 1d contained a statement that the Directors considered that compliance with SSAP19 on investment properties was appropriate. This statement, which was a requirement of UITF7, resolved the conflict between SSAP19 and the Companies Act.

- Note 11 included a Directors' valuation of the Bank's miscellaneous investments.

- Note 12 gave the Directors' opinion that consolidation of the various subsidiaries had not been done, because the effects would not be material.

- Note 24 on contingent liabilities included a statement that, in the Directors' opinion, the Bank had a strong defence against the BCCI claim.

The final dividend of £25,242,000 was acceptable to the Treasury.

Directors' folders contained a letter from Coopers & Lybrand confirming that they knew of no reason why the Letter of Representation should not be given. The Letter of Representation was noted by Court on 7 May. The Bank had also received a letter of comfort from Coopers & Lybrand on Corporate Governance; this was also in the folders.

The Deputy Governor asked for Court's approval for:

1 The Report and Accounts to be signed and printed, with publication on 21 May

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2 The final dividend of £25,242,000, to be paid on 3 October.

3 The giving of the Letter of Representation to Coopers & Lybrand. The letter would be signed by Mr Midgley and the Deputy Governor.

Court were content with all the points put by the Deputy Governor and gave APPROVAL for the Letter of Representation and Accounts to be signed and for the Annual Report and Accounts for the year ended 28 February 1997 to be published.

The Deputy Governor reported that, pursuant to Section 1(4) of the Bank of England Act, 1946, a further payment, in lieu of dividend, of £25,242,000 would fall due to HM Treasury on 3 October 1997, bringing the total payment in lieu of dividend for the year to 28 February 1997 to £48,742,000.
Court APPROVED thereto.

**The Banking Act Report (Mr Page and Ms Robertson in attendance)**

Mr Foot said that a few comments had been received on the Banking Act Report. He hoped Court would be content with the text. The Governor asked for comments, but there were none.

**Delegation of Powers (Mr Page in attendance)**

Mr Foot noted the report on delegation of powers was in much the same form as last year. With reference to a Minute of 15 May 1996, Court noted the names of those to whom the Bank's powers under the Banking Act 1987, the Financial Services Act 1986, the Financial Markets and Insolvency (Money Markets) Regulations 1995 and other relevant pieces of legislation had

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been delegated, together with details of the exercise of those delegated powers.

**Deposit Protection Board Report and Accounts (Messrs Page and Cobbold in attendance)**

Mr Foot also introduced the Annual Report and Accounts of the Deposit Protection Board. He noted that there had been comments last year that the Report was user unfriendly, and he said that that it had improved considerably. He said there was good news this year because the liquidators of BCCI had paid a first dividend in December 1996, and the Board received £45.8mn. Total recoveries by the Board in the year amounted to £52mn. After returning the fund to credit, £36.8mn would be repaid to contributor banks. Protection payments of £1.8mn were paid to depositors of failed banks, but no new failures occurred during the year.

The Governor said he particularly welcomed the fact that there had been no new failures. He hoped to see that in the Report on many future occasions.

<u>Court noted the Report</u>.

**A Report of the Trustees of the Court Pension Scheme**

Turning to the Report of the Trustees of the Court Pension Scheme, the Governor, having declared his potential interest in the Court Pension Scheme, together with those of the Deputy Governor and Messrs King, Plenderleith, Foot and Clark, invited Sir Colin Southgate, the Chairman of the Trustees of the Scheme, to introduce his Report which contained the following recommendations:-

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(a) the annual pensions in payment to former Governors and Executive Directors and allowances to the widows of former Members of Court be increased, with effect from 1 July 1997, by the amount of the increase in the Retail Prices Index for the twelve months ended 31 May 1997;

(b) similar increases be granted from 1 July 1997 to:

(i) the ex-gratia allowances payable to Lord Richardson, Sir George Blunden and Lord Kingsdown;

(ii) the ex-gratia payments awarded to widows of former Members of Court who retired prior to 1978 and whose allowances were based on their husbands' pensions net of commutation;

[redacted]

(c) the annual allowance paid to Lord Richardson from the Court Pension Scheme under special arrangements which were approved by Court on 10 February 1983 be increased in accordance with those arrangements.

<u>Court APPROVED the recommendations</u>

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**Millennium Risk (Mr Mann in attendance)**

With reference to a Minute of 20 November, the Deputy Governor introduced Colin Mann, Head of the Management Services Division. The Deputy Governor commented that, on the one hand, the nonsense quotient in discussions of millennium risk was extremely high, with people making predictions of doom. On the other hand, the issues involved were very real. The Deputy Governor said it was necessary to steer a course between the Scylla of complacency and the Charybdis of alarmism. The Deputy Governor said that it was difficult to understand the technical nature of the problems involved. However the note being presented to Court was largely procedural, covering the approach the Bank was taking, rather than going into the bowels of individual computer programs. As the result of a government initiative on raising awareness, the Bank had convened a group to try to get to grips with the problem at the centre. However, because of the Bank's rather large investment in software and new settlement systems a lot of its information technology infrastructure was quite recent, and that was quite helpful because the software would not have the problems that existed in older programs. Having asked all Heads of Division to confirm that they had made an initial assessment, the Bank felt that there was no insuperable problem.

The Deputy Governor drew attention to paragraph 5 of the paper, which pointed out that the Bank was itself a system supplier in the case of settlement systems, and had started to receive letters from customers. The Bank replied by explaining the current development strategy, for example in the case of Central Gilts Office it was introducing CGOII, based on CREST software. Its successful introduction was the immediate

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priority and, in introducing the software, it would be tested for millennium compliance.

It was not just a question of the Bank's own systems. The Bank was linked to many others. This could be considered in two parts. There were the central assets of the clearing companies, and the banks' own connecting systems. The Bank understood through its membership of the Association of Payment Clearing Systems that BACS and CHAPS, each of which had their own systems, were engaged in extensive testing programs. As far as banks' own payment systems were concerned, Mr Kentfield had asked at the November APACS Council meeting for assurances that individual banks were addressing millennium risk. Since the systems could be corrupted by erroneous messages from any member bank, this was an essential requirement. Following this, a note was sent to the March Council meeting asking whether members were still confident that they would be able to certify all their systems' interfaces with the clearings, whether members regarded millennium risk as a wholly competitive matter or whether there were elements where they would welcome a forum in which there could be confidential exchange of information. If so, did APACS have a role in supplying that forum? The Council would return to the subject in June. The Deputy Governor said that the Bank's understanding was that the banks would agree to treat this as a co-operative rather than a competitive issue. Before receiving firm assurances on the questions posed, it was impossible to give a categorical assurance on the state of readiness of each individual bank.

A third area of concern related to the potential impact on supervised institutions of millennium risk. The Deputy Governor said there was something of a dilemma. The Bank did

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not wish to second guess management not did it wish to be thought to be taking responsibility for a subject remote from its normal concerns with prudential supervision. On the other hand, a bank unprepared for the millennium would run serious risks in its payment and settlement systems and in the market, which could at the limit destabilise the institution as a whole. Because there was a material risk, it was legitimate to regard millennium risk as an issue for supervisors. In the normal course of supervisory activity, the Bank had asked banks at prudential meetings to give a view on their state of readiness, and had so far covered around the top 70 institutions in this way. Most claimed to have been satisfied with their own preparations, though one or two had said candidly that they saw some potential problems ahead. The Bank would therefore be pressing banks to give full particulars about their preparations in the next supervisory round.

The Bank also had a broader interest in the readiness of financial institutions and the City generally for the millennium. It had decided to focus on those sectors where it had a particular locus, namely APACS and the British Bankers Association. However, in an environment in which public comment veered from complacency to doom-mongering and back again, the Bank planned to publicise its line on millennium risk and the work it was doing. This would include an article in the October issue of the Financial Stability Review. Thought would also be given to contingency plans should there be problems in the year 2000. That would be covered in the Bank's Autumn assessment round. The Deputy Governor noted that the prime purpose of the paper was to show how the Bank approached the issue from a management perspective within the Bank.

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Dame Sheila Masters said she would welcome a further report on the matter. Sir Colin Southgate commented that it was important to look at the next level, for example the preparations made by the suppliers of paper to the Printing Works. It was also important not to overlook building management systems. Mr Mann said that Sir Colin's point about suppliers was helpful. With regard to building systems, the Bank had identified it as an area to look at.

Sir David Cooksey asked whether the impact on electronic archives had been assessed. He wondered whether millennium problems could affect the Bank's ability to search archives. The Deputy Governor pointed to recent developments in bar-coding the archives at Roehampton.

Sir David Lees noted that it might be preferable to look to compliance on millennium risk by mid-1998 to give extra time in case it was necessary. He also asked whether the banks knew that they were going to be asked about preparations for the millennium in the next supervisory round. The Deputy Governor noted that there was an interaction with EMU. There was some reluctance to aim for mid-1998 because of the concurrent burden of coping with the preparations for EMU. However, if at a later date there were a deferral of EMU, there might be some resources which could be reoriented. On the second question, Mr Foot said that he wrote to Chief Executives in the middle of last year and would do so again in the next month or six weeks. He also noted the involvement of the British Bankers Association.

Mr Neill noted that in his own organisation work had started two years ago, and as it got into the detail it was found to be very much more complex than had been thought at first. Most

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organisations had not got into the detail. He believed that the scale of resources required was quite frightening if some of the worst predictions were to be believed. He asked whether the Bank should suggest the establishment of an authoritative group that could evaluate and accredit major software suppliers, because otherwise the resources would not be there to do it.

The Deputy Governor said there had been some discussions at the British Bankers Association, which had been considering whether it made sense to co-ordinate a bank-wide approach to the problem. Bank of England people were part of that group. Mr Mann commented that there was a world-wide reluctance to take responsibility for accrediting software, because those who gave the accreditations might be sued if there were subsequent problems.

Mr Neill commented that it was not necessary that they should be put in a position where they could be sued. Without some initiative he believed the resources would not be available to tackle the problem. The Governor said that the Bank would take up the issue with the British Bankers Association.

Mr Simms said that he would like to recommend that, before the end of this year, a list was made available of the key demonstration projects. It might not be complete by the year end, but he believed it would be useful to see, and tick off the major projects as they went down the line. The Governor said that there would be a report back to Court on that.

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**The New Arrangements**

The Governor said that the Bank had established a Bill Committee, led by Mr Footman. The members were Messrs Berkowitz, Midgley and Tucker. The Committee had been asked to report to Govco. Its first task was to go through the Bank of England Act and the Charter to identify issues that might arise, and Mr Berkowitz had been asked to look at other legislation to see whether there might be any issues arising.

Second, the Committee had been asked to go through the Chancellor's letter and identify the issues for draft legislation. The Committee was having to move extremely rapidly. The Chancellor's ambition was to give draft instructions to Parliamentary Counsel by the end of this month. The Bill team of the Bank were in almost continuous session with the team at the Treasury.

The Governor gave an outline of findings from the Bill Committee's initial trawl. He commented that, given the pace of developments, it was difficult to know how far the Bank could keep Court in touch with this. But the Bank would do as much as it could on that front. He noted that the Chancellor's letter was not explicit about the form of the legislation. One possibility was that there could be a repeal of the Bank of England Act and possibly the Charter, which could be replaced by totally new legislation. There were several disadvantages to this, because it raised a range of possible issues that did not need to be raised if there were simply a Monetary Policy Act that amended the relevant parts of the Bank of England Act. Completely new legislation would also encourage the Treasury to pursue an idea, which was in the back of its mind, that the Bank should be converted to a public corporation. The Governor

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said he was not quite sure of the implications, but the Bank did not like the sound of it. So the Bank was encouraging the Treasury to think in terms of an Act that made amendments where necessary. However the Governor noted that the Bank could not determine any of these things. He also noted a legal complication. The Charter was under the Royal Prerogative, and it would be a constitutional hassle to change it.

Turning to the Bank's objectives in the legislation, he said that the current Act and Charter said nothing about the objectives of the Bank of England. The Bank had always found the situation quite comfortable, though for management purposes it had defined its core responsibilities internally. The Governor said that there was a question over whether to include the three core purposes in a detailed statement or in some general form, such as "the Bank's objectives were monetary and financial stability and the promotion of the effectiveness of the financial system", or whether the objectives could be defined simply in relation to monetary policy. A concern was that the Bank should be careful that it did not define its objectives so tightly that it could not do things that it had not previously thought of. That inclined the Bank to a minimum specification of objectives, except in the sense set out in the Chancellor's letter.

Dame Sheila Masters asked whether, having specified the objectives, the Bank would be restricting its other activities. Her inclination was to specify as little as possible. The Governor said the Bank had made clear in its discussions that it wanted maximum flexibility. Sir Chips Keswick said that if the public corporation route was chosen, there would be real problems. However, Dame Sheila Masters doubted whether there would be time to draft a law converting the Bank to a public

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corporation without a serious risk of mistakes. In reply to a suggestion by Mr Plenderleith, Dame Sheila said that the issue of transferring contracts on conversion to a public corporation would not be a problem.

The Governor noted another concern about specifying the Bank's objectives. To do so could raise in a very immediate way the question of banking supervision. He believed that question was likely to be raised on the evidence of a side letter from the Chancellor, and sooner rather than later. The logical sequence would be to make a decision on banking supervision first if the government wanted to remove banking supervision. It would make a very big difference to the structure and financing of the Bank, including the appointment of a second Deputy Governor. Nevertheless, it would be helpful to avoid having that issue discussed at all in the context of the new Act.

The Deputy Governor noted that the Treasury work was carried out under Alan Budd, but it was run by Stephen Pickford; and Sir Terence Burns, the Permanent Secretary, was interested in it.

Turning to issues of operational independence, the Governor said that the Bank of England Act at the moment gave the Chancellor the capacity to give the Bank directions. He asked whether it was desirable to try to get rid of that, or to try to ensure that it did not relate to monetary policy decisions. The Bank's discussions had led to the view that there was no justification for taking away the general powers of the Chancellor to give the Bank directions. Dame Sheila Masters commented that the Treasury might want to make the powers more specific, because general powers of direction were difficult to activate. The Deputy Governor agreed, saying that all the

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Treasury had said was that there was a need to exclude the decisions of the Monetary Policy Committee from the powers of direction (except for the override power). The Governor said it was possible to see how this would work in the context of legislation to amend the Bank of England Act. However, if there were a completely new Act, it would arise in a very forceful way.

Turning to the override power, the Governor said he did not see any substantive difficulties. The power did not prejudice the degree of independence on monetary policy because it would be extraordinarily difficult to use for arbitrary purposes. It was a public event. If it were used for arbitrary purposes, government would probably be prepared to repeal the Act anyway, and take back the independence it had given the Bank. In reply to a question from Sir David Cooksey, the Deputy Governor said that the override would be by affirmative resolution, and the Governor said he thought that would only be in the House of Commons.

Turning to the question of the constitution of the Monetary Policy Committee, the Governor said that decisions would be made by the Committee which comprised the Governor, the Deputy Governors, two members appointed by the Governor in consultation with the Chancellor for three-year terms, and four members appointed by the Chancellor. The Bank's instinct was that it would be desirable that the legislation required the Bank to establish the Committee rather than to establish it directly itself. This would be consistent with the role of the Court in overseeing all the activities of the Bank. It would also mean that the people concerned could be employees of the Bank, subject to terms and conditions of employment, including secrecy declarations and insider trading rules and regulations.

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The Governor said that the Bank was inclined to push for the legislation to say that the Bank would establish a Monetary Policy Committee, rather than legislate directly. He noted one consequence. In the Chancellor's letter executive members would be appointed by the Governor after consultation with the Chancellor. The Bank would suggest that this should be by the Court on the recommendation of the Governor after consultation with the Chancellor.

In response to a question by Sir David Lees about the Treasury representative on the Committee, the Governor said it would be important for the Committee to be informed of Treasury thinking and for the Treasury to be informed of the thinking of the Committee. So it was a good thing. There had been a similar provision in Bundesbank legislation. But this had recently been amended to exclude Finance Ministry officials, because the Bundesbank was trying to make itself EMU compatible in a way the proposed Bank of England Act was not intended to be.

Turning to the status of the members of the Committee, he referred to the so-called lunatic clause which disqualified Members of Court under the Bank of England Act. He thought such issues would be covered by making members of the Monetary Policy Committee members of staff. However, there could be awkwardness if the Chancellor's nominees behaved in a reprehensible way, for example by talking to the press before the minutes of their meetings were published. There could be a question of whether it was possible to dismiss a member of staff nominated by the Chancellor. In practice the Bank would talk to the Chancellor and say it was outrageous, and he would have to agree whether the person concerned was dismissed or not. The Governor said, if it ever arose, that the approach

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should be a pragmatic solution rather than to try to define it in law.

Mr Simms commented that the Bank did not want four people in the Bank who did not feel part of the team. The Governor said he would regard them as members of staff who happened to be nominated by the Chancellor.

In reply to a question from Sir David Cooksey, the Governor said that appointment of the members by the Chancellor would be non-negotiable from the beginning. The function of the four members was to give an outside cross bearing on the Executive. They had to be appointed by the government. Sir Colin Southgate said it would be possible for the Chancellor to write to say to the appointees that they were going to be appointed by the Bank under the Bank's normal conditions, but to include extra points such as the scope of their extra-mural activities in the letters.

Turning to the procedures of the Committee, the Governor commented that they were administrative matters and not for legislation. He also said that nothing had been said in the Chancellor's letter about the note issue. A tiny point which arose from the 1983 Currency Act was that increases in the note issue had to be approved by an affirmative vote in Parliament. In theory that could influence the monetary aggregates. In practice, it happened automatically and the legislation was redundant. If the Treasury wanted to get rid of it that would be acceptable, but the Bank did not want to complicate the picture by proposing it.

Turning to foreign exchange reserves, the Governor said the Bank still did not know much about the question. It had been

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pushed by the Treasury. What was clear to the Governor was that, if some foreign exchange reserves were transferred to the Banking Department, it would be necessary to discuss and agree with Court the purposes to which they could be put as part of Court's oversight of the proper uses of the resources of the Bank.

The same was true in relation to debt management. The statement said some functions would go to the Treasury. Mr Plenderleith was discussing what that meant. The Bank did not see at this stage any implications for the legislation itself.

Turning to governance of the Bank, the Governor noted that the Chancellor's letter proposed two Deputy Governors, one for Monetary Stability and one for Financial Stability. The Bank did not see great difficulties in this. It was clear that one of the two Deputies would be responsible for the management of the Bank, as the Deputy was now, and the Bank would want to ensure that the legislation did not preclude this. The Bank did not want unnecessary constraints written into the legislation.

The Governor said that a major question for Court was its own role and terms of reference. At the moment Court may choose and appoint staff and fix remuneration, and do whatsoever it may judge necessary for "managing the Bank of England and the affairs thereof". The Governor said he would be very surprised if that language could be retained in the Bill. The letter from the Chancellor said that the legislation would set out the terms of reference. The Bank had to try to negotiate those with the Treasury. The Governor had no idea how the Treasury would seek to expand the terms of reference. He said Court

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would be circulated with the relevant paragraph commenting on this in a paper circulated by the Bill Committee. This read as follows:

"Although the letter seems to make a distinction between Court and the Bank, we can only be talking about a conventional non-executive dominated unitary board. Its tasks could be defined as: to oversee the proper discharge by the Bank of its responsibilities; to hear reports from and oversee the activities of the Monetary Policy Committee, ensuring in particular that it takes full account of regional and sectoral information; to approve the Bank's strategy; to oversee the management and internal financial affairs of the Bank, ensuring that these are properly conducted; to determine the remuneration of the Governor and Deputy Governors; to appoint committees; and to make regulations for the good conduct of the Bank's affairs. (This last would include the major delegation instruments like Matters Reserved to Court, the HoDs' guide, and internal regs.) What we need to resist is any attempt to overspecify Court's role in legislation, while making it clear that Court is fully able to act as a body to which the Bank can be accountable."

Dame Sheila Masters asked whether the Bank was clear that this should be in the legislation. It could typically be done in a Memorandum of Understanding, leaving the legislation general. She recommended that the Chancellor should be encouraged to do this without putting it in the primary legislation. The Governor said he agreed. Mr Buxton said that Court was a board and he asked whether there was anything in the Companies Act about directors' responsibilities. Dame Sheila said there was a body of company law, but Mrs Heaton said that the Bank's

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responsibilities were different from those in the Companies Act. The Governor asked Court to agree that the broad approach was that the powers of Court should be as broad and unspecific as could be achieved, but there might have to be something like the language that he had just read out from the Bill Committee's report. Sir David Lees said that a Memorandum of Understanding would be very important for individual Members of Court to understand their responsibilities.

Sir Colin Southgate said he had always though that an Act would be followed by a Civil Service Memorandum of Understanding on how to run that Act. The Governor commented that this was not his impression, but it could be explored with the Treasury. He would adopt the approach proposed by Dame Sheila on both the points concerned.

The Governor raised other points of detail that the Bank would like to see tackled. These included the end of weekly Court meetings, and a change in Members' remuneration. It might also be desirable to end the current procedures for dealing with the Seal, and give responsibility for this to the Secretary.

The Governor said that the last major issue was that the Treasury wanted to make the Monetary Policy function a charge on the Issue Department, which would subject it to cash limits on public funds. The Bank was exploring this, and its conclusion was that it was quite difficult to see grounds on which to resist. It was equally difficult to see grounds on which the Treasury would wish it, because the expenditure would be transferred to the Public Sector Borrowing requirement. Banking Department profit would rise as a result of such a change, and so the Government would get two thirds back through dividends and taxation. The Bank's attitude was that, if the

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Treasury could provide a sensible rationale, then the Bank would go along with it.

In reply to Mrs Heaton, the Governor said he believed that the principle of the proposed change was that the functions of the Monetary Policy Committee would be undertaken at the behest of Parliament, and Parliament should have the ability to vote the money. It was quite difficult to resist that, he said.

The Governor noted that there might also be another agenda. Such a move was moving quite close to having everything under Whitehall oversight, except for banking supervision. The question could arise of whether it was appropriate to shift that off balance sheet. That was a possible motivation in the minds of some, but not all, Treasury officials. If that happened, the structure of Bank finances would not stand in the way, in any case. So this was not a fundamental point for the Bank. The Deputy Governor said that a review of the Bank's finances was being undertaken for the Bill team, and so was a review of debt management.

In reply to a question from Mr Simms on the status of Directors, the Governor said that they would be called Members of Court, and did not need to be called Directors. Court should be empowered to appoint an executive board comprising executive directors. That was a situation the Bank would like to achieve. The Governor noted that the Bank was not absolutely clear about the status of the Monetary Policy Committee. Court may be responsible for establishing it and, since the Committee had to meet in a month's time, in June, he said he would ask Court to appoint the Committee. He and the Deputy Governor were stated as members of the Committee in the Chancellor's letter. He asked Court to agree that it should

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appoint Mr King and Mr Plenderleith as executive members of the Committee with immediate effect, in case this proved necessary. <u>The appointments were agreed</u>.

Peter D Rodgers

11 June 1997

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A COURT OF DIRECTORS AT THE BANK

TUESDAY 20 MAY 1997

Present:

Mr George, Governor

Mr Buxton

Mr Clark

Sir David Cooksey

Sir John Hall

Sir Chips Keswick

Mr King

Sir David Lees

Dame Sheila Masters

Mr Plenderleith

Sir David Scholey

Mr Simms

Sir Colin Southgate

The Governor apologised for an unexpected and early meeting. He said he had seen the Chancellor the day before at 12.30pm, ostensibly to discuss names of people to be appointed to the Monetary Policy Committee. The Chancellor was not, however, ready to discuss the names. The Chancellor informed the Governor that he intended to make a statement before the debate on the afternoon of 20 May, which would cover his decision to give the Bank operational independence but also include the announcement of a decision to remove supervision from the Bank, and to transfer responsibilities to an enhanced Securities and Investments Board. Furthermore, the Chancellor informed the Governor that he would like Howard Davies, the Deputy Governor,

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to become the first Chairman of the enhanced SIB when Sir Andrew Large left. The Governor commented that this came as a surprise to him. He said that he had made it very clear to the Chancellor that he felt let down, and that it made his position extremely difficult. The Governor said that he had indicated to the Chancellor that he would need to make a statement of his own almost as soon as the Chancellor had completed his.

The Governor read to Court a side letter from the Chancellor on banking supervision.

The letter from the Chancellor:

"I have written to you today a separate letter on the operation of monetary policy. This letter focuses on the Bank's responsibilities for banking supervision.

As you know, our Business Manifesto commits us to restructuring the regulation of financial services. It is the Government's intention to introduce the necessary legislation at an early date. I stated that it was the Government's intention to consider transferring part of the Bank of England's responsibility for banking supervision to another statutory body.

I am pleased that you agreed that consultation will now start on this basis."

The Governor commented that he was in no doubt that the Chancellor was minded to make this step, and equally that he, the Governor, was in no doubt both as a result of a conversation with the Chancellor, also supported by the terms of the side letter, that the Bank would be consulted not just on the detail but on the principle of removing supervision.

The Governor said he recognised that the Government had a right to make such a decision. He noted that he later went back to see the Chancellor and urged him strongly to announce in his

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statement that he had instigated a review, as had been suggested in his letter.

The Chancellor said that he could not set up such a review. The Governor commented that his grounds for saying this were not wholly clear. An element in his decision was that it would make it easier to win acceptance for his Commons statement, because the Conservative Party had come out against independence and some Labour backbenchers would also oppose it. So the removal of supervision was seen as a countervailing step. The Governor said he believed that the Chancellor had presented to the Cabinet a fortnight before, a package combining independence with the removal of supervision. He had sold independence on the basis of the removal of supervision.

The Governor told Court that his immediate reaction was to hand in his resignation. He was still ready to do that if Court thought it a sensible step. However, the Governor said that, reflecting on it, there were a number of reasons why it was not a sensible thing to do.

Firstly, he should stay and hold the Bank together, which was particularly important if it lost the Deputy Governor, which would be a great blow to the morale of the staff. The Deputy Governor had said he would accept the post provided it was not in the context of a disagreement between the Bank and the Chancellor. A more fundamental reason for not resigning was that his resentment was not at the decision, but at the manner in which it had been carried out. He could perfectly well envisage the Bank continuing with the procedures outlined in the Chancellor's letter, making its case for retaining supervision and having it rejected. He could even see in the long run that these new arrangements might make good sense.

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They would remove the danger posed to the Bank's reputation in monetary policy by bank failures, though he noted its record was outstandingly good when compared with almost any other country. He commented that the removal of supervision was therefore a step not without pros and cons, and was a matter for debate. But fundamentally it was not possible to say that it was a foolish step. The implication was that if he resigned it would be out of pique that the Bank had not been consulted rather than a resignation based on a general issue of fundamental principles.

The Governor said that his next thought was that he could make a statement making plain that the Bank had not been consulted. It would say that, if the Bank had been consulted, it would have advised against, but would recognise that the Government had a right to decide. The Governor said that he pointed out to the Chancellor that the Bank would be forced into making such a statement. However, the Governor concluded that it was difficult to see what purpose would be served by such a statement, which would be declaring war between the Bank and the Chancellor, and which might carry over into a number of other battles that the Bank had to fight. The Governor said he had already made, as forcibly as he reasonably could to the Chancellor, the point about consultation. The Chancellor, in return, gave the Governor effusive assurances that it was all a misunderstanding, and that there would be proper consultation in future. The Governor commented that it was hard to see the useful purpose of a statement saying that the decision had been made over the Bank's dead body. The Bank should not say that it knew all along and approved. But it should comment in as constructive a way as it could about the decision. The Governor said he had prepared a draft of a letter to

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Gordon Brown setting out the line the Bank proposed to take. The draft letter was circulated to Members of Court. It read:

"When we met yesterday evening, I undertook to consider how the Bank might respond as constructively as we could to your intended statement this afternoon.

I have now discussed this with the Members of Court who have asked me to express to you their dismay that the Bank was not consulted on the substance of your decision to remove responsibility for banking supervision from the Bank, which both they, and I, had been led to expect as a result of both our conversation on 5 May and the terms of your side letter to me on supervision on 6 May. But that is over the dam. We have agreed that the Bank should take the following line in public.

1 The Government, in Opposition, had made clear that it intended to examine the Bank's role in banking supervision. We were nevertheless surprised at the speed and timing of the decision (as we had been also in relation to the decision on operational independence a fortnight ago).

2 What matters is not the Bank's position but the whole structure of financial regulation and what is best both for depositor/investor/policy-holder protection, on the one hand, and for systemic stability, on the other.

3 We have not argued that banking supervision, for the purpose of depositor protection, must necessarily be undertaken in the Central Bank, and we have recognised in particular that changes in financial markets are blurring traditional distinctions between banks and other financial intermediaries. We have, nevertheless, argued that banks remain of special systemic importance - because of their unique role as providers of liquidity, to both depositors and borrowers, including their central role in payments and settlements, and because their resulting unsecured exposures, including to each other, make them particularly vulnerable to contagion from elsewhere in the system.

4 The Government has decided, as is its right, that the needs of the regulatory structure can best be met by integrating individual bank supervision with supervision of other financial intermediaries in an enhanced SIB, leaving the Bank to focus on maintaining stability in the financial system as a whole. Under these arrangements it will be important that the Bank is still able to monitor, through the SIB, the financial condition of individual institutions.

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5 The Bank welcomes the Government's expressed intention to draw on the expertise in banking supervision of the Bank's staff and the appointment of Howard Davies as the first Chairman of the enhanced SIB, which will provide for continuity and at the same time help to ensure the necessary co-ordination between the SIB and the Bank in relation to their respective interests.

We look forward to co-operating with the Government in drawing up the detailed proposals."

The Governor commented that he had told the Chancellor that he could not think of anybody better to take on the job at the enhanced SIB than the Deputy Governor. He noted that the Deputy Governor had been taken aback by the offer of the post. The Deputy Governor had said that he recognised that it was a very big job, and that he would do it with the Bank's blessing. He had also said that in the event of the Governor's resignation, he would stay on as Deputy Governor until a new Governor had been appointed, to hold the Bank together.

Sir Chips Keswick and Sir Colin Southgate both urged the Governor not to resign. They commented that it was hard to trust a Government that behaved in such a way. The Governor noted that the grounds for resignation would be perceived as pique. The step of removing banking supervision from the Bank would in any case be well received. That was a position based on total ignorance, but it was not something that the Bank could fight as a publicly popular cause. Sir Chips Keswick said that it was a very destructive move. The Governor commented that everybody was united on that point, but the Bank had to admit that supervision was not universally done by central banks. For example it was not done by the Bundesbank. On balance, the Bank would not have advised removal of supervision at this time and in this way, but it could not say

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that it was a wholly irresponsible or foolish thing to do. The decision would mean that the Bank would have to work extremely hard with the SIB to ensure that it was fully involved in financial stability, in order to exercise its responsibilities for the stability of the system.

The Governor read out the words of the Chancellor's proposed statement that afternoon:

"The Governor of the Bank of England will be fully involved in drawing up the detailed proposals. The Bank will remain responsible for the overall stability of the financial system as a whole. The enhanced Securities and Investments Board will be responsible for prudential supervision and, in due course, for conduct of business rules.

As the House will already be aware, Sir Andrew Large, the current Chairman of the SIB, has decided to step down in July. I would like to take this opportunity to pay tribute to him, and thank him for his contribution to financial regulation over the past years.

It is crucial to the success of these reforms that we have a new Chairman with the stature and calibre to implement them quickly and smoothly. Because of the importance I attached to drawing on the Bank of England's expertise in these areas I have asked Howard Davies, the Deputy Governor of the Bank, to be the first Chairman of the enhanced Securities and Investment Board responsible for integrating the supervision of banking and financial services. I am pleased he has agreed. He is of course already a member of the SIB Board. He will take over as Chairman when Sir Andrew Large steps down. Two new Deputy Governors of the Bank will be appointed in due course."

He noted that the Chancellor had given us an assurance that he would present the statement in a way that was not critical of the Bank's performance. The Chancellor would say that the decision would allow the Bank to concentrate on monetary policy without exposure to the reputational damage of the supervisory side.

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Mr Buxton, commenting that it would be wrong for the Governor to resign, said he agreed that the supervision decision might go either way. However he disagreed with the decision itself. He also asked whether, as a result of the Deputy Governor's appointment to the new supervisory body, the Chancellor now had two Government appointments to make as Deputy Governor. The Governor said that the Chancellor would start talking to him about the appointment of a new Deputy Governor under the present statute. Only when the new legislation was passed would he announce the appointment of a second Deputy Governor. The logic of having a Deputy Governor for monetary policy and a Deputy Governor for financial stability would continue to apply. He commented that financial stability was very much broader than supervision. The Bank would still have central banking responsibility for the stability of the system. The SIB would have neither the Bank's presence in the market nor its ability to provide technical support. Both these aspects of the Bank's work were intended to continue. The logic was that the Bank could still have two Deputy Governors and that was what the Government was minded to do.

Mr Buxton noted that the first part of the draft letter to the Chancellor said that the Governor was surprised by the speed and timing of the decision. He suggested that the Government would make a virtue of speed and timing and that it might be better to make a point of saying that this had not been part of the consultation process. The question was, how far the Governor should go. The Governor replied that Mr Buxton had just said that he did not think he should resign over the matter and that was the conclusion that he himself had reached. It was necessary to consider whether the letter was, firstly, confidential, and secondly whether it was as constructive about the new proposal as it could be without saying things that the

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Bank did not believe. The letter made the point that the Bank was not consulted, which was what had happened a fortnight ago with the announcement of independence. The speed of decision-making was a plus as well as a minus.

In replying to a question from Mr Buxton, the Governor noted the possibility that a public statement that the Bank had not been consulted might be construed as a declaration of war. Sir David Scholey said that there was no need to declare war, and Sir Colin Southgate noted that it was advisable to tell the truth, by saying that the Governor had not been consulted. The Governor noted that if asked, he would have to say when he had heard about the decision.

Urging the Governor not to resign, Sir David Cooksey said that the press, IMRO and others were putting great pressure on the Government to come to a decision because of the uncertainty for their people and he believed that the Bank had been swept into that momentum. He described the decision as precipitous. It required a lot more thought than had been given to it at this stage. Urging the Governor not to resign, Dame Sheila Masters commented that everybody needed to find ways of working with the new Government. She hoped that analysis, discussion and consultation would become the ordinary course of events. In this case the Bank had not been consulted.

The Governor commented that the Government would claim that Alastair Darling had consulted very widely about removing supervision. Dame Sheila noted that he had attended a lot of dinners, but this did not represent a wide and open discussion. The Bank could make the point about not being given the opportunity to debate broadly on the advantages and

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disadvantages. Making a statement on not being consulted was more like a declaration of war.

Sir David Lees, commenting that the Governor should not resign, said that he was in favour of taking a very robust line. The Bank would look foolish if it did not. Questions would be asked about whether the loss of supervision had been a quid pro quo when the Bank was given independence. For its own peace of mind the Bank had to make clear that this was a Government decision and that the Bank had not been consulted.

Sir John Hall commented that it was a diabolical decision by the Government. But he believed it was a no-win situation. Sir Colin Southgate noted the necessity to be seen to go out and fight. The Governor commented that this had been his view at 4.00pm the previous afternoon, and also when he went to see the Chancellor at 5.30pm. However, he believed that the issue was how to put the Bank in the best position to influence events in the future. The Bank should not conceal the fact that it had not been consulted, or that if it had been consulted, it would not have advised this course of action. These points should not actually be made upfront in a public statement, which would show that the Bank was at loggerheads with the Government. They would nevertheless come out. The question was whether this outcome should be provoked through the language the Bank used in a statement.

Mr Simms urged the Governor to make a more robust defence of the Bank's role and experience, and what it had achieved so far. Sir Colin Southgate noted that the Bank had just rebuilt morale amongst staff. The Governor commented that the Bank was at the beginning of that process, and he was afraid that it was going to be set back a very long way. Sir David Lees asked

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whether the draft letter was in practice the Bank's press statement. The Governor said that he wanted to get a sense of the line the Bank should take in a statement or in interviews.

Having given a series of interviews when independence was announced it was difficult not to give interviews this time, or the Bank would be seen to be running into its hole. Sir David Scholey said he had assumed that the letter would not be published, but that it should be capable of being published in the future. Since it would not be published it might express in considerably stronger terms than in the draft the feelings of the Court and the Governor. These views should be firmly on file, from the point of view of the Bank and the Court and the Governor's personal position, Sir David Scholey commented. He also said that it was his strong desire that the Governor should not resign. The Bank needed his leadership through a very difficult period. He noted that he could fully appreciate the Governor's personal feelings. The Chancellor's actions had been very different from the terms of his side letter to the Governor on banking supervision. Sir Colin Southgate said that there could be two letters, one for public release and the second making clear that the Bank was offended by the Government's behaviour. Sir David Scholey said that the Bank had seen debt management taken away, supervision was going to the SIB, and the central bank was to become a monetary policy institution, banker for the Government and controller of the note issue.

Mr Plenderleith said that there was clearly a concern that the Bank was diminished to the degree that it became an insubstantial organisation. His view was that the Governor should not resign, because the Bank needed his leadership after these events. It had been a clumsy decision and precipitate in

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its timing. For the sake of integrity, the Bank should be consistent in its views and had a public responsibility to set them out. The Bank was not opposed ipso facto to the loss of supervision but there were some basic issues involved, including the responsibility for preventing systemic problems. The Bank also had to keep good faith with its staff. Mr Plenderleith commented that the letter covered these points, though it was possible to argue about the degree of intensity of the language.

Mr King said that it was clear that it would become public that the Bank disagreed with the Chancellor's decision. It was important that the reasons were made clear in language of the Bank's choosing. The reason for the disagreement was not that the Bank believed there was no case for moving supervision outside the Bank. A decision on whether supervision should be in or out of the Bank of England should follow logically from prior analysis of the supervision of banks and non-banks in the UK. There was no one clear answer. To decide on the structure without clear analysis was to put the cart before the horse. Mr King urged the Governor to say that clearly in public now. He said it was important not to be defensive of banking supervision in the Bank, but to concentrate on the way the decision had been taken. The Chancellor would have difficulty explaining why he had not announced the decision two weeks ago. Dame Sheila Masters said that it boiled down to the Bank having been treated badly. She wondered whether that was a good platform to have. The Bank had been handled extremely discourteously but had to make the best of a bad job. Sir David Scholey said he believed that the Government had behaved dishonestly. Sir David Lees said that Mr King had made a powerful point. There was a danger of the Bank being accused of pique. If it was possible to find a formula that expanded

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on the reasons why a lack of consultation was a loss to the process without being too verbose, that would be constructive.

The Governor noted that the Bank's complaint was that the Government had not taken account of the points it had made. It was clear from the draft text, if the Bank published it, that the Bank did not agree with the decision. The Governor said that he took the general sense of the meeting to be that Court would like something tougher. With the Executive Directors, he would consider how to accommodate that point by revising the draft.

One way would be to make it plain to the Chancellor, separately from the letter, that the Bank would have to say if asked that it would not have recommended such a course of action. The question was a narrow one of what the Bank volunteered and what it left to come out in subsequent comment. The Governor said that he would make plain to the Chancellor that the Bank's position would eventually emerge rather fully. The issue was still whether the Bank should be seen to be trying to down play disagreement in the interests of co-operation or whether it was going to make plain that there was a great rift between it and the Chancellor. He asked what purpose there would be in adopting the latter course.

Sir David Scholey said that if the latter course were adopted, the Bank should do it as gracefully as possible and not say it through gritted teeth. He repeated his recommendation that there should be much tougher language, but in a private letter. It was a question of putting a stake in the ground and indicating that if such events were repeated everybody would be off, including the Governor. The Governor said his judgement would be that the Chancellor had really not thought about it.

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It was clear that when he wrote to the Bank at the time of independence he was minded to move supervision. He was straightforward about that. The Governor noted that he had said to the Chancellor at the time, equally straightforwardly, that he would want to argue the case against removing banking supervision.

It was clearly in mind at the time of independence that the Government was hoping for a Financial Services Bill in the Queen's Speech. It was failure to get that which had precipitated the decision on supervision. There would be a statement in the House on independence and there would be a lot of questions on both sides of the House. The Chancellor would need to be in a position to answer those questions. The decision had been pragmatic to that degree. Sir David Scholey said he believed that the Bank should be graciously co-operative, to make sure that it got continuity in the system. The Governor noted suggestions that the first paragraph of the draft letter should be toughened. Sir David Lees suggested that the first three paragraphs of the draft should be the public stance. He asked whether, in the first paragraph, there could be a phrase that regretted the lack of opportunity for further consultation. The sense should be injured, not piqued. The Governor asked what useful purpose would be served by such a phrase.

Sir David Lees said the Governor was likely to be asked whether he was consulted. The Governor replied that he was going to answer no, that he had heard the day before, as with independence. Sir David Lees replied that if that were the answer, was it not right to say as much in the letter. The Governor said that this was why he suggested that, if asked about consultation, the Bank should say there had been none.

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If asked whether it advised such a course of action the answer should also be no. Sir David Lees accepted that this would come out anyway.

Sir Colin Southgate commented that people understood what independence meant but would not understand the implications of moving supervision to the SIB. He asked what would happen if there were another Barings and how would the Bank be involved. He did not believe the Bank knew. The Governor commented that this was why he had said that it would be very important that the Bank continued to monitor the financial health of individual institutions. Sir Colin Southgate noted that that would lead to two lots of bureaucracies. The Governor said that the SIB would take the flak in a crisis but Sir Colin Southgate said that such issues would nevertheless end up in the Bank's lap. Mr Buxton said that one of the tasks of the letter should be to put constructive arguments about the bigger picture, but it should not go so far as to create difficulties for the Governor's position in the future.

Sir John Hall noted that the Governor was being put in a very difficult position in terms of his personal standing if he said he was not consulted. The Governor said that the letter was going to the Chancellor during the course of the morning. The Bank had to give him notice before the statement, which was to be made at 3.30pm, before the debate, which was to take place between 4.00pm and 5.00pm. Sir David Cooksey said there was going to be a moment in time when the press was going to pick up the fact that the Government was firing from the hip. He regarded what had happened as a socialist ploy, dismembering some of the great institutions of state. One of the great things about having supervision in the Bank was the speed at which the Bank was able to act to stop systemic problems. He

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had no doubt that putting one organisation on top of another was going to slow the process. This reinforced the point about lack of consultation.

The Governor noted that that was why the Chancellor had promised to consult on the application of the decision. The relationship the Bank forged with the SIB would be absolutely critical and it was a great help to have the Deputy Governor there, as well as the Bank's own supervision staff. There would be an important continuity. The Bank had to work very hard to make sure that persisted. He also commented that, if the Bank drew attention to its great record in supervision, it would be laughed out of court. The perception was that the Bank had been asleep on the job more often than it should be. The reality was if there were another Bank failure, the removal of supervision would happen immediately. The difficulty was that the Governor could not stand up and give in a positive way the reasons why it was opposed to the decision.

Sir Colin Southgate suggested that the word dismay in paragraph 2 of the draft letter could be replaced with the word disgusted. Sir David Scholey said it would be hard to exaggerate the sense of outrage felt by Members of Court. The Governor commented that dismay was a strong word in his own terms.

Replying to a question from Sir David Lees, the Governor said that he believed that, while the Bank had not been consulted on the principle of the decision, it would be consulted on the practicalities. Sir David commented that it would be constructive if the Bank, while noting that it was not consulted on the principle, said that it expected to be consulted on the practicalities.

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The Governor said, in reply to a question from Sir Chips Keswick, that he would be talking to Supervision & Surveillance staff at 4.00pm that afternoon, with Mr Foot, who was at present returning from the Isle of Man. The Governor said he was very grateful for Court's support for his personal position. With his colleagues he would try to stiffen the language of the private letter and look again at those parts of the letter which would be published. He would make a clear statement at the end of the letter that questions would be asked, and the Bank could only give honest answers.

The next battle would come later in the week, on the question of the new members of the Monetary Policy Committee. The Chancellor had promised that he would be able to talk about the new members by the end of the week. The Governor noted that the Chancellor had also said that this week's events had been a misunderstanding, and he had expressed the hope that the Governor did not think that this was the way he conducted himself generally. Normally, he would consult rather than just tell. He would also take account of what the Governor said. The Governor commented that the appointments would be a test case. If the Chancellor behaved in a comparable way again, it would be more than he, the Governor, could stand.

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A MEETING OF DIRECTORS AT THE BANK

WEDNESDAY 28 MAY 1997

Present

Mr King

Mr Clark

Mr Foot

Mr Plenderleith

In the absence of the Governor and Deputy Governor, Mr King 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 Meetings of Court of 14 and 20 May, having been circulated, were noted.

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