COMMITTEE OF NON-EXECUTIVE DIRECTORS (NEDCO) MEETING

Wednesday 13 June 2007

Present:
Dr David Potter, Chairman
Mr Brendan Barber
Ms Amelia Fawcett
The Hon Peter Jay
Sir Andrew Likierman
Sir Callum McCarthy
Mr Paul Myners
Mr James Strachan
Mr Geoffrey Wilkinson

Absent:
Sir John Parker, Ms Rabbatts, Professor Rhind, Mr Sarin, Mr Wigley

Also attending:
The Governor, Sir John Gieve, Ms Lomax, Mr Bean, Mr Bailey, Mr Footman, Mr Jenkinson, Mr Jones, Mr Tucker, Dame Juliet Wheldon

1. Minutes – 17 May

Approved.

2. Matters Arising

None.

MANAGEMENT OF THE BANK

3. Executive Report

The Governor introduced the item.

Recent and forthcoming meetings and events

Domestic:

- Regional visit to Scotland (17-18 May);
- Regional visit to Wales, including speech (11-12 June);

- Mansion House speech (20 June);
- Treasury Committee Inflation Report hearing (28 June);
- Regional visit to West Midlands (9-10 July).

International:

- 100th anniversary of the Swiss National Bank in Zurich (21-22 June);
- BIS AGM meeting in Basel (23-24 June).

A telephone discussion with Nick Macpherson had taken place on 24 May. A breakfast meeting with the Chancellor and a telephone discussion with Nick Macpherson were scheduled for 19 June.

Susan Rice (Chief Executive of Lloyds TSB Scotland) and Roger Carr (Chairman Centrica) would be appointed to Court once Royal approval had been given. A public announcement by HM Treasury would then be made.

[redacted]

Loomis and the Note Circulation Scheme (NCS)

It was explained that Loomis Cash Management – a subsidiary of Swedish company Securitas – had told the Bank that they suspected a discrepancy in their reporting of notes held off balance sheet overnight in the Note Sorting Facility under the NCS. The effect of this misreporting was to over-declare the value of notes that they were processing, and thus to take out of circulation notes that, on the definition used in the NCS rules, were in circulation. By reducing the value of notes in circulation, Loomis were causing a reduction in the value of banknotes on the Bank's balance sheet, and thus a lower note issue and seignorage income for HM Treasury.

The senior management of Loomis, which was largely new, discovered this as part of an investigation that they had initiated concerning a separate matter, namely an accounting discrepancy between Loomis and its two major customers, Barclays and HSBC. Loomis (previously using the Securitas name) had become a member of NCS in 2001 when the two banks outsourced their cash processing activities. The accounting discrepancy was thought to have occurred at the outset of the transfer in 2001. There was no suggestion that the two issues were linked. Advisors acting for Loomis had put the loss to the Bank (in terms of lost note issue income) from the start of 2005 at £6 million.

Loomis had also informed the Bank that it was standing down from membership of the NCS, and would be replaced by Barclays and HSBC. The banks were in the process of establishing a joint venture company which would assume NCS membership. This would be subject to approval by the Bank. The Bank had immediately notified Loomis that it would be using its power under the NCS rules to send in auditors to investigate the mis-reporting. This was at the expense of the NCS member, not the Bank. KPMG had been commissioned. The Bank had requested an indemnity from Loomis and Securitas confirming their liability for any loss suffered by the Bank. Barclays and HSBC had provided the Bank with indemnities in respect of any risk to the Bank from, for example, operational problems or loss during the period of transition until the two banks take up formal NCS membership. Consideration would be given to how the NCS could be restructured to negate such risks of mis-reporting.

NedCo would be updated in July on progress and the outcome of the work by KPMG.

Financial Sanctions Unit

It was explained that the Bank's role as HM Treasury's agent to implement financial sanctions was a legacy role which was not closely aligned to the Bank's core activities and had raised reputational risks over the past few years. The work had moved from largely United Nations sanctions to those related to terrorist financing. Discussions had taken place with HM Treasury and they had now put forward a plan for a new sanctions unit in the Treasury to cover their work and that of the Bank. The Bank considered this a sensible proposal. HM Treasury wanted to implement the new arrangements by the end of the summer. It was likely to include seconding a small number of Bank staff for a few years.

Human Resources

A new Secretarial Development Framework for the Bank had been announced with the objective of increasing development opportunities for all by developing potential within current jobs, increasing mobility and, for some, preparation for senior secretarial roles.

It was asked if the Bank had considered how it might employ the new NVQ level training which was being launched the following day. The matter would be raised with the HR Director. It was stressed that the Bank wanted to ensure staff development was not restricted to graduate entrants but extended to all staff.

Credit conditions survey

The new Bank survey was launched at the end of May. It would ask banks, building societies and other lenders about developments in secured, unsecured and corporate lending demand, supply and terms. The survey would input into both monetary policy and financial stability work.

It was asked if the Bank was satisfied that the management of bank accounts referred to in the media in relation to the Saudi Arabian arms contract was compliant with directives on payments. In response, it was explained that the Bank was in the process of gathering information about the account and would report back to NedCo in July.

4. **Pensions**

The Governor and Sir John Gieve introduced the item.

The latest position in relation to legal advice relating to age discrimination regulations was outlined in the paper. On the basis of the advice, the Bank believed it could now start a formal staff consultation on the proposals agreed with Directors in October 2006. The new advice did not remove all legal risk but it did concur with a sensible assessment of the situation. There was no certain way of establishing what the law meant ahead of future interpretations in the courts. It was planned that the staff consultation would commence on 26 June and run until the end of August, after which Court would be asked to approve final proposals. It was envisaged that the scheme for new staff would commence in October.

It was explained that the Bank had already discussed its proposals with Amicus. The union's concerns centred on the less generous provisions of the new scheme relative to elsewhere in the public sector and the length of the period for phasing in the changed approach to requests for flexible retirement.

It was also noted that further consideration of the Bank's redundancy scheme – which had also been delayed by age discrimination concerns – would be taken forward over the Autumn.

Directors supported the reliance on the latest legal opinion. In relation to the union's concerns about the timescale for changes to flexible retirement requests, it was asked if the Bank had considered a longer period for phasing in the new approach and the strength of feeling the proposals were likely to provoke. In response, it was explained that the changes were material. Consideration had been given to limiting abatement to new accruals only but that would have resulted in a very slow adjustment in costs. It was suggested that the Bank might need to give greater clarity about the basis of future decisions on requests for flexible retirement. It was explained that it would be important to communicate that the Bank had slipped into a practice which made little sense, in that early retirement was an exit route for poorer performers while better performers were lost prematurely in order not to penalise good performance. This was plainly inconsistent with the HR objective to increase experience levels across the Bank. It would still be possible to take early retirement on an unabated basis but the Bank would no longer be encouraging it through the subsidy of unabated pensions. About 260 staff would be eligible to ask for early retirement ahead of April 2010. There might be complaints from staff that just missed out – e.g. those that turned 50 between say 2010-13. The consultation would establish the strength of feeling but it was not expected to be an issue for a large group of staff. The Bank could reflect on the position as it became evident during the consultation.

The figures presented on page 5 of the note outlined the cost of flexible retirement. Clarification was sought about the extent to which the costs were additive. It was explained that the present cost was around £3 million a year based on an average of twenty five staff taking early retirement each year. Under the proposals, the cost could rise to £30 million if all 260 eligible staff left under the flexible retirement scheme. It was estimated that some 30% would have left anyway over the remaining three years at a cost of £9 million leaving a net additional cost of £21 million. A note setting out the costs contained in the text on page 5 of the paper would be sent to non-executive Directors. In relation to the request listed in the 'Matters Arising' note for information on the past cost of the FRS, it was noted that flexible retirement was not the only issue that might be considered in an overall audit of past pension decisions.

There was a discussion about how future changes in longevity were to be accommodated. The wording on page 3 of the paper was not specific. It was asked if there would be an automatic formula embedded in the rules of the new scheme linking retirement age to life expectancy to insure against a future reduction in the real retirement age (i.e. retirement age relative to life expectancy). It was explained that there was no need to settle on specific wording at this stage. Directors would discuss that further after the consultation.

Directors also discussed the impact on the Bank's dividend payments of the agreed changes to the pension fund's investment strategy. It was explained that the issue had been discussed with Nick Macpherson. HM Treasury would prefer the dividend to remain at the same level as at present. The Bank wanted to consider further the accounting treatment. It was, of course, possible to change the percentage of profit paid as dividend from the current convention of 50%.

In relation to the investment strategy for the Pension Fund, it was noted that an investment sub-committee already existed. It was currently chaired by Alastair Clark. He would continue to undertake this role up to the point of outsourcing the Bank's investment unit. It would be important to build-up the expertise of the trustees and, following the merger of the staff and Court schemes, have more Court trustees. This seemed appropriate given the increasingly technical nature of the strategy in terms of matching risk-free assets and liabilities. It was explained that it was not necessary that membership of an investment committee comprised only of trustees, recognising the need for specialist technical advice.

In summary, Directors acknowledged the approach and considerable work undertaken by the executive management to pensions reform and the issue of age discrimination. Key points from the discussion were that the retirement age would be regularly reviewed alongside future changes in longevity, consideration would be given to a formula for the distribution of dividend in the light of changes to the pension fund investment strategy, and the paper for NedCo in September would address how the Bank would treat future requests for flexible retirement. Non-executive Directors supported the merger of the staff and Court pensions schemes, to be formally approved by Court.

5. **CRD Review**

Mr Jones introduced the item.

It was explained that there had been a ministerial statement about the CRD review on 14 May. Responses to the informal consultation were due to be received by 15 June. The financial plan underlying the Bank's position was that agreed by Court in February, specifically that nominal spending on policy functions would rise by 2% a year between 2008-11. This assumption had been extended over the entire five years of the CRD review to provide a cost envelope up to

2013. Table 3 showed the guide path for spending over the period 2008-13. At £563 million, this would be around 10% less in real terms than the CRD settlement for 2003-08. It was stressed that these spending assumptions would not be binding. The annual budget round would determine planned expenditure each year and, in any event, income generation might differ from the guide path and the income from capital could be drawn upon if necessary.

The attitude of institutions eligible to place CRDs at the Bank was discussed along with the likely approach of HM Treasury. It was explained that the Treasury had not so far raised any significant or contentious issues, and the overall mood appeared constructive. It was unlikely that alternative methods of financing the Bank would be attractive to HM Treasury. The banks would see a reduction in 'tax' under the Bank's proposals from a CRD ratio of 0.15% to 0.11%.

It was clarified that the Bank's finances were not part of the Comprehensive Spending Review. The Bank had reduced expenditure in real terms by 10 per cent over the past five years, which was similar to what Government departments were being asked to do. It was noted that the planned 2% nominal spending growth in future years was consistent with further efficiency gains alongside 4-5% growth in input costs.

There was a discussion about the inherent uncertainty in the projections for the five-year period and the potential impact on reserves if income was significantly lower. It was noted that reserves had increased lately. If they fell in future, it was thought unlikely that it would be by a significant amount. It was not felt sensible to argue for a higher CRD ratio on the grounds the Bank's income might be less. In effect, the five-year review captured the need to adjust the Bank's finances if circumstances changed significantly.

It was asked if HM Treasury was likely to come under pressure itself about the financing of the Bank. There was a potential perceived conflict between taxing financial institutions and the Treasury's receipt of dividend income from the Bank, alongside the fact the logic for such a 'tax' had diminished since the Bank had removed its third core purpose. The Bank did not want to prompt a wider debate about its financing. It was true that other central banks were financed differently, some directly from seignorage income. It was thought that financial institutions were not likely to see much merit in opening a debate about the Bank's financing relative to other areas of public expenditure. The Bank's proposals meant the burden imposed was not large and was reducing. A logical case for change could be made by the financial sector but not strongly and it was unlikely that the Treasury would accept a reduced contribution from the financial sector in terms of overall taxation. Provoking a public debate might damage rather than benefit the financial sector.

In summary, Directors supported the approach outlined in the paper which envisaged a reduced CRD rate of 0.11% and an unchanged threshold level of £500 million.

6. **Money Market Reform II: Update on Implementation Programme**
(Mike Cross – Head of Sterling Money Markets Division – in attendance)

Mr Cross introduced the item.

Following the previous update in October 2006, the paper updated Directors on the progress of the project, which would introduce electronic bidding for operations to purchase a gilt portfolio that would then be lent out to avoid strains in collateral markets exacerbating secured money market volatility.

In response to a question about the internal dress rehearsal work, it was explained that the front and back office function had operated well. There was what seemed to be a relatively small problem relating to the link with the financial accounting. This reflected the design of the dress rehearsal rather than anything fundamental. It illustrated the increasing effort being devoted to the links between the Markets and Banking areas and the Finance area.

7. **Payments Systems**

The Governor and Sir John Gieve introduced the item.

It was noted that payment systems oversight was the remaining area of the Bank's responsibilities that lacked clarity. There was a significant gap between the Bank's perceived responsibilities and its powers. The Memorandum of Understanding (MoU) did not provide a clear definition of the Bank's role, for example on why and how it should undertake payment systems oversight, and the Bank had no statutory powers to deliver its responsibilities. At the time that the MoU had been revised, therefore, it had been agreed that there needed to be a full review of payment oversight.

Following a lengthy internal review, the Bank had sent a paper to the Treasury and the FSA for an initial discussion. That was annexed to the NedCo paper. The Treasury envisaged that they would need to consult publicly on any change to statutory powers in this area. Before Ministers took decisions on which approach to propose, they wanted Court's views on the best approach. Following public consultation the revision to the MoU would be formally agreed by Court.

The conclusions of the Bank's review were set out in the paper. There were two grounds for public intervention in payment systems: competition and resilience. It seemed sensible for the Office of Fair Trading to continue to deal with competition issues. The questions were how widely 'resilience' oversight should extend and who was best placed to do it.

The Bank did not want to retain a vague responsibility and neither was it keen to have new statutory regulatory powers for payment systems, which would sit oddly with the Bank's current functions. Any such powers for the Bank would require primary legislation, which was unlikely to be on offer. The Bank did not now have a culture of regulation. It was envisaged that the Treasury would want to list the payment systems to be subjected to regulatory oversight, which might cover some retail systems that the Bank did not currently oversee.

In view of these considerations, the Bank had concluded that where statutory regulation was required it should fall to the existing regulator, namely the FSA. The key issue for the Bank was the position of RTGS/CHAPS and the related payment systems embedded in CREST and LCH. The Bank was not just the overseer of these systems, it owned and operated the RTGS infrastructure through which payments were made, it provided intra-day credit to enable the systems to work, and payments were made across its balance sheet. The resilience and control of these systems were, therefore, critical to the Bank's own operations and finances and the Bank had direct levers to impose requirements on the systems without statutory backing. For these reasons the paper recommended that these systems should remain the Bank's responsibility on a non statutory basis. There might be alternative arrangements, for example using an MoU with the FSA, which achieved the same objective. What was being sought today was agreement with the principles in order to proceed further with HM Treasury.

Directors discussed a number of issues related to the approach and proposals. It was explained that the FSA was not bidding for an additional regulatory role but was willing to take on the responsibility for some or all payment systems provided its legal powers were extended. The FSA recognised the Bank's special relationship with RTGS/CHAPS and the embedded payment systems. At the same time, it was made clear that if the FSA was given legal responsibility for regulation of RTGS/CHAPS, it would not be able to delegate that, through an MoU, to the Bank. It would need to satisfy itself on the systems and controls, including those run by the Bank, as it did for other recognised exchanges and clearing houses.

It was suggested that it might look odd for the most important payment systems to be excluded from a new statutory regime. A question was raised whether retaining the responsibility for RTGS/CHAPS might not still leave the Bank in a position of having responsibility without formal powers. In response, it was argued that the operational and contractual controls over RTGS/CHAPS were sufficient for the Bank to ensure the resilience of that system so there was not the gap between the Bank's responsibilities and powers that existed for other payment systems. It was not clear what additional role there could be for a statutory regulator; the danger was that it would add duplication and result in some confusion of responsibilities.

Directors agreed that if the Bank already had adequate powers in relation to RTGS/CHAPS, they were satisfied with the recommendations. It was noted that the case for additional regulation of RTGS/CHAPS was not clear and therefore would not amount to a good use of public money. Moreover, it was noted that there was no precedent in other G10 countries for oversight not being undertaken by the central bank.

A further suggestion was that, in view of the lack of urgency for regulation, it might make sense to wait for primary legislation. In response, it was stressed that there were ongoing risks for the Bank. It had responsibilities that could not be ignored, particularly for retail payment systems without the authority to deliver. The Bank did not want to be in such a position. More generally, regulation of retail systems fell outside the Bank's core purposes.

It was asked whether narrowing the Bank's role in the oversight of payment systems would weaken its ability to deliver its second core purpose. In response, it was explained that only high-value systems were central to financial stability and system-wide resilience. But regulation needed to be about more than financial stability, involving for instance consumer protection. It was expected that the Treasury would want to cover all aspects of regulation. The resilience of retail systems was important but not on financial stability grounds.

It was also clarified CREST and LCH were and would remain subject to regulation by the FSA as securities exchanges. The Bank's continuing role would be in relation to the payment systems embedded in CREST and LCH which were linked directly to RTGS. CLS was subject to US regulatory oversight and not by the FSA. It was proposed that the Bank would remain on the international advisory body that the US had set up.

It was noted that the Audit Committee had been concerned by the ambiguity in the Bank's role. It was felt that the ambiguity was cleared by the principles outlined in the paper. It was suggested that if regulation of RTGS/CHAPS went to the FSA, there would be potential duplication, complexity and confusion. In contrast, giving the Bank responsibility for oversight of RTGS/CHAPS would not create a new ambiguity.

In summary, conditional on the understanding that the Bank had adequate powers in relation to CHAPS/RTGS, Directors approved the Executive's proposal that the future of payment oversight should be as follows:

- CHAPS/RTGS not to be covered by statutory powers and overseen by the Bank as at present;
- FSA continuing as the statutory regulator of CREST and LCH as at present, with an MoU to set out explicitly the Bank's role in relation to their embedded payment systems; and
- FSA regulating all other payment systems under the Financial Services and Markets Act that HM Treasury designates.

Final approval of the proposed arrangements would be brought to Court following the consultations, likely to be over the Autumn. Sir John Gieve would provide an update to Directors in due course.

8. **Audit Committee report**

Ms Fawcett introduced the item.

Issues other than the Annual Report and Accounts discussed by the Audit Committee on 3 May were summarised. The draft minutes of the meeting had been circulated to Directors. The meeting had considered the banknote ECB/DSSI patent case, the Internal Auditor's report, the External Auditor's report and the Investment Unit outsourcing project.

It was also noted that the pension fund trustees review the appointment of auditors for 2007/08.

9. **{Health} and Safety**

Mr Footman introduced the item and summarised the report.

ITEMS FOR INFORMATION

10. **MPC Report to Court**

The MPC report to Court for June was noted.

Any other business

None.

The meeting of NedCo was closed.

MEETING OF THE COURT OF DIRECTORS

Wednesday 13 June 2007

Present:
Mr King, Governor
Sir John Gieve, Deputy Governor – Financial Stability
Ms Rachel Lomax, Deputy Governor – Monetary Policy
Mr Barber
Ms Fawcett
The Hon Peter Jay
Sir Andrew Likierman
Sir Callum McCarthy
Mr Myners
Dr Potter
Mr Strachan
Mr Wilkinson

Absent:
Sir John Parker, Ms Rabbatts, Professor Rhind, Mr Sarin, Mr Wigley

Also attending:
Mr Bean, Mr Bailey, Mr Footman, Mr Jenkinson, Mr Jones, Mr Tucker, Dame Juliet Wheldon.

1. **Minutes – 17 May 2007**

Approved.

2. **Merger of the Court Pension Scheme and Staff Pension Fund**

Court APPROVED the Deed of Amendment and merger on the basis described in the paper which had been made available to Directors.

3. **Monetary policy issues**

Court noted the submission of the monthly MPC report to Court for June.

4. **Pensions, CRD review, money market reforms project, payment systems oversight, Audit Committee report, health and safety report.**

Court noted the discussions in NedCo of the above items.

Any other business

It was announced that Heather Rabbatts had written to the Governor, received that day, to announce her resignation as a non-executive Director of the Bank due to other work commitments.

Directors were reminded of the need to inform the Secretary in advance of any proposed new directorships and involvements, in order to secure the Governor's approval.

[The Governors and other members of the Executive Team left the meeting.]

5. **Remuneration Committee report**

The chair of the Remuneration Committee reported to Court the recommendations for an increase in the Governor's salary following the meeting of the Remuneration Committee earlier that day. The Remuneration Committee recommended that the Governor should be awarded an increase to his salary of 2.5% from 1 July 2007. The Governor's salary would therefore rise from £283,564 to £290,653 per annum. The recommendation had been informed by an assessment of the Governor's performance in the year to June 2007 by the chair of NedCo.

The Remuneration Committee had also discussed the longer term direction of the salary of Governors, which would be considered further ahead of the start of the new term of office from 1 July 2008.

The recommendation was APPROVED.

Any other business

Following the points made at the second meeting of NedCo on 17 May, the balance between policy and process related items discussed in NedCo meetings was raised. It was suggested that it might be useful to create an opportunity for non-executive Directors to meet away from the Bank to discuss the formation of agendas.

The meeting of Court was closed.

COMMITTEE OF NON-EXECUTIVE DIRECTORS (NEDCO) MEETING

Wednesday 11 July 2007

Present:
Sir John Parker, Chairman
Mr Brendan Barber
Mr Roger Carr
Ms Amelia Fawcett
The Hon Peter Jay
Sir Andrew Likierman
Sir Callum McCarthy
Mr Paul Myners
Dr David Potter
Ms Susan Rice
Mr David Rhind
Mr Arun Sarin
Mr James Strachan
Mr Bob Wigley
Mr Geoffrey Wilkinson

Also attending:
The Governor, Sir John Gieve, Ms Lomax, Mr Bean, Mr Bailey, Mr Footman, Mr Jenkinson, Mr Jones, Dame Juliet Wheldon.

Susan Rice and Roger Carr were welcomed as new non-executive Directors of the Bank.

1. **Minutes – 13 June**

Approved, subject to two small amendments.

2. **Matters Arising**

None.

MANAGEMENT OF THE BANK

3. **Executive Report**

Recent and forthcoming meetings and events

Domestic:

- Mansion House speech (20 June);

- Treasury Committee Inflation Report hearing (28 June);
- Regional visit to West Midlands (9-10 July);
- Governor's Day (15 July);
- Regional visit to the South West (16-17 July);
- Inflation Report and press conference (8 August).

International:

- 100th anniversary of the Swiss National Bank in Zurich (21-22 June);
- BIS AGM meeting in Basel (23-24 June).

A breakfast meeting with the Chancellor (Gordon Brown) and a telephone discussion with Nick Macpherson had taken place on 19 June, and a breakfast meeting with the new Chancellor, Alastair Darling, had taken place on 4 July. The Chancellor planned to visit the Bank in the Autumn. Further meetings with Nick Macpherson and the Chancellor were scheduled for 19 and 26 July respectively.

<u>Pensions consultation</u>

It was reported that the launch of the consultation with staff about the Bank's pension proposals on 26 June had gone well. It had involved a video message and open meetings with staff that had been well attended. Three issues had so far emerged through discussions. First, that the proposals would mean staff achieving forty years service before the age of 60 would face an abated pension if they retired before 60. It was explained that the Bank believed it was right to introduce abatement for early pensions but it would look at the formula to avoid any sense of discrimination. Second, that the small number of people who had joined since October 2006 were being harshly treated. The Bank had made clear in contracts for staff joining since October that they would not join the final salary scheme and that would remain the case. Third, there was some concern about staff on career breaks who would not be able to re-enter the final salary scheme. The Bank had been careful over the recent period not to have staff resigning to take career breaks. It would be looking at those who had done so over the past few years. The issue of the changed approach to flexible retirement had not surfaced in a significant way to date. It was noted that there had been media reports about the consultation but these were not problematic.

<u>MPC appointments process</u>

The Chancellor (Gordon Brown) had announced changes to the appointment process for MPC members on 14 June at a Treasury Committee hearing. The proposals largely dealt with the issues raised by the Bank. A timetable of dates for appointing new MPC members would be announced before the end of an existing members' term, including by when a confirmed appointment would be announced. It was explained that the enhanced appointment process would be, most probably, first used in May 2008 when Andrew Sentance's current 3 year term expires, which was the remainder of David Walton's term. Andrew Sentance was given an expectation at the time he accepted his current part-term of appointment that he would serve a further full term. HMT would now need to advertise for expressions of interest from people, with a relevant background, who would wish to become a member of the MPC.

BAe bank account

In relation to press reports about a BAe account at the Bank of England being used to process payments in connection to the Al {Yamamah Saudi} Arabian arms contract, it was noted that the Bank's investigations had revealed no such account existed. A letter had been sent by the Governor to Robert Wardle, Director of the Serious Fraud Office, asking if a Bank of England account had figured in their investigation and, if it had, for details relating to that.

Staff

Tim Porter had been appointed to become Head of Financial and Management Accounting Division and Simon Politzer had been appointed to become Head of Project, Risk & Performance Division. Both appointments were effective from 1 July.

Open Door event

The Bank and Museum had opened its doors to members of the public on Saturday 7th July as part of the City of London Festival. Visitors had received a guided tour of the Parlours.

A question was asked about the merits of publishing the MPC vote with the decision rather than the MPC minutes. In response it was explained that the MPC preferred to publish the vote with the full explanation of the decision that was detailed in the minutes. The lag between the minutes and the decision was relatively short in view of the need for drafts to be discussed and amended by the MPC. It was explained that if the vote was released at the time of the decision without naming individuals, there would be considerable speculation ahead of the minutes about which members had voted which way. That would hinder speeches and other communications before the minutes were published. There would be pressure on MPC members to reveal their vote and reasoning in the face of such speculation and comment. It was important not to create incentives for MPC members to speak about the decision until the minutes had been published.

4. **Payment Systems: Bank powers**

Sir John Gieve introduced the item.

The paper set out the Bank's role in payment systems and the operational powers and tools at its disposal, principally its ownership and operation of the RTGS infrastructure – the central hub of the payment system whereby the Bank could set standards and oversee operational resilience – and the Bank's role as settlement agent for the banking system, which enabled the Bank to lay down conditions for CHAPS and CREST members to have RTGS accounts. Before finalising a consultation document in line with the joint Bank/FSA proposals, discussed at NedCo in June, HM Treasury had asked for confirmation from Court that the Bank had the ability to assure resilience in CHAPS and embedded payment systems without statutory powers. The Executive Team believe that the Bank's operational powers were adequate to ensure resilience and recommended to non-executive Directors that the Bank responded accordingly to HM Treasury. Directors were asked if they were comfortable with that conclusion.

It was asked if the Bank had powers to obtain information from banks in addition to its operational powers. In response, it was explained that the Bank did have powers to request information relevant to the operation of RTGS – for example, regarding banks' back-up sites in order to assess if there was excessive clustering of contingency operations.

It was suggested that the letter from HM Treasury was, in effect, an invitation to have more powers if needed. It was asking the Bank if it was sure that it had the capacity and capability to undertake oversight through its operational responsibilities to an extent that removed the need for statutory powers. In this context, it was asked if the Bank's approach relied on certain behaviours, conduct and understandings that might prove difficult or be diluted in a litigious environment. In response, it was acknowledged that the Bank could be liable to litigation, with or without statutory powers. The letter was seen more as a request that the Bank establish that it was certain that it had sufficient operational powers that were equivalent to statutory powers to ensure the necessary resilience of its systems. The executive management view was that the Bank did not need or want statutory powers.

In relation to paragraph 17 of the paper, it was asked if it was possible to withdraw an account without provoking a crisis. This deterrent would not be credible if it could not be used. In response, it was suggested that credibility was indeed more subtle but the powers were there nonetheless. It was also noted that in addition to the option of withdrawing an account, there were other options including penalties and suspensions. Moreover, the system was linked to the provision of liquidity by the Bank so the incentive for banks to follow the rules and guidelines were strong.

Directors agreed the approach suggested by the executive management.

5. **Assessing risks to Financial Stability**

(Mr Haldane – Head of Systemic Risk Assessment Division – in attendance)

Mr Haldane introduced the item.

The paper outlined the Bank's restructured approach to its financial stability work, aimed at providing a more analytical and rigorous approach to risk assessment. This involved using a set of modelling techniques to help track systematically how risks were propagated, and allowed risks to be broadly quantified and scaled. The work was an input into the Bank's internal and external dialogue.

It was explained that the approach had yielded three benefits. First, it had helped to transform internal discussions, focussed on the Financial Stability Board – it had created a framework with a common language. Second, it had improved the clarity of external communications. The Financial Stability Report had a clearer, shorter narrative and improved structure, which had solicited positive feedback. Third, the way the Bank's judgements about risk influenced the outside world had improved through a better dialogue with risk managers, a core constituency for financial stability work. It was also noted that collaborative work on modelling techniques was being undertaken with a group of ten banks in order to share best practice. In terms of next steps, it was highlighted that there were still gaps to fill in order to establish a complete picture of systemic risk – for example, in the area of counterparty risk. Further work would be reported to Directors in due course.

Directors welcomed the paper which allowed them to understand better the process of assessing and scaling risk. In relation to the collaborative modelling work with commercial banks, it was asked if the approach had revealed different insights about risks in the financial system. In response, it was highlighted that the work was at an early stage and there was considerable diversity in existing practices. It had not identified any looming gaps. There was a strong indication that liquidity risk was a central concern and a shared recognition that it was not possible for individual firms to manage or mitigate it fully insofar as it would materialise through the actions of others.

There was some surprise that other central banks had not taken this approach already. It was explained that the IMF and other central banks had undertaken similar modelling research, which was at various stages of development. But it had not yet generally been used to construct an apparatus to inform risk assessment and clarify why particular risks were more important. The Bank had pushed the approach further in terms of its external communications. It was asked how the Bank built data around the model and whether, alongside modelling how instability was transmitted, there was a methodology or model to help identify, a priori, instability in the system. In response it was stated that theory provided a guide to what data was needed, as with macroeconomic analysis. The main step forward was the modelling of interactions across the financial system and the spill-over effects of instability. The work had enabled a deeper approach than was the case hitherto in terms of considering issues of market structure, capacity and the incentives for firms to seek risks.

It was highlighted that while the approach taken was a step forward, there were inevitable pitfalls in establishing one particular stress model of this kind. Different institutions would experience different kinds of impact and, in turn, their impact on the wider system would differ. Competence and focus was needed at the top of financial institutions to identify and assess key risks. It could not be simply about using the Bank's stress model. There also needed to be engagement with key institutions.

There was some discussion about the means of assessing the success of the Bank's financial stability work. It was asked what were the appropriate measures of the quality and impact of the work? This was relevant to non-executive Directors' oversight role. It was explained that feedback to date was largely informal but that work was underway to progress performance measurement through consideration of feedback surveys and focus groups. It was suggested that this work could be reported to NedCo in the autumn.

6. Emergency Authorities

Dame Juliet Wheldon introduced the item.

The paper considered how Directors should be consulted about transactions outside the normal course of business, including support under the tripartite Memorandum of Understanding. It addressed paragraph 3(e) of 'Matters Reserved to Court' and the practicalities of consulting Court in a financial crisis. It was proposed that Court could use its powers to delegate authority by adding a paragraph after the present paragraph 3(e) to provide additional procedural flexibility in a crisis.

The proposed additional wording to follow paragraph 3(e) was:
"Consultation in a quorate meeting of Court is not required if the Governor (or any person whom he has authorised to act in his absence) believes that this is impracticable in the circumstances. In that case he will if possible consult the Chairman of NedCo and alert members of Court that there is an issue, and, if the transaction would involve a significant financial risk to the Bank, will in any event take all reasonable steps to hold a meeting with a quorum of 6 non-executive directors at which members can be present by telephone or any other means of communication. The Governor will report a decision under this procedure to Court as soon as possible thereafter."

Directors were content with the proposed approach and wording. Formal approval of a resolution would be sought from Court in September.

7. CRD Review

Mr Jones introduced the item.

It was reported that HM Treasury had accepted the Bank's expenditure envelop of a 2% increase per {annum} and the proposals to reduce the Cash Ratio Deposit (CRD) rate from 0.15% to 0.11% and to retain the existing thresholds for CRD eligibility. The proposals would form part of a formal consultation, which would commence in August for a period of 3 months. HM Treasury had raised the option of introducing a tiered CRD rate but this was considered overly complicated and unjustified.

The informal consultation had involved 393 institutions and had received 68 responses, of which 22 institutions currently paid CRDs. Eight had no comment or were content. The remaining fourteen had a mixture of comments, including paying less and requests for greater transparency. The British Banking Association made a number of points including whether the present surplus could be re-paid as a rebate. This was complicated but was being considered, along with how deficits might be recovered, and how transparency could be increased. A paper was being prepared ahead of a meeting of the Steering Group on 26 July which would consider how the formal consultation would, if thought necessary, present the issues of repayment and transparency.

8. **Loomis and the Note Circulation Scheme**

[Sir Andrew Likierman was conflicted out of the discussion as a non-executive Director of Barclays plc.]

Mr Bailey introduced the item.

The paper outlined the issues surrounding the misreporting by Loomis Cash Management of the value of notes held in its cash processing operation. Loomis had exaggerated the value of notes held thus lowering its funding costs and causing a loss of income to the Bank, and in turn HM Treasury. An initial estimate of the loss of income for the Bank provided by advisers to Loomis was £8 million, though the final figure was expected to be higher. The Bank had appointed KPMG to conduct a forensic audit of Loomis to identify the extent of the seignorage income lost. Consistent with the rules of the Note Circulation Scheme, the cost of this audit work would be met by the member (Loomis). In addition, Securitas AB – the parent company – had provided an indemnity to the Bank to cover the costs of the investigation and the lost income. Separately, the Bank was reviewing its Note Circulation Scheme to ensure a similar situation could not arise again.

It was asked if the possibility of such an event was part of the Bank's risk management framework. In response it was noted that the quality of controls in the Note Circulation Scheme had been reviewed by Ernst & Young, which had highlighted issues, including at Loomis. However, within the Banking area, prioritisation for compliance work had needed to be switched to physical controls following the Tonbridge and Tamworth robberies so these issues had not been addressed in the first phase of work to implement improved controls.

[redacted]

It was suggested that the Audit Committee should look at the Ernst and Young report from 2006 and the Bank's subsequent follow-up actions.

It was noted that Securitas AB had made a private disclosure to the Swedish Stock Exchange but would eventually need to make a full public announcement. It was added that the amount involved would not be material for Securitas but the issue was of greater consequence for the company's reputation.

It was stressed that the situation reflected underlying deficiencies with the Note Circulation Scheme. The scheme had largely evolved over time through a close relationship with the main banks. The Bank had been able to trust and rely on its relationships with the large banks. As a consequence, it had been possible to run the scheme at relatively low cost. The contracting-out of cash management operations had saved the banks money but sometimes resulted in large problems. Crucially, from the Bank's perspective, the constraints on non-bank members' behaviour were different. It was now necessary to review the Note Circulation Scheme and assess the robustness of its auditing arrangements. It was noted that the Bank was the only central bank that allowed non-bank security companies to be direct members of a note circulation scheme. It was felt that the bank needed to reach a position whereby it relationships – notably in respect of risk – were with the banks even if they subsequently outsourced their cash management operations. It was also asked if there were incentives in place to improve cost efficiencies. It was noted that there were incentives but the Bank largely took the benefits. These needed to be reviewed as well.

In summary, Directors noted the present position and requested further updates. The Audit Committee would look at the lessons from the episode.

9. Quarterly Reports

(i) Quarterly Financial Report

Mr Jones introduced the item.

It was noted that further work was to be undertaken to link the financial and management accounts.

(ii) Performance Measurement

Mr Jones introduced the item.

The key issues for the latest quarter had been the inflation rate and the letter to the Chancellor, the problems with Loomis, and publication of the Bank's Annual Report. The HR report – annexed to the Performance Measurement report – noted the increase in the resignation rate and the rate of reduction in Bands 5-7s as part of the customer banking redeployment programme.

It was suggested that Directors would find it useful to know the split between regretted and non-regretted resignations. It was explained that this classification was available in the Monetary Analysis and Financial Stability areas. A longer time series for resignations was also requested.

(iii) Strategy Implementation

Mr Jones introduced the item.

Among the highlights for the latest quarter were the launch of the first Credit Conditions Survey, HM Treasury's endorsement of the Bank's preferred option for payment systems oversight, and the start of the staff consultation on pensions. It was noted that the Globus upgrade had been launched on 9 July. There had been some working issues to resolve but overall the outcome had been good.

It was asked if anything further could be done at a high level in order to enact more progress on the part of HM Revenue & Customs in relation to the Bank's planned exit from customer banking. In response, it was noted that some important milestones had been reached recently, notably the launch of invitations to tender. Bids from commercial banks were due by 8 August. The Bank was both pushing and facilitating this progress. It was thought that once the chosen banks were in place, further progress would then be made as the banks were unlikely to want a prolonged implementation period.

(iv) **Bank Projects**

Ms Lomax introduced the item.

In relation to Level 1 projects, it was noted that the customer banking project was amber due to missed interim milestones by HM Revenue & Customs; and the Notes IT and Infrastructure project was subject to a peer review. In relation to smaller projects, it was reported that the rate of slippage was being reviewed with a view to improving the governance and monitoring of smaller projects.

(v) **Risk Report**

Ms Lomax introduced the item

The major incidents over the latest quarter included the cash reporting errors by Loomis Cash Management and CPI inflation rising above 3%. It was noted that difficulties with staff recruitment and retention was an area of risk that was receiving active attention.

(vi) **Balance Sheet report**

Ms Breeden introduced the item.

The report – the first quarterly report on developments in the Bank's balance sheet – provided a summary under the five policy purposes laid down by the remit from the Governor to the

Executive Director, Market: setting the MPC's interest rate and managing banking system liquidity; facilitating the provision of payment services; managing the Bank's foreign exchange reserves; facilitating the provision of banking services; and managing the Bank's free capital and Cash Ratio Deposits. It was noted that the largest changes in the balance sheet over the past year or so resulted from the Bank's money market reforms and the restructuring of the Bank's foreign exchange reserves. It was also noted that the balance sheet was typically around £100 billion larger intra-day than at the end of each day, reflecting the Bank's provision of intra-day liquidity to settlement banks in the CHAPS payments and CREST securities settlement systems.

[Mr Barber departed]

10. **Report from Risk Policy Committee**

Sir Andrew Likierman introduced the item.

The meeting of the Risk Policy Committee held on 27 June was summarised. The meeting had discussed six items: the latest Quarterly Risk Report; the current status of the Bank's risk standards, including those that had still to be finalised and reported to NedCo; the way in which reputational risk was captured in the framework – papers relating to this would be prepared for the Audit Committee meeting in September, including an assessment of risks and issues arising from Freedom of Information legislation; oversight of the Financial Stability Board including a suggestion that this should be undertaken by a formal committee of Court; and business continuity issues.

As previously agreed, the Risk Policy Committee then agreed to be wound up as a committee of Court. Its responsibilities were to be transferred to the Bank's Business Risk Committee, the Audit Committee and NedCo as appropriate.

NedCo expressed its gratitude to members of the Risk Policy Committee for the work it had undertaken. It was suggested that the Audit Committee might be renamed the Audit and Risk Committee.

11. Action Plan

Sir John Parker introduced the item.

Directors noted the progress to date with the agreed actions following the internal board evaluation exercise in 2006.

12. The Bank in the Community

([redacted] – Community Relations manager (Secretary's Department) – in attendance.)

Mr Footman and [redacted] introduced the item.

It was noted that, over the past year, there had been a significant increase in the number of staff involved in community programmes, consistent with the staff focus of the current community relations policy. There had also been an increase in the amount of leave taken by staff to undertake civic and volunteering activities. It was asked if Directors were content with the proposed change to the community relations policy.

In response, the increase in staff involvement was recognised as a positive development. However, it was suggested that it would be important to ensure that the Bank's approach remained focussed rather than led by the interests of staff. It was suggested that the Bank should consider how it could be more specific about its objectives, in order to ensure the various initiatives were targeted on particular aims. It was suggested that Mr Strachan could discuss the approach further with [redacted] and Mr Footman.

The policy was endorsed by Directors.

ITEMS FOR INFORMATION

13. MPC Report to Court

The MPC report to Court for July was noted.

Any other business

None.

The meeting of NedCo was closed.

MEETING OF THE COURT OF DIRECTORS

Wednesday 11 July 2007

Present:
Mr King, Governor
Sir John Gieve, Deputy Governor – Financial Stability
Ms Rachel Lomax, Deputy Governor – Monetary Policy
Sir John Parker
Mr Carr
Ms Fawcett
The Hon Peter Jay
Sir Andrew Likierman
Sir Callum McCarthy
Mr Myners
Dr Potter
Professor Rhind
Ms Rice
Mr Sarin
Mr Strachan
Mr Wigley
Mr Wilkinson

Absent:
Mr Barber

Also attending:
Mr Bean, Mr Bailey, Mr Footman, Mr Jenkinson, Mr Jones, Dame Juliet Wheldon.

1. Minutes – 13 June 2007

Approved.

2. Committees of Court

Court APPROVED the following appointments to the Committees of Court:

(i) Roger Carr to the Remuneration Committee;

(ii) Susan Rice and Robert Wigley to the Audit Committee.

3. **Risk Policy Committee**

Court APPROVED the resolution for the cessation of the Risk Policy Committee and for the appropriate re-assignment of responsibilities to Audit Committee or Court.

4. **Transfer of shares in Securities Management Trust Ltd (SMT)**

Court noted the transfer of 25 shares in Securities Management Trust from Mr Chris Mann to Ms Joanna Place.

5. **The Bank's Community Involvement Policy**

Court APPROVED the Bank's Community Policy for 2008-2011.

6. **Monetary policy issues**

Court noted the submission of the monthly MPC report to Court for June.

7. **Payments systems oversight, Financial Stability risk assessment, emergency authorities, CRD update, Loomis and the Note Circulation Scheme, quarterly reports on finance, performance management, strategy implementation, projects, risk and the balance sheet, Risk Policy Committee report, NedCo/Court action plan.**

Court noted the discussions in NedCo of the above items.

8. **Sealing Committee authorisations**

The Sealing book was made available for Directors' inspection.

Any other business

None.

The meeting of Court was closed.

COMMITTEE OF NON-EXECUTIVE DIRECTORS (NEDCO)
SECOND MEETING

Wednesday 11 July 2007

Present:
Sir John Parker, Chairman
Mr Carr
Ms Fawcett
The Hon Peter Jay
Sir Andrew Likierman
Sir Callum McCarthy
Mr Myners
Dr Potter
Mr Rhind
Ms Rice
Mr Sarin
Mr Strachan
Mr Wigley
Mr Wilkinson

Absent:
Mr Barber

1. **Minutes – 17 May**

Approved, along with their circulation to the Governors.

2. **Strategy and related issues**
(The Governor in attendance)

There was a discussion about outstanding areas of the Bank's strategic priorities. It was explained that work was underway to take forward the issue of performance measurement. In addition, Andrew Bailey had been asked to consider issues relevant to changing aspects of the Bank's culture. These issues would be discussed at an Executive Team away day later in July. Recent time and energy had been devoted to staff pensions and payment systems. In both cases, the Bank was now moving forward. Final decisions on pensions would be put to NedCo and Court in September following the staff consultation.

It was noted that there had been good progress in the Financial Stability area over the past year. It was hoped that there would be a further increase in the focus of the work in the period ahead.

The main rationale for the Bank's role was financial crisis management. It was important that this was central to the work undertaken and the Bank did not become engaged in too broad a range of issues. It was also noted that progress with the strategy for customer banking remained dependent on the Government's banking programme.

In the Central Services area, good progress was being made on the finance side. As the new structure for the Finance Directorate was put in place, responsibilities were being moved from Rachel Lomax to Warwick Jones as previously envisaged. Progress with a strategy for IT had been less satisfactory. The Bank needed an IT operating model that worked in practice. This would be discussed at NedCo shortly.

On the staff side, there was not undue concern about recent resignations. It was felt that there was a need to map out more effectively succession to senior positions. There was a discussion about how Court could best engage with HM Treasury about future senior appointments to the Bank, including through a continued relationship between the Chairman and the Chancellor. In this context, it was noted that all the Executive Directors had personal development plans and executive bonuses were linked to performance. The Chairman had advised HM Treasury of these developments.

The issue of whether there was greater individual responsibility and fewer committees – a theme of the Governor's original vision paper in 2003 – was raised. This would form part of the paper on the strategy to be discussed at NedCo in September.

It was noted that non-executive Directors had not seen the evaluation exercise of the Executive Team undertaken with Egon Zehnder. The Chairman and the Governor would discuss how best to take that forward.

3. **Directors' interests**

The paper outlined the requirements and reasons for non-executive Directors to inform the Bank of outside appointments and interests. In the light of recent experience, the Bank wanted to change the procedures to enable a more satisfactory consideration of requests from non-executive Directors. In future, fourteen days notice rather than seven days would be requested; notice should also be given to the Chairman of NedCo as well as the

Governor; and sufficient information should be provided by non-executive Directors to assist in an assessment of the issues for the Bank, including whether the activities of the company represented any conflict with the Bank's, whether there were any reputational issues around the people on the company's board, regulatory enforcement cases etc.

A resolution for Court would be drafted in due course to replace the existing 1995 resolution.

Directors were content with the proposed requirements. It was felt there was a reciprocal obligation for the Bank to expedite decisions quickly given the circumstances and requirements of many outside appointments. It was thought that fourteen days notice might not be possible in every situation but every effort would be made to ensure that requirement was met and where possible earlier.

4. **NedCo workplan for 2007/08**

Noted.

5. **Non-executive Directors' attendances at pre MPC meetings and visits to Agencies**

Noted.

6. **NedCo rolling agenda**

Noted.

Any other business

It was felt that the paper for item 5 of the first NedCo meeting – Assessing risks to Financial Stability – had been excellent in terms of its accessibility. It set the standard and it was hoped other papers would follow in the same vein.

Non-executive Directors briefly discussed the situation of Court in relation to the appointment of the Governor of the Bank. It was noted that boards generally would be fully involved with the appointment of chairs or chief executive officers. It was perplexing to have no involvement, which undermined the responsibility of the board. It was noted that there had been engagement with HM Treasury regarding the future appointment of Deputy Governors and the need for an appropriate consideration of internal candidates. It was agreed that NedCo should discuss the issue further ahead of any future appointments process.

The meeting of NedCo was closed.

COMMITTEE OF NON-EXECUTIVE DIRECTORS (NEDCO) MEETING

Wednesday 12 September 2007

Present:
Sir John Parker, Chairman
Mr Roger Carr
Ms Amelia Fawcett
The Hon Peter Jay
Sir Andrew Likierman
Sir Callum McCarthy
Mr Paul Myners
Dr David Potter
Mr David Rhind
Ms Susan Rice
Mr Arun Sarin
Mr James Strachan
Mr Bob Wigley
Mr Geoffrey Wilkinson

Absent:
Mr Brendan Barber

Also attending:
The Governor, Sir John Gieve, Ms Lomax, Mr Bean, Mr Bailey, Mr Footman, Mr Jenkinson, Mr Tucker, Dame Juliet Wheldon, Ms Redmond (for item 5), Mr Sentance (item 7)

1 Minutes – 11 July

Approved

2 Matters Arising

The Chairman noted that the meeting would be discussing market related matters and reminded members of Nedco about obligations regarding conflicts of interest and access to price sensitive information. It was suggested that Directors should consult the Legal Adviser to the Governor for clarification in the case of a specific sensitivity.

MANAGEMENT OF THE BANK

3 Executive Report on Financial Markets

The Committee was advised that a public statement from the Governor to the Chairman of the Treasury Committee was being released at 10:00am. Copies were provided for members of Nedco and attendees were given a period of time to assimilate its contents.

The Governor presented this item

Nedco was initially provided with some contextual background for the issue of the statement. The Committee was reminded that at the beginning of September the MPC had been able to reflect on what was known at that point about the market turmoil. A decision to leave interest rates unchanged had been accompanied by a short statement from MPC about the background to that decision. However, the Executive had felt that some more substantive public statement about the Bank's perspective on developments in the markets was necessary. At the same time, members were told that conversations with both the Chancellor and the Chairman of the FSA had indicated a clear wish for the Governor of the Bank to make a speech or statement. Consequently, it was agreed that a statement should be issued today, ahead of members of MPC attending the Treasury Committee hearing on 20 September. The idea was this should allow for a period of assessment and reflection in advance of the cut and thrust of the Committee appearance.

Ahead of taking questions, two points were emphasised. Firstly, the Executive believed that the events of the last month had proven the sense and strength of the tripartite framework. Whereas some commentators might have suggested that the problems highlighted the drawbacks of separating central banking from supervision, the opposite was the case. The arrangement had allowed the Governor, the Chairman of the FSA and the Chancellor to focus on their specific responsibilities. The crisis management exercises that had been undertaken had allowed all parties to become used to the communication issues and talking from respective {viewpoints}. Secondly, tribute was paid to the many areas of the Bank that had contributed to the work undertaken during this difficult period – specifically the FS team, the Markets area and the Economics side. It was noted that several members of the Executive Team had broken holiday commitments to respond to the crisis.

The Chairman of the FSA was invited to provide the regulator's perspective on current market events. Members were told that the FSA fully agreed with the Bank Executive's view about the strength of the tripartite arrangements. The Committee was advised that the FSA were in close and informed contact with all aspects of the market to ensure that they could identify problems as they occur. The Chairman of the FSA characterised the problems in the market as being ones of liquidity, not of institutional insolvency. He emphasised that the UK banking system was sound and that there was scope for bringing back onto institution's balance sheets, items that needed to be dealt with.

Members of Nedco were invited to raise any questions about the Bank's paper. In doing so, several Directors congratulated the Governor for setting out a rigorous intellectual underpinning of his position. The view was that it would be helpful for the market and for commentators and would lead to rather more informed comment.

A Director asked the Chairman of the FSA if, in his opinion, he believed that institutions were in a position to fully evaluate the risks that may come on their balance sheets in the next 12 months. In the FSA's view there were difficulties around valuation where there is a huge range of complex instruments that have traditionally been marked to market – making valuation in the current climate extremely difficult. The FSA was not concerned about Leveraged Buyout (LBO) problems for the major banks because the underlying credit was easy to assess and the complexity of the instrument was not great. However, a greater concern was thought to be whether banks could take back on their balance sheets what they are legally obliged to do. On the information available to the FSA there was no reason to suppose they could not do that.

Turning to the specifics of Governor's paper to the Treasury Committee, a Director noted the references to collateral and wondered if there was any thought about, or pressure to, accept lower quality collateral? The Bank Executive confirmed that collateral was an important consideration when targeting liquidity but emphasised that it should not be seen as a free good – there needed to be a penalty cost. It was emphasised that in relation to normal money market operations, use of the standing facility using high quality collateral should ensure that this accepted route for providing short term liquidity should not bring any reputational stigma. However, it was recognised that use of the facility in recent weeks had attracted adverse publicity for particular institutions. The market speculation and rumours had not been helpful and it was hoped the

Governor's comments in the statement might help understanding and remove the stigma from use. The Executive explained it would be wrong to penalise institutions that had taken out insurance and had not engaged in the risky activities of others. However, it was recognised that where there was prospective damage to the economy there may be occasions where the moral hazard issue had to be put to one side – it would need careful assessment of relative costs and benefits to judge when and if that should happen.

The Executive underlined the differences between generalised liquidity operations in the market and liquidity support for a particular institution that is otherwise solvent. The dangers of rushing into using all of the tools in the potential armoury were emphasised, and the potential longer term costs of short term actions needed to be carefully considered.

Directors recognised that the Bank had flagged, in earlier Financial Stability Reports, the key risks to institutions that were now manifesting themselves. {Nevertheless}, some Directors thought that when the current market turmoil had subsided it would be important to assess whether the tripartite institutions were sufficiently alert to the development of non-banks through some conduits, SIVs and hedge funds that were not regulated but which were essentially providing banking type functions. It was suggested that banks had been providing insurance for asset backed finance without properly appreciating or pricing of risk. In response, the Executive noted the extent to which the Bank's Financial Stability team had, in fact, analysed and publicly commented on these risks. The work of the Markets areas in maintaining contact with the people designing these instruments was re-emphasised. The Bank Executive believed that the risks were appreciated by most of the commercial sector players. The Chairman of the FSA said that hedge funds were not a contributory factor in the current market turmoil.

A Director asked if the risks associated with moral hazard vs the potential damage to the financial system were thought to be asymmetrical. The Executive felt that was difficult to judge but suggested that in the careful assessment that needed to be done it was important that someone should ensure that there is a voice for the moral hazard concerns. There needed to be accountability by policy makers for decisions and the outcome not only in relation to the current crisis, but also for the longer term consequences.

The Executive was asked to comment on the extent of interaction with other central banking institutions – particularly the Fed and the ECB. The ECB's actions were characterised by a large early injection of liquidity on the first day of the (9 August) followed by a gradual {withdrawal} of that liquidity over the following month as it became clear that was not required. The Fed did carry out some unusual money market operations with accompanying announcements about intentions for the discount rate to fall – that was viewed by the Bank as a contradiction in {objectives}. In contrast, the Bank had chosen to highlight that we had a developed monetary operations framework with reserve targets set by the banks themselves. Because the shock to the system had come after the banks had set their targets the Bank had offered extra flexibility in what it was offering through open market operations. In the current circumstances it was emphasised how it was important for Senior Management of banks to think carefully about the right strategy for setting their reserve targets.

[redacted]

The Committee was told that one of the key objectives of the paper to the Treasury Committee was to set out the range of policy instruments available to the central bank to deal with a developing liquidity crisis (including lender of last resort for specific functions). What the paper sought to do was highlight the importance of balancing the costs of doing something vs the costs of not doing anything and the need to be able to explain why a particular course of action is taken.

The international nature of the crisis was recognised by both Directors and Executive. The banks were borrowing and operating in international markets and that did raise further policy questions – both for dealing with the crisis but also in taking steps in good time to prevent such a crisis occurring subsequently.

In conclusion, the Executive assured members of the Committee that they would be consulted should there be a need to do so in the near future.

4 Financial Stability – Quarterly Report

Directors noted that many of the issues that might have been raised under this agenda item had been discussed during the previous discussion. They were advised that the FS area of the Bank was now in monitoring mode, assessing the key issues in preparation for the next Financial Stability Report.

Senior members of the Executive highlighted the effectiveness of the FS team in providing high quality briefing to difficult technical questions over recent weeks. The value of the tripartite crisis management exercises was, once again, emphasised.

5 Pensions – post consultation

Mr Footman introduced this item.

The Committee were told that discussions with the Union had been ongoing since the consultation had been launched. The Union had made several counter proposals. A suggestion that the new Career Averaging Scheme should be improved by having accrual at the rate of $1/60^{th}$ (rather than $1/65^{th}$ as proposed) was being rejected on the basis that it would not allow the cost savings required. Suggestions about the phasing in of abatement had also been made but the Bank had not been minded to accede to that request given the cost saving targets.

Most discussion had been around the proposals for the withdrawal of the flexible retirement facility. There were two key issues where the Bank was minded to give more consideration. Firstly, there was sympathy for the position of people who will have accumulated the maximum 40 years service before the time they were 60 and who, under the new scheme, would not be able to leave the Bank until they were 60 yet would not be accumulating additional pension. It was recognised that the Bank would be benefiting from the investment income from these delayed pensions and that the affected grouping included a significant element of experienced staff that the Bank relied on. Several possible offsetting arrangements were discussed but Directors believed that the Executive had the delegated authority to work out the details and select the appropriate option. The Committee accepted that certain options would create a temporary partial exemption of the two thirds limit in the final salary scheme for certain staff – but this would fall away over time.

The second issue related to staff working past 60 but the Executive sought to draw a distinction between the two groups. Here, Directors believed that flexibility on salary on an individual basis was the way to incentivise.

The Executive thanked members of Court for their input throughout the Pensions review process and noted that formal resolutions for change to the schemes would be put to Court. A Director noted that the proposed Court Resolution regarding future funding for active members of the Court Pension scheme suggested that the Bank would continue to make payments at 70.5% in future years but at a different date to the payment to be made in September 2007. After discussion, the Executive agreed that this proposal should be withdrawn and level of funding would be revisited on a year by year basis.

6 Arrangements for future Court visits

The Governor introduced this item

The Committee were told that much importance was attached to opportunities for Court, senior members of the Bank and Monetary Policy Committee members to visit the regions. In the view of the Executive the least successful part of the regional meeting visit based around Court, is the actual meeting of Court itself. Because of time constraints there is often little of substance that can be dealt with. So from next year the proposal was that the regional aspect of the visits would continue allowing more time for members of Court and members of MPC to visit the different groups and organisations in the area. The proposal was that the visits would occur in the third week of October. The Committee fully agreed with that suggestion – dates would be agreed.

MONETARY POLICY

7 The August Inflation Report and Monthly MPC Report to Court

Mr Bean introduced this item; providing a presentation on the key issues from the August Inflation Report.

A question was asked about the implications, for the UK, of a possible rebalancing of the world economy, led by a significant downturn in the US economy. The Executive noted that several exercises had been undertaken in recent forecast rounds to examine scenarios that envisaged a downturn in the US. For the UK there would be compensating increases from an upturn in other areas of the world economy, but much would depend on policy responses in other countries – notably the Euro area. It was emphasised that the MPC policy response would depend on the circumstances.

A Director asked about trends and influence of the services and goods sector on CPI where the charts exhibited some volatility over the last few years. Utility prices were acknowledged as one contributory factor – but those have masked an unfavourable underlying trend in this sector. In the period since the late 90s, the China effect has been working through as inflationary pressures have been building up in China added to which the effects of switching production from the UK to China and other producers in the Far East.

The Executive was asked about how important the financial services sector was to the UK and what effect a downturn in that sector would have. The meeting was told that financial services accounted for 10% of GDP. The issues discussed earlier in the meeting were thought to be significant for the statistics, given the way that the ONS construct them. However, the important matter was thought to be what real effect there would be on the utilisation of resources in the economy.

A Director observed that, whilst the Bank had no remit to target asset values, there was an implicit interest in the levels of assets given the flow through to the economy if asset values fall. In those circumstances did it raise questions about the limitations of the way the Bank's target is expressed? The Executive agreed that this was a significant talking point in central banking circles at present. It was suggested that there were two polar schools of thought: (i) central banks cannot do much about asset price booms but they should stand by to deal with the effects of a price bust, (ii) an alternative BIS led view is that asset price busts can be very messy so central banks should try and lean against the price increase whilst they are rising. The Bank's view is that within an inflation targeting framework we can deal, through monetary policy decisions, with a messy unwinding of prices in the short term. Over two to three years it might be that the MPC would choose to undershoot the target in the near term with a view to hitting in further out.

ITEMS FOR INFORMATION

8 Risk Policy Committee Minutes for 27 June

The Committee had received an earlier briefing - the minutes were simply tabled for the record.

Any Other Business

None

The agenda item dealing with review of strategy would be brought to a later meeting. However, members discussed the paper that was tabled over lunch.

MEETING OF THE COURT OF DIRECTORS

Wednesday 12 September 2007

Present:
Mr King, Governor
Sir John Parker, Chairman, NedCo
Sir John Gieve, Deputy Governor – Financial Stability
Ms Lomax, Deputy Governor – Monetary Policy
Mr Carr
Ms Fawcett
The Hon Peter Jay
Sir Andrew Likierman
Sir Callum McCarthy
Mr Myners
Dr Potter
Mr Rhind
Ms Rice
Mr Sarin
Mr Strachan
Mr Wilkinson
Mr Wigley

Absent:
Mr Barber

Also attending:
Mr Bean, Mr Bailey, Mr Footman, Mr Jenkinson, Mr Tucker and Dame Juliet Wheldon

1. **Minutes – 11 July and 9 August 2006**

APPROVED.

2. **Pension Fund Issues**

Court APPROVED the following Pension Fund issues -

(a) Rule changes to Final Salary Section to allow accrual past age 60

(b) Closure of Final Salary Section from 30 September 2007

(c) Rules for new Career Average Section and its opening from 1 October 2007

(d) Agree September contribution for Court Section members and change to March thereafter.

3. Emergency Authority – Process of Consultation through Court

Court APPROVED the resolution to amend Matters Reserved to Court, as agreed by NedCo in July to provide an emergency procedure for transactions outside the normal course of business.

4. Monetary Policy issues

Court noted the submission of the monthly MPC report to Court for September and the discussion of the August Inflation Report.

5. Financial Markets – update, Financial Stability Quarterly Report, Arrangements for future Court visits

Court noted the discussions in NedCo of the above items

Any other business

None.

COMMITTEE OF NON-EXECUTIVE DIRECTORS (NEDCO)
SECOND MEETING

Wednesday 12 September 2007

Present:
Sir John Parker, Chairman
Mr Carr
Ms Fawcett
The Hon Peter Jay
Sir Andrew Likierman
Sir Callum McCarthy
Mr Myners
Dr Potter
Mr Rhind
Ms Rice
Mr Sarin
Mr Strachan
Mr Wigley
Mr Wilkinson

Absent:
Mr Barber

1. **Minutes – 11 July**

Having been circulated were agreed for circulation to the Governors

2. **Report from RPC Members on the Financial Stability Board Meetings**

Mr Myners presented this item.

It was explained that the report being presented was on behalf of Nedco members who formerly sat on Risk Policy Committee (RPC). A summary of the report had already been provided to Sir John Parker and Sir John Gieve.

Members of the RPC had had the opportunity to observe Financial Stability Board meetings since Spring 2007. This had provided an improved understanding of how the Board operated as part of the governance of the oversight of FS. It was emphasised that this initiative preceded the current situation in financial markets.

Attendance at the FSB meetings had been judged as helpful in improving understanding but it had, in the Directors' opinion, brought into sharper focus core questions about the role of Court and NEDCO in the FS area; questions raised by the Legal Adviser to the Governor in her paper in March.

Directors who had attended these meetings recognised that they had only limited exposure to the broader work of FS and comments needed to be gauged accordingly. Nevertheless, they had been impressed by a number of people at the meeting and the quality of debate. However, there had been surprise at the relative lack of data and any modelling of data to support the debate. However, one observation had been that some data had been made available to the meeting participants – but not to the observers.

The Directors attending believed that more work needed to be done in specifying clearly the way in which Court/NEDCO fulfill fiduciary responsibilities and apply the necessary duties of care, skill and diligence in meeting over-sight obligations. In their opinion that could not be done without better engagement with the issues and this matter needed to be addressed as a matter of urgency.

Market developments during August/September had, in the opinion of the Directors who had attended the FS Board meetings, brought the issue of information and communication into sharper relief. Several Directors believed that the Bank could and should have been doing much more to keep Directors briefed on developments and strategies in relation to the market turmoil since mid August. There was a view that the degree of consultation with, and information passed to, the Directors compared less favorably with NEDs' experience and expectations of plcs. Other Directors recognised that there were a lot of sensitive issues that the Governor had to take into account in communications. Other Directors noted that Matters Reserved to Court was quite clear in relation to the delegated authority to act and where the Governor needed to consult. Several Directors also accepted that it must have been quite hard for the Executive to judge when to communicate in such a fast moving environment.

It was suggested that a small number of NEDCO members might work with the ET to develop the Chairman and Governor's proposed criteria for consideration by Court and NEDCO in examining ways in which NEDCO members could provide effective engagement and oversight, to ensure they fulfilled their governance remit. Andrew Likierman and David Potter had volunteered to join such a group if NEDCO and ET agreed that it should be formed.

In the meantime, the former members of the RPC would, if possible, wish to continue to attend FSB meetings and also saw value in being provided with an opportunity of making observations and providing feedback at the end of each meeting to a smaller group of participants.

The Directors who had attended these meetings sought to underline the value they had derived from their participation in FSB meetings and expressed their appreciation to those who facilitated this.

In the view of several directors, the key conclusion was that the way that the process currently worked, and with the information that is shared with Nedco, it was not possible for the Directors to conclude that they could fulfil their fiduciary obligations as set out in a note from the Legal Advisor to the Governor.

There was a firm view expressed by one Director that simply by having a programme of directors sitting in as observer at FS Board meetings should not be thought of as any sort of systemic mechanism for fulfilling the Directors' obligations in respect of Financial Stability – other measures were necessary. Another Director was frustrated about the speed of progress in relation to this topic - NEDs had been expressing their concern about FS oversight for over a year yet they were still not in a position to comfortably sign off on their responsibilities.

The Chairman's view was that attendance at the FS Board was just one element that contributed to the FS oversight process. He had advised members that as regard to earlier he had considered what practical steps could be taken to enable Directors to sign off on their FS obligations. With this in mind he had drawn up a list of possible criteria against which Directors could assess whether sufficient evidence existed for them to have confidence regarding their FS obligations. An initial draft had been discussed with the Governor and was being worked up by the Executive with a view to bringing back to the Committee in due course for discussion. The Chairman suggested that two nominees from Nedco could help to develop that concept in conjunction with the Legal Advisor to the Governor who would provide governance guidance.

Most Directors agreed that the list/survey concept proposed by the Chairman would be useful but one felt it may not provide the depth of enquiry that was necessary for members of Nedco to feel able to sign off on the responsibilities. Several Directors favoured a formal role – possibly a sub-Committee, or sub-group, of Court that would look deeper and would report back to provide the necessary level of comfort. Another view was that representatives of Nedco might become full members of the FS Board. However, other views around the table were that all Directors would want the opportunity to input to discussions on this topic and therefore, even if it was thought appropriate, gaining comfort on FS responsibilities via a small representation or group might not be the best approach. Additionally others sought to draw a clear distinction between NEDs pushing for assurance about the quality of analysis at the FS Board meetings and the suggestion of NEDs actually intervening – the latter was felt to be outside the remit of NEDs.

A brief discussion took place about the most appropriate line of communication for Directors to raise concerns with the Executive – it was confirmed that this should be through the Senior Non-Executive Director.

Action Points:

- Draft list of FS 'comfort' criteria to be discussed between Sir John Parker and the Governor

- Idea of a small working group (Dr Potter, Sir Andrew Likierman and Dame Juliet Wheldon) to consider further possible options for how members of Nedco could provide effective engagement and oversight (for discussion between Sir John Parker and the Governor)

3 **Any Other Business**

None

(See following annex)

Note from a discussion at a working lunch following Nedco2

A strategy review paper had been tabled for discussion at the earlier Nedco meeting but had been deferred to allow Nedco to be briefed on the substance of the Governor's letter to the Treasury Committee that had just been released. However, the strategy issue was discussed (unminuted) by Directors over the lunch following Nedco2. One Director felt it was important to have a record of views expressed insofar as they linked with the earlier discussion of Director's concerns about Financial Stability governance in Nedco2.

In the view of the Director, there was a clear differentiation between the clarity of objective and success achieved in relation to its Monetary Stability core purpose and the strategic gap that appeared to exist in relation to the stewardship of Financial Stability in the Bank, the second core purpose.

The Director had noted that the FSA was the institution responsible for individual and market regulation including prudentiary risk. But that raised a question about when the emergence of such issues in a number of institutions became a collective issue which represented a systemic risk? The Director recalled that the Executive had described the Bank's role as monitoring threat issues, communicating those through the Financial Stability review publicly and through speeches and to monitor payment systems and to prepare for crisis management. But, in the Director's view, that was not enough.

The culture of markets in the current period, the level of innovation in financial products and new financial entities had created significant systemic issues. Could the Bank (and Directors) be certain that these issues and threats had been identified and were being addressed by the Financial Stability function, including possible measures to mitigate against those risks? The Director felt that more could be done – perhaps by seeking to influence the FSA and HMT to take more substantiate action on regulation?

In summary, the Director felt there was more clarity required about the Bank's role in ensuring greater control to avoid systemic issues in Financial Stability. Given the limited transparency to Court on that matter (discussed in Nedco2 earlier) this remained a significant area of concern.

EMERGENCY MEETING OF COURT, 13 SEPTEMBER 2007

Present: The Governor (Chairman)
Sir John Gieve
Ms Lomax
Sir John Parker
Mr Barber
Ms Fawcett
Mr McCarthy
Mr Myners
Mr Strachan
Mr Wigley

Via Phone: Professor Rhind
Mr Sarin
Mr Wilkinson

In attendance: Dame Juliet Wheldon
Mr Bailey
Mr Allen (Secretary)

Members of Court were thanked for having amended their plans to attend the meeting of Court which had been called at very short notice.

Members were advised that the meeting would concern Northern Rock plc and were asked to declare any material interest. Mr Wigley noted that Merrill Lynch had acted as adviser to Northern Rock on certain matters, Mr McCarthy noted that the FSA had a close interest and Professor Rhind noted that a colleague at the Statistics Commission was a Non-Executive Director of the institution. It was agreed that none of these issues required members to withdraw.

Court was advised that the FSA had been closely monitoring the financial position of a number of institutions during the liquidity difficulties in the market over recent weeks; Northern Rock plc had been one of those institutions. That evening, Northern Rock had formally applied to the Bank for liquidity support – the purpose of the Court meeting was to advise members of the details and to seek Court's agreement to proceed. A package of papers showing the relevant correspondence between Northern Rock and the Bank, the Bank and the Chancellor, the terms of the proposed facility, the impact on the Bank's balance sheet and the Tripartite statement that would be made, was circulated.

Members were reminded that in the statement the Governor had sent to the Treasury Committee on 12 September, he had set out the clear criteria under which Lender of Last Resort facilities might be made available to an institution and which were also explicit in the Memorandum of Understanding between the Bank, FSA and HMT.

Court were advised that both the Governor and the Chairman of the FSA had, that evening, advised the Chancellor to authorise a liquidity facility to be made available to Northern Rock. Members attention was drawn to the Tripartite statement that would be issued and which explained the reasoning.

The issues for members of Court to be certain about were (i) the terms of the facility given that this would be taken onto the Bank's balance sheet and (ii) to satisfy themselves that the risk to the taxpayer would be minimised – as required by the MoU (paragraph 15).

Members were told that the facility would be made at a penalty rate of 150 basis points over Bank rate. The important point to note was that this was above the one percentage point that is imposed on the Bank's standing facilities in normal money market operations. The risk to the taxpayer would be minimised by ensuring that the facility was made against collateral at an appropriate margin. It was explained that the justification for the margin was that in the event of default, the Bank would take some time to realise the sale of assets deposited as collateral.

On this basis, members were told that the Governor was recommending the terms of the facility to the Chancellor and to Court.

However, turning to legal considerations, members were advised that it was important that Court should be aware that there was a risk that this facility constituted state aid, in which case it would be unlawful unless and until it was approved by the European Commission. The Legal Adviser to the Governor told Court that state aid that was not approved had to be recovered from the recipient and competitors could, in theory, sue the Bank for damage suffered in the meantime. But the Government's view, with which she agreed, is that the facility being offered is not 'aid' because it is given on tough terms equivalent to those that a commercial investor would offer in more normal times.

A central bank has a reasonable margin of appreciation when it is giving, as the Bank is proposing to do, emergency liquidity assistance to a bank it believes to be solvent. But if the Bank was to take an indemnity from the Treasury, the Government believed that the facility probably would be considered to represent state aid and would notify the facility to the EC, although not make any formal concession as to whether it was aid. The Commission would probably then examine the facility to see whether they were willing to approve it as rescue aid.

Reverting to background to the facility being proposed, the Chairman of the FSA was invited to provide a short assessment. Court were told that the FSA, as the regulator, had two clear responsibilities – firstly to assess the financial problems of Northern Rock and secondly to consider the systemic issues arising. The FSA characterised Northern Rock as a fast growing mortgage bank. It exceeded its capital requirement, it had a loan to value ratio of 60% and was responsible for around 7.5% of the residential market. There was only a small sub-prime exposure and it had a good quality loan book.

Court were told that the FSA were clear that Northern Rock's problems were liquidity related – there was not a solvency issue. The FSA believed that with the assistance that was being proposed the institution would remain solvent. Without that assistance the FSA would be requiring that Northern Rock closes to new deposits.

Members were also advised that the FSA had been seeking a private sector solution. Two possible financial institution suitors had assessed a possible acquisition but had decided not to proceed. However, in both cases they had also concluded that Northern Rock's issues were liquidity based, rather than solvency related. Their assessment had been (like that of the FSA) that Northern Rock's business model needed to change.

Court recognised that one of the benefits that the provision of the Bank's facility might bring would be that it would increase the chances of Northern Rock continuing in calmer waters and to allow the measured assessment by potential private buyers.

Court's attention turned to the disclosure obligations that Northern Rock faced. The Chairman of the FSA advised that whilst there had been a possibility of a resolution without assistance it was proper for Northern Rock not to make any trading statement. However, given that the share price had dropped from £12 six months ago to around £6.40 it was becoming clear that they would need to make a statement to the market tomorrow morning at 7:00am. The FSA's view was that if they made that statement without the proposed facility in place they would not have been allowed to continue in business. Hence the Tripartite statement and that from Northern Rock were both scheduled to take place at 7:00am the next day.

In answer to a question, it was confirmed that there was no maximum size to the facility other than that governed by the extent to which collateral is offered, netted by the margins described in the papers that were available to Court. The margins that are proposed on the different classes of collateral were based on a 99% confidence interval for assessing the risk of loss to the Bank, which is the approach adopted on all Bank of England money market operations and the same as that used by the ECB. There was a brief discussion about the margins being imposed on the various classes of collateral. Court recognised that the terms meant that if Northern Rock defaulted on the loan facility, the Bank would be exposed to the performance of the underlying mortgages, but the margins meant that house prices would have to fall considerably for the Bank to realise a loss.

Court went on to consider the possible domino effect that this action might have on other institutions. The Chairman of the FSA advised that there were two groupings at risk. Firstly, there were a small number of small building societies who had holdings in Northern Rock; if Northern Rock was to fail then those institutions were likely to be placed into a loss making situation and it was noted that no building society that has reported making a loss has survived. Secondly, there were three institutions that had a similar business models to Northern Rock. The FSA could not guarantee that the provision of the facility to Northern Rock would provide the assurance that would save those other institutions from encountering difficulties, but it seemed certain that if Northern Rock were to fail those institutions would be in a more precarious position.

Members of Court were told that both the Bank and the FSA were in total agreement that if Northern Rock was allowed to fail it would create serious economic damage. It was also emphasised that in the Tripartite press statement the wording would say, "In its role as lender of last resort, the Bank of England stands ready to make available facilities in comparable circumstances, where institutions face short-term liquidity difficulties".

There was potential for some commentators to suggest that the Governor was doing a U turn by comparing what had been said in terms of bailing out banks in the letter to the Treasury Committee and what was being proposed for Northern Rock was raised. However, Court recognised that the Governor's decision to include, as a footnote to the Tripartite statement - the key extract from the 12 September letter should mitigate against that risk. There was a clear distinction to be drawn between the moral hazard of a general bail out to banks, eg by relaxing interest rates to try to influence inter-bank lending rates and the type of collateralised assistance considered here.

A question was raised concerning the extent to which Northern Rock had overseas operations. Court was told that branches existed in Dublin and Copenhagen and a subsidiary in Guernsey. The FSA had been liaising with the relevant regulators.

A Director asked to what extent the provision of this facility might allow the Tripartite members to exercise influence over the management. Court recognised this was a matter for the FSA. The Chairman of the FSA agreed that the facility would strengthen the FSA's hand – it was going to be essential that a new business plan should be formulated and agreed.

Court was asked for a formal approval to proceed with the facility for Northern Rock – there was unanimous agreement.

Finally, the Executive told Court that this would be the most significant lender of last resort facility since the lifeboat episode in the 70s – when times were very different. In the Executive's view the fact that the three parties to the Tripartite arrangement had their responsibilities clearly mapped out in the Memorandum of Understanding had helped significantly in managing and progressing this matter; the episode had provided the evidence of the virtue of the new framework.

Secretary's Department
13 September 2007

MEETING OF COURT, 25 SEPTEMBER 2007

Present: The Governor (Chairman)
Ms Lomax
Ms Fawcett
Mr Jay
Sir Andrew Likierman
Mr Myners
Dr Potter
Professor Rhind
Ms Rice
Mr Strachan
Mr Wigley
Mr Wilkinson

Via Phone: Sir John Parker
Mr Sarin

In attendance: Mr Tucker
Dame Juliet Wheldon
Mr Allen (Secretary)

Members of Court were thanked for the messages of support to the Governor during the recent difficult period. Directors were told that the Bank believed that the situation in the markets was still fairly serious and was characterised by fragility in two sectors.

Firstly, there was the issue of retail fragility where there was a need for greater clarity about the practical arrangements surrounding the potential application of a Government guarantee should that need to be applied to Northern Rock or any other institution. If there was any thoughts in depositor's minds that they would have to wait days or weeks to be able to access their funds via the guarantee, that could be sufficient to restart a run on the bank. Directors were told that the Bank was emphasising the need for urgent process clarification to HMT.

Secondly, there remained considerable fragility within the wholesale markets despite some improvement in market conditions; 3 month LIBOR spreads had reduced to levels that were almost identical to dollar and euro markets. There were positive signs that spreads would fall back as banks took more of the investment vehicles back onto their balance sheets. But a great deal of current focus was on discovering the extent of the problem with institutions. Members were told that the Chairman of the FSA was currently in the US talking to banks and the authorities with a view to bringing about a collective response to the task of identifying the institutions who were at risk.

The Executive underscored the point that the difficulties for institutions were ones of liquidity – not solvency. The fact that Northern Rock was the institution with the highest of all Tier 1 capital ratios amongst British banks emphasised that point. The case of Countrywide Bank in the US, which had been analogous to Northern Rock in terms of the difficulties it had faced, was highlighted. The value of having secured comprehensive deposit protection arrangements was emphasised as having been the significant factor in Countrywide not having experienced the type of run that Northern Rock had endured. The Executive's view was that Northern Rock had simply gone too far down the line with its own problems such that, in the end, only public sector lending was able to help.

Looking ahead there was a need for more proactivity from the Tripartite members in order to spot institutions that might be heading for difficulties. The focus would be on securing better data about liquidity, monitoring institutions and taking earlier intervention action to ward off bigger problems.

Court was told that in the days and weeks ahead the Bank may be in the position of having to deal in this way (in consultation with the Chancellor and the FSA) more frequently and before there has been an opportunity for discussion with Court. Nevertheless, Directors were given an assurance that the Executive would keep Directors briefed on developments.

A Director noted that the markets were still in a nervous frame of mind and asked the Executive what lessons had been learnt from Northern Rock. The Executive were clear that the most important lesson was the need for early warnings of institutions experiencing liquidity difficulties and in that context Court was advised that the Bank was seeking to obtain daily liquidity data for a wide range of institutions. Directors were told that a problem is that there is no formal system of liquidity regulation – discussions were in progress with the FSA and the Chancellor was being very supportive of this initiative.

Another Director asked about the legal ambiguity that appeared to exist and which had obstructed the Bank's ability to act as Lender of Last Resort covertly in the case of Northern

Rock. The Executive confirmed that the lawyers for all three parties in the Tripartite framework had advised that under the Disclosure and Transparency Rules a company needed to disclose price sensitive information. It was for the company, supervised by the FSA, to decide what had to be disclosed but in the particular circumstances of Northern Rock the emergency liquidity facility from the Bank had fallen into that category. There was a provision in the Rules that potentially allowed a delay in the disclosure of such information – much of the discussion prior to the Northern Rock announcement had been in relation to the feasibility of drawing on that feature.

Some members of Court asked whether the Bank's Lender of Last Resort technique as a means of contributing to financial stability through exceptional lending to institutions was now, effectively, dead in the water. The Executive's view was that unless there was an acceptance that in certain circumstances the need to conduct covert operations could legally override transparency requirements the lender of last resort operations would remain difficult.

Directors asked the Executive for clarification about whether or not they felt they had an effective 'toolkit' to tackle the liquidity issues if the status of the Lender of Last Resort weapon had been effectively nullified. In the opinion of the Executive they were equipped with sufficient tools to manage the situation if a limited number of institutions had difficulties but a wider problem would be difficult to manage. Directors were told that the Governor had segmented responsibility amongst the Executive – Rachel Lomax was responsible for covering the arrangements for the future of Northern Rock, Sir John Gieve would be inputting to the examination of issues arising in relation to the Tripartite arrangements and Alastair Clark had been asked to return to the Bank to advise on the market fragility matters.

A Director asked what recommendations could be made to the Chancellor regarding the handling of the retail fragility issues. The Executive indicated that the initial priority was to clarify what the Government guarantee to Northern Rock and (potentially) other banks meant in practice for depositors in a situation where the guarantee is called. Secondly, it was imperative to review our deposit protection arrangements and to introduce something akin to the arrangements in the US. It was noted that most of the countries that had the more substantive deposit protection arrangements in place had been motivated by problems experienced in their respective banking sectors.

There was a brief discussion about the prospects for the 3 month auction to be conducted on 26 September. One director asked if alternative strategies had been considered to ensure there were a number of successful bidders thereby ensuring that additional liquidity would therefore be injected into the market. However, the Executive emphasised that the objective was not simply to pump money into the market – it was to ensure that liquidity was available where it was needed. By charging a penalty rate the intention was that only those who needed the liquidity would apply for the facility. A view was expressed that if a bank successfully bid at the penalty rate it could prove to be a poisoned chalice in that the institution would effectively be identified as ailing. That was recognised as a risk but the converse argument was that a cheaper facility might reward institutions that did not need the liquidity – and at a cost to those that did. The Executive indicated that there may be methods through which we could adopt a targeted approach to providing liquidity to the needy institutions through auction by ensuring that those bodies were not alone in the spotlight.

A question was asked about what level of responsibility lay at the door of Northern Rock management. The Executive indicated that the current focus was on the liquidity management aspects and the time for post mortems would be later. It was noted that the Northern Rock business model was not unique – it was following a path of a number of other, larger institutions where the strategy had worked successfully. Northern Rock's downfall was their failure to spread their risk by having a diverse business basis.

Another director asked about the process of resolving Northern Rock's particular position – he felt that needed to be expedited. The Executive agreed – up to a point. There was much work being undertaken and the Bank was involved (although not in the lead). The crucial matter was to ensure clarity about the government guarantee for depositors so that any uncertainty about access to funds in a disposal situation would be dealt with – and thereby avoiding a further run on its resources.

It was noted by a director that the FSA had been providing constant assurances about the solvency of Northern Rock and asked if that had that been verified by independent accountants? Court agreed that was a matter for the FSA but also recognised that the Board of Northern Rock must be addressing that question daily.

One Director noted that HMT had said that the government guarantee would remain good for as long as the situation lasted. The Executive agreed that statements had some ambiguity and indicated that it had been suggested to HMT that they reconsider their wording carefully.

Finally, Directors asked if the Bank had sufficient confidence that liquidity could be directed to where it is needed. The Executive indicated they were confident – work was underway to monitor institution's liquidity positions, to talk to them regularly and counsel them regularly and, should there be a need for injections of liquidity, to take action sooner rather than later.

Having had the opportunity to raise these questions Directors were asked to allow the Governor flexibility, where he believed it necessary, to provide additional liquidity to an institution, or institutions, through a range of possible covert mechanisms without having undertaken ex-ante consultation with Court on each facility. Assurance was given that these mechanisms would all be undertaken within the Bank's remit, no transaction would be undertaken if it could create a significant financial risk to the Bank and that Court would be briefed on the transactions in due course. A director asked how the transactions envisaged now differed from the Northern Rock situation and facility. The answer was that Northern Rock's problem had escalated to a position where the problems and facilities required were of such magnitude that it was impossible to provide the liquidity covertly. The Bank was considering other tools within its armoury to inject that liquidity at an earlier stage. Another director voiced an opinion that the Governor had, in any case, already obtained that degree of autonomy that was being sought via the resolution that Court had agreed on 12 September - a number of other Directors concurred.

[clarification of the agreement sought by the Executive was subsequently provided by the Legal Adviser to the Governor – attached]

Secretary's Department
27 September 2007

COURT: 25 SEPTEMBER

The Governor consulted Court about the current situation and asked them to agree that in these circumstances he was authorised to enter into covert transactions to target liquidity at particular institutions, without further consultation with Court, provided that the transaction in question would not involve a significant financial risk to the Bank. He undertook to report to Court in due course.

The Governor has a duty under Matters Reserved to Court to consult Court about matters outside the ordinary course of business. On this occasion he was consulting members generally about a range of possible covert transactions so that he would not need to consult about each specific transaction.

This consultation took place under the normal, rather than the emergency, procedure and did not enlarge the Governor's ability to take a significant financial risk onto the Bank's balance sheet. The emergency procedure agreed by Court already allows him to do that, without consultation, if he judges that it impracticable to consult. But in that case he must if possible consult Sir John Parker, alert members of Court and take all reasonable steps to hold a meeting with at least 6 non-execs present. And a decision under that procedure has to be reported to Court as soon as possible thereafter.

ADDITIONAL MEETING OF COURT, 8 OCTOBER 2007

Present:	The Governor (Chairman) Sir John Gieve Sir John Parker Mr Carr Ms Fawcett Mr Jay Sir Andrew Likierman Professor Rhind Dr Potter Mr Strachan Mr Wigley Mr Wilkinson
Via Phone:	Ms Rice
In attendance:	Mr Bailey Mr Jones Dame Juliet Wheldon Mr Allen (Secretary)

Court was advised that the purpose of the meeting was for the Executive to consult them on a proposed new facility for Northern Rock. The proposal (which was essentially a Government initiative) would see the existing lending effectively frozen and a new facility put in place backed by a Government indemnity.

Directors were told that the Government's objective was to try and stabilise the position of Northern Rock over the following three months in order that two things could happen. Firstly, that decisions on long-run options for Northern Rock could be taken forward (ie either it continued to stand alone, a takeover is arranged or an orderly wind down is effected). The Government had decided that there should be a period in which Northern Rock could make the choice in a considered way.

The second objective was to use the time to improve the ability to pay out Northern Rock depositors quickly if necessary. The proposal being discussed with Court and the associated three month period should allow preparation for an orderly administrative mechanism for payment should something happen to the company.

Copies of four documents were circulated to members of Court. These were: (i) a description of the revised facility (including terms) and indemnity from HMT, (ii) a note from the Legal Adviser to the Governor explaining the legal risks involved, (iii) an explanation of the effect on the Bank's balance sheet by the Finance Director and (iv) a draft of the proposed HMT indemnity.

The Executive provided some further background to the proposal. Whilst the guarantee for depositors announced by the Chancellor on 17 September had dispersed queues at Northern Rock branches it had not stopped the outflow of funds – wholesale funds, in particular, were being lost. As a result Northern Rock had now drawn down over £12bn on the ELA facility. They were now approaching the limit of what current eligible collateral arrangements allowed – that limit was expected to be reached within the following 48 hours.

Over the next few months leading up to the beginning of February, most of the remaining wholesale funding and some of the retail funds might be withdrawn with the result that Northern Rock's requirement for extra liquidity could rise to £40bn.

The Government's proposal was that the Bank should provide the additional liquidity and this would go well beyond what would be protected by the eligible collateral that the Bank currently held security over. The proposal was for security to be extended to a general debenture with fixed and floating charges over the assets of the business. This sort of collateral would not, of course, normally be acceptable so given the scale of the lending and the possibility that it would exceed the value of collateral it was proposed that the Bank should be covered not just by the collateral but also by a Government indemnity against losses on the facility and related costs .

Court's attention was drawn to several aspects of the terms of the new facility. The rate of interest charged remained the same as previously (Bank Rate plus 150 basis points) but the premium over Bank Rate would be rolled up to be paid at a later date. There was an ongoing discussion amongst the tripartite authorities and Northern Rock about whether this should be treated as an ordinary unsecured claim or subordinated to other creditors in recognition of the FSA's concerns about impact on capital ratios. Since the Treasury would be bearing the risk, they would also receive the benefit of the premium over Base Rate. HMT would also charge a guarantee fee and the Bank would charge a facility fee of 10 basis points on the unused facility up to a notional ceiling of £40bn.

Directors were told that there were several issues still under discussion. Firstly, on timing, HMT were aiming for a 7:00am announcement on Tuesday, 9 October but it was possible that might slip to Wednesday. On communications, there was still consideration on what should be said. From the Bank's perspective the Bank would seek to make clear that new drawdowns will be on new terms and will be backed by a Government indemnity – ie this marked a move from lender of last resort to a government backed loan arrangement. There was also discussion about how much of the Bank's legal costs to date should be covered by the HMT indemnity.

There was also work continuing on the exact terms of the comfort letter that would go to Northern Rock when the new facility documents were agreed – the terms would address current intentions as to whether the loan might be renewed or extended beyond 10 February. It was recognised that the Northern Rock board should not have to organise their business to repay £40 bn on 10 February whatever the circumstances, but equally the Bank and HMT would need to retain the right to require repayment depending on the circumstances. The way this issue would be expressed was still under discussion.

Finally, Court was advised that the Executive were intending to propose arrangements for indemnifying all Bank staff and directors (including non-executive directors) against the possibility of litigation on this matter. It was recognised that non executive directors already enjoyed a previously agreed general indemnity but the proposal was that this should be more specific. Proposals were expected to be brought to Court in Belfast later in the week.

The Legal Adviser to the Governor was invited to brief Court on the associated legal issues. The terms of the Government indemnity being offered by HMT were still being finalised but it would certainly cover risks going forward under the new facility. The indemnity would not cover any financial risk relating to the existing (ELA) facility but litigation risk in relation to the ELA facility would be covered in relation to matters arising after the date of the new facility

Court were advised that the recovery mechanism within the indemnity did not give the Bank a right to payment until a net loss figure has been established, having had recourse to all remedies.

The indemnity provided for HMT to pay interest for the period between a sum becoming due and payment.

Discussions with Clifford Chance had indicated that the Bank certainly faced litigation risks but based on information currently available (and leaving aside EU issues) they had not identified grounds for a successful claim against the Bank.
There were two European legal issues that were highlighted. Firstly, the new facility would constitute state aid. There was no provision for pre-approval by the Commission of such measures so, pending subsequent negotiations the facility would/ could be unlawful. The prohibition of monetary financing (article 101 of EC Treaty) was also noted as a potential legal issue as the postponement of payment under the indemnity until a net loss figure was finally established could be thought to create a credit line, or overdraft, to the Government. This risk was being mitigated through a side letter to the indemnity with HMT which would allow for an early review of the repayment mechanism if this was creating difficulties.

Having presented the background and details of the revised facility and government indemnity, Directors were invited to raise any questions.

One Director asked whether the Bank was being instructed to provide this facility. The Executive confirmed that this was a Government decision but the Bank agreed that this approach was necessary in order to maintain the possibility of an orderly resolution of Northern Rock's difficulties through one of the options referred to earlier. The alternative, ie letting Northern Rock close with no viable plans for a quick pay out for depositors under the existing government guarantee was thought likely to induce runs on Northern Rock with risks of contagion to other banks. It was emphasised that the Bank should not express a preference for a particular option to decide Northern Rock's future – it should be for the Northern Rock Board and the market to decide. The Bank was not seeking to preserve Northern Rock's position in the longer term. Arguably there was an economic need for rationalisation in the number of mortgage lenders – the Bank should not be seen to be seeking to preserve the existing number of players in this market.

There was a discussion about the terms of the Government indemnity. The Executive noted that it did not provide a legal entitlement to repayment of losses as they occurred – the HMT preference had been to wait and see if losses materialised and then effect repayment on an overall basis, rather than establish terms to repay as losses occurred. Nevertheless, the Executive indicated that they would expect some interim payments. It was noted that HMT would provide a comfort letter and there was an expectation that both the NAO and the Bank's auditors would examine the terms and implications for provisioning in accounts. In summary, the Executive told Court they were confident that any losses under the new facility would be reimbursed.

A question was asked about the rationale for the February deadline. The Executive indicated that Government were now potentially committing huge sums to this exercise and they needed a clear point at which they could call a halt. HMT were also mindful of the 'state aid' legal position and the fact that there was a 6 month 'rescue aid' leeway provision – February was within that timeframe. Finally, there needed to be an incentive for the Northern Rock Board to push for a permanent solution rather than simply soak up the additional facility and wait for something to turn up.

A Director asked who was now leading the pursuit of a permanent solution. The Executive indicated that Northern Rock board were, in their opinion, very keen to arrive at a permanent solution on acceptable terms and were actively engaged in discussion with the investment banks who were acting as their advisers (Merrill Lynch and Citibank). At the same time, the company was drawing up plans to handle the rapid closure of accounts should that be necessary in a wind down. For the Government, Goldman Sachs had been employed to represent the taxpayers' interests – they were working with the company's advisers examining corporate solutions for the sale of the business. The Executive emphasised that effective communications was going to be critical and every effort was being made to make the details of the new facility public in a reassuring way.

The issue of Deposit Protection was raised. It was noted that the FSA had recently agreed that current arrangements should be changed to guarantee 100% of the first £35k of depositor's funds. Court were told that the Chancellor's intention was to publish a short consultation document later in the week which would initiate a wider discussion on whether we needed a system more akin to the US FDIC regime.

A question was asked about the effect of the new indemnity on the old ELA facility. Court were told that the Bank had negotiated with HMT such that although the Treasury would not be indemnifying the existing agreement, the Bank would be able to take value out of the new facility to ensure that the collateral cover for the existing facility was preserved.

Given the potential additional exposure to the Bank's balance sheet Directors asked whether we would have enhanced insight into Northern Rock's situation. The Executive confirmed that the terms of the new facility would provide the Bank with a much clearer line of sight into the company's financial position.

The Finance Director provided a summary of the points outlined in his note of 8 October on the effect of the indemnity on the Bank's balance sheet and indicated that there would be a more detailed note on this matter going to the Audit Committee in November.

Court was advised that an update on the position would be provided at the Court meeting to be held in Belfast later in the week.

Secretary's Department
11 October 2007

COMMITTEE OF NON-EXECUTIVE DIRECTORS (NEDCO) MEETING

Wednesday 10 October 2007

Present:
Sir John Parker, Chairman, NedCo
Ms Fawcett
The Hon Peter Jay
Sir Andrew Likierman
Sir Callum McCarthy
Mr Myners
Dr Potter
Mr Rhind
Ms Rice
Mr Sarin
Mr Strachan
Mr Wilkinson
Mr Wigley

Absent:
Mr Barber, Mr Carr

Also attending:
The Governor, Sir John Gieve, Ms Lomax, Mr Bean, Mr Footman, Mr Jones, Mr Jenkinson, Mr Tucker, Dame Juliet Wheldon

1. Minutes – 12 September

Approved – subject to minor inclusion in 3rd paragraph, page 4 (..sufficiently alert to the development of non-banks through some conduits, SIVs and hedge funds).

2. Matters Arising

None

MANAGEMENT OF THE BANK

3. Executive Report and Review of Financial Markets

The Governor introduced this item

Members of Court were thanked for having travelled to Northern Ireland and for taking part in the events. The previous night's dinner and the following breakfast meeting had been considered successful and worthwhile.

Recent and forthcoming meetings and events

Domestic:

- Treasury Committee appearance, 20 September.
- speech at the Ramada Hotel, Belfast.
- Inflation Report Press Conference, 14 November.

International:

- Ecofin meetings in Porto, 14 September.
- IMF Annual Meetings in Washington, 19, 20 & 21 October.

Regular meetings and telephone conversations had taken place with the Chancellor and Chairman of FSA, including informal meetings of the Tripartite Standing Committee. Also meetings with Chief Executives of some of the larger banks. A breakfast meeting with the Chancellor was scheduled for 23 October and another with Nick Macpherson on 30 October.

Pensions

It was reported that an open meeting with staff had taken place on 24 September to conclude the pension consultation period. Staff were generally content with the outcome and the new pension scheme came into operation on 1 October.

MPC: Ten Years On

The Treasury Committee had published its report on 'The Monetary Policy Committee of the Bank of England: ten years on' on 18 September. The Treasury Committee had made many recommendations to which the MPC will respond in due course. Some of the key recommendations were:

- A single, 6 year, term for external members. Reviewed by Court after 3 years.
- The Treasury Committee should have the power to require a debate in the House of Commons on any nomination it considers unsuitable.
- Court should have flexibility to decide on a number of MPC meetings per year greater than 8.
- Size of Court should be reduced.
- Publish votes with MPC decision.
- MPC minutes should attribute views.

- Annual reports from individual MPC members listing work to promote transparency, explain their own voting record and their thoughts on prospects. Publish 1 in each of 9 months of the year.

A brief discussion took place on the process of responding. Court were advised that there would be a discussion in Nedco in November prior to feeding back to the Treasury Committee and it was recognised that Court, itself, may wish to make some formal response to recommendations about Court. It was not thought likely that the Treasury Committee would be considering hearings or expect a formal written response in the immediate future. Liaison would take place with the Committee to determine expectations in terms of timing.

House of Lord's Economic Affairs Committee inquiry "The Economic impact of immigration"
The Bank had submitted written evidence to the House of Lords Economic Affairs Committee last week.

Credit Conditions Survey Report Published
The Bank had published its first credit conditions survey report on 26 September, covering the result of the Q2 and Q3 surveys. The key results were: (i) the supply of secured credit to households was expected to remain largely unchanged over the next three month, (ii) the supply of credit to corporates had fallen over the past three months, and was expected to fall further in the future and (iii) the terms and conditions applied to loans to corporates were expected to tighten significantly over the next three months, especially for large private non-financial corporations and other financial corporations.

Current Market Issues

The Governor introduced this item.

There were three aspects to this report (i) an update on developments in financial markets, (ii) issues related to the new facility for Northern Rock, (iii) preliminary thoughts about what, if anything, might be considered for helping some of the smaller banks that might fall into a group of vulnerable institutions.

(i) Update on Financial Markets
The Executive characterised the broad picture as one of gradual improvement but still with some way to go and continuing fragility. Three month or longer term money market rates had come down since the difficulties began (from over 100 basis points above the market's expected Bank

Rate to the current level of about 50 basis points above expected Bank Rate). The spread was reported to be smaller in sterling, currently, than in the euro area or dollar markets.

Equity markets had recovered. It was suggested that an interesting question was why, despite the recent problems in the financial and credit markets, equity markets had still gone on rising and were still very strong. Looking further ahead the implied forward rates in financial markets suggested that the conditions were unlikely to be back to normal for a further three to six months. But whilst there were some signs of general improvement, Directors were reminded that the particular focus remained on the asset back markets; the Executive Director for Markets was invited to update Directors on developments here.

Mr Tucker introduced this section.

Court were told that disclosure of credit portfolio losses by UBS and Citi that had been taken, on balance, as good news. However, there were still a number of large institutions that had results to announce over the next quarter. The problems of the leverage loans market where banks were holding a large amount of undistributed paper would probably persist for a further three months or so, possibly longer. It was noted that this problem would add to a constraint on the ability of banks to expand their balance sheets.

Turning to the asset backed securities markets, the Committee was told that there was more differentiation between asset backed paper with US sub-prime in it, and other kind of asset backed paper. The assessment was that the markets were nowhere near conditions of even a year ago but there was movement in the right direction. The most important fact was that the market for asset-backed commercial paper which, a month ago, was almost impossible to roll over, had been improving slightly. Supporting evidence was the fact that the outstandings in that market did not shrink in the US last week for the first time in around a month. The spreads at which commercial paper had been rolled forward had gradually come down, and the maturities had gradually pushed out.

However, a major concern remained about the structured investment vehicles (SIVs). The differentiation between the SIVs and other conduits was that the SIVs typically did not benefit from 100% liquidity lines from big banks. Their assets were being marked down as they approached trigger points, where they would have to be leveraged.

Despite the limited market improvement, Directors were advised that some banks continued to experience difficulties in raising funds in the money markets. In term of the Bank's market operations to implement monetary policy where the goal was to ensure that the overnight rate is close to Bank Rate, that was characterised as being in a much better position since the Bank started to take action at the beginning of the September/October maintenance period. The distribution of volatility in the UK overnight market had been good.

Director's attention was drawn to the charts showing cumulative folded distributions for spreads of overnight rates to policy rates within the sterling, US and Euro zones. Looking at August, it was suggested that there were three features – firstly, the Fed had softened their overnight rate by a large amount (effectively easing monetary policy), secondly that the sterling overnight rate was, on average, materially above the MPC policy rate during August, and thirdly that the ECB's performance during August could reasonably be judged to have been the best.

However, in contrast, the charts for September showed sterling as being inside the distribution for euros and dollars. The Executive believed that this was because the Bank's new money markets regime introduced last year had more instruments built into it that could be used in conditions such as were being currently experienced. The banks were able to increase reserves that they target, whereas in the US and Euro area their targets were set for them. Additionally, to the extent that the Bank injected reserves over and above the aggregate target, practice in the US and ECB meant that they either had to drain them out later in the maintenance period or let their rates soften. But in the UK we can broaden the range of reserves at which we remunerate at Bank Rate, which stabilised the market rate.

Nedco was told that the Bank faced a significant monetary policy operational challenge arising from the Northern Rock facility. The scale of the injection into the money markets that will flow from the facility, which could rise to roughly £40 billion, was about the size of Banking Department's balance sheet and is double the size of bankers' reserves. In these circumstances it was not obvious that the Bank would be able to use the instruments used so far to continue to implement monetary policy. Assessment of how that could most effectively be done was still being considered but a leading option was that the Bank would issue bills in its own name to drain reserves from the system.

The Chairman of the FSA concurred with the analysis that had been provided by the Bank Executive but added that it would be wrong to underestimate the continuing effect of the shortening of maturity of funding for a whole range of institutions. Although this had improved, there remained a number of major institutions which were too heavily dependent on overnight funding - that was a huge source of fragility in the system. In the Chairman's opinion, following Northern Rock, were there to be another accident, it would have a huge effect on the standing of the financial services sector in the UK. The Bank Executive agreed with that view and believed that the market events surrounding Northern Rock had already stigmatised certain UK banks – and, in degree, the UK banking system as a whole - compared to where they had been six or eight weeks ago.

(ii) Northern Rock Facility

The Committee was told that the new facility which had been discussed at Court on 8 October had been announced in a short statement by Government on 9 October. Few details were in that announcement but it was noted that the Chancellor would be making a more detailed statement to the House of Commons on 10 October. At that point, the nature of the facility – specifically the fact that there was a Bank indemnity from HMT - would become clear.

The Executive told Directors that the documents covering the new facility and indemnity had been signed on 9 October. In summary, the larger facility from the Bank may rise to £30 or £40 billion, secured against fixed and floating charges over the whole of the assets of Northern Rock, and backed by a Treasury indemnity. Northern Rock had, as a condition, undertaken to produce by 24 October a plan for an orderly pay out of depositors should that be necessary in a solvent wind down. Also by mid-January a restructuring plan for the authorities to consider was required. The facility would run to 12 February, at which point the Bank would have to decide whether or not it should continue. It was emphasised that this represented a major change of emphasis ie moving from a lender of last resort facility on the Bank's balance sheet and at our risk, to a position where the Bank would be acting as the Government's agent.

Turning to the work in hand, Ms Lomax was leading on oversight of the pay out plan – this would include assessment of Northern Rock's plans for IT enhancements. Secondly, there would be a good deal of work involved in monitoring the facility, including taking of collateral, and then the release of collateral should Northern Rock be able to find commercial lenders to finance its operations. There would then be a question about what the Bank would release.

Nedco was advised that the Chancellor's statement to the House was likely to focus on the need for review of the deposit protection arrangements in the UK. It was anticipated that he would issue a short consultation document inviting views on the right way forward. Secondly, it was thought that the Chancellor would say something about liquidity regulation with consultation led by the FSA. Thirdly, it was expected that some reference to a review of Tripartite arrangements may be mooted. Finally, Directors were told that the Chancellor was expected to put a lot of weight on the international policy issues, and how those might be taken forward.

A Director noted that the new facility was a major economic and political undertaking and that when the details emerged, including the scale, public perceptions might change. The Executive agreed and noted that the Chancellor would have needed to have informed Parliament of the indemnity, or at least informed the Public Accounts Committee, that the indemnity had been issued. The understanding was that the Chancellor would make that clear as part of the announcement – but the Executive were adamant that the Bank would publicise that feature of the arrangement if Government did not. The proposal was that only broad terms (like the existing facility) would be published eg it is still at a premium rate, and it is secured on the assets including the mortgage book of Northern Rock and it is to run for a period of months. There was no plan to publish more detailed aspects of the facility

The difficulty of striking an appropriate balance between the desire for transparency on these matters and the need to communicate information about new facilities to Northern Rock (and potentially other institutions) in such a way that will not give rise to further runs on the bank was discussed – carefully planned communication strategy was recognised as essential.

A Director asked the Chairman of the FSA to comment on how the limited information release from Government and the Bank squared with obligations to equity and bondholders. The Committee was told that the FSA Board had been concerned to answer that it discharged its responsibilities properly. The FSA had taken a series of judgements about the information it could put into the public domain. Its main focus had been protections of depositors but it had also been conscious of the position of equity and bondholders.

The FSA Chairman noted that in reality, the key factor underpinning Northern Rock was the Treasury guarantee. The FSA were still able to say that, in relation to regulatory capital, Northern Rock was solvent. The FSA had taken that view on the basis of an extended analysis and plan from Northern Rock which presumed that it would be run-down over a period of three years. At the end of the three year period there was projected to be just enough regulatory capital. But the Chairman suggested that it was unlikely to reach that stage as either Northern Rock would no longer be a deposit-taking institution, in which case regulatory capital would no longer be an issue, or something else would have happened (for example, a merger with another institution).

In the Executive's view the important point was that the new facility ought to increase confidence in the fact that Northern Rock would keep going. People were beginning to work out that there were limits to the amount of money that Northern Rock could borrow on the lender of last resort facility as it would run out of collateral. The only basis for giving confidence was a facility that would stabilise the institution for long enough such that it would become credible and that there was a mechanism by which the depositors could be repaid either by transferring their accounts to another bank or putting in place a mechanism for paying them.

Court was told by the Executive that Northern Rock was capitalised at around £0.5bn (but pretty volatile around that level). There was a varied mix of equity holders - depositors who received shares when the company went public, speculative investors and a group of subordinated debt holders who were, with the bond holders, in the queue for any assets. It was felt that this latter group would be becoming increasingly worried about their prospects and who might well turn to the legal system for recourse. It was in that context that Court was to be consulted about indemnities later.

Summarising this part of the discussion the Executive confirmed that there was no financial risk to the Bank because of the Government indemnity. However, as had been noted, a major challenge for the Bank would be to find ways of draining the liquidity that would be injected into the banking system as a result of the new Northern Rock facility, and that may prove difficult. There was a potential reputational risk, if not a financial risk.

(iii) Arrangements for other small banks in vulnerable financial situations

The Executive was simply seeking to flag, for the Committee, the fact that thought was being given to this issue. The intention was to consult with Court at some point in the near future.

4. **Strategy Paper**

Directors noted that they had discussed the Governor's paper on strategy (5 September) over lunch following the September meeting of Court on 12 September. Whilst it was not for formal approval it was recognised that this was the document that would provide the underpinning for the Executive to prepare budget and strategy statements later in the year. Therefore, Directors were asked if, in their opinion, there were any aspects that needed more, or less, emphasis. It was noted that one issue that had already been identified had been in relation to arrangements that might be put in place so that Court could satisfy itself that it had fulfilled its governance remit in relation to Financial Stability. It was anticipated that a paper would go to Nedco2 in November (dependent upon progress by the working group consisting of Dr Potter, Sir Andrew Likierman, Dame Juliet Wheldon and Nigel {Jenkinson}).

Other Directors agreed that the FS issue was important to progress. [redacted] Subject to those issues that had been highlighted, Court confirmed that it was content with the strategy document.

5. **Quarterly Reports**

<u>(i) Quarterly Financial Report (QFR) and Balance Sheet Report</u>

Mr Jones introduced the Quarterly Financial Report

The forecast included an initial assessment of the revised pension costs on a financial accounting basis reflecting the changed investment policy of the Pension Fund. The adoption of the new policy had reduced income as previously predicted. The treatment still needed to be confirmed with KPMG.

There were a number of one-off income terms going through the accounts this year, an additional surplus on CRD income and a small surplus on remunerated functions. The net effect was to compensate for the additional pension costs and produce a marginally higher financial profit and, therefore, dividend than had been originally budgeted.

It was emphasised that the forecast did not include any estimates for potential costs of, or the additional income from, the lender of last resort facility to Northern Rock. At the time the report was produced, the Executive believed it would be inappropriate to provide speculative estimates. Whilst there were a number of technical accounting issues related to the new facility which were being worked through with KPMG, the important point to underline was that there was no anticipated impact on reserves of the Bank as a consequence of the indemnity from the Government. A more substantive report on the accounting aspects relating to the Pension Fund and Northern Rock would go to the Audit Committee in November. In answer to a question from a Director the Executive confirmed that Audit Committee would also review the financial treatment of the penalty interest rate charge on the Northern Rock ELA facility

Mr Tucker introduced the Balance Sheet report.

Most of the key issues under money market operations had been raised earlier in the meeting but Court were told that the use of the standing facility had clearly attracted some stigma for the banks who had used it. It would be necessary to consider in due course how to repair this if it proved to be more than a crisis- period phenomenon.

Directors were alerted to an exposure that flows from the Bank remaining, for the time being, a member of the Euro area Target wholesale payment system, and from its management of euro liquidity intra day. The Bank holds substantial intraday balances with some Euro area national central banks. Technically this was outside the parameters of the Credit Risk standard. Court were told that this would be addressed by the Business Risk Committee in due course.

Regarding the provision of banking services, Court were told that during the current crisis foreign central banks had been placing increasing amounts of deposits (in both sterling and other foreign currencies) with the Bank. The Executive Directors of Banking and Markets normally worked to a monitoring threshold of around £15 billion but that had been increased to £20bn, with approval from the Governor. The Bank had on-placed these extra inflows in the money markets on an entirely secured basis.

The balance sheet implications of Northern Rock was explained. Directors were told that although Banking Department lending to Northern Rock was currently around £10 billion, our balance sheet had in fact so far expanded by only £2 - £3 billion. The Bank had reduced the scale of weekly open market operations (ie lending into the banking system) to compensate for the additional injections but, as reported earlier in the meeting, the scale of the new facility created difficulties. The Bank wanted to avoid a position whereby the Bank's injection of liquidity into the market was coming, in the limiting case, entirely via the Northern Rock facility. A secondary danger was that if the banks knew that £40 billion was to be injected via Northern Rock then they may be dis-incentivised to set their reserve targets above zero. Directors were told that during the months ahead, arrangements would need to be put in place such that the Bank could maintain the implementation of monetary policy and that our normal regime for doing so did not fall into disuse.

Finally, in the context of managing the financial risks on the balance sheet, the Committee was told that since the middle of August ED/Markets had reduced the risks incurred from new business more conservatively than required by the Risk Standards. Also, Markets and the Credit Risk Advisory Committee had been meeting weekly rather than fortnightly.

(ii) Performance Measurement

Mr Jones introduced the remainder of the quarterly reports. Director's attention was drawn to several aspects of the report.

On the second outcome, (Physical Integrity of the currency is maintained) the Committee was told that KPMG had been engaged to undertake a substantial forensic accounting analysis of the reporting shortfalls from Loomis. The fees would be approaching £2mn for the full year and although they would be recoverable from Loomis they would need to be disclosed in the Annual Report; some thought would need to be given to presentation and description. The Chairman of the Audit Committee reported that Audit Committee had been told that the expectation was that the Bank's estimated losses arising from the under-reporting appeared to be around £12mn. [redacted]

On the third section of the report, (financial system is stable) Court's attention was drawn to the fact that the commentary confirmed that heavily flagged risks had {crystallised} and described how the Bank had reacted. One Director noted that one of the performance measures for this key outcome was "Financial crisis management and business continuity processes are 'fit for purpose'". There was a suggestion (accepted by other Directors) that there should be an additional bullet in the commentary saying that the strategy and performance measure would be "subject to review post current events".

On the fourth outcome (Bank trusted to carry out its functions effectively), the Executive highlighted the commentary regarding the public statements that had been made by the Bank in relation to the current crisis. A brief discussion of the change direction indicator for performance measure 6 (no major security incidents) concluded that this should not be shown as a downward change.

A Director noted that the HR director's quarterly report mentioned that an analysis of reasons for staff leaving had recently been undertaken – could the Executive provide guidance on the assessed top reasons? Court were told that a primary driver for analyst departures was the limited career scope here. Remuneration was also relevant to people going to the City, but exit interviews did not suggest that was the prime driver.

(iii) Strategy Implementation

The key issue highlighted by the Executive was a recognition of the need to identify work streams that had been, or might have to be, delayed because of the impact on Bank resources of the Northern Rock issues. Next quarter the report would show things which had been deliberately postponed.

(iv) Projects

Court's attention was drawn to the fact that there were two major projects where there were significant risks to envisaged timescales – (i) Notes Process and IT Infrastructure where replanning was in hand (ii) Custody, Settlement and Liquidity (CSL) where the IT software design and build was proving more difficult than originally envisaged. It was noted that both projects came under the purview of the Executive Director for Banking Services and given his involvement with Northern Rock exercise these may be examples of projects that might have to be delayed.

In answer to a question from a Director, the Executive indicated that the Bank was not yet in a position to know whether a delay in CSL's implementation would be a constraint on pushing ahead with Money Market 2 developments. However, there were concerns over the increasing costs of CSL and the Executive indicated that a more fundamental assessment of whether CSL should actually be progressed at all would be undertaken. The Directors indicated that they would wish to receive a further briefing on status of that issue.

(v) Risk Report

It was emphasised that the report being presented covered the quarter to end August but that, where appropriate, updates to September had been included to encompass the Northern Rock issues. Directors' were provided with more details of measures taken to deal with the drain on resources in terms of running the Bank's normal operations. There had been temporary redeployment of staff to assist in the areas most involved in the Northern Rock crisis; Rachel Lomax was heading up a small sub-group of ET that was considering 'business as usual' issues; all Executive Directors had been asked to consider current and projected activities to see what might be reprioritised for a later date - or to be brought forward if that would help; HR had been requested to produce a Bank wide inventory of skills across senior and managerial levels to determine if others could assist in certain areas. The underlying ethos was to ensure that if issues are to be delayed it is through a conscious decision rather than by default.

An action point arising from the subsequent discussion was the desirability of running a short briefing session for new NEDs (and other Directors who were interested) on the details of the red book money market reforms introduced last year. It was suggested that this might take place on the morning of the next normal Court meeting.

6. **Report from the Audit Committee**

This item was introduced by Ms Fawcett

On the Investment Unit/Pension Fund issue, the Audit Committee had been told that the outsourced management contract had been awarded to Legal & General and by July approximately 90% of the portfolio had been under Legal & General management.

Consequently, having pushed for a firmer understanding of actions and lessons for management, and given the Legal & General update, the Audit Committee had been content to draw a line under the Investment Unit issue.

(Sir Andrew Likierman declared an interest and withdrew for the next item)

Loomis: as requested by Court, the Audit Committee had reviewed the Ernst & Young reports. With hindsight, the Audit Committee were clear that the Bank could have responded to some of the warning signs on Loomis. It was recognised that by the time the report came the Bank was very much focused on the issues arising from the Tonbridge robbery.

Audit Committee, revised Terms of Reference, these were being recommended for approval by Court and reflected changes following the cessation of the Risk Policy Committee.

Reputational Risk, the Committee had discussed a series of papers arising from actions from the last Risk Policy Committee in June. One of the issues was the tension that existed between having to comply with anti-money laundering requirements and the Bank's promise to pay when dealing with note exchanges

There had also been a helpful discussion on measurement of change in reputation, the qualitative and quantitative methods used by the Bank, and the differences between doing so for monetary policy and financial stability. A number of suggestions had been made which Nigel Jenkinson and Peter Rodgers would be taking forward, including how the Bank could survey key opinion formers, including Non-Executive directors of large financial institutions, to get a sense of how they viewed the Financial Stability Report and the financial stability work of the Bank. There was an understanding that a report would come to Court in due course on that matter.

On the Internal Audit report, it was reported that a positive sign was that management were proactively asking Internal Audit to undertake reviews – which was seen as a sign that the Division was adding value. The internal auditor had reported to the Committee that there was an upward trend in the number of satisfactory reports. The Committee had also discussed the concept of secondments and the positive trend of secondments in from other central banks and also the possibility of doing more secondments out into the market.

External Audit report; the Committee had heard that the External Auditors were placing greater reliance on the work of Internal Audit – this was viewed as a positive. The threshold for reporting unadjusted audit differences would remain at £250k. On segregation of duties (following the Bankwide exercise) there were a couple of the outstanding issues in Markets relating to who prepares the Markets' Directorates management accounts and the need to reduce the number of reconciliations at year-end. A note would be going to the Audit Committee in November on this matter.

Annual Bilateral with the Internal Auditor the Committee had sought (and received) confirmation that there were no issues about which they were unaware. Full accessibility to senior management at the Bank was confirmed. There were no other outstanding issues that needed to be brought to Court's attention. On staffing, the Committee had been told that Internal Audit staffing was sufficient to achieve an 80-85% completion rate, having taken account of the requests from management to do additional work on projects and other issues. However the Audit Committee considered that additional resources and requests for additional work on projects needed to be monitored to ensure they didn't interfere with the initial Audit plan.

A Director noted that following the legal issues/reputational risk discussion the Audit Committee had signified it was 'satisfied' with the risk assessment. However, he questioned whether that was appropriate given the advice the Bank had received about pensions and the Market Abuse Directive . It was emphasised that the issue under discussion in the Audit Committee had only been in relation to the Al-Yamamah bank account. Nevertheless, the Chairman of the Audit Committee recognised the wider issue about quality of legal advice received and would consider what, if anything, the Committee might do in relation to that.

7. IT Operating Model

This item was deferred due to time constraints

ITEMS FOR INFORMATION

8. MPC Report to Court

The report had been placed in folders – Directors noted the contents

A Director asked how, in the Bank's view, the turmoil in financial markets would manifest itself in the economy? The Executive agreed that the key question for the Monetary Policy Committee looking forward was the extent to which it would impact on the real economy. Directors were told that so far the credit crunch had primarily impacted on interbank lending rather than affecting lending to households and firms. There would be two key sources of information to monitor going forward.

Firstly, the new Credit Conditions Survey. The one carried out in September had, surprisingly, suggested that lending standards to household would not be tightened very much but that there were signs of tightening of credit availability to firms. But it was unclear if that would just affect lending for mergers and acquisitions and leverage buyouts or whether lending for real investment would be affected. The latter was of most significance to the MPC.

{The} other source of information which would be useful in the coming months would be the Agent's reports. They would be interested to know if contacts were finding access to credit difficult.

9. **Non-Policy Meetings of the MPC**

The meetings were noted.

10. **Any Other Business**

A note from the Legal Advisor to the Governor on 'Consultation about Transactions Outside the Ordinary Course of Business' had been circulated to members at the start of the meeting.

Court were reminded that Matters Reserved to Court required that transactions outside of the ordinary course of business needed consultation with Court. This normally required a minimum quorum of nine present in person. However, Court had previously agreed that this requirement could cause difficulties in a business continuity crisis and so had agreed a new emergency procedure on 12 September. Under that arrangement the Governor, should he regard it as impractical to have a full Court meeting, could seek to make best endeavours to alert members and, if the transaction would involve a significant financial risk to the Bank, take all reasonable steps to hold a meeting with at least six non-executive members; any decision having to be reported to the full Court as soon as possible.

The proposal being put to Court now was that Matters Reserved to Court might be amended again to create an additional method of consultation. Court would establish a sub-committee consisting of the Chairman of NEDCO and two non-executives. The Governor could choose to consult that sub-committee instead of Court either if the transaction in question involved no significant financial risk, or if he and the Chairman of NEDCO were agreed that more limited consultation was appropriate. The sub-committee could itself decide to refer a transaction and consultation to the full Court, and wouldn't be required to report automatically as soon as possible thereafter.

During the subsequent discussion several Directors raised doubts about what was proposed. Concerns were expressed that by agreeing to this proposal (which could allow significant financial risk to the Bank and which did not require reporting back) Directors might be abrogating their legal responsibilities of oversight. Before agreeing to such an arrangement some members of Court felt they would wish to have assurances about the legal position. Other Directors felt that in times of crisis (such as this) it was important for Court to operate in a mutually supportive manner – the proposal did not appear to adhere to that ethos.
The Executive advised Court that they would revisit the proposal and bring it back to Court at a later date.

The meeting of Court was closed.

MEETING OF THE COURT OF DIRECTORS

Wednesday 10 October 2007

Present:
Mr King, Governor
Sir John Parker, Chairman, NedCo
Ms Lomax, Deputy Governor – Monetary Policy
Sir John Gieve, Deputy Governor – Financial Stability
Ms Fawcett
The Hon Peter Jay
Sir Andrew Likierman
Sir Callum McCarthy
Mr Myners
Dr Potter
Mr Rhind
Ms Rice
Mr Sarin
Mr Strachan
Mr Wilkinson
Mr Wigley

Absent:
Mr Barber, Mr Carr

Also attending:
Mr Bean, Mr Jones, Mr Footman, Mr Jenkinson, Mr Tucker, Dame Juliet Wheldon

1. **Minutes – 12, 13 and 25 September**

Approved.

2. **Terms of Reference of the Audit, Remuneration and Risk Policy Committees**

Court noted the annual submission of the Terms of Reference of the sub-committees.

3. **Monetary Policy Issues**

Court noted the submission of the monthly MPC report to Court for October.

11. Audit Committee report, quarterly report for projects, finance, strategy implementation and performance measurement.

Court noted the discussions in NedCo of the above items

Any other business

None

The meeting of Court was closed.

COMMITTEE OF NON-EXECUTIVE DIRECTORS (NEDCO) MEETING

Thursday 15 November 2007

Present:
The Governor
Sir John Gieve – Deputy Governor, Financial Stability
Ms Lomax – Deputy Governor, Monetary Policy
Sir John Parker, Chairman, NedCo
Mr Barber
Mr Carr
Ms Fawcett
The Hon Peter Jay
Sir Andrew Likierman
Sir Callum McCarthy
Dr Potter
Mr Rhind
Ms Rice
Mr Strachan
Mr Wilkinson
Mr Wigley

Absent:
Mr Sarin

Also attending:
Mr Bailey, Mr Bean, Mr Footman, Mr Jones, Mr Tucker, Dame Juliet Wheldon

1. **Minutes – 10 October**

Approved – subject to minor amendments submitted by Sir Callum McCarthy (seen by the Committee) and Ms Fawcett.

2. **Matters Arising**

None

MANAGEMENT OF THE BANK

3. **Executive Report**

The Governor presented this item

The Committee were told that, whilst market conditions remained fragile, the model for the Executive report to Nedco would be for (i) the Governor to provide the usual Executive Report, (ii) the Deputy Governor (FS) to provide an update on Northern Rock, (iii) a quarterly report on financial stability, (iv) Executive Director for Markets to provide an update on financial markets, including money market operations.

(i) Executive Report

It was reported that Paul Myners had stepped down from Court, for a period, due to a conflict of interest. He was involved in the JC Flowers bid for Northern Rock. There was a brief discussion about the legal aspects of the temporary withdrawal. It was confirmed that the Bank had sought Freshfields' advice which had provided the necessary comfort that all was in order – that advice would be circulated to all NEDs.

Recent and forthcoming meetings and events

Domestic:

- Open meeting with Staff on the Financial Stability Stabilisation work being done with Sir John Gieve and Rachel Lomax, 24 October.
- Interview to BBC Radio 4, 'File on 4', on Northern Rock, 6 November.
- Inflation Report Press Conference, 14 November.
- Treasury Committee appearance on the November Inflation Report with Rachel Lomax, Charlie Bean, Tim Besley and Danny Blanchflower, 29 November.

International:

- IMF Annual Meetings in Washington, 19, 20 & 21 October.
- G20 and BIS meetings in South Africa, later today, 15 November until 20 November.
- New York visit to meet with CEOs of leading financial institutions, 10 & 11 December.

There had been a breakfast meeting with the Chancellor, 30 October a telephone conversation with Nick Macpherson, 1 November and a Tripartite meeting, 12 November. There would be a further breakfast with the Chancellor, 28 November.

Financial Sanctions Unit

The responsibilities of the Financial Sanctions Unit had transferred to the Treasury, with effect from Wednesday 24 October. Two members of Bank Staff had accepted two year secondments to HMT.

Money Market Operations

Lending to Northern Rock was creating a challenge for our money market operations. The size of weekly OMOs had been reduced to accommodate that lending. An objective, going forward, would be to increase the size of OMOs by drawing some of our lending to Northern Rock from the markets. The Committee were provided with further details later in the meeting.

Money Market Reform 2

The last report to Nedco on progress with MMR II had been in June. Members were reminded that the project had three elements: (i) introducing electronic bidding for the existing repo OMOs; (ii) introducing routine OMOs to purchase gilts in order to provide longer-term finance to the banking system; (iii) OMOs to purchase foreign currency bonds swapped into sterling. Members were already aware that (i) and (ii) had been delayed from early autumn due to counterparties (and the Bank team) having been focused on the market turmoil.

As conditions in the short-term money markets had been calmer, the Bank was intending to hold the first electronic short-term repo on 22 November; the first electronic long-term repo on 18 December; and the first gilt-purchase OMO in the New Year. The current estimate for go-live for the final phase of MMR II would move from spring 2008 to some time in the summer.

Staff Opinion Survey

Questionnaires had been sent to staff on 1 November by BMRB (an external, independent market research company). Members were told that these surveys help produce useful information to identify, and respond to, staff concerns and to measure improvements over time. This would be the fourth of a regular programme of opinion surveys – the last (2005) had a response rate of 75% which was seen as positive.

Papers on Northern Rock

Members were advised that the legal documentation and a summary of the legal issues arising on Northern Rock were available, in Dame Juliet Wheldon's office, to members who wished to look at them, subject of course to any conflict of interest.

(ii) Update on Northern Rock

Sir John Gieve and Andrew Bailey presented this item

The Committee was initially briefed on the financial position. Since the October meeting of Court a further £10 bn had been lent by the Bank to Northern Rock under the second facility bringing the total borrowed, under both facilities, to around £21 bn. That number was projected to rise to around £25 billion by February. Most of the wholesale deposits had now been withdrawn from Northern Rock and retail deposits continued to be lost at a rate above the company's expectations.

The Company was now operating under the stabilisation plan that the authorities agreed with them at the end of October. Their new lending was reducing -- at the peak earlier in the year Northern Rock were approving more than 5,000 new mortgage applications per week but were now targeting 150 per day.

It was emphasised that it was important to maintain some new mortgage lending as Northern Rock had a large securitisation vehicle (Granite) and needed the new business to feed that and to prevent a trigger event for rapid amortisation. But the Committee was told that the net new lending was about to turn negative and the scale of the negative lending position would increase over time. On the basis of what the Executive had seen, the company's operational performance was robust, particularly given the circumstances.

It was explained that a Northern Rock project team had been established in the Bank, led by Sarah Breeden and working to Andrew Bailey and there were three main work streams. The first was dedicated to the stabilisation arrangements and how Northern Rock was operating under those. This included the Bank's own lending facilities and managing the security taken under those.
The second work stream was focused on the longer term resolution of Northern Rock. The Treasury's guarantee to depositors and the Bank's second facility were state aid and needed Commission approval as rescue aid. The six month limit for rescue aid was important because it created a clear requirement for the Northern Rock board to achieve a resolution within that period although the Bank's ultimate weapon was that we could withdraw the lending facility on demand.

The third work stream was described as the 'pay out' work stream, where the Bank is in the lead, but working with the other two members of the Tripartite. The focus was on the question of how to respond if something happened which caused another run on Northern Rock.

The Committee were told that Ernst & Young were advising the Bank and, inter alia, were collecting management information in order to provide a weekly report for all Tripartite authorities. Further advice being provided was related to Administration issues and the options for a solvent wind-down.

It was reported that the Bank had had to change lawyers because Freshfields were conflicted as Northern Rock's lead lawyers. Their decision on conflicts had come after they had acted for the Bank for the first facility.

HMT had engaged Goldman Sachs to advise on the resolution options. However, the Bank would not become a formal engaging party with Goldman {Sachs} until HMT had agreed their terms of engagement.

Fishburn Hedges had been engaged to offer media advice. So far, this had focused on gauging how the various payout options might run should that stage be reached.

The resolution options were characterised in four forms. Firstly, a corporate Merger and Acquisition solution which would be a form of acquisition of Northern Rock which could either be a whole company acquisition, or in parts. The second option would be a restructuring of Northern Rock where new capital and funding might be injected. The Committee was told that there could be some permutations which could have elements of both the first and second options. A third outcome might be the solvent wind-down. That would involve the winding-down of the company under a management team and a board of directors but with the expectation it would be solvent at the end. The fourth (and least favoured option) was administration.

There were a number of question from Directors. Firstly, the Executive were asked if they felt they had sufficient resources to manage the workstreams. Secondly, how were the Bank's significant costs arising from this work being absorbed. Thirdly, there was a question about why Freshfields had made a late decision about conflict. Other questions were around the extent to which there may be other potential issues in the market and, finally, what planning was in hand for the year end.

On the resources issue, the Executive confirmed they were content. A good team had been put together and whilst they were working under great pressure they were being effective. Regarding costs, the Executive suggested they would prepare, for Audit Committee, a short account of what the Bank was expecting to pay – all advisors had already been asked to provide an estimate up until mid February. However, it was stressed that recoveries would be achievable from Northern Rock – they had paid the first bill of around £800,000 which was primarily Clifford Chance legal fees.

On the matter of Freshfields being conflicted, the Committee were told that the Bank had been alerted to the conflict from the outset and both the Bank and Northern Rock had provided the necessary release. However, as the problems developed and the second facility was evolving it had become clear that the arrangement could not continue. As it would not have been in the public interest for Northern Rock to lose its lead corporate lawyers at that point, the Bank decided to release Freshfields and retain Clifford Chance.

On year end arrangements, the Executive indicated that contingency plans were being drawn up to deal with possible difficulties in the market that may emerge during that period. Consultation would be taking place with the market and also with other central banks. However, Directors were reminded that under our money market arrangement, UK commercial banks could set their own reserves targets and so could cover themselves for the year end period.

A Director asked about the extent to which the Bank and the UK taxpayer's interests were being considered in relation to the facilities being made to Northern Rock. From a formal perspective, the Committee was reminded that the Bank was a senior creditor. Security had been taken – for the first facility this was against dedicated collateral at a margin, and the second facility was set against a charge against all remaining assets of the company.

However, the Executive indicated that a longer term concern for them was how the Bank could extricate itself from this situation without compromising the public interest. It was suggested that those concerns would be a key element of how the Bank would view the proposals that come in for restructuring of Northern Rock. But HMT (as a result of the indemnity to the Bank) would have a decisive input

There was a question about what legal powers the Bank had to direct the board of Northern Rock, or to veto decisions about its future. The Committee were told that the board continued to run Northern Rock. The Bank was not running the company and did not have powers very different from those that a major creditor would normally write into agreements. But Clifford Chance had prepared a summary of the legal documentation, including the Bank's legal powers and Directors were welcome to review that paper

(iii) Quarterly Report on FS work

Sir John Gieve presented this item

The Committee were briefed on three areas of work; (i) assessment and monitoring, (ii) contingency planning and actions to reduce vulnerability of institutions in the short term and (iii) longer term reforms. .

On assessment and monitoring, the Committee were told that the FSR had been published in October. The Bank had sought to provide a dispassionate and rigorous account of market developments and to identify initial lessons on liquidity management, transparency and bank resolution. The forward looking assessment of vulnerabilities had been received as a gloomy, but realistic, assessment.

The Executive said that one vulnerability was the continuing rise in defaults in the sub prime housing market in the US. There was still a risk of fire sales of assets by CDO's and Structured Investment Vehicles (SIVs) many of which had not yet been restructured and put on a more sustainable basis. The position of the Monoline insurers was also causing concern; if they were downgraded a number of securities that they have insured would also be downgraded and this would put further pressures on banks to reabsorb assets.

Two other potential vulnerabilities had been highlighted in the last FSR. Firstly that the substantial losses could occur in the commercial property sector (both in the US and in the UK) and secondly the vulnerability of the equity markets

Turning to the short-term measures and contingency planning Directors heard that the FSA had identified a number of vulnerable institutions. Whilst these had not gone as far as

Northern Rock in adopting a wholesale based funding strategy they still need to raise considerable sums on the wholesale markets and their main assets are mortgages. The FSA had been encouraging these banks to secure longer term funding in order to avoid the fate of Northern Rock.

The possibility of more general measures of support to help the market had also been discussed with the commercial banks. Those discussions had encouraged the larger banks to lend to the second-tier but their view was that the announcement of a new general measure directed at the mortgage sector was likely to have adverse effects which would {outweigh} any benefit.

The Committee was told that work on longer term reforms was focused on the legislation planned for next year. HMT had said it would issue a consultation document in January on bank resolution and reform of deposit insurance. It was noted that the Chancellor was still considering what, if any, change was necessary to the Tripartite arrangements.

Work was also reported to be ongoing in Basle and IOSCO which was being coordinated by the Financial Stability Forum on measures to be taken internationally to address the vulnerabilities that have been exposed. Both Callum McCarthy and John Gieve were on the FSF Working Group preparing a report for the G 7 on the international policy implications for April.

In response to a question about whether there were particular banks causing concern the Executive provided a brief summary of the situation (no institutional details were provided).

Asked whether the Committee would have an opportunity to discuss, and comment on the Northern Rock outcome scenario, the Executive agreed that a paper setting out the implications of the various alternatives should come to Court – possibly in December if the options and bids had been clarified by then.

A further request from Directors was for sight of the summary document on the bids, that had been prepared for the Tripartite authorities. The Executive agreed to consider if it would be appropriate to circulate this third party document.

It was reported that the FSA subscribed to the assessment of the market position as described by the Executive and the ongoing risks. In the FSA's view, the overall position had deteriorated significantly since the last Court meeting. They believed that there was much bad news to come out from the mortgage market in the US where impact of soft or hard fraud was still to come through. The continuation of shortage of funding combined with the year end funding issue were considered to be significant factors.

Referring to the significant range of policy announcements and reforms that were being planned for the New Year, the Committee were told that the FSA had severe concerns about capacity constraints within HMT to be able to implement the changes proposed. This was felt to be a vulnerability as it was thought that a poorly thought through, or enacted, set of initiatives could unintentionally affect the attractiveness of wholesale deposits coming to the UK.

Whilst the Bank Executive agreed with the FSA's assessment of the dangers of rushing through badly thought through legislation they, nevertheless, indicated that the only alternative to the Government giving an unlimited guarantee would be to prioritise new legislation on bank resolution and a reform of the deposit protection scheme.

(iv) <u>Recent Financial Market Developments</u>

Paul Tucker introduced this item and referred to the data sheet that had been circulated.

The Committee's attention was initially drawn to the recent trends on the graphs showing 'ABCP yields and amounts outstanding' and 'ABX prices'. The significant factor was the downward price trend in October/November which showed that the price of even the most highly rated tranches of securitized bonds had fallen. The Committee was told that some of the {world's} biggest banks had retained these 'super senior' tranches of debt.

Partly reflecting this, the equity prices for the major banks had fallen sharply in recent weeks (bottom left chart), and the Credit Default Swap spread (chart at bottom right) was increasing. Directors were told that this was placing the banks under pressure to disclose more about their valuations of complex securities - and some of the UK banks had done that.

The credit spreads for the, so called, Monoline financial guarantors credit risk assessment (bottom right chart) was also highlighted. It was explained that the AAA rating for these institutions (which provide insurance against credit risk) was central to their raison d'etre. If their rating was downgraded there would likely to be complex {spill-overs} in the market place.

A further concern was that questions were emerging about money markets mutual funds, particularly in the US, some of which had bought SIV paper over the years. Some asset managers were now supporting their funds. It was suggested that a serious scare around money market mutual funds could create new a new level of fear and uncertainty, which was why some of the big banks were supporting their money mutual funds.

Turning to the Bank's own balance sheet (second page of data sheets), Directors' attention was drawn to the ongoing inflow of central bank deposits (bottom right chart). The Committee was told that since mid-August these had been placed out into the secured money markets and so our secured/unsecured money market asset profile had changed significantly.

The Committee were told that in normal market conditions the profile of Bankers Reserves (top left) and that of Short-term Repos on Banking Department (top right) would be similar – but the profiles were actually significantly different – ie a build up in Banker's reserves, accompanied by a decline in short term repos. It was explained that this reflected the problem for the Bank whereby the scale of the injections into the market via Northern Rock was offset by smaller OMOs. Directors were told that if Northern Rock borrowed more, the short-term repos on Banking Department would eventually get to zero – that was an unsustainable position.

Thought had been given as to how this situation could be rectified, and two options were being considered for draining money from the market in some other way – possibly by issuing Bank of England bills from Banking Department, possibly by repo-ing out bonds. But the Bank does not have a large bond portfolio to repo out at present), so the Bank was in discussion with HMT for them to replace the Ways and Means overdraft on Issue Department with a portfolio of gilts. That would enable the Bank to repo out those gilts for cash. Directors were told that, if this route was taken, it would raise about £13 billion and as further funds were lent to Northern Rock bill issuance could increase.

Although this would work, technically, the idea did carry some significant presentational challenges. Firstly, this would amount to the Bank of England borrowing to lend to Northern Rock – that would be a reputational hazard but one that the Executive thought could be overcome. The other hazard would be that the Bank would be borrowing at 3 months at a time when the market was saying that we should be lending more at 3 months.

The challenge was, therefore, how to present this concept. It was felt to be important to emphasise the neutral effect and the fact that this would simply be a different way of doing what the Bank was already engaged in. There would be a good deal of consultation with market contacts to ensure the underlying rationale was understood. Some part of the process would need to go to the Chancellor for approval.

4. **CRD Review**

Warwick Jones presented this item

Members were told that a formal consultation process had been underway since August (finishing on 9 November) for interested parties to make representations to HMT about the following recommendations:

(i) The proposal to reduce the CRD ratio from 0.15% to 0.11% but leave all other parameters of the scheme unchanged;
(ii) Whether there are any technical aspects of the operation of the scheme that could be improved; and
(iii) How the transparency of the CRD scheme could be further improved, either through the release of further information or through the release of information through different communication channels.

Current status was that HMT were reviewing representations and their public response would be reviewed by the CRD Steering Group on 27 November; it required approval by the Chief Secretary to the Treasury. Once published, HMT will be in a position to lay the Statutory Instrument - which will {affect} the proposed reduction in the CRD ratio, should that be adopted - before Parliament.

The Committee was advised that laying the Statutory Instrument needed to be approved by Parliament and that the laying would usually be followed within a few weeks by a Parliamentary debate. The Bank had originally expressed a preference for the SI to be laid before Parliament before Christmas, so it would be passed before February Court / year end. It is anticipated that the budget for 2008/09 presented for approval at February Court will assume that the reduction in the CRD ratio proposed in the consultation paper goes ahead.

However, HMT had indicated there were possible risks to the envisaged timetable. Whilst the delay was not ideal, presentationally, Nedco was told that a short delay would be acceptable from a financial and operational perspective as any revision to the scheme would only take effect from June 2008.

5. **Budget Warm-up**

Warwick Jones presented this item.

Nedco was told that the timetable would be the same as last year, ie refreshed strategic objectives to Court in December, a draft budget proposal would come in January followed by a final budget to Court in February.

Each Directorate had been asked to identify value for money proposals. These were being collated and a section would be included in the pack coming to Court. A number of topic papers were being produced for the challenge sessions as background (eg property cost, IT, capital charges).

A number of underlying principles were being applied to this years budget round. Firstly, there was no attempt to guess at any budgetary consequences of recent market events. Secondly, the envelope of 2% pa growth for policy functions for each year had been maintained. Thirdly, the projection for 08/09 was in line with budget objectives so no further specific cuts were targeted. Fourthly, there was an objective of bringing the investment budget even closer to recurrent expenditure. Finally, there was a lot of work being undertaken on the effect on staff costs of turnover.

The Committee was told that Project Group had discussed the outline investment budget with a number of changes recommended – the impact of that was being worked through. Initial ground clearing meetings had been completed with all areas and there was considerable work being done in preparation for the first Governors' challenge session in two weeks time.

6. IT Operating Model

John Footman and Chris Piper presented this item

The Committee were told that the situation had moved on from when the paper had originally been scheduled for Nedco in October. The changes discussed in the paper had now been announced within the Bank and implementation work on the restructuring of the IT department was in hand. Recruitment of the senior management vacancies was underway and it was anticipated that there would be some people who will be surplus as a result. The process of recruiting the business engagement partners had also been initiated – it was anticipated that these might be relatively difficult to fill.

By way of background the Committee were reminded that the IT transformation program had been discussed by Court last year and had sought to simplify and standardise processes, bringing all core IT systems together to increase the resilience. There were a number of projects within the infrastructure program including reducing the number of servers, taking control of the basic first line IT service and transferring local IT support staff into the Centre. The IT operating model program sought to build on the benefits from the earlier centralisation and standardisation.

The Committee was told that the reorganisation, and centralisation, of the IT department was creating a model recognisable in the commercial sector and would certainly provide synergies with an outsourcing partner should a decision be taken to travel that route in the future. Realising the benefits of the infrastructure program was characterised as strand 1 of the IT re-modelling work.

The second (and perhaps more important) strand was to improve the business engagement with the Centre. The first challenge was to engage with the Monetary Analysis and Financial Stability areas (ie the analytical areas) to identify their own IT strategy and separately with the Markets and Finance areas to develop their strategy.

The decision to give these key areas a more direct role in establishing their own IT strategy arose from a view that the IT Department had been dominated by work on large, sophisticated banking systems and that the analytical areas' interests suffered as a result. The objective of appointing IT partners was to make sure the analytical areas have a greater input into setting strategies (not delivery). The recruitment of personnel for these positions would be crucial but may take some time because they might be difficult roles to fill given the required skills set. For instance, the MA IT partner will require a person who has a strong background in economics, in IT and a strong character to deal with the personalities that exist in MA. The Executive told the Committee that a strong project team was in place to see the change process through.

In response to a question about what trade-offs between centralisation and localisation had needed to be made, the Executive indicated that a key issue had been consideration of the relative benefits of having IT teams working and identifying with the business area or the IT Department. A further issue that had arisen was that the logical organisational structure for delivery of the IT objectives did not necessarily fit with the Bank's established structure.

Referring to the Executive's concerns about finding the right person for the IT partner role, one Director reflected on his own experience with this sort of appointment and warned against an unrealistic pursuit of perfection. It was suggested that the real responsibility for the IT business partner should be much more of a technical enabler to help translate the business thought into a technical reality. It was suggested that a decision would need to be made on which side of the line should take precedence (ie a business focused bias or an IT technical bias. The members of the Executive recognised that issue and were realistic in their expectations of having to make a certain degree of compromise in their selection.

The Committee supported the four cornerstones set out on the first page of the document and endorsed the objectives – specifically the reduction of costs.

7. Business Continuity Annual Report

Sir John Gieve presented this item

The paper being presented set out work undertaken over the past year to address business continuity risks. It described the forward programme of work, both in the Bank and as part of the {Tripartite} group with the FSA and HMT. The continuation of a series of continuity related exercises was highlighted – a pandemic exercise had been undertaken and a live test in money markets. The project to strengthen resilience through split site working was emphasised.

A benchmarking exercise had been undertaken to measure the Bank's arrangements against the standards set for the industry more generally was described. [redacted]

[redacted]

[redacted]

[redacted]

[redacted]

[redacted]

MONETARY POLICY

8. **The November Inflation Report and monthly MPC Report to Court**

Charlie Bean presented this item.

The Committee were given a brief presentation of the key points arising from November Inflation report.

A Director asked about the trade-off between inflation and unemployment – had that risen? In the Executive's view that had not worsened but it was suggested that the economy had been hit with a demand shock and a supply shock at the same time and that may lead to some longer run, relatively persistent, adverse movement in the trade off. An associated factor was that the UK was no longer seeing the beneficial effect of terms of trade improvements from China. We had now moved to an environment where some of the biggest gains from the China effect were behind us. There was also an adverse effect from upward pressure on commodity prices including oil.

The Committee was also briefed on the recent Federal Reserve Bank announcement. The Fed had been undertaking a review of its communications strategy over the previous 18 months. [redacted] There were obstacles relating to their legislation that would prevent them going to fully fledged inflation targeting but they had concluded that they should be more open in their communications of what is going on in the economy.

The Fed had announced that they would publish forecasts four times a year, extending the period for which they are forecasting and providing more information about differences in views amongst members. In summary, the Fed were echoing some of the things in the Bank's model. The Executive felt this was a significant step – and noted that the author of Bernanke's speech was Spencer Dale who was on secondment from the Bank.

ITEMS FOR INFORMATION

9. **Audit Committee Minutes of 12 September**

A summary had been discussed at the previous meeting of NedCo – the completed minutes were noted.

Any other business

None

MEETING OF THE COURT OF DIRECTORS

Thursday 15 November 2007

Present:
Mr King, Governor
Sir John Parker, Chairman, NedCo
Sir John Gieve, Deputy Governor – Financial Stability
Ms Lomax, Deputy Governor – Monetary Policy
Mr Barber
Mr Carr
Ms Fawcett
The Hon Peter Jay
Sir Andrew Likierman
Sir Callum McCarthy
Dr Potter
Mr Rhind
Ms Rice
Mr Strachan
Mr Wilkinson
Mr Wigley

Absent:
Mr Sarin .

Also attending:
Mr Bean, Mr Bailey, Mr Jones, Mr Footman, Mr Jenkinson, Mr Tucker and
Dame Juliet Wheldon

1. **Minutes – 11 October**

Approved.

2. **Financial Stability Operations – Sub-Committee**

The Governor presented this item.

The Executive briefed Court on the proposal to create a new sub-committee of Court consisting of three non-executive directors with which the Executive could consult outside the normal course of business. The proposal had originally been tabled in October Court but had been withdrawn at that time to deal with some of the points raised by Directors at that meeting.

Directors were told that the Bank would not have needed to access such a committee since the concept was initially discussed. Nevertheless, it was thought to be a helpful facility to have available. The Directors were given an assurance that any major undertaking such as that for Northern Rock, would be brought to Court. It was emphasised that the Sub-Committee would have full discretion about whether any matter referred to it should be referred to the full Court.

The Executive were asked to comment on the type of transactions and circumstances that might need to be routed through this Committee. Directors were told that it was possible to envisage situations involving relatively small scale operations which did not have implications for the balance sheet of the Bank. It was suggested that it would be unnecessary to convene an entire meeting of Court for such transactions, particularly as it would carry the risk of publicity being given to an emergency meeting of Court.

The Committee was told that the initial thought had been that it might be appropriate to hold a bilateral meeting between the Governor and the Chair of NedCo to consult about the sort of transactions being discussed. However, it had been agreed that, in a fast moving situation, it would be more appropriate for the Chair of NedCo to have two colleagues engaged in making any decision that was necessary at that point, but subsequently reporting back to Court.

The Chair of NedCo noted that the revised draft drew heavily on input from one of the Directors who had been opposed to the proposal when it had originally been tabled in October. The Committee was told that if the new Sub-Committee was needed for consultation, the default expectation for membership would be the Chairman and Deputy Chairman of NedCo and Chairman of Audit. In the event that any of those individuals were not available the Chairman would look to the other members of Audit Committee. The proposed membership was discussed and the rationale was accepted by the Committee.

A question was asked about whether the existence of this Committee would be given publicity – the expectation of the Executive and the Chair of Nedco was that there would not be any reporting.

The Executive were asked to comment on the process of reporting back to full Court. Directors were told that it would depend on the specific circumstances of a particular transaction. Under most circumstances there would be an immediate report back to Court. However, it was possible that if an operation was particularly sensitive and there was a concern within the Tripartite authorities that the number of people knowing about it should be limited, then it was possible that reporting back to Court might be deferred. The key virtue of the new arrangement was that it delivered flexibility in a situation where, for instance, decisions on a series of small transactions within a relatively compact timescale needed to be agreed. It would not be feasible to, say, have three full Court meetings a week to sanction those transactions.

An amended resolution (adjusted to take account of the discussion and decision on membership) was put to the Committee. Court APPROVED the following resolution:

THAT paragraph 3(e) of the Matters Reserved to Court be replaced by the following new paragraph 3(e):

(i) The Governor consults Court about any loan, commitment or other transaction which is not in the ordinary course of the Bank's business, including any involvement by the Bank in support of individual banks or of the financial system, as contemplated by the Memorandum of Understanding between the Bank, the Financial Services Authority and HMT.

(ii) Consultation will take place as follows:

(a) Subject to sub-para (ii)(b) and (c) the Governor will consult a quorate meeting of Court.

(b) If the Governor determines that it is impracticable to consult a quorate meeting of Court, he will unless he determines it to be impossible consult the Chairman of NedCo and alert members of Court that there is an issue, and, if the transaction would involve a significant financial risk to the Bank, will take all steps he determines to be reasonable to hold a meeting with a quorum of 6 non-executive directors. The Governor will report a decision under this procedure on any transaction to Court as soon as possible thereafter.

(c) If the Governor determines that more limited consultation on any transaction is appropriate, and until Court determines otherwise, the Governor may consult a sub-committee of Court (comprising the Chairman of Nedco and two other non-executive directors selected at the time by the Chair of Nedco), which is fully authorised to act on behalf of Court in connection with the transaction. The Governor will report a decision under this procedure on any transaction to Court as soon as possible thereafter or at such other times as the sub-committee, in consultation with the Governor, shall determine. The sub-committee may decide to refer a transaction to Court for consultation for any reason.

(d) If the Governor determines that consultation under sub-para (ii)(b) or (c) is impossible, the Governor will unless he determines it to be impossible consult the Chairman of NedCo and agree what procedure should be followed, including the procedure for reporting any decision to Court as soon as possible after any decision is made .

(iii) If the Governor is not available, any consultation may be carried out by any person he has authorised to act in his absence. For the purposes of sub-paras (ii) (b), (c) and (d) members can be present in person or by telephone or any other means of communication. Members of the sub-committee may, with the agreement of the Chairman of the sub-committee, be consulted individually, rather than in a meeting.

(iv) Any determination by the Governor or any person authorised to act in the Governor's absence pursuant to para (iii), purporting to be made under sub-paras (ii) (b), (c) or (d) and confirmed in writing by the person making the determination, and any written confirmation by the Governor that consultation has been duly conducted, shall be conclusive and binding as between the Bank and any third party.

THAT pursuant to Schedule 1 paragraph 11 of the Bank of England Act 1998 and until such time as Court determines otherwise:

(a) A sub-committee of Court (to be known as the 'Transactions Committee') be created and constituted for the purpose set out in para 3(e)(ii)(c) Matters Reserved to Court.

(b) The sub-committee shall comprise the Chairman of Nedco and two other non-executive directors selected at the time by the Chair of Nedco

(c) The quorum shall consist of not less than two members.

(d) Subject to the foregoing, the sub-committee shall determine its own procedure.

3. **Personal Indemnity**

Sir John Gieve introduced this item

The Committee was told that the Executive had been intending to table a resolution concerning indemnities for Governors, Directors and Bank staff in relation to Northern Rock for agreement by Court. That proposal had been 'Option 1' as described in the paper from the Legal Adviser to the Governor circulated to Directors ahead of the meeting. However, after further consideration that proposal was now being withdrawn.

Directors were told that the background to consideration of this issue had been concern that the Bank had no statutory immunity – and that contrasted with the immunity enjoyed by the FSA under FSMA. Until now, this had not thought to have been a major issue as, unlike the FSA, the Bank did not regulate distressed institutions. But Northern Rock and the ongoing financial crisis now raised the prospect that the Bank, its staff and Directors, could potentially be involved in litigation. The Bank felt it was correct to protect the Bank, staff and directors from the threat and cost of litigation and this principle had been accepted by HMT in their indemnity to the Bank in relation to Northern Rock.

Having reflected further , the Executive now placed greater weight on the fact that action to specifically implement back to back indemnities for staff and directors in relation to Northern Rock could be misconstrued if it became public, eg some could view this as evidence that we expected in some way to act unlawfully or in bad faith or negligently. Equally, it was thought that it sent an odd message to staff to say the Bank would indemnify them from in acting in bad faith.

On balance the Executive now recommended the second option in the paper. Under this approach Court would approve a policy statement that the Bank would, in practice, intend to treat its staff as though they enjoyed the indemnity from the Treasury which Non Executive Directors currently enjoy. Bank staff did not have that specific indemnity in their terms and conditions but the Bank would expect to pursue that for the future.

In addition the Executive were recommending that the Bank should press HMT and Ministers to include, in legislation intended for next year, a statutory immunity for Bank staff akin to that enjoyed by the FSA. It was recognised that any legislative immunity would not be retrospective.

A Director asked for the Executive Directors' views on the alternatives. All concurred with the view that Option 2 was the best for the Bank although there was a recognition that Option 1 offered the better coverage for an individual.

The Executive said that they felt it would be important that the Governors reassured staff about the degree of support the Bank would offer all staff in the Bank. The concern felt by individuals about their position was fully understandable even if there was no suggestion of having acted in bad faith. It was noted that the BCCI case had created great uncertainties for some ex members of staff for which there had not been any justification. With this in mind, the Executive thought it was imperative for the forthcoming legislation to address this matter.

The Committee endorsed the proposals.

4. **Monetary Policy Issues**

Court noted the submission of the monthly MPC report to Court for November and the discussion of the November Inflation Report.

5. **Northern Rock, Financial Markets Financial Stability, CRDs, Budget, IT Operating Model, business continuity annual report**

Court noted the discussions in NedCo of the above items

Any other business

None

The meeting of Court was closed.

**COMMITTEE OF NON-EXECUTIVE DIRECTORS (NEDCO)
SECOND MEETING**

Wednesday 15 November 2007

Present:
Sir John Parker, Chairman
Mr Carr
Ms Fawcett
The Hon Peter Jay
Sir Andrew Likierman
Sir Callum McCarthy
Dr Potter
Mr Rhind
Ms Rice
Mr Strachan
Mr Wigley
Mr Wilkinson

Absent:
Mr Barber, Mr Myners, Mr Sarin

Visitors (for whole meeting)
Mr Berkowitz
Dame Juliet Wheldon

1 Minutes of 12 September

Having been circulated were agreed for circulation to the Governors

2 MPC Non-Policy meetings

The contents were noted

3 Chief Economist's 2007 Questionnaire completed by MPC members

The format of, and questions contained in, the draft questionnaire was agreed by the Committee.

4 Role of Court Members, Conflicts and Delegations

By way of background, the Chairman reminded the Committee of the very helpful note on Director's responsibilities that had been provided by Dame Juliet Wheldon earlier in the year. However, it was viewed as important (especially in the circumstances of the current financial market turmoil) to remain refreshed about the NEDs responsibilities. There was a particular interest in understanding the background to current matters reserved for the Court and how certain delegations from the Court to the Executive were decided by predecessors. It was thought to be an important discussion prior to considering the Financial Stability processes and issues paper that had been drafted and circulated to members by two of the Directors (ie the following agenda item).

The desired outcome from these two agenda items was the formulation of an agreed list of (i) processes that NEDs felt they required knowledge of, (ii) information that they believed they should receive and (iii) debates and meetings where NED's believed their involvement was necessary in order to provide members with assurance on NED's oversight responsibilities in relation to FS. This would, in turn, drive the agenda and provide clarity for taking this matter forward. A further desirable refinement was thought to be an assessment of whether there needed to be a variation of requirements between periods when the Bank's Financial Stability operational role was being invoked and when the scenario was more benign (ie a 'wartime' and 'peacetime' model).

It was recognised that there were two factors that could affect the requirements of the NEDs oversight role on FS looking ahead – (i) whatever emerges from the HMT review of the Tripartite arrangements and (ii) lessons learnt within the Bank about the Northern Rock crisis. But NEDs agreed that those matters were for the future and should be separated from the current discussion.

Dame Juliet Wheldon and Len Berkowitz were invited to describe the important constitutional arrangements.

The first point emphasised for the Committee was that, because the Bank is established by Royal Charter, it is not regulated by the Companies Acts and there is no legal document that sets out all its powers. In that respect the Bank was unlike a PLC where the company's constitution established what it can do. The Bank started from the position that it is able to do anything that a natural person can do. It is necessary to look at its charter, and the special legislation that regulates it, to find the exceptions to that presumption.

It was noted that, significantly, the Bank of England Act 1998 does not set out the Bank's powers comprehensively and does not even mention financial stability. [Directors] were told that when the Bank had suggested that a financial stability objective might be included in the legislation, HMT had said the Bank's powers were adequate and there was no need, either as a matter of law or policy to define its financial stability role in legislation. There was even some concern that a statutory objective might reduce flexibility. Financial stability was, therefore, part of the general business of the Bank. It had long been among the Bank's key functions and was now regarded by Court as one of the Bank's two core purposes. The scope of the role is reflected in the MOU entered into between the Bank, the FSA and HMT in 1998 and updated in 2006.

The 1998 Act recognised that Court's primary function was to manage the Bank's affairs, other than the formulation of monetary policy. It also established NedCo, giving the non-executive directors a new status and some specific functions. But it did not give any detailed guidance about the Directors' duties or how those should be met.

The Committee were reminded that Dame Juliet Wheldon's note of 22 March (which had since been agreed by Freshfields and Clifford Chance) suggested that non-executive directors had analogous duties to those owed by Companies Act directors, in particular the duty to exercise independent judgment and the duty to exercise reasonable care, skill and diligence. As in a PLC, the role was essentially one of constructive challenge and oversight. But it was emphasized that there were differences between the Bank and a PLC and the standard applied to PLC directors could only be a benchmark and not a proxy.

Conflicts of Interest

One area was highlighted where there may be differences between a PLC and the Bank. This was in relation to conflicts of interest and confidential information, because of the range of sensitive information available in the Bank and the Bank's public role.

Directors were told that the rules in the 1998 Act about actual conflicts of interest were fairly flexible and did not, in themselves, seem to present any problem. Directors must declare an interest but (unless the matter touches or concerns them directly) they do not have to leave a discussion and could vote on the matter if the others resolve that the interest does not create a conflict.

But the Committee was told that confidential information may need care even if it does not produce a conflict. Some non-executives have appointments to which Bank confidential information is relevant, even if it does not create a formal interest and that produced a tension. On one hand HMT had appointed the non-executives because of their particular expertise and because they are people who can be trusted to behave scrupulously with confidential information. On the other, the Bank needed to be careful not to make such information available in a way which would be resented by those to whom it related, or perceived as giving the non-executives or their organisation some form of unfair advantage.

Although it was ultimately a matter for the non-executives concerned, the Bank needed to try and avoid putting them in a position where they, or a financial institution for which they work, could be accused of breaching the market abuse regime [in FSMA and the FSA's Code of Market Conduct] or the insider dealing rules [under the Criminal Justice Act 1993]. In practice non-executives were thought likely to be too senior to be involved in day to day trading decisions but they may be involved indirectly, for example through membership of risk and approval committees.

It was suggested that NedCo and the Executive might want to discuss this issue further, perhaps with a view to agreeing guidance. The Bank might, for example, ask non-executives to record the arrangements they have made with other organisations for which they work to avoid any perception of misusing information.

Some Directors noted that these issues had been discussed within their own {organisations}. In one case, the institution had realized there was a balance to be struck between upholding a rigorous conflicts regime and the practical implications that the very people you want participating in these discussions (because of their expertise) might, otherwise, have to absent themselves. Another Director noted that, for the Bank, other {confidentiality}/conflict issues arose in relation to the role played by the institution in the evolution of policy.

It was agreed that a specific discussion paper on processes and management of conflicts should be prepared for a forthcoming NedCo2 meeting – with the expectation that this would subsequently be discussed with the Executive in Nedco (**Action**: Juliet Wheldon)

The Executive continued with their presentation.

Delegation

Directors were reminded that the 1998 Act gave Court very wide powers of delegation and it was emphasised that a distinction could be drawn between general oversight and operational involvement. Non-executives had the same legal duties and objectives as Executive Directors but the law did not expect them to devote the same amount of time to the organisation's affairs or to have uniform knowledge and experience.

The general business of the Bank, including financial stability, has for many years been delegated by Court to the Governors. When Court passed a resolution to that effect in 1999, this simply made explicit what had been happening as far back as 1918 and earlier. But there are exceptions to the general delegation and Court has kept a varying degree of control, or involvement over, a number of issues. This is recorded in the Bank's main internal constitutional document: 'Matters Reserved to Court'. Both the Executive and Directors recognised that this document needed to be reviewed, made more user-friendly and, where appropriate, updated. It was noted that Secretary's Department had already initiated that process and, in consultation with the Legal Unit, would bring a revised draft to Nedco for discussion and agreement.

There was acknowledgement that there needed to be greater reference to Financial Stability in the Matters Reserved to Court document but that this could not be finalised until the current debate about the scope of NEDs engagement with FS matters had been fully resolved. There was recognition by Directors that a redrafted version could not, in any way, suggest that Court was delegating its oversight role in relation to Financial Stability.

Action: Secretary's Department and Legal Unit would continue to develop a revised draft of Matters Reserved to Court and would incorporate necessary issues relating to FS when the mechanics of Court's oversight were agreed.

Financial Stability

In the absence of any direct reference in the 1998 Act, it was suggested that the best starting point when thinking about how Court should discharge its responsibilities in this area is the Tripartite MOU.

The Committee was told that the MOU established a framework for co-operation between the Treasury, the Bank and the FSA, describing the role of each authority and explaining how they are meant to work together, both in normal conditions and in a financial crisis. The framework was non-statutory but created public law obligations. Were the Bank to ignore these, it could in theory be challenged in judicial review proceedings.

Directors were told that, consequently, members of Court needed to be satisfied that the framework was a workable one and that the Bank was discharging, or was capable of discharging, the functions described in the MOU, including formulating a Bank view about the need for, and terms of, support operations.

As to how Court was to fulfil that role, it was suggested that this involved formulating strategy and objectives for the financial stability function and appropriate arrangements for monitoring performance against them. That, in turn, led back to the issue of delegation, the MRC and the need to find a balance between informing Court, consulting Court and seeking Court approval. The ultimate objective was to see that the financial stability work is done and is subject to adequate monitoring and controls.

It was suggested to Directors that, even in normal conditions, there was a balance to be struck between, at one extreme, leaving the Governors to run the Bank without proper oversight and, at the other, becoming immersed in operational decisions.

In abnormal conditions, operational decisions might need to be taken very quickly, on the basis of particularly sensitive information, and if a support operation was being considered, ultimate responsibility rested with the Chancellor.

Traditionally, the Governor enjoyed a unique role in a financial crisis and the Chancellor relied on his personal advice and authority. Were Court to feel that they were not getting enough information to exercise their oversight role, it would be open to Court to ask for more. But the Governor's response involved a judgment as to how he should exercise his own responsibilities, in the light of the obligations of the Bank and role of the Chancellor under the MOU.

It was suggested that one option that Directors might consider would be to approach the Treasury and seek their views about where the balance should be struck, given that they are responsible for the legislation and for the MOU, own the Bank and appoint all the members of Court.

In the discussion that followed Directors agreed that the tension between oversight and operations was a difficult one – but a strong opinion voiced was that they did not want, or need, to be involved in operation matters covered within the MoU. But the Directors recognised that the MoU was likely to change as a fall out from the current Northern Rock crisis. In one Director's opinion the main change to the MoU would be to paragraph 14 where there was felt to be, specifically, some ambiguity about the way in which liquidity should be provided to markets as a whole in a crisis scenario.

Finally, in the context of Northern Rock, Directors were told that Clifford Chance had prepared a short note about legal issues relevant to Court and a summary of advice on the legal risks. This, together with a detailed note about the legal documentation, was available to be read in Juliet Wheldon's office. Dame Juliet Wheldon and Len Berkowitz were thanked for their presentation.

5 Financial Stability – Criteria for Governance Working Group

The Committee turned their attention to the issues arising from the draft note from two of the Directors, but noted the interconnectivity to the previous agenda item.

The authors presented the key findings

Directors were told that the paper had sought to separate the specific, policy related question about governance of financial stability from the shorter-term (but highly significant) governance related issues that might flow from the ex-post review of the Northern Rock crisis.

There were three issues discussed in the paper that one of the authors sought to highlight for the Committee. Firstly, on information provision - there had been a divergence of views amongst Directors who had voiced an opinion, about the extent to which monthly or quarterly information about the financial stability function should be presented to NedCo. Secondly, as had already been highlighted in the previous agenda item, the conflict of interest issue was a concern to some Directors and clearly needed to be addressed. The third matter was around the extent to which Directors should be entitled to attend/participate in any meetings within the Bank. There was a view expressed that Directors should have greater access to allow themselves to become better informed to what is going on.

The second author noted three further points. Firstly, that the paper's first proposal – ie that Court needed to decide which financial stability matters should be reserved to it and where major issues/decisions needed to be discussed – was in harmony with the earlier discussion on Matters Reserved to Court. Secondly, the Committee's attention was drawn to the proposal number 4 – ie that there should be a written briefing for NEDs on the mapping arrangements for financial stability. In summary, that should start with the Bank's strategic FS objectives, should explain the processes and mechanics that are involved in achieving those objectives and then how there is reporting back to Court. Finally, it was suggested that there needed to be greater briefing to Court about Tripartite activities; this was thought to be especially important in the context of proposed revisions to the MoU.

One Director said that he agreed with most of the issues raised in the paper – but with two caveats. Firstly, he felt that it was important that there was a need for some negative statements, ie an expression of what the NEDs did <u>not</u> seek to do. For instance, not seeking to participate in the execution of operations, not 'back seat driving', and not seeking to second guess the Executive and take decisions about operations. It was suggested that that division needed to be made exceedingly clear, not least because NEDs may need to rely on it should they be called to explain themselves. His second concern was about timing in that if the NEDs sought to adopt all of the recommendations in the paper, this could appear as some form of action against the Executive in relation to perceived failings over Northern Rock – whereas the genesis of this report was, in fact, entirely unconnected and from a much earlier date.

Those points were recognised but the Committee was told that the Governor was very keen for the NEDs to produce a paper explaining what it is, in a Financial Stability context, that Court wants to be involved in and how the Directors feel that they can feel satisfied that their commitments are met. It was reported that the Governor also wanted Court to debate the lessons learnt on the current crisis and situation but it was recognised that it was too early for that.

The Chairman emphasised his view that in order to manage the agenda better it was imperative to set down the specific inputs the NEDs actually wanted to see implemented in order to fulfil their Financial Stability oversight obligations.

In summarising **actions**, the Chairman indicated that he would take away the points made during the discussion and try to produce a draft list of the influences that NEDs had indicated they would wish to see (or which need resolution) and which could then be debated. Additionally, the 'mapping' exercise referred to earlier should certainly be taken forward with the Executive and there needed to be a far better understanding of the linkages between the Bank, the FSA and HMT. Once this has been done and discussed by the Committee there should be far more clarity about what changes needed to be made to Matters reserved to Court in a Financial Stability context.

6 Any Other Business

None

COMMITTEE OF NON-EXECUTIVE DIRECTORS (NEDCO) MEETING

Wednesday 12 December 2007

Present:
The Governor
Sir John Gieve – Deputy Governor, Financial Stability
Ms Lomax – Deputy Governor, Monetary Policy
Sir John Parker, Chairman, NedCo
Mr Carr
The Hon Peter Jay
Sir Andrew Likierman
Sir Callum McCarthy
Mr Rhind
Mr Sarin
Mr Strachan
Mr Wilkinson
Mr Wigley

Absent:
Mr Barber, Ms Fawcett, Mr Potter, Ms Rice

Also attending:
Mr Bailey, Mr Bean, Mr Footman, Mr Jenkinson, Mr Jones, Mr Tucker, Dame Juliet Wheldon, Mr Brierley (for item 7)

1. **Minutes – 15 November**

Approved

2. **Matters Arising**

None

MANAGEMENT OF THE BANK

3. **(i) Executive Report**

The Governor presented this item.

Recent and forthcoming meetings and events

Domestic:

- Treasury Committee appearance on the November Inflation Report with Rachel Lomax, Charlie Bean, Tim Besley and Danny Blanchflower, Thursday 29 November.
- Treasury Committee appearance on Northern Rock with Sir John Gieve, Tuesday 18 December.
- Regional Visit to the South East, Thursday 20 December.
- Breakfast meeting with the Chancellor, 19 December.

International:

- G20 and BIS meetings in South Africa, Thursday 15 November until Monday 20 November.
- Sir John Gieve led the Bank's team visit to New York, 10 & 11 December.
- BIS Meetings, Sunday 6 and Monday 7 January.

It was reported that since the last Court there had been a number of meetings between Principals of the Tripartite authorities and also separate meetings with the Chancellor.

A useful meeting with Karen Dunnell, ONS had taken place on Tuesday 4 December. Discussions had included the challenges faced by the ONS in their move to Wales and the work they planned to do on migration. There had also been discussion about the progress towards reforming the national accounts. Directors heard that the Executive had been slightly concerned about pace of progress reported.

Transactions Committee (the extreme sensitivity and confidentiality of this item was emphasised)

The Committee were reminded that Court had previously established the Transactions Committee to discuss possible transactions between the Bank and individual financial institutions. Directors were told that a meeting of the Committee had taken place on Monday, 26

November and had agreed a transaction with a small institution (one of a number of potentially vulnerable institutions that had been monitored closely).

The institution had established a substantial target figure of longer run funding that it needed to raise in order to eliminate their need to raise funds daily in the money markets – with the inherent uncertainty of being able to do so under current market conditions. Their expectation had been that this would secure the position through to the beginning of Q3 2008. As part of the arrangements being put in place, a loan agreement with a commercial bank had been arranged for £4 billion – however, that was conditional on the entire target package of funding being in place. But there had been no prospect at that point that the institution seeking to raise the funds could secure the further £3 billion and, as a consequence, the £4 billion facility, and the wider funding package, was at risk.

The Transaction Committee considered a proposal that the Bank of England would provide £3 billion as a collateral swap (ie not an outright loan). There would be haircuts on the collateral of assets provided by the institution that was ineligible in our normal operations in return for eligible assets. We would provide gilts to that institution which they could use either to borrow in the market or in the Bank's Open Market Operations.

In making that facility available both the Bank and the FSA had emphasised to the institution that it should not slow down on any discussions which it was having with prospective partners in terms of a corporate takeover. The Transactions Committee had approved the Bank's Executive to enter into the collateral swap.

The Executive said that it was possible that they may need to revert to the Transactions Committee to discuss another possible operation but would, of course, report back to NedCo if that was the case.

A Director asked about the public relations difficulties surrounding this facility that might arise when the arrangement became known. The Executive suggested that there was no obvious reason for the transaction to become public; its existence could not be deduced from the Bank's balance sheet. Nonetheless there were dangers of a "leak" which could undermine the market position of the bank in question. In due course the Bank would have to consider whether to publish a general description of the transaction. But even general disclosure might make it harder to intervene effectively in future.

Finally, one Director asked whether the type of facility that had recently been sanctioned by the Transaction Committee would have saved Northern Rock from its perilous position. The Executive noted that Northern Rock's problems had required financial restructuring on a completely different scale from that which had been sanctioned by the Transaction Committee.

Coordinated Central Bank Action in Short Term Funding Market

Directors were briefed on a market announcement to be made at 2:00pm. They were told that a key topic of discussion at the BIS meeting in Cape Town had been the absence of co-ordinated actions by central banks during the crisis. It had been noted that there had been a decline in sentiment largely linked to concerns about the capital position of institutions (including the largest players) in the banking system, the liquidity of markets and mounting tensions as the end-year approaches. It was emphasised that these were different concerns from the liquidity worries in August and September.

The central banks had now decided to announce a co-ordinated set of money market operations. This would cover the Federal Reserve Board, the ECB, the Swiss National Bank, the Bank of Canada and the Bank. The Committee was told that the nature of the operations would vary from central bank to central bank depending on their method of operation and timing of their auctions.

The operation was largely focused on improving confidence. It was noted that 3 month Libor spreads relative to the expected policy rate were similar in the financial centres. The operation was not related to implementing monetary policy as extra reserves injected would be offset in the Bank's routine monetary operations.

The action was being taken to address the credible scenario that saw a serious downturn in the world economy inevitably leading to losses in the banking system. This, coming on top of the losses that may result from the current repricing of complex financial instruments, would pose a challenge to the capital base of the banks. The central banks had resolved to address the confidence issue and demonstrate that the central banks are working together.

Although they supported the action, the Japanese central bank would not be undertaking any operations because their Governor had said there were no such money market problems in Japan.

The Bank would be announcing that it would be conducting two auctions - on the 18th December and 15th January (ie dates on which we normally conduct our long term repo open market operations). Instead of a relatively small amount of money, £10bn on both dates would be offered at the 3-month maturity. The Bank would accept a wider range of high quality securities as collateral against funds advanced at the 3-month maturity. The Bank would not take raw mortgages, but marketable instruments like mortgage and other high quality asset backed securities. It would be a variable rate tender.

The Committee heard that the operations conducted by other central banks would differ slightly. The US and Canadian authorities would be undertaking one month operations and the ECB and SNB would conduct their auction in US dollars rather than Euros or Swiss Francs.

Noting that this was a coordinated operational action, one Director asked how far the central banks might go to coordinate policy in future. There was a view expressed that it would be difficult to get agreement to ongoing policy co-ordination as the US authorities had traditionally been reluctant to argue the policy has been co-ordinated. Equally, the ECB would be against it because they have consistently sought to distinguish anything that is done in terms of money market operations from monetary policy. Directors were told that the US, Canada and the UK had recognised, and were speaking about, how the vulnerabilities were now around what would happen in the world economy, and not just the US. It was unclear if the European central banks were yet focused in the same way.

Another question was about prospects for success of the two auctions being announced today, bearing in mind there was no take up of the Bank's earlier term auction. It was explained that when the previous auction had been announced, the spread between the Libor rate and official rate had been sufficiently wide to make it a viable offer – but in the event spreads narrowed towards the auction. The present level of market spreads suggested that there would be take up of the facility, and the auction would not have a minimum rate or spread. The Executive also emphasised that the Bank would have to undertake sterilisation operations after the auction in order to offset the injection of reserves.

(ii) <u>Northern Rock Update</u>

Sir John Gieve and Andrew Bailey introduced this item.

The Executive highlighted the main points from the paper that the Committee had seen. In their view the prospects for resolving the Northern Rock crisis as a merger/acquisition outcome appeared to be declining. There were now just two bidders; Olivant which appeared to be favoured by the shareholders and Virgin whom the company had given preferred bidder status. The process was scheduled to run until the middle of February.

Resolving the financial aspects of the bids was identified as the key source of pessimism about the prospects for this form of resolution. Firstly, raising finance would be difficult because of the damaged business model. Secondly, because there was an ongoing loss of retail deposits. Directors were told that there had been a further mini run on the bank in November when £2bn of retail deposits had been withdrawn – and which added to the financing requirement. The challenge would be to refinance against the fixed amount of collateral available. There would be reliance on wholesale financing, whether it came from the Bank or the private sector, and that would become more difficult as the borrowing requirement continued to increase relative to the collateral.

Given the increasingly difficulties in a private sector solution, it was becoming important to have a well developed 'Plan B' – and it now seemed that nationalisation, rather than administration was the better option. One strong argument against insolvency was the absence of a special resolution regime for UK banks. An administrator is a court officer and has to act independently. The expectation was that the active shareholder groups would fight against the administration process and, in doing so, might create a further run of the remaining depositors

Nationalisation would require specific emergency legislation. Northern Rock would be put into public ownership and the shareholder rights could be overridden. But it was recognised that this option was not likely to be easy politically and would also raise risks of depositors taking fright.

The Committee were told that the Bank, within the Tripartite grouping, was seeking to firm up thinking about the 'Plan B' and especially to foster a recognition that a plan for nationalisation should not simply be drawing up legislation to put through Parliament. The plan needed to go further and there needed to be agreement on what to do with the institution post nationalisation. Issues like how it would be governed and managed needed to be decided. Similarly, what would be the strategy, ie to hold and run down, to sell it, or to restructure?

Directors recognised that there would be a tension between the interests of the three sets of stakeholders, ie Northern Rock, their shareholders and the Government and were keen to know how the Bank would minimise its exposure.

The Executive emphasised that the Bank's financial exposure was covered by the Government guarantee. However, it was acknowledged that nationalisation and administration options could increase the risk of litigation. The Committee recognised that the difficulties and risks reflected the fact that the UK does not have a suitable legal regime to properly address these problems.

A question was asked about the resource capacity of the Bank to cope with a scenario that saw a number of banks in crisis conditions akin to Northern Rock. Whilst the Executive did not perceive that as a likely scenario, it noted that some of the work on Northern Rock had been devoted to analysing the technical issues and building plans of action; there had been no blueprint in place. Much of that could be used again in another case. Nonetheless, dealing with a further case would stretch the Bank's resources , even allowing for the heavy use of professional outsiders (lawyers, accountants, PR advisers and investment bankers). That would inevitably lead to the deferral of some other work.

(iii) Update on Financial Markets

Mr Tucker introduced this item.

Asset backed securities markets were still impaired. The chart of US mortgage backed securities (top left, p1) demonstrated the significantly increased amount of downgrade activity by the credit rating agencies in the last six weeks

That had given rise to greater levels of uncertainty of valuations in banks. There had been a lot of variation across the largest banks in the world over recent weeks about how they were valuing their assets. Some major banks had {had} to raise capital – it was estimated that something around $20 billion had been raised so far although, anecdotally, views amongst some of the larger banks had been that up to $100bn could be required.

The Committee were briefed on developments in the Bank's balance sheet. Commercial banks had increased their reserve requirements again in the latest month - an increase of about 37% since August. It was noted that the UK system was the one where that was possible, so extra reserves were being injected into the system as demanded. Attention was drawn to the chart which showed that there were now no short-term repos left on Banking Department at all - the reason being that the £25 billion being lent to Northern Rock was largely being offset by reducing short-term repos.

Good progress was being made on persuading HMT to replace 'Ways and Means' with gilts or cash.

A question was asked about the fact that short term repos on Banking disappeared in November – was that a concern? The Executive agreed that it was not ideal but was not a significant worry so long as the Bank was able to develop a mechanism for draining reserves through the issue of, say, one week bills.

The Executive noted that year end was a vulnerable period and so they were monitoring the position carefully as well as providing some technical flexibility in the money markets by having recently undertaken repos that mature in the early New Year.

4 Financial Stability Paper from Nedco 2

Sir John Parker introduced this item

The Committee were told that the paper summarised the inputs by which the Non Executive proposed to obtain the information about the Financial Stability function such that they would be able to sign off on their oversight responsibilities. The proposals were the product of considerable discussion amongst NEDs at Nedco2 and had been formulated in consultation with members of the Executive. The Legal Adviser to the Governor had reviewed the proposals and had confirmed that the proposals would allow the NEDs to discharge their responsibilities.

The Committee agreed the proposals. The next actions were for Matters Reserved to Court document to be updated and brought back to Court for approval, and the schedule of inputs to be assessed and worked into the forward agenda for 2008.

5 Strategic Priorities

The Governor introduced this item.

The Committee were reminded that Court agrees the Strategic Priorities annually as part of the annual budget process. Minor wording and drafting changes had been made for this year but otherwise there were no significant changes proposed. Attention was drawn to strategic priority No 8 and the acknowledgement of the need to establish clear priorities for HR for performance measurement.

There was a brief discussion about the extent to which 'lesson learnt' from the recent financial market turmoil should be reflected in the strategic priorities. It was agreed that the Executive would reconsider SP6 with a view to reflecting the work that the Bank might have to undertake eg in relation to influencing new policy arrangements on deposit protection and work in relation to the tripartite arrangements.

6 Cash Ratio Deposit Negotiations Update.

Mr Jones introduced this item.

The Steering Committee dealing with the CRD review had met to discuss the response to the consultation exercise. In summary, the draft response was to make no change to the scheme except to revise the percentage of eligible liabilities from 0.15% to 0.11%. Some further changes to the draft response were being made to meet the concerns expressed by some respondents - particularly emphasising the fact that the scheme is reassessed every 5 years and can be kept under review during that period. The redrafted document was expected from HMT shortly.

The original timetable was for a statutory instrument to be laid before Parliament with a debate taking place in January or February prior to going to the House of Lords. However, as had previously been suggested, that timetable was now at risk. That plan had been at the Bank's request so that, ideally, the new arrangements would formally be in place by the time the Court signed off the budget in February. That was unlikely to happen now but the legislation would need to come in to effect by the beginning of June which was the next refixing point for CRDs.

Directors were told that the Bank needed 2 to 4 weeks to prepare so the legislation needed to be passed by the beginning of May in time for the next refixing. If it did not come into effect on the second June we will continue with existing arrangements and the higher level of CRD income.

7 Reform of the Tripartite Arrangements

It was explained that Sir Callum McCarthy would not be present for this discussion. Similarly, Sir John Gieve would not participate in the equivalent discussion at the FSA.

The Governor introduced this item.

He said that the Tripartite authorities were in the odd situation of having to try and learn lessons and draw conclusions whilst in the middle of managing the crisis. It was not an ideal situation but the Chancellor was keen to have an assessment of lessons learnt in the early New Year so that the debate can move on.

Most other advanced countries were also reflecting on the lessons of the financial turmoil. However, unlike in the UK, they were focusing on the wider macro level issues to be addressed in the banking system and the wider economy rather than on the narrower focus of why Northern Rock failed. That was because those countries already had sufficiently robust resolution frameworks. This was a case where the UK could learn from others.

Three key lessons from the Northern Rock crisis were highlighted for the Committee. Firstly, the need to create a special resolution mechanism whereby direction of failing banks could be taken over before they become insolvent, overcoming the blocking powers of shareholders. Secondly, we needed to improve our Deposit Protection Scheme so that it reassured depositors more effectively in future. Thirdly, we needed to improve the regime of liquidity regulation. Directors were told that the Bank and the FSA were working closely together on that, given the close links between the liquidity of assets and their acceptability in Central Bank money market operations.

The Executive suggested that criticism of the Tripartite arrangements had become shorthand for criticism of wider arrangements. In fact much of the MOU had worked reasonably well. The FSA had stepped up its monitoring of individual institutions as the market turmoil developed, the Bank maintained enough liquidity in the money markets to keep the rate close to the bank rate and both the Chair of the FSA and the Governor wrote letters to the Chancellor with recommendations about support for Northern {Rock and} the Chancellor had authorised the Bank's support. Nonetheless improvements could be made in clarifying the Bank's role at times of stress and the paper set out some proposals.

In particular, as conditions deteriorated the Bank needed to become more closely involved in the monitoring of banks and to open direct discussions with them on their funding proposals and tactics. The MOU's clear implication that it was only for the FSA to deal directly with and collect information from individual institutions needed to be revisited. The paper suggested that it would be sensible to have triggers for levels of escalation and threshold for specific institutional involvement.

Directors were told that a review of Money Market operations would be undertaken in the New Year and that external advice on auction procedures would be sought. It was anticipated that this would lead to a new version of the Red Book.

The Executive said that there had inevitably been some tensions within the tripartite, for example over the role of market wide operations, because the different institutions had different interests and outlooks. Unfortunately some of those tensions and disagreements had come out in the press and media. That had not been from the Bank.

Given the pressures for rapid legislation, the Treasury and FSA had been attracted to a smaller reform package not involving a new insolvency regime for banks. The Bank team was continuing to press the case for a full reform. The acid test was whether any new legislation, if enacted, would have provided the Tripartite authorities with other options for resolving Northern Rock in a more orderly fashion.

There was a discussion about the feasibility of implementing a system of risk related contributions to the Deposit Protection scheme – one Director was sceptical about the possibility. The Executive pointed to the US as an example which worked but added that the more important factor was to have a robust resolution management framework in place.

One Director voiced support for the overall thrust of the 'lessons {learnt}' paper but had concerns about the blurring of the edges of 'who does what and when'. If the Bank became more involved in data collection or visiting banks, would the Tripartite not run the risk of losing clarity of responsibility? The Executive agreed that the FSA and Bank would have to work together to minimise compliance burdens and to define clearly when arrangements would change from "peacetime" to "wartime". This needed further discussion with the other members of the Tripartite in due course.

Another comment from the Committee related to Communications. Multiple voices could create problems. There was a view that there needed to be greater clarity as to who speaks to the market at large in respect of action being taken. The Executive acknowledged that this was one of the most awkward issues. The principles in the MoU required the separate members of the Tripartite to answer for their own responsibilities. There were attractions in a crisis in having a single lead voice. However it was important that this did not muddy the clear allocation of responsibilities for decisions or to give the impression that the Treasury could take over supervisory responsibility for a bank or for implementing monetary policy.

A Director said that the Government may want to take control of decisions on market wide operations to diffuse a financial crisis. The Executive noted first that the overall impact of money market operations had to be looked at together and all could affect the implementation of monetary policy. Secondly, there was no other central bank in the world that suffered from that level of interference – the Government would look foolish if they sought to intervene in that way.

Another Director noted the suggestions that the Bank might receive more data on individual institutions but, referring back to the discussion about decisions taken by the Transaction Committee, asked if the Bank was already receiving such data and, if so, were the FSA content? It was confirmed that following the Northern Rock rescue, the Bank had set up new arrangements with the FSA to collect more liquidity reports on a number of banks which followed a Bank template.

On the wider question of lessons learnt, a Director asked whether the Bank was as fully prepared as it should have been. If we knew we did not have a mechanism to prevent a Bank run why had we not taken action to resolve that omission? The Executive said that the problem had been identified by the Bank and the preliminary work had been undertaken in the Bank. Earlier in 2007, the Treasury had agreed to set up its own team to draw up proposals for legislation. If there had been a fault it had been in not anticipating how urgently the reform was required.

The Executive thanked the Committee for their contribution to the debate. Comments would be considered and integrated into the paper as appropriate. Directors were told that the Chancellor was expecting the paper before Christmas.

The Executive were told that the submission would go with the full backing of Court.

8 Staff Pay Review

The Committee considered the proposal for an overall settlement of a 2% Satisfactory Performance Award, 3.5% discretionary merit award and a 7% bonus pot. Directors were content with the overall figures proposed but questioned the logic of a 2% across the board component. Several members of the Committee believed it would be better to allocate that on a discretionary basis as well. Others thought that an across the board could be warranted only if the Bank was able to point to equivalent productivity gains. Whilst the Executive recognised the basis of the arguments, they believed there were practical and motivational reasons why they would prefer to keep the across the board award. The Committee sanctioned an overall salary increase of 5.5% and 7% bonus, with the Executive having the discretion to decide how it was allocated.

9 HR Strategy – Where Next?

Ms Redmond presented this item.

By way of introduction, the Committee's attention was drawn to the four areas where the Bank would be putting more effort, (i) recruitment; having a better presence in the market for experienced hires, (ii) active talent management; managing and focusing the careers of, particularly, the Bank's best people. (iii) Improved performance management was required – this linked with the ET priority to enhance individual accountability and performance management, (iv) looking at the components of our total reward package.

On performance management one Director felt that something proactive was necessary to encourage management to give honest assessments. Anecdotally, he recalled one Government department that had, for a time, released the bottom ranking 10% of its staff annually. That was a fairly extreme example but it focused minds on honest feedback and performance management.

There were a number of other observations. The Bank had made valiant efforts to retain good staff but were the Bank's pay scales really competitive enough? On development, could the Bank make more use of the CCBS facility to train its own staff? Why not call on NEDs to participate in mentoring schemes for senior staff?

Other Directors felt there needed to be more measurable performance criteria to determine progress in HR rather than just having a sense of having made progress – that was accepted by the Executive.

There was a brief discussion about the benefits of horizontal moves for staff to gain experience. That was seen as a good way for staff to gain experience. The Executive felt that Bank staff, generally, recognised the advantages of moving horizontally for their longer term benefit.

10 Bank's approach to handling confidential third-party data

Rachel Lomax introduced this item and John Footman presented.

[redacted]

[redacted]

[redacted]

[redacted]

11 Report from Audit Committee

The minutes were noted. The Committee had been debriefed on matters arising previously.

ITEMS FOR INFORMATION

12 MPC Report to Court

Mr Bean's paper was noted

13 Health & Safety

Noted

14 Any other business

None

MEETING OF THE COURT OF DIRECTORS

Wednesday 12 December 2007

Present:
Mr King, Governor
Sir John Parker, Chairman, NedCo
Sir John Gieve, Deputy Governor – Financial Stability
Ms Lomax, Deputy Governor – Monetary Policy
Mr Carr
The Hon Peter Jay
Sir Andrew Likierman
Sir Callum McCarthy
Mr Rhind
Mr Sarin
Mr Strachan
Mr Wilkinson
Mr Wigley

Absent:
Mr Barber, Ms Fawcett, Mr Potter, Ms Rice

Also attending:
Mr Bean, Mr Bailey, Mr Jones, Mr Footman, Mr Jenkinson, Mr Tucker and Dame Juliet Wheldon

1. **Minutes – 15 November**

Approved.

2. **Monetary Policy Issues**

Court noted the submission of the monthly MPC report to Court for December. .

3. **Update on Northern Rock, Update on Financial Markets, Strategic Priorities, FS paper from NedCo2, Reform of the Tripartite Arrangements, CRD Review, HR Strategy, Staff Pay Review, Bank's approach to handling confidential third-party data and Audit Committee**

Court noted the discussions in NedCo of the above items

4. **Any other business**

None

The meeting of Court was closed.