

## COMMITTEE OF NON-EXECUTIVE DIRECTORS (NEDCO) MEETING

**Wednesday 16 January 2008**

Present:

Sir John Parker, Chairman  
 Mr Brendan Barber  
 Mr Roger Carr  
 Ms Amelia Fawcett  
 The Hon Peter Jay  
 Sir Andrew Likierman  
 Sir Callum McCarthy  
 Dr David Potter  
 Prof David Rhind  
 Ms Susan Rice  
 Mr James Strachan  
 Mr Geoffrey Wilkinson

Absent:

Mr Sarin, Mr Wigley

Also attending:

The Governor, Sir John Gieve, Ms Lomax, Mr Bean, Mr Bailey, Mr Footman, Mr Jones, Mr Tucker

**1. Minutes – 12 December**

Approved.

**2. Matters Arising**

None.

## MANAGEMENT OF THE BANK

**3. Executive Report**

The Governor introduced the item.

Recent and forthcoming meetings and events

Domestic:

- Treasury Committee appearance on Northern Rock with Sir John Gieve (18 December);

- regional visit to the South East (20 December);
- regional visit to the South West, including a speech in Bristol (22-23 January);
- regional visit to the North West (30-31 January);
- Inflation Report and press conference (13 February).

#### International:

- BIS meetings (6-7 January);
- G7 meetings in Tokyo (8-10 February).

A tripartite meeting with the Chancellor and Sir Callum McCarthy, which the Prime Minister had joined for part, had taken place on 19 December. A breakfast meeting with Gus O'Donnell had been scheduled for 25 January. A breakfast meeting with the Chancellor and telephone discussion with Nick Macpherson had both been scheduled for 29 January.

#### Chancellor's response to the Bank submission on lessons for the Tripartite Authorities

It was explained that the likely timetable for the consultation document to be published was the following week (subsequently published on 28 January). There had been extensive discussions about the scope of the proposals and it was likely that they would include consultation on the need for a special resolution regime for banks as the Bank had suggested. It was noted that there had yet to be a discussion about the reforms of the tripartite arrangements that the Chancellor was minded to make.

#### Loomis update

It was reported that Loomis had been replaced as a member of the Note Circulation Scheme by Vaultex on 24 November 2007. Vaultex was a new joint venture company, wholly owned by Barclays and HSBC. KPMG's view was that the estimate of the maximum initial loss had risen to £28mn, although the figure needed further fine tuning. The Bank was currently being refunded on a monthly basis by Securitas. Securitas were keen to end the cost of the KPMG investigation and therefore the Bank had offered to settle at £28mn. [REDACTED]

#### Staff

[REDACTED] joined the Bank on 2 January to become Head of Risk Oversight Unit, part of the Projects, Risk and Performance Division in Finance. [REDACTED]

[REDACTED] He takes over from [REDACTED] who had acted as interim head for the past 10 months.

#### Paul Myners – leave of absence from Court

It was reported that Mr Myners had requested that his leave of absence from Court be brought to an end now that JC Flowers had withdrawn from the bidding process for Northern Rock. The Governor had replied following discussions with Sir John Parker and Dame Juliet Wheldon. It was considered premature for Mr Myners to return to Court in January ahead of a discussion about the matter with Directors.

It was felt that there was no absolute guarantee that JC Flowers had withdrawn completely from its interest in Northern Rock. It was reasonable to think they might re-enter discussions if circumstances changed. In such circumstances, a further period of absence would be desirable. It was thought that if Mr Myners returned to Court now, it would be necessary for him to give an undertaking that he would play no further role with JC Flowers. It would not be acceptable for Mr Myners to return and subsequently have to stand down again. Directors were not comfortable for a member of Court to have access to information knowing that a potential future involvement remained a possibility. But it was also felt that it was not ideal to leave the situation open-ended. Legal advice at the time of the original decision was that a Director could not stand aside from Court indefinitely. So the situation should ideally be resolved rapidly. There was a suggestion that Mr Myners should either return or stand down as a Director, the former being the strong preference.

It was agreed that Mr Myners would be invited back on the basis he gave an assurance that he would have no further involvement with JC Flowers or any other entity in relation to Northern Rock. The Governor and Sir John Parker would consult further with Mr Myners.

#### Northern Rock update

Sir John Gieve introduced the item.

It was reported that Northern Rock had been trying to stem, with some success, retail outflows and ensure that asset quality remained high. The company had also been working on plans for a rapid pay out of depositors' money with the Bank's team. In relation to the private bids for the company, it was explained that it had been apparent before Christmas that neither of the bidders had secured the bank finance they needed in the original structure of their offers. Therefore, Goldman Sachs had been asked to investigate alternative financing options.

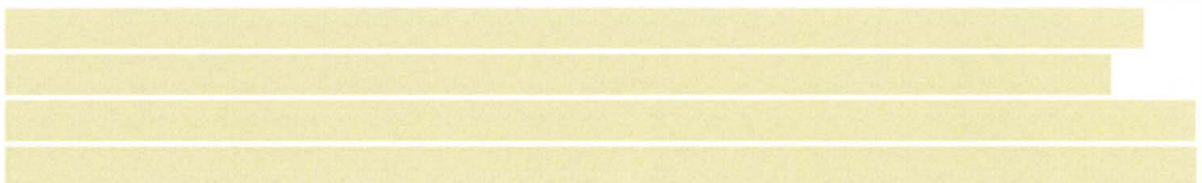
It was reported that the authorities were now intensively examining options, either to secure the recovery of the company in the private sector, including the company's management proposal to slim its balance sheet and recover under its own steam; or, alternatively, to nationalise Northern Rock. It was clear that a private sector solution would require continuing public support both in

the form of financing and a continuing guarantee to depositors. This would raise ongoing state aid issues and risk public sector exposure over a long period of implementation (during which state aid clearance would need to be obtained) when circumstances would inevitably change. In that respect, nationalisation might be cleaner but involved sizeable political and business risks.

It was highlighted that the current search for a resolution was being undertaken in the absence of a special resolution regime for banks. The consequences of that meant the authorities were in something of a game with other players, including the shareholders. The preference remained a private sector solution but it was necessary to have a credible plan B to ensure a better plan A outcome. The authorities needed to create leverage over the shareholders in order to achieve a resolution in the absence of the special regime. Nationalisation was an option to deal with shareholders – and some pressure had been applied ahead of Northern Rock's emergency general meeting on 15 January through the announcement that Ron Sandler would act as chair of a nationalised entity. The principal lever was through the financing. It was explained that there could not now be a purely private sector solution given the financing needs and the assets available. The financing options proposed by {Goldman} Sachs required a Government guarantee. Issuing bonds could repay the entirety of the Bank's lending to Northern Rock. Alternatively, the current loan facilities would remain to help finance a solution and would then be paid down organically as Northern Rock reduced its balance sheet as its mortgages matured. The authorities were mindful of the risk of a need for ongoing financial support. An announcement about the financial options was expected fairly soon (subsequently announced on 21 January).

Directors were informed that the Bank's existing lending facilities for Northern Rock would need to be rolled over beyond mid-February (12 February) until state aid clearance was granted for the new financing arrangements. A submission had to be made on the proposed restructuring to the European Commission by 17 March. The Commission would then launch an enquiry which, under an accelerated timetable, would take around four months. It was stressed that no financial restructuring could happen until state aid clearance was in place. The concern was that over that time period, those that had committed themselves to the Goldman's package would start to ask for renegotiated conditions in the light of changed circumstances.

It was also reported that work to ensure a rapid payout of deposits should the need arise had progressed well and was at the stage of final testing.



In discussion, it was noted that nationalisation only dealt with the legal position of Northern Rock's shareholders, nothing more. It was agreed that it would be crucial to have a clear post-nationalisation plan that addressed the company's future and ability to repay its debt. The Bank and the FSA were concerned that the Government's view was that the board of the nationalised entity would determine the company's strategy after nationalisation. It was stressed that nationalisation was not a substitute for the need to have a plan for the company. Rather it was a means of getting to the point where the future plans for the bank could begin. The Governor and Chairman of the FSA planned to make this point to the Chancellor.

In response to a question about why the Government needed to make a decision in the next few weeks rather than test out the Goldman Sachs' proposals, it was explained that potential bidders would need to consider the financing structure and revise and confirm their bids, and how much they would be prepared to offer in equity. This would then enable a decision on the bidders ahead of having to make a submission to the European Commission about the restructuring plan. The current state aid permissions lapse on March 17<sup>th</sup>. It was thought that the bidders would not need a great deal of time to consider the proposals given what was on offer and the alternative of nationalisation. The choice for shareholders was to agree to a capital injection or face the prospect of a valuation of the company in the absence of official support, which would be very small.

It was asked when the Bank and FSA would make their views clear to HM Treasury about the need for a plan post-nationalisation. It was agreed that the situation had reached an important juncture. It was vital to have a clear notion of what public ownership would do; whether the plan was to slim down the company, run it down and return depositors' money, or run it with a view to a sale. The concern was that the absence of a clear plan would create uncertainty amongst depositors and risk another retail run.

It was pointed out that while it was true that nationalisation did not itself solve the company's problems, it did open up another option. It would enable a fresh bidding process without the shareholders and with the Goldman Sachs financing option on the table. That might encourage JC Flowers or others to enter the bidding process at this stage. An alternative would be to transfer the depositors to another bank and run down the rest of the assets though it was acknowledged that that would be a more difficult political message to convey.

In response to a question, it was clarified that the FSA continued to be satisfied that the company met its solvency requirements. There was a discussion about the role of new equity for the



company and the position of bond holders. It was noted that the private sector recovery option was seeking to ensure that shareholders (existing and new) subscribed more equity to bolster the capital position. There was a suggestion that £1 billion was a fairly limited sum compared to liabilities of £100 billion so the additional cushion provided by additional equity was not significant. However, it was explained that this was a significant addition to a {bank's} capital reserves – banks were by their nature highly levered businesses and the solvency cushion was not typically large. In this respect, an additional £1 billion would make a difference.

In relation to the Bank's own exposure, it was noted that the original lender of last resort facility, which had risen to £14 billion, had now been reduced to around £8 billion, secured against collateral.

It was asked whether Goldman Sachs would underwrite the bond issuance for a fee. In response, it was noted that there was no commitment that Goldman Sachs would themselves by selected to put the financing together. It would be put out to competitive tender. More generally, it would be a question of whether the fee represented value for money compared with the Government accepting the exposure it was undertaking through the proposed financing route.

In summary, Directors were concerned that there was a prospect of imminent nationalisation without any clear plan in place. It was agreed that the Bank and FSA would convey to HM Treasury the necessity of ensuring that there was a clear corporate plan at the time of any nationalisation announcement. Although there had been working level discussion across the tripartite authorities, the issue had not yet been discussed at Principals' level.

#### Update on Financial Markets

Paul Tucker introduced the item.

It was explained that the picture from financial markets had become more mixed. In the money markets, conditions had improved over the past month. There had been co-ordinated central bank action, reported to NedCo in December, which had probably helped market sentiment as intended. LIBOR spreads had fallen relative to expected policy rates and, importantly, banks had recently been able to raise more funds at three months. Although this could be reversed, the signs to date had been positive. The Bank had conducted its two special operations – offering wider collateral in its scheduled monthly three-month repo operation. The December operation had resulted in an average bid premium of around 60 basis points; the operation on 15 January had not resulted in a premium to the expected policy rate. Overall, funding conditions had eased albeit not back to the position last July. And there remained some latent risk in relation to

individual banks getting into difficulty, as revealed by credit default swap spreads, which had not improved much over the past month.

In terms of the underlying story about problems in the asset backed securities market, there had been some improvement over the past month, in particular in the financing of vehicles that issue commercial paper and other notes to invest in asset back securities. The yield on asset backed commercial paper had fallen since the end of the year, and the volume of this paper being issued in the US had risen slightly.

However, the news was by no means all positive. Spreads on asset backed securities remained very elevated, and the spreads on US credit card asset backed securities had been rising, suggesting that problems were spreading beyond sub-prime mortgage borrowers. That was reflected in some recent bank results (e.g. Citibank). Concerns remained about the commercial property market.

But, more generally, the pre-occupation in markets had switched to the macroeconomic outlook, particularly in US and UK. This was reflected in weaker equity prices – financial firms' equity prices had been particularly weak. Lack of certainty about how banks were valuing their portfolios and what was buried in those portfolios remained. In that respect, the coming few weeks would be crucial as banks published their results and revealed further write-downs.

It was noted that there was some concern in the market about the effects of the introduction of Basel 2, which is widely regarded as procyclical in nature. It also probably meant that banks would be less well capitalised than might have been expected by the authorities and the banks even six months ago. That in turn was feeding into a tightening of credit conditions, as indicated in the Bank's latest survey.

Overall, it was stated that some aspects of the financial market situation had improved compared with the position in September or December. But there were probably greater concerns about the macroeconomic outlook than even a month earlier. That left markets fragile and the outlook for the financial system highly uncertain. There were a number of elements to that, including the capital adequacy of banks.

A question was asked about the extent of year-end issues in financial markets. In response, it was noted that the earlier concerns had not materialised though the preparation and contingency actions had probably played an important role.

It was suggested that markets had moved from preoccupations about liquidity to broader concerns about credit risks. There was a particular concern about monoline insurers. A failure on

their part to secure necessary refinancing would be a serious blow to sentiment, which the system was not particularly robust to withstand. Problems surrounding commercial property were likely to have some effect on consumer confidence if they materialised.

#### **4. Draft Business Plan and Budget, and CRD review update**

The Governor and Warwick Jones introduced the item.

By way of introduction it was noted that, despite the extra work that had been undertaken over the past few months in the wake of Northern Rock, there had not been a significant increase in overall expenditure. Extra work had been accommodated within the existing budget, partly because a number of projects had been postponed. Looking ahead, it was proposed to retain the ceiling for spending which corresponded to a 2% nominal rise each year. In relation to the Bank's financial stability role, it remained unclear what, if any, changes would arise from the current financial stability policy debate. Therefore, no judgments about potential implications for the budget had been made. It would be necessary to revisit this in due course when legislation was in place and any changes to the Bank's circumstances evident.

Directors were updated on the status of the CRD discussions with HM Treasury. The consultation period for the CRD review had ended in early November. The draft summary of the responses to the consultation document and the Treasury's response had been reviewed by the Bank before Christmas. A summary of responses to a consultation would normally be published within three months i.e. early February. It was not clear if this would be achieved. The draft timetable now envisaged a statutory instrument being put before Parliament in March. It was explained that the Bank's budget assumed that proposed changes to the CRD scheme would be agreed – specifically a reduction in the CRD rate from 0.15% to 0.11% of eligible liabilities with effect from June 2008. It was probable that the Government response to the consultation document would emphasise that the Bank would consider ways in which it could provide more information not only to CRD participants but other parties as well. The Treasury would also state that if the Bank's CRD income and policy expenditure diverged significantly before the next formal review, ways would be considered to close such a gap.

Directors were taken through the key points highlighted in the budget pack. It was noted that over the coming month further details would be added but the overall shape of the budget would



not change materially. There would be a closer analysis of the later years of the plan – 2011-13 – where there was some concern that the policy areas and remunerated functions appeared too optimistic. Financial stability and, possibly, market intelligence work would be subjected to zero based reviews for the 2009/10 budget.

Attention was drawn to the key milestones envisaged for 2008/09 (page 9) which would be reviewed through the year and reported quarterly to Directors. In terms of the headline budget numbers (page 22), it was noted that spending on policy functions had been kept within the 2% nominal growth rate in each of the four years of the plan. Remunerated functions would break even in 2008/09, partly as a result of the assumption that the higher balances deposited with the Bank by other central banks this year would be maintained. They would show a deficit in 2009/10 though the projection was better than that projected last year.

CRD income and policy expenditure were projected to be more or less in line as a result of the CRD review. The dividend was expected to fall compared to the current year, partly because surplus CRD income would be lower.

It was highlighted that the budget assumed a 2% reduction in payroll costs as a result of turnover of staff in 2008/09-2009/10, partly as a result of resignations of older staff in the window for flexible retirement up to April 2010. This effect was reduced to 1.5% in the later years of the plan. Should this assumption prove to be flawed the pay settlement would be reconsidered. It was also noted that investment spending would fall next year compared to the current year. Following previous discussions with Directors, smoothing assumptions had been made in the latter years of the current plan in the absence of precise spending plans.

A question was asked about investment spending in the banking services area given the planned exit from retail customer banking. In response it was noted that projected spending on customer banking would fall, though a decision would need to be taken about the replacement for Globus after the exit from customer banking. There was provision in the budget for that. It was explained that the other parts of Banking Services had a fairly constant investment profile. There was also provision for a replacement of the RTGS system. At the aggregate level, spending in future years was considerably lower than the current level of around £7 million.

Directors' attention was also drawn to Appendix C on page 77 which for the first time offered a value for money plan for 08/09. More work would be undertaken on this presentation. There were some strong value for money processes in place in the Bank – such as the procurement initiative – where value for money was driving change. But, like the work on performance measurement, there was much more to do in the year ahead to take this forward.

It was explained that divisional and directorate budgets had been through 'clearing' sessions with Finance and challenge sessions with the Governors. No further significant changes were anticipated in the business area numbers.

Directors welcomed the progress on the structure of the budget, including the value for money presentation. It was suggested that in due course it would be productive to have an independent view from the Audit Committee on how the Bank's culture was moving towards value for money. It was felt that there had been significant change over a short period of time. The Audit Committee would undertake some benchmarking work. It was suggested that Internal Audit, in the course of their routine audits, should report where they thought efficiencies could be made. The Audit Committee would discuss further whether Internal Audit should undertake an independent review after six or twelve months. It would certainly keep the issue on its agenda, in terms of monitoring and providing assistance to the Finance area about best practice and benchmarking.

In relation to the Bank's strategic priority 6, it was asked if the Bank's desire to see the introduction of a special resolution regime for banks should be included. It was explained that a redraft of that strategic priority would be brought forward next month to include reference to a special resolution regime.

In response to a question about whether there were sufficient resources to handle the increased workload that the Bank was presently undertaking, it was pointed out that there was an implicit expectation that the amount of work devoted to Northern Rock would be lower next year. If that did not prove to be true or other work increased due to financial market events, it would be necessary to make adjustments. There was some concern about whether there were enough resources to undertake all the work the Bank wanted to do. It was asked whether it was sensible to be postponing projects and other workstreams beyond the short-term. It was suggested that it

might be sensible to have a larger contingency in the budget rather than opt to move work forward if other workloads remained high.

It was noted that there was a contingency within the policy budget of around £1.5 million. Part of the challenge process with each directorate had included an assessment of what could and could not be postponed. The executive management had been very conscious of the need to prioritise work but there was no sense that any of the work that had been delayed put the Bank at risk. More generally, it was not considered sensible to increase the contingency in the budget. In many areas, capacity was determined not by money but the availability of senior and experienced management time. That could not be increased easily. It was felt that it would be a mistake to add more contingency expenditure into the budget that would change the overall budget ceiling, particularly without having a clear idea of what additional expenditure would be for.

It was thought desirable for Directors to have a better sense of which projects and work were at risk, and their relative prioritisation, to judge how the business plan might be impacted. It was for the executive management to decide priorities and allocation but it would help if non-executive Directors understood what the options were. In response, it was suggested that the Audit Committee should be informed about which work was being delayed or postponed on a regular basis, to take a view about the prioritisation and risks.

It was also suggested that it would be useful for Directors to have a sense of the proportion of overall costs accounted for by staff costs in each of the business areas, and the trends over time. It was explained that the Finance area were considering incorporating such information into the regular reporting and would consider what could be provided for NedCo in February.

In summary, it was acknowledged that the structure of the budget report met Directors' requirements and was set out with considerable clarity, showing the linkages between the Bank's strategic priorities, the business plan over the next three years and the budget. There was also clear ownership amongst each of the directorates, linked to milestones and outputs. The budget would be discussed again at NedCo in February – ahead of being approved by Court – but it was anticipated that there would not be any material changes between now and then.

## 5. Diversity Annual Report

Louise Redmond introduced the item.

It was reported that a staff survey had been undertaken since the report had been written. This had provided responses to questions about the Bank's attitude and activities to promote diversity. Responses had improved significantly since the previous survey.

Directors acknowledged that the Bank was undertaking a number of valuable initiatives, notably through its flexible working programme. It was emphasised however that good intent needed to result in tangible success. In that respect, measurement needed to be strengthened. The question was what specific goals were going to be set. In the context of recruitment, it was suggested that HR might assess the extent to which candidates might not be a good fit, and therefore potentially add something that the Bank did not currently have – the point being that recruitment should not simply aim to find people who were a good fit. In response, it was thought necessary to achieve a consensus about the nature of any targets that the Bank would want to establish. There was no such consensus at present or even firm individual positions about how to progress the agenda.

It was noted that the Bank was in a fairly strong position in terms of recruiting the people and skills it needed. The risk in a diversity context was one of laziness, resulting in recruitment tending towards similar people to the existing profile. The challenge was to attract the full range of talent in the pools where the Bank was active. That was not obviously the case at present. In particular, the ethnic diversity of the Bank's recruitment was not satisfactory, though the Bank's ethnic minority staff were not critical of the Bank's approach per se.

Directors discussed issues around ethnic diversity and the Bank's recruitment. It was suggested that the absence of ethnic minority staff, particularly at senior level in the Bank, meant there was inevitably a shortage of role models. It was asked if the Bank was comfortable about the balance between internal and external recruitment, particularly for senior posts. It was noted that the greater the reliance on internal recruitment, the greater the likelihood that the established staff profile would be replicated at senior levels. In relation to external recruitment, it was important to ensure head hunters were kept abreast of the Bank's agenda and preferences to avoid their actions being driven by preconceptions. In relation to internal recruitment, it needed to be recognised that diversity issues occupied a difficult space. It would be wrong to assume that the

corporate aspirations were shared evenly amongst the Bank's staff. It was also asked whether and how changes in staff make-up were reported to staff.

It was noted that many of the finalists in the schools' competition had Asian backgrounds whereas the Bank's recruitment of economist was predominantly European. In this sense, the Bank did not reflect the number of quality Asian students leaving university which was a potential worry over the coming decade. At the same time, many of the finalists, including Asian pupils, were from independent schools. It was acknowledged that the issues were much broader than the Bank and reflected, in part, some resistance within the British Asian community about entering the public sector in view of the lower earnings potential. It was noted, however, that the Bank employed a number of Asian economists. Rather, the main gap in professional positions was Afro-Caribbean staff. This might reflect, in part, the low proportion of Afro-Caribbean students at UK universities. While it was agreed that the Bank should continue to widen its efforts, this was not an issue it could tackle unilaterally as an employer. It was noted that the Bank participated in events to bring ethnic minority school children to the Bank to provide a feel for what the Bank did and what it was like.

It was suggested that the universities that were the focus of the Bank's recruitment efforts were unlikely to provide Afro-Caribbean recruits. So it might be necessary to look at different universities. In response, it was noted that the Bank had discussed how far it should spread its search efforts even though the return from previous experience had been very low. The fact was there were relatively few Afro-Caribbean students studying economics where work permits would not be an obstacle. It was asked if the Bank had looked at links with the US offices of the major banks in view of the fact that many top UK and European students attend colleges in the United States. It was explained that the Bank had in the past undertaken significant recruitment drives in the US but without much return. It was generally agreed that increasing the ethnic diversity of staff was not straight forward, particularly given the numbers the Bank recruited each year. But it was suggested that without some quantification of ambition, it was unlikely that processes and behaviour would change.

The executive management were more optimistic about progress around gender, where the new flexible working programme was due to be launched. Over the coming years, it was the expectation that there would be a significant increase in the number of senior women in the Bank.



Ethnic minority recruitment was more difficult. It was largely about changing perceptions and creating an impression over time that the Bank was a welcoming institution to people of all backgrounds.

Directors encouraged the efforts on diversity to continue and for HR to work with the diversity sponsors – Mr Bailey and Mr Strachan – to make further progress in the year ahead.

## **6. ‘MPC 10 Years On’ – response to the Treasury Committee’s report**

Charlie Bean introduced the item.

It was proposed that the response to the Treasury Committee’s report should come jointly from the MPC and Court. Directors agreed to that approach. Much of the text was from the MPC but there were three main items that particularly concerned Court/NedCo.

First, the issue of lengthening the terms of appointment for external members of the MPC. The Bank was broadly supportive of the idea but the Treasury Committee’s recommendation included a proposal that NedCo should review external members’ appointments after three years and decide whether they should continue or not. The MPC had thought that this could introduce awkward incentives and create tensions between the Bank and HM Treasury.

Directors discussed the recommendation and proposed response (lines 41-45). Some Directors thought the Treasury Committee’s proposal was acceptable on a narrow basis. The second sentence could be deleted insofar as current legislation gave Directors the right to review an individual MPC member at any time in terms of their overall fitness to serve. But it was the Government that had responsibility for external MPC appointments. NedCo/Court could undertake a review after three years but only to judge external MPC members in terms of whether or not they were able to undertake their duties in a fit and proper way. A judgement on wider grounds would impair the independence of the MPC and external members. Directors felt they were not in a position to make a more finely tuned judgement about whether or not an MPC member should continue in any other sense. If non-executive Directors had reservations about individual MPC members, views should rightly be expressed to the Governor. But it was felt that NedCo/Court should reject the concept of making judgements about the suitability of individuals to serve on the MPC beyond their current duties in the 1998 Act.

It was established that the MPC generally agreed that a six-year term was preferable to three. This would avoid the issue of reappointment arising, which created uncertainty and speculation. But there should be no expectation that an individual would necessarily serve a full six-year term. Some appointees would not have been able to accept such a commitment and keep open their university positions had the appointment been for six years. So there needed to be a clear understanding that some members might have an intention of serving only three years. This was reflected in the draft response (lines 33-40).

It was acknowledged that the role of Court/NedCo was clear and that it was not felt to be appropriate for Directors to have the power to judge whether an individual member served for three or six years. The wording needed to reflect that and avoid any ambiguity. It was suggested that the response should make clear that it was not appropriate for Directors to judge the length of the term. Rather, the power of Court to remove individuals for grievous behaviour should not be restricted to being exercised after three years. That could be exercised at any point in time.

There was some concern that a commitment to a six year term would bring just as many difficulties. For instance, it might screen out some individuals given there would be some implicit expectation placed on them to serve six years. Equally, without some form of review after three years, there was some risk that individuals might only serve two years, thereby breaking the existing pattern. It was noted that the Federal Reserve appointed people for fourteen years, which was sufficiently long that it was widely understood that individuals were unlikely to serve a full term.

It was suggested that the idea of reappointment for external MPC members should be rejected, whatever the length of term agreed. It was proposed adding to line 34 that both the MPC and Court believed that longer but non-renewable terms for external MPC members was desirable. But it should be acknowledged that it was the Government's decision whether or not to have reappointments.

The second issue concerned the working arrangements for external MPC members since terms of employment were a matter for Court not the MPC. The MPC collectively believed that it was sensible to retain the norm of the position being a three day a week appointment but to recognise the need for flexibility. This might be necessary for appointees with a business background,

particularly in the early part of their appointment until some arrangements had been made for other outside responsibilities.

It was suggested that the wording should be strengthened to say external membership of the MPC would be part-time. Any contemplation of full time external members should not be tolerated, not least on the grounds that being a full-time employee of the Bank meant an individual was no longer external in a meaningful sense. It was stressed that if there was value in having external members, they needed to remain external which implied they had some serious activities and commitments outside the Bank. It was noted that of the five internal members of the MPC, four had been appointed to their MPC roles from outside the Bank. This illustrated that the position held before membership of the MPC did not establish whether or not an individual was internal or external. It was agreed that what defined an external member of the MPC was someone that was not a full-time employee of the Bank and not part of its management structure.

Third, in relation to reducing the size of Court (lines 114-116), Directors discussed the optimal size of Court and specifically the merits of limiting the reduction to no more than twelve. It was agreed that the response to the Treasury Committee should not be specific. The draft wording would suffice.

#### **7. (i) Quarterly Reports – performance measurement; financial and balance sheet, strategy implementation, projects**

Warwick Jones introduced the item.

It was explained that the quarterly reports had been amalgamated into one pack. This was still work in progress, particularly tying performance measures to risk. In place of the Quarterly Risk Report, the plan was to relate risks and performance to the Bank's outcomes. However, as this was still under development, it was thought appropriate to produce a separate risk report for this quarter (see 7(ii) below).

The quarterly financial report was briefly summarised, along with an update on projects activity.

It was highlighted that the estimated outturn for policy spending was precisely as budgeted. The £1.2 million contingency was now being used, reflecting the additional time being spent on financial crisis related work.

The balance sheet report was also briefly summarised (Paul Tucker). Attention was drawn to the changed structure of the balance sheet. Ordinarily, the asset side of the balance sheet would be dominated by short-term and long term repos against eligible collateral. But it was now dominated by the Northern Rock loan and the expanded long term repos against wider collateral. Draining the consequent injection of reserves remained an issue. It was hoped that HM Treasury would shortly repay part of the Ways & Means facility. Further ahead, it remained a possibility that the Bank would need to issue bills to offset the lending. It was also noted that Mr Tucker had provided the Treasury Committee with a private briefing on the Bank's money market framework as background for their enquiry into Northern Rock.

## **(ii) Quarterly risk report**

Rachel Lomax introduced the item.

It was proposed that this would be the final stand-alone Quarterly Risk Report, in view of the plans to amalgamate quarterly reports (see above). Directors were content with the plan. It was explained that the Quarterly Risk Report showed how the Bank's risk profile had changed significantly as a result of recent market turbulence. The major incidents occurring in the past quarter were related to financial markets and Northern Rock. The report attempted to capture the risks that had emerged since August including the impact on other business areas and activities. This included the implementation of monetary policy. In terms of assigning risks to the Bank's outcomes, much of the re-thinking concerned outcome 3 and the discharge of financial stabilisation work, including the diversion of resources from other financial stability work such as payment systems oversight. It was noted that the impact on staffing and balance sheet risks was also drawn together under outcome 4.

Directors welcomed the further progress in the quarterly reporting. There was some concern that the commentary had increased and that the volume of information might become unmanageable if left unchecked. It was noted that one of the reasons for the regular risk assessment was to help Directors judge what might go wrong. In this context, the reference in the Quarterly Risk Report

to 'the severe risk in some parts of the Bank that there are insufficient staff with the appropriate experience to handle the new work on the markets turmoil' sounded alarming. In response, attention was drawn to actions being taken to manage the risk. This had been discussed and challenged at the Audit Committee. The position remained uncomfortable but the mitigating actions had reduced the severity of the risk in terms of likelihood. At the same time, the potential impact on the Bank remained severe. It was stressed that it was inevitable experienced staff were working on financial crisis management and that other work consequently had to be reprioritised. An example was that the Bank was undertaking a lighter form of payment systems oversight at present than compared with a year ago. It was explained that this was a conscious risk-based decision.

In summary, Directors welcomed the continued improvement and development of the suite of quarterly reports. A list of the various abbreviations used was requested.

## **ITEMS FOR INFORMATION**

### **8. MPC Report to Court**

The MPC report to Court for January was noted.

### **9. Audit Committee minutes**

The draft minutes of the meeting of 20 November 2007 were noted.

### **10. Remuneration Committee minutes**

The minutes of the meeting of 15 November 2007 were noted.

### **Any other business**

None.

**The meeting of NedCo was closed.**



## MEETING OF THE COURT OF DIRECTORS

**Wednesday 16 January 2008**

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  
 Mr Potter  
 Mr Rhind  
 Ms Rice  
 Mr Strachan  
 Mr Wilkinson

Absent:

Mr Sarin  
 Mr Wigley

Also attending:

Mr Bean, Mr Bailey, Mr Jones, Mr Footman, and Mr Tucker

### **1. Minutes – 16 January**

Approved.

### **2. Monetary Policy issues**

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

### **3. Northern Rock, financial markets, business plan and budget, diversity, Treasury Committee response, quarterly reports**

Court noted the discussions in NedCo of the above items

### **Any other business**

*The Governors and other members of the Executive Team left the meeting*

#### **4. Report from the Chairman of Remuneration Committee**

David Potter updated Court on progress on the review of the Governor's and other senior executives' salaries.

The Remco meeting of 15 November had discussed the terms of appointment of a Governor, or the reappointment of the current Governor, with effect from 1 July 2008. Court had previously agreed to quinquennial reviews of Governors' salaries. It was noted that because the Governor's and Deputy Governors' salaries had been increased by 2.5% per {annum} over a number of years, it was acknowledged that they had become out of line relative to other senior public positions based on benchmark analysis. To rectify this position, it was proposed that the Governor's salary should be increased to a figure between £350,000 and £400,000. It was envisaged that the net effect would be cash neutral, offset by smaller pension contributions in line with the staff pension scheme.

The proposals had been put to Nick Macpherson at HM Treasury. It was acknowledged that the Governor was sensitive about his own personal position. Moreover, in the light of recent events and the more stringent approach to public sector pay, this was likely to be a sensitive matter for the Treasury. Remco would discuss the issue further at their meeting later in the day.

**The meeting of Court was closed.**

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

**Wednesday 16 January 2008**

**Present:**

Sir John Parker, Chairman  
The Governor  
Sir John Gieve  
Ms Lomax  
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

**Absent:**

Mr Sarin, Mr Wigley

The Governor present for item 5.

### **1 Minutes of 15 November**

Approved, along with their circulation to Governors.

### **2 Non-executive Directors' attendance at pre-MPC meetings and visits to Agencies**

Noted.

### **3 Themes for NedCo's Annual Report**

Item deferred until February.

### **4 One-to-one meetings with MPC members**

Non-executive Directors were asked to forward any questions they wanted the Chairman to raise with MPC members.

## **5 Executive team performance**

The Governor introduced the item.

The Governor outlined the main themes and issues arising from the Executive Team's performance assessments.

### **Any other business**

## **6 Succession planning**

Following previous discussions with HM Treasury about NedCo's input into senior appointments at the Bank, {Nick} Macpherson had asked for non-executive Directors views about future Governor and Deputy Governor appointments. The Chairman had compiled a short questionnaire which, after discussion, was completed by non-executive Directors and passed to the Chairman.

**The meeting of NedCo was closed.**

**COMMITTEE OF NON-EXECUTIVE DIRECTORS (NEDCO) MEETING****Wednesday 14 February 2008**Present:

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

Absent:

Sir Andrew Likierman, Mr Arun Sarin

Also attending:

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

[Prior to the meeting, non-executive Directors had attended a financial stability seminar held by staff from the financial stability area.]

**1. Minutes – 16 January**

Approved.

**2. Matters Arising**

Directors were encouraged to put questions to external MPC members as well as internal members during items on monetary policy.



## MANAGEMENT OF THE BANK

### 3. (a) Executive Report

The Governor introduced the item.

#### Recent and forthcoming meetings and events

Domestic:

- regional visit to the South West, including a speech in Bristol (22-23 January);
- regional visit to the North West (30-31 January);
- Inflation Report and press conference (13 February).

International:

- G7 meetings in Tokyo (8-10 February);
- BIS meetings in Basel (9-10 March).

Tripartite meetings had taken place on 25 January and 13 February. A lunch meeting with Nick {Macpherson} and telephone discussion with Yvette Cooper – the new Chief Secretary to HM Treasury – had also taken place on 25 January. Breakfast meetings with Sir Gus O'Donnell and the Chancellor had been scheduled for 18 and 19 February respectively.

It was reported that the former {Principal} Private Secretary to the Prime Minister, Tom Scholar, would be moving back to HM Treasury to take charge of the area that dealt with financial regulation. He would be responsible for the work on the new banking bill. The Bank considered Mr Scholar to be a very able official and looked forward to working with him on the reform agenda.

#### Governor's reappointment

The Chancellor had announced on 30 January that the Governor would serve a second term from 1 July 2008. Non-executive Directors were thanked for their support.

#### MPC appointment

Andrew Sentance had been reappointed to the MPC. His new term would run from June 2008 for three years, until May 2011. [Andrew Sentance's first term had been the remainder of David Walton's term following his sudden death in 2006]

Treasury Committee's report 'The Run on the Rock' and the Tripartite's 'Financial Stability and Depositor Protection' consultation document

Both documents had been published since the previous NedCo meeting and short summaries had been circulated to Directors. It was noted that the Treasury Committee's report had avoided cheap criticisms and usefully focused on the reform agenda going forward. It merited a serious response. In relation to the Tripartite consultation document, the Bank had played a key role in its production. Among the issues it covered, there was a proposal for a new structure for Court. Non-executive Directors would initially discuss the issues raised over lunch after the NedCo meeting, followed by discussions at both the March and April meetings of NedCo (see under 'Any other business' below).

Redundancy scheme

It was reported that a staff consultation on proposals for changes to the Bank's redundancy scheme had been launched. Directors were reminded that the previous arrangements had to be discontinued in the light of age discrimination legislation. It was proposed that a new scheme would pay 15% of base pay for each year of service up to a cap of 20 years service. If accepted, the new scheme would be introduced on 5 April 2010. Interim arrangements would be put in place in the meantime. The Bank considered the proposals to be generous and the staff union was broadly content with them. It was explained that it had not been an objective to reduce the costs of the redundancy scheme. The consultation period started on 16 January and would last ninety days. It was noted that the Bank did not anticipate many redundancies over future years based on current plans.

**(b) Northern Rock update**

Sir John Gieve & Andrew Bailey introduced the item.

It was explained that again the situation appeared to be reaching a critical stage with a decision anticipated shortly, possibly over the weekend. Of the private bidders, Virgin was preferred over the Northern Rock management offer. Virgin was offering more money, had a better team and a more realistic business plan. However, for a number of reasons, the risks implicit in the private bids were becoming more of a concern. First, the level of subsidy required to make the Virgin offer feasible was extremely high. The figure could be calculated in different ways but the estimate was around £2-2.5 billion over a period of three or so years. Second, the upside returns being offered in the event of success were limited. Third, and most importantly, the execution risk had become an increasing concern. If a private sector solution was chosen, it would then have to be passed by shareholders and the European Commission, a process that would take

several months. During this time, it would be necessary to retain the confidence of the markets and in particular the rating agencies. There was a risk that rating agencies would not give a Virgin led bank a sufficiently high rating to enable the plan to go forward. They would need to have confidence that Northern Rock under Virgin ownership would have sufficient solvency and liquidity, both in a base case scenario and a so-called recession scenario – assumed to be a re-run of the early 1990s housing market. This was currently under consideration by the agencies. If they did not give Northern Rock the rating it needed for its securitisation activities, it was not obvious that any plan would be viable.

It was explained that in view of these concerns and issues, there was now renewed focus on whether nationalisation was the best option. A draft bill was more or less ready. It was emphasised that the Bank and the FSA continued to have concerns about the strategy that a publicly owned Northern Rock would pursue. As discussed at NedCo in January, HM Treasury continued to prefer that a new board under Ron Sandler should have a reasonable period to assess the prospects and produce a business plan to take Northern Rock forward as a going concern in the expectation that in three years or so it would be possible to sell it. It was thought that Mr Sandler felt that his task was essentially to run a going concern and make it successful. There were clearly risks in that approach. Other options would include using nationalisation as a forerunner of a new special resolution regime i.e. to remove shareholders and restructure the bank, possibly splitting it into its good and bad elements, and running the latter down over a period. The Bank and the FSA had made clear their concerns to HM Treasury, along with lines discussed at NedCo in January. The post nationalisation strategy remained unclear – it could be either to achieve an orderly run-down or pursue a ‘phoenix’ objective.

It was also explained that the Bank continued to be involved in a large amount of work to manage the Northern Rock loan facilities. Assuming there was no further adverse shock, the peak in borrowing had now been reached and drawings were currently a little under £25 billion – Northern Rock was beginning to repay its borrowings. Borrowing from the Bank’s first facility stood at £7 billion. Two further issues were noted: first, the continuing due diligence being undertaken by Ernst & Young on the business and the portfolio of mortgage collateral; second, the rapid payout project, where systems were now in place to deliver the repayment of depositors’ money should that contingency be required.

In response to a question, it was explained that the notion of a public subsidy had two main elements. First, relating to the funding of Northern Rock, was the estimate of the difference between the price that Virgin would pay the Bank/Government for its funding and what would have to be paid in the market if such funding was obtainable. Second, the same estimate relating to the Government guarantee of those other liabilities that were covered. The net present value estimates depended on the market prices for such protection, which were currently very high. Part of the pitch of the private sector bidders had been that the price, and therefore the subsidy, would fall in due course as market conditions recovered.

## **FINANCIAL STABILITY ISSUES**

### **4. Update on financial market developments**

Paul Tucker introduced the item.

It was noted that there had been a number of overlapping phases in the ongoing financial market turmoil. The first phase, which was continuing, was a significant deleveraging across the financial system. This had resulted in a sharp liquidity crunch which was at its most severe during the autumn. That had then led to concerns about the capitalisation of the banks as the deleveraging led to losses and write-downs. The present phase continued to have those earlier features but also included concerns about the macroeconomic environment, which were feeding back into the financial system. This was not yet a sharp feedback loop but it might intensify. It was noted that the ongoing problems were now reflected in equity markets. They had not been affected significantly last year but this had changed since the beginning of 2008. Nearly every sector had now seen price falls, which underlined the extent of the perception of a broad-based macroeconomic slowdown. It was also noted that corporate bond spreads had continued to rise as the perception that defaults were likely to rise over the next few years increased.

Attention was also drawn to the wholesale loan market. This had worsened and was potentially quite serious. Many deals had been stuck on banks' balance sheets on both sides of the Atlantic over the summer. Markets had expected difficulties to sort themselves out by Christmas and then early 2008, but they had not. Consequently, market participants had become preoccupied with problems in the corporate loans market over recent weeks. It was also noted that spreads on commercial property backed securities and residential mortgage backed securities had risen as

perceptions of risk increased. These developments were all indicators of feedbacks from macroeconomic developments into financial markets.

Reference was also made to the redemption from open-ended property funds. It was now, belatedly, considered odd to run open-ended funds for such illiquid assets. Many funds were bringing the shutters down, which was a further symptom of market stress. Similarly, monoline insurers were now figuring more prominently in market developments, as previously predicted. Some recapitalisation was taking place along with new entrants appearing, such as the initiative by Warren Buffet. But separating out the better elements of their insurance business, such as municipal bonds would weaken the other elements to which the banking system and securities dealers were exposed. It was explained that these entities did not provide collateral to counterparties for over-the-counter derivative-related exposures. It was a complicated situation but one that mattered in terms of how the market situation might evolve.

These developments in particular markets were reflected more generally in credit default swap spreads – the market measure of credit risk – for banks. The market did not perceive that the circumstances facing the largest financial institutions had improved over the past few months in terms of their credit risk. Nor was the situation facing UK mortgage banks perceived to be much better. How the Northern Rock situation played out would affect the perceptions of UK mortgage banks abroad.

Turning to money markets, it was noted that the spread between three-month unsecured rates and the expected policy rate had remained much lower than last year but had started to rise again more recently. Conditions, although still somewhat better than markets had feared before Christmas, were not considered as good as in the early weeks of January. It was suggested that there was a risk that the situation could worsen with tighter funding conditions for the banks and building societies. The Bank would continue to monitor the situation closely.

Attention was also drawn to measures of uncertainty in financial markets. It was evident that the situation was expected to persist for considerably longer than was generally thought a few months ago. It was highlighted that the situation was currently in a crucial phase as financial institutions revealed their results. Banks needed to recapitalise and promptly in order for the position to be clarified and stabilised. It was noted that there was some concern about the position and reporting of AIG – the world's largest insurer.



In relation to the Bank's balance sheet, it was reported that the Government had made a repayment of £6 billion on its longstanding overdraft (Way & Means account) to help the Bank's management of flows into the money markets following the lending to Northern Rock and extended long-term repos. Additionally, it was reported that the MMR2 project to inject funds via outright purchases of longer-term bonds was on track. The first such open-market operation had been conducted successfully at the end of January.

In discussion, it was suggested that the focus so far had been on losses relating to flows through the banking system. But a large amount of product had been distributed elsewhere in the financial system such that the true extent of losses had not yet been revealed. In this sense, AIG's announcement was said to be the tip of an iceberg. It was also noted that there had been a deterioration in confidence in financial markets resulting from the events at Société Générale, and the position of smaller German banks remained difficult. In response to a question, it was explained that the first round of the reporting period for banks would run up to the end of March. There might be a degree of consistency in both what was covered in announcements and the methodology used, which would help. But, it was felt that, as the real economy in the US deteriorated, what was judged to be an aggressive mark down today might prove to be less than adequate in a few months time. Therefore, even if there were a series of realistic evaluations, there might need to be further write downs even in the near-term. It was noted that some market participants had observed disparities in reporting amongst their counterparties, even where they used the same auditing firms.

## **5. Financial Stability Quarterly Report**

Nigel Jenkinson introduced the item.

The latest quarterly report was summarised. Consistent with the discussion of financial market developments, there were large uncertainties about firms' valuations of complex products and levels of transparency about where losses resided in the banking system and more broadly. This could hamper market corrections and price discovery.

It was asked if there was evidence in the Bank's credit conditions survey that financial companies with decent balance sheets could not access finance. In response, it was suggested that firms were generally able to access short-term funding but it was much more difficult at

longer maturities. Some bilateral deals were progressing but the market more generally was not functioning normally. It was added that, although the survey pointed to a tightening of lending terms, the impact on non-financial firms was not yet visible by and large, which might reflect the fact that companies would only occasionally need to raise new finance and approach their banks.

It was noted that the quarterly report included an annex on the work programmes in the Financial Stability area over the forthcoming year, which non-executive Directors had requested as part of the revised framework for their oversight of financial stability.

## **6. Financial stability performance measurement**

Sir John Gieve introduced the item.

The paper covered how financial stability messages were reaching key audiences, and a progress report on the work to produce a summary indicator of financial stability that mapped changes to key vulnerabilities.

In discussion it was noted that the measures being used to assess financial stability were backward looking in nature. It was apparent that in April 2007 many of the indicators were stable yet the system was clearly unstable. In contrast, the final chart presented in the update of financial market developments showed a spike in market instability in May 2006 and again in February 2007. In response, it was highlighted that measures of market volatility were used in the overall assessment of financial stability risks. In April 2007 these had been very stable and the Bank had conveyed its reservations that the position was sustainable in the April FSR. It was clearly a challenge to produce indicators that could be mapped into what the FSR commentary was saying – as in April 2007 – when some market indicators were not consistent with the Bank's analysis and judgement. The earlier financial stability seminar had discussed modelling and stress testing, which were part of a forward looking approach. Further thought would be given to the approach, and whether it should aim to be concurrent – i.e. what the level of stability is – or provide a forecast, although it was noted that a fan chart for the financial stability outlook might be particularly wide. It was acknowledged that the red line was a correct assessment of the various indicators in April but that did not encapsulate the analysis in the April FSR. It was acknowledged that the pentagon was not the diagram to present a future assessment. The

question was what would capture the FSR assessment in a forward looking sense, which would require something different.

In relation to conveying the message, it was suggested that such an approach, although elegant, might be worth less than direct conversations with key players in financial firms. The critical question was whether a year ago the Bank's financial stability apparatus gave a clear indication of what was going to happen. If the apparatus gave the correct indications, the question was then whether the right people read it or not? It was suggested that the Bank should use a 'hot line' network between the Governors and key players, such as chairman and chief executives of the major banks, to convey key messages in the FSR. In response, it was noted that when a crisis was in train, such individuals would be well aware of the issues. Rather, it was more a question of ensuring that firms gave more weight to the dangers of the situation when financial conditions were more favourable. It was noted that the Bank did have regular contact with the chief executives of the main banks and other financial institutions. Further thinking was presently being undertaken to consider how the Bank could raise its game with key messages to ensure that actions followed. A hotline was appropriate when something dramatic had happened – something the Bank and the FSA used. But that was not necessarily the right approach to convey concerns when markets were healthy but potential dangers lay ahead.

In response to a suggestion – taken from the earlier seminar – that perhaps the wrong people were reading the messages, it was stressed that the problem was not thought to be the transmission of messages. Few chairs or chief executives of the major banks would have been unaware of the strong beliefs of the Bank and the FSA via both {discreet} conversations and public statements. Senior market participants knew twelve months ago that they were enjoying very profitable conditions in financial markets. But, in such a situation, not many wanted to listen to the notion that it would end and there was little appetite, despite clear warnings, to stop or adjust behaviours. It was emphasised that real world behaviour was such that markets would not hear messages in such buoyant circumstances. This was consistent with a theme in the April FSR, notably a tension between financial and business risk. It had been highlighted that there was a sense amongst investors that they were not receiving appropriate compensation for risk – credit risk premia had been reduced to negligible levels. But many contacts had said they thought they had to maintain positions from a business relationship perspective. Equally, they had thought that they had good hedges and would be able to exit markets should the need arise.

It was agreed that behaviour was a key factor. There was a mis-match between individual and team incentives and risks relative to the corporate purpose to preserve stability. The Bank needed to continue to blend statistical analysis and judgement with a finely tuned sense of what was happening and how people were behaving. It was crucial that the Bank's work penetrated to affect behaviours and outcomes. It was also asked if the Bank's messages about risks were adequately reflected in media headlines. It was suggested that the Bank should be less timid at times in expressing its view so that statements impacted on behaviour. It was also suggested that the Bank should provide an analysis of what was required to improve its messages in the form of practical goals that captured where it wanted to be and how to get there.

## **MONETARY POLICY**

### **7. MPC Procedures – support for MPC processes**

(Kate Barker and Tim Besley – external members of the MPC – and John Bartlett – Agent for the West Midlands – in attendance.)

Charlie Bean introduced the item.

The report was one of the inputs to enable NedCo to fulfil its responsibility for keeping the procedures followed by the MPC under review. The report noted changes to processes over the past year and responses from members of the MPC to the annual questionnaire.

It was noted that, over the past year, there had been some fairly minor changes to MPC processes (section 3 of the report). Some of the briefing provided to the MPC had been revamped, particularly on the international side. It was also noted that last year's survey of MPC members had highlighted that the forecast process was not satisfactory in some respects. Some changes had been introduced which had improved the dynamics of forecast meetings, such as alterations to the seating arrangements. The attempt to introduce more discussion about monetary policy strategy into the forecast meetings had been less successful. Chapter 5 of the Inflation Report had also been revamped to focus more of the discussion on risks. That had been in response to a survey of business economists (with the Society of Business Economists) carried out in 2007, which had revealed a desire for more discussion about risks and the outlook. It was noted that the changes to the Inflation Report, in addition to improving external communications, had also changed internal discussions of risks in a fruitful way.

Turning to this year's survey of MPC members, it was noted that most question categories showed a modest improvement in average scores. The area of relative weakness remained the forecast process. There had been some improvement in scores but some dissatisfaction remained, including about the effectiveness of the MPC's own discussions. But it was noted that the February forecast round that had recently been completed had received positive feedback from MPC members, despite the key issues being ones on which the model was largely silent.

In relation to the section on external commentary, the main item over the past year had been the Treasury Committee's report – 'The MPC 10 years on', which NedCo had previously discussed.

The final section reported on the work of the Agents. Over the course of the past year it was noted that there had been number of initiatives directed at trying to improve the rigour of the intelligence gathering side of the Agents' activities. This included the way Agent's statistical scores were produced and analysed, the effort to increase access to, and intelligence from, large and strategically significant firms in the economy. Agencies had also been encouraged to increase their contact with non-business audiences, which the Treasury Committee's report had flagged. It was hoped that further progress would be made. The rationalisation of the Agency office premises was also noted. That project was currently about half way through and had so far been implemented successfully, with little adverse external commentary or reaction.

It was asked if the more turbulent economic conditions meant greater weight was being placed on intelligence from the Agencies in order to interpret events. In response, it was explained that the most valuable feature of the Agent's input was its timeliness. The current situation was characterised by many attributes that were not yet showing up in the official data. The MPC was trying to identify straws in the wind from the Agents' Reports which were potentially effective at providing a steer on likely developments. Intelligence from the Bank's financial market contacts was also very valuable at the present time. Based on non-executive Directors' own visits to the Agencies, the high value of the Agencies for the Bank's reputation was emphasised.

A question was raised about the MPC's interpretation of the target. How did the Committee view the relationship between the Government's objectives for growth and employment and the inflation target in present circumstances? In response, it was suggested that the second clause relating to growth and employment essentially meant the MPC should not be obsessive about



bringing inflation back to target as rapidly as possible. In short, excessive volatility in economic activity should be avoided. That was embedded in seeking to meet the inflation target over the medium term. The second clause in the Remit was most relevant to considering the path and timing for inflation to return to target i.e. the potential cost to output of achieving the inflation target over a particular time frame. Beyond that, it was important to recognise there was no long run trade-off between inflation and growth. It was also stressed that at a fairly uncertain time for the economy, the clarity of the Bank's mandate was a strength of the framework.

There was a discussion about the relatively low scores from the MPC questionnaire regarding the effectiveness of research and its channels of communication. This was not considered to be a major concern insofar as the MPC was not the primary audience for the research undertaken in Monetary Analysis. Although some research addressed particular issues that were of interest to the MPC, much of it was of a more general application to central banks and others. It was noted that it was also undertaken to develop human capital in order to sustain the Bank's ability to support the MPC in the future. The channels of communication had been improved, for example through the introduction of a research newsletter which kept MPC members and others abreast of research taking place in the Bank and more broadly across the economics profession. It was noted that the next MPC questionnaire should separately ask about Working Papers and Quarterly Bulletin articles as some MPC members found the latter a useful conduit for keeping abreast of research rather than research papers themselves.

It was suggested that there might be a budgetary dimension to the research issue. It was explained that the budgetary squeeze had so far impacted disproportionately, though unintentionally, on research activities. The recorded number of hours of research undertaken was now around 40% lower than in 2003.

It was asked whether the reduction in research was the result of a squeeze in financial resources or head count or both. Would the situation be rectified by increasing the number of researchers or improving systems? In response, it was suggested that it partly reflected a squeeze on resources and the associated reduction in headcount. But the solution partly lay in improving the efficiency of the delivery of conjunctural briefing and so liberate staff time to undertake more analysis and research. That was the aim of the business improvement project that was underway in Monetary Analysis. It was important to retain research activity, not least as a recruitment tool as research remained an important draw for many staff. However, it was not thought to be simply



a question of the resources devoted to research. It was also a question of leadership to direct resources and deliver effective research. It was possible to waste many hours on ineffective research with the wrong management leadership. Changes had been made to the heads of division in 2007 to ensure research activity would be {led} by people better able to bring teams together and make research more effective. At the same time, it was felt that the MPC itself needed to be more disciplined about its demands for additional information and analysis.

The issue of the nature of staff presentations to the MPC was raised. Did staff need to be more provocative in their approach? It was noted that in the early years of the MPC, staff took the view they needed to serve the MPC as a whole and they developed a cautious approach to taking positions and sides, partly because of the very strong way divergent views on the MPC were expressed at that time. The MPC now wanted staff to indicate, for example, where they thought there was a risk that something might go badly wrong with the current policy path, or where they thought the forecast judgments previously made by the MPC were hard to reconcile with subsequent events. It was noted that the US Federal Reserve did not publish a collective forecast and did not pay a great deal of attention to the staff forecast. One of the benefits of the MPC forecast process was the resulting exchange of views and ideas – the forecast created an interactive discussion about the issues which was of greater importance than numerical judgements. For the pre-MPC meetings, the Committee wanted staff to challenge the MPC more readily, for example to say when data challenged an assumption that had been made. It was not about asking staff to take sides on particular issues.

It was asked if it was necessary to have a full forecast round every quarter. Would it be feasible to have a lighter process in between a full forecast, say, every six months? In response, it was explained that while the forecast process was intensive and demanding for both MPC members and staff, there was little desire to change its frequency. It was explained that policy judgments needed to be based on a forward-looking assessment of the inflation outlook and risks over the next two years or so. It was difficult to set policy based simply on the assessment of data published since the previous meeting. Rather, new data had to be placed in the context of the latest forecast and balance of risks. This made a strong case for a fairly frequent forecast. Circumstances tended to change such that a six-monthly forecast would feel too infrequent. Of course, it was also possible for the MPC to decide it could have a lighter forecast round if there were fewer issues to consider. It was stressed that had the MPC not undertaken a forecast process this February, it would have been in a much worse position in terms of its ability to

navigate through difficult waters. It had been immensely valuable to discuss the issues through the lens of the forecast process. Additionally, it was felt that a regular forecast process insured against the risk of individual MPC members getting locked into positions insofar as it facilitated reassessment and fluidity of views.

In summary, it was noted that the annual round of one-to-one meetings with MPC members had been undertaken by the chairman, which would be reported to the second meeting of NedCo as a further input into non-executive Directors' oversight of MPC procedures. This was an ongoing process and one of continuous improvement. Non-executive Directors supported the efforts by Monetary Analysis to drive through business improvements. It would also be important that the Bank ensured it retained its research position and did not bear down on resources for this too heavily.

#### **8. Inflation Report and monthly MPC report to Court**

(Kate Barker and Tim Besley – external members of the MPC – in attendance.)

Charlie Bean introduced the item.

The main recent economic developments were summarised along with the MPC's latest growth and inflation projections.

The Bank's view on the current extent of the gap between CPI and RPI inflation was requested, in view of the influence of the latter in wage negotiations, including progress to incorporate housing costs in the CPI measure. In response, it was stated that Eurostat showed no signs of incorporating housing costs into the harmonised CPI methodology in the foreseeable future. With continued delays, the ONS might feel compelled at some point to introduce housing costs into the UK index. It was explained that part of the reason for the current large size of the wedge between CPI and RPI inflation was that mortgage interest payments had been rising earlier in the latest twelve-month period. That element would now unwind and start to reverse in response to recent interest rate reductions. Similarly, the previous increases in housing costs – which also contributed to the gap between CPI and RPI inflation – would now start to unwind. Consequently, it was noted that it was quite possible that during the forecast period RPI inflation would fall below CPI inflation.

A question was also asked about the extent to which the Government's squeeze on public sector pay was relevant to the inflation outlook. In response, it was noted that public sector wages did not have a direct impact on the prices of market determined output, which accounted for most of the CPI basket of goods and services. Rather the impact would be indirect through wage settlements in the private sector, though empirical evidence suggested that the link was not very strong, at least over the short run. Moreover, what mattered to the MPC was not pay increases in particular sectors but overall pay growth relative to the inflation target and likely productivity growth.

#### **9. Agents' issue of the month**

(Kate Barker and Tim Besley – external members of the MPC – and Kevin Butler – Agent for south west England – in attendance.)

Kevin Butler introduced the item.

The Agents' recent special survey for the MPC on credit conditions was summarised and discussed.

### **MANAGEMENT OF THE BANK (continued)**

#### **10. The Bank's budget and business plan**

Warwick Jones introduced the item.

It was highlighted that the wording of strategic priority 6 had been changed to include a reference to the Bank's work on introducing a special resolution regime for banks. Other strategic priorities remained the same. It was also noted that each of the milestones to deliver the strategic priorities (p10-11) were the responsibility of individual executive directors. The budget numbers themselves had not changed materially since the January NedCo. There had been minor changes relating to the IT operating model, the updating of some project costs and some general tidying up. In relation to dividend payments, it was noted that the budget continued to maintain a 50% assumption. There had been no pressure from HM Treasury to reconsider this.

It was reported that there had been delays with the CRD review, partly because of staffing changes at HM Treasury. The Bank had recently received HM Treasury's final version of the responses to the consultation document, with which it was largely content. One of the issues to be considered by the CRD steering committee was the level of the Bank's capital, which was relevant to the Bank's dividend. That work had been delayed in the light of market circumstances over the past few months. Discussions would resume in the Spring.

It was explained that the anticipated yield from future investments – both CRD income and capital – had changed (p24-25). An assessment of forward market rates showed that the market was anticipating falls in interest rates so projected income had been scaled down. That had no impact on policy or remunerated functions expenditure.

Some consideration had been given to cost allocations across customer banking. There was considerable uncertainty ahead due to the consequences of future changes in infrastructure following the exit from customer banking. Rather than try to fine tune the numbers at this stage, they had been left broadly unchanged.

It was explained that the new table on page 31 represented how the budget data would be presented in the Annual Report, which NedCo would initially consider in April.

In response to the discussion at NedCo in January, attention was drawn to the additional schedule of information presented on page 32. It showed that total staff costs represented 46% of Bank expenditure. The second largest expense was the note supply contract, which was charged to HM Treasury. Computing and communication costs were another large component. It was noted that a benchmarking study was being undertaken as part of the first phase of the implementation of the IT operating model. It was clarified that this particular breakdown of costs had not previously been presented to NedCo. Within the Bank's financial framework and reports provided for Directors, costs were allocated across the policy and remunerated functions rather than monitored by cost type. Finance were considering further additional regular reporting formats and analysis.

Attention was also drawn to the first attempt to draw together information to present a value for money plan. (p80). A first half-yearly report would be produced, possibly in September. It had

been suggested in January that some benchmarking should be undertaken and some provisional discussions were planned with potential benchmarking firms about how this might be done.

In discussion, it was asked if the Bank was being overly modest with regard to the detail provided on value for money. In response, it was stated that Finance did not want to include numbers that could not be monitored or were not specific. It was agreed that NedCo would consider the information again in September.

Directors briefly discussed the draft letter from the Governor to the Chief Secretary, which explained the Bank's finances. The draft letter included reference to the assumption that the CRD ratio would change but omitted reference to a benchmark rate of return for the investment of the Bank's reserves. This had been agreed by the CRD steering committee. It had been explained to Treasury officials that the investment policy followed by the Bank was mechanistic and did not strive to achieve any particular rate of return.

## **11. Notes IT project**

Rachel Lomax introduced the item.

It was explained that the Notes IT project – which was the largest project in the Projects Group portfolio – aimed to replace the IT systems which supported the warehousing, distribution and accounting functions for banknotes with a single integrated system.

The project had been first approved by Court in July 2006. The total anticipated cost of the project had been £6.4mn at that time, and the original timescale for the project was aggressive (phase 1 by August 2007; phase 2 by June 2008). Slippage of the phase 1 go-live date to October 2007 had been reported to NedCo in January 2007, along with an increase in total projected costs to £7.0mn. In the project report to NedCo in October 2007 and a paper to the Audit Committee in November, it was made clear that the project had encountered further slippage and that the plan and costs were being reviewed. That review concluded with a change in the project management team, and a re-planning of the overall project. It was explained that Projects Group had discussed the proposed changes on two occasions, and accepted the new plan – subject to approval by Court. There was now confidence in the new project management team and in the new timescales set out. The current plan envisaged implementation of phase 1 by December



2008, with phase 2 following in March 2009. Projected costs had risen to £8.5mn (which included a small contingency). It was emphasised that a project of this importance needed to be implemented with care and attention to quality. The delay in timescales was disappointing, but not in itself a serious issue. Moreover, the fact that the issues with the project were identified well in advance of go-live of the first phase was an indication that assurance processes within the project management framework were working well.

It was noted that all costs were allocated against seignorage income. The policy budget was unaffected. The key question was whether the project still delivered value for money. It was noted that the cost-benefit position had changed somewhat. Although net present value had never been positive, in the original business case management had put forward a set of financial benefits which partially offset the costs of the new system. These were supplemented with non-financial benefits such as improved controls and increased flexibility to absorb changes in the business – for example changes to Note Circulation Scheme rules or membership. In the latest business case, the financial cost-benefit position was worse. Not only had project costs increased, but ongoing support costs were also higher for the new system. However, the area management believed the non-financial benefits now carry even greater value and continued to offset the negative net present value. Projects Group had asked the management to improve the business case by defining the non-financial benefits more sharply, providing metrics to judge the success of the project. These benefits would be reviewed again at the meeting of the Projects Group in April.

In discussion, it was asked if the project was optional. In response, it was noted that there was no longer a choice in relation to phase 1 but there remained a choice about phase 2. Efficiency gains would be lost if that option was not taken. Of the estimated cost of £8 million, £6 million had already been sunk. It was explained that a large part of the costs already incurred related to the development of the SAP system to fit the Bank's business need. This involved systems to track the movement of notes around cash centres, including the introduction of bar coding. It was clarified that no expenditure had been written off. The increase in costs was largely due to the lapse in time rather than any re-engineering.

In response to a question about whether the area had enough management resource for the project given other demands on senior Banking management over recent months, it was explained that this was one of the reasons why the project had taken longer than originally



planned. Following the review with the Projects Group, it had been decided that it was important to take more time and resource it properly. It was emphasised that notes distribution was a key function of the Bank and involved significant reputational issues. At the present time, the supporting infrastructure was evidently not fit for purpose. The issue of senior management capacity to oversee the project had been a key issue considered by the Projects Group. For those reasons, a decision had been taken to scrap the COMA project which was also experiencing difficulties and involved senior management in the Banking area.

In summary, NedCo were content with the proposals which would be formally approved by Court.

## **ITEMS FOR INFORMATION**

### **12. CCBS Annual Report**

It was noted that there might be courses run by CCBS which would benefit non-executive Directors. Non-executive Directors were encouraged to consider attending courses – or components of – as part of their general efforts to deepen their understanding of central banking.

### **13. Annual salary review**

Noted.

### **Any other business**

#### **Treasury Committee report ‘Run on the Rock’ and the Tripartite consultation document on financial stability and depositor protection**

Ahead of further discussion over lunch and at meetings of NedCo in March and April, there was a brief introduction to the Treasury Committee’s report on Northern Rock and the consultation document on financial stability and depositor protection. The Bank would be expected to respond to the Treasury Committee’s report and would be involved in discussions with HM Treasury and the FSA about legislation following the current public consultation. It was highlighted that HM Treasury’s timetable was very ambitious. The draft legislation was being produced during the

consultation period and first instructions to parliamentary council were planned by the end of February. Both the Bank and the FSA had significant concerns about the timetable and, in some respects, the level of expertise within HM Treasury. Both had stressed the importance of ensuring that the legislation was right – it would set the scene for banking for the next 20 years or more. The Bank did not plan to respond to the Treasury Committee's report until after the consultation on the tripartite proposals. It was not thought to be sensible to invite others to provide views on the consultation but then offer the Bank's in the meantime.

It was explained that there were four main areas that the Bank would want to focus on. First, the need to review its money market operations, which the Treasury Committee report had commented on. All major central banks were looking very carefully at their money market operations, both individually and collectively in view of the common issues. The Bank planned a new version of the Red Book but would not rush its judgments about changes to the framework. Second, the regulation of liquidity, which was an area of importance to the FSA. Third, a special resolution regime for banks, which was one of the centrepieces of the consultation document, along with the fourth, the reform of depositor protection. The Bank was generally pleased with the consultation document. It included the issues that had initially been raised in the Bank's evidence to the Treasury Committee in September and in the Governor's Belfast speech in October.

It was stressed that a great deal of work needed to be done to turn the principles into effective legislation. In relation to designing a special resolution regime, it was mentioned that the FSA was undertaking a mapping exercise to establish what might have been the appropriate trigger points in relation to Northern Rock. It would be useful if that could be agreed with the Bank and discussed at NedCo. It would enable the Bank and the FSA to see the reality of the decisions that would have to be taken with a new regime.

It was reported that in order to manage the Bank's input into the legislation, a group had been established (BillCo) to centralise communications between the Bank and HM Treasury. It was being chaired by John Footman and involved a number of people from around the Bank who were working on the policy issues. The committee would report to the Governors once a week on developments and progress with the legislation. It was stressed that the detail behind a special resolution regime for banks was critical, which heightened the reservations about the existing legislative timetable.

A key issue for the Bank would be its own statutory role in relation to financial stability, and the implications of that for the tools that might be available to the Bank, which Directors would need to discuss.

**The meeting of NedCo was closed.**

## MEETING OF THE COURT OF DIRECTORS

**Thursday 14 February 2008**

Present:

The Governor  
 Sir John Gieve, Deputy Governor – Financial Stability  
 Ms Rachel Lomax, Deputy Governor – Monetary Policy  
 Sir John Parker, Chairman, NedCo  
 Mr Brendan Barber  
 Mr Roger Carr  
 Ms Amelia Fawcett  
 The Hon Peter Jay  
 Sir Callum McCarthy  
 Mr Paul Myners  
 Dr David Potter  
 Prof David Rhind  
 Ms Susan Rice  
 Mr James Strachan  
 Mr Bob Wigley  
 Mr Geoffrey Wilkinson

Absent:

Sir Andrew Likierman, Mr Arun Sarin

Also attending:

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

**1. Minutes – 16 January**

Approved.

**2. The Bank's budget 2008/09 and the Governor's letter to the Chief Secretary of HM Treasury**

Court APPROVED the budget for 2008/09 and was content for the Governor to send the letter to the Chief Secretary of HM Treasury.

### 3. **Monetary policy issues**

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

### 4. **Northern Rock, financial market developments, financial stability report, financial stability performance measurement, MPC procedures, Agents' issue of the month, notes IT project.**

Court noted the discussions in NedCo of the above items.

### 5. **Sealing Committee authorisations**

Noted.

### **Any other business**

None.

[Members of the Executive Team, other than the Governor, left the meeting].

### 6. **Remuneration Committee report**

David Potter – chair of the Remuneration Committee – introduced the item.

The recommendations for the annual review of salaries for Deputy Governors, Advisers to the Governor, Executive Directors and external MPC members were outlined.

It was reiterated that it was the second year of the introduction of a bonus system for executive directors, judged on the basis of their performance. The target level for bonuses this year was 12% of salary, which would rise as planned to 15% next year – the overall target level. It was explained that next year there would also be an opportunity to review salaries.

Court APPROVED the recommendations, with effect from 1 March 2007.

A salary increase for the Deputy Governors and external MPC members of 2.5%.

[REDACTED]

[REDACTED]

[The Governor left the meeting]

Directors also discussed the issue of the Governor's salary for his second term. It was explained that the principle of quinquennial reviews had previously been established. The {Remuneration} Committee supported the intention of raising the base salary of a Governor to a figure of 375,000 a year, and a pension contribution of 30% of salary. It was noted that the current Governor's pension at the end of his first term would be fully accrued. As requested by Court, the chair of the {Remuneration} Committee had discussed the issue with HM Treasury. Mr. {Macpherson} had indicated that HM Treasury, including the Chancellor, would be comfortable with the proposals.

[REDACTED]

[REDACTED] The Remuneration Committee would consider the issue further and revert back to Court in April.

In discussion, it was emphasised that over a 15 year period, the Governor of the Bank had received an annual increase of 2.5% so the salary level had become detached from comparators in the public sector. The Governor's salary had previously been at the top of the public sector pay scale but had slipped substantially over time – it was now outside the top fifty positions.



It was asked to what extent had the Remuneration Committee considered internal relativities and sensitivities. In response, it was explained that the Governor's salary created a log jam for Deputy Governors, Executive Directors and others. In relation to the broader reactions of staff, it was stressed that the total remuneration package of the Governor would be reduced and he would not receive a supplement in lieu of his pension being fully accrued under the new proposals. It was acknowledged that the salary element of the overall package was more transparent than the pension element. One of the difficulties for any transition was that the salary had been the headline figure presented publicly with little attention paid to the substantial pension benefit.

There was some sense that Court should decide the rate for the job irrespective of individual considerations at a particular time. It was suggested that if the current pay arrangements remained the preferred option for the present Governor, Court should still decide on a preferred remuneration package. This would be a valuable benchmark for the future.

It was clarified that the Annual Report reported the Governor's remuneration over the past year so disclosure would not ordinarily arise in the forthcoming report. However, given the Governor was commencing a second term, it was appropriate to articulate the intentions for his remuneration.

In summary, Court agreed to await the Remuneration Committee's consideration of the auditor's views at its March meeting, to be discussed by Court in April.

**The meeting of Court was closed.**

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

**Wednesday 14 February 2008**

Present:

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

Absent:

Sir Andrew Likierman, Mr Arun Sarin

**1. Minutes of 16 January**

Approved, along with their circulation to Governors.

**2. Review of MPC's procedures paper and discussion**

It was noted that the one-to-one interviews with MPC members undertaken by the chair of NedCo had generally portrayed a more satisfactory and settled picture than had been the case last year, when there had been four relatively new members of the committee. The forecasting process in particular had been difficult with a new head of the forecast team in position following Spencer Dale's departure to the New York Federal Reserve. The position was now considered to be much better.

There was some sense amongst MPC members that leading edge research had been squeezed which Directors should remain aware of. There was also some dissatisfaction with the wording used in the Bank's response to the Treasury Committee's report on the MPC. It had been emphasised that if an external MPC member worked full time, that would not make them internal – as the words in the response implied – insofar as they did not work for the Governor. The

issue of external MPC members' pay was also raised in the interviews. Like the Governor's pay, it had been increased by 2.5% a year for a prolonged period and so had not kept pace with external benchmarks. External MPC members were looking to the Remuneration Committee to review the position. There had also been some discussion about the need for flexibility in the number of days worked, perhaps allowing an initial period of full-time working where an individual would have difficulty securing another complimentary position from the outset to cover, say, two days a week.

**3. Expenses policy for non-executive Directors**

Noted.

**4. Electronic access to NedCo and Court papers - update**

It was explained that an initiative was underway to enable Directors to access electronically and remotely past and current NedCo and Court papers. It would be a matter of choice whether Directors wanted to continue receiving paper copies of papers generally. However, information security considerations might mean the Secretary would opt not to send some very sensitive papers by post and make them available only electronically. The system was expected to be very user-friendly.

**5. NedCo annual report**

A draft would be discussed in March. Directors were content with the proposed themes. It was suggested there should be some discussion of the proposed legislation in the report.

**Any other business**

None.

**The meeting of NedCo was closed.**

## COMMITTEE OF NON-EXECUTIVE DIRECTORS (NEDCO) MEETING

**Wednesday 12 March 2008**

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  
 Prof David Rhind  
 Ms Susan Rice  
 Mr James Strachan  
 Mr Bob Wigley  
 Mr Geoffrey Wilkinson

Absent:

Mr Brendan Barber, Mr Arun Sarin.

Also attending:

The Governor, Sir John Gieve, Ms Lomax, Mr Bean, Mr Bailey, Mr Footman, Mr Jenkinson, Mr Jones, Mr Tucker.

**1. Minutes – 14 February 2008**

Approved.

**2. Matters Arising**

None.

## MANAGEMENT OF THE BANK

**3. (a) Executive Report**

Recent and forthcoming meetings and events

Domestic:

- regional visit to West Midlands (17-18 March) (subsequently deferred);

- talk to cross-party members and peers of the House Magazine (12 March);
- Treasury Committee Inflation Report hearing – Governor, Rachel Lomax, Charlie Bean, Andrew Sentance and Danny Blanchflower (26 March).

#### International:

- BIS meetings, Basel (9-10 March);
- Bank bilateral meeting with the ECB Board (13 March);
- visit to Israel including talk at Bank of Israel (30 March – 3 April);
- Ecofin meetings in Ljubljana, Slovenia (4-5 April);
- visit to Prague and talk at Czech National Bank (7-8 April);
- IMF meetings, Washington (10-13 April).

Breakfast meetings with Sir Gus O'Donnell and the Chancellor had been held on 18 and 19 February respectively; a meeting with Yvette Cooper, Chief Secretary of the Treasury, had been held on 27 February and a telephone conversation with Nick Macpherson on 28 February. Breakfast meetings with Nick Macpherson were scheduled for 20 March and 15 April, and with the Chancellor on 25 March.

#### MPC appointment

The Chancellor had approved the re-appointment of Paul Tucker to the MPC for a third term, with effect from 1 June 2008. A public announcement would be made later in the day.

#### Environmental Award

The Bank had received a Platinum Award for best practice in waste management at the Corporation of London's 'Clean City Awards'.

#### Coordinated actions by central banks

In response to the recent deterioration in financial markets, the G10 central banks had announced a series of further coordinated money market operations on 11 March, following discussions between the Governors over the weekend in Basel, and phone-calls between the Governor and Ben Bernanke last week. The Bank had announced that it would continue its expanded 3-month long term repo operation against a wider range of high quality collateral, scheduled for 18 March and 15 April. The size of the 18 March 3-month operation would be £10 billion, as in December and January. The size of April's operation would be determined at a later stage.

The Federal Reserve had announced a new Term Securities Lending Facility. It would lend up to \$200 billion of Treasury securities to primary dealers for 28 days, in exchange for a range of other securities. This measure was in addition to the twice-monthly Term Auction Facility (TAF), the expansion of which to \$100bn per month was announced on the previous Friday.

There had been some concern that the Fed's facility might raise concerns that would confirm rumours in the markets that one of the primary dealers was in difficulty but rumours had subsided. The ECB undertook to repeat their December operation by offering \$15bn to Euro system banks alongside each TAF auction and the Swiss National Bank offered US\$6bn in the same way. The Bank of Canada had also announced smaller operations, totalling CN\$4bn. The actions demonstrated effective central bank coordination. The Governor had suggested coordinated action on Sunday evening in Basel. Central banks had agreed their actions by Monday, which were announced on Tuesday.

It was explained that these actions would essentially buy time but would not solve the underlying problems in the markets. In the Federal Reserve's case, the actions were an attempt to lend to whoever might be in trouble. Central banks agreed that the underlying issue was about solvency concerns amongst banks. Lack of liquidity was a symptom that might be relieved by the various facilities. The actions undertaken in December had worked for a time but from the middle of January onwards, conditions had deteriorated again. Consequently, the new measures did not remove the need for longer-term solutions. This would be the subject of quite intense discussion over the next few months, centred on the need to recapitalise the banking system, certainly in the United States but probably elsewhere. The aim was to ensure that the financial sector as a consolidated entity was in better shape to lend to the real economy. That would only come about by resolving the current issues.

It was noted that there were quite significant differences between the US and elsewhere, both in terms of the economy and the financial sector. The underlying problem was that mortgage backed securities, and possibly a wider set of asset backed securities, had prices that needed to be marked down significantly on their pre-crisis levels. The incentive structure of the 'originate and distribute' model for mortgage backed securities was very different in a period when the underlying asset prices – i.e. houses – were falling. It was explained that when house prices were rising, buyers of mortgage-backed assets did not need to monitor the credit worthiness of the borrower on the grounds that default rates would be stable. However, when house prices were falling, the situation was very different. There was a particular aspect to the problem in the US insofar as borrowers had the ability to walk away from a mortgage if the house price fell below its outstanding value. That was not the case in the UK or more generally. Consequently, there was a much increased need to monitor individual borrowers and house price prospects which had meant a much reduced demand for mortgage backed securities. It would require a significant fall in the value of these financial assets before anyone would want to start buying them again. It was suggested that this needed to happen sooner rather than later. The market operations announced by central banks would provide more time for a solution to be found either by the private sector or the authorities.



In discussion, it was suggested that it would be helpful for non-executive Directors to have an aide memoir on the different policies and operations of the main central banks, and why they differ. Differences in eligible collateral were marked. It was asked to what extent UK banks were using the ECB's facilities to raise funds in a way they could not through the Bank, and if there were concerns about that. In response, it was noted that central banks – including the Bank and Federal Reserve – had extended their lending against wider collateral through special auctions. This collateral was charged at a higher price than would be the case in ordinary market operations. The ECB lent against mortgage backed securities in its normal market operations which had meant that most of those assets generated in the Euro area had ended up with the central bank. That might be sensible to address a short-term liquidity problem but it was not a longer-term solution because the private market would not reopen. Overall, the collateral that the ECB took in their operations and the collateral the Bank took in its three-month operations were similar. The essential difference was that this was a routine part of the ECB set up whereas the Bank was conducting special operations. Distinctions were not primarily about collateral at present.

It was emphasised that there were significant challenges facing all central banks and the Bank would be considering the issues further as part of its review of its market operations. The aim would be to design a regime that provided temporary liquidity support when necessary but did not end up providing incentives for banks to put assets which needed to fall in price with the central bank at the original face value.

Overall, there were concerns about solvency amongst banks. Many institutions had ample liquidity but others could not borrow due to a lack of willingness to lend and lack of confidence in other institutions. A part of that might reflect irrational panic, which would be helped by the provision of additional liquidity by central banks. But much of the present situation was a more rational fear due to the lack of knowledge about the balance sheet strength of many institutions if asset prices were to fall further.

#### **(b) Update on Northern Rock**

Sir John Gieve & Andrew Bailey introduced the item.

Following the nationalisation of Northern Rock on 17 February, it was noted that the next milestone was the Government's submission to the European Commission. This would be based on the business plan agreed between HM Treasury and the board of Northern Rock. It would need to establish how Northern Rock would restructure its finances and become viable for a return to the private sector, either as a free-standing institution or to be sold to another entity.

The principal issue for the Bank was the outstanding loan facilities. It was expected (subsequently confirmed) that the Budget statement by the Chancellor would state an intention to refinance Northern Rock during the course of this year. This was important both for the Bank's balance sheet and legal restrictions under the Maastricht Treaty whereby central banks in the EU could not lend to public institutions. The Bank had taken legal advice about the interpretation of the law now that Northern Rock had been taken into public ownership. The advice was that Northern Rock needed to be refinanced in a reasonable time period. There was no cardinal rule but a refinancing by the end of the year seemed a reasonable objective.

It was explained that refinancing would most likely be through two sources. First, via the reduction of Northern Rock's balance sheet. Current inflows were between £1.5-2 billion per month as Northern Rock reduced its mortgage lending. The continuation of these inflows was conditional on mortgages being exported to other lenders which might become more difficult in present market circumstances. The business plan assumed a repayment by this means of around £10 billion. Second, HM Treasury would repay the remainder and thereby take on the outstanding loan commitment.

A further issue was the increasing inflows of retail deposits since public ownership. They had averaged around £50 million a day which had raised concerns amongst other banks, and would most likely be of concern to the European Commission. This would need to be addressed in the refinancing plan put to the European Commission. Over the short term, it would be necessary to roll-over the existing Bank of England facilities for a period of time until the new financing arrangements were put into place.

Directors were reminded that the Bank supported the decision to nationalise Northern Rock, but on the basis that the balance sheet would be contracted sharply under a strategy of not extending new mortgages and not accepting new deposits. It was asked how the authorities could constrain the flow of retail deposits to Northern Rock and whether this was likely to become a major problem across the financial sector if it continued. In response, it was suggested that the issue would need to be addressed in Northern Rock's business plan, where there would need to be credible controls in place. It was stated that there was a tension for HM Treasury between a 'business as usual' strategy under an {arm's} length relationship with Northern Rock, and the need for stronger controls over pricing. To date there had been agreements about Northern

Rock's position in the so-called best buy tables. But that was considered largely meaningless insofar as the price sensitivity of particular deposit rates was unknown for a public owned bank.

It was suggested that if the problem was unresolved and retail deposits continued to grow, it would become an issue for the Bank in terms of financial stability, particularly if sentiment towards other banks deteriorated in the current environment. It would then become rational for more depositors to gravitate towards Northern Rock.

In relation to continued reporting on Northern Rock to NedCo, it was agreed that a monthly report would continue to be produced but it would be decided whether it warranted discussion at NedCo each month.

#### **4. Update on Financial Markets**

Paul Tucker introduced the item.

It was explained that over the past month the situation in financial markets had deteriorated significantly. The sentiment in New York was particularly gloomy. Uncertainty about monoline insurers had not abated, which amongst other aspects, had put further pressure on the municipal bond market in the US. Yields on triple A municipal bonds relative to US treasuries had risen sharply which was very rare. This and the passage of time continued to put more pressure on the banks and dealers, which had tightened terms for hedge funds considerably over the past month or so. Hedge funds had not been central to the current crisis to date but it was suggested that might change if there were forced liquidations because of tightening of margin terms by the banks.

It was also noted that even Fannie Mae and Freddie Mac bonds spreads, which were normally perceived as having the same risk as US government bonds, had started to reflect concerns about mortgage backed securities. Even those mortgage backed securities which were based on mortgages guaranteed by Fannie Mae and Freddie Mac were becoming difficult to trade and finance. The significance of that was that banks and primary dealers had large inventories of these securities, which explained the Federal Reserve's recent actions. These did not inject any further central bank money into the market but were effectively offering to swap treasury bonds for private mortgage backed securities. The treasury bonds could then be used in the Federal

Reserve's open market operations and in the private repo markets. Over the past week, the only fixed income instruments that could be traded and financed in dollar markets were the obligations of the government itself.

It was noted that the market measure of credit risk for large complex financial institutions (LCFIs) reflected this worsening position. There was considerable fear in the market and through the official community in the US which lay behind the actions taken by the Federal Reserve on the previous Friday and Tuesday.

The reception to the announcement had been fairly good to date but the situation remained fragile. Hedge funds had been approaching large banks to try to get positions transferred from dealers. Credit committees around the world had been meeting to determine their approach and discussions between dealers and their counterparties were very active. It amounted to a very precarious position, which could affect the price of credit in the real economy.

## **5. Balance Sheet remit 2008/09**

Paul Tucker introduced the item.

It was explained that the Remit was an annual item reported to NedCo detailing the remit given by the Governor to the Executive Director for Markets. The paper identified key changes to the Remit compared with 2007/08. It was noted that, aside from special operations, the Remit was essentially for routine operations, including relatively routine contingencies.

The structure of the Bank's balance sheet continued to be in transition. The programme of purchasing longer-term bonds for the Issue Department (the MMR2 project) had commenced. Additionally, HM Treasury had repaid a part of the Way & Means overdraft facility to assist the Bank's market operations, and this would continue when possible. The Bank would also withdraw as planned from the euro area's Target wholesale payment system later in the year, which would reduce – but not eliminate – the amount of euro intra day liquidity the Bank needed to facilitate the Bank's provision of banking services in euros.

Two aspects of the high level Remit were highlighted relating to draining of reserves. Having bonds on Issue Department's balance sheet meant that if the Bank was to repo out those bonds

for cash, it would for the first time place a liability on Issue Department's balance sheet that was not a banknote. HM Treasury was content but it was necessary to make provision for it in the remit. Second, and less important, it had not been made clear previously in the Remit that the Bank could drain reserves via repo operations using bonds that are held on Banking Department's balance sheet. Explicit provision for those operations was now being made in the Remit. It was noted that the potential issuance of Bank of England bills was not included in the Remit at this stage because that remained under discussion with HM Treasury. Directors would be updated in due course.

It was also mentioned that this year's issuance of bonds to finance the Bank's own foreign exchange reserves to enable MPC intervention should the need arise, had been undertaken earlier in the week. The issue had been undertaken in adverse market circumstances but it had been the best priced quasi-sovereign issue so far this year and had gone smoothly.

## **6. Tripartite consultation on financial stability and depositor protection**

(Alastair Clark in attendance)

The Governor and Mr Footman introduced the item.

It was explained that there were a variety of issues in the consultation that had a bearing on the Bank. Some were reasonably straightforward, others were more complex. The discussion aimed to review the issues but would not seek to reach conclusions. A full discussion would take place in April when the Bank would present a paper covering its thinking and options for Directors to consider.

There was some concern at the present time that HM Treasury had involved lawyers in the early drafting of the legislation ahead of decisions about the objectives that the legislation was seeking to address. A key question was what kind of special resolution regime the UK needed. There was widespread agreement about the need to have such a regime but not about its nature. Related questions were what kind of triggers should be used to determine actions to deal with failing banks; which authority should control particular triggers; and what measures of a bank's performance should trigger special regulatory oversight, special measures taken by the authorities, and ultimately, placing a bank in a special resolution regime at which point shareholders would {lose} control.



It was felt that it was important to learn more about overseas experiences. Some countries had clear objectives and measurable criteria for triggers, leading to a mechanical decision. In the US this was expressed in terms of a level of capital. Other countries had a more subjective approach where judgment played a greater role, in which case the identity of the body making that judgment became more important. More knowledge was needed about how different regimes worked in practice. For instance, was it the case that the US had a mechanical approach? And where judgment was used, what kinds of measures were used? Recent experience suggested that capital measures would not be sufficient – liquidity would be a key ingredient.

In terms of the question about the body that should have responsibility for activating triggers, there were different examples around the world involving financial supervisors, central banks, deposit insurance agencies or special bodies set up for the purpose. There were arguments for and against each of these different bodies which would be discussed further in April. It was emphasised that the triggers used mattered to the decision about which body would take responsibility for them.

In terms of the Bank, there were two related considerations in the consultation. First, the Bank's future financial stability role, which was itself dependent on decisions about the Bank's role in a special resolution regime. Second, the role of Court in monitoring the work of the Bank in this area. Again, it would be difficult to reach firm conclusions about Court's role ahead of knowing more about the role of the Bank and whether it would have more or fewer powers.

It was suggested that some of the issues contained in the consultation that were relevant to the Bank could be placed aside. The question of the oversight of payment systems had previously been discussed in NedCo. The Bank was still proposing that it should be responsible for those payment systems that it had the capacity to oversee through its operations. It was not seeking additional powers to do this. This could be discussed separately, though it was relevant to the discussion about the Bank's statutory financial stability role. A second issue, which was less central to the present debate, was the revised arrangements for Scottish and Northern Irish banknotes.

[Susan Rice declared an interest in relation to Scottish banknotes as a director of Lloyds TSB which operated a Scottish clearing bank. It did not issue its own notes but provided services to handle the notes of one of the issuing banks.]



In relation to enhancing the Bank's lender of last resort function, the Bank had made a series of requests to HM Treasury, some of which were part of the consultation document. These included measures to enable the Bank to enforce collateral more easily when it acted as lender of last resort and to limit the transparency of its operations through the Bank Return. It was noted that disclosure was not simply an issue for the Bank but also for banks that received assistance. The Bank had asked HM Treasury to consider again the way various European directives were implemented in the UK. It was noted that the particular position of central banks seemed to be recognised in other countries. It was recognised that there was little point in the Bank having disclosure exemptions if banks in receipt of funding had to announce it. Legal advice was being sought on the issue. It was acknowledged that the request the Bank had made might not be achievable insofar as it sought to override principles of market disclosure.

In relation to defining a special resolution regime, there was a discussion about the Treasury's current thinking and how it fell short of the Bank's view. HM Treasury were largely considering options centred on their own role and issues concerning the transfer of property rights from shareholders. The present draft legislation amounted to adapting the emergency powers that had been taken for Northern Rock. HM Treasury were considering the mechanical instructions that would be required to enact the powers that ministers would have, which therefore politicised the process of dealing with failing banks. In the Bank's view, what was required was a regime removed from politics with well defined processes and responsibilities rather than one centred on ad hoc decisions by the Chancellor of the day.

Part of HM Treasury's thinking was that a failing bank would be classified as either a systemic or non-systemic institution. A systemic bank would be placed in the special resolution regime whereas a non-systemic bank would enter a special insolvency procedure. Banks entering the special resolution regime might require liquidity from the Bank and might see the transfer of property rights by order of Parliament. The Bank considered such an approach to be very different from what it envisaged was needed, which would cover all banks and activated in circumstances when financial stability was threatened.

It was stressed that it would be important to move HM Treasury from the current timetable. If the present formulation was taken forward, there could be damaging effects on the existing system of bank regulation. The Governor and FSA chairman would continue to impress on HM Treasury the importance of ensuring that the legislation was properly considered and judged.

It was noted that senior figures in the private sector had welcomed the concept of a special resolution regime while recognising that the precise detail would be crucial. The Bank and the FSA needed to make their case to HM Treasury and ensure the wider consultation solicited views about the precise arrangements for a special resolution regime. It was noted that the BBA and CBI had made the same point.

In response to a question about the purpose behind such a short timescale for legislation to be considered and drafted, it was suggested that it was driven in the main by the need to demonstrate that the Government was acting to address the identified problem. It was also noted that there was some space in the legislative program. The sunset clause in the Northern Rock nationalisation bill would expire in February 2009, which provided a date for a special resolution regime to become law.

It was suggested that in April Directors should have a full discussion about what should trigger a bank to enter a special resolution regime, what powers the agency authorised to deal with such a bank would have, and whether those powers should be vested in the FSA, the Bank or a special body. Ideally, the Bank would want to spend the next three months consulting intensively with both the private sector and official agencies overseas with experience of such regimes, and to discuss with non-executive Directors the principles of a regime. By May or June, the Bank would then be able to map out its preferred options. What it did not want to do is re-draft a badly formulated piece of legislation. It was not thought necessary to delay the timetable indefinitely but more time was required to undertake a proper consultation.

It was asked at what point in the process the Bank would say that it would not commit itself to an ill-conceived and rushed legislation programme. In response, it was noted that the Governor and FSA chairman had made it clear to the Chancellor that ensuring the legislation was right was far more important than meeting an arbitrary timetable. That message would be repeated along with the importance of making the consultation a reality. It would also be conveyed that what was currently being drafted did not amount to a special resolution regime and that it would be difficult for the Bank and FSA to support legislation that fell well short of what had been identified as necessary to overcome the problems experienced with Northern Rock.

It was noted that the Bank had been successful ahead of the consultation document in making the case for a special resolution regime with HM Treasury. There was now perhaps some reluctance

to acknowledge that what had been stated was not consistent with the timetable the Government wanted to achieve. It was hoped that HM Treasury would not want to proceed with legislation that was so short of the stated objective. There were new senior officials at HM Treasury that were conscious of the position they had adopted, and so there were some reasons not to be too pessimistic.

It was emphasised that private sectors representations would be important. Discussions with the BBA had suggested that they were some way from understanding a number of aspects of the proposals.

Non-executive Directors supported the Bank's desire to have a robust legislative framework for a special resolution regime. It was stressed that establishing triggers for taking over property rights was a fundamental issue. If triggers were quantitative, it might not stand the test of time as circumstances changed. Alternatively, if it was qualitative in nature, it would inevitably be vague and open to legal challenge. However, it was noted that such issues had been overcome in other G7 countries.

It was asked if it was envisaged that there would be preliminary triggers – say from green to amber – which would prompt efforts by perhaps the FSA and Bank to return the institution back to green, followed by secondary triggers which pushed a bank into the special resolution regime. In response, it was explained that the FSA was thinking in terms of moving to a heightened supervision regime which might include Bank involvement. An important question was how that was decided. It was perhaps simplifying the discussion to talk only about single triggers. Beyond heightened supervision, an institution might move to one of a number of positions, one of which would be nationalisation.

It was suggested that little support might be forthcoming from banks who would inevitably support the concept of a special resolution regime applicable to all institutions but not the implications for themselves. Therefore, looking to the private sector for guidance might be of modest value to policy makers. It was also suggested that thinking of a regime in terms of triggers might not be sufficient. Instead, triggers might be better as part of a spectrum of stages in a special resolution regime but did not themselves define it. Another view was that there might only need to be one trigger, namely when a bank applied to the Bank for emergency lending assistance which would attract various terms and conditions such as legal immunities.

It was stressed that the key issue, both in practice and looking at the experience of other countries like the US, was the ability to act promptly. The US had devised the phrase ‘prompt corrective action’. Difficulties would arise if triggers were defined without giving careful consideration about what incentives might be created to delay the point at which the trigger was activated by the authorities. The example of Northern Rock was illustrative insofar as there were no powers available ahead of the ultimate trigger of nationalisation. In such circumstances, the trigger was inevitably delayed in view of the consequences. It was preferable to have a regime with smaller triggers that were relatively easy to define that might lead to heightened supervision and perhaps liquidity support by the Bank. Final triggers might not necessarily involve nationalisation. It was not thought sensible to wait for the latter stages before the provision of support by the Bank of England was made available. Liquidity support might be sensible before a point was reached where it was necessary to nationalise a bank, run it down or sell it to another party. It would be undesirable to have a trigger that had so many consequences that there was a reluctance to use it until it was too late.

In relation to the private sector’s appetite for a regime, it would be necessary to persuade banks that a special resolution regime was preferable to the situation that arose with Northern Rock. Within a well defined regime, banks would know that if they reached a particular point, the authorities would have the ability to invoke special measures and take over a failing bank.

Directors supported the Bank’s position in broad terms to seek a fuller interpretation of a special resolution regime beyond what was currently envisaged by HM Treasury. It was clarified that detail issues would be discussed at the NedCo meeting in April. Directors also believed that the existing timetable for legislation was unrealistic, although it was acknowledged that it was necessary to work to a politically feasible timetable rather than seek a long delay. It was requested that, in addition to the main papers for NedCo in April, Directors also receive the research on the experience of other jurisdictions, for special resolution regime and the other issues to be discussed.

[Break]

There followed a discussion of the three further issues most relevant to the Bank in the consultation document: a statutory objective for the Bank's financial stability role; a financial stability oversight role for Court; and the size and nature of Court.

Some work had been undertaken to consider possible definitions and the scope of a statutory reference to financial stability. But it was stressed that a statutory objective would depend in large part on the functions that the Bank might have under a special resolution regime. There was a need to see what powers the Bank would have and then ask what the Bank could do in terms of financial stability with such powers. The Bank had little appetite for an open-ended statutory objective such as 'maintaining and promoting financial stability', which would amount to different things for different people. That would leave the Bank in the same position as with the original Memorandum of Understanding. It was preferable to establish the powers the Bank would have and then define what the Bank could do in practice.

In response to a question about whether consideration had been given to defining the Bank's financial stability objective proactively, perhaps mirroring in some way the MPC's objective, it was stressed that, however defined, the role had to be centred on the Bank's powers. For example, if a bank moved from a normal to a heightened supervisory regime, where the Bank might have a greater monitoring role, such a situation could be clearly defined. That would contrast with the position that prevailed until last August, when the presumption was that the Bank would not be involved in discussions with individual institutions. In the case of Northern Rock, the Bank had moved from no contact to funding the bank. It was preferable to have a graduated involvement. What that meant in practice was amongst the issues being discussed with the FSA in a proactive way.

In relation to the Bank's role in a special resolution regime, the Bank was not arguing for greater powers for itself. There were arguments for and against, which Directors would discuss in April. Additional powers might provide the Bank with a much better defined role which would enable it to move away from a general objective of trying to prevent financial instability. It would be able to describe its role in terms of what it was supposed to do to promote financial stability.

It was felt that a financial stability objective was unlikely to have parallels with the Bank's monetary policy responsibilities. The strength of the MPC framework was the principle of one person, one vote, which was only feasible when the decision involved a single variable, namely



the level of Bank rate. Financial stability involved a large number of potential variables and was not a quantitative decision. In such a situation, a voting mechanism would not work. It was noted that there were no such approaches to financial stability elsewhere in the world. Such a simple voting system would not be appropriate. But it was thought that the formality of the MPC framework might be replicated in terms of a financial stability committee with external input. In response, it was reiterated that establishing the powers that the Bank would have was necessary before a decision-making mechanism could be considered.

The potential for a financial stability role to be in conflict with the Bank's monetary policy role was raised. Anything that compromised the Bank's commitment to monetary stability would be a high cost to bear. There needed to be a consideration from first principles that identified what aspects of the financial stability regime were currently regarded as deficient and what the Bank alone could do to address them. This would also address the relationship between the Bank, HM Treasury and the FSA, and some outcomes might involve the Bank being empowered to give directions to the FSA. It was stressed that a central bank could not avoid some aspects of financial stability work, not least because of its role in monetary policy which gave a central bank a minimum financial stability role through its money market operations. Moreover, a central bank had to provide lender of last resort financing even if another authority took the decision. The provision of such financing would involve monitoring a recipient institution and engaging in discussions about its future. A central bank would not want to move from no involvement to a major financial involvement as had happened with Northern Rock.

In view of the fact that the FSA was concerned with many institutions and market behaviour, and given the linkages between the Bank's monetary stability and finance stability roles, it was suggested that it might be right for the Bank to have responsibility for the prudential regulation of the liquidity of banks. This might involve having powers to request the FSA to take action or seek information. Reference was also made to the Treasury Committee's suggestion that there might usefully be creative tension between regulators. In response, it was suggested that creative tension would most probably mean ambiguity. Clarity of responsibilities would be crucial for the two bodies.

It was noted that there were inevitable sensitivities between the Bank and the FSA such that it might be appropriate to undertake part of the discussion in April in the absence of the FSA chairman.



In response to a question, it was explained that the review of the Bank's money market operations was unlikely to have a major bearing on the current debate. It was clarified that the Bank did not intend to make a submission to the consultation in view of the fact that the consultation was a tripartite exercise. It would not reach final judgements until it had considered responses to the consultation. The aim over the coming month was to put a paper together for discussion at NedCo in April that outlined the Bank's views as they stand. It was suggested that it might make sense to discuss fall back positions in the event that the Bank's preferences did not carry the day.

The FSA's work on assessing triggers points was also discussed. A paper had been discussed by the FSA's board which the FSA was content for Directors to see. In identifying points at which intervention would have been possible and relating points of intervention to criteria, the exercise had provided a good flavour of the decisions that would need to be taken in a new regime. The Bank was also undertaking work on potential triggers. A key question was how much objectivity could be introduced into the judgments about trigger points.

## **7. Staff survey and flexible working**

(Louise Redmond – HR Director – in attendance)

Louise Redmond introduced the item.

Directors discussed elements of the recent staff survey. It was noted that there were a number of positive outcomes, some of which reflected earlier actions. Responses about communications and the way the Bank treats its staff were particularly satisfying. In response to a question, it was explained that a number of questions in the survey were identical to those asked by other organisations. It was therefore possible to provide benchmark data which were in the report.

One area where responses had declined concerned the sense staff had about their workloads. It was suggested that the timing of the survey – in November 2007 – coincided with extra pressures on some areas of the Bank alongside difficult financial market conditions. The Bank had announced that it would make special bonus payments prior to the survey being undertaken but payments had not been made.

The ongoing perception that lower band staff from ethnic minorities received lower bonuses was raised. It was puzzling why the responses were persistent over a two or three year timescale. It was asked if such staff received appropriate mentoring and training and support needed to improve their performance.

It was suggested that the present positive situation was potentially dangerous if it resulted in a relaxed management approach. Even when results were strong, local discussions about areas that have declined slightly helped to tease out issues before they became more acute. It was noted that there were discussions at divisional level, and divisions considered and acted on their own particular data. A further point was made about the need to ensure that a sense did not develop amongst better performing staff that nothing was done to tackle poor performance. It was explained that a good deal of energy had been spent on the issue three years ago when new processes had been put in place and new guidelines for managers issued. That had resulted in an improvement in survey responses initially but they had fallen back again. The Human Resources area was conscious of the need for renewed focus and efforts in this area.

## **8. Audit Committee report**

Amelia Fawcett introduced the item.

The summary paper outlined the main items discussed by the Audit Committee at its meeting on 14 February. It was highlighted that the Audit Committee had discussed the level of non-audit fees for KPMG. There was some uneasiness about the amount of work KPMG was doing. This understandably reflected in part conflicts and an unwillingness in the Bank to use Deloitte's for work on the Loomis accounting problems. Nonetheless, the Audit Committee had raised the issue and asked the Bank to consider using other firms whenever it could, including in some instances second-tier firms. The situation would be kept under review by the Committee.

In relation to the Bank's annual accounts, the possibility of disconnect between the accounting standards that the Bank believed should be used for disclosures relating to Northern Rock and what the Government might prefer was noted. It was expected that the issue would be resolved but the Audit Committee had made clear that it would want to see a standard employed that was appropriate rather than expedient.

On the subject of value for money, it was noted that a report would be provided for NedCo in September. An update on the Bank's procurement work would be provided in May.

It was reported that the Audit Committee had considered papers from the internal auditors and the executive management about the Bank's performance against the priorities set by the Audit Committee for 2007. A review paper from the Audit Committee would be provided for NedCo in April (subsequently deferred to May), which would also outline the key issues to address in 2008.

It was also noted that Bank's internal auditors would be undertaking another evaluation survey. The Audit Committee would undertake its surveys on a bi-annual basis.

#### **9. MPC report to Court**

Noted.

#### **10. Non-policy meetings of the MPC**

Noted.

#### **Any other business**

None.

**The meeting of NedCo was closed.**

## MEETING OF THE COURT OF DIRECTORS

**Wednesday 12 March 2008**

Present:

The Governor  
Sir John Parker, Chairman, NedCo  
Sir John Gieve, Deputy Governor – Financial Stability  
Ms Rachel Lomax, Deputy Governor – Monetary Policy  
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 James Strachan  
Mr Bob Wigley  
Mr Geoffrey Wilkinson

Absent:

Mr Brendan Barber, Mr Arun Sarin

Also attending:

Mr Bean, Mr Bailey, Mr Footman, Mr Jenkinson, Mr Jones and Mr Tucker.

**1. Minutes – 14 February 2008**

Approved.

**2. Payment to HM Treasury in lieu of dividend**

Warwick Jones introduced the item.

It was noted that the paper identified three issues that impacted on the size of the proposed dividend payment relative to initial estimates made in November. Any further changes in the Bank's estimates would be reflected in the second payment to be made in October.

Court APPROVED the interim payment of £39 million, in lieu of dividend for 2007/08, payable on 4 April.

**3. Monetary policy issues**

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

**4. Northern Rock, financial markets, balance sheet remit 2008/09, tripartite consultation issues, staff survey and flexible working, Audit Committee 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 12 March 2008**

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  
Prof David Rhind  
Ms Susan Rice  
Mr James Strachan  
Mr Bob Wigley  
Mr Geoffrey Wilkinson

Absent:

Mr Brendan Barber, Mr Arun Sarin

**1. Minutes of 14 February**

Approved, along with their circulation to the Governors.

**2. Nedco Annual Report – first draft**

It was agreed that comments should be sent to the Secretary. A further draft would be discussed in April.

**Any other business**

The Governor in attendance.

Directors discussed issues around the future size, structure and role of Court, ahead of the main discussion in April. It was explained that the Bank favoured reducing the size of Court to a membership of around twelve, weighted as now towards non-executive directors. The future role of Court, particularly in relation to financial stability, would be an important driver of its structure in terms of the split between executive and non-executive membership. It was



suggested that the present structure of the Bank's executive management might also form part of the forthcoming legislation. The 1998 Bank of England Act had introduced the present structure of two deputy governors. The structure of the FSA's board was noted. The frequency of Court meetings and the desirability of having a nominations committee were also discussed.

The Bank's proposals would be outlined in a paper for NedCo in April. Non-executive Directors were supportive of the general direction of the suggestions made which would be incorporated in the paper. There was a desire for future legislation to be drafted in a way that enabled flexibility about the precise make-up of Court and how it operated so it could adapt to changing requirements in the future.

There was also a discussion about the merits of undertaking a board evaluation exercise at the present time rather than later in the year as planned. It was agreed that the previous questionnaire would be reviewed by the Secretariat and sent to non-executive Directors in April or May.

**The meeting of NedCo was closed.**

**COMMITTEE OF NON-EXECUTIVE DIRECTORS (NEDCO) MEETING****Wednesday 16 April 2008**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  
Prof David Rhind  
Ms Susan Rice  
Mr Arun Sarin  
Mr James Strachan  
Mr Bob Wigley  
Mr Geoffrey Wilkinson

Also attending:

The Governor, Sir John Gieve, Mr Bean, Mr Bailey, Mr Jenkinson, Mr Jones, Mr Tucker, Dame Juliet Wheldon.

**1. Minutes – 16 March 2008**

Approved.

In relation to the reference about the potential for more depositors to gravitate to Northern Rock, it was confirmed that the Bank had raised the issue with HM Treasury.

**2. Matters Arising**

None.

## MANAGEMENT OF THE BANK

### 3. (a) Executive Report

#### Recent and forthcoming meetings and events

##### Domestic:

- Treasury Committee Inflation Report hearing – Governor, Rachel Lomax, Charlie Bean, Andrew Sentance and Danny Blanchflower (26 March);
- Regional visit to the Isle of Wight and Southampton (21-22 April – subsequently deferred).
- Treasury Committee Governor re-appointment hearing (29 April).
- regional visit to Cambridge and Peterborough (1 May);
- Financial Stability Report (24 April, subsequently delayed until 1 May)
- Inflation Report (14 May).

##### International:

- visit to Israel including talk at Bank of Israel (30 March – 3 April);
- Ecofin meetings in Ljubljana, Slovenia (4-5 April);
- IMF meetings, Washington (10-13 April).
- BIS meetings (4-5 May).

Breakfast meetings with Nick Macpherson had been held on 20 March and 15 April, and a meeting with the Chancellor on 25 March. A breakfast meeting with Sir Gus O'Donnell had been scheduled for 24 April, and meetings with the Chancellor on 17 April and 30 April.

#### CRD review

The CRD review had been completed. HM Treasury had announced the results of the consultation and confirmed the original proposals. A statutory instrument would now be laid before Parliament. Assuming no delays, the new regime would start on 2nd June.

#### Redundancy policy

The proposed changes in redundancy policy had been accepted by the union and a vote of members held. Some ninety per cent voted in favour. The proposals would be implemented with immediate effect.

#### Staff

A number of appointments were reported. Jenny Scott – currently a BBC presenter – would replace Peter Rodgers as Director of Communications after his retirement on 30 June. The Bank

had used a headhunting firm to suggest potential candidates. The chair of NedCo had interviewed the final two candidates, in addition to the Governor and Peter Rodgers.

Jonathan Curtis – currently a senior manager in ISTD – would become Head of Human Resources Services Division on 1st August, succeeding Kevin Evans who would retire in July.

A number of Agents would retire over the next year or so. The following appointments had been made in preparation:

- Graham Chaplin would become Agent for the West Midlands;
- Phil Eckersley would become Agent for the south east England;
- Chris Piper would become Agent for the central southern England;
- Neil Ashridge would become Agent for Wales.

A new head for ISTD would be appointed in due course to replace Chris Piper.

#### MPC visit to Yorkshire and the Humber

Directors were reminded that it had been agreed to end the annual out-of-London Court meeting and replace it with an extended MPC focussed visit. The week long event this year would be to Yorkshire between 20th and 24th October, the centre piece of which would be a dinner and speech on 21st October in Leeds. It was hoped that non-executive Directors would be able to attend that event and to take part in some of the other events and meetings before and after the dinner.

#### New liquidity scheme

Directors were informed of the work being undertaken in the Bank on a scheme to allow banks to refinance their illiquid assets. There had been some references to the proposals in the media. It was explained that the financial crisis had entered a new and more difficult phase. During the Autumn concerns had centred on weaker banks but, more recently, the fragility had become sufficiently widespread that any institution was potentially vulnerable to rumour and speculation irrespective of their underlying position – the experience of Bear Stearns had illustrated this. Interest rates in the interbank market had risen sharply again, reflecting a lack of trust by banks in each other. That had been palpable at the G7 meeting with banks the previous week.

Consequently, something concrete needed to be done in order to reassure financial markets that if a bank was in need of more liquidity by refinancing some of its less liquid paper, it could do that. The Bank was proposing a new facility to enable banks to swap government securities,

which would be highly liquid, for some of their illiquid paper, primarily mortgage backed securities. The scheme would be in place for a period of up to three years. It was noted that the Federal Reserve's current facility was for 28-day periods which still left banks with concerns about access to liquidity beyond a few months.

A key principle behind the Bank's proposed scheme was that credit risk should remain with the banks. It was explained that an interest rate would be payable on the swapped assets which would be above the policy rate, and haircuts would be applied to the assets provided by banks. There would be only a very small residual probability that credit risk could fall on the taxpayer. This would result only if a participating bank failed and the value of the collateral exchanged with the Bank proved inadequate to cover the securities lent. It was stressed that there was no question of purchasing assets outright.

It was explained that the Bank had been discussing the proposals with a group of main banks over the past few weeks. Alastair Clark and Paul Tucker had led an intensive effort, in addition to the Governor's discussions with chief executives of the banks. They were very supportive of the idea, including the need for the banks to retain the credit risks associated with their illiquid assets. That would help to demonstrate that the issue was not one of solvency.

A further important principle was that the scheme would only accept assets that existed at the end of 2007, or securitised assets that corresponded to assets that existed at that date. The scheme would not provide artificial incentives to create more of these illiquid assets by allowing new assets to be placed in the scheme. This would avoid the ECB's position insofar as all such assets in the euro area were now on its balance sheet.

It was explained that over the past nine months, central banks had found it very difficult to operate discount window and standing facilities because use of them had become stigmatised. That had prompted a move towards auctions which enabled many banks to bid for funds and so lessen the possibility that individual banks would be singled out. However, auctions only provided funding on particular dates. The Bear Stearns episode had illustrated why that might not be sufficient even when pre-announced as the Federal Reserve had done. The challenge had been to design a facility that would be available when needed but which avoided the stigma issue.

In terms of timing, it was explained that the Bank was ready to proceed with the scheme. However, it could not undertake such operations by itself given the relatively small size of the Bank's balance sheet. If the Bank had a sufficient quantity of Government securities on its balance sheet it could provide such a facility itself. But it was necessary for the Government to issue new securities to the Bank. One of the problems that had arisen related to the treatment of

the scheme by the ONS. If the Bank was undertaking the asset swaps using its balance sheet, the ONS would have no interest. Yet, although the economic effect of the transactions would be identical, the issuance of new securities by the Government meant that the ONS might decide that the scheme constituted an increase in public sector net debt rather than being an equivalent increase in gross assets and liabilities. The ONS judgement on the matter would be 'either/or' which might amount to a very large rise in public sector net debt. It would not be a proportional judgement, for instance that net debt would increase by 10 per cent based on the characteristics of the scheme. This issue was still being discussed but represented a serious consideration for the Government. In the Bank's judgement, the scheme had no economic consequence of the sort that the calculations on net debt were designed to reveal. The scheme would involve a temporary expansion of the public sector balance sheet in order to enable the banking sector to contract its balance sheet in a more orderly way than would otherwise be likely to occur.

It was reported that the Governor had written to the Chancellor the previous week outlining the purpose and details of the scheme, and recommended implementation as soon as possible. Speculation was such that it was necessary to make a clear decision one way or the other.

Directors discussed various aspects of the proposal. It was noted that the ONS were less likely to treat the scheme as increasing net debt if the swaps were for a period of less than one year. The potential size of the scheme was highlighted in view of the fact that institutions would be allowed to create new securitised assets with assets that were on their balance sheets up to the end of 2007. It was suggested that the details of the design of the scheme should ensure institutions, including a number of smaller building societies, could readily access it. It was stressed, however, that the scheme was in no way a solution for the mortgage market. Indeed, there was considerable scepticism about broader solutions for the mortgage market. The Bank had no desire to facilitate a return to the previous conditions in the mortgage market where lending had become excessive and risky, and lending conditions too lax. The Bank would be opposed to public sector measures that either bought mortgages outright or underwrote mortgage lending, or other measures that distorted the appropriate pricing of mortgages. For the scheme that the Bank was proposing, there would be a need to distinguish very clearly between the mortgage and housing market on one hand, and the problems in the banking sector on the other. They were linked insofar as a large amount of bank lending was for mortgages. But the purpose of the scheme was to improve liquidity conditions in the banking system. If that was achieved, the mortgage market could largely be left to take care of itself.

It was clarified that a large proportion of the assets eligible for the scheme would be UK mortgage backed securities. It was noted that the total stock of lending at three months against wider collateral that the Bank had undertaken to date was £25 billion. The scale of the scheme would reflect its use. Discussions with the main banks had established an expectation that the



initial use of the scheme would be in the region of £50 billion. But it was impossible to know what the future access would be. If the scheme worked by improving confidence in banks and their ability to access to liquidity when needed, recourse to it might be relatively small. It was noted that there would be no arbitrary limit. It was important that banks could access the scheme as needed. The Bank would however have the right to limit access in aggregate or for an individual institution. It was stressed that the scheme was not designed to be a lender of last resort facility. It was to prevent a sudden crisis of confidence leading to the interbank market freezing up. It could not be certain that such a scheme was necessary but the risks were clearly asymmetric. If it was necessary and was not put in place, the consequences might be very considerable if one or several institutions faced a crisis of confidence regardless of their underlying financial soundness.

A view was expressed that the need to put such a scheme in place, which amounted to a sector-wide support initiative, was a sad day for all concerned. It was asked, if the scheme was the right thing to do now, why was it not the right option to take earlier in the crisis. There was concern that there were no consequences being imposed on banks in return for the scheme, in terms of raising capital, reducing dividends and management sanctions, or any changes to the regulatory environment. It was suggested that the payment of very large bonuses to bank executives would continue. For these reasons, by itself the scheme would be deficient. More details about the scheme's risk assessment were requested in view of the fact that the inability to adequately quantify and manage risk were at the root of the present financial crisis. In view of this background, it was asked if haircuts would be adequate. In relation to fees, it was asked if the interest rate to be charged would be a premium to the interbank rate to ensure it did not amount to a subsidy.

In response, it was stressed that the scheme would not replace the need for banks to raise new capital and that would continue to be conveyed by the Bank publicly.

It was disappointing that banks had not done this earlier in the year but had instead made large dividend payments. However, the position now appeared to be changing. Markets had not reacted negatively to those banks that had made capital calls. It was suggested that the amount of capital that banks held would need to be higher and liquidity requirements would also have to be increased. But the present circumstances were not the point to raise banks' regulatory capital requirements. Rather, it was the point for banks to raise more capital to re-establish their cushion against existing capital requirements. Market pressures on the banks at present were consistent with this.

It was clarified that participating banks would pay a fee based on the spread between the 3-month LIBOR rate and the 3-month gilt repo rate. LIBOR was currently very high so in no sense was the scheme a subsidy for banks. In relation to credit risk, this was a core part of the proposal.

Haircuts would be substantial. In the event of a bank defaulting, the Bank would hold collateral to repay the value of the securities lent to a bank. These assets would be based on prime residential mortgages. Over a period of three years, the Bank was confident it could put a floor on the plausible economic value of these assets. These were high quality assets but the market was temporarily closed. When the instruments matured, the value should be realised. Indeed, most of the assets would mature within three years reflecting the relatively short life of most mortgages. Moreover, the Bank would have the ability to re-margin the assets at any point. Therefore, if the default experience on mortgages was deteriorating, the banks could be asked to place more collateral in the scheme. Those conditions enabled the Bank to say that there would be virtually no credit risk with the scheme, and no more than in its normal operations or the recent auctions it had conducted. In that sense, the scheme was not a bailout of the banks. They would not gain advantage but were collectively being given the opportunity to borrow from the public sector to deal with temporary illiquidity of their assets. The scheme was designed to be in the interests of the wider economy, to prevent the credit crunch having a more severe impact.

It was clarified that the scheme would have no implications for monetary policy. It was proposed to structure the scheme around a separate vehicle rather than on the Bank's main balance sheet. Unlike the term auctions, the Scheme would not involve having to withdraw equivalent funding following an injection of new liquidity. The scheme would create new public sector assets which would be swapped for private sector assets. It would therefore not amount to an injection of new liquidity.

In response to a question about the stage the financial crisis had reached, it was suggested that it was impossible to know in view of the nature of crises of confidence. The situation had been grave in March when almost any bank, irrespective of its fundamental position, was perceived to be at risk because of rumours. The present position now could not be judged in terms of an assessment of the fundamentals insofar as market sentiment reflected fear and uncertainty.

It was asked what the next best alternative to the proposed scheme would be. In response, it was suggested that a marginal increase in the Bank's term auction facilities would be a possibility. However, there was not much scope to do that because of the limits of the Bank's balance sheet. To provide a more substantial facility required new government securities to be issued. Doing nothing might be the next best alternative and allow the situation to improve gradually.

It was explained that if the proposal was to go ahead it needed to be announced within the next week or so. Overall, the Bank expected the scheme to go ahead. Uncertainty centred on the ONS's treatment of the scheme for its assessment of public sector net debt, and whether the swaps would be undertaken for one year or more. In response to a question about the need for the Government to issue securities, it was explained that one way or another new securities had to be

created. Precisely how that was done would not change the ONS's treatment.

There was some discussion about moral hazard and the extent to which the financial sector as a whole should be berated for the crisis. It was agreed that the debate should not be rhetorical. At the same time, it had to be appreciated that the current crisis was the product of the actions and behaviour of financial sector itself. The damaging consequences for the rest of the economy could not be overlooked. It was emphasised that outside the City it was difficult to explain why the financial sector should not endure the same disciplines imposed on the rest of the economy. The Bank's constituency was the whole economy so it was important to strike the right balance in public comments.

#### **4. Update on financial markets**

Paul Tucker introduced the item.

It was noted that markets were still in a fragile condition. Equity markets remained resilient alongside very difficult conditions in money markets, with bond and credit markets slightly better. There had been some improvement since the very difficult period in mid-March around the Bear Stearns rescue, when the situation had been perilous.

[Roger Carr joined the meeting]

#### **5. (i) Banking reform**

The Governor introduced the item.

It was explained that the reforms currently being considered would define the Bank's role for the next two decades. The aim of the discussion would be to consider what powers the Bank should seek. Those powers would form the basis of defining the Bank's statutory financial stability role if agreed with the Government. It was noted that the financial crisis had helped to clarify what the Bank's operational role was and ought to be. The paper set out a list of powers that the Bank could conceivably have. Some existed already or were new but fairly uncontroversial. The key questions for discussion concerned the Bank's role in prudential supervision and a special resolution regime. In relation to a special resolution regime, Directors would need to decide what kind of regime they preferred and, given that, the Bank's role in it.

It was suggested that the experience and lessons of the past eight months illustrated that the tripartite Memorandum of Understanding (MoU) was not sufficiently workable or relevant to managing a crisis. In particular, the Bank could not in practice avoid being involved in what was happening to individual institutions in the way that the MoU envisaged. In the case of Northern Rock, the Bank had only had direct contact with the company a few days before it provided lender of last resort funding. This had not been adequate to establish important information about Northern Rock's balance sheet and collateral, and consider the wider position including the issue of a deposit guarantee. Additionally, it was clear that the Bank could not absent itself from discussions about capital and liquidity regulation. The inference was that the Bank would have to be involved to a greater extent in those issues in the future than was implied in the MoU. The emerging international debate on regulation envisaged a different or greater role for central banks than before. It was noted that the US Treasury Secretary had recently proposed significant changes to the structure of US regulation that would move the US system closer to a separation of business and consumer protection on the one hand, and capital and liquidity regulation on the other. It also envisaged a separate oversight role for the central bank, with large but rather ill-defined powers. This illustrated the types of questions that were being raised about the structure of regulation in the wake of the current crisis.

In terms of the UK debate about a special resolution regime, it was noted that there continued to be concerns about the approach being taken by HM Treasury, which was both legalistic and somewhat minimalist in terms of the changes felt to be desirable. The Government's concept of a special resolution regime appeared to amount to a narrow set of powers exercisable largely by ministers rather than by the FSA or another agency.

Directors first discussed proposals for a deposit insurance scheme. It was suggested that the economic and cyclical arguments put forward in the paper supported a pre-funded scheme although the banking sector was opposed to pre-funding. There was a concern that the authority responsible would be taking on many of the functions of a ratings agency. It would be important to determine the extent to which the information was made public. A view was expressed that risk-based premiums should be applied aggressively to ensure that there were no incentives to run banks irresponsibly, which had been the early experience of the United States.

It was asked what an aggressive risk-based approach would amount to quantitatively. It was explained that the FSA was not opposed to the idea but it wanted to see the practical implications of the approach and how it would avoid being either tokenist or punitive. That required some understanding of what premiums were likely to be levied. It was noted that there were detailed working level discussions underway and it would be possible to provide a note for Directors on an illustrative scheme.

The issue of publicising risk assessments for the purposes of the scheme was discussed. Disclosure might be necessary or indeed preferred. But it was stressed that in difficult market conditions it might be extremely unhelpful to announce that a particular institution's risk premium had been increased. Alternatively, it might be a policy choice to have such incentives built into the system of deposit insurance. It was agreed that the detail around such a scheme was critical and unintended consequences would need to be bottomed out.

Directors agreed that the Bank should support the principle of having a deposit insurance scheme, funded along the lines suggested in the paper. It was agreed work on the detailed practical characteristics would be shared and reviewed in May.

Directors then discussed the questions posed about a special resolution regime. The main questions to address were what kind of triggers should be used and which body or bodies would activate them. It was stated that a special resolution regime needed to be as predictable as possible so that it was clear how it would operate. In turn, that might have a potentially positive influence on market discipline. At the same time, it was recognised that quantitative triggers would be difficult to define, particularly in terms of liquidity, and there were strong arguments for exercising qualitative judgments. The broad idea was that pre-announced quantitative triggers should be a necessary part of the new regime but should not in themselves act as a trigger without additional qualitative judgments. It was emphasised that there would also need to be mechanisms to limit regulatory forbearance to counter against decisions being made too late.

It was agreed that a key issue was the extent that qualitative judgements could be used with quantitative, risk-based triggers for capital and liquidity. That was relevant to both entry into a special resolution regime and the earlier 'amber' stage of heightened supervision. It was noted that the triggers employed to enter a special resolution regime would be relevant to the earlier stage when an assessment would need to be made about how long an institution could continue if



say its access to wholesale markets was restricted. It was noted that the US employed a quantitative model based on a fairly rigid capital-based ladder. This placed an institution under special measures and eventually, if it reached a certain level, into the resolution regime. In practice, it was more complex but the essence of the US regime was based on quantitative measures. The Bank and FSA had undertaken work that suggested it was feasible to go further than the US system in terms of capital and liquidity measures but necessary to include a degree of discretion.

It was clarified that the decision to place an institution on the FSA's 'watchlist' was based on a large number of judgments. The FSA's view was that the trigger for a special resolution regime should be based on an overall view of conditions similar to those that determined whether or not an institution was authorised by the FSA. That would include capital and liquidity measures but also views about the prospects for a firm and how it was operated. In effect, it would be a qualitative judgement informed by quantitative measures. It was noted that a qualitative decision would inevitably be less definitive and therefore more open to challenge by shareholders.

It was noted that the FSA's analysis of the Northern Rock case (paper circulated) had revealed the difficulties of using a simplistic set of quantitative criteria. Automatic criteria would not necessarily enable intervention at an earlier enough stage. Conversely, there were also occasions when an institution might breach a particular threshold measure but had a sensible remedial plan in place.

Directors agreed that triggers should involve a qualitative judgement informed by quantitative measures.

The second question was which body or bodies would make the judgments. The paper suggested that, firstly, the FSA needed to have a hand on the trigger, consistent with its ability as the regulator to withdraw an institution's authorisation to operate. In most circumstances, that would be tantamount to putting an institution into administration. In addition, the paper suggested that there was a case for a special resolution authority to have a hand on the trigger. It would be the body that would receive a failing bank. Moreover, a second hand would guard against the risk of regulatory forbearance causing the regulator to defer a decision in the hope that problems could be resolved. It was highlighted that, in addition to the FSA's decision to withdraw authorisation, there was a separate consideration about whether or not an institution should be placed in a



special resolution regime, perhaps to continue as a functioning bank but not as a stand alone entity under shareholder control. This would be akin to having two triggers rather than two hands on the same trigger. The special resolution authority could decide that an institution was in a sufficiently difficult position to pull the trigger to invoke the special resolution regime even if the FSA judged that it was capable of continuing as an authorised firm.

It was pointed out that the necessary corollary of what was proposed was that the resolution authority would have to undertake a detailed assessment of the performance of an institution in order to discharge its responsibilities. That would potentially mean having two sets of supervisory requirements. It was agreed that the special resolution authority would need to be involved in an individual institution prior to the trigger being pulled. That would be one of the characteristics of an institution moving to heightened supervision – i.e. from green to amber. It was noted that the FDIC in the United States became involved with banks that might need to enter the FDIC regime.

There was discussion about the extent to which having two authorities with the power to activate triggers would create uncertainty and confusion in practice. It was suggested that it might be preferable if responsibility for an institution in difficulty transferred to a special resolution authority thereby establishing one channel of communication and responsibility. There was concern about the possibility of two authorities sending different signals and identifying different requirements. That was potentially a dangerous cocktail. It was emphasised that certainty and clarity of communication and authority would be essential in such circumstances. The need to ensure there was not a conflict with the FSA's existing powers was also noted.

It was explained that the ongoing supervision of institutions was distinct from the role of the body in charge of a special resolution regime. Supervision was concerned with many aspects of oversight. For a special resolution regime which involved transferring rights from shareholders, a decision had to be made about whether an institution was run down, sold to another organisation, or managed through a bridge bank. The authority responsible had to decide that a bank was in a sufficiently bad position, particularly in relation to its capital and liquidity positions, to warrant being put into the special resolution regime. It was not a case of two bodies having the same task.

It was suggested that it might be feasible to have a hierarchy of responsibility whereby the

supervisor passed the judgment to the other authority once a certain position had been reached. This would avoid a situation where either authority could pull a trigger. In such circumstances, the use of quantitative measures to determine which regime applied would be attractive. In response, it was thought to be unlikely that a regulator would want to pass on a problem institution in such a way.

To overcome regulatory forbearance, it was suggested that a requirement for the regulator to have to consult would act as a restraint. But it was noted that such a requirement might not address the risk that the regulator would be too slow to reach a decision rather than too quick. It was suggested that the choice was between the FSA pulling the trigger after consulting the special resolution authority and others, and the special resolution authority pulling the trigger having consulted the FSA and others.

The FSA's position was that it did not want to have the responsibilities of being the special resolution authority. Of the options presented in the paper, it would prefer to have the responsibility for pulling the trigger after consultation with the Bank or special resolution authority, and in the context of much greater involvement of the Bank in individual institutions. In response, it was suggested that no body would want to take responsibility for being the special resolution authority if it did not have some control over the trigger. Otherwise, it could face a situation of wanting to act but where the regulator was not ready to pull the trigger. The special resolution authority would want a major input into deciding when the regime was put into effect. It was suggested, however, that if the FSA was given more powers, it would want to use them to take action earlier than was currently possible.

[Break]

Directors discussed the tools that could be used in a special resolution regime, with reference to the flow diagram on page 28 of the paper which set out what would happen to an institution within the regime. It was stressed that as well as defining clearly the responsibilities and powers of a resolution authority, it would be important to define goals. A parallel was drawn with the resolution by banks of businesses in difficulty. It was outlined that if a business began to falter, it would be placed in a business support framework with the goal of helping it get back on its feet. If that did not work, a business would progress to a workout phase, the goal of which would be to reduce a bank's losses and exit the relationship. In relation to a special resolution regime, it

would be important to identify the goals at particular stages. At particular points, goals would change; for example, returning a bank to the amber zone or winding it down. That was relevant to a graduated involvement for the Bank, where initially there would be attempts with the FSA to return an institution back to health. It was noted that in the US the goal was one of least cost resolution for the taxpayer once a bank had entered the special resolution regime.

It was noted that the authorities had had discussion about objectives, which was covered on pages 11-12 of the paper. HM Treasury's view was that the objectives should be linked to financial stability without any follow-up or subsidiary objectives, although there had been some acceptance of the need to include least cost to public funds as an objective.

It was highlighted that the information the resolution authority would require to undertake its role would be similar to that required by the FSA. Therefore, it would be important that it did not duplicate demands on financial institutions and ensure that the information requested was in a similar format. It was noted that the FSA and the Bank had discussed how a single shared database could be used for such purposes, centred on the FSA's data collection, to which the Bank already contributed.

In response to a question about the role of HM Treasury and public funding once a trigger had been pulled, it was explained that the authorities would expect to have a reasonable idea of the likely path and the choice of tools available ahead of a trigger being pulled. It was envisaged that the resolution authority might approach the Government with options – for example, to close a bank down or, with public money, save a part of it or more of it. At that point, the Government could consider the public interest and the use of taxpayers' money. In this way, the roles of the resolution authority and the Government would be clear and separate. It was suggested that options would need to be time constrained to avoid political delay in the hope that the situation would improve with the passage of time.

Directors discussed which body should be the special resolution authority. It was explained that the choice was effectively between the FSA acting both as the regulator and the special resolution authority, or the special resolution authority being a separate body. There were three main considerations: first, which body had the relevant expertise and skills; second, conflicts of interests; and, third, political accountability and the closeness of ministers to decisions. In terms of skills and expertise, that pointed to either the FSA or the Bank. The FSA had a thorough

knowledge of individual institutions and an ongoing relationship. The Bank, by presumption, would also have contact with an institution through the amber stage. It was noted that the Bank had some additional capability as a bank, in terms of lending to institutions and banking transactions. It was less evident that the HM Treasury had the relevant skills and expertise though it was adept at creating teams from scratch. In terms of conflicts of interest, it was noted that the FSA might face potential conflicts if the resolution authority was trying to keep part of the business going and to do so it was promoting a particular solution. In terms of political accountability, it was noted that the Treasury's current view was that the powers would be so draconian that they needed to be held by ministers and Parliament and used on a case by case basis. That was at odds with the view that the purpose of the regime would be to move decisions out of the political arena.

The Bank's view was that the resolution authority should not be the FSA in view of the risk of regulatory forbearance. It was a separate question whether or not the separate body should be the Bank. It was stated that it would probably make sense for the Bank to take on the role with a set of clear responsibilities and powers, consistent with a model of graduated involvement and its role as lender of last resort. It was noted that the Chancellor and ministers were bound to be involved whatever the model chosen, most obviously to take decisions relating to the use of taxpayers' money. The Government should always have the right to overrule another authority.

It was stressed that clarity was essential throughout the design of the legislation. That would be achieved most readily with one trigger and one institution. It was thought that, although the Bank was reluctant to put itself forward as the body best placed to be the resolution authority, recent events and external commentary suggested that now was the time to be fairly forceful. In this vein, the Bank should seek to push for a decision that moved away from a politicisation of the special resolution regime.

Director agreed that there should be a resolution authority separate from the FSA.

The paper asked whether or not the Bank should propose the creation of a new Deposit Insurance Resolution Agency (DIRA), either self-standing or under the wing of the Bank. It also asked whether the Bank should act as the resolution authority if establishing a new body was considered too complicated. It was suggested that having a special body to run the resolution regime was a model that commanded most support overseas – i.e. a specific institution for a

specific role. The Bank and the FSA would inevitably have an involvement because of their roles in managing liquidity and financial supervision. To avoid tensions between the roles of the Bank and the FSA, the best option might be to create a freestanding body that would be fairly dormant in normal times but gear up its effort when financial difficulties emerged. That was what the US FDIC had done over the past 18 months.

A second reason to propose a separate body was that the Bank had taken a leading role in presenting the case for a special resolution regime and understanding the issues involved. The Bank did not want to undermine its role by creating a sense that it was itself seeking new responsibilities. It was felt that had too often been the motivation behind arguments for new roles in the past. It would not be in the Bank's long-term interest to expand its role for that reason. There was therefore a preference for the Bank to propose the creation of a new agency to be the resolution authority. However, if Government and others felt that was not the right solution, the Bank would be prepared to undertake the role on the condition it had an involvement ahead of the trigger being pulled and the decision to pull the trigger.

Non-executive Directors expressed the view that it would be preferable for a special resolution authority to be part of the Bank and preferably to be the Bank itself. Another agency alongside the existing Tripartite was not considered to be an attractive option. It was stated that the Bank should ensure that the option proposed by the Treasury Committee – namely, to have a new quasi-independent Deputy Governor's office – was not acted upon. It would be better for a new body to be wholly in, and under the command of the Bank and under the single integrated management of the Governor and Court.

It was asked whether the relatively small number of deposit taking institutions in the UK warranted a separate body for a deposit insurance role. In response, it was stated that the key question was whether a special resolution regime should be run by a body other than the FSA or the Bank; if so it would probably make sense to incorporate deposit insurance into such a body.

In response to a question about the Bank's reputation in the area of monetary policy and its capability to take on the role of running a special resolution regime, it was acknowledged that there would be concerns about the Bank maintaining its focus on monetary policy. That favoured having a specialist group handling the special resolution regime. It was noted that staff for a standalone agency could be drawn from the commercial banking sector, similar to the FDIC.



However, it was stressed that the Bank could not distance itself from the resolution regime even if it was not the authority running it. The Bank's provision of liquidity support to the banking system meant it would have an involvement, which would interact with its money market operations for monetary policy purposes. As noted earlier in the discussion, the Bank's provision of lender of last resort funding would require it to have information about an institution at an early stage. The Bank also had a deep interest in capital and liquidity requirements for the banking system.

For all these reasons, the Bank needed an understanding of the banking system which needed to increase in the light of the recent crisis. That was separate from the issue of whether or not it should run the special resolution regime. What was required was greater clarity about its role and responsibilities. It was evident that the expectations of what the Bank could do ran well beyond the formal powers that it had. It was stated that one of the virtues of the crisis had been that it had clarified what the focus of the Bank's work should be. At the same time, there was some reluctance to seek to acquire responsibilities involving individual institutions which required different competencies to those that the Bank was widely endowed with. The Bank needed to be cautious about new responsibilities that would change its focus, particularly in view of the challenges it faced in relation to monetary policy. It was noted that it had taken many years for the Bank to exit its involvement with Johnson Matthey. There was a danger that over time the Bank's affairs would be dominated by failed banks and associated balance sheet considerations. It would be essential therefore to find a way of ring fencing the balance sheet consequences of dealing with the resolution of failing banks if the Bank became the resolution authority.

It was acknowledged that it might not be possible to persuade people of the need for a fourth institution given the existing criticism of the workings of the Tripartite authorities. It was suggested that a proposal for fourth institution would almost certainly be rejected so the Bank's position could not be dependent on that option. Indeed, it might damage the Bank's credibility to propose a fourth institution. It might be better to present the case for the resolution authority to be within the Bank but clearly separated from its main responsibilities and governance. It was noted that deciding which body should operate the resolution regime was related to the judgments about pulling the trigger. The resolution authority would have to have sufficient credibility and could perhaps only be the Bank.

It was suggested that it might be best to say publicly that, because the functions of a special



resolution authority would be new, it was sensible to have either a new fourth body, which would correspond to overseas experience, or for it to within either the FSA or the Bank as a separate entity; there were arguments for and against these different positions; as the Governor represented the Bank, he did not want to be bid for new functions or roles – it was for others to decide. However, there was a concern that the legislative timetable was very compressed which risked the process resulting in the wrong answer – i.e. neither a fourth institution or the Bank. That argued towards stating very clearly what the Bank thought would work and who should be in charge.

It was noted that international experience suggested there was no single way of operating a special resolution regime. Using such comparisons might help presentationally. An alternative view was that, in the interests of clarity, the Bank should not appeal to overseas experience, which was not in any case free from crises. Rather, it should present a clear-cut case. The Bank could make clear in public statements that it would be prepared to accept the role if others felt that was the right approach but, as an interested party, it did not want to lobby for new responsibilities. The Bank's central argument was the need for a special resolution regime in the UK; it was a secondary question which authority operated it. It was stressed that it would be important not to appear disingenuous. The proposed formulation was a sensible way forward – namely that a special resolution regime was essential; how it was operationalised was secondary; overseas experience pointed to a separate institution but the Bank was prepared to be the resolution authority should that be the wish of Parliament. The Bank was encouraged to make a positive presentation. It was suggested that being the resolution authority could help align perceptions with reality insofar as the Bank was seen in crisis circumstances as the vehicle for execution. If the Bank could resource and ring fence the regime, then it could present a positive case. It was stressed that the Bank should certainly not be seen to be reluctant to take on the role.

There was a concern that a resolution authority would not be active most of the time. It was explained that overseas bodies tended to expand and contract their resources and activities according to the demand for services. The FDIC had a pool of potential people who worked for the body when required, drawn from accountants, auditors, commercial bank executives and former regulators. In that sense, the special resolution regime was a function of demand which varied over time in an unpredictable way.

## **(ii) The Bank's financial stability role**

Directors addressed the questions posed in relation to defining the Bank's financial stability role within the forthcoming legislation. It was noted that this would be inextricably linked to decisions about whether the Bank would be the special resolution authority.

It was explained that the Bank's financial stability role lay not in the implementation of prudential regulation, but the design of the regulatory framework which had a bearing upon risks within the system as a whole. That was relevant to the earlier discussion about triggers. It was explained that legislation in many countries included a requirement to consult the central bank about prudential regulatory issues. Some formulations went beyond a requirement to consult; for example, a requirement or right to initiate thoughts on regulatory design, pre-emptively ahead of problems and proposed changes. A stronger formulation still was a veto, which some non-supervisory central banks had over aspects of prudential regulation. There was a separate dimension about the set of institutions that a central bank had some jurisdiction over in relation to regulatory design i.e. banks or other parts of the financial system.

It was stated that it was important to recognise the extent to which some of the options set out were already in place in practice. The FSA readily consulted the Bank about proposals on liquidity regulation. Indeed, it was noted that the FSA had initially suggested a joint FSA/Bank consultation exercise. In relation to capital and liquidity regulatory design, the Bank had been fully involved in the development of Basel 2 and Nigel Jenkinson currently chaired the current Basel group on liquidity. It was stressed, however, that a central bank veto would be difficult for the FSA board. It was likely to object to a situation where its responsibilities were subject to a central bank veto.

There was some support for a 'twin peaks' regime – separating the regulation of business and market conduct from prudential regulation. It was stated that it was clear that financial instability impacted on, and was profoundly linked to, monetary stability. And it was clear that it was difficult to separate systemic responsibility for financial stability from a detailed knowledge of individual institutions. However, if it was not politically viable to separate responsibility for business and market conduct, in the hands of the FSA, from responsibility for prudential supervision, in the hands of the Bank, then the options outlined in the paper went in the right direction. It was clear that the Bank needed more powers and authority to be responsible for systemic financial stability more generally.

It was agreed that there was a powerful case for the Bank to take a greater role in prudential supervision, which was part of the debate about the appropriate response to the financial crisis. However, that was not supported by the executive management, as the paper made clear. The potential reputational damage to monetary policy from a central bank having responsibility for supervising financial institutions was one of the main motivations behind the current UK regime. Although related, there were important differences between monetary and financial stability. In a fundamental sense, it was possible to achieve the former but not the latter. No regulatory regime could ensure that there would not be another financial crisis or bank failure. It was possible to limit the impact and improve regulation, but financial crises were endemic. A second argument was that it would be difficult to identify a set of institutions that the central bank could plausibly regulate on a day by day basis, while maintaining the focus of the senior team on monetary policy. It would always be likely that, in retrospect, the criteria were judged to be wrong. It was noted that successive banking acts in the 1970s and 1980s had tried to draw distinctions between banks and non-banks. There was merit in a system which recognised that there were sufficient similarities between retail banks, investment banks and even insurance companies to regulate them through one body, namely the FSA.

It was suggested that there were other ways that a central bank could have a voice in the supervision of financial institutions, consistent with its role as the central bank. As well as being involved in the design of capital regulation, the central bank might want to be able to say publicly when it was appropriate for capital requirements to be raised or, alternatively, when it was not the time to raise capital requirements. In relation to Northern Rock, it was noted that the Bank might have been more exercised about the liquidity aspects of the company's business model. However, banks had a range of ways to cause problems. It might not have been apparent to those responsible for dealing with Northern Rock to focus in advance on liquidity or, for instance, potential fraud. A central bank was not well placed to detect fraud, evidenced from the experience of the 1980s and 1990s. To expect one body to perform all aspects of supervision well was very difficult. The FSA had been building up expertise over a number of years to meet those challenges. It was stressed that this was not to say that the Bank should not have any involvement. The challenge was to find ways in which the Bank could contribute and have an impact on the regulator, but over a narrower subset of the issues than the FSA was involved with.

It was agreed that the Bank needed to add greater rigour to its armoury of instruments and powers to meet its responsibilities for financial stability. It was also noted that the FSA was in a more difficult position because it was intimately related to the financial sector and its authority was based to a degree on its acceptance within the financial sector. In that way, it had to give and take. If the financial sector did not agree with the direction that the FSA was taking, it could obstruct it in many ways and had effectively done that via special investment vehicles and conduits.

A key question was how the Bank could strengthen its position. It was recognised that good co-operation existed at many levels between the Bank and FSA. However, this was largely based on custom and practice – and the present FSA Chairman and Governor would not always be in position. It made sense to formalise the relationship and working practice. It was noted that the paper outlined practical steps that could be taken in the realm of prudential oversight such as the right to initiate proposals. Most central banks had that power in one form or another. Directors were asked if they had any issues with the list outlined in the paper. The material on page 4 concerned the implementation of prudential regulation. The idea of a protocol for the Bank and FSA setting out a new model of operation was thought to be uncontentious. A draft protocol would be discussed with NedCo. The material on page 5 of the paper concerned the design of prudential regulation. The paper offered some alternative options – a requirement to consult the Bank, the right of the Bank to initiate proposals and a right of veto for the Bank.

It was clarified that, in relation to the provision of data, the paper proposed that the Bank should have the right to request data to meet its statutory financial stability role. In that sense, there would be a ‘dual key’ even if operationally it was conducted through the FSA. But the principle would be that both authorities would have the right to ask for data that was considered necessary to meet their own responsibilities. The principle was accepted. It was noted, however, that there were reputational risks associated with the provision of data. Data received from financial institutions had to be fully operational to avoid a situation arising whereby had data been analysed and acted upon, the authority concerned would have been able to prevent something happening. In that sense, the Bank needed to be careful about what it asked for. It was suggested that the reputational risk facing the Bank and the FSA would keep data demands in check and ensure effective coordination to avoid duplication. It was agreed that the issue of data was worthy of further debate. It was also suggested that, although information requested by the authorities was sometimes a driver for banks to generate the data they needed themselves to

monitor risks, it was often irrelevant to forming a view of a business and threw little light on the risks being monitored and managed.

### **(iii) Reforms to Court**

The paper outlined a series of proposals relating to reform of Court. It was proposed that Court should consist of twelve members with flexibility retained around the number of non-executive and executive members. It was suggested that it might be better to propose a minimum of, say, six non-executives plus the chair. It was accepted that a smaller Court membership would put pressure on having a regional and sectoral spread of Directors.

The proposal of a three-year term was in line with modern practice, with a further three-year term of appointment after a rigorous performance assessment, conducted through a nominations committee. It was noted that cross-directorships were discouraged in modern governance practice. The misunderstandings evident during the parliamentary hearings following the Northern Rock rescue illustrated the confusion about the nature of the role of the Bank's Deputy Governor on the FSA's board. However, there remained a desire to retain the Bank/FSA cross-directorship to help cement co-operation between the two authorities. It was suggested that the governance of the Bank should not take its lead from private sector practice. It was also noted that cross-directorships were far from uncommon in the public sector. The presence of the FSA chairman on Court was seen as valuable and its continuation supported. It was emphasised that withdrawing from the arrangement might convey the wrong message after a period of criticism about the workings of the tripartite system.

There was some concern that the proposed number of non-executive Directors was too few in view of the role of Court, which was to bring judgement and experience from outside the Bank. The Bank was a very different organisation to private sector companies and so required a fairly significant majority of non-executive Directors. The original proposal had been eight non-executive Directors plus the chair. The purpose of the revised proposal was to limit rigidity and leave it to a nominations committee to propose the composition of Court at a particular point in time. It was clarified that legislators were likely to be content with the proposal to have a minimum number of non-executive Directors.



The issue of Court membership and confidentiality was raised, specifically the extent to which it would be possible to share information with non-executive Directors who were active in the financial sector if the Bank's financial stability role was enhanced. It was suggested that might effectively preclude people from the financial sector from membership of Court. It was noted conflicts of interest were due to be discussed by NedCo in the near future.

[Sir Callum McCarthy withdrew from the meeting]

It was felt that reducing the number of Court members through a process a natural attrition was not the right basis to select a board. Instead, selection should be based on a full assessment of the skills and experience required. In response it was clarified that discussions with HM Treasury had indicated that the approach might be one of natural attrition and that HM Treasury would not be seeking any new appointments at this time. It was suggested that a nominations committee should undertake an annual assessment of the skills required for Court in the light of the Bank's responsibilities, and present a gap analysis to inform future selection. There were some reservations about the proposed role and power envisaged for a nominations committee. Court was intended to reflect a range of interests, which might be lost under such arrangements. In response, it was stated that that was not the intention. Rather, a nominations committee would formalise the arrangement that had been in place over recent years, namely providing an analysis of skills to HM Treasury each year, prior to the selection of new non-executive Directors. It would provide recommendations only.

In relation to the frequency of Court meetings, there were some reservations about the proposal to reduce the number of meetings if that was the intention. There was some support to retain monthly meetings on the grounds that non-executive Directors not drawn from the banking sector might find seven meetings a year too infrequent to keep fully abreast of the Bank's affairs. It was clarified that the proposal was designed to avoid being locked in by legislation as was presently the case. Beyond that, Court would meet as often as it felt necessary.

The role of the chair of Court under the proposed arrangements was discussed. It was asked if the role would that of the senior non-executive Director or whether something more formal was being contemplated. In response, it was suggested that the only person other than the Governor who could chair Court was the person appointed by the Government to be the senior non-executive director. The proposal would amount to formalising the existing practice.



The discussion on the special resolution regime and the Bank's role was continued over lunch. In summary, it was agreed that the Bank should ensure that it had access to information about individual institutions at an early stage; that responsibilities given to the authorities should be unambiguous and matched by equivalent powers; that the special resolution regime should be operated by the Bank. The Bank's paper to HM Treasury would reflect the direction provided and circulated to NedCo in May.

#### **6. Annual Report – draft**

In view of time constraints, it was agreed that suggestions and comments on the draft report should be sent to the Finance Director. The full Annual Report & Accounts would be discussed at the NedCo meeting in May.

#### **7. (a) Combined quarterly reports – fourth quarter**

Noted.

#### **(b) Quarterly Risk Report**

Noted.

#### **8. Major projects 2008/09**

Noted.

#### **9. MPC report to Court**

Noted.

#### **10. Houblon Norman Fund report**

Noted.

**11. Central banks' collateral frameworks**

Noted.

**12. Remuneration committee minutes – 12 March**

Noted.

**Any other business**

None.

**The meeting of NedCo was closed.**

## MEETING OF THE COURT OF DIRECTORS

**Wednesday 16 April 2008**

Present:

Mr King, Governor  
 Sir John Parker, Chairman, NedCo  
 Sir John Gieve, Deputy Governor – Financial Stability  
 Mr Barber  
 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:

Ms Rachel Lomax

Also attending:

Mr Bean, Mr Bailey, Mr Jenkinson, Mr Jones, Mr Tucker and Dame Juliet Wheldon.

### 1. Minutes – 12 March 2008

Approved.

### 2. Monetary policy issues

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

### 3. Liquidity scheme, financial markets, special resolution regime, the Bank's financial stability role, reforms to Court, draft Annual Report, quarterly reports.

Court noted the discussions in NedCo of the above items

### **Any other business**

None.

[Members of the Executive Team left the meeting]

### **4. Remuneration Committee report**

David Potter – chair of the Remuneration Committee – introduced the item.

The minutes of the Remuneration Committee meeting held on 12th March had been circulated. In relation to the salary and pension arrangements for the Governor, Directors were reminded that the present Governor's pension would be fully accrued on 30 June. So there would be no cost to the Bank of additional accrual from that date.

The Remuneration Committee had considered two options. First, the rate for the job, which was considered to be £385,000 per annum, with no pension payment for the present Governor; and second, the Governor's existing salary of £290,653 increased by 2.5 per cent from 1 July, without a 30 per cent payment in lieu of pension. It was noted that the Remuneration Committee had considered whether or not it was legitimate to pay an additional sum in view of the fact that the Governor's pension had now fully accrued. The Committee was of the view that this was not appropriate. The two options had been put to the Governor who had decided that, in the current climate, it would be difficult for him to accept the higher salary. Therefore, it was recommended that the Governor should remain on the existing salary base, increased by 2.5%.

It was noted that the Governor's salary had implications for those for Deputy Governors as well. The longer the present structure was left in place, the greater the gap would be between actual salaries and a rate for the job commensurate with similar positions. At the time when a new governor was appointed, there would be a very significant gap. Directors agreed that it was therefore important that the remuneration report in the Bank's Annual Report stated that the Governors' salaries were continually reviewed and that, having benchmarked salaries with the aid of outside consultants, the rate for the job was considered to be around £385,000 for the Governor. This would set a clear benchmark for the future. The position would be reviewed again in five years.

Court APPROVED the recommendation.

The issue of non-executive Directors' fees was raised. It was suggested that they should be similar to other public sector bodies. It was possible that setting the fee at such a low level might be excluding some people from applying to be non-executive Directors of the Bank, and reinforcing an impression that Court is not a serious governing body. A further study was proposed for later in the year to allow the Governors to reconsider the recommendations. Any new recommendations could be incorporated into forthcoming changes to Court.

**The meeting of Court was closed.**

## COMMITTEE OF NON-EXECUTIVE DIRECTORS (NEDCO) MEETING

**Thursday 15 May 2008**

Present:

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

Absent:

Ms Amelia Fawcett, Mr Bob 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 – 16 April 2008

Approved.

### 2. Matters Arising

None.

## MANAGEMENT OF THE BANK

### 3. Executive Report

Recent and forthcoming meetings and events

Domestic:

- Treasury Committee Governor re-appointment hearing (29 April).
- regional visit to Peterborough and King's Lynn (1 May);



- Financial Stability Report (24 April, subsequently delayed until 1 May)
- Inflation Report (14 May);
- speech at the BBA Annual Banking Conference (10 June).

International:

- BIS meetings (4-5 May);
- ECB's 10<sup>th</sup> anniversary celebrations (2 June).

A meeting with the Chancellor had been held on 17 April and a breakfast meeting with Sir Gus O'Donnell on 24 April. Tripartite Principals would meet on 30 April and 15 May. A telephone discussion with Nick Macpherson was scheduled for 14 May.

Special Liquidity Scheme

It was noted that the Special Liquidity Scheme was operating smoothly. The pressures on resources across the Bank were being reviewed by Rachel Lomax. A new team had been established to run the Scheme and to manage the collateral received. Most of the staff involved were from other parts of the Bank, which meant gaps elsewhere that would need to be filled. It was noted that some additional staff costs would be incurred over the coming months, a large proportion of which would be chargeable against the income from the Scheme. All the costs would be audited. At present it was not expected to result in budgetary pressure but that would be reviewed. It was possible that extra resources would be required, possibly charged against the policy budget. It was noted that the contingency reserve was £1.3 million for 2008/09 and £2.7 million for 2009/10 following year. It would be possible to review the budget again in the Autumn to take stock of the resources needed on the financial stability side of the Bank.

Northern Rock

It was explained that the loans originally extended by the Bank to Northern Rock expired on 30 April and had been amended as of that date. The original facilities had been frozen and a new committed reserve facility, secured against the assets of the company and indemnified by HM Treasury, had been made available for contingency purposes until 2010. The Transactions Committee had been consulted. The amended facilities were subject to state aid clearance by the European Commission. It was noted that HM Treasury had agreed, in principle, to replace the funding from the Bank by the end of the calendar year.

Court appointments

It was reported that Rachel Lomax would be leaving the Bank at the end of her term on 30 June. HM Treasury had not reached any decisions about forthcoming Court appointments. It was hoped progress would be made over the few coming weeks. It was noted that Peter Rodgers and his wife would attend the Court dinner on 30 May.

### Governor's Day

Governor's Day would take place on Sunday 27 July, the Bank's 314<sup>th</sup> anniversary, at the Bank's Sport Centre in Roehampton. All Directors were invited.

### Staff

Frances Hill, currently the Deputy Agent for Greater London, had been appointed as the Bank's Agent for Northern Ireland. She would take up her new role in the autumn.



### Treasury Committee

Members of the Treasury Committee would be attending the lunch following the meeting. It was explained that the discussion would centre around issues raised by the Treasury Committee.

It was noted that the FSA's Chairman and Chief Executive had appeared before the Treasury Committee recently. During the hearing, differences of view had been expressed about new financial stability arrangements to those of the Bank. These related to the triggers to activate a special resolution regime and the cross-membership of Court and the FSA board.

### Financial stability reforms

The letter and accompanying paper sent to the Chancellor, setting out the key points from NedCo's discussion in April, had been circulated to Directors. The Chancellor had yet to respond.

In response to a question about the present timetable envisaged for the legislation, it was explained that HM Treasury still wanted to publish a consultation document before the summer which would outline draft clauses of a new banking bill. New legislation would then be introduced in the autumn, to come into effect in mid 2009. It was noted that there had not been any indications so far whether the Treasury's position on the type of special resolution regime they preferred had changed. It was expected that scheduled discussions for the Tripartite Principals would clarify the present position. There remained concerns that there had not been sufficient in-depth discussion about the key principles of a special resolution regime and how it would work. It was suggested that, even though the timetable for legislation had been extended, the idea of producing draft legislation for further consultation in mid-June was entirely impractical. That would require some fundamental issues to be resolved over the next few weeks. Ideas needed to be both discussed and reflected on. The Bank and the FSA continued to make the

case to the Chancellor for a longer timetable. There was a risk that draft legislation would be introduced and the debate about the underlying principles would continue alongside discussion about detailed drafting.

It was asked what the Bank could do further to ensure the process was more effective in order that the legislation was right. It was stressed that the point would be made again to the Chancellor that it was not in anyone's interest to rush legislation. Additionally, both the Governor and FSA chairman were due to make public speeches at the BBA's annual conference in June. It was noted that there was some merit in the Bank and FSA having different views about the design of a special resolution regime to emphasise the need for public debate about the principles.

In terms of the process at working level, it was noted that the tripartite steering group was meeting regularly, with the Bank represented by Nigel Jenkinson in John Footman's absence. Over the coming few weeks, the issues of substance would be discussed at more senior levels. It was also noted that the Chancellor was conscious of the timeframe for the legislation relating to Northern Rock, which expired in February 2009.

## **FINANCIAL STABILITY**

### **4. Financial markets update**

Mr Tucker introduced the item.

It was noted that financial markets remained in a better position than had been the case in March. There was a sense that the position was similar to January with a degree of optimism that conditions would continue to improve. But there were qualifications to this. First, the financial system was continuing to deleverage, which might continue into 2009. A key question was whether the system could stabilise before the macroeconomic slowdown both in the UK and abroad started to result in rising household and corporate credit defaults, which would further impair banks' capital. In this sense, the position remained fragile and there might easily be further set-backs. Second, the charts showed that spreads had declined over the past few months and equity markets had improved, although the money markets were an exception. Derivatives products implied that the spread between LIBOR and the expected Bank rate in three months' time would fall over the next few months from 70 basis points presently to around 40 basis points. However, the spread implied by actual cash transactions over various timeframes was

still much higher, at around 100 basis points in nine months. It was suggested that the inference to draw was that perceptions of credit risk in the banking sector were expected to improve but banks remained very constrained in terms of their balance sheets and so were still charging a premium for providing liquidity to others. The distinction was between lenders' capital constraints and liquidity, and the credit risk of the borrowers. It was apparent, therefore, that there was considerable uncertainty about just how much better the money market would be over the next few months. It was also noted that there remained a large premium on raising dollars via swaps using other currencies. This underlined the extent that there remained a dollar financing problem globally.

Turning to the Bank's balance sheet, it was highlighted that the Government overdraft facility at the Bank – the Ways & Means balance – had been reduced to £300,000, which had improved the liquidity of the Bank's balance sheet. The proceeds of repayment were currently invested in repos, but this would over time be turned into holdings of bonds, especially gilts. Attention was also drawn to the increase in the aggregate reserve balances held by banks. Over the past month, the Bank had introduced arrangements to lift the ceilings that applied to the reserves targets chosen by banks. This was done partly to provide banks with more scope to raise their reserves targets to allow them to use the Treasury Bills they would acquire through the Special Liquidity Scheme to access cash through the Bank's open market operations. It was reported that to date eleven banks had used the Scheme, making drawings of over £13 billion. Almost forty institutions had requested the legal documentation in order to consider using the Scheme. Further use was anticipated in the near future in line with what the larger banks had indicated during the design phase.

The collateral received into the Scheme had been mostly mortgage-backed securities from banks' own mortgage portfolios. That was expected to remain the case as drawings increased. Overall, the Scheme had been widely welcomed in terms of underpinning confidence in the UK banking system. It had significantly reduced the sense that the UK banking system was somehow more liable to be short of liquidity than elsewhere. Although not the acid test, it was noted that sterling LIBOR spreads had fallen more in line with dollar and euro spreads. However, the key observation was that there was no longer an atmosphere of fragility around the UK banking system due to the Bank's approach to liquidity provision.

In response to a question, it was stated that the use of the Scheme so far was broadly as expected. The Bank team had some ability to affect the pace of usage by the larger banks. One of the aims had been to ensure that the use of the Scheme by any individual institution was not out of kilter with others, which might otherwise risk the market observing that one bank had an unusual amount of Treasury bills relative to their peer group.

It was suggested that the Treasury Committee might be interested in the transmission mechanism from large institutions to smaller building societies. It was noted that many of the larger building societies were eligible to use the Scheme, and the largest would quite possibly on-lend some of the money as cash to smaller building societies. In addition, because the perception of risk around the UK banking system had eased, smaller building societies were likely to be finding that funding conditions had eased somewhat.

## **5. Financial stability and depositor protection issues**

(Ian Bond – Head of Financial Resilience Division – in attendance)

In relation to the paper on the feasibility of risk-based premiums for a pre-funded deposit insurance scheme, Sir Andrew Likierman's and Susan Rice's interests as directors of deposit-taking banks – Lloyds TSB and Barclays respectively – were declared.

Sir John Gieve introduced the item.

It was noted that the paper had been requested at NedCo's April meeting, to illustrate the plausibility of the potential premiums that might be needed to create a pre-funded, risk-based scheme. It was noted that, at present, the FSA remained unconvinced on cost-benefit grounds about the merits of such a scheme and that HM Treasury's position was unclear but seemed to be mildly supportive.

The features of the scheme outlined in the paper were summarised. It was noted that a key question was how large a deposit insurance fund should aim to be. It was generally acknowledged that it was not feasible to have a fund that was large enough to cater for all conceivable circumstances. The aim was to devise a scheme that was sufficient for a reasonable number of cases. A fund of around £5 billion was suggested as an initial goal, which represented



around 0.5% of total bank deposits. There was then a question about how quickly the fund should be built up. The paper presented calculations based on a five-year timescale.

It was explained how risk-based premiums might be determined. The two principal dimensions were the likelihood of a bank defaulting and, in that circumstance, the likely proportion of assets that would be recovered for the benefit of depositors i.e. default and recovery risk. Recovery rates would depend on the overall recovery rate and the relative seniority of retail deposits in each bank's balance sheet. The illustrative tables showed a reasonable spread across risk categories for the twenty largest banks, so there would be a similar diversity of premiums. It was emphasised that the exercise had not aimed to be precise but rather to provide an illustration of the spread of premiums that might be levied for a £5 billion fund. These were within the scope of the annual levy limit which the FSA had recently set for the deposit insurance part of the Financial Services Compensation Scheme's funding.

It was noted that one of the practical issues for a scheme would be how quickly premiums would be adjusted to reflect changing market conditions. It was suggested that it would be undesirable for premiums to be adjusted frequently and rapidly but rather for adjustment to be relatively slow in response to changes in circumstance, unless the deposit insurer took the view that there had been a fundamental change in a bank's business model and associated risks.

In discussion, there was a request for aggressive risk-based premiums to ensure that the worst banks did not free-ride on the reputation and behaviour of better banks. Premiums needed to reflect judgments of the risks at each bank, and avoid being too broad-brush in nature. It was clarified that the paper's emphasis on risk 'classes' did not mean banks with significantly different risk profiles would be charged similar premiums. It was suggested that banks might find an approach in which judgments formed part of the premium assessment to be too imprecise.

Reference was made to the preference given by the US legal system to insured depositors. It was asked how that worked and whether it reduced the demands on the fund. It was explained the US (and other countries, such as Australia) gave retail depositors senior creditor status, which increased the likelihood of the deposit insurer recovering funds. The idea had not been pushed in the current UK debate. There were quite complicated questions about how such arrangements might interact with the behaviour of other classes of creditor. Although it would make retail



deposits less risky, that would be at the expense of putting other creditors in a more exposed position and, perversely, might make bank failures more likely.

A question was raised about whether the presence of a deposit protection fund would change the behaviour of retail depositors or have a wider impact on savings. Were there other factors that needed to influence the design of a deposit protection fund? It was suggested that greater awareness of deposit protection and its limits might encourage those with large deposits to diversify their holdings. That was evident in the United States

It was stated that the paper was helpful in revealing some of the real issues underlying the design of a risk-based pre-funded scheme. It emphasised the liquidity that any insurance scheme would require. There was some concern that the discussion implied that the deposit insurance body would need to form a view of a bank's risk profile. To do that effectively would require a quasi-supervisory operation. It was suggested that a simpler approach might be to rely on credit default swap spreads. In relation to the adjustment of risk-based premiums, it was suggested that over the past six months higher premiums would have intensified the difficulties faced by some institutions, which would not have been desirable in terms of wider financial stability.

A point was also made about the existing insurance system, where there was a degree of cross-subsidisation between different insurance pools – i.e. banks might pay claims on broker dealers or insurance intermediaries. Separate arrangements for banking insurance had implications for the rest. In response, it was suggested that it was not a good idea to combine insurance for different types of financial activity. The position of banks was special and distinctive, which justified a separate insurance structure.

Directors supported the idea of a risk-based scheme on the basis of the illustrations outlined in the paper. It was explained that discussions would continue with HM Treasury and the FSA in order to put proposals forward in the draft legislation. It was noted that it was unlikely that the three authorities would reach agreement on all of the issues before the Treasury intended to publish its draft legislation.

It was noted that there were market mechanisms in place in the United States to enable depositors to spread their money using brokers and money market funds. These issues would not be addressed by the introduction of a new deposit insurance scheme, which might exacerbate

consumers' tendency not to spread their deposits across institutions. It was suggested that the experience of Northern Rock had alerted the public to deposit insurance arrangements and resulted in some diversification. It was noted that the consultation document had asked for views on deposit insurance, and the FSA had consulted separately about the broader FSA scheme and would report on that shortly. Behaviour would inevitably be determined by consumer reaction. Explaining the scheme would itself take the debate forward and raise levels of awareness.

## **6. Quarterly financial stability report**

Mr Jenkinson introduced the item.

The report was briefly summarised. The main developments over the past quarter had been the implementation of the Special Liquidity Scheme, contingency work on vulnerable banks with the FSA and HM Treasury, continuing work on the banking reform bill, and the publication of the latest Financial Stability Report. It was noted that the FSR had, as usual, described vulnerabilities in the financial system and acknowledged that the position was worse than that envisaged at the time of the October Report. The FSR's summary of changes in risks since October were in the red and amber territory, highlighting the continued downside risks to financial stability. However, it was explained that as risks to the financial system were already centre-stage, it had been decided that it was appropriate to give more emphasis on this occasion to the central view. Therefore, a key message that was emphasised in the presentation of the Report had been that conditions in financial markets had eased somewhat since the low point in March and there was now a prospect that market participants were over-pricing risk in contrast to the low risk premia that had characterised the system prior to the crisis. There were indications that prices in some credit markets were likely to overstate eventual losses. Furthermore, the actions taken by central banks to provide additional liquidity support and by a number of major banks to raise capital had improved the resilience of the system, which was highlighted in the FSR.

It was noted that a number of initiatives had accompanied the publication of the Report to strengthen the effectiveness of communications, including a new summary handout and an email targeted at directors of all the major financial institutions in the UK. In addition, the FSR presentation to city contacts continued, and a team from the Bank would meet with rating agencies and bank analysts to discuss the main themes and issues raised in the FSR. It was also

noted that the FSR had attracted a significant amount of media coverage, unsurprising in view of the topicality of the issues at the present time.

## **7. Bank's annual report and accounts**

(Mike Ashley and Mike Heath – KPMG – in attendance)

Warwick Jones introduced the item.

It was noted that Court would formally approve the Annual Report and Accounts in June. Current auditing standards required the auditors to read all the documentation accompanying the accounts in their final form. As publication of the Annual Report was towards the end of June, there might be a need to reflect additional events before the publication date. Directors would review the Report today. Any changes thereafter would be notified ahead of Court's approval at the June meeting.

Changes incorporated since April were highlighted in the note circulated to Directors. It was noted that a new section incorporated into this year's Annual Report outlined the responsibilities of the Governors. There was also a box on the Bank's activities in relation to Northern Rock and a box on the Tripartite consultation on financial stability and depositor protection.

A discrepancy in the phrasing about the Bank's responsibilities was raised. It was noted that the text on page 15 referred to the Bank being focused on promoting monetary and financial stability. However, the headline text on page 1 referred to the Bank existing to ensure both monetary and financial stability. In view of the present context of financial instability and the debate about responsibilities matching powers, it was thought that the wording on page 15 was preferable. It was agreed that the executive management would consider the wording further.

It was reported that the Annual Report and Accounts had been discussed by the Audit Committee. Particular attention had been paid to the level of disclosure about Northern Rock. It was felt necessary that the Bank should disclose the interest income it had accrued and the costs it had recovered from Northern Rock. The Audit Committee agreed that the Bank should not disclose the interest rate charged on the grounds that it might be viewed as the going rate for emergency assistance. In response to a question it was explained that it would not be possible to derive the rate of interest charged from the numbers disclosed, although commentators might

presume it was possible and so calculate it wrongly. To derive an accurate rate would require knowledge of the evolution of the lending through the year, not simply the amount outstanding at the end of the financial year, and how much of the lending was by reverse repo. It was also explained that the net income figure disclosed had a number of elements to it in addition to the interest margin. It included [REDACTED] an estimate of the loss of income from the weekly interest capitalisations that would have been receivable from the short term OMOs that the lending to Northern Rock had replaced and the fee receivable for the facility. It was noted that similar issues had arisen in relation to Northern Rock's own accounts.

A variety of detailed points were noted on the Bank's accounts, as described in the paper that had been circulated. These included the specific references in the Accounts to the opinion of members of Court.

The external auditors were asked if they wished to comment on the Annual Report and Accounts. In response, it was explained that KPMG had completed their audit other than to review the final few items of text to be completed. A formal post balance sheet review would be undertaken with the auditors. Any adjustments would be notified to Court ahead of approval of the Annual Report and Accounts in June, along with the final tranche of the dividend payment to HM Treasury and the letter of representation.

## **8. Annual Turnbull report and quarterly risk report**

Rachel Lomax introduced the item.

It was explained that the Annual Turnbull Report was submitted on behalf of the three Governors. Its purpose was to provide Directors with assurance to sign off the Bank's system of internal controls, in the terms which were set out in the executive summary. The report had been reviewed in draft by the Business Risk Committee on 1 April and the Audit Committee on 29 April. Changes in the Bank's risk framework enabled the report to refer to the quarterly risk reports through the year rather than being a single annual risk report as in previous years.

It was stated that the attestations by executive directors demonstrated that the current operating environment had placed stresses on the Bank's system of internal controls. So far, however, those stresses had not compromised internal controls. Increased operational risk exposures had

not yet been reflected either in the level of incidents reported, or in staff related indicators such as sickness levels and staff turnover.

It was noted that the latest Quarterly Risk Report included a summary of the risks arising from the Special Liquidity Scheme. As earlier reports had indicated, the need to respond to the financial crisis had exposed the Bank to greater levels of operational risk than would be tolerated under normal conditions. New and sometimes unfamiliar demands had arisen from the work on financial stabilisation and policy work on forthcoming legislation. Those had both stretched staff resources and put strains on business processes and systems. The areas primarily affected were Banking Services, Markets and Financial Stability but there had also been considerable extra demands on supporting functions such as Finance, Legal Unit and the Press Office. The Bank was currently reviewing the need for additional resources, controls and projects to meet these short term challenges.

In relation to staffing levels, it was asked if the Bank was being too conservative in its approach given it had been under pressure for some time. Different capabilities and skills might be needed in the future so it might be better to start a recruitment programme now rather than later. In response, it was accepted that some new demands were evident such as financial accounting expertise. However, it made sense to review the broader picture rather than respond in a piecemeal way. It was noted that there were plans in place to create a central project management pool in the Finance area in order to improve further the Bank's execution and delivery of projects. In response to a question about how current demands would be handled while the wider review was undertaken, it was noted that the Bank was employing more contract staff, including management, in the Banking area. In the Markets area, staff had worked longer hours and been diverted from other work.

It was asked if the risk management apparatus that had been developed over the past few years was providing value for money. Furthermore, had the framework correctly identified or mitigated risks that had materialised over the recent period. A review of the framework and processes was suggested to assess value for money, which should not focus on the issue of whether or not the Bank was following best practice. In response, it was noted that there was not a particularly large apparatus in place. The central framework involved the Business Risk Committee and the Incident Management Committee, which drew together people from around the Bank to focus on Bank-wide risk management. Other committees were in place within



business areas to manage their operations, some of which were longstanding. Moreover, the central risk unit consisted of four full-time equivalent staff. There had in fact been criticisms that the Bank's risk management was too slim and decentralised. It was also stated that if business areas were managing risk properly, the task of putting together risk reports should be straight forward. The processes were only onerous when that was not the case. It was noted that there was some additional work involved in putting together a quarterly risk report that was in an effective format for NedCo/Court. The usefulness of that depended on how well the reports provided a basis for Directors to have a meaningful discussion about risks and risk management.

It was suggested that the value of the risk management framework came from managers realising it was an effective management tool, and in providing oversight and transparency of events. The quarterly report revealed a large amount of information. It was felt that NedCo should be cautious about diluting the effort.

## **9. Inflation Report and monthly MPC report**

Charlie Bean introduced the item.

The current economic conjuncture, outlook and Inflation Report projections were summarised. In response to a question about the strength of the recovery projected for GDP in 2009, it was explained that part of the apparent strength of the rebound in the GDP fan chart reflected the fact that it showed growth relative to the corresponding quarter a year earlier. Quarterly growth, by contrast, was projected to be sluggish for the rest of this year, picking up gently in 2009. But that made the four-quarter growth rate appear quite jagged. A further question concerned the doubling in the oil price over the past year and the consequent removal from the non-oil economies of a significant amount of spending power. In response, it was noted that the sum was indeed very large. What would determine the overall impact on global demand would be the extent that oil producers re-cycled the extra oil revenues. There was some evidence that this was greater than in the 1970s, which would help to support global demand.

## **10. Audit Committee – minutes of 14 February**

Noted.



**Any other business**

None.

**The meeting of NedCo was closed.**

## MEETING OF THE COURT OF DIRECTORS

**Thursday 15 May 2008**

Present:

The Governor  
 Sir John Parker, Chairman, NedCo  
 Sir John Gieve, Deputy Governor – Financial Stability  
 Ms Rachel Lomax, Deputy Governor – Monetary Policy  
 Mr Brendan Barber  
 Mr Roger Carr  
 The Hon Peter Jay  
 Sir Andrew Likierman  
 Sir Callum McCarthy  
 Mr Paul Myners  
 Dr David Potter  
 Prof David Rhind  
 Ms Susan Rice  
 Mr Arun Sarin  
 Mr James Strachan  
 Mr Geoffrey Wilkinson

Absent:

Ms Amelia Fawcett, Mr Bob Wigley

Also attending:

Mr Bean, Mr Bailey, Mr Jenkinson, Mr Footman, Mr Jones, Mr Tucker and Dame Juliet Wheldon.

**1. Minutes – 16 April 2008**

Approved.

**2. Internal controls – compliance with Turnbull**

Following the discussion in NedCo, Court was satisfied that the risks faced by the Bank had been reviewed and that appropriate controls were in place. Court ENDORSED the Turnbull paper which provided the basis for Directors to sign-off on internal controls for the Annual Report.

**3. Financial markets, financial stability and depositor protection, financial stability quarterly report, Bank's annual report and accounts, quarterly risk report.**

Court noted the discussions in NedCo of the above items.

**4. Monetary policy issues**

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

**Any other business**

None

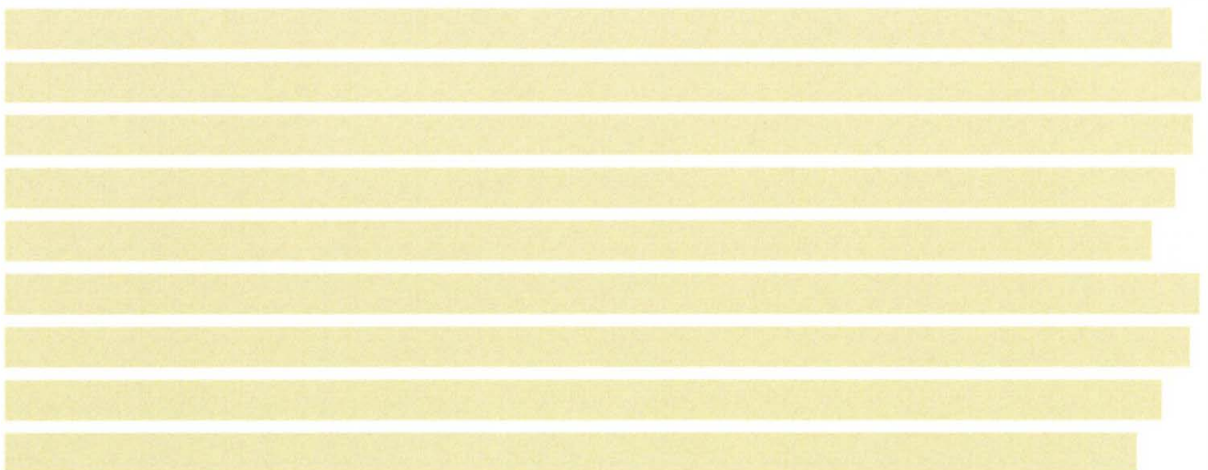
[Members of the Executive Team withdrew]


**5. Remuneration Committee report**

David Potter – chair of the Remuneration Committee – introduced the item.

Following the meeting of the Remuneration Committee earlier in the day, it was recommended that the Governor should be awarded an increase to his salary of 2.5% from 1 July 2008. The recommendation had been informed by an assessment of the Governor's performance in the year to 2007 by the chair of NedCo.

Court APPROVED the recommendation.





It was also noted that the issue of fees for non-executive directors' was being considered with Louise Redmond and the Governor.

In response to a question, it was noted that the Governor's draft objectives for the year ahead were being considered with the Chairman of NedCo. These reflected the anticipated changes in the Bank's responsibilities and the resultant reshaping of the organisation; the development of the Bank's best people; and getting outside help to increase the effectiveness of the Executive Team and the development of the Bank's senior management. They would also include defining the Bank's corporate governance structure in relation to financial stability.

**The meeting of Court was closed.**

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

**Thursday 15 May 2008**

Present:

Sir John Parker, Chairman  
Mr Brendan Barber  
Mr Roger Carr  
The Hon Peter Jay  
Sir Andrew {Likierman}  
Sir Callum McCarthy  
Mr Paul Myners  
Dr David Potter  
Prof David Rhind  
Ms Susan Rice  
Mr Arun Sarin  
Mr James Strachan  
Mr Geoffrey Wilkinson

Absent:

Ms Amelia Fawcett, Mr Bob Wigley

Also attending:

The Governor

### 1. Minutes of 12 March

Approved, along with their circulation to the Governors.

### 2. Update on senior positions

The Governor introduced the item.

It was explained that the Governor's vision for the next five years would be discussed in September, and then mapped into a strategy. It has been hoped to discuss this before the summer break but it made sense to delay it until the Bank's responsibilities in the financial stability area were clearer. One of the key objectives for the Governor's second term would be to establish a framework for financial stability which mirrored the success of the framework for monetary policy. A second key objective would be to ensure there was a very strong group of younger people that could lead the Bank in the following decade.

In the short-term, there were likely to be some significant changes on the Executive Team in the wake of Rachel Lomax's planned departure. Progress was expected over the next month. The Governor had made his preferences known to the HM Treasury and the importance of not taking risks with the monetary stability side of the Bank, whatever the difficulties faced over the past nine months. This would be particularly the case if the Governor was going to spend more time himself on financial stability issues than had been the case during his first term. [REDACTED]

[REDACTED] It was noted that ideas had been discussed with Nick Macpherson regarding the role of Court and the idea of a financial stability committee. It was explained that the outcome was by no means certain. Although Treasury officials thought they could persuade the Chancellor, it was unclear where the Prime Minister stood. [REDACTED]

It was noted that if Charlie Bean was appointed Deputy Governor, a consequence of that would be the need to replace him as Chief Economist. The Bank would want to appoint Spencer Dale (CV circulated). Spencer Dale was currently on secondment at the Federal Reserve in Washington where he had been leading the work on the Federal Reserve's attempts to build a new communications strategy. Within the Bank, he was regarded as the both the strongest economist and manager. In response to a question about whether the chief economist appointment would be advertised externally, it was explained that timing precluded that. More fundamentally, it was vital to provide career progression opportunities for the best internal people. Otherwise it would be evident that the best way of reaching a senior position in the Bank would be to leave. The appointment of Spencer Dale as Executive Director was proposed on a contingent basis which Directors supported

It was suggested that NedCo should communicate formally to the Treasury that the situation regarding senior appointments to the Bank was still very unsatisfactory. There was a discussion about the consequences for other senior staff in the Bank; some concern was expressed about the potential impact on the Bank's financial stability expertise.

**Any other business**



None.

**The meeting of NedCo was closed.**

## COMMITTEE OF NON-EXECUTIVE DIRECTORS (NEDCO) MEETING

**Wednesday 11 June 2008**

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  
Prof David Rhind  
Ms Susan Rice  
Mr Arun Sarin  
Mr James Strachan  
Mr Bob Wigley  
Mr Geoffrey Wilkinson

Also attending:

The Governor, Sir John Gieve, Ms Lomax, Mr Bailey, Mr Footman, Mr Jones, Mr Tucker, Dame Juliet Wheldon.

It was noted that it was the final meeting for Rachel Lomax, who was thanked for her significant contribution to NedCo and Court.

It was also noted that the lunch discussion would be with Hector Sants and Sally Dewar, in addition to Sir Callum McCarthy, from the FSA.

**1. Minutes – 15 May 2008**

Approved.

**2. Matters Arising**

None.

## MANAGEMENT OF THE BANK

### 3. Executive Report

#### Recent and forthcoming meetings and events

##### Domestic:

- speech at the BBA Annual Banking Conference (10 June).
- speech at the Mansion House (18 June).
- Inflation Report Treasury Committee hearing – Governor, Sir John Gieve, Paul Tucker, Kate Barker and Tim Besley (26 June).

##### International:

- ECB's 10<sup>th</sup> anniversary celebrations (2 June).
- ECB General Council meeting in Frankfurt (19 June).
- BIS meetings in Basel (28- 29 June).

A meeting with Nick Macpherson had been held on 30 May and a Tripartite Principals meeting had taken place on 11 June. Breakfast meetings with the Chancellor and Nick Macpherson were scheduled for 24 June and 27 June respectively. A further Tripartite Principals meeting was scheduled for 9 July.

#### Re-appointment of non-executive Directors

The Chancellor had announced today the re-appointment for a second term of Paul Myners, Arun Sarin and Geoffrey Wilkinson. Sir Callum McCarthy's re-appointment had also been confirmed until September, when he will step down as Chair of the FSA.

#### Staff

Peter Westaway – currently Head of Monetary Instruments and Markets Division – would become Senior Research Advisor in MA, assuming many of Alex Bowen's responsibilities when he leaves the Bank in September. Jens Larsen would be appointed the new Head of Monetary Instruments and Markets Division on his return from secondment at the International Monetary Fund. Gill Hammond had been appointed Director of CCBS with immediate effect. She succeeds Mario Blejer who resigned from the Bank earlier this year.

### 4. Financial markets update

Mr Tucker introduced the item.

It was noted that the key issue remained whether or not the process of deleveraging in the financial system could be more or less complete before the macroeconomic slowdown in the US, UK and continental Europe prompted a rise in defaults and a resulting impairment to banks' capital. Over the past month there had been a sea-change in the market's expectation of the path of monetary policy globally. Markets had focussed on the potential for the persistent rise in commodity prices to feed through to broader inflationary pressures, and the resolve of monetary authorities to keep inflation under control. In one sense, this change in expectations was good news insofar as it underlined that financial markets appreciated that central banks were focused on inflation and not just demand management. However, the race between the financial system deleveraging before the macro economy slowed had become more uneasy as a result of the tightening of monetary and credit conditions.

It was noted that, during the month, there had also been a number of moments of further uncertainty in the markets: monoline insurers had been downgraded which had implications for some of the largest financial firms; Lehman's had been the subject of rumour and speculation over a few days, which fortunately had been so far contained; and, in the UK, Bradford and Bingley served as a reminder that the situation remained fragile. Although there was still some sense that the worst had passed, it was liable to remain a bumpy ride and, depending on the scale of the bumps, the destination might be changed.

It was explained that the general problem in relation to Bradford and Bingley was that the underwriters had believed that there had been a material adverse change in circumstances. Fortunately, arrangements were made over the weekend to ensure that the funding was replaced by a combination of re-underwriting at a lower price and a private equity stake. It was suggested that the episode did not reflect well on the underwriters. The significance of the episode was considered to be twofold. First, interruptions to the rights issue process had significant implications; second, the problems at Bradford and Bingley were representative of problems at a number of smaller mortgage specialist institutions. It was also noted that the potential loss of confidence at Bradford and Bingley had not been liquidity driven. It was not that they could not raise money; they had reassured the markets on their ability to fund themselves. Instead, it was more about profitability and the business model of the company. That was perhaps indicative that the wider situation had moved to a different phase. It was nonetheless a worrying moment because what was intended to be the 'icing on the cake', in terms of establishing a strong capital

position and re-enforcing confidence, had become a significant threat to depositor and shareholder sentiment.

It was noted that there had been a constructive and graduated engagement by the FSA and the Bank, which perhaps would characterise a shift from the 'green' to 'amber' phase in the new resolution regime. Further ahead, it was likely that there would be a rationalisation of the sector in some form. The question was whether that would be orderly or not.

## **5. Treasury Committee response on financial stability oversight**

The Governor introduced the item.

Following the lunch discussion with members of the Treasury Committee in May, a letter had been sent by the chair of the Treasury Committee asking Court to submit a paper on its role in relation to financial stability. A draft note had been prepared and circulated to Directors.

It was noted that there had been intensive discussions recently about the forthcoming legislative proposals, including at the Tripartite Principal's meeting earlier that day. The Government intended to publish a second consultation document outlining its thoughts on the banking reform bill before the end of June. Directors would have an opportunity to discuss in July. The Chancellor was likely to announce in outline the proposals in his Mansion House speech on 18 June.

It was suggested that the request from the Treasury Committee for Court's views should be seen as seeking the views of non-executive Directors. It was apparent that the Treasury Committee would carry out an enquiry into the proposed legislation. In that context it expects to ask a number of non-executive Directors to give oral evidence. It was suggested that the response should be sent by Sir John Parker on behalf of the non-executive Directors. It would then be an input into the evidence to the Treasury Committee, which could be followed up with oral evidence.

In discussion, it was suggested that there should be some caution in the way that the letter stated that Court now had the right oversight framework and engagement with the Bank's financial stability work. This remained work-in-progress while the new arrangements were implemented.

Furthermore, the draft conveyed the message that Bank's engagement with banks in peacetime circumstances was adequate, which was perhaps debatable. It was suggested that it should say that the Bank needed to work harder at ensuring more regular contact with banks such that there was a step change, but not a sharp change, between peace and wartime circumstances.

In response to a question about media coverage of plans for a financial stability panel that was separate from Court, it was explained that the Bank had no knowledge of such plans and had not had discussions with HM Treasury along those lines. It was not the Treasury's preferred option as far as the Bank was aware. Discussions had been entirely in terms of the role of Court in the oversight of financial stability. It was noted that prior to 1997, there had been a separate Board of Banking Supervision, which had oversight of the Bank's supervisory work. There had been some tension between Court and the Board at that time, even though the role of non-executive Directors was taken less seriously than today. There would be a similar issue of how to reconcile Court with a separate body if such a proposal was put forward. There was also a concern that an external financial stability panel might involve individuals with conflicting private interests, which was inconsistent with the Bank's public interest role. It was noted that the issue of conflicts of interest was also pertinent to a sub-committee of Court. The issue had already been raised by media commentators. It was suggested that the example of the consultations about the Special Liquidity Scheme was instructive. That had involved an exchange of views with the major banks and discussions about the practicalities of the scheme. But the scheme had not been devised or designed by the banks.

It was felt that the drafting of the paper needed to be sensitive to future questioning by the Treasury Committee – for example, the term 'fully briefed' should be reconsidered. It was also suggested that the paper should not specify that Court was first consulted about support for Northern Rock on 13th September, given there was a scheduled Court meeting on 12th September.

There was some concern about what was being said in paragraphs 13-14 on the way forward. In response, it was explained that it was felt that Directors might want to respond to the Treasury Committee now, prior to seeing the proposals from the Chancellor. Otherwise, it might then be necessary to respond directly to those proposals and whether Directors agreed with them or not. The proposed statements were clearly conditional on what the Bank's additional responsibilities would be. But it was for non-executive Directors to decide what they wanted to say. It was



suggested that it would be more appropriate to set out the issue of conflicts of interest rather than favouring a particular direction, which was difficult to do in the absence of specific proposals. It was thought odd to send such a letter that pre-empted proposals that were imminent. It was thought preferable to raise the governance issues that ought to be considered further during the consultation rather than offer a particular position. An alternative view was that Court should spell out what it believed to be the right approach rather than wait for the Treasury's proposals. But it was questioned whether Directors had considered the matter sufficiently to formulate an agreed set of specific proposals. In response, it was noted that Court had already made a submission to HM Treasury that detailed its preferences.

It was explained that the paragraphs were intended to offer conditional statements about accountability and Court's oversight on the basis that the Bank would be given more responsibilities, to avoid being on the back foot. It was asked whether Directors felt anything in the draft was inconsistent with the previous response to HM Treasury. It was suggested that the draft could simply be hedged by adding the phrase "matters discussed include...".

There was a view expressed that, rather than discussing the drafting, which was trying to finesse a difficult position, it would be preferable first to consider and establish a policy statement that captured what Court wanted to achieve. The drafting could then follow. A contrary suggestion was that the issue was one of tone not substance, as the draft was consistent with the earlier response to HM Treasury. It was possible to set out Court's position based on the earlier response to HM Treasury without adding extra elements to the drafting. It was suggested that the submission to HM Treasury could be attached to the letter to the Treasury Committee rather than covered selectively in the letter itself.

It was asked if the position had changed since Court had formulated its views for the response to HM Treasury. In response, it was stated that the thinking about Court's financial stability oversight was progressing but was not yet finalised. It would depend significantly on the powers and responsibilities granted to the Bank. It would not therefore be possible to offer firm views on the method of oversight exercised by Court but rather to outline general principles consistent with the discussions Directors had had on the matter.

It was noted that part of the letter covered what had been done over the past year in relation to Court's oversight of financial stability; other elements related to the consultation document.

These were weaved together in the current draft. It was thought that the Treasury Committee would be interested in what non-executive Directors had done. In relation to what should be done, the preference was to repeat what had been said in the response to HM Treasury.

The question of whether the points made in the letter should be unanimously supported by non-executive Directors was discussed. It was suggested there could not be dissent if Directors were asked to attend a Treasury Committee hearing. But there were elements in the present draft that would not receive unanimous support – for example, the need for the special resolution authority to have a separate hand on the trigger mechanism. It was suggested that there was a risk that a special resolution authority would have an incentive to place a bank in the resolution regime early – the opposite of the risk of regulatory forbearance. In response, it was noted that the paper to HM Treasury had called for a voice rather than a trigger. It was suggested that the letter could make clear that it represented the majority view, and each point was not necessarily unanimously supported.

A further concern was that there were issues associated with the corporate governance of the Bank's financial stability role that were not dealt with in the letter or earlier response to HM Treasury. It was thought that there remained a need for further discussion of the issues to establish the policy decisions to be taken. The letter might therefore refer to the proposals to give the Bank new responsibilities that would raise questions about governance, which would need to be considered further. It was agreed that a detailed response could only be formulated once the reference point was known. At the current time, it was necessary to offer broad statements about governance and provide an opportunity to return to points of detail. The general statements were relatively straightforward: first, that non-executive Directors should not seek to undertake the role of the executive management; second, that with greater complexity, conflicts of interest would become more important and need greater clarity; and, third, more difficult situations needed to be managed in a disciplined way with a smaller group of non-executive Directors. Beyond that, the detailed arrangements had to follow from the proposals about the Bank's new responsibilities and powers.

In summary, it was agreed that the drafting should reflect the broad position rather than detailed points about governance. The letter should also be checked for consistency with the non-executive Directors' annual report as well as Court's initial response to HM Treasury. A covering letter from the chair of NedCo would identify that the submission was from non-

executive Directors of Court, acknowledging that every point was inevitably not unanimously agreed.

It was also agreed that a note would be circulated over the coming month outlining the extent of the Bank's existing network of contacts with the financial sector, through its market intelligence work and other senior level contacts. It was suggested that it might be useful at some point to take the views of banks themselves on the extent and nature of their contact with the Bank.

## **6. The Bank's communications**

(Peter Rodgers and Jenny Scott – outgoing and incoming Director of Communications – in attendance.)

Peter Rodgers introduced the item.

The report was briefly summarised. It was highlighted that over a ten-year period, it was notable that understanding about monetary policy had increased significantly amongst market and media commentators. In 1998, the MPC had faced intense criticism about its response to the threat of recession. That contrasted with the present debate which, although often critical, was centred on an understanding about the dilemma facing the MPC. The fact that the MPC had undertaken visits around the UK for over a decade had helped establish that it was setting policy for the country as a whole, and was not an ivory tower or representing the City. The new Director of Communications would need to assess whether more needed to be done given the more difficult economic circumstances ahead.

In relation to Northern Rock, it was stressed that communications had been very difficult and had not worked. Communications could not overcome the absence of a framework or planning to deal with a depositor run. There had been no agreed strategy and inadequate preparation for stopping a run. Initially, briefings against the Bank, including from senior people, had been intense; and they had continued in a lower key way through the Autumn. Since then, the Bank had been trying to win back lost ground in terms of its reputation. It was suggested that the situation had gradually improved through 2008 but there remained work to do. It was also noted that the Press Office had brought in additional external and internal resources to undertake specific work. There were now better contingencies in place for crisis circumstances.

Directors were asked to consider the priorities outlined for the year ahead. Reference was made to the MORI survey of journalists. It was asked how the points raised about the Bank's communications would be addressed. In response, it was explained that the feedback was used in a detailed way to influence Press Office behaviour and activities. It was pointed out that some of the feedback consisted of off-the-cuff remarks by journalists who did not necessarily have regular contact with the Bank. Nonetheless, the overall picture was very useful.

It was outlined that the new Director of Communications would bring a communications plan to NedCo in the Autumn. That would relate to both the Governor's strategy for his second term and the Bank's new financial stability role.

The work undertaken by Peter Rodgers during his eleven years at the Bank was acknowledged. He had made a very significant contribution and provided strategic leadership in his field, based on building long-term credibility and authority, and not damaging that with short-term manipulation or spin. Reference was made to the current media stories about the deputy governorship, which were hard to reconcile with that approach. It was stated that the stories were not being generated by the Bank. Journalists had indicated some of the multiple sources. The Bank's Press Office tended to react passively consistent with its overall stance. This helped persuade media that the Bank did not engage in such tactics.

In addition to being damaging for HM Treasury, it was noted that the coverage was also very difficult for MPC members and the wider standing of the MPC.

## **7. Annual Report and Accounts**

Warwick Jones introduced the item.

It was explained that in view of the publication date of 14 July, it would be necessary to ensure the Governor's foreword was suitably up to date at that time. Therefore, further changes would be made. In order to sign-off the Report & Accounts, and to authorise the Letter of Representation to KPMG and the final payment in lieu of dividend, it was proposed that authority should be delegated to the Annual Report & Accounts Committee<sup>1</sup>. A meeting was

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<sup>1</sup> Membership is the Governor, Sir John Parker, Rachel Lomax (now Charlie Bean) and, Amelia Fawcett.

scheduled for 27 June (subsequently rescheduled to 3 July).

The main changes to the previous draft of the Annual Report were highlighted. A few further minor changes were proposed. It was agreed to acknowledge that non-executive Directors' attendance at the Financial Stability Board had operated in a way that managed potential conflicts of interest and that non-executive Directors had been excluded from discussions about individual institutions.

It was noted that there would be a formal discussion with the external auditors, KPMG, to ensure no further changes needed to be made to the Report & Accounts.

#### **8. (i) Audit Committee annual report**

Amelia Fawcett – chair of the Audit Committee – introduced the item.

The key themes of the report were highlighted. It was noted that during the course of the year the Bank's executive management had been helpful and forthright in discussions with the Audit Committee. There had been good progress across a range of areas including the risk management framework and reporting, the integration of the Risk Policy Committee and the Audit Committee, financial reporting, cross-directorate working, and internal controls. Central oversight and assurance of projects remained a strength, and the IT operating model and reorganisation was progressing. Less progress had been made in some other areas. Using systems and processes to drive better outcomes was an area that the Audit Committee continued to believe the Bank could place a higher value on. More expertise rather than resources was required. More proactive work with business areas on risk and value for money was required. These were areas that the executive management had also identified for further work. The Audit Committee was therefore content that despite limited progress to date, these issues were being addressed.

It was stated that the foundations for change and continuous improvement were now largely in place in terms of architecture and processes. The Audit Committee acknowledged the contribution made by Rachel Lomax in sponsoring much of this foundation. It would be important for the executive management to maintain this momentum.



The report indicated some of the priorities for 2008 for the executive management to consider. The broad themes highlighted were the need to use the structures and processes to drive more effective outcomes; continuing the work to improve internal controls and processes to be in line with best practice among major financial institutions; a sharper focus on crisis decision-taking and developing a deeper cadre of professionals in-house; and formulating plans to deal with inevitable strains on resources over the next year. This latter point was an area that NedCo and Court should focus particularly on in the year ahead. Overall, the Audit Committee thought the Bank was focused on this forward agenda and significant work was already in train.

In discussion, Directors agreed that there had been significant progress in a number of areas. But it was suggested that cross-directorate working appeared to remain patchy overall. It was also stressed that frameworks and processes should not take precedence over outcomes, which were the key to driving and changing behaviours more broadly. It was also noted that it had taken a long time to put the basic structures in place, which had required patience. But, although slow moving, the careful and cautious culture of the Bank also meant the frameworks would not be treated lightly and, in that sense, they would be sustainable. It was stated that, although there were pockets of excellence for execution and implementation in the Bank, the ethos was largely analytical. It was suggested that, if the Bank operated the Special Resolution Regime, there would need to be some shift in that focus. It was acknowledged that cross-directorate working remained a challenge but in this area processes were not a substitute for people and leadership.

It was also noted that, from the executive management's perspective, the relationship between it and the Audit Committee had become significantly more productive over recent years. The Audit Committee had made a major contribution to the management agenda of the Bank. Although NedCo and Court would be rightly focussed on the forthcoming changes to the Bank's financial stability role over the coming year, it was felt that it would be all the more important that the Audit Committee kept a focus on its agenda. It was felt that the impetus would not be lost on the executive team. It was stated that Warwick Jones would take forward that part of Rachel Lomax's portfolio. It was also stated that the Governor's strategy paper for his second term, to be brought to NedCo in September, would include how the Bank would take forward some of the priorities outlined in the Audit Committee's report.

## **(ii) Audit Committee report**



Amelia Fawcett – chair of the Audit Committee – introduced the item.

The main items discussed at the meeting on 29 April, detailed in the minutes, were summarised. It was noted that the Audit Committee's discussion about the Turnbull process for internal controls and the Annual Report & Accounts had already been covered at NedCo's meeting in May.

It was reported that the Audit Committee had strongly endorsed the introduction of an incident management system, which would be an important part of changing the culture of the Bank. It was early days but there had been a promising start. In relation to data protection, it was noted that the Bank had acted quickly in the light of the much publicised incident at HM Revenue [&] Customs. The Audit Committee emphasised the need for executive management to support visibly IT initiatives in this area in view of the natural resistance to follow such policies. It was also highlighted that KPMG had provided strong support and encouragement for the work of the Risk Oversight Unit and the new structure.

## **9. Procurement**

(Peter Higgs – Head of Property and Security Services Division – in attendance.)

John Footman and Peter Higgs introduced the item.

It was noted that NedCo had previously discussed procurement in May 2007, which had focussed on the initiative to improve the management of procurement, initially within the Central Services area. The remit had been extended across the Bank. The procurement team was planning reviews of each directorates' spending; the first was currently in progress in the Financial Stability area. Work was also underway to consider a fairly wide range of individual contracts. The aim was to continue delivering demonstrable value for money through the use of the procurement discipline that had been put in place. Over the past year, there had been independent verification and endorsement of the approach taken by both the internal audit area and externally by the Chartered Institute of Purchasing and Supply. It was also noted that some contracts had been benchmarked to verify value for money. Further benchmarking was envisaged, for example for professional services, which featured significantly in the Bank's list of major suppliers.

That volume had increased in recent years due to the effect of issuing the new £20 note, which meant replacing an existing stock of notes. The Bank was now beginning to build up contingency stocks again, having run them down during the change over period. A paper would be discussed at NedCo in July on the way forward for the contract with De La Rue. The contract had a pricing agreement for seven years which was presently in its sixth year, so the point had been reached to decide on a suitable way forward.

The fact that the Bank's cleaning contractor paid the London living wage (£7.20 an hour) for its staff in the Bank prompted the question of whether the Bank's catering contractor also paid the London Living Wage to its staff working in the Bank. It was agreed that the terms would be checked. Pay rates were above the minimum wage.

It was noted that the Bank still appeared to have a large number of suppliers, and that the number had increased since 2006. In response, reference was made to the requirement for diversity in the supplier base. Although there had been a fall in the supplier base for commodity products and services, there had been an increase in the use of external advisors, notably professional services and training providers. It was also noted that the Bank often needed to hire professional services staff at short notice and to ensure that there were no conflicts of interest.

It was also asked what timescale would apply to the work underway to look at smaller value purchases and to move to more on-line ordering. Would the use of procurement cards for low-value purchases allow greater progress? In response, it was noted that the Bank did use procurement credit cards for low-value purchases, and that this was expected to be expanded as business-area procurement reviews were undertaken.

## **ITEMS FOR INFORMATION**

### **10. MPC report to Court**

Noted.

## **11. Health and safety bi-annual update**

[REDACTED]

In response to a question, it was explained that health and safety reviews were undertaken on the Bank's power plant frequently.

### **Any other business**

Directors were reminded of the requirements to inform the Bank at least 14 days before committing to an outside interest, along with the need to provide information to support the Bank's assessment of actual or perceived conflicts of interest.

Details of each Directors' existing commitments had been circulated to be checked and verified as being up to date.

**The meeting of NedCo was closed.**

## MEETING OF THE COURT OF DIRECTORS

**Wednesday 11 June 2008**

Present:

The Governor  
 Sir John Parker, Chairman, NedCo  
 Sir John Gieve, Deputy Governor – Financial Stability  
 Ms Rachel Lomax, Deputy Governor – Monetary Policy  
 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  
 Prof David Rhind  
 Ms Susan Rice  
 Mr Arun Sarin  
 Mr James Strachan  
 Mr Bob Wigley  
 Mr Geoffrey Wilkinson

Also attending:

Mr Bailey, Mr Footman, Mr Jones, Mr Tucker and Dame Juliet Wheldon.

**1. Minutes – 15 May 2008**

Approved.

**2. Annual Report and associated issues**

Following the discussion in NedCo, Court APPROVED the delegation of authority for the signing of the Annual Report and Accounts, the letter of Representation, and the final payment in lieu of dividend to HM Treasury, to the Annual Report and Accounts Committee. A meeting of that Committee was scheduled for 27 June (subsequently changed to 3 July).

### 3. Core purposes

Court APPROVED the change in wording of the introduction to the Bank's core purposes in the Annual Report to read:

"The Bank exists to ensure monetary stability and to contribute to financial stability."

### 4. Financial markets, Treasury Committee response on financial stability oversight, the Bank's communications, Audit Committee reports, procurement

Court noted the discussions in NedCo of the above items.

### 5. Monetary policy issues

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

### Any other business

None

[Members of the Executive Team withdrew]

### 6. Remuneration Committee report

David Potter – chair of the Remuneration Committee – introduced the item.

[REDACTED]

It was also noted that the Remuneration Committee had considered the Governor's objectives next year. Sir John Parker was continuing to discuss these with the Governor. A set of agreed objectives would be circulated once finalised.

It was reported that the fees paid to non-executive Directors were being reviewed.

Finally, it was noted that the remuneration of the new appointee to Deputy Governor was discussed in broad terms. Recommendations would be brought to Court in due course once an appointment had been made.

**The meeting of Court was closed.**



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

**Wednesday 11 June 2008**

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  
Prof David Rhind  
Ms Susan Rice  
Mr Arun Sarin  
Mr James Strachan  
Mr Bob Wigley  
Mr Geoffrey Wilkinson

### 1. Minutes – 15 May 2008

Approved, along with their circulation to the Governors.

### 2. Matters Arising

Three issues were raised.

First, the risk of non-executive Directors communicating on sensitive issues by email was highlighted. Where possible, such email correspondence should be minimised.

Second, concerning the consultation with NedCo on senior appointments, it was recalled that in January non-executive Directors had been asked to complete a short questionnaire which was relayed in a complete way to HM Treasury. This had followed earlier discussions about the need for greater input from NedCo. It was noted that subsequent to that some non-executive Directors had spoken separately to the Treasury about appointments which had, in large part, repeated the earlier input. The Treasury had indicated that they preferred the structured input rather than that offered individually. It was agreed that non-executive Directors should be sensitive to the feedback though if asked for their individual views they would be offered.

Third, reference was made to recent press coverage about the deputy governorship. Some articles, in particular in the Financial Times, were particularly damaging. Both the Bank and HM

Treasury believe that some of the information had come from a member or members of Court. One newspaper had indicated to the Bank's Press Office that they had been given the substance of the briefing the Governor had given to the second meeting of NedCo in May. This was highly improper and inconsistent with the oath Directors take on appointment. It was clearly a very difficult situation. It was requested that any non-executive Directors that had had conversations with members of the media about those issues to speak privately with the chairman. It was stressed that the events had impacted on the Governor's confidence to share critical and sensitive information with NedCo.

### **3. Board evaluation survey**

The results of the survey and a summary note had been circulated. It was proposed that the Secretariat was tasked to produce an action plan to address the main issues raised for NedCo to consider in July. It was also suggested that the previous action plan should be tabled for a further review.

### **Any other business**

Directors were informed that a new web-based facility to enable non-executive Directors to access NedCo/Court papers had been completed and tested. Three non-executive Directors (Amelia Fawcett, David Potter and Susan Rice) had been shown the system earlier. It appeared to be user friendly and effective. Papers for forthcoming and previous meetings, agendas, terms of reference, contact details and other material would be held for Directors to view. It would be trialled over the next few months ahead of being made available to all non-executive Directors. It was noted that in future the system would be used for sensitive papers rather than hard copies being sent by courier., which would reduce the risks associated with paper distribution.

A request was made for the dated of the 2009 NedCo and Court meetings to be made available as soon as possible. The Secretariat would provide indicative dates ahead of the formal timetable for 2009 being agreed.

### **The meeting of NedCo was closed**