COMMITTEE OF NON-EXECUTIVE DIRECTORS (NEDCO) MEETING

Wednesday 16 July 2008

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

Absent:
The Governor, Ms Amelia Fawcett, Sir Callum McCarthy

Also attending:
Sir John Gieve, Mr Bean, Mr Bailey, Mr Dale, Mr Jenkinson, Mr Jones, Dame Juliet Wheldon.

1. Minutes – 11 June 2008

Approved.

2. Matters Arising

None.

MANAGEMENT OF THE BANK

3. Financial markets update

(Mike Cross – Head of Sterling Markets Division – in attendance)

Sir John Gieve and Mike Cross introduced the item.

It was explained that the overall issue remained how far the process of financial system deleveraging would be complete before the macroeconomic slowdown prompted a rise in defaults in bank lending books, and therefore a further impairment in banks' capital. There had been broad based falls in equity markets and corporate bond spreads for banks and other financial firms had risen. Against that backdrop, it was explained that conditions in financial markets remained very tense. Financial institutions were reluctant to expand their balance sheets and liquidity remained relatively poor even in core markets. Rumours continued about the health of particular banks. There had been an intensifying focus on US regional banks, given their concentrated exposures to US consumers and real estate, which had predated the failure of Indymac last week.

It was noted that concerns about the US mortgage agencies Fannie Mae and Freddie Mac had dominated the financial markets over the past few weeks. Market concerns around them had grown over the past week, resulting in considerable volatility in equity and debt prices, and the prices of mortgage backed securities that they originated. Freddie Mac and Fannie Mae were significant institutions for both macroeconomic and financial stability reasons. Their guarantees meant the cost of US mortgages was lower than it would otherwise be, which supported US home ownership. Financially, their debt securities amounted to over a trillion dollars and were very widely held in the US and international investment portfolios. The announcements by the US Treasury over the weekend about it seeking powers to inject capital and for the Federal Reserve to make its discount window available to Fannie and Freddie resulted in debt spreads falling back somewhat but their equity prices had continued to fall. That was suggestive of a market belief that the institutions would not be allowed to fail, but that shareholders faced large write downs on their investments. It was also noted that both the SEC and FSA had introduced measures relating to short selling certain financial stocks. Overall, market conditions remained tense, and in relation to the road ahead, if anything the bumps appeared larger than a month ago.

In response to a question about LIBOR spreads, it was explained that they had been fairly stable over the past month – that they had not risen further was possibly the good news over the month. It was also reported that the take-up of the Special Liquidity Scheme (SLS) currently stood at just over £40 billion, with the larger banks fulfilling their original commitments, and second and third tier organisations were also beginning to use the Scheme. Further drawings would be made as new securitisations were created and delivered. This included a number of building societies and monoline mortgage banks. It was noted that banks were planning drawings throughout the six-month window as part of a deliberate process. The Bank was currently expecting the eventual take-up to be between £50-100 billion.

Directors were also updated on the position of individual banks. The concerns about banks being able to finance their balance sheets had eased slightly since March but, as noted earlier, there were growing concerns about the impact of the macroeconomic slowdown on profitability and capital. The consequent impact on equity prices had made a number of high profile rights issues difficult to manage. That continued to play out, notably with Bradford & Bingley which had seen its earlier plan unravelled following a ratings downgrade. The Bank had been actively involved in the efforts to secure backing from the large banks. The authorities were very mindful of the risks of a withdrawal of deposits in response to adverse media coverage. That concern had now abated and it looked as though Bradford & Bingley would finally secure the £400 million injection, albeit with a damaged franchise and without a chief executive or chief operating officer. It was noted that Alliance & Leicester had accepted an offer from Santander, which was a positive development. There remained concerns about some mid-sized building societies that had expanded rapidly in recent years. The FSA's strategy was to encourage and facilitate mergers with stronger institutions. The HBOS right issue was also being monitored. It was noted that the Governor had formed a small group comprising the Governor, Sir John Gieve, Paul Tucker and Andrew Bailey, that would meet regularly to consider individual institutions and the Bank's internal work and approach alongside the other tripartite authorities.

In response to a question about whether the workings of the tripartite authorities had improved since the Autumn it was explained that, although relations had been strained, the authorities were working well together on the current workload. There were daily calls with the FSA to share information and a Bank team was analysing the liquidity position of banks under stress. In relation to individual institutions, the authorities had worked closely to ensure a concerted message was coming from the tripartite. The recent approach had been consistent with the graduated involvement for the Bank envisaged under the new legislative framework. It was thought that the Bank was engaging and getting information at an early enough stage. At the same time, the FSA was gearing up its supervision following the lessons of Northern Rock which had been documented.

Issues remained regarding the Bank's access to information. It could be difficult to accelerate and deepen involvement in an institution in order to obtain information that the Bank might find useful. This was relevant to the future framework and the operation of a Special Resolution

Regime. It would not be acceptable for the Bank to arrive at an institution and demand information. It was noted that the UK did not have a system of bank examination as in the US such that profile risk was a real consideration relevant to designing the way the Bank would engage with institutions and access the information it required. A second issue was the presence of termination events and clauses written into rights issue documentation specifically relating to engagement by the FSA and the Bank. These included heightened supervision by the FSA and, in future, would include heightened engagement by the Bank. This was an issue that was being considered in the context of the proposed bill.

It was asked if the Bank was equipped in terms of staff resources to handle unexpected events such as those that arose over the previous weekend in relation to Bradford & Bingley's rights issue. In response, it was stated that staff had been able to respond to such episodes and, following Northern Rock, there were more people in the Bank with knowledge and expertise to handle such difficulties. Bank staff had considered the implications of an increase in retail deposit outflows and what processes could be employed to transfer deposits and close down the remainder of the bank if that proved necessary, which it had not. However, actually dealing with a resolution of a Bank would stretch the Bank's capabilities to the limits.

In response to a question about whether the existing deposit insurance arrangements were well understood by the public, it was thought that it was increasingly understood that deposits up to £35,000 were covered by the arrangements. In fact the scheme was more generous than that as it covered the first £35,000 of loss. That was not well understood by the public, nor had it been well understood in the FSA and Bank until recently. It was noted that the consultation document had indicated that the limit would be increased to £50,000 but on the basis of a simpler method of calculation. There would also need to be clarification about which institutions were covered separately. In its present form, the coverage of the deposit protection arrangements depended on the legal structure within banking groups even when they operated as different brands. This was potentially misleading for the public who might assume that their deposits were diversified in say two banks when in fact the limit applied to the combined total where they were part of the same group. It was asked if there was a case to bring forward the deposit protection legislation ahead of the other reforms given the importance of the issue in the current environment. In response, it was explained that, if anything, the timetable would be slower as deposit protection was under the jurisdiction of the FSA and the formal consultation had not yet been started.

The issue of the regulation of banks was raised. Given a number of institutions were in a difficult position and had needed refinancing, was there a need to have much tighter regulation in the future? The proximity of the FSA to its client base was also raised. It was stressed that the focus of regulation had to be the public interest. Looking back over the past decade, banks had been allowed to become too risky by their boards and the environment in which they had operated. The current regulatory response would be judged in the future against the experience of the past decade. It was suggested that the Bank should try to seek as many tools and powers that it could to ensure that it was able to fulfil its broader systemic responsibilities. In response, it was noted that the FSA had acknowledged that its prudential supervision had not been exacting enough – the FSA was currently recruiting heavily to strengthen that aspect of its work. But it was highlighted that the more intrusive and expensive style of supervision in the United States had not proved any more effective. It was still possible to miss large risks with tighter regulation. It was noted that the engagement over the past eight months had encouraged a broader view of the Bank's role, both in individual cases and in terms of policy issues such as the FSA's liquidity regime. Prudential requirements were being raised for capital, liquidity and management. The FSA had accepted the need to undertake more intensive questioning about the viability of business models across all states of the economic cycle, especially for monoline mortgage banks which were struggling in the current environment of falling house prices and funding constraints. It was also noted that the Basel Committee was assessing the regime for capital and liquidity regulation and how Basel 2 could be modified and strengthened.

A brief update on Northern Rock was provided. It was explained that the new management team were progressing well with the business plan but that the bank's financial position had worsened. This was, in part, due to the attempts to shrink the mortgage book. Better borrowers had moved their mortgages elsewhere while lower quality borrowers had not, so overall credit quality was falling. With no new business, fee income was low. Overall, capital was only just adequate and would need to be supplemented soon. The Bank was being repaid ahead of schedule as the repayment of mortgages generated strong cashflows. The size of the outstanding facility was now a little over £20 billion.

4. **Banking reform bill**

(Mike Cross – Head of Sterling Markets Division – and Peter Brierley – Adviser, Financial Stability – in attendance)

Sir John Gieve introduced the item.

An update was provided on progress with the agenda for financial stability and depositor protection. Over the past month, a second Tripartite consultation document had been published along with a letter from the Chancellor to the Treasury Committee. A paper had been circulated to Directors on the scope and extent of the Bank's existing market intelligence effort and contact with financial institutions. It was expected that there would be a considerable amount of work to undertake over the Autumn.

It was noted that the proposals in the consultation document were very close to those recommended by Court. They embodied the idea of graduated involvement for the Bank, the right to have access to information through the FSA, and a powerful voice in prudential policy and triggering the Special Resolution Regime (SRR) for failing banks, which would be the responsibility of the FSA. The Bank itself would run the SRR and choose the instruments to use within it, subject to the Government's right to decide whether to deploy taxpayers' funds. The consultation document was however fairly light on details. A further consultation document had been promised by HM Treasury before the parliamentary recess next week to provide more detail on the SRR, particularly how a bridge bank would be operated and what would happen to the rest of a bank's assets[2]. It was also noted that the consultation document included reference to legislating for a smaller-sized Court and a Financial Stability Committee as a committee of Court. It was expected that the remit for such a committee would be to oversee the Bank's financial stability responsibilities and operations. It was stated that this would therefore go beyond the province of the existing Financial Stability Board. It would also include the issues covered by the Transactions Committee, the Bank's market operations that bear on financial stability, and the Bank's role in relation to the SRR.

It was explained that a key challenge was to sell the proposals for a SRR to stakeholders given the invasiveness of the powers to take control of an institution before it became insolvent and override the property rights of shareholders and creditors. Safeguards were being included that would be set out in a code of practice to be attached to the legislation. It was acknowledged that the timetable for the follow-up consultation was very challenging.

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[2] Subsequently published on 22 July along with draft clauses of parts of the bill.

It was asked what the Bank wanted from the legislation in terms of both the timing of access to information and its content. In response, it was explained that the Bank wanted the power to demand information from a bank that helped it meet its financial stability responsibilities. The Bank was actively considering the kind of resources and information that it would need in practice. It was scoping how many and what type of people would be needed to run the SRR, which would be informed by discussions with the Federal Deposit Insurance Corporation (FDIC) in the United States and resolution authorities in other countries. It was noted that the FDIC operated a concertina approach that brought extra people in to deal with active cases. It was hoped to have a plan for discussion with Directors in the Autumn in order to have a Special Resolution Regime in place in the Spring. It was clarified that the Bank would have its own power to request information, within a code of practice similar to its statistical code of practice which ensured requests were justified on cost-benefit grounds. The FSA would act as a conduit so systems were not duplicated.

It was highlighted that there was a lot of work to do to ensure the new Financial Stability Committee looked credible, including the accountability of the Bank's executive management given that the Governor would chair the committee. Conflicts of interest would also need to be managed in a credible way, along with the links with the FSA. It was suggested that one way of approaching the work was to determine what decisions would need to be taken by the Bank and then to decide on the allocation between Court, the Financial Stability Committee and the executive management. Consideration would need to be given to how the Bank's financial stability role was organised. For example, the Financial Stability Board did not consider market operations but that would most likely be part of the remit of the Financial Stability Committee.

In relation to the note on the Bank's contact with financial institutions and the complaints that had been voiced by some bankers about their contact with the Bank, it was asked how the Bank judged whether its regime was working. It was suggested that a large part of the recent dissatisfaction related to liquidity provision rather than contact with the Bank. The Bank had understood what banks were requesting and the market situation. It was suggested that the real test of the market intelligence apparatus was whether the Bank understood what was happening and what financial institutions wanted. It was a separate decision whether to give banks what they wanted. It was agreed that criticism about Northern Rock and liquidity provision was separate to the question of the Bank's engagement. It was felt that the level of access and joined-up nature of the communication between markets and financial stability within the Bank and senior people within institutions had been transformed over the past few years. Many institutions now thought there was a good dialogue with the Bank that was useful in both directions.

In summary, it was noted that a large amount of work would need to be undertaken by the executive management in consultation with non-executive Directors. Three main modules were identified: the terms of reference and role of the Financial Stability Committee, and its composition and skill requirements; the review of the money market framework; and the construction of the Special Resolution Regime and related tools and processes. Discussions would progress through the Autumn and perhaps into the new year. This would require a continuing dialogue with HM Treasury. It was thought that advertisements for appointments to Court could not be progressed until the legislation was tabled. But the timetable would be clarified with HM Treasury. It was also noted that the Governor's strategic review for the next five years, to be discussed with NedCo in September or October, would encompass the Bank's contact with the City.

5. **The Bank's contract for note printing with De La Rue**

(Lee Dobney and Mark Robson – Notes Division – in attendance)

[redacted]

6. **Business continuity risks: a proposed strategy**

(Stephen Collins – Head of Business Continuity Division – in attendance).

[redacted]

[redacted]

7. Combined quarterly reports

Quarterly Performance Report

It was explained that the report captured the main points about the Bank's activity over the quarter to the end of May. Performance monitoring against the Bank's two core purposes continued to be mapped though the Bank's four outcomes. Some of the commentary was inevitably already out of date given the fluid nature of the current environment.

Under outcome 1, it was noted that the challenges facing the MPC had been well documented publicly. That in itself could be seen as a result of the communications strategy to ensure effective and transparent communication of MPC thinking. The rise of CPI to 3.3% in May had triggered an open letter to the Chancellor and the anchoring of inflation expectations remained a key risk.

[redacted] The Bank had undertaken a review of its education and information activities, and considered whether it should adopt a more high profile approach that involved public warnings about counterfeiting. It had been decided not to do so at the present time due to the risk of adverse media and public reaction. Having taken advice from an external PR agency, it had been agreed to enhance the existing education campaign to stress banknote security features. The public's understanding of security features was monitored through opinion polls. [redacted]
The Bank continued to encourage the police to put more resource into anti-counterfeiting operations.

It was also noted that agreement had been reached with Loomis over the amount to be paid to the Bank following the mis-reporting of banknotes in circulation last year. The agreed figure was £28 million, which had been noted in the annual accounts. The KPMG report was currently being finalised. [redacted]

In relation to outcome 3, it was noted that the commentary was somewhat out of date given the fluid nature of events and market conditions. Reference was made to the fact that LIBOR spreads had not changed very much over recent weeks. The main activities over the past quarter had been the introduction of the Special Liquidity Scheme and the publication of the second consultation on banking reforms. There were general risks relating to the new legislation in terms of matching expectations of the Bank with the tools it would have available – identified in the Quarterly Risk Report. It was stressed that the reputation and credibility of the Bank was a key risk underlying a large amount of what was currently in train.

It was noted that there had been media reports about discussions between the Bank and banks concerning the Special Liquidity Scheme and whether the terms of the Scheme needed to be varied or extended. It was explained that there had been a routine meeting with bank treasurers but that issue had not been raised. It was emphasised that the Bank did not view the Special Liquidity Scheme as a means of rescuing weaker banks. Rather, it was a market-wide scheme to ease overall liquidity pressures. The Bank had been managing the Scheme so that it did not become disproportionately focussed on a small number of banks. There was some concern in the market about what would happen after the Scheme closed to new drawings in October and whether or not wider collateral would still be eligible in some form. That pressure was likely to grow over the coming months. A more permanent set of arrangements was being considered in the review of the Red Book.

It was asked if the measures used to evaluate outcome 3 were the best available and whether it would be sensible to reconsider them. In addition, it was suggested that the commentary should refer to the tables to a greater degree. In response, it was noted that a range of charts were considered with the Financial Stability area. They were not fixed but would change with circumstances. It had been decided to reduce the length of the report to two sides for each outcome in the interests of self-discipline. A key chart in the FSR and an important output from the Financial Stability Board was the summary of risks. There had been a debate about whether the chart should convey levels or changes in risk. It was asked if the chart was still considered to be the best means of representing judgements about changing risks in the financial system. In response, it was explained that the summary chart continued to be reviewed. On the one hand, there would be benefits in having a format that was reasonably fluid and changeable; on the other hand, many of the summary risks were broad enough to allow for a six-monthly assessment and comparison.

It was highlighted that although Outcome 4 was often characterised as being part of the enabling strategy, it was essentially about ensuring the Bank was trusted to carry out its core purposes. As had been discussed in June's Communications item, the Bank's reputation had been affected by events in financial markets in the latter part of 2007. This was reflected in the selected indicators although it was thought that there had been some recovery since the latest media survey. A further key risk related to staff. In response to existing strains and new demands, it was noted that thirty nine new positions over and above those currently in the budget had been approved, and the recruitment effort was underway. Some of the positions related to the Special Liquidity

Scheme; others included positions for the legal and finance areas. It was noted that there had been good progress with the IT operating model. New IT business partners were in place, and strategies were being developed with a view to incorporating some in the forthcoming budget planning round. In response to a question about the red indicator against the RTGS system (page 17), it was explained that the time to recover RTGS, in terms of switching from one site to the other, currently fell outside the target. This would be addressed before the end of the year by a project currently underway.

Quarterly Financial Review

The report was briefly summarised. It was highlighted that CRD income was anticipated to be more or less equivalent to the budgeted position, resulting in a surplus over expenditure. It was noted that there was a fairly substantial increase in anticipated income from capital and reserves compared to the budget. The budget had not included additional income from Northern Rock as it was not known when loans would be repaid or additional income from long-term repos on Banking Department's balance sheet, which had not been anticipated. An additional £30 million of income from those sources was now anticipated. It was also noted that budgeted pension costs wrongly showed a reduction due to a glitch in the calculations. Pension costs under IAS19 were expected to be substantially above those shown in the forecast.

In relation to policy functions, estimated spending for 2008/09 was £108.2 million, which would absorb some of the contingency that had been built into the budget. It was noted that some cost estimates were fluid, dependent on the current recruitment effort. But it was not expected that spending would exceed the policy budget overall on current assumptions.

Remunerated functions showed a larger surplus than budgeted. Central bank deposits had fallen recently but it was uncertain how these balances would evolve over the remainder of the year. Attention was drawn to the income and costs estimated for the Special Liquidity Scheme (page 30). It was stressed that the figures were only illustrative at this stage. Assumptions had been made about the total amounts drawn down in the scheme, margins, and amounts payable to the Debt Management Office. The amount of income generated – in the region of £250 million – would be large in absolute and relative terms: the Bank's expected pre-tax profit for the year was £140 million. It was explained that, following discussions with auditors, it was anticipated that the surplus would be taken directly to reserves rather than through the profit and loss account. HM Treasury's indemnity meant the Bank was taking hardly any risk so the income was not being received on a commercial basis. It would therefore not be part of the Bank's profit and loss activities but it would be treated as a capital contribution. The tax treatment was being considered and a letter was being drafted for Revenue & Customs. At the end of the three-year period of the Scheme, there would be a substantial increase in the Bank's reserves which might require payment of a special dividend to HM Treasury. Whether or not and how that might be tax deductible was being considered. A paper was being written for the Audit Committee in September that explored the accounting and tax issues and how they should be dealt with in the internal and external reporting.

It was stated that the dividend issue related to the wider question about the appropriate size of the Bank's capital. There had been a change of heart at HM Treasury following the events of the past year. Previously, it had questioned the need for the Bank to have its own capital. But, under European state aid rules, it was advantageous for the Bank to have a larger capital to undertake its own larger operations. HM Treasury was considering the issue further.

Quarterly balance sheet report

It was noted that one of the highlights of the report was the substantial repayment of the Way & Means balance by HM Treasury. A small residual balance remained. The option to use such a facility was not allowed under the Maastricht rules should the UK join the single currency. It was noted that the Banking Department balance sheet continued to be unusual because there were no short-term repos at the present time, reflecting the change in market operations to accommodate the lending to Northern Rock and the increase in long-term operations. It was also noted that central banks' deposits had fallen by around £7 billion over the quarter. Such deposits were normally swapped into other currencies in order to remove the foreign exchange risk. However, those activities had stopped as part of the special controls on foreign exchange settlement exposures which, in turn, had reduced the Bank's ability to take such deposits.

It was highlighted that the original Northern Rock facility had been fully repaid on 16 May. It was anticipated that all the remaining facilities would be refinanced by the Government by the end of August, with phased repayment in cash over the following few months.

Strategy delivery and projects

Attention was drawn to the fact the second money market reform project had been deliberately postponed. The Bank's exit from Target 2 and progress with the re-tendering of the contract for banknote printing were also highlighted. The plans to streamline and simplify the Bank's management accounting activity had been impacted by IT developers being deployed to work on the Special Liquidity Scheme. That was an example of the ripple effects to different parts of the Bank from events in financial markets over the past year. The management accounting project had been rescheduled. It was also noted that the CSL Openlink project had gone live since the report had been finalised. In relation to crisis management (page 44), it was stated that the Bank was considering working with the FSA to undertake a stress test in combination with some of the major banks.

It was noted that there had been some slippage with the customer banking transition programme. Despite that, there had been some good news recently. First, Citi and RBS were now engaged in relation to the replacement of banking services provided by the Bank. Second, the procurement process for the service integrator, which was not provided by the Bank, had collapsed. This was positive from the Bank's point of view insofar as it would mean that HMRC would not progress with the migration of the service integrator ahead of migrating customer banking services provided by the Bank.

Quarterly Risk Report

It was noted that the report largely replicated information in the Quarterly Performance Report. Its purpose was to inform Directors about how the Bank viewed the risks it faced and how they were being addressed. The report included an attempt to explain whether risks had increased, decreased or stayed the same, though this was inevitably judgemental. The summary flagged four key areas of risk that the Bank currently faced: the ability to meet the inflation target; the banking reform bill process; the Special Liquidity Scheme, including increased operational risks; and the increase in activities across the Bank putting a strain on existing staff resources, business processes and systems, and management capability.

A question was asked about the risk relating to the FSA's data warehouse project in view of the Bank's future use of the FSA to collect data to support its new responsibilities. It was explained that the Bank was putting pressure on the FSA to take the project forward. There had been slippage but it was acknowledged that the FSA was under pressure in terms of increasing resources for prudential supervision. The FSA recognised the need to collect more information, such as liquidity data. In response to a question about the incident involving a Euro payment (page 11), it was explained that this occurred on the first day of the new process being implemented to make euro payments following the Bank's exit from Target 2. The euro liquidity provided to the Bank by UBS had not been returned due to a flaw in the IT coding which had been corrected.

It was noted that there had been a discussion at a previous meeting of NedCo about the value of the risk management framework. The question of whether the Bank was getting value for money from the reporting apparatus had been raised subsequently with the Risk Oversight Unit, who had agreed that it might be worthwhile to review the framework. The request was therefore repeated to undertake such a review at an appropriate time. In response, it was stated that non-executive Directors had to satisfy themselves that the executive management was abreast of the key risks facing the Bank and taking appropriate mitigating actions where necessary. If that was the case, it was reasonable to ask if the means of achieving that were satisfactory or too expensive – i.e. was the machinery making a contribution proportionate to its cost. It was explained that the Governor's strategic review would consider how the Bank should be run, including the role of the Business Risk Committee. It was stressed that, whatever the apparatus, it was important for the executive management to consider key risks, particularly in a period of increased risk to the Bank's reputation on a number of fronts. It was also stated that it was difficult to assess value for money in relation to risk management. That would only be feasible if and when a risk crystallised. The right question was whether the regime was prudent. It was suggested that it might be reasonable to undertake a benchmarking exercise with other central banks. There was some unease about the idea of dismantling parts of the Bank's risk framework at the present time.

It was clarified that the Bank's risk management apparatus was not extensive or particularly costly. A relatively small four person, central unit collated information, oversaw and developed the risk standards and produced the reports. There were risk units in other areas of the Bank, notably in Banking Services and Markets. Based on experiences outside the Bank, it was not felt to be a large apparatus. Some of the Bank's risk management – such as credit and market risk – was essential and common to all financial institutions. It was thought that a significant proportion of the overall costs related to those risks rather than operational and policy risks.

It was suggested that the Governor could be made aware of the comments made to inform his strategy paper. It was also mentioned that the Governor's 2003 paper had referred to the need to reduce the number of committees, meetings and amount of paper in the Bank.

ITEMS FOR INFORMATION

8. MPC report to Court

There was a short discussion on current economic conditions and the outlook for inflation, along with the issues facing the MPC. The discussion covered rising energy and commodity prices, margins, firms' pricing behaviour, inflation expectations, and the need to create an output gap to bear down on inflation.

11. Community involvement – 2007/08 report

Noted.

10. Remuneration Committee

The minutes of the meeting on 15 May were noted.

Any other business

None.

The meeting of NedCo was closed.

MEETING OF THE COURT OF DIRECTORS

Wednesday 16 July 2008

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

Absent
The Governor, Sir Callum McCarthy, Ms Amelia Fawcett

Also attending:
Mr Bailey, Mr Dale, Mr Jenkinson, Mr Jones and Dame Juliet Wheldon.

1. **Minutes – 11 June 2008**

Approved.

2. **Changes to the boards of Bank subsidiaries**

Court APPROVED the resolution that Charlie Bean should replace Rachel Lomax as a Director of Houblon Nominees Ltd.

3. **Committees of Court**

Court APPROVED the appointment of Charlie Bean to become Trustee and Chair of the Houblon Norman Fund.

4. **Monetary policy issues**

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

5. **Financial markets, financial stability and banking reform, note printing contract, business continuity, quarterly reports.**

Court noted the discussions in NedCo of the above items.

6. **Annual Report and associated issues**

Court noted that the Annual Report and Accounts Committee had met on 3 July and approved the signing of the Annual Report and Accounts, the Letter of Representation, and the final payment in lieu of dividend to HM Treasury.

Any other business

None

[Members of the Executive Team withdrew]

7. **Appointment of Executive Director for Monetary Analysis & Statistics**

Court APPROVED the appointment of Spencer Dale as Executive Director for Monetary Analysis and noted his appointment as a member of the Monetary Policy Committee from 1 July.

8. **Remuneration Committee report**

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

[redacted]

[redacted]

[redacted]

[redacted]

[redacted]

The meeting of Court was closed.

COMMITTEE OF NON-EXECUTIVE DIRECTORS (NEDCO)
SECOND MEETING

Wednesday 16 July 2008

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

Absent:
Ms Amelia Fawcett, Sir Callum McCarthy

1. **Minutes – 11 June 2008**

Approved, along with their circulation to the Governors.

There was a discussion about the issue raised at the previous meeting concerning apparent leaks from NedCo meetings to the media. It was reported that following last month's meeting, the Bank's Press Office had been called by a newspaper with information about the meeting. This had further damaged confidence. Following the previous meeting, it was noted that one non-executive Director had approached the chairman, as had been requested, to explain that they were contacted occasionally by the media, including in relation to the deputy governorship. They routinely refused to comment on matters relating to the Bank. It was agreed the position was very serious and wholly unsatisfactory. The loss of trust impinged on the way NedCo operated as a body. It was felt to be unacceptable to have to leave the situation as it was, particularly if it had damaged the Bank's appetite to share sensitive information with non-executive Directors.

Possible ways of resolving the issue were discussed. One option was to instigate a formal, in-depth investigation by a QC. But it was thought that such an exercise was unlikely to be productive, as well as being high profile and therefore risk further media reporting. It was hoped that perhaps the damaging nature of the episode would act to ensure there were no further breaches of confidentiality.

2. Review the workplan for 2008/09

The current workplan was driven largely by non-executive Directors' responsibilities relating to the MPC and their annual report. Inevitably, the workplan would be re-shaped once the new legislation was in place.

3. Nedco/Court evaluation survey – action plan

The proposed actions were reviewed and would guide the future management of agendas and the operation of Court and NedCo. It was acknowledged that some of the issues were part and parcel of the forthcoming transition to a smaller Court. If Directors had further points that they wanted to raise on the action plan, they could do so with the Secretary in the first instance.

4. Review the rolling agenda for Nedco

Directors were reminded that the twelve-month rolling agenda was a planning tool which they could use to review future agenda management and whether time was being spent on the most appropriate issues and topics, and whether there were items omitted which they wanted to discuss.

5. Attendances at pre-MPC meetings and Agency visits

Noted.

Any other business

None.

The meeting of NedCo was closed.

COMMITTEE OF NON-EXECUTIVE DIRECTORS (NEDCO) MEETING

Wednesday 10 September 2008

Present:
Sir John Parker, Chairman
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 Arun Sarin
Mr James Strachan
Mr Bob Wigley
Mr Geoffrey Wilkinson

Absent:
Mr Brendan Barber, Mr Paul Myners.

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

1. **Minutes – 16 July 2008**

Approved.

2. **Matters Arising**

None.

MANAGEMENT OF THE BANK

3. **Executive Report**

Recent and forthcoming meetings and events

Domestic:

- Treasury Committee hearing on banking reform – Governor, Sir John Gieve, Andrew Bailey and Nigel Jenkinson (22 July);
- regional visit to Scotland (28-29 July);
- Inflation Report and press conference (13 August);
- Treasury Committee Inflation Report hearing – Governor, Charlie Bean, Paul Tucker, Andrew {Sentance} and David Blanchflower (11 September);
- regional visit to the West Midlands (18-19 September).

International:
- BIS meeting in Basel (7-8 September);
- Ecofin meeting in France (12-13 September);
- Visit to New York and Vermont (23-29 September – subsequently cancelled);
- IMF annual meetings (9-12 October).

A meeting of Tripartite Principals had been held on 22 July and a meeting with Nick Macpherson on 6 August. Meetings with Nick Macpherson with the Chancellor were scheduled for 17 September and 30 September. A further Tripartite Principals meeting was scheduled for 7 October.

Sir Callum McCarthy

It was noted that it was Sir Callum's final meeting of NedCo and Court. He was thanked for his considerable contribution over the past five years, and the integrity and intellect he had brought to his role and relationship with the Bank.

MPC week in Yorkshire

It was noted that the various events would take place between 20-24 October. The Governor would make a public speech in Leeds on 21 October. Non-executive Directors had been invited to the dinner and invited to select other events to accompany MPC members.

Northern Rock

It was reported that the loans made by the Bank to Northern Rock had formally been transferred (novated) to HM Treasury. They were no longer on the Bank's balance sheet although cash payments had still to be made. The final payment would be made by end October. The transfer of the lending was necessary to be compliant with the European Union's legislation on monetary financing (Article 101).

It was noted that shareholder litigation against HM Treasury was due to heard in January. Although the Bank was not a defendant in the action, Ian Bond – Head of Financial Resilience Division – had provided a witness statement on the Bank's lender of last resort role. This had been done in response to a statement for the shareholders by Tim Congdon that had made incorrect assertions about Northern Rock's entitlement to lender of last resort financing. The Bank had been clarified that no individual institution had an entitlement to central bank support. Such support was discretionary and determined by judgements about the financial stability of the system as a whole.

ECB investigation

It was reported that the ECB was undertaking an investigation into whether any central bank action over the recent period had breached Article 101 of the EU treaty, in providing financing that should have been provided by government, and therefore amounted to finance to government. It was explained that the ECB was the legal authority that had a duty under the Treaty to monitor compliance with Article 101. Therefore ECB officials needed to apply a procedure to investigate all countries in an even way.

As part of the investigation, the ECB had made a very broad request for information and documents, including Court papers. The Bank had instead supplied a statement about what had happened, and offered to answer further questions. Legal documents setting out the terms of the facilities provided for Northern Rock and the state aid material had also been provided. The Bank had not sent any internal papers or conceded the ECB's right to these.

It was noted that, even if the ECB disagreed with what had been done, it was likely that it would only be able to criticise the UK authorities for not having transferred the lending to the Treasury when Northern Rock had been nationalised or earlier. There were good arguments for HM Treasury having phased the repayments rather than having to issue gilts rapidly following their clear statements of intent.

However, it was stated that the ECB had the right to take a central bank to the European Court for breach of the monetary financing prohibition. This was relevant to the Bank's future role as the Special Resolution Authority. The Governor had spoken to the ECB President to ensure an overly legalistic interpretation of Article 101 did not inhibit financial stability operations or circumscribe what the Bank could do as the Special Resolution Authority. It was explained that Article 101 had originally been framed to ensure national central banks did not buy government debt as part of the need to anchor fiscal discipline within monetary union. It had never been designed with lender of last resort or special support operations in mind. Mr Trichet had agreed with that distinction.

Special Resolution Authority

It was reported that work was underway to plan and establish the Bank's capability to operate the Special Resolution Authority. Given the timetable for the legislation and the ongoing financial crisis, the Bank needed to ensure it was ready to assume the responsibility once legislation was passed. Victoria Cleland – a senior manager in the Financial Stability area – was leading the planning team. The Bank was consulting authorities in other countries, particularly in the US and Canada, who had been very willing to help and, in turn, wanted to learn from the UK's experience of setting up a resolution authority. During the Autumn the Bank would advertise for a head of the Special Resolution Authority, targeting an individual with experience of bank workouts, possibly from an overseas authority.

Staff

The Bank had appointed Don Randall as its new Security Adviser following Mike Britnell's retirement. Mr Randall joined the Bank on 18 August. He had worked for the City of London Police until 1995 after which he joined JP Morgan as International Security Manager.

Open letter

It was noted that if, as expected, CPI inflation remained above 3% in August, the Governor would be required to write an open letter to the Chancellor. CPI inflation would have remained more than 1% above target for three consecutive months since the previous letter. The next CPI release would be published on Tuesday 16 September.

4. Governor's vision and strategy for 2nd term

The Governor introduced the item.

It was noted that one of the significant changes over the past five years had been the interaction between NedCo/Court and the Executive Team, especially on the Bank's strategy and its implementation. It was hoped that the new strategy paper, once finalised, would similarly provide a framework for future decisions and discussions.

It was explained that the major objectives for the Bank over the next five years would be essentially unchanged. The focus of the Bank would remain centred on its two core purposes. The main challenge was to manage current economic and financial circumstances such that they did not undermine the Bank's core purposes and divert attention from monetary policy. Restoring financial stability would make it easier to manage monetary policy. It would also be important to continue explaining externally what the Bank was doing and to maintain confidence and trust in the Bank as a public institution.

The paper set out the main policy challenges ahead – bringing inflation back to target; to make a success of the new responsibilities for financial stability, particularly the new Special Resolution Regime; and to maintain the reputation of the Bank. Internally, it would be important to carry forward the programme of reforms to the internal management of the Bank, including distinguishing better between inputs and outputs, and for staff to be more focused on their outputs and what they were trying to achieve. Significant changes had been achieved in the Central Services area and more were planned, particularly for the IT function.

Other challenges included the changes to Court – its size and membership – and the new Financial Stability Committee. It was highlighted that it would be important that the Bank's new financial stability responsibilities did not result in the Bank becoming, or being perceived to be, a shadow banking supervisor. That would be less straightforward after the present crisis than it had been before it. But it would remain crucial to have a clear view of what delineates the Bank's new responsibilities from those of the FSA.

In relation to the Governor's own work plan, it was noted that the intention was to maintain the existing strategy for public speaking in broad terms. The number of regional visits would be reduced from eleven to eight, which would maintain the commitment while freeing up time for other duties. It was felt that the investment that had already been made over ten years of regional visits had built up a stock of capital that meant it was safe for the Governor to reduce the number moderately. There would be increased contacts with the City, managed collectively with the Deputy Governor and Executive Director, Markets.

It was suggested that if the Bank succeeded over the next five years, it would have a strong framework for both monetary policy and financial stability, with clarity about the relationship between the two. It would have demonstrated that, despite very difficult conditions, monetary and financial stability had been restored, and that the Bank framework would be a successful model for other central banks.

Directors discussed a number of points. The continuity with the 2003 vision and strategy was welcomed. It was asked if, in seeking to achieve excellence and to be at the forefront of central banking, the strategy could commit to undertake ongoing benchmarking against best practice. In response, it was acknowledged that benchmarking was an important means of evaluating performance. Directors were reminded that one of the methods the Bank had adopted previously was to invite a senior figure from another central bank to conduct a review of a part of the Bank's operations, and that would be done again after the present circumstances had passed. A successful example was the review of monetary policy processes and the work of Monetary Analysis by Don Kohn, now the deputy chairman at the US Federal Reserve. At the present time it would be impossible to find an equivalent figure to commit such time. In the meantime, the Bank should focus on setting up its Special Resolution Authority with an open dialogue with those international partners who had experience and expertise in the field.

On the issue of reducing silos, it was felt that good aspirations and will would not be enough. It was asked if the Bank had particular plans that would provide incentives for areas to work more collaboratively. In response, it was stated that there was no simple answer. Very significant progress had already been made. One of the most effective ways to break down silos further was for the top of the Bank to make clear to all staff that they played a role in the overall objective of achieving stability. At the level of analytical staff, the financial crisis had had the benefit of demonstrating what financial stability was about and why the interplay between monetary and financial stability was crucial. It was also noted that considerable progress had been made over the past five years in explaining to staff in the Banking area that they were not part of a separate area or activity; that a banking function was an essential and integral part of setting interest rates. In turn, this was helping staff to move in and out of the area more successfully. It was stressed that the vision had to come from the top of the Bank to achieve this change. In relation to the Bank's wider working culture, it was suggested that the desired outcomes should be specified more clearly in relation to issues such as flexible working and diversity.

It was agreed that the position of the first core purpose had to remain primary. However, it was suggested that the paper might give more emphasis to the Bank's financial stability role and be more ambitious than aiming to have a world class framework. The Bank might, for example, have a strategic objective to dampen the inevitable cyclicality of the financial system and reduce its excesses.

The Bank's relationship with the City was raised. This was considered important but it should not be a re-invented third core purpose. Rather it had to support the two core purposes. Directors suggested more emphasis should be given in the paper to the relationship between the two core purposes. This was important given their inter-dependences. It was noted that the Bank's monetary analysis work was a continuum whereas financial stability work involved long periods of relative calm. Yet financial instability could cause major disruption out of the blue to the economy. The challenge was how the Bank could articulate the inter-dependency in periods of calm if issues were building that might result in financial instability. In the same vein, it was noted that, although the Bank did not want to be seen as a shadow supervisor, its responsibilities were however inevitably concerned with supervision in a broader sense. The paper needed to give more emphasis to the fusion between the two core purposes.

In response, it was stated that the experience of past year had demonstrated that monetary stability could not be achieved without an appropriate degree of financial stability, and that the kind of financial stability work that the Bank undertakes should be defined by those issues that affect its ability to achieve monetary stability. It was accepted that the Bank had a role in relation to macro prudential supervisory policy. However, it was thought that an objective to dampen the cyclicality of the financial system and economy would be very ambitious for a central bank. Many of the tools required for that were not available to a central bank. The Bank could and should contribute to the intellectual debate about what policies were relevant and the Bank had succeeded in dampening the cyclicality of the economy that resulted from unpredictable monetary policy. But the cyclicality of the financial system had not been dampened. There would be a debate about what policy measures might contribute to that after the present crisis – for example, the appropriate level of capital banks should hold and whether capital requirements should change over the business cycle. However, that was not an issue for a central bank alone or for individual nations. Many of the recent interventions had been undertaken by governments not central banks – for example, with Freddie Mac and Fannie Mae in the United States. It was therefore difficult for a central bank's strategy to include strong aspirations of this kind, notwithstanding the important contribution a central bank could make to the debates.

It was stated that, although the Bank should not become or been seen as a shadow banking supervisor, such a desire should not underplay the importance of developing further a positive relationship with the FSA. In particular, because the FSA focussed on individual institutions it was not best placed to step back and assess what was happening to the system as a whole. It was suggested there was an opportunity for the Bank to go further in this realm, and for the Tripartite Authorities to work better more effectively. If Bank's contribution was put in more positive terms, it need not feel it was as constrained by trying to avoid stepping on the FSA's terrain as the regulator. It was hoped that a new Memorandum of Understanding and the protocol between the FSA and the Bank would encourage that. It was also suggested that the Bank's work to identify risks to financial stability could be more focussed. It should not seek to identify every risk and assess their weight but more strictly prioritise those risks that if felt were most pressing and in need of mitigation by regulators and firms. It was suggested that the paper should give more weight to the Bank's relationship with the FSA, particularly given new personalities and responsibilities. It should be a key objective to ensure that the new structures and people bonded effectively to strengthen the relationship for the future. The FSA was also an important audience for the Bank's communications.

In relation to the Special Resolution Authority, it was agreed as the paper stated that it would be akin to the fire brigade. However, that comparison in some ways understated the nature of its role and the management challenge. Such an authority might not experience any interventions for many years and then be faced with a fire, which in the UK's case might be very large given the structure of the banking system. It was noted that the FDIC in the United States dealt with more frequent and smaller bank failures. Keeping a permanent team occupied sensibly during the calm period would be challenging. It was also noted that the tools and techniques that worked well for small banks would not necessarily be easily applicable to large banks. It was explained that the Bank was discussing the type of person needed to head the Special Resolution Authority. The head would need to be entirely motivated by the management and operational challenges of such a body.

A concern was expressed that the Bank's new responsibilities for financial stability and Court's Financial Stability Committee could face a very difficult baptism in 2009 if financial sector problems continued and intensified. It would be necessary to be in a state of readiness straight away and to import the necessary talent and expertise quickly. In response, it was noted that there was less risk of getting the principles wrong than the operational details in view of the timeframe available. The major risk was that the framework would have to be suddenly operational with a major institution without people who had the relevant experience of dealing with a large scale resolution. The broader challenge, which was being considered in the United States, was the scope of special resolution regimes beyond deposit-taking banks. There was an evolving debate about investment banks, hedge funds and other institutions that were highly leveraged. That was not a matter for present UK legislation but it was on the debating table and illustrated the intellectual challenge ahead. Freddie Mac and Fannie Mae were examples of the broader issue. It was noted that NedCo would be discussing the planning and work underway to establish the Bank's Special Resolution Authority in October.

In relation to the present situation, it was noted that although the Bank had identified the seeds of the crisis, its communications had failed to have an impact on behaviour. It was therefore asked if the Bank should review what it had done in the light of what had happened. A review could ask what might have been done differently and how financial stability communications should be changed in the future. In response, it was suggested that the main issue was not essentially about communication but rather incentives. That banks had not acted in response to a risk of a low probability event was not unreasonable. It was always possible to present a number of disaster scenarios that would require large resources to mitigate their effects. It was not realistic to be able to point to one very low probability event for which there was a clear mitigating remedy. The Bank had pointed generically to the risks being taken but banks had not taken enough insurance to prepare for the scale of the problem that subsequently erupted. For any crisis, it would always be possible to point to general warnings beforehand. The issue was whether cost-effective actions could have been taken in response to those warnings. It was noted, however, that after the risks had been identified by the Bank and others, they had in fact intensified. It might therefore be worth considering how the Bank's communications responded. It was explained that the debate about appropriate capital requirements was relevant to that observation. The dilemma was how to respond if a warning was made and a risk did not materialise – would the conclusion be that it was less or more likely in the future. It was a natural response now to believe that earlier warnings should have been heeded, but the challenge remained to decide how rational it would be for banks to contemplate and mitigate risks in advance.

In relation to increasing communications with the City, it was explained the Bank was considering in a systematic way who should be part of its constituency and how contact should be undertaken – collectively and individually – and how to co-ordinate the effort between the

Governor, Sir John Gieve, Paul Tucker and others. It was stressed that all major institutions had contact with the Bank in one way or another. There needed to be a clear delineation in the nature of the contact undertaken at different levels in the Bank, particularly by senior staff. It was noted that the Governor had allocated fifty breakfast and lunch meetings in his diary over the next twelve months for members of the financial community.

It was noted that the paper referred to a review from first principles of MPC communications. It was explained that it was important at the present juncture for the MPC to consider its communications, both collective and individual communications. The MPC would be discussing communications shortly. The balance needed to be right. Directors were also reminded that the Director of Communications would bring a paper on the Bank's overall communications strategy to NedCo later in the year.

It was noted that the execution of the new strategy would be difficult in a number of areas, as the paper acknowledged. The importance therefore of having key performance measures and indicators was emphasised, along with implementation milestones. Once the strategy was agreed, milestones would be established as part of its implementation, and would again by monitored via regular reporting to NedCo/Court. It was agreed that performance measurement was a major challenge. Less progress than was desired had been made over the past five years. The Finance area was actively taking it forward. The Bank's strategy was linked to performance objectives and indictors for each member of the Executive Team. Further progress was needed, which should be discussed and monitored at NedCo regularly.

It was noted that the paper discussed what functions should be provided by the Central Services area and what could be undertaken in individual business areas. It was stressed that wherever possible services should be centralised rather than undertaken locally in order to achieve efficiency gains. This issue of achieving efficiency savings was also raised. It was requested that the paper offer more information about the implications of making progress in that way.

It was asked how the vision and focus for the next five years be transmitted to staff.
In response, it was stated that advice from Directors was very welcome. It was thought that the previous strategy had been communicated well, initially with a booklet for staff about the strategy and open meetings. Open meetings with staff would follow Court's agreement of the strategy later in the year. It was stressed that the message that the Bank existed to maintain

stability, and that every member of staff ultimately played a role in achieving it, would again be central to staff communications.

Concluding, it was noted that discussion on the vision and strategy would continue at the lunch meeting and a revised paper would be brought to NedCo in October.

5. **Value for money**

Warwick Jones introduced the item.

The paper outlined how work had progressed on developing a value for money framework and culture. As part of the budget presentation in February, a preliminary value for money plan had been formulated with a commitment to report to NedCo after six months to provide an update on specific items and to indicate how the plan itself was being developed.

It was noted that a framework for undertaking external reviews to assess value for money remained undeveloped. Over recent years, a number of successful benchmarking reviews had been undertaken in the Central Services area. Work was currently underway to determine whether that could be extended beyond cost information to consider broader value for money aspects of the Bank's central services. Finance had been put forward to be the first area to be subject to an external review but it was not yet clear how the process would be taken forward. That would be considered further in the context of the forthcoming budget round. More thoughts and proposals would be shared with NedCo in due course.

Two issues were noted relating to experiences to date with value for money plans. First, there needed to be a greater read across from claims in one business area that they had made savings for both local budgets and budgets in other business areas. On a number of occasions, savings had been claimed for other areas. Second, there was a question about how specific targets should be for individual activities. Targets so far had not always been successful and some in retrospect had been ill-defined. For the forthcoming budget round, the intention was to seek sharper targets for value for money plans.

Directors supported the general direction proposed. It was stated that in addition to asking how value for money could be increased, business areas should also question whether particular activities needed to be undertaken. That was also part of the direction that needed to be taken.

6. **August Inflation Report and monthly MPC report to Court**
(Kate Barker and Tim Besley – external members of the MPC – in attendance)

Spencer Dale introduced the item.

The current economic conjuncture, outlook and Inflation Report projections were summarised.

In response to a question about the depreciation of sterling, it was explained that interpretation of exchange rate movements was never straight forward. Part of it might relate to a perceived deterioration in the UK's growth prospects. However, there was such a stream of financial news at the present time that it was difficult to be sure what underlying factors might be driving market sentiment. It was noted that the timing of the recent fall might reflect recognition that the UK had suffered a greater productivity shock due to its relative dependency on financial services compared with the rest of Europe.

It was noted that China continued to grow rapidly and recent messages from the Chinese authorities indicated that they were giving increased emphasis to growth rather than earlier concerns about inflation. A key question was how long Asian emerging market economies in general could sustain their recent growth, alongside a slowdown elsewhere in the world and the rise in oil prices. It was reported that Charlie Bean had recently attended an OECD meeting (WP3 group) of central bank and finance ministry officials. There were signs that China was slowing marginally but there was more evidence that growth in other Asian economies' had fallen. In turn, that might be one of the reasons why oil prices had fallen back.

It was asked how the MPC would view an intensification of financial sector stress given the central assumption in the August Inflation Report projections was that conditions would start to improve. In response, it was explained that such an outcome would amount to the downside risks to the central projection materialising. The implications for monetary policy would depend on wider developments and the likely impact on consumer and investment spending. However, a more prolonged period of financial tension and the likely greater impact on the real economy would amount to significant news for the MPC.

7. Financial markets update

Paul Tucker introduced the item.

It was noted that financial market conditions remained very difficult indeed. Commodity prices had fallen, which was positive in some respects as, by alleviating the cost shock it had prompted markets to believe that monetary policy might have somewhat more scope to support demand growth over the coming period. Sterling's exchange rate had fallen over the past month but increased in recent days. It was suggested that, in addition to the factors mentioned under the previous item, a risk premium had perhaps been added to sterling over the recent period because it was perceived for the moment that the UK macroeconomic and financial policy regime had lost some of its gloss. In consequence, there had been a significant shift in expectations of Bank Rate, indicating that financial markets believed the MPC would now give greater emphasis to downside risks than previously.

In relation to one of the risks to stability highlighted earlier in the year, it was noted that the gap between, on the one hand, de-leveraging in the financial sector and, on the other hand rising loan arrears and defaults arising from a macroeconomic slowdown, had disappeared – the two scenarios were now playing out simultaneously. This was reflected in renewed nervousness in financial markets. It was explained that money markets remained tense, though overnight markets were reasonable and so not preventing monetary policy implementation. However, the premium for borrowing unsecured funds at longer maturities had increased and conditions were not expected to normalise in the near future.

It was noted that there had been some improvement in credit markets since the US actions to support Fannie Mae and Freddie Mac. But presently there was considerable nervousness around Lehman Brothers which would announce results today. Whatever those results, it was thought that markets would remain tense. No matter what actions were taken by the authorities, market participants appeared to think that there was always one more significant institution to worry about. It was suggested that the US housing market would have to bottom out before there was any material and lasting change in sentiment. It was emphasised that the UK was not immune and there remained concerns in the market about UK mortgage banks.

Overall, the main change in financial market conditions over the past month had been a realisation that the macroeconomic slowdown would require banks to raise more capital than previously anticipated over the coming period, but that it would have to be undertaken in a more difficult capital raising environment than had been the case during the first part of the year. That made financial institutions more inclined to shrink their balance sheets, which fed back into the real economy and then, in turn, back to the financial system – an adverse feedback loop of the type feared earlier in the year.

9. **Financial stability – quarterly report**

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

Sir John Gieve introduced the item.

It was noted that there had been some positive developments in August such as the US actions taken in relation to Freddie Mac and Fannie Mae. However, the overall situation remained worrying as the paper identified. The main risk previously identified was that a more prolonged period of deleveraging would coincide with the materialisation of downside risks to the economy, and that the feedback loop from the economy to the financial system would become more severe. It was judged that that risk was materialising and the feedback loop had become more severe. There remained considerable uncertainty about how severe it would be, which was not of course independent of how the authorities reacted, both in the UK and elsewhere. A more prolonged period of retrenchment and deleveraging, alongside present financial market conditions, had cast greater doubts about the viability of some banks, notably the mortgage banks.

It was reported that the Tripartite Authorities were working through contingency plans to handle individual institutions in the event of difficulties. A key issue was how far the Authorities should act to pre-empt market sentiment rather than be reactive. Over recent months, the approach had been to take pre-emptive action when the viability of an institution had started to be questioned. Good work had been undertaken by the FSA to address issues facing some building societies. Alongside this, there had been a reactive approach to market signals about banks that were considered vulnerable before specific actions were taken. It was stated that if the authorities were confident that a much larger downsizing and restructuring of the banking system was inevitable, then there would be a strong case to be more proactive in bringing that outcome about. This issue had been discussed at the latest meeting of the Financial Stability Board. But that was a very difficult judgment to make when the depth of the crisis was so dependent on actions; and actions could easily make the situation worse.

It was agreed that the position remained very fragile, perhaps more so than indicated in the paper. Banks' balance sheets had weakened further but it was difficult to see that the successful capital raising undertaken earlier in the year could be repeated. Investors had already lost around forty per cent of those injections. Some estimates suggested that US banks would require another $250 billion. In the absence of new capital or assets sales, lending would need to contract more sharply, which would feed into the economy and then back to the financial system.

It was noted that to date, it had been possible to address problems institution by institution and decide whether a bank should and could be saved, and if so the means to achieve that in an orderly way. There was a concern that there were few institutions that could act as a potential 'godparent' for any large institution that was in difficulty.

In the longer term, aside from injecting more long-term capital into banks, which might take three to five years, a key question for the authorities was how the system could become more resilient to cope with failures such as Bear Stearns, such that the outcomes were not so damaging that they could not in future be contemplated. That would involve initiatives such as moving the credit default swap market onto an exchange traded platform and away from over-the-counter trading. Such a change would make it easier to accept the abrupt departure of an individual institution.

It was agreed that it was now more difficult to raise capital though that, in effect, meant at prices acceptable to the management and shareholders of banks. There were many incentives for banks not to seek capital a second time. It was conceivable that a point could be reached where the interests of individual institutions would diverge materially from the wider public good. There were sources of capital available but it was harder to identify how the interests of existing shareholders should be subordinated to those of new shareholders. The policy issue was whether, in the interests of the system as a whole, shareholders of large institutions with small amounts of equity should be subordinated.

It was suggested that the very negative sentiment expressed in the discussion about the current situation was not fully reflected in the paper, which was more balanced in its conclusions. In response, it was noted that the position had developed significantly since the paper had been finalised. The assessment in the paper had been discussed at the Financial Stability Board, which had acknowledged the speed at which the situation was developing. It was agreed that the paper should in future seek to be more definitive when possible.

12. **Banking Reform**
(Peter Brierley – Financial Stability adviser – in attendance)

Sir John Gieve introduced the item.

The current position regarding the progress of the Banking Bill was outlined. The Government still intended to introduce the Bill in October. The consultation period would end shortly. Two main issues had been raised so far. The first related to the fundamental question about the transfer of property rights. There was resistance within the banking community about inclusion in the Bill of an explicit power for the authorities to split a bank – essentially into a good part and a bad part – as part of a resolution process. This raised worries that some creditors would find themselves in the bad bank, with preference given to depositors. From the Bank's point of view, the option and power to exercise it was an essential part of the reforms. There was a technical issue to consider regarding how such a split should be undertaken but the {principle} of having the power was essential. Otherwise, it would be necessary for the authorities to rescue all creditors as had happened with Northern Rock.

Second, different views had been expressed about the governance of the Bank. It was expected that the Treasury Committee would publish its opinion later in the month – it had previously proposed that the Financial Stability Committee should be separate from Court. The question would no doubt be examined further once the Bill had been published.

It was acknowledged that the issue of partial property transfers was so controversial within the financial sector that it had the potential to delay the passage of the Bill. There was a clause in the current draft of the Bill that gave an undertaking to protect creditors in the residual bank such that they would not be disadvantaged relative to their position had a bank been placed into liquidation. If the issue could be addressed in such a way, the Bank was hopeful the present timetable would be met. It was stated that the Government was very determined to publish the Bill and start parliamentary proceedings at the beginning of October. The aim was for the Bill to be passed by 20 February when the special nationalisation powers expired under current legislation. But achieving that timescale was very uncertain given the opposition to some core elements of the proposals.

It was noted that an associated risk with the timetable was that the Bill would be launched before a number of policy issues had been fully assessed and determined. There was a risk that the Bill would be taken through its committee stages by relatively inexperienced ministers. They would be asked technical questions for which answers had not been fully formulated. The Tripartite Authorities needed to ensure that there was a system to prevent accidental policymaking.

It was noted that the issue of raising the level of deposit insurance to £50,000 had been detached from the Bill because it was possible to use existing legislation or FSA rules to modify the scheme. When to enact the changes and decide how the scheme would be funded was still to be determined.

The precise meaning of the additional objective 'to maximise the franchise value of the failing bank' (page 2 of the paper) was queried. It was explained that it related to maximising the value of the remaining parts of a bank that had been placed into the Special Resolution Authority. It was understood that the Association of British Insurers had wanted the inclusion of an objective to maximise shareholder value from the brand and any remaining customer goodwill.

In relation to the work of NedCo/Court over the coming months, Directors would need to discuss planning for establishing the Special Resolution Authority, the Bank's payment systems oversight role, and the terms of reference for the Financial Stability Committee. Given events in the financial system, it was noted that the timetable might need to be adjusted. Further consideration would be given over the next month.

10. **The Bank's framework for market operations**

Paul Tucker introduced the item.

It was noted that earlier in the year the Bank had said it would be undertaking a review of its framework for market operations, how it had worked and the lessons learnt over the past year. That had been part of an international exercise. All the major central banks had been meeting and sharing ideas over the past six months.

In terms of the Bank's review, it was explained that high level objectives had been identified with a view to articulating more clearly than in the past how the Bank's operations could address issues of financial stability without impacting adversely on the implementation of monetary policy. In terms of timing, it was stated that the key date ahead was the scheduled closure of the drawdown window for the Special Liquidity Scheme after six months of operation. There was increasing interest about what the Bank would do following that. Therefore the aim was to consult with market participants in broad terms about a new steady state framework. At the same time, it was envisaged that the Bank would identify the first phase of that, which could be introduced around the time of the closure of the SLS window.

It was stated that the proposals and ideas would be brought to NedCo, probably in parallel with the market consultation. A more detailed presentation and discussion would take place at that time, expected to be next month.

In response to a question about the take-up of the SLS, it was explained that drawings currently stood around £70 billion. It was expected that the figure would increase quite significantly over the remaining weeks to the end of October because of later applications from smaller and medium-sized banks that needed time to act and create eligible securitisations. More importantly, a deterioration in the outlook in financial markets had meant an increase in demand for liquidity insurance by the larger banks to tie them over the next three years.

It was also brought to NedCo's attention that there had been some comment from banks that they had found it difficult to utilise Treasury Bills in the money markets and therefore the SLS had been less effective than it might have been. It was noted, however, that around £15 billion had already come back to the Bank through its normal market operations. The remainder were, in fact, being actively used in bilateral transactions in the market. It was true that secure money market rates had risen relative to risk free rates, which was not desirable for Government funding of the gilt market. But this primarily reflected an increase demand for secured funding. A shift from unsecured to secured funding was expected to persist.

It was noted that the Bank's income from the SLS would be sizable, assuming there were no defaults. The Bank was managing the collateral tightly. Haircuts were being increased where a portfolio or counterparty looked stretched. If that proved sufficient and losses proved minimal, then the income would be substantial. It was noted that the Finance area were considering the treatment of the income, in the context of making the first corporation tax payment shortly that would be based on an assessment of the Bank's estimated pre-tax profits. A current estimate for the income from the SLS was around £300 million to the end of February 2009. That compared with a normal pre-tax profit of around £140 million. It was highlighted that income could be substantially less than that if firms withdrew from the SLS significantly, maintaining only their committed minimum amount.

ITEMS FOR INFORMATION

11. Remuneration Committee Minutes

Noted.

12. Key responsibilities and objectives for the Executive Team

Noted.

Any other business

None.

The meeting of NedCo was closed.

MEETING OF THE COURT OF DIRECTORS

Wednesday 10 September 2008

Present:
The Governor
Sir John Parker, Chairman, NedCo
Sir John Gieve, Deputy Governor – Financial Stability
Charlie Bean, Deputy Governor – Monetary Policy
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 Arun Sarin
Mr James Strachan
Mr Bob Wigley
Mr Geoffrey Wilkinson

Absent
Mr Brendan Barber and Mr Paul Myners

Also attending:
Mr Bailey, Mr Dale, Mr Footman, Mr Jones, Mr Tucker and Dame Juliet Wheldon.

1. Minutes – 16 July 2008 and 14 August 2008

Approved.

2. Changes to the Pension Fund Rules

It was noted that the changes were related to the pension reforms undertaken in 2007. They concerned individuals in the final salary scheme who might reach 480 months service. The maximum service within the Scheme was 40 years but where this is achieved before the age of 60, the Bank would have discretion to enhance pensions if an individual remained in employment. The Bank would have discretion to take staff returning from career breaks back into the Final Salary scheme rather than force them into the Career Average scheme. Both schemes had also been amended to accommodate the Bank's unremunerated leave policies, which have implications for pension accrual. It was also explained that within the career average scheme, there was facility to give up a proportion of salary to buy more pension accrual. The rules had been amended accordingly.

Court APPROVED the changes to the Final Salary and Career Average section rules.

3. Monetary policy issues

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

4. Vision and strategy; value for money; financial markets update; financial stability quarterly report; banking reform; framework for market operations.

Court noted the discussions in NedCo of the above items.

Any other business

None

[Members of the Executive Team withdrew]

5. Remuneration Committee report

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

[redacted]

Court APPROVED that Charlie Bean would be paid an annual salary of £246,338 plus a continuation of his final salary pension.

The minutes of the Remuneration Committee meeting of 10 September had been circulated to non-executive Directors. It was noted that the objectives for the Executive Team members had been reviewed and approved by the Committee.

The meeting of Court was closed.

COMMITTEE OF NON-EXECUTIVE DIRECTORS (NEDCO)
SECOND MEETING

Wednesday 10 September 2008

Present:
Sir John Parker, Chairman
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 Arun Sarin
Mr James Strachan
Mr Bob Wigley
Mr Geoffrey Wilkinson

Absent:
Mr Brendan Barber, Mr Paul Myners.

1. **Minutes – 16 July 2008**

Approved, along with circulation to the Governors

2. **Governor's vision and strategy**

It was agreed that further informal discussion on the Governor's paper would take place over lunch. It was noted that the paper had not included a section on the future make-up of the Executive Team. Directors discussed expected and potential changes over the coming year.

There was a short discussion on potential changes to the Executive Team in response to the planned departure of Sir John Gieve in early 2009. It was explained that the position of Deputy Governor for Financial Stability would be advertised. A panel that would include Sir John Parker would select a shortlist of names to propose to the Chancellor. There was confidence in the process being employed by HM Treasury, although there could be no certainty about the nature of the final decision or its timing. If an internal candidate was successful, that would open up another vacancy on the Executive Team and possibly the MPC, which would need to be filled promptly.

It was reported that Nigel Jenkinson also planned to step down at the end of the year as Executive Director for Financial Stability. It had been agreed that he would stay at the Bank for a period beyond that as an Adviser, focussing on the continuing work on the Banking Bill and international liquidity regulation. It was explained that the position would not be advertised as it was not an MPC appointment. Proposals would be discussed with non-executive Directors next month. [redacted]

It was noted that, as part of the new structure for financial stability in the Bank, a director of the Special Resolution Authority would most likely report directly to the Deputy Governor for Financial Stability rather than the Executive Director.

It was also reported that Dame Juliet Wheldon would leave the Bank at the end of 2008. A replacement as the Bank's Legal Adviser would be appointed shortly. A good short-list had been drawn up.

In the Central Services area, it was explained that there was a desire to develop a chief operating officer role for central operations, including finance. It was hoped that the Finance Director's role would be gradually evolved in this way. [redacted] A formal role as chief operating officer would need to be clearly defined and discussed further with Directors.

Progress in the HR area was also discussed. There was a desire to see considerably more progress in the area of talent management. To this end, the Bank planned to employ an external adviser to review its approach and assess what needed to be done next. Once that had been established, it could be decided who should lead the work. It was noted that it was difficult to find very good people in this area and therefore an external review should avoid simply producing a wish list of attributes for an individual to lead the work.

It was also noted that the terms of at least two external members of the MPC would end in 2009. The Treasury had stated its intention to advertise MPC appointments. Directors expressed concern that the process needed to be more robust than it had been in the past and that the Bank should continue to make representations about the importance of having a good process for MPC appointments.

Any other business

None.

The meeting of NedCo was closed

COMMITTEE OF NON-EXECUTIVE DIRECTORS (NEDCO) MEETING

Wednesday 15 October 2008

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

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

Lord Turner – the chairman of the FSA – was welcomed to NedCo.

1. **Minutes – 10 September 2008**

Approved, subject to further comments to the Secretary.

2. **Matters Arising**

It was noted that Paul Myners had resigned on 6 October with immediate effect as a non-executive Director of the Bank following his appointment as Financial Services Secretary.

Further discussion of the Governor's vision and strategy had been deferred to November. Similarly, the discussion of the planning for the Special Resolution Authority would now take place in November.

MANAGEMENT OF THE BANK

3. Executive Report

The Governor introduced the item.

Recent and forthcoming meetings and events

Domestic:

- Treasury Committee Inflation Report hearing – Governor, Charlie Bean, Paul Tucker, Andrew Sentance and Danny Blanchflower (11 September);
- regional visit to the West Midlands (18-19 September);
- speech in Leeds as part of the 'MPC week in Yorkshire' (21 October);
- Inflation Report press conference (12 November);
- possible Treasury Committee hearing on the financial crisis with the Chancellor and FSA chairman (subsequently arranged for 3 November).

International:

- IMF annual meetings (9-12 October).

Over the past month there had been regular meetings between Tripartite Principals and regular meetings between the Governor and the Chancellor, some of which had also involved the Prime Minister. A meeting with the Chancellor had been scheduled for 29 October.

Non-executive Director's terms

It was reported that, as part of the Banking Bill, existing non-executive Directors terms would end on 31 May 2009. New appointments to the reconstituted Court would commence from 1 June 2009.

Annual salary review

It was reported that the Executive Team had agreed to propose to the staff union a total pay increase of 4.0% for 2009. The increase would consist of a 2.0% satisfactory performance award, and a 3.5% merit increase (offset by a reduction of 1.5% in staff costs due to turnover). This was the same as the 2008 award. It was felt to be appropriate in the present circumstances. The amount of money available for bonus payments – which was not subject to union agreement – would be 7%, the same as 2008.

Staff changes

Graham Nicholson had been appointed to become the Bank's Chief Legal Adviser. He would succeed Dame Juliet Wheldon from next January.

Harrison Young, a former Chief Operating Officer of the US Federal Deposit Insurance Corporation, had been commissioned by the Governor to prepare a report on how the Bank might organise its Special Resolution Authority work. Mr Young would be in the Bank over the next few months and would deliver his report by Christmas.

4. **Banking crisis – recent events**

The Governor introduced the item and outlined events since the previous meeting of NedCo.

It was noted that the past month had been traumatic for financial markets and the banking system. In the United States, Lehman Brothers had failed, Merrill Lynch had been sold and AIG had been taken into quasi public ownership. These events had illustrated that the crisis had become much more serious. It was suggested that the failure of Lehman Brothers would be viewed as the date that triggered the crisis but it was not the underlying cause.

There had been an initial belief that resolving individual institutions on a case by case basis was workable. But that had not proved to be the case as concerns spread across the financial system. It was explained that the Bank had sent a paper to the Government to outline a possible plan to recapitalise the banking system. For some time it had been apparent that only a complete system-wide plan could resolve the ongoing problems in the banking system. Earlier in the crisis, there had been reluctance outside the Bank to accept that the provision of central bank liquidity was not a solution to underlying problems. The Bank's view was that the provision of liquidity was necessary but it was only a 'sticking plaster' that provided time for banks to make the adjustments that were needed.

There had been a further deterioration in funding conditions for banks during September, with a collapse in term inter-bank lending and even difficulties in securing overnight funding. By the beginning of the week of 6 October, some of the UK's largest banks were facing failure without intervention, and complete seizure of the banking system threatened. At that point decisions were taken by the Government, culminating in the announcement on 8 October of the UK recapitalisation plan.

It was reported that a vast amount of work had been undertaken across the tripartite authorities to enable the announcement to be made. The Bank itself had contributed a major effort which had involved Sir John Gieve, Andrew Bailey, Paul Tucker, Juliet Wheldon and their teams and others. There was now a real sense that a corner had been turned and the Bank could be proud of its work and contribution.

In the wake of the UK plan, it was noted that there had been a real sense of urgency at the IMF meetings over the weekend of 9-12 October. At the G7 meeting the UK had proposed that the draft eight-page communiqué was scrapped. In its place a one-page communiqué was produced. It was not possible to determine national policies at the meetings but it was important to outline the clear principles for action. Those principles were essentially the three key points from the UK plan – recapitalisation of banks; partial and temporary guarantees to regenerate funding; and provision of central bank liquidity to ensure stability of the banking system. At the IMFC meeting there had been both a sense of urgency and belief that, since something had to be done, the UK plan was what should be adopted more generally. Contributions at the meeting from the Japanese, Swedish and Finnish representatives had made a significant impact. They had each described their own previous experiences with a force and passion not normally associated with such meetings. The Japanese message was particularly powerful, that capital needed to be injected and the sooner the better. The IMF also had made clear that its study of banking crises had showed that injections of capital were always the key ingredient. Following their meetings at the end of the weekend, the main European countries had a clear sense that they would announce measures based on the three principles of the UK plan. Most significantly, the US team had also reached a view that they should also adopt such a plan.

It was noted that, since the plans had been announced, bank credit default swaps had fallen, in most cases significantly. In that sense, the immediate crisis had passed. It would however take a long time to regenerate confidence back to the levels that existed before the crisis – the 'disease' was no longer life threatening but recovery would take time. It was explained that the adjustment process would have major implications for the UK economy, affecting both the demand and supply side. To the extent that the supply of credit to the economy had been damaged, the recapitalisation plan would over time help to improve credit conditions.

Directors were thanked for their support during the past month. It was noted that the Transactions Committee had been consulted on a number of occasions at short notice as the crisis unfolded. In relation to the future of the Bank, it was noted that the Bank had been criticised over the past year for being out of touch and not having sufficient understanding of banks and markets. It had been suggested that the Bank needed more staff with practical banking and markets experience. It was stressed that such a view was misplaced. What had been demonstrated over the recent period was that the most important role of a central bank was policy making and it needed to have the right expertise to do that. That was a role done by central bankers rather than bankers. Central bank liquidity could never be sufficient in such circumstances, however much was provided. There had to be a deeper consideration of the underlying problems. Events had forced that view to the fore. It was hoped that when the role of the Bank was considered in the future, it would be recognised that the Bank had a vast amount of expertise in markets and banking relevant to its policy role.

It was asked if the requirement to suspend dividends could derail the recapitalisation plan, as reported in the Financial Times. In response, it was explained that the issue would not undermine the plan. Some comeback on the issue of dividend payments was to be expected. Some institutions were effectively saying that if there was some flexibility on dividends, then the Government might not need to take large stakes as private investors would be more prepared to inject equity. But it was noted that during the negotiations some of the major banks had indicated that they would like to be told that they could not pay dividends while they were in receipt of public equity. It was peculiar to pay dividends if a bank was trying to rebuild capital. It was highlighted that a part of the plan that had not received much attention was that capital injections would be made from a special reconstruction fund. This could take the form of a mutual fund in which units could be sold to private investors such as pension funds. This meant the Government's equity stakes need not be long lasting.

Market liquidity operations

Paul Tucker introduced the item.

Updates on the Bank's market liquidity operations and financial markets were provided.

It was noted that the failure of Lehman Brothers had been an approximate cause of the recent crisis. One of the maxims of the central banking and regulatory community over the past decade had been that no institution was too big to fail. But it was apparent that some were too large to wind down in an orderly way. Attempting to do that had tipped the system into the final throws of a crisis. It was also noted that whilst international coordination proved to be the route to a solution, the lack of it also proved to be as much a trigger for the crisis as the failure of Lehman Brothers. Actions announced first by the Irish government and then the German government were both unclear and uncoordinated, and led effectively to a 'beggar thy neighbour' policy which froze the international banking system. It was fortunate that two key episodes during the financial crisis had coincided with international meetings, at the IMF most recently and previously in South Africa. That underlined the importance of working actively across international borders.

Commenting on financial markets, it was noted that the situation in money markets had deteriorated to the point that money was not really being distributed between banks, even in the overnight market. It was explained that the Bank faced a very difficult decision regarding whether or not to narrow the interest rate corridor on its operations to zero i.e. to Bank Rate. In effect, this would have substituted the Bank for the money markets and banking system. It was explained that the argument for doing that was that the banking system was only just getting through each day; the argument against was that if the Bank acted too soon, it would precipitate the very freezing of the system that it was trying to avert. It had been a close call not to take that action.

It was reported that the Bank had lent dollars for the first time over the past month. The underlying shortage of liquidity in the market was for dollars. Directors were reminded that the ECB and other central banks had initially entered into a swap agreement with the Federal Reserve in August 2007 to enable them to lend dollars to their domestic banking systems because banks were unable to secure sufficient dollar liquidity from their US operations. At that time, the Bank had not taken that option having discussed requirements regularly with the large and medium-sized UK banks.

That position had changed in the more recent episode. Initially, the Bank had offered up to $40 billion, which had been extended to $80 billion. It was now an unlimited facility – banks could request whatever they wanted at the price offered. The current amount placed was $76 billion. The constraint was now essentially banks' eligible collateral rather than the amount offered.

The range of collateral the Bank accepted in its dollar and three-month sterling repo operations had been widened. That had commenced in December 2007 as part of the co-ordinated action with other central banks when the Bank had widened the collateral taken in its three-month repo operations to include mortgage-backed securities. Those operations had been for around £15-20 billion in two out of every three months during the Spring. When conditions had eased, the amount was reduced to around £5 billion in two out of every five months. However, over the past few weeks, the amounts offered had reached
£40 billion each week, which was an indication of the difficulties being experienced in money markets. Collateral had recently been widened further to include corporate securitisations of various types. It was noted that, in parallel to term operations, the Special Liquidity Scheme had continued to operate. In mid-September, the Bank had decided to extend the drawdown window to the end of January rather than 20 October, and to delay publication of its consultation document on its proposed new permanent liquidity facilities.

Attention was drawn to the impact of the various operations on the Bank's balance sheet. The assets on Banking Department's balance sheet had increased significantly, probably to their largest size in real terms in the Bank's history. These assets included the US dollar reverse repo lending and the long-term sterling repos. It was also noted that because the Bank had injected so much sterling into the money markets via long-term repo operations, in order to implement monetary policy effectively it had been necessary to drain (withdraw) a substantial amount of sterling from the money markets. This was designed to ensure that the net supply of overnight lending was in line with demand from reserves from the Bank. For the first time, this had been achieved by issuing Bank of England bills. Around
£30 billion one-week bills had been issued to date.

In relation to the fall in credit spreads for UK banks discussed earlier, it was noted that credit spreads for sovereign governments had risen, including the UK and Germany. That reflected the fact that governments would be borrowing more money and taking on more contingent risk to support the banking system.

Regarding the issue of haircuts applied to collateral, it was also noted that some central banks, including the Bank of Canada and the ECB, had revised the haircuts they applied more towards those adopted by the Bank. That did provide a degree of comfort that the Bank's judgements were broadly in the right territory.

In relation to inter-bank lending, it was stated that there was a little more than there had been for periods beyond one month. Importantly, the foreign exchange swap market – which allowed institutions to borrow euros and transfer them into dollars – had shown signs of opening up again after having completely ceased up. Further progress would depend not only on the position of banks but also non-bank financial intermediaries such as money market mutual funds. In the UK, such funds had invested disproportionately in banking paper. That had been viewed as a problem, although in the wake of the Government package it was potentially also their salvation.

Directors raised a number of points and questions. It was noted that the issue of publicly owned banks competing with privately owned banks had been discussed at the time of Northern Rock's nationalisation. It had been acknowledged then that Northern Rock needed to succeed but not too well. It was suggested that the dilemma now loomed even larger as a number of banks became publicly or part-publicly owned. It was explained that the situation would depend upon the duration and style of public ownership. If capital injections came from a bank reconstruction fund, it would be possible for the Government to sell its stakes relatively quickly, although the Government might be cautious about doing so too quickly in order to demonstrate that taxpayers were benefiting. In response to a question, it was explained that the timeframe could be any time between six months and six years. There would be no economic reason not to sell stakes once capital injections had been made.

It was stated that the main purpose of the plan was to enable banks to lend when they had profitable opportunities to do so, rather than not lend because they were constrained by their capital position. The aim was to put banks back in a position whereby they could compete amongst themselves for lending opportunities. The difference with the rescue of Northern Rock was that this was a co-ordinated capital injection into all of the major banks.

It was also noted that the initial US plan was focused on purchasing assets. The UK plan did not seek to do that so banks would continue to hold very significant liabilities of this type. It was explained that the strategy of recapitalisation had been preferred to the purchase of assets for two main reasons. First, one of the reasons assets had become toxic was that they were not easily valued. If the private sector was not able to value assets, neither could the public sector. There was a risk of the public sector being offered the very worst assets. If the Government over-paid for assets, it would amount to a haphazard strategy of injecting capital; if assets were under-valued then the Government would pay too little which would not then resolve the problems in the banking system. The second reason to favour recapitalisation was that it put the burden on the banks' shareholders rather than taxpayers. If taxpayers committed money, they ought to have a stake. There was also an important, albeit cosmetic, factor that if the Government bought assets as opposed to injecting capital, the gross upfront public spending would be far greater. In the United States, this had been a political problem given the concern about the scale of the amount of money involved. Consequently, the scale of the plan had been reduced and the money only made available in tranches.

The judgement in the UK was that the banking system had moved from a position where it was believed to be well capitalised to a realisation that it was under capitalised. The negotiations with the banks had been described by one bank participant as being more about compulsion – 'a drive by shooting' – than negotiation. It was stated that it had been right for banks to be compelled to accept what was being proposed. At the time the plan had first been endorsed by the banks, they had offered a recapitalisation figure of £25 billion, far less than the Bank believed was necessary. The banks did not collectively address the issue. Some were not prepared to participate and a number of others said they were not prepared to commit to a large sum of money. The weaker banks could only accept the terms offered.

It was emphasised that the injection of capital was also a sign of commitment that the authorities would act. The plan provided a safety net that other banks knew they could utilise if their efforts to raise capital failed. In that sense, it had been important to create the right incentives for banks, which justified the penal rates embedded in the plan. It was stated that having a blanket debt guarantee not linked to recapitalisation would have created asymmetric incentives.

It was also suggested that the idea of {arm's} length stewardship of banks by the Government sounded attractive. However, there were genuine public policy interests in the policies and activities of financial institutions, and ownership brought responsibility. Banks' policies on house repossessions, for example, were a matter of public interest, as was the use of overseas tax havens to minimise UK tax liabilities. It was asked therefore how {arm's} length could the Government's relationship be?

In response, it was stated that would involve political judgements. The issue of loan arrears and house repossessions was difficult. Banks could not be expected to accumulate bad debts without having recourse. On the issue of bonuses and remuneration, it was thought that many banks might welcome the push to re-think compensation structures. It was difficult for banks individually to take action whereas a collective approach would make it easier to change the culture of compensation in ways that would be more conducive to sensible risk management in the future.

It was explained that capital injections would be used to influence remuneration. The FSA had been tasked to take the policy forward. It was a complicated issue and needed to be managed carefully. There was an immediate issue of remuneration for directors and managers of those banks that were in receipt of public money. This was a normal issue for shareholders – and so the Government – rather than regulators. The issue for the FSA concerned the structure of remuneration rather than its level, and the way that influenced risk management. A question was whether in the past large cash bonuses and relatively short-term deferred stock encouraged individuals to undertake business that looked sensible at the time but turned out not to be so over a longer period. It was reported that, alongside the announcement of the recapitalisation plan, the FSA had sent a letter to bank chief executives setting out a set of principles on remuneration and asking them to reply by the end of the year on how their remuneration structures compared to them. It was stated that if the FSA was not satisfied with particular remuneration structures, it would set out requirements in its risk mitigation programmes. It had a range of levers available, including increasing risk-based capital requirements. It was stressed that it would also be important to progress the issue at an international level through the Financial Stability Forum's agenda. Furthermore, it was important to recognise that behaviours would not necessarily respond as intended. It was noted that bonuses paid as longer-term stock options were already common and had been prevalent at Lehman Brothers.

In addition to regulatory action, it was suggested that the market itself would impose disciplines on risk management in the wake of the crisis. The role of the FSA would be to provide a framework to support collective action. It would be difficult for individual banks to change their approach unilaterally given market pressures. Remuneration committees were inevitably led by market forces and competitor actions. It was also the case that, unlike other sectors, the highest paid individuals in financial services were not necessarily those at board level but in the trading area, which were not captured by formal disclosure requirements. Therefore, controls over bank directors' remuneration were, in practice, only a part of the issue of the appropriate structure of remuneration within banks.

It was agreed that the use of offshore tax and regulatory havens did need to be addressed. Throughout recent months, the resolution of particular banks had been hampered by a number of relatively minor issues concerning deposits and operations in the Isle of Man and elsewhere. It was unacceptable for UK institutions to avoid what were judged to be sensible tax and regulatory requirements by transferring some aspects of their business offshore. It was thought likely that the G7 would take a stand against regulatory havens in the future in response to the crisis. The number of smaller countries that promoted themselves as centres for financial services ought to reduce. Iceland was a very telling example. It was noted that the Icelandic central bank had visited the Bank at the beginning of the year and had been told that they should sell their banks now. Iceland's balance sheet was far too large. It was stated that the Bank would be supportive of efforts to constrain the use of tax and regulatory havens. It was noted, however, that there was a legacy of Foreign & Commonwealth Office advice, which had encouraged former dependencies to enter financial services as a means of reducing their reliance on commodity products.

A question was raised about the relatively small amount of capital being offered compared with the overall support put in place for the banking system and the size of banks' balance sheets. It was suggested that the role of the recapitalisation appeared to be largely cathartic, to demonstrate that the Government was prepared to do whatever was necessary to maintain financial stability. As asset prices continued to fall, it was asked whether more capital would be required and therefore whether that should be reflected in public communications to ensure it was understood. In response, it was stated that initially there had been a reluctance to acknowledge that the banks were short of capital, yet this had been the clear message from financial markets. Whatever the calculations made under the complex and sophisticated risk weighted rules of Basel 2, this was the broad brush judgement. Basic calculations suggested that the shortfall was at least £50 billion. Therefore, the Bank had always argued that the commitment had to be at least £50 billion. It was suggested that the impact was not simply cathartic but was a significant step towards addressing the capital shortfall. It was agreed that over time, if further losses were incurred, banks would want to build capital further. But this large injection would have a significant impact both on the underlying position and the ability of banks to obtain funding and raise further capital in the future. If more was needed, it would hopefully not prompt another sense of crisis.

In view of the very substantial increase in the size of the Bank's balance sheet, it was asked how that would be managed and whether the Bank itself would be seeking additional capital at some point. In response, it was explained that the size of the balance sheet was unpredictable insofar as it depended on market operations which were exceptional at the present time. There was a desire to secure a significant capital injection from HM Treasury but that would need to be discussed at a later stage.

In response to a question, it was explained that only the Special Liquidity Scheme was covered by an indemnity from HM Treasury. Haircuts applied to collateral were considered to be robust and were being very actively managed. It was noted that the Bank was utilising advice from the private sector alongside its internal processes.

A question was asked about what the Bank now considered to be the main risks facing the financial system. In response, it was stated that it was unlikely that the supply of credit from the banking system would recover quickly. Despite the recapitalisation plan, the risk was that the banking system remained vulnerable after funding an increasing part of its lending via riskier wholesale short-term borrowing, sometimes from overseas. It was stated that the adjustment to other forms of funding would not be easy and could constrain lending for a prolonged period. A second risk highlighted concerned the outlook for emerging market economies. A number of countries were now beginning to experience difficulties with foreign exchange and sovereign debt. It was noted that the IMF had received many inquiries for assistance. The risk was that, although the corner had been turned in relation to the banking system, damage had already been done in other parts of the global financial system. It was fairly certain that further problems would emerge as the rebalancing of the world economy progressed. The process of unwinding the very large expansion of banks' balance sheets would cause further difficulties. The UK's own trade deficit would decline and the capital inflows that had been financing the banking system would lessen. It was also suggested that there was a significant macroeconomic risk as the major economies entered recession, which would impact on other countries and, in turn, banks. Much would depend on the Far East. It was noted that two of Europe's strongest banks –

HSBC and Santander – had to date weathered much of the storm because of their strong bases in Asia and South America. A more serious feedback loop from the global economy was a significant risk.

Individual institutions

Andrew Bailey introduced the item

The work on resolving individual banks was summarised in the paper. It was explained that prior to the resolution of Bradford & Bingley, a great deal of contingency planning work had been undertaken given the bank's underlying vulnerability arising from its funding position and rising arrears rate. A detailed Bank plan had been in place at the end of August, which was largely adopted. The objectives of the resolution had been to establish quickly and clearly the position of retail depositors and to find a solution for the remainder of the bank.

It was explained that the retail deposit book had been sold via an auction process over the weekend. Deposits had to be matched by an asset which in the timeframe of a weekend had to be cash. The auction process designed by the Bank had not commenced until 5 pm on the Saturday. Bids had invited on a narrow basis – retail deposits and branches – and a wider basis which included the Head Office. The result was that Abbey Santander paid approximately £600 million for the retail deposit business and the remainder of Bradford & Bingley was placed in public ownership. The money paid for the retail deposit book and branches would be available to absorb losses in the rump. It was noted that there had been effective cooperation from Bradford & Bingley's management throughout the process and the situation since the resolution had been positive.

It was noted that there was a remaining issue to be settled concerning the compensation order for shareholders and investors in the capital instruments of the bank. The capital structure of the rump had been frozen. As assets were sold, losses would be realised and passed through the capital structure in the normal way. It was hoped that the process under public ownership could progress over a somewhat longer timeframe and in a more orderly fashion than would have been the case under administration.

During the following weekend two Icelandic bank deposit books were sold to ING. That process had not involved an auction but the outcome was as effective insofar as deposits had been transferred without having to deal with depositors directly. It was stated that although the resolution of the Icelandic banks had not been the largest in terms of scale, it had the potential to cause the most difficulty as had been illustrated by the subsequent issues and media attention

The paper provided details of the lending provided by the Bank. It was emphasised that the Bank's funding had been indemnified by HM Treasury or the Bank had acted as the Treasury's agent. In a number of cases, the Bank had provided a loan to the Financial Services Compensation Scheme (FSCS). This funding matched the retail deposit books and was done on the basis that if the banks had failed, the FSCS would have been required to pay depositors. In this way, the approach was one of burden sharing between the Government and the banking industry. It was noted that the amount that would need to be claimed from the contributors to the FSCS would depend on what was raised from the remaining assets of Bradford & Bingley. There was a grace period in place to avoid a large claim on the banks over the next year. It was also stated that the facilities funded by the Bank were temporary and had to be refinanced by the Government under European Union rules.

It was emphasised that it had been a considerable achievement to reach a successful resolution for these banks, which stood in contrast to Northern Rock last year. The special powers introduced after Northern Rock had been used to mimic the forthcoming UK banking legislation. It was noted that the FSCS had praised the Bank's work. This showed that the Bank could operate the Special Resolution Authority and demonstrated the importance of having a coherent legal and intellectual framework to exercise powers. It was noted that, following the collapse of Lehman's, the Federal Reserve had told the Bank they now understood the Bank's remarks at the time of Northern Rock regarding the absence of powers and the difficulties that posed.

5. **Banking reform update**

Overview

Sir John Gieve introduced the item.

It was explained that the Bill had had its second reading yesterday and would proceed to the committee stage on 21 October. The second reading had met some criticisms. John McFall – Chair of the Treasury Committee – had said that he was disappointed that the Bill had not adopted the Treasury Committee's recommendations for the Bank's Financial Stability Committee and he would be seeking to make amendments on that aspect. Both George Osborne and Vince Cable supported the Bill in broad terms. Ken Clarke had commented that the Bank would have to approach the FSA for information.

It was reported that Nigel Jenkinson and John Footman would attend an evidence session at the Banking Bill Committee. It was anticipated that the committee stage would be completed by the end of November. The Bill would then be part of the Queen's speech for the new parliamentary session in December. With cross-party support, it was possible that some of the House of Lords stages would be undertaken before the end of the present session. That meant that the process of drafting amendments would be very compressed.

It was reported that, on the whole, the Bill was very much as the Bank had proposed and wanted. There were a few issues that were not fully satisfactory. The most important area concerned information gathering powers. The Bill currently stated that the FSA could collect information and provide it to the Bank but it did not give the Bank the authority to demand what it wanted, and did not give the FSA authority to collect information because the Bank wanted it. A second issue reflected the concern in the City about the ability of the authorities to undertake partial transfers of assets and liabilities i.e. to split a bank into a 'good' bank and a 'bad' bank. Creditors and debt holders were concerned about what that would mean for their positions. They had pressed for restrictions on how far a bank could be split in this way. It was, of course, in their interests to prefer that a bank was rescued as a whole and at the taxpayers' expense. But from the public policy perspective, it was vital to be able to split a bank – the purpose of the Special Resolution Regime was to try to save part of a bank and wind up the residual elements. The Bank had therefore pressed that this {principle} should not be diluted. It was noted that the Treasury had been persuaded to introduce a provision such that no creditors should be worse off than they would have been if the whole bank had been put into administration. That offered some reassurance to creditors.

Overall, the timetable remained ambitious to introduce the legislation by February. However, with cross-party support, that was perhaps more realistic than it had been a month or so ago.

Financial Stability Committee terms of reference

John Footman introduced the item.

The paper outlined the new arrangements for Court following the legislation. It was noted that NedCo would have a slightly smaller reviewing function because it would not include financial stability. It was stated that the Bill referred to the Financial Stability Committee (FSC) as a committee of Court. Court could determine what functions it wanted to delegate to the FSC though the functions of the FSC would be embodied in the Bill.

The Bank's financial stability objective contained within the legislation would be broad brush in nature. The current draft of the Bill stated that the Bank would "contribute to protecting and enhancing the stability of the financial systems in the United Kingdom". Turning that into a remit would be a matter for Court. It was stated that the principal role of the FSC would be to make recommendations in relation to the Bank's strategy to meet its financial stability objective. The FSC would advise Court but Court would make decisions.

It was noted that the precise outcome remained uncertain. The current draft was not the position the Treasury had begun with, which had been closer to the Treasury Committee's recommendation of a standalone committee.

It was stated that it would be important to consider at a later stage the position of the FSC within the overall framework for financial stability in the Bank. That should be part of a further discussion. It was noted that one of the earlier criticisms made by the Treasury Committee had been that the Governor would chair the FSC and therefore the executive of the Bank would not be accountable. But Court would be chaired by a non-executive Director, so that arrangement would ensure that the Governor did not have an unfettered position, which should allay the concern. It was suggested that Court might review annually the delegated authorities given to the FSC.

In relation to the Bank's financial stability objective, it was suggested that there was an implicit weakness in having an objective that required an organisation merely to contribute to an outcome. That was open-ended and minimalist in nature. It would be more desirable to have an objective that attempted to maximise an outcome in a more positive way. It was explained that the difficulty was that the Bank could not itself be responsible for financial stability. It would not have the powers for that, nor was it the only body with responsibilities relevant to financial stability. Therefore, it might be preferable to state that the Bank would play its full part in the tripartite objective of protecting and enhancing the stability of the system, which would reflect the fact that the tripartite arrangements were meant to ensure the overall objective of financial stability. It was a joint objective and part of the Bank's responsibility was to make the partnership work. The Bank would consider the wording further.

Directors were satisfied with the current position of the FSC. It would be important for Court to retain the authority to delegate appropriately to the Committee. It was crucial to ensure that there would not be two-tier Court membership. The Treasury Committee's proposal amounted to an MPC like body. In fact, logically it would be the MPC with a slightly different external membership. That would interfere with the Bank's monetary policy role and how individuals were selected for the MPC. It would make the Bank more like the Federal Reserve and remove much of Court's role.

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

Ian Bond introduced the item.

Directors were reminded that the Bank already had a payment systems oversight role but that was not on a statutory basis. The paper outlined the key features of the Bill. It was highlighted that the scope of the Bank's oversight would be explicit for the first time with a formal recognition process for payment systems. This would establish precisely what the Bank was and was not responsible for. The Bank would have enforcement powers for the first time to meet its responsibilities. It was expected that the scope would be similar to the current oversight system although it was likely that retail card payment systems would not meet the threshold for recognition. The Bank would in any event want to maintain a relationship with those service providers.

It was explained that the proposed recognition process was not entirely what the Bank had hoped for. The Bank had wanted a process whereby the Treasury would consult and agree with the

Bank which schemes needed to be recognised – as drafted in the second consultation document. It was noted that most respondents to the consultation wanted the Bank to be the recognising authority rather than the Treasury. However, the Bill omitted the phrase 'and agree' which meant the Treasury would consult the Bank but make the decision alone. The concern was that the Bank would be asked to oversee more than it believed was appropriate. Discussions on the matter continued with the Treasury. It was stressed that the issue did not amount to a major flaw in the legislation but it introduced vulnerability for the Bank.

It was asked if the Treasury was required to agree with the Bank, what would happen if there was not agreement. It was explained that either the Bank or the Treasury would have the right of veto. That would not, however, impact on the ability of a payment system to operate as a business – i.e. recognition for oversight purposes would not act as a license to function in the way that it did when the FSA licensed banks.

In response to a question, it was explained that the Bank wanted to avoid responsibilities that were outside its core purposes, where it had less expertise. The Treasury apparently had legal reasons to draft the Bill in the way it had but the Bank did not accept that. It was essentially designed to retain discretion for the Treasury. The Bank should try to avoid a situation whereby it could be given responsibility for aspects of oversight – notably consumer protection issues – that were outside its main area of expertise with wholesale payments.

A second issue was that the Bank would need to review its internal governance arrangements and delegation of authorities to accompany the new payments oversight regime. That would be considered further and be brought back to NedCo before the end of the year with some specific proposals.

Directors supported the Bank's position to argue for a change to the wording of the Bill along the lines discussed.

6. **Red book review**

Paul Tucker introduced the item.

It was stated that the consultation document on the Bank's permanent framework for its market operations would be published the following day. The main proposals were summarised in the paper. A material change from the position envisaged a month earlier, at the time of the original plan to publish the consultation document, was that the Bank would now introduce two of the principal reforms from Monday rather than after a consultation period.

It was explained that the reforms introduced in 2006 had centred on the implementation of monetary policy. The current proposals aimed to provide clarity, for the first time, about the way the Bank's market operations would provide liquidity insurance to meet its financial stability objectives. The Bank would be transparent about what facilities firms could access rather than simply outline a menu of potential options, as had been included in the current Red Book.

The main principles behind the design of the new facilities and the three major reforms were summarised in the paper. It was stressed that the proposals sought to balance the desire to ensure institutions knew what insurance facilities were available with the need to establish appropriate incentives so that institutions did not take more liquidity risk in the knowledge that insurance was available. The consultation document set out very carefully the Bank's objectives in this area, and stated that the terms of the insurance facilities would be set to balance the benefits and costs in the best way possible, and to protect the integrity of the Bank's balance sheet. It was also highlighted that the Bank continued to favour repo or swap operations rather than outright asset purchases, which transferred risk to the Bank. The Bank also believed that its facilities should only be available to commercial banks whose liabilities were money. Beyond such a definition, it would be difficult to know where to draw a line.

It was explained that two of the three reforms were a solution to the problem faced over the past year with the existing standing lending facility, which had become stigmatised. The Bank would now provide two separate facilities. First, an operational standing facility designed to address frictional glitches in the payment system or in the money markets. The rate charged for lending would be reduced to 25 basis points above Bank Rate (100 basis points currently) and disclosure about the use of the facility would be less timely. Second, a discount window facility designed for stressed circumstances. It would accept a wider range of collateral in exchange for government securities. Both these facilities would be introduced from Monday 20 October.

It was noted that counterparties using the Discount Window Facility would pay more or less depending on the amount they borrowed. They would also pay more or less depending on the type of collateral offered. It was also noted that the use of the facility would be discretionary. The Bank would need to be satisfied that an institution did not have a solvency or viability problem, in which case it would need to be treated outside such central banking operations.

The third reform – the introduction of permanent three-month repo operations against a wide range of collateral – would be subject to consultation, principally to take views about the proposed design of the auction process. It was explained that counterparties would bid separately against different types of collateral. How much cash was allocated against particular collateral would depend upon the bids – if bids were high to borrow against mortgage back securities then more of the auction would be allocated to that particular collateral.

The matrix of fees that would be applied to the Discount Window Facility (detailed in the Annex) was discussed. It was emphasised that the facility would be amended permanently to ensure the fees and haircuts were appropriate. Collateral might move between the different levels and new instruments could be introduced. It was also noted that the Bank would specify in a degree of detail what characteristics a security or securitisation had to have in order to be eligible. That was a means over time to help to protect the Bank in addition to haircuts applied to collateral.

Although the Operational Standing Facilities and Discount Window Facility were being introduced without a formal consultation period, it was stated that the Bank had spoken to the largest six banks. They were supportive of the idea of splitting the current standing facilities into two to address the stigma problem and recognise the two separate purposes.

It was noted that the design of the reforms had been another example of a successful team effort across the Bank. The aim was to ensure the overall design stood the test of time.

A general observation was that over the past year many central banks had probably used their balance sheets for operations that ought to be carried out by governments. It had been recognised, initially with the US plan to purchase assets, that central banks' balance sheets had been stretched to the point that, irrespective of size, some of the collateral taken was on the margins of what central banks should accept. The Bank's framework ensured wider collateral should only be made available at a price. But it was also recognised that some collateral should not be accepted by central banks at any price. It was explained that collateral was regularly rejected at a number of levels of authority in the Bank's Special Liquidity Scheme and longer-term repo operations. In practice, the Bank would pre-screen lower level collateral to ensure it was assessed well before it was offered for use in the facilities.

7. **Combined quarterly reports Q2**

Discussion was deferred until November.

8. **Audit Committee report**

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

The main issues discussed at the meeting of 26 September were highlighted. It was reported that the Audit Committee had acknowledged the strong creativity and collaboration that had been evident across the Bank during the recent period of intense work. The Committee had received a good insight into the processes employed and the management of operational and reputational risks around recent exceptional work and operations. The strains on resources remained an area of concern. The Bank was focussed on this issue and some additional resources had been recruited. Directors would want to keep the situation under review and receive regular updates. The need for the Bank to retain its focus on its business as usual activities had also been discussed.

The Committee had received an update from Internal Audit and discussed the audit plan with KPMG. This year's plan was broadly similar to the previous year, though there would be particular focus on the collateral management in the Special Liquidity Scheme, and financial reconciliation and the accounts assembly process in the Finance area. The Committee were also updated on work in the Finance area, notably the accounting issues that were likely to arise and the presentation of the Special Liquidity Scheme in the Annual Accounts.

Private bilateral discussions had been held with Sir John Gieve and the Internal Auditor.

9. **Houblon Norman Fund expenditure**

Charlie Bean introduced the item

The paper provided background on the Fund and its activities. It was stated that at the current rate of expenditure, the Fund would be exhausted in twenty five to fifty years, depending on how fast academic salaries grew and the Fund's rate of return. The trustees of the Fund had an obligation to be fair to all current and potential future beneficiaries. It was noted that the Fund had in the past had occasional additional injections, most recently to commemorate the retirement of Eddie George. At a meeting earlier in the year, the Trustees had requested guidance on whether it was reasonable to act on the basis that there would be future injections into the Fund. It was stressed that the Trustees were not seeking additional funding now or a specific commitment for the future. Rather, they were seeking general guidance to assist in their management of the Fund. It seemed sensible to establish the funding strategy in order to determine approximate expenditure each year.

Directors expressed support for the Fund as an ongoing activity and therefore the Trustees could assume funding would be made available to enable that in the future.

ITEMS FOR INFORMATION

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

Noted.

Reference was made to a monetary policy round table meeting held at the Bank in September, jointly hosted with the Centre for Economic Research. The event was designed to provide a forum for economists from the City, academia and the Bank to discuss key monetary issues. The genesis of the idea had come from the Treasury Committee's report 'The MPC: ten years on'. Around one hundred economists attended the meeting under the Chatham House rule. It allowed external economists to debate policy issues and the Bank's views in a private forum and to enable the Bank to explain some of its underlying thinking. The real value would come from a regular dialogue. A summary of the discussion had been published on the Bank's website.

12. MPC report to Court

The special meeting of the MPC on 7 October was discussed. It was noted that, despite some media commentary suggesting the Government had exerted pressure on the MPC, the meeting was entirely within the MPC's framework and the decision made independently in the usual way. The Committee had considered the proposal for central banks to act in a co-ordinated way.

There was a discussion about calls in the media and elsewhere to change the MPC's remit. It was explained that the Bank was stressing the virtues of the clarity of the present mandate which gave the MPC constrained discretion and flexibility in how it responded to shocks. The MPC did not believe it was constrained by its mandate. It was suggested that the calls for reform might increase, in terms of having an explicit mandate for growth and perhaps to address asset prices.

It was suggested that there was a case for that part of the existing remit that referred to growth and employment to be more fully recognised and clarified. This was an important communications issue in present circumstances. In response, it was stated that the MPC should not create any impression that it was deviating from the goal of meeting the inflation target. There was flexibility in the present remit in terms of the timeframe over which inflation should be brought back to target. But it would be a mistake to create a situation similar to that of the US Federal Reserve where the monetary policy objective was not clear. It was acknowledged that the MPC would face a significant challenge to explain and communicate its monetary policy decisions and thinking over the next year or so, which all members of the Committee were conscious of.

A point was raised about the apparent breakdown in some of the MPC's conventions regarding how individual members of the MPC convey their views publicly. Recently, one member had indicated his voting intention for the next meeting and appeared to be lobbying other members through public comment rather than at MPC meetings. It was noted that some of the language had been extreme. The risks of individual MPC members communicating in this way was stressed. It was not sustainable to present views publicly in such a way. It was stressed that the MPC had to have a collective discipline in relation to its behaviour.

Any other business

None.

The meeting of NedCo was closed

MEETING OF THE COURT OF DIRECTORS

Wednesday 15 October 2008

Present:
The Governor
Sir John Parker, Chairman, NedCo
Charlie Bean, Deputy Governor – Monetary Policy
Mr Barber
Mr Roger Carr
Ms Amelia Fawcett
The Hon Peter Jay
Sir Andrew Likierman
Dr David Potter
Prof David Rhind
Ms Susan Rice
Mr Arun Sarin
Mr James Strachan
Lord Turner
Mr Bob Wigley
Mr Geoffrey Wilkinson

Absent
Sir John Gieve

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

1. Minutes 10 September 2008

Approved.

2. Bank subsidiaries

Andrew Bailey and Juliet Wheldon introduced the item.

It was noted that the creation of a Bank subsidiary required the approval of Court. The Bank had set up a subsidiary to facilitate the transfer of retail deposits from Kaupthing Singer & Friedlander (KSF), specifically the KSF 'Edge' internet based deposit book.

In the circumstances, it had not been practicable to obtain Court's prior approval. Instead, the Transactions Committee had been consulted on 7 October about transactions relating to Icelandic banks and the intention of acquiring a subsidiary to facilitate this. The Transactions Committee noted that Court would have to ratify this subsequently. In the event, on 8 October a purchaser had emerged for the Edge deposits, which were immediately transferred on from the Bank subsidiary to ING.

Freshfields had advised that, in the circumstances, the procedure followed was appropriate and proportionate.

Directors were asked to ratify the following resolution:

In connection with the resolution of Kaupthing Singer & Friedlander Ltd, Court resolves that: The acquisition of the whole of the issued share capital of Deposits Management (Edge) Limited by the Bank and the appointment of Andrew Bailey and John Footman as directors of that company be ratified and confirmed, notwithstanding the lack of prior Court approval as required by paragraph 3 (d) of Matters Reserved to Court.

Court RATIFIED the Resolution and APPROVED the appointment of Andrew Bailey and John Footman as Directors of Deposit Management Edge Limited.

It was stated that it might be necessary for the Bank to acquire other subsidiaries in similar circumstances. In view of this, Directors were asked to authorise the Governor to consult the Transactions Committee, where appropriate, rather than seeking full Court approval. It was therefore proposed that a temporary amendment be made to paragraph 3 (d) of Matters Reserved to Court.

Directors were asked to approve the following resolution.

Having regard to the need to act urgently in current market conditions, in particular in connection with the involvement by the Bank in support of individual banks or of the financial system and with the exercise by HM Treasury of their powers under the Banking (Special Provisions) Act 2008, Court resolves, until such time as it determines otherwise, that: paragraph 3 (d) of Matters Reserved to Court (prior approval of matters relating to subsidiary companies) is suspended with immediate effect and for so long as such suspension remains in place, paragraph 3 (e) of Matters Reserved to Court (transactions outside the normal course of *business) shall be deemed to include the acquisition or disposal of a controlling interest in a subsidiary company and the appointment of directors or officials to represent the Bank at any meeting of such company.*

Court APPROVED the Resolution.

It was asked if Directors could be informed in a more timely way when the Transactions Committee had met or was meeting. Directors not involved in Transactions Committee meetings did not need to be informed of the detail of discussions, but it would be helpful to be kept up to date in a more general way. It was explained that that would be considered in addition to the updates provided at NedCo and Court meetings.

3. **Terms of reference – Audit and Remuneration Committee**

The annual submissions of the terms of reference for the Audit and Remuneration Committees were noted.

4. **Monetary policy issues**

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

5. **Banking crisis, market liquidity operations, individual institutions, banking reform, Financial Stability Committee terms of reference, payment systems oversight, Audit Committee report**

Court noted the discussions in NedCo of the above items.

Any other business

None.

[Members of the Executive Team other than the Governor withdrew]

6. **Executive Director for Financial Stability**

The Governor introduced the item.

The proposed appointment of Andrew Haldane as Executive Director for Financial Stability was discussed. Directors considered the merits of the proposal and other potential candidates.

Court APPROVED the appointment of Andrew Haldane, as Executive Director for Financial Stability from 1 January 2009.

Mr Haldane would replace Nigel Jenkinson who, for a period of time, would be an Adviser to the Governor until he leaves the Bank in later in 2009.

The meeting of Court was closed

COMMITTEE OF NON-EXECUTIVE DIRECTORS (NEDCO) MEETING

Thursday 13 November 2008

Present:
Sir John Parker, Chairman
Mr Brendan Barber
Mr Roger Carr
The Hon Peter Jay
Sir Andrew Likierman
Dr David Potter
Prof David Rhind
Ms Susan Rice
Mr Arun Sarin
Mr James Strachan
Lord Turner
Mr Bob Wigley
Mr Geoffrey Wilkinson

Absent:
Ms Amelia Fawcett

Also attending:
The Governor, Mr Bean, Sir John Gieve, Mr Bailey, Mr Dale, Mr Footman, Mr Jones, Mr Tucker, Dame Juliet Wheldon.

1. **Minutes – 15 October 2008**

Approved.

2. **Matters Arising**

Following the information provided in October, it was agreed that a list of dates of Transaction Committee meetings would be circulated to non-executive Directors. The topics would not be revealed at this time unless related information had already been released.

MANAGEMENT OF THE BANK

3. **Executive Report**

The Governor introduced the item.

Recent and forthcoming meetings and events

Domestic:

- speech in Leeds as part of the 'MPC week in Yorkshire' (21 October);
- Inflation Report press conference (12 November);
- Treasury Committee hearing on the financial crisis with the Chancellor and FSA chairman (3 November).
- Treasury Committee Inflation Report hearing – Governor, Charlie Bean, Sir John Gieve, Andrew Sentance and Kate Barker (25 November);
- dinner with TUC (27 November).

International:

- IMF annual meetings (9-12 October);
- visit to Italy (25-29 October);
- visit to Germany (18-24 November);
- visit to New York (4-9 December.

It was noted that a series of international visits were planned to discuss the financial crisis with central bankers, financial institutions, government officials and others.

Meetings with Tripartite Principals and Nick Macpherson had taken place on 23 October. There had been a number of meetings over recent weeks with Treasury ministers, including Lord Myners. A Tripartite meeting was scheduled for 26 November. Meetings with the Chancellor and Nick Macpherson had been scheduled for 11 and 26 November respectively.

G20 meeting

It was noted that the forthcoming meeting of the G20 on 15 November was potentially important as marking the beginning of a process of reform to the international financial system. The Governor had written to the Prime Minister and Chancellor setting out thoughts and ideas. It had been suggested that it might be sensible to follow a precedent from ten years ago, when the then G22 set up three working groups, chaired by finance ministers and central banks. The subsequent reports had been successful and framed much of the work that the IMF had put into effect over the following decade. It had been suggested that working groups might cover: first, reform of the international financial system; second, banking regulation; and third, cross-border regulatory issues. It was hoped that the meeting would produce a commitment to put in place discussions at a more technical level. It was reported that Charlie Bean had attended G20 meetings for central banks and finance ministers in Brazil the previous weekend.

Pension Fund Trustees

David Rhind had agreed to be considered for the role of Chair of the Pension Fund Trustees. His appointment would be recommended to the Trustees to replace Kit Farrow.

Staff

Simon Moorhead would join the Bank on 17 November as Chief Information Officer and Head of ISTD. He would replace Chris Piper who would become Agent for Central Southern England in early 2009. Mr Moorhead had previously led the IT team for the global sales and service business at Reuters. He had earlier spent eleven years as a management consultant at Ernst & Young and Capco.

Non-executive Directors pay

The Governors committee on non-executive Directors' remuneration had met earlier in the day. It was noted that the advertisement for new non-executive Director had wrongly advertised new salary levels which had not been determined or approved by the Bank. The Bank proposed to recommend to the Chancellor the following remuneration rates: chair of Court £30,000, deputy chair and sub-committee chairs £20,000, directors £15,000.

4. Governor's vision and strategy for 2nd term

The Governor introduced the item.

It was noted that a significant amount of work needed to be undertaken over the next five years, reflecting a combination of the lessons learnt from the financial crisis, the change in the Bank's responsibilities resulting from the new Banking Bill, and to make more progress internally in areas such as performance management. The comments made at the previous NedCo meeting had been taken on board.

Directors discussed a number of points. It was noted that a large part of the paper related necessarily to near-term operational issues affecting the Bank. The notion of a strategy paper was more difficult in present circumstances. It was asked, therefore, whether it would be sensible to revisit the paper regularly to ensure it remained up to date.

It was stated that because the present financial crisis had its roots in the preceding five years, that raised questions about the Bank's methodology and policy instruments – for example, whether inflation targeting remained the right approach for monetary stability. If it was the right approach, the question would be how the credit cycle and the over-valuation of asset prices could be controlled? It was suggested that a review of policy ought to be part of the Bank's strategic agenda for the next five years, including recommendations to the Government about how the policy regime might need to be changed and what new financial architecture might be needed. In terms of the document, this would amount to the Bank having a goal to address these policy issues and influence the debate.

In response, it was stressed that the Bank was actively influencing the debate about the policy framework to respond to the circumstances underlying the financial crisis. It was clear that a policy of aiming at low and stable inflation was not enough. Policy also needed to address what was happening in the banking and wider financial system. That suggested two objectives – low inflation and ensuring the financial system was not overly geared – which, in turn, demanded two policy instruments. In that sense, the debate needed to focus on additional instruments rather than the merits of an inflation target. It was noted that recent Bank speeches and discussions had considered the need for counter-cyclical capital requirements. Macro-prudential regulation had figured highly in the recent G20 discussions in Brazil. There was also merit in having gearing ratios for banks. These issues would be debated across the financial stability community and it was important that the Bank played a full role. However, there were two separate levels for the Bank's work: first, its contribution to the UK and international policy debate; second, to determine its strategy for the remit it had been given by the Government. The paper reflected the remit the Bank had, although its contribution to the wider debate was fully acknowledged.

It was noted that a large amount of work was underway on policy options to influence the financial cycle and system as a whole rather than at the level of individual institutions. The Bank had highlighted dynamic provisioning in its recent Financial Stability Report. The type of credit control mechanisms in place in the 1970s had illustrated the difficulty of designing policy regimes that worked over a long period, particularly on an international basis. In relation to the Bank's role, it was possible that a discretionary system of varying capital and liquidity requirements would involve the Bank whereas an automatic system would imply less of a role.

It was stated that the purpose of the paper was to provide high-level direction for the debates and decisions on the Bank's strategy and business plan that took place each year. The annual strategy discussion was the means of reconsidering the Bank's priorities. It was noted that the 2003 paper had encompassed a clear change of direction for the Bank. That was not the case now, therefore the paper was quite different from that presented in 2003. In essence, the vision remained the same but there were ways in which it needed to be adapted to accommodate recent circumstances and new responsibilities.

It was noted that the paper referred to the strain on resources over the past year and also discussed staff development and performance. It was asked if there should be an explicit statement about an objective to ensure that the Bank was appropriately structured for the changing and potentially more complicated environment ahead.

It was suggested that the next five years could be, in effect, a tale of two halves. Managing through the first few years might be a different challenge to the following years. In that sense, it was asked if the main priorities for the next twelve to eighteen months should be more sharply identified.

A question was asked about the reference in the paper to the limited quality and relevance of discussions at the IMF and the BIS. In response, it was explained that there was an ongoing reluctance at international meetings to discuss key global issues and include a wider group of countries. In the absence of countries such as China, India and others, the G7 had struggled to be effective on all questions related to the international financial system. The IMF had been pressed to introduce a mechanism for informal consultations on particular issues but this had not been utilised effectively. Other European countries had been reluctant to participate in a positive way. Meetings of central bank governors in Basle lacked continuity and participants were uncomfortable discussing issues relating to other countries despite the observation that many national economic and financial stability reports referred to difficulties stemming from the rest of the world. The system of national policy frameworks with flexible exchange rates had worked well across the G7 for a period but had broken down when China and other Asian economies wanted to keep their exchange rates fixed to the US dollar without monetary policy accommodation. This had created serious tensions, with low levels of interest rates and a resultant search for yield and investment in riskier assets.

It was noted that the current situation was, in some ways, similar to the problems experienced with the {Bretton} Woods system in that there was no symmetry between the obligations placed on deficit and surplus countries. The problem of the international monetary system had been rediscovered in a more sophisticated and complicated form. To resolve the issue, there had to be a technical debate with surplus countries to encourage them to accept that it was in everyone's interest to engage with general rules and have a framework that applied equally to them. It was hoped that would emerge from working groups following the G20 meetings.

Concluding the discussion, it was suggested that the paper should be accepted as the basis for providing direction for setting the strategy and budget this year and beyond. Comments made during the discussion could feed into the thinking about the Bank's strategic priorities for 2009/10, to be discussed in December. It was also suggested that when the new Court was assembled, the paper should be tabled for further discussion and consideration. It might also be useful to organise a discussion around the issues between the new and existing members of Court.

5. **Combined Quarterly Reports Q2**

Warwick Jones introduced the item.

It was noted that the reports formally covered the quarter to the end of August but they had been updated in parts following the deferral of NedCo's discussion in October.

Quarterly performance report
Attention was drawn to the impact of the ongoing financial crisis on the Bank's own performance. In relation to Outcome 2, it was noted that the increased demand for £50 notes was likely to reflect a lack of confidence in the banking system over the period. The note issue was estimated to be around £750 million higher in value terms over recent weeks than would have been expected. That excess had reduced from a peak of around £1 billion. It was explained that it would be more difficult to estimate any excess between now and end of the year because the note issue increased significantly around Christmas.

Directors asked for an update on efforts to recruit additional people and whether the strain on resources across the Bank had eased over the recent period. It was noted that the intensity of work on bank resolution issues had reduced. But the ongoing work to manage the extended collateral placed with the Bank through its market operations and Special Liquidity Scheme remained heavy. That was utilising an existing infrastructure that was designed for smaller and simpler market operations. So the workload remained testing. Financial risks were being well managed but the demands on the team remained high. It was explained that most remaining vacancies would be filled through the next graduate intake into the Financial Stability area. It was also noted that, unsurprisingly, staff retention rates in the Markets area had improved over the recent period. The Bank had been approached by head hunters with middle ranking people on their books, and the Bank had hired a few people from Lehman Brothers.

In relation to Outcome 4, it was asked if any actions were being taken in response to the fall in confidence measures, and whether any comparisons existed with other central banks. In response, it was explained that the ECB did collect some opinion poll data, but they were less meaningful and not comparable to the surveys done by the Bank. It was noted that popularity was in no way a measure of success for central banks. Rather the surveys provided context for the Bank's communications strategy, which would be discussed at NedCo in February. It was queried whether the surveys were the best indicator to use for Outcome 4.

In relation to monetary policy, it was asked if the Bank thought it was observing data often enough in present circumstances – was it possible to assess information and change judgements outside the normal cycle. In response, it was explained that the Bank assessed three kinds of data – the official statistics, business surveys produced outside the Bank, and the Agents' reports. The ONS data was produced on a monthly and quarterly basis using large samples that would not be feasible to undertake more frequently. Business surveys were also undertaken monthly and quarterly. Increasing the frequency of those surveys might mean smaller sample sizes. For the Bank itself, it had set up a group to monitor and bring together information on bank lending to the real economy. In relation to the intelligence provided by Agencies, the Bank did specify what kind of information the MPC needed in order to guide Agency discussions with business contacts. Furthermore, the Agencies had been asked to report somewhat earlier on specific issues. It was stressed that it was important to demonstrate that interest rates were set on the basis of a full consideration of the available information, and making those decisions once a month remained an appropriate timeframe. The Bank had the ability to seek more information when required.

In relation to the Bank's performance against agreed actions (page 25), it was noted that a number of projects and initiatives had been deliberately re-planned in order to release people for urgent work in connection with the financial crisis – for example, IT staff had been re-directed from the MPC chart pack automation project. Other initiatives had been put in place that had not been foreseen at the time of the business plan. These were mostly additional activities required to meet the timetable for the Banking Bill, notably to set up the Special Resolution Regime. Overall, there had been a deliberate approach to release resources and defer some activities. At the same time, other business-as-usual activities were progressing – for example, the CLS project had gone live in July and work was progressing on the banknote contract with De La Rue.

Quarterly financial review

The consequences of additional market operations and facilities on the Bank finances were highlighted. At the time of the forecast in July it had been assumed that the Bank would record a pre-tax profit of £266 million in 2008/9. In September, profit before tax for 2008/9 had been estimated to be around £600 million, which was likely to be an under-estimate – it did not include, for instance, the interest margin on the Bank's lending to the FSCS for Bradford & Bingley and Icelandic banks. It was noted that such a strong outturn might prove negative for the Bank's reputation and lead to complaints about the spreads charged for its lending.

Reference was also made to the estimated surplus on the Special Liquidity Scheme (SLS). This would be very uncertain over the three years of the Scheme. It had been estimated at £660 million in September and the latest estimate had reached £900 million. It was noted that the Bank was not expecting to pay a dividend on the surplus from the SLS in the year. The lending was underwritten by HMT Treasury and therefore not considered to involve commercial risk. In terms of the accounting treatment, it would be taken directly to reserves rather than through the profit and loss account. It was possible that a special dividend would be payable at the end of the three-year life of the SLS. It was noted that the Audit Committee would receive further information about the accounting treatment for {all} the special operations in December.

Quarterly balance sheet report

It was noted that the Bank's balance sheet had expanded considerably over the past year. Prior to the money market reforms of 2006, lending to the banking system would typically have been around £30 billion, which was approximately equivalent to the size of the note issue. The present size of the Bank's balance sheet was about £250 billion, plus some £100 billion of collateral swaps outstanding within the SLS.

The Bank's capital was, in comparison, very small at around £2 billion. So the Bank was presently highly geared. That placed the projected profit in perspective. In terms of managing the

assets held by the Bank, in addition to HM Treasury indemnities for some of the facilities, collateral was being very carefully selected and valued. It was stressed that haircuts varied according to the type of security taken and also the quality of the counterparty. In response to a question, it was noted that the Bank had discussed with
HM Treasury whether the Bank should have extra capital in the future. In response to a question, it was explained that valuations of the collateral taken reflected expected impairment of asset values but not the probability of counterparty default. Re-margining was undertaken on a daily basis and the Bank could change the haircuts it applied, which it had done on an idiosyncratic rather than across-the board basis.

6. **Budget warm-up**

The Governor and Warwick Jones introduced the item

It was noted that the Bank's additional responsibilities within the Banking Bill would require budgetary provision. In the context of the review of Cash Ratio Deposits, the budget set in the previous year assumed an increase in nominal spending on policy functions of two per cent a year. It was also noted that it had been intended to undertake a zero-based budget of the financial stability function on the grounds that even at the start of 2008 it was difficult to know what the Bank's responsibilities would be. There were three specific areas where the Bank would take on additional responsibilities: first, the Special Resolution Authority; second, responsibility for the statutory regulation of payment systems; third, collateral management, which would require some permanent increase in resources.
It was explained that the approach to the budget this year would be to bring proposals to NedCo for step increases in expenditure but, thereafter, to revert to the limit of a two per cent annual increase in cash spending for policy functions each year. It would be important to retain budgetary discipline through this period. The executive management was conscious that there would be a temptation in any organisation to use the present situation as an opportunity to ask for additional resources. It would be necessary to distinguish between those areas where there was a case for an increase in expenditure and those where that was not the case. Although it was conceivable that after the budget round had been completed, there might be further changes to the Bank's responsibility over the next few years, there would not be a case to alter the budget until a specific change and reason had been identified.

It was noted that the terms of the indemnity provided for the Special Liquidity Scheme allowed for reasonable operating costs to be charged to the Scheme, which was budgeted for separately. It was also noted that last year's budget plan for 2009-10 included a small contingency for policy functions. Most of the contingency for the current year would be consumed.

In summary, Directors were content with the proposed approach to recognise areas that would require a step increase in expenditure but to ensure budgeting did not increase more generally.

7. **Inflation Report and MPC report**

Spencer Dale introduced the item.

The current economic conjuncture, outlook and Inflation Report projections were summarised.

In discussion, the conditionality of the MPC's projections was noted. In addition to the projections being based on the interest rate path implied by market yields which had prevailed prior to the MPC's decision, it was asked if other variables would similarly change the MPC's projections. In response, it was noted that the evolution of many variables would influence the MPC's judgements about the future path of inflation, such as oil prices, the exchange rate and data on the real economy. In that sense, the projections were always changing. It was normally the case that one of the two interest rate assumptions used – an expected market interest rate and a constant interest rate – would capture a reasonably likely path for future interest rates. However, that was not the case on this occasion. Neither paths were consistent with inflation returning to its target over the medium term. Likewise, the MPC's projections were always conditioned on the Government's published fiscal plans but the Government had announced its intention to publish plans for a fiscal stimulus, which would influence the MPC's growth and inflation projections.

It was asked if the Bank had assessed the extent to which the change in what the MPC expected had been the result of errors of judgement about what had previously been expected rather than new facts emerging about the economy – i.e. had the MPC missed something. It was explained that the factors outlined in the paper were the key drivers for the changes to the MPC's projections. Whether the MPC could have made those judgements earlier was difficult to assess. One guide would be to consider other forecasters' positions. Most outside forecasts had been changed by a similar degree – the MPC's projections did not appear out of line. The IMF had, for example, revised down its projections for UK growth in 2009 by over 1 percentage point between its World Economic Outlook forecast published on 6 October and the past week; and consensus forecasts had been revised down between September and October by the largest amount on record.

Directors agreed that there had been a sharp contraction in business order books in many sectors during September and October. The pace at which the economy was slowing had changed and evidence from the Bank's Agents in September and October was consistent with that judgment. At the same time, the inflation environment had changed substantially, with sharp falls in oil and other commodity prices. Combined, this changed the nature of the monetary policy balancing act substantially and led to a fundamental shift in the inflation outlook.

It was noted that previous MPC reports had referred to concerns about wage pressures potentially contributing to higher inflation. It was stated that those concerns had lessened and were part of the shift in the balance of risks. There were few signs that employers were expecting higher wage increases and the number of pay freezes had started to rise, suggesting labour market dynamics had shifted very significantly. Furthermore, measures of inflation expectations had also fallen back quite markedly. It was asked if MPC members now felt the concerns about potential wage pressures had been given too much weight earlier in the year. Labour market behaviour was now quite different than in the past such that the concerns had seemed overstated. The role of unionised labour in the private sector had declined and wage bargaining practices had moved away from the notion of a 'going rate'. In response, it was clarified that the central projections up to the August Inflation Report assumed there would not be much passed through from higher inflation into wages, but it was recognised that there was some upside risk to that judgement. It was stressed that it was not just a question of pay but other costs and prices generally. What mattered was whether businesses felt they could pass on cost increases in higher prices or not. The dilemma facing the MPC at that time was that removing higher inflation once that process was underway would be difficult and painful. Therefore, even if it was a low probability event, it was still felt necessary to be reasonably cautious in the face of such a large external price shock. Commodity prices had risen very sharply and it was notable that in August the probability markets had placed on oil prices being at their current level was less than 1%. That very significant change in the external inflation environment over the past three months meant inflation was now likely to fall more quickly.

It was explained that, although the data on the economy had shifted, it was also the case that there was little previous experience of analysing a cycle of this kind over the post-war period. Unlike previous cycles that had been driven by an inflationary boom and subsequently monetary policy tightening, the current episode was more akin to the cycles experienced in the earlier part of the 20th century and 19th century, which were driven by financial developments. This had tested the tools available to model and analyse the economy to help form judgements about how an economy might perform in such a situation. It also followed eleven years of inflation targeting. Overall, it was very uncertain how the balance of forces being experienced would evolve.

Some MPC members were somewhat uncomfortable about their earlier judgements. However, it was not the case that earlier reductions in Bank Rate were not made simply because of concerns about wage pressures. Moreover, it was certainly not the case that a small reduction in Bank Rate over the summer would have prevented the financial crisis and its impact on the wider economy.

It was asked how the MPC went about deciding the scale of the reduction in Bank Rate given that its projections did not show inflation returning to target over the medium term. In response, it was stated that there had been a much wider range of alternatives than usual facing the MPC. The judgement was inevitably approximate. It was explained that if there was a marked changed in circumstances such that the level of interest rates was wrong, it was right to change the interest rate level as quickly as possible. That was the starting point and then the MPC had considered factors that suggested the extent of the change should be tempered. In particular, the extent to which the decision would surprise and confuse the markets and general public had been given some weight. The MPC had been conscious that it was making a decision based on its Inflation Report projections that would not be published for another week. Therefore, the outcome had not simply reflected a view about what level of Bank Rate was necessary to return inflation back to target. The MPC had decided to reduce Bank Rate by an amount that would be sensible given market expectations, forthcoming developments and uncertainly – notably fiscal policy and the exchange rate.

10. (i) **Quarterly financial stability report**

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

Sir John Gieve introduced the item.

The latest report was summarised. Over the past month the stabilisation of the banking sector had continued. It was stressed that having announced the UK's recapitalisation package in October it had been important that money was made available quickly. A number of recapitalisations were underway and Government guaranteed debt issues of one sort or another now totalled around £40 billion. However, funding markets remained very impaired. The main development over the recent period had been the increasing concerns about the scale and scope of the downturn in the world economy. The large mark-downs in expectations for emerging market economies meant a wider range of banks were now being impacted.

Against this background, the Bank had published its Financial Stability Report (FSR) in October. It was noted that, along with widespread media coverage, website traffic had risen very significantly. The FSR had provided an authoritative account of the financial crisis to date and the reasons for the interventions by the UK authorities in October. The significance of the failure of Lehman Brothers was highlighted, in terms of its impact on financial markets and, crucially, perceptions of policy. It had previously been presumed that the authorities would step in to rescue large financial institutions. Consequently, allowing Lehman Brothers to fail had caused a step change in sentiment about financial institutions.

The policy agenda and work that was underway was summarised in the paper. It fell into three broad categories. First, plugging obvious gaps in existing policy – for example, the lack of regulation of mortgage originators in the United States, the inadequate capital weighting of structured credit products, and the way some regulations had been evaded by firms taking business off balance sheets. Second, more serious gaps in the international regulatory framework, some of which had previously been considered to be too difficult – for example, liquidity regulation and cross-border crisis management. Third, macro-prudential measures to bridge the gap between monetary policy and the regulation of individual institutions. The FSR had discussed the potential merits of dynamic provisioning in particular.

In discussion, the long-term fall in the amount of capital held by banks was noted. It was stated that the level of capital held by banks was one of the major policy questions at present. Opinion had turned away from the approach embedded in the Basel 2 framework. That had established that setting a capital requirement against any type of asset irrespective of its risk was too simple. But the approach missed two important dimensions: first, it did not take account of liquidity; and second, the level of capital requirements might be wholly inadequate in the face of exceptional events. Instead of simply adjusting for variation in the riskiness of assets, it might be necessary to consider the amount of gearing financial institutions took on board. Such regulation might need to cover any institution that became large enough to have an impact on the stability of the wider financial system and economy. A very large gearing ratio meant quite small changes to underlying returns could make a firm insolvent and cause wider problems. It was noted that it had not been clear at the start of the financial crisis that the large banks would be the main source of problems. The increased leverage of the banking system was extraordinary. This was a macro prudential issue rather than something that could be addressed through regulation and supervision of individual institutions.

In response to a question about US policy, it was explained that there had been a change of plan away from the original policy of purchasing toxic assets from the banks. It had run into two problems: first, the long debate about it through Congress; and second, it had never got off the drawing board. The US authorities had said they would use part of the funds for recapitalisation but this had amounted to a more or less wholesale change of direction.

A point was raised about credit default swaps and the over-the-counter (OTC) derivatives market. It was suggested that the market was one of the most precarious parts of the financial infrastructure, even though it had received less attention over recent months. The FSR had rightly identified the need for central clearance and greater transparency on pricing. It was asked if the Bank planned to be proactive in this area and join forces with others to accelerate progress. An obstacle was the number of disparate players and trade associations involved, which suggested progress would need a regulatory push. In response, it was noted that the FSA had been very engaged with the New York Federal Reserve in relation to promoting moves to bring more OTC trading onto exchanges and through central counterparties and common settlement and clearing systems. The Bank supported that and Ian Bond was leading a group which was considering the payments aspects. It was likely to be easier to find a way forward in the present environment. At the same time, there might still be major problems with the existing legacy. The most notable problem to date had been with AIG which had significant exposures to credit default swaps and other derivative trades. The scale of its insurance through the CDS market had been one of the reasons why it needed to be rescued. The present difficulties facing hedge funds were an indication that further problems might arise as they were forced to sell and crystallise their positions. It was noted that the failure of Lehman Brothers had been handled without a major incident {of this kind}.

It was noted that the estimated size of the CDS market – around $65 trillion – was a notional value. The mark-to-market exposure was much smaller and smaller still if account was taken of bilateral netting, which happened in the case of Lehman Brothers' failure. Transferring to an exchange-based market required a degree of standardisation. It was stated that the FSA would continue to press for progress.

It was highlighted that the issue raised was broader than the CDS market. It was a characteristic of the financial crisis that the markets that had become most impaired had been OTC markets. This reflected a lack of transparency and counterparty credit risk; two features that central clearing and trading would help to address directly. In that sense, the issues were generic to OTC markets and instruments. It was suggested that if the CDS market could be progressed, other markets might follow.

(ii) **Financial markets update**

Mr Tucker introduced the item.

It was noted that, although the recapitalisation plan introduced in October had helped to reduce perceived credit risk amongst the banks and so prevented seizure in the overnight money markets, term money market conditions had improved only marginally, which was of concern across the financial system. The spread between the three-month LIBOR rate and the expected policy rate in three months time had remained very high. That was partly because of the deteriorating macroeconomic picture worldwide and the resulting cashflow pressures on the corporate sector, which therefore place a very high value on liquidity. Money market funds were, in consequence, placing a large weight on their own liquidity circumstances. Hedge funds had also been liquidating portfolios and holding funds short-term in the banking system or in Government securities. In other markets, corporate bond spreads had risen and equity prices had fallen. It was noted that measures of volatility in the equity market were not far from the levels experienced in 1987. Exchange rates had also become highly volatile with carry trades unwinding. Overall, prospects ahead were very uncertain. It was possible that further adverse events could occur in financial markets, such as large hedge fund failures or wind downs, as large redemptions were made and funds moved out of riskier investments. And in the private equity field, asset managers were having to sell assets in order to meet commitments to subscribe to private equity funds, whereas in the past they would have been financed by payouts from 'old' funds. It was evident that the process of deleveraging was spreading out, which could lead to more losses in the banking system and so potentially a further adverse shift in the supply of credit.

It was also noted that there was a growing perception in financial markets that a new minimum level of capital was being required for banks, not necessarily by regulators but market participants. That was part of the background to the recent Santander capital raising. There was a risk therefore that the perceived level of capital required in the banking system was ratcheting upwards, whereas what was required was for banks to hold – and to be seen to hold – a buffer of surplus capital to absorb losses and as a necessary condition for them to resume lending.

It was asked if the Bank had undertaken a risk analysis of potential scenarios over the next six months or so. In response, it was stated that it was impossible to assess how long the present crisis would continue. Many had thought that the worst might be over earlier in the year, which had not been unreasonable at the time. What followed the failure of Lehman Brothers was a progressive collapse of confidence in banks that earlier would have been almost unimaginable. An assessment of the situation in, say, August would not have included a complete collapse of confidence in the international banking system as one of the prime risks facing the economy. So it was very difficult to list the things that could go wrong over the coming months, let alone attach probabilities to them as might have been attempted previously. The example of oil prices was used to underline the uncertainty of the recent period. The Bank was thinking actively about potential options, for instance, to address the absence of lending by the banking system. But it was very difficult to be confident about what might lie ahead given the scale and nature of recent events.

8. Progress on banking reform legislation

Sir John Gieve introduced the item.

It was reported that good progress had been made on the Banking Bill over the past month. The committee stage had not thrown up any particular difficulties from the Bank's perspective. It was noted that more opposition might arise when the Bill went to the House of Lords. Recent discussions around the Bank's powers to split an institution into a good and bad bank had been positive. It was hoped that the Bank would retain some freedom to tailor resolutions to obtain the best prospects of saving the most worthwhile parts of a failed institution.

It was stated that work was underway to set up the Bank's Special Resolution Authority which would be discussed at NedCo in December. The overall parliamentary timetable remained in place, although there remained doubts about the February deadline. It was stated that the Bank's state of readiness was satisfactory and helped by recent experiences of bank resolutions. The main issue was to ensure the Bank had sufficient powers to execute its responsibilities.

9. **Court meetings in 2009**

The Governor introduced the item.

It was reported that thought had been given to appropriate dates for meetings of Court in 2009. It was considered sensible to agree a timetable now in view of the expected changes incorporated in the Banking Bill.

On the basis of earlier discussions that there should be fewer Court meetings, it had been agreed that seven meetings a year would be the target number. It was proposed, however, that Court would meet eight times in 2009 in order to allow an extra meeting in June for the new Court to meet shortly after being formed. It was noted that the timing of the remaining seven meetings might appear irregular but they had been carefully designed to ensure Directors could discuss the suite of quarterly reports in a timely way. That explained the timing of meetings towards the end of particular months.

It was asked whether the changes should come into effect from June 2009 in line with the legislative changes affecting Court. Until then, Court would still be legally obliged to meet monthly. In response, it was stated that meetings could be held more frequently if Directors wished to do so but the substantive meetings would be around the proposed timetable.

10. **Business continuity annual report**

Deferred.

ITEMS FOR INFORMATION

11. **Audit Committee minutes for 26 September**

Noted.

12. **Agents issue of the month**

Noted.

Any other business

None.

The meeting of NedCo was closed.

MEETING OF THE COURT OF DIRECTORS

Thursday 13 November 2008

Present:
The Governor
Sir John Parker, Chairman, NedCo
Charlie Bean, Deputy Governor – Monetary Policy
Sir John Gieve, Deputy Governor – Financial Stability
Mr Brendan Barber
Mr Roger Carr
Ms Amelia Fawcett
The Hon Peter Jay
Sir Andrew Likierman
Dr David Potter
Prof David Rhind
Ms Susan Rice
Mr Arun Sarin
Mr James Strachan
Lord Turner
Mr Bob Wigley
Mr Geoffrey Wilkinson

Absent
Ms Amelia Fawcett

Also attending:
Mr Bailey, Mr Dale, Mr Footman, Mr Jones, Mr Tucker and Dame Juliet Wheldon.

1. **Minutes –15 October 2008**

Approved.

2. **Governor's vision for 2nd Term**

The vision for the Governor's 2nd Term was APPROVED.

3. **Monetary policy issues**

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

4. **Budget, quarterly reports, financial stability report, financial markets update, banking bill, Court meetings in 2009**

Court noted the discussions in NedCo of the above items.

Any other business

None.

[Members of the Executive Team other than the Governor withdrew]

5. **Executive Director for Financial Stability**

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

[redacted]

The meeting of Court was closed.

COMMITTEE OF NON-EXECUTIVE DIRECTORS (NEDCO)
SECOND MEETING

Thursday 13 November 2008

Present:
Sir John Parker, Chairman
Mr Roger Carr
Mr Brendan Barber
The Hon Peter Jay
Sir Andrew Likierman
Dr David Potter
Prof David Rhind
Ms Susan Rice
Mr Arun Sarin
Mr James Strachan
Lord Turner
Mr Bob Wigley
Mr Geoffrey Wilkinson

Absent:
Ms Amelia Fawcett.

1. **Minutes – 10 September 2008**

Approved, along with their circulation to Governors.

2. **Draft MPC questionnaire**

Directors considered the draft MPC questionnaire prepared by Mr Dale. It was explained that the questionnaire was one of the inputs into NedCo's assessment of the effectiveness of MPC procedures, as required under section 16 of the Bank of England Act. The questionnaire responses would be followed by individual discussions with MPC members held by the Chairman of NedCo.

It was suggested that it might be useful at the present time to include a question about how MPC members judged the results of their forecasts over the past year, and whether they wanted to make any changes to their forecasting process as a result. It was suggested that the issue could be raised as part of the one-to-one discussions with the Chairman. Directors were invited to raise further questions for the meetings with MPC members, which would take place in early 2009.

3. **MPC non-policy meetings**

Noted.

4. **Deputy Governor interviews and new non-executive appointments**

It was reported that the short-listing meeting for the position of Deputy Governor, Financial Stability had taken place on 12 November at HM Treasury. Non-executive Directors were informed that there [redacted] internal candidates and three external candidates. Interviews would take place on 27 November. The interviewing panel would be comprised of Nick Macpherson, Tom Scholar, Sir David Clementi, and Sir John Parker.

It was also reported that advertisements for new non-executive Directors and the chair and deputy chair of Court had been published. Any current non-executive Director could apply to serve the balance of their current term. There was a desire that the new Court included some current Directors. Serving the balance of existing terms would help ensure terms were tapered rather than all commencing and ending together. It was noted that the current chair of NedCo would not be re-applying for appointment. In view of the fact he would only have one year remaining of his term, it was felt important that his successor should be involved in the selection of the new Directors. There would be a short-listing meeting on 9 December and interviews on 18 or 19 December for the positions of chair of Court. Interviewing for the position of deputy chair and non-executive Directors would follow. It was expected that interviews for non-executive Directors would take place around 26 January.

Any other business

There was a brief discussion about the nature of debate at NedCo meetings and the split between comments made by executive management and non-executive Directors. It was hoped the smaller size of the new Court would improve the interactivity of discussion. It was also noted that it would be desirable if papers could to be taken as read as the working presumption for meetings.

The meeting of NedCo was closed.

COMMITTEE OF NON-EXECUTIVE DIRECTORS (NEDCO) MEETING

Wednesday 10 December 2008

Present:
Sir John Parker, Chairman
Mr Brendan Barber
Mr Roger Carr
Ms Amelia Fawcett
The Hon Peter Jay
Prof David Rhind
Ms Susan Rice
Mr Arun Sarin
Mr James Strachan
Lord Turner
Mr Geoffrey Wilkinson

Absent:
Sir Andrew Likierman, Dr David Potter, Mr Bob Wigley

Also attending:
The Governor, Mr Bean, Sir John Gieve, Mr Bailey, Mr Dale, Mr Footman, Mr Jones, Mr Tucker, Dame Juliet Wheldon.

1. Minutes – 13 November 2008

Approved

2. Matters Arising

None.

MANAGEMENT OF THE BANK

3. Executive report

The Governor introduced the item.

It was noted that it was Dame Juliet Wheldon's last meeting of NedCo and Court. Dame Juliet was thanked for the work she had done at the Bank, which had been considerably more than had been anticipated at the time of her appointment. The Bank was very grateful for her contribution.

Recent and forthcoming meetings and events

Domestic:

- Treasury Committee Inflation Report hearing – Governor, Charlie Bean, Sir John Gieve, Andrew Sentance and Kate Barker (25 November);
- TUC dinner (27 November);
- regional visit to South East England (17 December);
- regional visit to the East Midlands, including public speech by the Governor in Nottingham (20-21 January);
- House of Lords Economic Affairs Committee appearance – Governor, Charlie Bean (27 January)
- Inflation Report and press conference (11 February).

International:

- visit to Berlin (18-21 November);
- visit to New York – Governor, Sir John Gieve and Paul Tucker – including a G30 meeting and meetings with the chairmen and chief executives of major banks (4-9 December);
- BIS meetings (11-12 January);

Over the past month, there had been meetings with Tripartite Principals and others in HM Treasury and the Government. A meeting with the Chancellor, Lord Turner and bank chief executives – the 'Lending Panel' – was scheduled for 11 December. Further meetings with the Chancellor, Nick Macpherson and Lord Turner were scheduled for December and January.

Bank lending

It was reported that the Bank had established a monitoring team to provide high frequency assessments on bank lending to the real economy. The Bank would provide reports to the newly formed Government Lending Panel. Jo Paisley – Head of Monetary and Financial Statistics Division – was leading the work internally, reporting to Spencer Dale. Banks already provided regular data to the Bank but this was not sufficient for present purposes. The Governor had held a meeting with bank chief executives who had agreed to co-operate and provide additional data on the understanding that the confidential data provided on their own positions would not be revealed to other banks or the Lending Panel. The Bank would construct an aggregate picture for the Lending Panel.

It was asked if further measures would be needed to restore bank lending. If so, what would be the best option in the Bank's view and what role would the Bank play? In response, it was stated that the banking sector was not at present in a position to easily finance an increased flow of lending to the real economy. One of the concerns was that companies with committed credit lines were tending to draw down funds as a precaution, whether or not the credit was needed. That was then constraining banks' new lending to companies that did not have committed facilities. Potential measures to increase bank lending came under two broad headings: first, capital – did the banks have enough capital or was more needed and what else could be done on the capital front; second, funding which was considered to be the larger issue. It was noted that the Credit Guarantee Scheme offered a vehicle for banks to borrow in a guaranteed form. The question was whether the scale of the scheme and its conditions were right to encourage more lending.

In response to a question about the general mood of bank chief executives, it was noted that there was a realisation that, without the authorities, a number would not have survived. It was recognised that further changes would have to be made to banking activities and the scale of leveraging in the future. It was also recognised that the desire to see banks increase their lending was in conflict with the required de-leveraging that they needed to undertake. Reconciling that contradiction was the main challenge in the current policy debate.

In response to a request, it was agreed that non-executive Directors could receive a summary of the trends in lending that the Bank was providing to the Government's lending panel.

It was asked what stage the financial crisis had reached in the Bank's view. In response, it was stated that it was difficult to be confident in the light of events. Assuming there was not a further collapse in confidence, then it was reasonable to say the situation had progressed some way since October, and there might be grounds for thinking that there could be some upward movement in financial markets ahead. The sense of panic that had been present in the Autumn had subsided. The deleveraging process had progressed and the size of balance sheets had reduced. That did not mean, banks would increase lending – that might require further Government initiatives. It was apparent that the scale of the problem was now broadly understood and a number of initiatives were in train – for example, reducing the scale of exposure in the CDS market with netting agreements. It was too late to prevent the impact on the corporate sector and real economy. The scale of the initiatives taken by central banks and governments made it clear that the authorities were willing to do whatever was necessary. There was willingness in the financial sector to look forward and anticipate a slow crawl back to financial health.

4. **Financial markets update**

Mr Tucker introduced the item.

Recent market events and trends were reviewed (charts circulated). The resolution of Citibank and the US government's support had been the most significant event over the past month. It was also highlighted that the real yield on UK government bonds had risen considerably over medium-term maturities, and the price of credit default swaps on UK government debt had risen sharply over the past month. It was noted that in the past over indebted nations have sometimes inflated away the value of their debt. However, the increased credibility of monetary policy reduced that possibility such that debt would remain a burden, which raised the probability for financial markets of debt being rescheduled.

Attention was drawn to the increase in uncertainty and volatility indicated by a variety of option prices (Chart 7). Some measures were now slightly better than their highest levels, but remained considerably higher than over the period 2003-7. There had been a significant shift in expectations about UK equity prices since August (Chart 8), with a material probability based on options prices of the FTSE 100 falling below 3000, with similar outcomes indicated for US and European indices. If such falls were to crystallise, questions would arise about insurance companies and pension funds. It was also noted that LIBOR rates had fallen though spreads over official rates remained high (Charts 9 and 10) and reflected the difficulties that banks still faced in funding themselves in term money markets. Market expectations for short-term interest rates now included a material probability that interest rates would reach zero, which was now entering the public debate about the course of monetary policy in the coming months and what central banks might do in those circumstances.

In relation to the Bank's balance sheet, attention was drawn to the increase in market operations (Chart 4). A significant part of the increase reflected the extended collateral long-term repo operations. The stock was currently £120-130 billion, about half of which reflected bids against wider collateral. The Bank's dollar repo operations (Chart 5) and use of the Special Liquidity Scheme (Chart 6) were also highlighted. It was noted that some three-month repo operations would mature during January and it was expected that many of those assets would be placed in the Special Liquidity Scheme ahead of its closure at the end of January.

In response to a question, it was stated that there were fewer liquidity concerns about the year-end than in 2007, largely because a number of longer-term operations were already in place that covered the year-end period. Nonetheless, tensions remained and banks were actively managing their liquidity positions and balance sheets.

5. **Strategic priorities**

The Governor introduced the item.

It was noted that the strategic priorities followed the Governor's vision paper, discussed in September and November. There would be a preliminary discussion today ahead of the approval of the strategic priorities, business plan and budget in February 2009.

It was explained that the priorities set out the key challenges for the Bank for 2009/10 consistent with the Bank's strategy, and would, in turn, guide the budget for the year. This year's budget presented considerable challenges in view of the new responsibilities the Bank was acquiring in the Banking Bill and increased collateral management work. There were also a number of IT projects to finance.

Following a brief summary of the strategic priorities, Directors discussed various points. In relation to the sterling money market framework, it was asked if there would be alignment with other central banks' approaches over time. The Bank had been one of the first central banks to make major reforms in response to the financial crisis – would the Bank's framework evolve as others were changed? In response, it was noted that several central banks had reported on their market frameworks and there was a shared understanding about the principles involved. Operational designs would never be identical because individual markets differed. The Bank had discussed general principles with other central banks – it was noted that one of the academic consultants used by the Bank had since been hired by the US Federal Reserve.

There was a concern that there was not explicit recognition of the ongoing financial crisis and recession in the strategic priorities for the coming year. In particular, it was suggested that the first priority – returning inflation to target – was perhaps incomplete without reference to the role monetary policy would play in minimising the impact of recession. The MPC's remit referred to the wider dimension of growth and employment in the economy such that there might be more articulation of that in the strategic priorities. In response, it was stressed that the MPC's objectives in relation to monetary policy had not changed. It was because of the primary focus on inflation that the MPC had been able to take measures that would boost growth and employment, insofar as the failure to do so would result in inflation falling below target. In addition, the work that was underway to monitor bank lending was also crucial to the economy and the outlook for growth. Under Strategic Priority 6 – enhancing public understanding through development of a robust communications strategy – it was stressed that the Bank would need to continue to explain to the public that maintaining low inflation was the best means of promoting growth at sustainable levels. The fact that the MPC had cut Bank Rate from 5% to 2% over a short time should demonstrate that the Bank was prepared to act swiftly in order to ensure that the real economy was supported. It was stressed that the MPC was not trying to target growth but had a framework that supported it. It was acknowledged that communications would be an important aspect of the MPC's work over the coming year.

In relation to the Bank's communication strategy, which would be discussed at NedCo in February, it was asked if there were any building blocks already in place given the importance of communications at the present time and its role in policy implementation. In response, it was explained that the discussions on the Bank's communications strategy had been moved to February from December due to other pressures on the agenda this month. A number of thoughts were in train which would be presented by the Director of Communications in the new year. It was also asked if specific mention should be made in the communications objective of the need for more co-ordination between the Tripartite authorities so messages were consistent, which would help to underpin public confidence.

Reference was made to the distinction between the more definitive wording in the first two strategic priorities and that of the third – 'discharging the Bank's enhanced financial stability role'. It was felt that the wording could be more aspirational; for example, the Bank might seek to maximise its contribution to reducing the length and depth of the financial crisis. It was also asked if wording should be added to reflect the establishment of the new Financial Stability Committee. It was noted that there would be a need for Court to review the end-to-end processes for oversight of the Bank's financial stability responsibilities and work. In response, it was agreed that establishing the Financial Stability Committee and undertaking such a review was an action for Court rather than the Bank and therefore that did not need to be reflected in the strategic priorities beyond the current wording.

In relation to Strategic Priority 7 – increase accountability and efficiency across the Bank – it was suggested that increasing the diversity of skills and experience could be included in the reference to improving talent management. It was agreed that the wording could refer to succession planning and diversity. Care was needed in relation to skills because the Bank did not require a great diversity of skills but rather those relevant to its core purposes. Secondments were a key element of talent management to diversify experience. A challenge for HR was to ensure that senior management time was devoted to delivering an effective program for talent management. The Executive Team had agreed to employ external consultants to work in this area and develop proposals about how HR should be modified in order to deliver better talent management.

It was stated that it remained apparent to the Audit Committee that the Bank remained under strain and lean. It was noted that Audit Division had cut back significantly on its regular auditing because resources had been diverted to other priorities. Similarly, in the Finance area systems that the external auditors had said should be progressed had been delayed. Those decisions were entirely understandable but some caution about resources was sensible at this time. It was thought that it would be better to be slightly more lenient on staffing in the present environment.

In response to a question, it was stated that the Bank had a low capital position. That would need to be addressed in time but was not urgent. HM Treasury had accepted the need to increase the Bank's capital. There was no common international position on the amount of capital for central banks, varying from close to zero to very large capital bases

In summary, the wording of the strategic priorities would be brought back to NedCo in February for the discussion on the business plan and budget.

6. **Banking Bill – update**

Sir John Gieve introduced the item.

It was stated that the parliamentary process was progressing as planned and the Act was expected to be passed in February. The outstanding matters noted in the paper were not critical for the Bank. It was noted that it was quite common for bills to pass through the House of Commons with no amendments but for the issues raised to be debated more fully in the House of Lords. The points listed in the paper (page 5) were the main areas of interest for the Bank. These included the ongoing concern in the financial sector about the Bank's power to affect a partial transfer of assets and liabilities and the protections afforded to creditors in any rump entity. The

Bank and HM Treasury had agreed some fairly powerful protections but the position would be tested in the House of Lords debates.

It was asked if any further thought had been given to strengthening of the wording of the Bank's financial stability objective. Concerns remained that 'contributing' was too weak. It was noted that the Bank had put forward alternatives but HM Treasury were not inclined to change the wording.

It was asked what the Bank considered to be the most important issues outstanding. In response, it was thought that the Bank could work around all those issues listed. In relation to the collection of information from banks, the Bill as currently drafted would leave that decision to the FSA, which would be able to collect information for the Bank where it was necessary for financial stability. The Bank believed it would help the FSA if the Bank could formally request information rather than the FSA having to make its own assessment about a request from the Bank. The current formulation was workable but might be less effective and involve more process, including assessing whether the information requested placed undue costs on firms. The largest issue was perhaps the treatment of bank holding companies (paragraph 6). It might be necessary to have some powers of discretion over holding companies when a bank was placed into the Special Resolution Regime to ensure, for instance, that other group companies continued to provide services to a stricken bank.

It was noted that at the recent G30 meeting in New York, there had been a widespread assumption that the power to have a resolution authority needed to go beyond banks and cover any institution that could have an impact on systemic stability. Discussions about the precise definition of a bank were seen as an irrelevance. It was now accepted that financial institutions in general required a different process of insolvency to ordinary companies, and that required the authorities to have powers that extended beyond the narrow definition of banks. It was possible that the Bill when passed would be seen as already being behind the wider international debate.

In discussion it was stressed that the provision of timely information would be critical to future bank resolutions. That had been the experience during the financial crisis. It was hoped the Bank and the FSA could find an effective means of ensuring the Bank had the information it needed in a timely way.

7. Special Resolution Authority – progress with organisation

Sir John Gieve introduced the item.

It was reported that good progress had been made on preparations. Recent practical involvement with bank resolutions meant that there was a body of staff in the Bank with experience and capabilities. In that sense, the Bank would not face a standing start for the new Special Resolution Authority (SRA).

As the paper noted, it was envisaged that a unit of 20-25 people would be required, including the existing team that worked on contingency planning for financial crises. Other staff with professional and banking experience would be recruited externally. A number of positions had been advertised.

It was noted that the report from Harrison Young provided valuable insight into how such a unit would work and why the culture would necessarily be different from other areas of the Bank. He had recommended that the head of the SRA should report directly to the Deputy Governor, Financial Stability rather than be placed in either the Financial Stability or Banking directorates. The Bank had decided to adopt that approach.

In response to a question about handling the aftermath of bank resolutions, it was noted that running off assets was a potentially very long process. The Bank had been involved in such a process in the past in relation to Johnson Matthey, which had lasted over twenty years. A process had to be established to handle claims on the assets held. That would not involve active decisions in terms of managing a bank and would normally be a function of a separate organisation. The issue required further consideration.

It was noted that building shared experience and associated communication and trust across the team would be relatively easy during an active period of bank resolutions. But that would be more difficult in normal times. It was asked how the unit would create shared experience with a core and virtual team, particularly a number of years after an active period. It was explained that there would be a flow of people through the unit such that over time there would be a body of people in the Bank with experience of the SRA's work. They could be called upon during a crisis or active period. Regular exercises and secondments were also a practical means of building and retaining experience. The main characteristic was that the unit would not be a fixed group of people over time. In addition, staff from outside the Bank might be brought in under special contractual arrangements with their employers in the event of an emergency.

It was suggested that Harrison Young should be asked back in six or twelve months' time to undertake a short review of the Bank's progress with its SRA.

8. Business continuity annual report

(Stephen Collins – Head of Business Continuity Division – in attendance)

Stephen Collins introduced the item.

[redacted]

It was noted that the Bank had made progress against the FSA's benchmarking standards and leading practice criteria. [redacted]

[redacted]

A further question was raised concerning planned recovery times. It was asked why the standard for market operations was less than that for the RTGS system, which had a two hour recovery target. It was noted that the need to have RTGS working more quickly was because RTGS activated the existing liquidity in the system. That did not enable the Bank to change the amount of liquidity in the system but RTGS provided a period of time for other operations to recover. It was noted that the impact partly depended on the time of day. If a problem with market operations occurred early in the morning, the four hour timeframe would be sufficient for operations to take place later in the day. But later in the day would be more problematic. It was added that having a spit-site working capability for market operations would reduce recovery times to much less than four hours, as was the case with RTGS whereby recovery could be achieved in considerably less than two hours.

It was stated that more thought needed to be given to the incidence of a business continuity crisis during a financial crisis. It was noted that the Bank was assessing the lessons learnt in handling a default following the Lehman's experience. The exercise had been relatively straightforward for the Bank because its lending was against gilts, but it had nevertheless still involved a large amount of work. In a more complex case, it would be necessary to be able to draw up information on exposures and collateral quickly to meet deadlines in legal agreements to avoid sacrificing the Bank's interest as a creditor. That could be difficult if information or systems were impaired due to a business continuity event. An update on those considerations was requested in six months' time.

In relation to the delays to the business continuity work programme over the past year, it was asked if there was a timetable in place to plan the outstanding work and assess performance against a plan. It was noted that there was an informal timetable. [redacted] Delivery was dependent on a number of business areas so other priorities might inevitably cause further delays. It was suggested that there should be defined reference points for the work programme so slippage could be tracked. Otherwise, there was a risk of work straying with events.

[redacted]

9. Banknote contract

Andrew Bailey introduced the item.

[redacted]

[redacted]

10. Diversity report

(Louise Redmond – Director for Human Resources – in attendance)

Louise Redmond introduced the item.

It was highlighted that the report covered the Bank's review of flexible working, which had identified an increased and positive take-up by staff of flexible working arrangements. It was noted that efforts had been made to improve the measurement and benchmarking of the Bank's diversity outputs and trends. In addition, the Bank had published, as required, its Disability Equality Scheme on the external website.

In discussion, it was stated that the Bank's emphasis on diversity and its approach to flexible working were both positive. There remained, however, a question about how improvement was measured such that the outcomes rather than processes were centre stage. It was suggested that there needed to be more analysis of diversity outcomes to inform discussions about, for example, succession planning. Good intentions needed to be matched by changed outcomes. In response, it was acknowledged that the Bank's sense of its progress needed to be challenged. It had always been accepted that it would be important to persevere with the diversity agenda for a number of years in order to achieve changes. Progress was now becoming evident in the statistics rather than simply from a vague sense that it was heading in the right direction. The initiatives on recruitment and the women's network had been particularly successful and laid foundations for continued progress over time.

In relation to the flexible working programme, it was stated that initially it was important to measure how many staff made use of the arrangements and how satisfactory they found them. But over time it would be important to map how many staff that had a flexible working arrangement had progressed in the Bank. That would be a critical measure of success rather than how many people used the arrangements. In response, it was stated that staff had been surveyed about the new program and the response had been positive. Notably, there was a greater sense that it was possible to have a part-time career at the Bank, rather than simply a part-time job.

It was asked if the new arrangements had caused any problems in the context of the extra work demands during the financial crisis. In response, it was noted that the staff survey had indicated that some staff had not been able to take as much advantage of the arrangements as they might have done, and many managers had said there was scope for more flexible working. It was also noted that many staff had worked very flexibly to the Bank's benefit over the past fifteen months, in part because there was a framework that demonstrated to them that the Bank would be flexible in return. Directors were reminded that the Bank had introduced a new discretionary leave policy that could be used if staff had been working longer hours and more days than they would normally.

It was noted that the Bank continued to employ relatively few people from ethnic minorities and those that had been employed tended not to stay very long. It was acknowledged that ethnic minorities remained relatively poorly represented in the Bank. There was no uniform reason. At an individual level, there had been some issues around poor performance over the past year. The Bank was monitoring the situation carefully. It was stressed that it would be important to establish why the Bank was not attracting and retaining staff from ethnic minorities. It was also noted that the relative absence of black employees was a feature of the City more generally.

It was asked how the Bank considered the issue of the age profile of staff and age discrimination issues in view of recent legislation and wider trends across society, such as increased life expectancy and the need or desire for older workers to continue in employment for longer. In response, it was stated that the issue had not been investigated thoroughly. The Bank had had an early retirement culture which would be wound down over the next year. Some members of staff had opted to work beyond the pension age of sixty although the numbers were not yet large. It was noted that the issues had been fully discussed at NedCo in the context of the Bank's pension reforms in 2006. The Bank was committed to regularly reviewing the retirement age for the pension scheme to ensure it was adapted to changes in life expectancy and it was hoped that staff joining the Bank under the new arrangements would view their working life extending beyond sixty.

It was stated that it was important for the senior management team to engage with the issue in addition to having a senior champion so that staff understood and followed the agenda. It was asked how often the Executive Team reviewed statistics on diversity and if individuals had specific objectives relating to diversity and recruitment. Referring to the Bank's silver award, it was also asked what the Bank would need to do and demonstrate to achieve a higher award.

A question was raised about the nature of the dialogue and negotiations with the union in view of the fact that staff might pull in different directions on some of the issues concerning flexible working. In response, it was stated that the relationship and discussions with the union had been and remained very constructive – the union were enthusiastic for the type of changes that the Bank was trying to achieve. There had been concerns about some aspects of the flexible working framework but they had been dealt with. In addition, the union had been particularly active with the disability work.

In summary, it was stated that the position was encouraging with some identifiable improvements. Directors had made a variety of comments and suggestions for the Bank to consider further.

ITEMS FOR INFORMATION

11. MPC report to Court

Noted.

It was reported that the Bank had established a small dedicated team of economists to work on issues relating to the operation of monetary policy in an environment where Bank Rate was close to or at zero – so-called quantitative easing. The aim of the group would be to ensure that the MPC had the capability to operate monetary policy in such an environment. Detailed discussion with the MPC would commence early in the New Year. The work had meant some other research projects had been curtailed for the time being to free resources.

12. Health and safety – bi-annual update

Noted.

In response to a question, it was stated that new staff received a comprehensive presentation on health and safety issues at Debden.

Any other business

None.

The meeting of NedCo was closed.

MEETING OF THE COURT OF DIRECTORS

Wednesday 10 December 2008

Present:
The Governor
Sir John Parker, Chairman, NedCo
Charlie Bean, Deputy Governor – Monetary Policy
Sir John Gieve – Financial Stability
Mr Barber
Mr Roger Carr
Ms Amelia Fawcett
The Hon Peter Jay
Prof David Rhind
Ms Susan Rice
Mr Arun Sarin
Mr James Strachan
Lord Turner
Mr Geoffrey Wilkinson

Absent
Sir Andrew Likierman, Dr David Potter and Mr Bob Wigley

Also attending:
Mr Bailey, Mr Dale, Mr Footman, Mr Jones, Mr Tucker and Dame Juliet Wheldon.

1. Minutes – 12 November 2008

Approved.

2. Monetary policy issues

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

3. Financial markets update, strategic priorities, banking reform update, organisation of the Special Resolution Authority, business continuity, banknote contract, diversity

Court noted the discussions in NedCo of the above items.

Any other business

None.

The meeting of Court was closed.