The pursuit of financial stability

In 1992, in the first LSE Bank of England lecture, the former Governor discussed the case for price stability. In 1993's lecture,(1) *the* **Governor** *discusses the Bank's approach to the other main group of central bank responsibilities: preserving the stability of the financial system. The* **Governor** *argues that the close, two-way interdependence with monetary stability means that the preservation of systemic stability is inevitably a matter of concern to central bankers. Financial stability is maintained both through supervision and intervention (the 'lender of last resort' role). The Bank aims to prevent or contain pressures on the system through supervision. The* **Governor** *surveys the evolution of the Bank's supervisory role, and defines the essential task of central banks in supervision as to preserve the system's stability without unduly constraining the ability of financial businesses to service the wider economy. Systemic supervision sits comfortably with newer responsibilities to protect the interests of the depositors in individual institutions. The* **Governor** *moves on to explain the key questions the Bank considers when deciding whether and how to intervene in its role as lender of last resort, and considers the experience of recent cases. He says that it may often be necessary to conduct specific operations in secret, and so it is important that the Bank should explain the basis of such operations; he outlines the principles that guide decisions on intervention.*

A year ago, my predecessor as Governor inaugurated this series of lectures with a discussion of the case for price stability. Tonight I have the different, but related, theme of financial stability, the stability of the institutions that make up the financial system. In this lecture, the word 'crisis' will crop up almost as much as 'stability'. On the whole, I dislike the word crisis: its supply has increased too fast, and so has its velocity of circulation. But that much-devalued word does properly describe what can happen when pressure in a financial system gets out of hand. No central banker can be relaxed about that danger, but I hope you will be able to relax this evening, while you listen to me worrying.

What I will be dealing with is practical reality, of the kind that makes headlines and moves markets. The developing country debt drama, the US Savings and Loans saga, the worldwide stock market crash of 1987, the Drexel Burnham affair, the tensions affecting banks abroad, from the United States to Japan and Scandinavia, the strains on small banks here in the United Kingdom: all these are recent examples of financial pressure, and all raise questions about how central banks can and should respond.

Tonight I will not just list the questions; I will also try to answer them, by explaining the principles that guide us through the minefield of incomplete information and uncertain consequences. These principles are often misunderstood. I daresay that is largely our own fault; we have typically been very coy about this area of central banking. That is a pity: the powers of central banks carry with them a duty to account for how they are used. It is in that spirit that I offer you these thoughts.

Why financial stability matters

Let me begin with a basic point: why should I, as a central banker, think that financial stability matters?

My answer to that is that monetary stability cannot be divorced from financial stability. The line that leads from monetary policy to the health of the financial system is pretty clear, so let me deal with that first. Abrupt or unexpected shifts in monetary conditions are a potent cause of financial disorder. The most recent stresses in the world's financial system stemmed largely from rapid growth in credit during the mid and late 1980s, which in time produced excessive demand, rising inflation, including a big inflation of asset values, and finally—inevitably—a sharp change in policy. The need to tighten policy was beyond doubt. But the effects—much higher interest rates—were enough to invalidate many of the assumptions which had seemed to justify the earlier rapid increase in lending and borrowing. The result was painfully clear: many marginal borrowers, who had geared up quite easily during the boom, were unable to meet their servicing commitments or to renew short-term loan facilities. And the corresponding fall in the asset and collateral values of the banks and other financial intermediaries threatened some of them as well.

I could, of course, develop this theme, but I hope I have said enough to acknowledge that financial instability can often be born of official misjudgment: *nostra culpa*—though, in mitigation, I should point out that we are never short of willing accomplices. Without doubt, the main thing that central banks can do to ensure financial stability in the sense

(1) Delivered on 18 November.

of tonight's lecture is to maintain monetary stability in the sense of last year's lecture.

Now let us consider the line that runs the other way, from financial health to monetary policy. Here, central banks have several concerns, one of which has to do with their own effectiveness. They operate through firms and markets to transmit monetary policy to the real economy. If those firms and markets are unstable, then the policy itself will be less effective than it might be.

But that concern needs to be seen in a wider context, which comes from the essential characteristics of banks as providers of monetary intermediation to the rest of the economy. On one side, the liquid liabilities of banks, and building societies, are money. One can argue about degrees of moneyness, but for my purposes now it may be enough that people regard a deposit as money because it can normally be used to make payments or turned into an obligation of the central bank. On the other side, the banks are still the overwhelming providers of finance to the rest of the economy. Their loans are illiquid, so—because their liabilities are largely liquid—they are taking a risk. This willingness to take on the risk of maturity transformation is a main source of the value added of the banking system. Competition will mean that some institutions expand at the expense of others, and for the efficiency of the system it is vital that they should. Occasionally, a particular bank will find the competition so tough that it fails, without any serious implications for monetary stability in the macroeconomic sense.

Those sorts of failures are essentially isolated hiccups. They can happen but, before they do, the central banker always has to consider the possibility that the failure will spread, affecting other banks. The reasons are plain: a loss of confidence might be contagious, and some of the liabilities of one bank are almost bound to be the assets of another. Through the interbank market, banks are substantially exposed to each other; and the interbank market is enormous—roughly £654 billion in the United Kingdom alone.

This explains why a financial failure *can* be quite unlike an industrial failure. If a shoemaker goes bust, there is no particular reason to think that other shoemakers will also fail. In fact, they will expect to attract more business. But if a bank fails, things may be quite different. Although it is true that some visibly stronger banks may benefit, others may fall under a cloud of suspicion, either because their businesses are linked through the interbank market or because the problems one has encountered are presumed to affect others with similar assets or liabilities. The foundation of the banking system is credit; yet a banking failure may mean, in Bagehot's words, that 'instead of credit, there is discredit'. Unlike with shoemakers, the liabilities of banks are typically short-term, often callable on demand. Their assets are longer-term, and generally have no ready market; this makes it extremely difficult to realise them quickly, at least not without paying a large penalty.

All these features mean that panic can be quick to spread and, once it has taken hold, hard to halt.

The potential for such contagion has increased with the evolution of the financial system. Crises can spread not just from bank to bank, but also from country to country. And today it is not only banks that can cause difficulties. A major international securities house, for example, can take large positions in many markets. Although in theory these assets may be self-liquidating, in an atmosphere of crisis the counterparties of the securities house may take fright. Then financial markets are disrupted, and the effects feed through to undermine the normal workings of all commercial life.

As the potential for contagion has increased, so too have the risks of individual financial failure. All financial firms now operate in a highly competitive environment, encouraged by—and in turn encouraging—better communications and technology and the development of new markets, instruments and techniques. Although many of these changes provide the means of dispersing or diversifying risks, they also allow greater risks to be taken on. And there are obvious dangers that some of the newer risks will not be properly understood or managed, and that they will be mispriced, in an atmosphere where judgments are coloured by a perceived need to build up the book.

I am not complaining about these developments. The financial system has evolved as it has, presumably in response to the needs of the wider economy, which would not be prepared to pay for the services unless it found them useful. I simply want you to understand the nature and complexity of the challenge that confronts us.

Meeting the challenge

In meeting this challenge, central banks do not see it as their job to eliminate risks and put the financial system in cotton wool. No doubt the authorities could use their powers to shape the system in that direction. If society wanted a largely risk-free financial system, they could indeed produce one. But this would be only at enormous cost—by constraining financial intermediaries to such an extent that they would be able to provide far fewer of the services to industry and commerce than they do now.

Even well short of draconian controls, *any* intervention by central banks is bound to affect the shape and dynamics of the system. This raises difficult questions about the appropriate balance between risk and stability. We see it as our task to provide a regime in which the users of financial services can benefit from robust competition among financial firms, which will not happen unless each individual firm takes on some risk. But at the same time, we must ensure that there is public confidence in the monetary system as a whole. In short, lots of small uncertainties must add up to an overall certainty.

This is difficult arithmetic, and we achieve it in essentially two ways. First, through supervision: in conjunction with financial regulators, we try to prevent the emergence of general financial pressures. And, second, when such pressures do arise, we try to contain them, through direct central bank intervention, acting if necessary as the 'lender of last resort'. Let me deal with each of these in turn.

The evolution of the Bank's supervisory role

First, prevention. This can take different forms, which are not mutually exclusive. At one end of the spectrum, there is the idea of 'narrow banks', a special class that would be constrained to invest only in high-quality, fully marketable assets, and which alone would be able to join the payment system and have the assurance of official arrangements for deposit protection. Depositors who wished to participate in the returns available from the riskier aspects of banking would then do so through institutions which would be closer to unit or investment trusts.

It is fascinating to speculate about such arrangements and, although I am personally sceptical about how they might work out in practice, we are following the debate with interest. For the time being, as practising central bankers, we have to deal with the markets as we find them.

Moving along the spectrum, there is one area where structural change can realistically reduce risk, and that is in the payment and settlement system. The trend towards real-time gross settlement of large-value payments, made possible by improvements in technology and which will be introduced in this country in 1995, will greatly reduce the involuntary exposures that banks take with one another in the payment system; and the realisation of delivery versus payment in securities and eventually foreign exchange settlements will greatly reduce risks in those markets.

From there, I move on to the familiar end of the spectrum of prevention: the supervision of individual institutions. In this country, supervision grew out of the Bank's direct involvement in markets, an involvement almost as old as the Bank itself. In the nineteenth century, we were the central participant in the bill market, which was itself widely used by industry and commerce as a source of working capital. Like every active market participant today, we needed to know that our counterparties were sound, and that the names on the paper we discounted were of good quality. Disruption to the bill market caused by the failure of a discounter of bills could produce commercial chaos, in the same way as the suspension of all overdraft facilities might do today. So in the financial crises of those days the Bank acted as discounter of last resort, to prevent disorderly conditions. Out of this developed our more specialised role as discounter of last resort to acceptors themselves—as, for example, in the Barings crisis of 1890.

By the early twentieth century, this role of discounter of last resort was fairly well established. The Bank, either on its own account or acting with other banks, supported some small retail banks, including the Yorkshire Penny Bank, Cox's and Kings, and Williams Deacons. Because of this involvement, the Bank then took a direct interest in the financial health of those banks, and had the influence and authority needed to exercise an informal surveillance of their activities. By the 1930s, the Accepting Houses were regularly providing information on their balance sheets to the Bank. All this was just a shadow of what happens today, but a recognisable shadow nonetheless. Our surveillance was informal and non-statutory. It was based on our willingness to recognise a firm's acceptances in our operations, as well as the possibility—never more than that—of assistance, if the firm got into difficulties.

This situation lasted for years, and neither the Bank nor parliament tried to bolster the Bank's role by giving it statutory powers. Even the Bank of England Act of 1946, the main purpose of which was to take us into public ownership, was remarkably vague. It gave us a power to 'make recommendations' to bankers, or to issue directions, but none of this was considered to be a supervisory power. Rather, the Act was seen as justifying the qualitative lending guidance that was part of monetary policy in the 1950s and 1960s.

Statute comes into play

It was the secondary banking crisis of 1973–74 that prompted a new look at the Bank's supervisory role. At a time of acute uncertainty in world markets, a group of unsupervised 'fringe', or secondary, banks in Britain lent too much to the volatile property sector, on a fragile base of wholesale deposits that suddenly melted away. The risk of contagion was there, and growing; so too was the risk that the economy as a whole would be disrupted. In the circumstances, we decided to organise a support operation, with much of the finance coming from the clearing banks. These efforts were successful, in two senses. One, the secondary banks were able to meet their market obligations; two, and more importantly for my present purpose, we managed to avoid any disturbance to the wider financial system. But the episode demonstrated the need for a more formal framework for the supervision of banks, and it led to the 1979 Banking Act. The main feature of this Act was the requirement that all deposit-takers be authorised and supervised by the Bank.

In a sense, the 1979 Banking Act simply recognised and codified the logic of previous extensions of supervision. As we had come to feel responsibility for more and more institutions, so we had taken a closer interest in what they were doing. But in the 1973–74 crisis, we had put a safety net under institutions which were outside this informal surveillance and equally outside our quantitative credit controls. Under the old regime, they were in effect enjoying a free ride at the expense of the major banks and, ultimately, on the back of the Bank of England. That made no sense. Both competitive and systemic considerations meant that these fringe institutions should be subject to the Bank's oversight, and the way to do that was through statutory powers of supervision.

The 1979 Act had another purpose that I should mention. It was explicitly designed to provide a degree of protection for the banks' depositors; indeed, it provided for compensation when a bank failed. Nonetheless, it established the principle that depositors should bear some of the risks if their bank failed. Only 75% of their deposit was eligible for compensation, and only up to a maximum payout of £7,500 for any one depositor. The 75% proportion was retained in the 1987 Act, but the maximum payment increased to £15,000. The scheme is financed by the banks in proportion to their deposits.

This novel emphasis on depositor protection reflected an entirely legitimate social concern. The argument is that small and often financially unsophisticated depositors cannot know enough about the affairs of the whole range of deposit-taking institutions to be able to make informed judgments about their reliability. Small depositors therefore need special protection. But that protection was deliberately —and, in my view, wisely—limited. The intention of the Banking Act is unmistakable. Banks *can* fail and depositors *can* lose some of their money. Otherwise, if depositors were relieved of all responsibility, deposits would simply flow to the highest bidder regardless of risk, which would undermine market disciplines and greatly increase the dangers of instability.

The emphasis on banks

Understood in this way, supervision of individual banks for the purpose of reducing the risk of failure and the risk of depositors losing money sits comfortably alongside supervision for the quite different original purpose of reducing systemic risk. The nature of the supervisory activity is essentially the same, and there is an obvious efficiency in conducting that activity as a single operation. But the objectives are distinct. The central bank's essential task in this area is to preserve the stability of the financial system as a whole, without unduly constraining the ability of financial businesses to service the wider economy. If too much came to be expected of our relatively new role in depositor protection—if, for example, Bank of England authorisation came to be regarded as a guarantee against failure of each individual institution—then our capacity to perform that essential task would be seriously, perhaps fatally, undermined.

So far I have talked mostly of banks, as though they were synonymous with the financial system. But even as extended by the Banking Acts, it is clear that the Bank of England's direct prudential supervision does not cover *all* the financial firms that are systemically important, or even *all* the systemically important *domestic* financial firms. In these circumstances, it is reasonable to ask why we concern ourselves particularly with the stability of the banking system.

The conventional answer is that the line of financial instability will typically run *through* the banking system, even though it may not originate there. This is because the liquid nature of the banks' liabilities leaves them still peculiarly vulnerable to a loss of confidence, and because of the dominant role that the banks still play in the payment and credit systems.

To me, this answer remains essentially valid, even though I recognise that the previously sharp distinctions between different forms of financial intermediation have started to blur over the past decade and more. But it does not mean that the central banker is not vitally interested in what goes on outside the banking system. If I can take one example, the stock market crash of 1987 prompted the closest collaboration between bank and securities regulators nationally, and among banking supervisors internationally, which helped to maintain relative calm. And in another case —the difficulties of Drexel Burnham, a US securities house—we and other central banks had to intervene to assist in closing out Drexel's positions. This involved no risk for us, but it did give some vital assurance to Drexel's counterparties. They were able to pay out money owing to Drexel in one currency, in the knowledge that what was owed to them had already been paid to us in another. In this way, we eased a potential logjam in a number of settlement systems.

This kind of collaboration seems set to grow, and supervisors will need to adapt to reflect evolving market structures.

Protecting the system

Supervision is also a powerful defence against systemic instability. Through setting and monitoring minimum standards for capital adequacy, liquidity and the concentration of risk, we can ensure that banks have a cushion against developing pressures, which gives them time to respond. We also use the supervisory process proactively, to draw attention to pressures often before they hit individual banks and to encourage them to prepare themselves. They can do this by strengthening their liquidity or scaling down their business to the levels of liquidity likely to be available to them.

This was the approach we adopted recently, when some of the smaller banks came under pressure in 1991 and 1992. A measure of its success is that, for the group of 40 banks we thought vulnerable to the contraction of the sterling wholesale markets, their total assets declined by over 25% between end-1990 and end-1992—and yet very few got into actual difficulty.

Lender of last resort

But not all such pressures can be avoided by prophylactic supervision. It is then that we consider acting as 'lender of last resort'.

The phrase itself is liable to cause confusion, so let me first clarify what it does *not* mean. As I have explained already, we do not see it as our job to prevent each and every bank from failing. The possibility of failure is necessary to the health of the financial system, as it is to the efficiency of all other economic activity. If I can quote Bagehot again: 'Any aid to a present bad bank is the surest mode of preventing the establishment of a future good bank.' We need those cautionary words, if only to refute the notion that a bank failure necessarily represents a failure of banking supervision.

But when a bank does seem likely to fail, the central bank must at least consider the option of supporting it. The Bank of England frequently does no more than that: we think about support, but we decide against it. There have in fact been nine bank closures since 1987; and the majority of them proved unable to meet all their liabilities. But there are circumstances when we may decide that, were an institution not to meet its obligations as they fell due, that would pose a serious threat to the financial system as a whole.

I should emphasise here what I believe is a crucial, but often misunderstood, point: if we decide to support a particular bank, it is not because we carry a flag for that bank as opposed to others. Our involvement is not designed to give special protection to its depositors, or to safeguard the positions of its employees, nor is it based on a wish to help its shareholders or management, who should, indeed, expect to be penalised. I am reminded of the wise central bank governor who, confronted by a banker with a tale of woe, replied: 'Thank you for telling me about your bank's problems. I look forward to discussing them with your successor.'

Of course, our support may help the bank and its various stakeholders, but this would be essentially as a by-product of meeting our wider objective. The only issues for us are: (a) what effect the failure of the institution would have on the system as a whole; and (b) what should be done to protect the system from contagion.

In reaching a decision on support, we take care not to be predictable. Central bankers have raised unpredictability to an art form, so that the phrase 'constructive ambiguity' has become rather popular in our circles. But it is essential that no one—no one—should expect support as a matter of course. I often hear it said that some banks are 'too big to fail', that some occupy such key positions that their failure is almost unthinkable. It is, indeed, true that size is an important factor in considering systemic effects. Even so, I have to say that there is *nothing* automatic about our acting as lender of last resort, and even if we did decide on support, no bank should assume that it would be immune from penalty.

In practice, systemic dangers have tended to originate among the smaller banks. The central bank then has to decide how best—that is, with least damage to the financial system—it can stop the rot. There are no hard and fast rules, and there cannot be any. At one extreme, imagine an institution that is in difficulty for internal reasons—poor credit assessment, for example, or weak lending controls or even fraud; and in addition, there is no suggestion of wider financial fragility. In those circumstances, we would consider, *as supervisors*, whether there were possibilities short of closure that would be in the interests of the bank's depositors. But it is highly unlikely that we would intervene as lender of last resort.

At the other extreme, an institution might have had an unexpected loss of either retail or wholesale deposits because of some wider concern; perhaps there were severe financial problems in a particular industry with which that bank was closely associated. If a series of other banks could be affected by those factors, and if those banks had large direct commitments to other banks, then we would be more inclined to conclude that our support was justified. In reality, of course, most cases fall awkwardly between these extremes.

In the case of our recent intervention, we had during 1990 been conscious of growing pressures on a sizable group of smaller banks. They had some retail deposits, but were generally heavily dependent on large wholesale placers of funds: building societies, local authorities, big industrial companies, as well as other banks. All of these were under pressure of some kind and withdrew funds from the wholesale markets. Foreign banks, for example, reduced their sterling claims on UK banks from over $110 billion at end-1990 to less than $76 billion two years later. Meanwhile, the assets of the smaller UK banks were becoming increasingly vulnerable to the recession, particularly as it affected the property values supporting their loans.

In early 1991, three small banks—Chancery, Edington and Authority—closed their doors, after significant loan losses that were followed by a shrinking of their deposits. At that stage, we saw no clear evidence of systemic fragility so we did not intervene.

The wholesale markets continued to tighten. This process accelerated when BCCI was closed later in the year, trapping some large local authority deposits. Meanwhile—and there is always a meanwhile, for banking troubles come in a crowd—there was, quite coincidentally, a run on a building society and growing talk of banks in difficulties overseas.

As I have already mentioned, we had been engaged in prophylactic supervision for some time. But as the bigger picture got more threatening, one particular institution did run into an immediate liquidity crisis: its auditors could not certify that it had enough assurance of liquidity to allow it to continue to trade. It was then that we decided to provide support to that and to a small number of other banks.

It is, of course, impossible to be sure what would have happened if we had not provided support in this, or any other, particular case. It is easy to slip into the position of the man on the train to Brighton who kept snapping his fingers out of the window to keep the elephants away. Since he saw no elephants, his technique was self-evidently effective. But in the early 1990s, we were quite clear that, had we failed to intervene, the pressure would have spread, and we would then have found it harder to stop. It was the first time since 1973–74 that we had offered such widespread support, and it has prompted us to update our thinking on the principles that should guide such operations.

Principles of last resort assistance

The overriding principle is not new, and I have already referred to it several times. Our support, whatever form it takes, is directed to safeguarding the financial system (and therefore preventing damage to the wider economy), not the institution itself. Central bankers have to keep this permanently in the front of their minds, which is why I make no apology for repeating it now.

Beyond that, there are various rules which we apply. *First*, we will explore every option for a commercial solution before committing our own funds. Initially, we will always look to major shareholders to provide support. Short of that, we will encourage the bank to try to find a buyer, for some or all of itself, even at knock-down prices. Or a bank's major creditors may decide to provide support, to protect their own positions. Or there may be a coherent group of other banks with a common interest in an orderly resolution. It is only when these options have been exhausted that we will consider providing support ourselves—and even then we may decide against it, as we did in the case of British and Commonwealth Merchant Bank in 1990.

Second, central banks are not in the business of providing public subsidy to private shareholders. If we do provide support, we will try to structure it so that any losses fall first on the shareholders and any benefits come first to us. And any support we provide will be on terms that are as penal as we can make them, without precipitating the collapse we are trying to avoid.

Third, we aim to provide liquidity; we will not, in normal circumstances, support a bank that we know at the time to be insolvent. Our own capital is not there to be used as risk capital. But it would be wrong to conclude from this that loans or guarantees never involve any risk. Even if a bank is apparently solvent at the time we provide support, it can easily become insolvent later. When we supported the small banks in late-1991, their problem was one of liquidity rather than solvency. As the impact of the recession on their balance sheets got worse, the value of our collateral fell, until eventually we needed to make provisions against possible losses.

Fourth, we look for a clear exit. The company may be required to run down or restructure its operations, under our surveillance, to the point where it can do without our support within a given period. Making the terms of our support as unattractive as possible has the great advantage of encouraging this process. Alternatively the company may be wound down under our management—which is what happened to JMB and, earlier, to Slater Walker and many of the lifeboat banks. We aim to protect the system, not to keep in being unviable banking capacity and so interfere in the market process unnecessarily.

Fifth, we usually try to keep the fact that we are providing systemic support secret at the time. In principle, I am against secrecy for the sake of it. And in this field, there can certainly be circumstances where the markets will be reassured by knowing that we are involved. Very often, however, the opposite is true. If people know that we are so concerned about systemic fragility that we have judged it necessary to provide support, that could lead to a wider loss of confidence. They would wonder how far that support would be extended, and we could rapidly find ourselves in the position where we were in practice underwriting all the liabilities of the banking system. It would then be extremely difficult for us to disengage. We will, as a matter of public accountability, always reveal the fact of our support after the event, when the danger has passed. Even then, it will often be difficult to disclose publicly the details of our support. The full details could weaken even those banks that had succeeded in dispensing with our support.

If we need to provide against possible losses in our accounts, we draw attention to that when the danger has passed. Although we are not required by statute to produce our accounts for parliament on a Companies Act basis, we do so 'in so far as that is appropriate for a central bank'. We aim to make minimum use of this 'in so far' provision, but we did take advantage of it, in not drawing attention to a small provision for our support operations, in our 1991/92 accounts. The Treasury knew of the provision, of course. But it was not until this year, in the 1992/93 accounts—which took account of the latest assessment of the likely costs of the operation—that we judged the small bank sector was again in calmer waters, so that we could reveal what we had done in the storm.

The Bank has a balance sheet of its own, and makes profits on its own account. A large part of our resources are provided by the banking system, through the cash ratio deposits which the banks place with us; we use the income to finance the many activities which help to ensure a sound and well-functioning banking system, and those activities sometimes include support operations. But our money is nevertheless 'public' money in the sense that, if we make provisions that reduce our profit, then our payments of tax and dividends to the Treasury are reduced. Our decisions are decisions of public policy. They are sanctioned by our Court of Directors, who are appointed by the Crown to oversee the affairs of the Bank. They are discussed with the Treasury as our shareholder, but we do not seek formal Treasury agreement. If it were ever necessary to provide support on a scale that would strain our own balance sheet, that clearly would be a matter directly for the Treasury.

Conclusions

The Bank of England's role in preserving financial stability and acting as lender of last resort has tended to be somewhat obscure. I have spoken about it tonight in some detail, because I believe it needs to be properly understood. Although we sometimes have to play it in great secrecy, it is right that we should try to explain what we do and how we do it.

I hope that I have cleared up at least some of the misunderstandings. The central bank has a vital duty to support the soundness of the financial system. We are clear about our objective: it is not to prevent each and every failure, but to ensure that, when a systemic threat arises, it is dealt with quickly and efficiently. We have the ability to do this because we know a lot about all the institutions and markets through which threats can materialise. We get our information largely from the process of supervision—from being a direct supervisor ourselves, and through our involvement in the markets, and through our contacts with other supervisors at home and overseas. And, in our central banking role, we have the resources to do this job—not just money, but also the technical skills to manage out difficult positions, and the reputation for impartiality which enables us to co-ordinate commercial solutions.

I also hope that I have stimulated some of you here tonight to fresh thoughts on this whole topic. I have tried to describe our approach, but I am well aware that the ground on which we stand is shifting all the time. We need to be open-minded about the future, as ready to consider new ideas as we are to accept new market realities.

I conclude as I began. Financial stability, like price stability, is a public good. Central banks must pursue both objectives, because they are mutually dependent. And they must explain their objectives, and account for their performance. What I have said tonight, and what my predecessor said here a year ago, represent an attempt to explain and to account; I hope that, at least in a small way, we have helped to make the Bank of England's role better understood.