Changes at the Bank of England

*In this article, **Peter Rodgers**, Secretary of the Bank of England, outlines the major changes affecting the Bank recently announced by the Chancellor of the Exchequer. These include a new framework for monetary policy—giving the Bank operational responsibility for setting interest rates—and reform of financial services regulation, under which responsibility for banking supervision will be transferred to an enhanced Securities and Investments Board.*

In May 1997 the Chancellor of the Exchequer announced the most important institutional and operational changes at the Bank since nationalisation in 1946.

New legislation, expected to be approved by Parliament early next year, will give the Bank operational responsibility for setting interest rates and will transfer banking supervision to an enhanced Securities and Investments Board. The Bank will remain responsible for the overall stability of the financial system. Responsibility for debt management will be transferred from the Bank to the Treasury.(1)

The Chancellor announced the new monetary policy framework on 6 May, four days after he took office. He described it as a British solution to meet British needs, putting the arrangements for monetary policy on a sound and stable long-term footing. The reforms of monetary policy and supervision will have a profound effect on the functions and internal processes of the Bank and on how it accounts to Parliament and the public.

The Chancellor said that the Bank would have operational responsibility for setting short-term interest rates to achieve an inflation target. The inflation target will be confirmed in each Budget Statement. Without prejudice to this objective of price stability, monetary policy will 'support the Government's economic policy, including its objectives for growth and employment'. The changes establish clear responsibilities for monetary policy, with the Government setting the target and the Bank of England charged with meeting that target.

In extreme economic circumstances, if the national interest demands it, the Government will have the power to give instructions to the Bank on interest rates for a limited period. This power will only be exercised through subordinate legislation approved by Parliament. Publication of the Bank's *Inflation Report* each quarter will become a statutory requirement, as a means of setting out and justifying the Bank's analysis of the economy, and of explaining how the Bank intends to meet the inflation target and support the Government's economic policy.

The Bank's operational decisions on interest rate policy will be made by a new Monetary Policy Committee (MPC), comprising the Governor, the Deputy Governor, a second Deputy Governor who will be formally appointed when the new legislation has been passed,(2) and six other members. Decisions on interest rates will be made by a vote of the MPC, with each member having one vote. The Governor will have a casting vote if there is no majority. A representative of the Treasury will attend meetings of the MPC and may contribute to the discussion, but has no vote.

Under the proposed legislation, two members of the MPC will be appointed by the Governor, after consultation with the Chancellor, to take full-time executive responsibility for the Bank's monetary policy functions. Their appointments will be for three years. Four members will be appointed by the Chancellor, also for three years, and they will be recognised experts in their field. The intention is that eventually these six members of the MPC will be appointed on a rolling basis, two per year. There will be no limit to the number of terms a member can serve.

The Governor and the Chancellor agreed to establish immediately an interim MPC. Until the new legislation comes into force, all aspects of the new procedures for making and announcing decisions on monetary policy will operate *de facto*. On 14 May the governing body of the Bank, Court, appointed two Executive Directors of the Bank, Mervyn King and Ian Plenderleith, to the interim MPC. On 2 June, the Chancellor announced the names of a further four members of the MPC, who were subsequently appointed formally by Court as part of the agreed interim arrangements. When the legislation has been passed, the four will be reappointed by the Chancellor as Bank officials, but they will be allowed to engage, with the permission of the Chancellor, in outside activities that do not represent a conflict of interest.

Two of the members announced by the Chancellor joined the MPC immediately and were present at the meeting on 5–6 June, which made the first decision by the independent Bank to change interest rates. They are Professor Willem Buiter, Professor of International Macroeconomics at

(1) The main relevant documents are attached as annexes to this article: the Chancellor's letter to the Governor, the Chancellor's statement on the Bank of England, and an extract from the Chancellor's speech at the Mansion House.
(2) The existing legislation, the Bank of England Act 1946, makes provision for the appointment of only one Deputy Governor.

Cambridge since 1994 and a Professor at Yale from 1985–94, and Professor Charles Goodhart, the Norman Sosnow Professor of Banking and Finance at the London School of Economics since 1985, who worked previously at the Bank of England for 17 years.

The other two members are Sir Alan Budd, Chief Economic Adviser at the Treasury since 1991, who was Group Economic Adviser at Barclays Bank from 1988–91 after 14 years at the London Business School, and Dr DeAnne Julius, Chief Economist at British Airways since 1993 and Chief Economist at Royal Dutch Shell from 1989–93. Dr Julius will join the Bank on 1 September and Sir Alan Budd will join later in the autumn when he retires from the Treasury.

On 31 July, it was announced that David Clementi, vice-chairman of Kleinwort Benson Group, will become Deputy Governor from 1 September, succeeding Howard Davies. He will support the Governor on financial stability issues and will be responsible for the day-to-day running of the Bank. It was also announced that, following the passage of the Bank of England legislation, it will be recommended to the Queen that Mervyn King will become the Deputy Governor supporting the Governor on monetary policy issues.

MPC meetings and pre-meetings

The MPC will normally meet on the Wednesday afternoon and Thursday morning following the first Monday of each month, though this arrangement has been varied for September. At the Wednesday meeting, the MPC will identify and discuss the important underlying issues, and any tactical considerations. The Thursday meeting will decide on any necessary policy action. Decisions will be announced at noon, immediately after the Thursday meeting. In addition, the MPC will meet for a whole day shortly before these meetings to be briefed by Bank staff on the latest developments. Three of the Bank's Agents will attend the pre-meetings, to provide regional input.

The MPC will be supported by the whole range of the Bank's monetary, economic, statistical and market expertise, supplemented by intelligence from the Bank's network of twelve regional Agencies, which covers the whole country. The non-executive members of Court and the Bank's wide range of industrial, commercial and financial contacts will provide further input. The MPC will be closely involved in preparing the quarterly *Inflation Report*, contributing both to analysis and forecasting.

The dates of the Thursday meetings for the rest of the year are 11 September, 9 October, 6 November and 4 December. Decisions taken by the MPC will be announced on the wire services' Bank of England pages.

The MPC meets monthly, and its decisions are announced immediately after the meeting, once the Chancellor has been notified. The minutes of the meetings are published within six weeks, usually on the Wednesday following the subsequent meeting, and in the Bank's quarterly *Inflation Report*. The minutes identify how each member voted, with an explanation of why any individuals voted against the majority decision. They contain a summary of the recent economic developments considered by the committee. The MPC reports to a monthly meeting of Court as part of Court's responsibility to review the performance of the MPC.

The Chancellor also announced plans to set out new terms of reference for Court. The Bank will continue to be accountable to Court for its operations and finances. Court will be reconstituted by the legislation to comprise no more than 19 members. These will include the Governor and his two deputies. All three will be appointed, as now, for five years, by the Queen on the recommendation of the Government. The rest of Court will be non-executive and will be appointed by the Queen on the recommendation of the Government, but for three years rather than the present four. These members will be representative of the whole of the United Kingdom; they will be appointed for their expertise, and drawn widely from industry, commerce and finance.

The non-executive members will be responsible for reviewing the performance of the Bank as a whole, including the MPC. They will have particular regard to whether the Bank is collecting proper regional and sectoral information for the purposes of monetary policy formation, and they will continue to be responsible for ensuring that the internal financial affairs of the Bank are properly conducted.

The Chancellor said that accountability would be enhanced by a fully transparent decision-making process on monetary policy, through the arrangements for appointing Court and the MPC, and by the Government's overall accountability to Parliament for economic policy, including the inflation target that the Government sets. The Bank will make reports and give evidence to the House of Commons through the Treasury Select Committee. There will also be a debate in Parliament on the Bank's *Annual Report* each year.

The Chancellor said that the Government would be responsible for determining the exchange rate regime, but the Bank would have its own separate pool of foreign exchange reserves to use at its discretion to intervene in support of its monetary policy objective. If the Government gave instructions, the Bank, acting as its agent, would intervene in the foreign exchange markets by buying or selling the Government's reserves, as it does now. All such intervention would be automatically sterilised.

The Chancellor also announced two other changes at the Bank. He proposed that the Bank's role as the Government's agent for debt management, in selling gilts, overseeing the gilts market and in cash management should

The inflation target

The Chancellor announced on 12 June that he was setting the Bank a target of 2.5% for retail price inflation, excluding mortgage interest payments (RPIX). The previous target was set at '2.5% or less'. The Treasury commented in notes on the inflation target and the remit for the MPC, published on 13 June, that this ambiguity had caused confusion because it could have been interpreted as setting a ceiling for the Government's aspirations, but no floor. The target will be confirmed in each Budget, but the Treasury said that it expected the same target to remain in force for at least the current Parliament.

As Chairman of the MPC, the Governor is required to write an open letter to the Chancellor if inflation strays by more than 1% either side of the 2.5% target. The letter would refer as appropriate to the *Inflation Report*, and explain why inflation was adrift, how long the divergence was expected to last, and the action taken to bring it back on course. The Chancellor has, however, made clear that this is not to be seen as a target range for inflation. A deviation of 1% either side of 2.5% simply provides trigger points for a letter.

The new inflation target makes clear that, in setting policy, the Bank is to aim consistently at 2.5% as a mid-point. Operationally it implies that, with a balanced distribution of risk, there should be an even chance of an outturn either above or below 2.5% at the end of the two-year forecast horizon. The measure of the Bank's success will be how close it comes to 2.5% on average over time.

be transferred to the Treasury. The financial arrangements of the Bank will be reviewed to ensure that they are in line with the new responsibilities, with appropriate standards of accountability and transparency.

On 20 May, two weeks after announcing operational independence for the Bank in setting interest rates, the Chancellor proposed that the Treasury should start work on legislation to simplify and reform the regulatory structure by ending the two-tier system that splits responsibility between the Securities and Investments Board (SIB) and the Self Regulatory Organisations. He said that this system was inefficient, confusing for investors and lacked accountability and a clear allocation of responsibilities. As part of the consolidation into a single regulatory body, responsibility for banking supervision will be transferred to the enhanced SIB. This transfer will be included in the Bank of England Bill.

The Chancellor said that the Governor would be fully involved in drawing up the detailed proposals. The Bank will remain responsible for the overall stability of the financial system, with the enhanced SIB responsible for prudential supervision and for conduct of business rules. He also announced that Howard Davies, Deputy Governor of the Bank, had agreed to be the first chairman of the enhanced SIB, replacing Sir Andrew Large, who stepped down at the end of July.

On 18 June, the Securities and Investments Board announced a project team to assist in establishing the new regulatory body. The team comprises representatives from the Bank, the Investment Management Regulatory Organisation, the Personal Investment Authority, the Securities and Futures Authority and the SIB. The team was asked to prepare a plan to be submitted to the Chancellor by the end of July.

Annex 1
Letter from the Chancellor to the Governor: 6 May 1997

Dear Governor

The new Monetary Policy Framework

Improving the institutional arrangements for economic policy will be accorded a high priority by the Government in order to deliver long-term economic stability and rising prosperity. Our Manifesto commitment is to 'ensure that decision-making on monetary policy is more effective, open, accountable and free from short-term political manipulation'. The reforms I lay out below will put the arrangements for monetary policy-making on a sound and stable footing for the long term.

Within its overall responsibility for economic policy, including stability, growth and employment, and for setting the inflation target, the Government intends to give the Bank of England operational responsibility for setting interest rates. The Government plans to provide in the Queen's Speech for legislation to amend the Bank of England Act 1946. The Bank will of course remain in public ownership. The legislation will set up the new monetary policy framework, and provide for greater accountability. It is my intention to ensure the passage of this legislation as soon as possible.

This letter sets out how the new arrangements for monetary policy-making will work and how I propose that we manage matters during the transition.

1 The New Framework

(i) Objectives of the Bank of England

Price stability is a precondition for high and stable levels of growth and employment, which in turn will help to create the conditions for price stability on a sustainable basis. To that end, the monetary policy objective of the Bank of England will be to deliver price stability (as defined by the Government's inflation target) and, without prejudice to this objective, to support the Government's economic policy, including its objectives for growth and employment.

(ii) The Inflation Target

The Bank will have operational responsibility for setting short-term interest rates to achieve an inflation target which the Government will determine. This target will be confirmed in each Budget Statement. The Bank will be required to publish a quarterly *Inflation Report* in which it will account for its monetary policy actions, set out and justify its analysis of the economy, and explain how it intends to meet the Government's inflation target and support the Government's economic policy.

The legislation will provide that if, in extreme economic circumstances, the national interest demands it, the Government will have the power to give instructions to the Bank on interest rates for a limited period. This power is in line with practice in other countries, and could only be exercised through subordinate legislation approved by Parliament.

(iii) Exchange Rate Policy

The Government will be responsible for determining the exchange rate regime. The Bank will have its own separate pool of foreign exchange reserves which it may use at its discretion to intervene in support of its monetary policy objective.

If the Government so instructs, the Bank, acting as its agent, will intervene in the foreign exchange markets by buying or selling the Government's foreign exchange reserves. All such intervention will be automatically sterilised.

(iv) Governor and Deputy Governors

The Bank will be managed on a day-to-day basis by the Governor and two Deputy Governors. One Deputy will support the Governor on monetary stability and the other will support the Governor on financial stability. The Governor and Deputy Governors will be appointed according to the existing procedure and for five-year terms.

I am grateful to know that you are willing to allow the current contracts of yourself and your Deputy Governor to run their course. The second Deputy Governor will be appointed once the legislation has come into force, at which point the division of responsibilities will take effect.

(v) Monetary Policy Committee

Operational decisions on interest rate policy will be made by a new Monetary Policy Committee comprising the Governor, the Deputy Governors and six members. The decisions will be made by a vote of the Committee, with each member having one vote. If there is no majority, the Governor will have the casting vote. The Treasury will have the right to be represented in a non-voting capacity.

Two of the members will take management responsibility for monetary policy and market operations, respectively. They will be appointed by the Governor, after consultation with the Chancellor, for three-year terms.

The remaining four members will be appointed by the Chancellor, for three-year terms. They will be recognised experts. They will be allowed to engage, with the Chancellor's approval, in other activities which do not give rise to a conflict of interest.

The intention is to move to a situation where the six members of the Monetary Policy Committee are appointed on a rolling basis (two per year). There will be no limit to the number of terms a member can serve.

The Monetary Policy Committee will meet on a regular monthly basis. Any decisions on interest rates will be taken by the Committee and announced immediately, after the Chancellor has been notified of the decisions and proceedings of the Committee. The meetings will be minuted, and the minutes, including a record of any vote, will be released no later than six weeks after the meeting. The new arrangements for release will be agreed between us and announced this month.

The Monetary Policy Committee will report to a monthly meeting of a reformed Court of the Bank, my proposals for which are set out next.

(vi) Reform of the Court

The legislation will set out the Court's terms of reference. The Bank will be accountable to the Court for its operations and finances.

I propose that the Court of the Bank be reconstituted to comprise no more than 19 members consisting of the Governor, his two Deputies, and 16 non-Executive Members. The Court will be representative of the whole of the United Kingdom. The non-Executive Members will be appointed for their expertise and will be drawn widely from industry, commerce and finance.

The non-Executive Members will be appointed according to the existing procedure and for three-year terms. I do not intend to increase the size of Court beyond its present size, other than the addition of a new Deputy Governor. But, in the first instance, I intend to appoint four new non-Executive Members, as soon as the legislation has come into force. The non-Executive Members will review the performance of the Bank as a whole, including the Monetary Policy Committee. They will have particular regard to whether the Bank is collecting proper regional and sectoral information for the purposes of monetary policy formation. In addition, they will be responsible for ensuring that the internal financial affairs of the Bank are properly conducted.

(vii) The Bank's Financial Arrangements

The financial arrangements of the Bank will be reviewed to ensure that they are in line with the Bank's new responsibilities, and appropriate standards of accountability and transparency.

(viii) Funding

The Bank's role as the Government's agent for debt management, the sale of gilts, oversight of the gilts market and cash management will be transferred to the Treasury.

(ix) Accountability

The changes I propose will enhance accountability by ensuring that the decision-making process is fully transparent, by the arrangements for appointing the Court and the Monetary Policy Committee, and by the Government's overall accountability to Parliament for economic policy, including the setting of the inflation target. The Bank of England will make reports to and give evidence to the House of Commons, through the Treasury Select Committee, on an enhanced basis, and I will write to the Chairman of the Committee.

2 The Transition

It will take some months for this legislation to be enacted. In the meantime, the following arrangements will be put in place.

(i) May Monthly Monetary Meeting

The May monthly monetary meeting will be brought forward to 8.00 am on Tuesday 6 May. It will be held in the normal way. It will be the last such monthly meeting.

(ii) Transitional Arrangements for Monetary Policy

I propose to make the following announcements immediately after the May meeting:

(a) the details of any decision taken at that morning's meeting;

(b) the Government will provide in the Queen's Speech for legislation to give the Bank of England operational responsibility for setting interest rates, and to give effect to the other reforms outlined in this letter;

(c) we have agreed to establish immediately an interim Monetary Policy Committee. You, the Deputy Governor and two of the existing Executive Directors will be members of this interim Committee. In addition, you have asked me to give you the names of four new members of the Committee as soon as is practicable. You will then ask the Court to appoint them as Bank officials. I will subsequently confirm these appointees as members of the new Monetary Policy Committee once the legislation is in force;

(d) during the intervening period until the legislation has come into force, all aspects of the new procedure for making and announcing decisions on monetary policy will operate *de facto*;

(e) in this interim period, you will set policy to meet the Government's inflation target.

I intend to use the Mansion House speech to set out more fully the Government's overall approach to economic policy and how these new monetary arrangements will form part of our wider strategy to improve the performance of the British economy in the long term, and deliver high and stable levels of growth and employment. I am confident that these arrangements will enhance the credibility of UK monetary policy-making.

With best wishes

Gordon Brown MP
Chancellor of the Exchequer

Annex 2
The Chancellor's statement on the Bank of England: 20 May 1997

It has long been apparent that the regulatory structure introduced by the Financial Services Act 1986 (FSA) is not delivering the standard of supervision and investor protection that the industry and the public have a right to expect. The current two-tier system splits responsibility between the Securities and Investments Board (SIB) and the Self Regulatory Organisations (SROs), together with the Recognised Professional Bodies. This division is inefficient, confusing for investors and lacks accountability and a clear allocation of responsibilities. Reform is long overdue to simplify the delivery of financial service regulation, and this was a key commitment in our Business Manifesto. At the same time, it is important to preserve the beneficial aspects of the current Act, including practitioner involvement and differential levels of regulation for wholesale and retail business.

I can announce today that work is to start immediately on the legislation needed to give effect to these reforms. We will introduce a Bill to simplify and reform the regulatory system at the earliest opportunity. I am announcing our intentions in advance to give the SIB and the self-regulating bodies the opportunity to work very closely with the industry on the detailed implementation of our proposals, to ensure the smoothest possible transition to the new regime. I am confident that the simpler system we are proposing will reduce compliance costs, and increase public confidence in the regulatory regime.

But simply reforming the Financial Services Act is not enough in itself. In today's world of integrated global markets, the financial services industry transcends geographical and political boundaries. The regulatory response must meet this challenge. The UK financial services industry needs a regulator which can deliver the most effective supervision in the world.

You cannot ensure the success of British financial services in the 21st century without modernising arrangements for the protection of investors. My reforms are essential to ensure the future confidence of investors, large and small, and the future success of the increasingly integrated financial services industry on which so many British jobs rely.

At the same time it is clear that the distinctions between different types of financial institution—banks, securities firms and insurance companies—are becoming increasingly blurred. Many of today's financial institutions are regulated by a plethora of different supervisors. This increases the cost and reduces the effectiveness of supervision.

So there is a strong case in principle for bringing the regulation of banking, securities and insurance together under one roof. Firms organise and manage their businesses on a group-wide basis. Regulators need to look at them in a consistent way. This would bring the regulatory structure closer into line with today's increasingly integrated financial markets. It would deliver more effective and more efficient supervision, giving both firms and customers better value for money. This would improve the competitiveness of the sector and create a regulatory regime to meet the challenges of the 21st century.

So I have decided to take the opportunity presented by the Bank of England Bill to reform the regulatory system. Responsibility for banking supervision will be transferred, as soon as possible after passage of the Bill, from the Bank of England to a new and strengthened Securities and Investments Board, which will also, as a result of forthcoming legislation take direct responsibility for the regulatory regime covered by the Financial Services Act.

SIB will become the single regulator underpinned by statute. The current system of self-regulation will be replaced by a new and fully statutory system, which will put the public interest first, and increase public confidence in the system.

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

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

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

I have today written to Sir Andrew Large with further details of my proposals. I have placed a copy of this letter, together with my earlier letter to the Governor on monetary policy, in the Library of the House.

I am confident that the new arrangements, taken together, will enhance significantly the credibility of UK monetary policy and improve the workings of the financial markets. That means lower long-term interest rates and higher growth and investment. Indeed, we have already seen long-term interest rates fall by over 30 basis points since my announcement a fortnight ago, reflecting the positive reaction to the new monetary framework.

These reforms are founded on sound economic principles. This is a long-term policy for long-term prosperity. It provides the building blocks for a new economic strategy for monetary and financial stability aimed at enhancing longer term growth and prosperity. I am confident that their success will be reflected in a stronger and more robust economy for the long term.

Annex 3
Extract from the Chancellor's speech at the Mansion House: 12 June 1997

If inflation is 1% higher or, for that matter, lower than the target of 2.5%, then the Governor, on behalf of the Monetary Policy Committee, should write an open letter to the Chancellor.

That letter should explain:

- the reasons why inflation has moved away from the target by more than one percentage point;
- the policy action which they are taking to deal with it;
- the period within which they expect inflation to return to the target;
- how this approach meets the Bank's objectives as set by the government.

Of course, any economy at some point can suffer from external events or temporary difficulties, often beyond its control. Attempts to keep inflation at the target in these circumstances may cause undesirable volatility in output.

But, if inflation is still more than 1% away from the target after three months, I will expect the Governor to write to me again.

Instead of the old procedures that were *ad hoc*, personalised, and could not last credibly for the long term, this government has set in place clear rules, divisions of responsibility and a target supported by tight procedures for monitoring whether it is delivered. It is because there are clear rules and rigour that our approach will command greater confidence.

Over the coming years I want the British economy to enjoy the far greater underlying strength that comes from a base of low and stable inflation.

If we succeed in strengthening the ability of the British economy to sustain growth with low inflation, and if international conditions permit, I would hope to lower the inflation target. But the long-term inflation target of 2.5% I have reaffirmed for the Bank of England today, reinforced by the open letter system, provides the final building block for our new framework of British monetary policy.

The open letter is yet another example of the Government's commitment to a more transparent and accountable system of monetary decision-making.

The committee's performance and procedures will also be reviewed by the reformed court. The Bank will be accountable to the House of Commons through regular reports and evidence given to the Treasury Select Committee. Finally, through the publication of the minutes of the Monetary Policy Committee meetings and the Inflation Report, the Bank will be accountable to the public at large. I believe, in time, our new framework may become a model for other countries to follow.