The Bank of England Act

In this article, Peter Rodgers, Secretary of the Bank of England, outlines the main provisions of the Bank of England Act, which gives legislative force to the major changes to the Bank's structure, powers and responsibilities announced by the Chancellor of the Exchequer in May 1997.[1]

The Bank of England Act received Royal Assent on 23 April 1998 and will come into force on 1 June 1998. It provides a statutory basis for the functions of the Monetary Policy Committee (MPC), which was established as an interim committee following an arrangement set out in a letter from the Chancellor to the Governor dated 6 May 1997.[2] The Act also transfers responsibility for the supervision and surveillance of banks from the Bank of England to the Financial Services Authority. The governance of the Bank itself is changed by the Act, which reforms the constitution, composition and duties of Court, the Bank's Board of Directors. The Act makes new provisions relating to the funding, the accounts and the profits of the Bank, and the collection of monetary statistics by the Bank is backed by legislation for the first time.

The Monetary Policy Committee

In his letter to the Governor on 6 May last year, the Chancellor said that all aspects of the new procedure for making and announcing decisions on monetary policy would operate *de facto* until the new Bank of England Act came into force. The Committee was therefore in a position to take its first decision on interest rates within a month of the announcement that the Bank was to be given operational independence.

The Bank's monetary policy objective, described in the Chancellor's letter, has now been set out formally in the new legislation. The Bank is to maintain price stability and, subject to that objective, to support the government's economic policy, including its objectives for growth and employment. The Treasury is responsible for defining and publishing what it means by price stability, and for specifying the economic policy of the Government. In other words, the Government sets the inflation target and the Bank takes the operational decisions required to reach it.

The Chancellor announced on 12 June 1997 that he was setting the Bank a target for retail price inflation excluding mortgage interest payments (RPIX) of 2.5%, rather than the previous formulation of '2.5% or less'. 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. These detailed provisions relating to the inflation target are not contained within the Act itself.

However, the legislation does specify that the Treasury must publish a statement on its price stability objective and on the Government's economic policy within seven days of the Act coming into force, and thereafter at least once every twelve months.

The Act establishes the MPC as a committee of the Bank, and gives the Committee the responsibility for formulating and implementing monetary policy. It also sets out the composition of the MPC, which will comprise the Governor and two Deputy Governors of the Bank, two members appointed by the Bank after consultation with the Chancellor, and four members appointed by the Chancellor. Of the two members appointed by the Bank, one will be the executive responsible for monetary analysis within the Bank, and the other the executive responsible for monetary operations. A Treasury observer may attend meetings and speak, but not vote. The legislation says that the four external members appointed by the Chancellor (who become employees of the Bank) must have knowledge and experience 'relevant to the Committee's functions'.

The Treasury is given reserve powers to give orders to the Bank in the field of monetary policy, but the Act states that this is only if the Treasury is satisfied that they are required in the public interest and by 'extreme economic circumstances'. The Act also specifies a number of detailed operational and reporting procedures for the MPC. It says that the MPC must meet at least monthly, must publish its decisions as soon as practicable and must publish minutes of its meetings within six weeks (though there are provisions for delaying publication of information on market intervention by the MPC in certain circumstances). The minutes must record the votes of members, each of whom has one vote, but in the event of a tie the Governor, as chairman of the MPC, has a second, casting vote. The MPC is responsible under the legislation for approving the Bank's quarterly *Inflation Report*, and is closely involved with Bank staff in the preparation of the forecasts for the *Report*. Finally, the collection of statistics by the Bank for monetary policy purposes is to be backed by legislation for the first time.

Outside the specific provisions of the Act on such matters as structure and reporting, the MPC is free to set its own procedures, including the organisation of its programme of

(1) These changes were set out in an article on pages 241–47 of the August 1997 *Quarterly Bulletin*.
(2) The letter was published in the August 1997 *Quarterly Bulletin*, pages 244–45.

MPC membership

Professor Willem Buiter of Cambridge University and Professor Charles Goodhart of the London School of Economics were nominated by the Chancellor to join the MPC as external members, and appointed by the Bank in time for the first meeting on 5 and 6 June 1997. The other members of the Committee who attended the first meeting in June 1997 were the Governor, the Deputy Governor (at the time Howard Davies, now chairman of the Financial Services Authority), Mervyn King, Executive Director for Monetary Analysis, and Ian Plenderleith, Executive Director for Monetary Operations.

Two further members announced by the Chancellor took up their positions later in the year; Dr DeAnne Julius, previously chief economist at British Airways and now full-time at the Bank, joined in September. Sir Alan Budd, Chief Economic Adviser at the Treasury, acted as a Treasury observer at a number of meetings of the Committee until he retired from his post in November, and joined the MPC in time for its December meeting. David Clementi, appointed as Deputy Governor to succeed Mr Davies when he left for the FSA, joined the MPC in September. Finally, John Vickers, Drummond Professor of Political Economy at Oxford University, joined the Bank part-time on 1 April 1998 and will be full-time from 1 July. Mr Vickers succeeds Mr King as Executive Director for Monetary Analysis. He will join the MPC when the Act comes into force, bringing its membership to the full complement of nine. The Government has said that it intends to recommend Mervyn King to the Queen for appointment as a Deputy Governor when the legislation comes into force, and he will therefore remain a member of the MPC.

work. For example, the Committee has decided to hold an intensive all-day briefing of its members by the Bank of England's professional staff on the Friday before the monthly interest rate meetings. This 'pre-meeting' includes input from the Bank's twelve regional Agents, three of whom are asked to give a presentation each month. During the summer of 1997, the MPC met to consider a number of other operational matters, including its relationship with the press and the public. It was decided to institute a period of purdah each month, lasting eight days, from the Friday before the interest rate announcement—which is normally made on a Thursday—to the Friday immediately following, inclusive. During this period, MPC members will not normally make any public statements relating to monetary policy. In *Inflation Report* months, purdah is extended to the following week, to the morning that the *Report* is published. Since August 1997, the press conference on the *Inflation Report* has been televised live.

In his letter dated 6 May 1997, the Chancellor set out a framework for accountability of the MPC, including regular reports and evidence to the Treasury Select Committee (TSC). These arrangements for accountability through the TSC do not stem directly from the new legislation but are a matter for Parliament. In a further development, in October 1997 the TSC published its own report on the accountability of the Bank of England, which led to an announcement in February that it would hold hearings on the appointments of MPC members.

The Act does contain a number of provisions that relate to the accountability of the MPC. The Committee is to submit a monthly report on its activities to Court of the Bank. Court must, through a sub-committee comprising all the Non-Executive Directors, keep under review the procedures followed by the MPC. This includes ensuring that the MPC collects the regional, sectoral and other information necessary for formulating monetary policy. (The Non-Executive Directors' responsibilities are described in more detail later in this article.) Court is furthermore required by the Act to report annually to the Chancellor, who must lay the report before Parliament, including a report by the committee of Non-Executive Directors relating to their own responsibilities.

Banking supervision and financial stability

The Bank will retain responsibility for the overall stability of the financial system as a whole. This was set out in a letter to the Governor from the Chancellor on 20 May last year, but is not part of the Act.

The Act transfers to the Financial Services Authority (FSA) the Bank's functions under the Banking Act 1987 and the Banking Coordination (Second Council Directive) Regulations 1992, together with its functions under Section 43 of the Financial Services Act 1986, the Investment Services Regulations 1995, relating to the listing of money-market institutions, and Section 171 of the Companies Act 1989, relating to the listing of those who provide settlement arrangements.

A Memorandum of Understanding (MoU) between the Treasury, the Bank and the FSA,(1) published on 28 October 1997, established a detailed framework for co-operation between the three organisations in the area of financial stability, setting out their respective responsibilities. The MoU provides for the Bank and the FSA to exchange information freely and to consult where their interests interact or overlap. It also establishes a high-level Treasury—Bank—FSA Standing Committee, which will provide a forum where a common position can be developed for emerging problems. To further ensure that each is aware of the other's concerns, the chairman of the FSA, Howard Davies, has become a member of Court, and

(1) Reprinted as an Annex to this article.

Membership of Court

The membership of Court once the Act comes into force will be as follows:

Eddie George (Governor)
David Clementi (Deputy Governor)
Mervyn King (Deputy Governor)
Dame Sheila Masters (Partner, KPMG; designated by the Chancellor to chair the sub-committee of Non-Executive Directors)
Christopher Allsopp (Fellow in Economics, New College, Oxford)
Roy Bailie (Chairman, W&G Baird Holdings)
Andrew Buxton (Chairman, Barclays Bank)
Sir David Cooksey (Chairman, Advent Ltd)
Howard Davies (Chairman, Financial Services Authority)
Graham Hawker (Chief Executive, Hyder)
Frances Heaton (Director, Lazard Brothers)
Sir Chips Keswick (Chairman, Hambros plc)
Sir David Lees (Non-Executive Chairman, Courtaulds; Non-Executive Chairman, GKN)
Sheila McKechnie (Director of the Consumers' Association)
John Neill (Deputy Chairman and Group Chief Executive, Unipart Group)
Bill Morris (General Secretary, Transport & General Workers' Union)
Sir Neville Simms (Deputy Chairman and Group Chief Executive, Tarmac)
Sir Colin Southgate (Chairman, EMI Group; Chairman, Royal Opera House)
Jim Stretton (Chief Executive, UK Operations, Standard Life Assurance Company)

the Deputy Governor responsible for Financial Stability, David Clementi, serves on the FSA board. When the Bank of England Act takes effect, the Board of Banking Supervision will become a committee of the FSA.

The Bank has on its own initiative also established a new internal Financial Stability Committee, which parallels the roles and procedures of the MPC. Relieved of its responsibilities for supervising individual banks, the financial stability role of the Bank is to focus on detecting and limiting systemic financial risk, a standard central bank responsibility. Under the MoU, this involves close monitoring of the financial system infrastructure, particularly payments systems, to detect and advise the Chancellor on any major problems. The Bank will closely monitor economic and financial market developments, as part of an overview of the system as a whole. In exceptional circumstances, it will undertake official financial support operations, to limit the risk of problems affecting individual institutions spreading to other parts of the financial system. The Bank will also oversee the efficiency and effectiveness of the financial sector, particularly its international competitiveness.

Financial Stability Committee

The members of the Bank's internal Financial Stability Committee are :

Eddie George (Governor)
David Clementi (Deputy Governor)
Mervyn King (Deputy Governor)
Ian Plenderleith (Executive Director)
John Vickers (Executive Director)
Alastair Clark (Executive Director)
John Footman (Deputy Director)
Professor Dick Brealey (Adviser to the Governors)

Corporate governance

Until the Act comes into force, the Bank's Court of Directors consists of the Governor, the Deputy Governor and sixteen Directors,(1) up to four of whom may have executive responsibilities in the Bank. Members of Court are appointed by the Crown—Governors for five years and Directors for four years.

When the Bank of England Act comes into effect, the composition of Court will change to comprise the Governor, two Deputy Governors and sixteen Non-Executive Directors, all of whom will be appointed by the Crown—the Governor and Deputy Governors for five years and the Directors for three years. The Executive Directors will cease to be members of Court.

The Bank of England Act provides that Court will meet at least once a month. Court will manage the Bank's affairs, other than the formulation of monetary policy. This will include determining the Bank's objectives and strategy, and ensuring the effective discharge of the Bank's functions and the most efficient use of the Bank's resources. The sixteen Non-Executive Directors of Court will form a sub-committee, whose functions will include reviewing the Bank's performance in relation to its objectives and strategy, monitoring its financial management, reviewing its internal financial controls, and determining the Governor's and Deputy Governors' remuneration and pensions. It will also review the procedures of the MPC (as described above). The Chancellor of the Exchequer has designated Dame Sheila Masters to chair the sub-committee, and to chair Court in the Governor's absence, as provided for by the Act.

The Bank's finances

The Bank's *Annual Report* has been placed on a statutory basis, and is to include a report by the sub-committee of Non-Executive Directors, as described earlier.

(1) One directorship is currently vacant.

The Act also includes a section on cash ratio deposits (CRDs)—money that commercial banks place interest-free with the Bank to finance its operations, until now agreed with the Bank on a voluntary basis. These deposits will become statutory, and will cover institutions authorised under the Banking Act 1987, European bank branches in the United Kingdom and UK building societies. The latter are included in the CRD net for the first time. The legislation includes powers for the Bank to obtain information related to these functions. It also includes a formula under which the Bank's dividend to the Treasury will be 50% of its post-tax profits for the previous financial year 'or such other sum as the Treasury and the Bank may agree'. The Bank is required to keep proper accounts and to prepare a statement of accounts corresponding to those that would be required by the Companies Act (which it has done, in practice, for some years). The Treasury is given power to require the publication of additional information relating to the accounts.

The Bank has handed responsibility for the Government's debt to the Treasury, which set up a Debt Management Office with effect from 1 April 1998. The Government's cash management will also be transferred towards the end of the year (in October). The Chancellor also said on 6 May 1997 that the Bank would have its own pool of foreign exchange reserves to use in support of its monetary policy objectives, in addition to the Government's foreign exchange reserves. Neither of these changes requires legislation.

Annex
Memorandum of Understanding between HM Treasury, the Bank of England and the Financial Services Authority

1 This memorandum of understanding establishes a framework for co-operation between HM Treasury, the Bank of England and the Financial Services Authority in the field of financial stability. It sets out the role of each institution, and explains how they will work together towards the common objective of financial stability. The division of responsibilities is based on four guiding principles:

- clear *accountability*. Each institution must be accountable for its actions, so each must have unambiguous and well-defined responsibilities;
- *transparency*. Parliament, the markets and the public must know who is responsible for what;
- no *duplication*. Each institution must have a clearly defined role, to avoid second guessing, inefficiency and the duplication of effort. This will help ensure proper accountability;
- regular *information exchange*. This will help each institution to discharge its responsibilities as efficiently and effectively as possible.

The Bank's responsibilities

2 The Bank will be responsible for the overall stability of the financial system as a whole which will involve:

(i) stability of the monetary system. The Bank will monitor this, as part of its monetary policy functions. It will act daily in the markets, to deal with day-to-day fluctuations in liquidity;

(ii) financial system infrastructure, in particular payments systems at home and abroad. As the bankers' bank, the Bank will stand at the heart of the system. It will fall to the Bank to advise the Chancellor, and answer for its advice, on any major problem inherent in the payments systems. The Bank will also be closely involved in developing and improving the infrastructure, and strengthening the system to help reduce systemic risk;

(iii) broad overview of the system as a whole. The Bank will be uniquely placed to do this: it will be responsible for monetary stability, and will have high level representation at the institution responsible for financial regulation (through the Deputy Governor (financial stability), who will be a member of the Financial Services Authority Board). Through its involvement in the payments systems it may be the first to spot potential problems. The Bank will be able to advise on the implications for financial stability of developments in the domestic and international markets and payments systems; and it will assess the impact on monetary conditions of events in the financial sector;

(iv) being able in exceptional circumstances to undertake official financial operations, in accordance with the arrangements in paragraphs 11 to 13 of this Memorandum, in order to limit the risk of problems in or affecting particular institutions spreading to other parts of the financial system;

(v) the efficiency and effectiveness of the financial sector, with particular regard to international competitiveness. The Bank will continue to play its leading role in promoting the City. Much of this work will be directed towards improving the infrastructure.

The Financial Services Authority's responsibilities

3 The Financial Services Authority's powers and responsibilities will be set out in statute. It will be responsible for:

(i) the authorisation and prudential supervision of banks, building societies, investment firms, insurance companies and friendly societies;

(ii) the supervision of financial markets and of clearing and settlement systems;

(iii) the conduct of operations in response to problem cases affecting firms, markets and clearing and settlements systems within its responsibilities, where:

(a) the nature of the operations has been agreed according to the provisions of paragraphs 11 to 13 of this Memorandum; and

(b) the operations do not fall within the ambit of the Bank of England defined in paragraph 2 above. (Such operations by the Financial Services Authority may include, but would not be restricted to, the changing of capital or other regulatory requirements and the facilitation of a market solution involving, for example, an introduction of new capital into a troubled firm by one or more third parties.)

(iv) regulatory policy in these areas. The Financial Services Authority will advise on the regulatory implications for firms, markets and clearing systems of developments in domestic and international markets and of initiatives, both domestic and international, such as EC directives.

The Treasury's responsibilities

4 The Treasury is responsible for the overall institutional structure of regulation, and the legislation which governs it. It has no operational responsibility for the activities of the Financial Services Authority and the Bank, and will not be involved in them. But there are a variety of circumstances where the Financial Services Authority and the Bank will need to alert the Treasury about possible problems: for example, where a serious problem arises, which could cause wider economic disruption; where there is or could be a need for a support operation; where diplomatic or foreign relations problems might arise; where a problem might suggest the need for a change in the law; or where a case is likely to lead to questions to Ministers in Parliament. This list is not exhaustive, and there will be other relevant situations. In each case it will be for the Financial Services Authority and Bank to decide whether the Treasury needs to be alerted.

Information gathering

5 Through the exercise of its statutory responsibilities, the Financial Services Authority will gather a wide range of information and data on the firms which it authorises and supervises.

6 The Financial Services Authority and the Bank will work together to avoid separate collection of the same data, to minimise the burden on firms. Where both need access to the same information, they will reach agreement as to who should collect it, and how it should be transmitted to the other.

7 The Bank will collect the data and information which it needs to discharge its responsibilities.

Information exchange

8 This will take place on several levels. The Bank's Deputy Governor (financial stability) will be a member of the Financial Services Authority Board, and the Financial Services Authority Chairman will sit on the Court of the Bank of England. At all levels, there will be close and regular contact between the Financial Services Authority and the Bank. The Financial Services Authority and Bank will establish a programme of secondments between the two institutions, to strengthen the links and foster a culture of co-operation.

9 The Financial Services Authority and the Bank will establish information sharing arrangements, to ensure that all information which is or may be relevant to the discharge of their respective responsibilities will be shared fully and freely. Each will seek to provide the other with relevant information as requested. The institution receiving this information will ensure that it is used only for discharging its responsibilities, and that it is not transmitted to third parties except where permitted by law.

Standing Committee

10 In addition to the above arrangements, there will be a Standing Committee of representatives of the Treasury, Bank and the Financial Services Authority. This will meet on a monthly basis to discuss individual cases of significance and other developments relevant to financial stability. Meetings can be called at other times by one of the participating institutions if it considers there to be an issue which needs to be addressed urgently. Each institution will have nominated representatives who can be contacted, and meet, at short notice.

11 In exceptional circumstances there may be a need for an operation which goes beyond the Bank's routine activity in the money market to implement its interest rate objectives. Such a support operation is expected to happen very rarely and would normally only be undertaken in the case of a genuine threat to the stability of the financial system to avoid a serious disturbance in the UK economy. If the Bank or the Financial Services Authority identified a problem where such a support operation might be necessary, they would immediately inform and consult with each other.

12 Each institution (the 'lead institution') would take the lead on all problems arising in its area of responsibility as defined in paragraphs 2 and 3. The lead institution would manage the situation and co-ordinate the authorities' response (including support operations). The form of the response would depend on the nature of the event and would be determined at the time.

13 In all cases the Bank and the Financial Services Authority would need to work together very closely and they would immediately inform the Treasury, in order to give the Chancellor of the Exchequer the option of refusing support action. Thereafter they would keep it informed about the developing situation, as far as circumstances allowed.

Consultation on policy changes

14 Each institution will inform the other about any major policy changes. It will consult the other in advance on any policy changes which are likely to have a bearing on the responsibilities of the other.

Membership of committees

15 The Financial Services Authority and the Bank will co-operate fully in their relations with international regulatory groups and committees. They will both be represented on the Basle Supervisors' Committee, the EMI Banking Supervisors' Sub-Committee, and on other international committees where necessary. Where only one institution is represented, it will ensure that the other can contribute information and views in advance of any

meeting; and will report fully to the other after the meeting. This will promote co-operation and minimise duplication.

16 The Financial Services Authority and the Bank will keep HM Treasury informed of developments in the international regulatory community which are relevant to its responsibilities.

17 The Financial Services Authority and the Bank have agreed the following arrangements for chairing domestic market committees:

- Sterling Joint Standing Committee: Financial Services Authority.
- Foreign Exchange Joint Standing Committee: Bank of England.
- Derivatives Joint Standing Committee: Financial Services Authority.
- Stock Lending and Repo Committee: Bank of England.

18 The Financial Services Authority and the Bank will each use best endeavours to facilitate contacts by the other with overseas central banks and/or regulators, where necessary to discharge their respective responsibilities.

Provision of services

19 In some cases it will be more efficient for a service to be provided by the Financial Services Authority to the Bank, or *vice versa*, rather than for both institutions to meet their own needs separately. In these cases, service agreements will be established between the two institutions setting out the nature of the service to be provided, together with agreed standards, details of timing, charges (if any), notice periods, and so on. These agreements will in the first instance cover: the provision of facilities (premises, IT etc) during the transitional phase; the provision of analysis on domestic and overseas financial markets; the provision of research; and the processing of statistical information.

Litigation

20 The Bank will retain responsibility for any liability attributable to its acts or omissions in the discharge or purported discharge of its banking supervisory functions prior to the transfer of those functions to the Financial Services Authority and shall have the sole conduct of any proceedings relating thereto. The two institutions will co-operate fully where either faces litigation.

Records

21 The Financial Services Authority will be responsible for the custody of all supervisory records. It will ensure that, within the framework of the relevant legislation, the Bank has free and open access to these records.

Rt Hon Gordon Brown MP
Chancellor of the Exchequer

Eddie George
Governor of the Bank of England

Howard Davies
Chairman, Financial Services Authority