The New Lady of Threadneedle Street

*The **Governor**[1] reviews the new framework for the governance, finances and functions of the Bank set out in the Bank of England Bill and the Memorandum of Understanding agreed between the Bank, the Financial Services Authority and the Treasury.[2] He concludes that this new framework sets out the functions of the Bank more clearly than ever before, defining its responsibilities, the powers to exercise those responsibilities, and the lines of accountability to the Government, to Parliament and to the public at large. The Bank remains a bank, as it always has been, at the heart of the financial system, but it now has a more precise framework for its operations, which is more appropriate to modern times.*

At some point in the next few months the Bank of England will receive a new Charter. The occasion will lack the ceremonial that accompanied the grant of our first Charter in 1694, when the Governors and Directors gathered in a solicitor's office in Lincoln's Inn Fields and swore oaths of allegiance to the King and of fidelity to the Company of the Bank of England. The Charter itself will be a typescript bound with red ribbon—quite unlike the massive illuminated manuscript of the original Charter displayed in our Museum. As a milestone in the Bank's long history, this new Charter is almost as significant as its first; and taken together with the new Bank of England Bill currently before Parliament, it foreshadows a rebirth of the Bank—the New Lady of Threadneedle Street.

Just four days after taking office last May, the Government announced its intention of giving the Bank immediate operational independence in relation to the conduct of monetary policy. A fortnight later, the Government announced a radical reform of the entire structure of financial services regulation in this country. This leaves the Bank with its traditional responsibility for maintaining the stability of the financial system as a whole, but transfers our present specific responsibility for banking supervision to a new, single regulator for the whole of the financial services industry. The Bill now before Parliament legislates for these changes insofar as they affect the Bank, and it also changes the arrangements for the Bank's internal governance and puts our finances on a statutory footing.

The new legislation does not fundamentally alter the Bank's *raison d'être*—our core purposes. The heart of it remains the maintenance of monetary and financial stability, as well as the promotion of the effectiveness and efficiency of the financial system. But it brings new clarity to our responsibilities, and it ensures greater transparency and public accountability in relation to all our activities. It is in fact a radical restyling of the Old Lady. And I should like to introduce you to the New Lady, and explain just what it is that the new-style Bank of England is seeking to do and how we are organised to manage our affairs.

Governance of the Bank

Let me begin at the top, with the changes to our governing body, the Bank's Court—or Board—of Directors. We already have a heavily non executive based board, consisting of myself and the Deputy Governor, four full-time Executive Directors, and twelve Non-Executive Directors. The new Court will be entirely non-executive apart from myself and two Deputy Governors. Court as a whole will set the Bank's strategy, determine its budget and—in the hallowed language of the 1946 Bank of England Act—'manage the affairs of the Bank'. In this sense we remain a unitary board. But under the present Bill, the sixteen non-executive members, as a group, will be given the specific duty of reviewing the performance of the Bank, including the conduct of its financial affairs and the procedures of the Monetary Policy Committee (MPC), satisfying itself, *inter alia*, that the MPC takes proper account of economic conditions in the various regions of the country. The prospective non-executive appointments to Court announced last week include increased representation from the regions, with members from Scotland, Wales and Northern Ireland. The non-executives will have their own chairman, appointed by the Chancellor. The first chairman will be Dame Sheila Masters of KPMG, currently Vice-President of the Institute of Chartered Accountants of England and Wales. The non-executives will be required to report on the Bank's performance to Parliament in a separate section of the Bank's *Annual Report*. The Bank's Remuneration and Audit Committees will, as now, be made up entirely of non-executive members of Court. All of this is in the spirit of the most modern principles of corporate governance.

The Bank's finances

A second important change relates to our finances. In some senses the Bank is like a conventional trading company: we have our own capital and balance sheet, we trade, we make profits, and we pay both tax and a dividend to our shareholder, the Government. But there are also parts of our public policy functions—relating to monetary and

(1) In the Vital Topic Lecture given at the Manchester Business School on Tuesday, 24 February 1998.
(2) See the article on pages 93–99.

financial stability—that, by their nature, cannot be directly charged out to individual beneficiaries of our activities and which we need to finance in other ways. Like other central banks, we therefore take unremunerated deposits from the banking system for this purpose, on which we earn income. Central banks generally levy this charge on the banking—or deposit-taking—sector specifically, because one of the essential services we undertake through our money-market operations is the provision of sufficient cash day by day to the banking system to allow it to balance its books. Without that, the banks collectively would need to hold more cash with the central bank in place of interest-bearing liquid assets than they do at present. These 'cash ratio deposits' in this country have hitherto been voluntary. The new Bill puts them on a statutory footing, with the rate of deposit to be determined by the Government.

The charge on the banks in this form has always been lower than in other major centres. This reflects the fact that the Bank of England is among the lowest-cost central banks in the world—with a fraction of the staff of the Bundesbank, the Banque de France or the Federal Reserve System, even when adjustment is made for differences in function. The charge will certainly now be significantly lower, to reflect *inter alia* the transfer of banking supervision to the FSA. But I recognise that whatever our costs, we need to be accountable for the resources that we use and the burden that we place on the banking system. We shall now be more accountable—to Court, to the Government that will set the charge, to the banks themselves and to the wider public through our *Annual Report*.

The Bank's functions

Below Court, the new Bank will be organised administratively into three main subdivisions, reflecting our responsibilities for monetary stability and financial stability, each under a Deputy Governor, and the third, specifically responsible for all forms of financial market operations, under a senior Executive Director. The central services of the Bank, including personnel and finance, will report to the Deputy Governor, Financial Stability, who will remain responsible for the day-to-day management of the Bank.

The main changes in the Bill affect our monetary stability and financial stability functions, which I shall discuss in turn.

Monetary stability

Let me start with monetary stability—although the new arrangements may be familiar to you, not least because they are in place already! The Chancellor decided last May that he would no longer exercise his powers to set short-term interest rates. Anticipating the Bank of England Bill, he set an inflation target and delegated the technical implementation of monetary policy to achieve that target to the MPC, newly-established within the Bank. The MPC has been operating independently in setting interest rates ever since.

This position is formalised under the Bill. With respect to monetary policy, the Bill defines the Bank's objective as the maintenance of price stability and, subject to that, as supporting the Government's economic policy, including its objectives for growth and employment.

The Chancellor will tell the Bank each year what precisely we are to understand by 'price stability'—he will, in other words, set a specific inflation target. He has in fact initially set a target of $2^1/_2$% for underlying inflation, and although the Bill provides for him to set the target each year, the expectation is that the target is for the medium to longer term. That is the political decision. The task of achieving that target—the technical implementation of monetary policy—is then delegated to the Bank of England. The Government will no longer have the power to issue directions to the Bank in the field of monetary policy (except, in the terms of the Bill, in 'extreme economic circumstances'). Instead, the Bill will formally establish the MPC. This is to be made up of myself, the two Deputy Governors, two Executive Directors of the Bank—responsible respectively for the Bank's economic analysis and the Bank's financial market operations—and four outside members nominated by the Chancellor and having professional knowledge and experience relevant to the Committee's functions. It also includes a Treasury observer, who may participate in our discussions, and acts as a link between the fiscal and monetary authorities, but who may not vote in our monetary policy decisions.

The overriding purpose of these new arrangements is to improve the credibility of monetary policy, and to demonstrate to the world at large the Government's commitment to achieving and maintaining effective price stability. But it is important to understand that this objective is not simply an end in itself. The ultimate objective, of course, is growth of output and employment and rising living standards—there is no question about that. The argument is about means, not about ends. And effective price stability as the immediate objective of monetary policy is a necessary condition for growth to be sustained into the medium and longer term. The aim of achieving permanently low inflation is a deliberate attempt to break away from the boom-bust cycles of the post-war years, which led, as we can all remember, to a persistent ratcheting up of inflationary expectations and a steady erosion of long-term thinking and planning, saving and productive investment on the part of consumers and businesses. By pursuing price stability—by keeping aggregate demand consistently broadly in line with the underlying, structural, supply-side capacity of the economy to meet that demand—we hope to be able to moderate, rather than aggravate, the cyclical swings in output and prices, and to ensure that growth is sustained in the medium term, and is then greater in the long term than it would otherwise be.

The operation of the MPC

That then is what the MPC is trying to do. Let me say a word about our procedures.

On the Friday before our regular monthly decision-taking meeting, the MPC members are given an intensive, all-day briefing by the Bank of England's professional staff on all the latest relevant data and on the staff's analysis. This includes real economic and financial, statistical, anecdotal and survey information and analysis, comparison with the work of outside analysts and commentators, and, importantly, input from our twelve regional Agents, who are in regular contact with all sectors of economic activity across the country.

The (currently eight) MPC members, alone with only a small Secretariat, then reconvene on the following Wednesday afternoon to identify and discuss the key issues and any tactical considerations, before meeting to take and announce their decision the following morning.

This process of regular and systematic assessment, based on the economic and financial data, is unimaginably different from the erratic reaction to financial market disturbances that characterised the conduct of monetary policy too often in the more distant past. And the reflective, interactive debate within the MPC is very different too from the sometimes exaggerated advocacy of a particular viewpoint that inevitably crept into the 'Ken and Eddie show', when the Bank usually had at most an hour in which to persuade a sometimes reluctant Chancellor! The present arrangements allow us to explore, without initially taking hard positions, alternative possible interpretations of the data and their implications; and those discussions capture far better than before the uncertainties inherent in the conduct of monetary policy. It is, I think, how monetary policy really should be made.

Transparency and accountability

With operational independence comes—quite rightly in my view—even greater transparency and public accountability.

The minutes of the two-day meeting at which that decision is taken, together with a summary of the information presented by the staff, are published in the week after the following meeting. Those minutes also record the individual votes of each member of the Committee.

Beyond this, we publish a regular assessment of monetary policy—including a forecast of inflation for the two-year period that we believe is relevant, given the lags between policy actions and inflation outturns—in the Bank's quarterly *Inflation Report*. And the Treasury Select Committee of the House of Commons regularly summons me and other members of the MPC to give evidence on the basis of these *Reports*.

Finally, the Government has made it a requirement that if we miss the target of 2½% by 1% or more in either direction, the Committee must write an open letter to the Chancellor, explaining why, how long we expect to stay adrift from the target, and what we intend to do about it. These arrangements, taken together, provide a framework of transparency and accountability that, as far as I am aware, goes far beyond any that applies elsewhere in the world.

Public understanding of what we are trying to do and why—even understanding that the conduct of monetary policy is not a precise science, but rather a matter of balancing risks—is crucial to our success. And transparency and public understanding should, by influencing public expectations, reduce the costs of maintaining low inflation.

But of course, we need broad shoulders. As you know, the minutes of our January meeting, published a fortnight ago, revealed that the MPC was for the first time divided in its policy decision. That inevitably led to an excited and over-simple categorisation of individual members of the Committee as either hawks or doves. In reality, the division between us was very narrow, reflecting the fact—now acknowledged by most outside commentators—that the decision as to whether or not we shall need to raise interest rates moderately further, sooner or later, is very finely balanced. I hope this is a situation that we shall get used to. I would expect the professional experts on the MPC to agree quite easily when monetary policy is clearly off track, but I would equally expect them to disagree as often as not at the margin, when we are there or thereabouts. As it is, I was actually encouraged by the reaction of many of the more thoughtful commentators, who, in the circumstances, recognised that it was a reflection of a grown-up process that we could publish a division within the Committee and the reasons for it without generating significant market disturbance. In this sense too, I think it likely that once the new arrangements are properly bedded down, they will be seen to be a very considerable advance on what has gone before.

Financial stability

Let me turn now to the Bank's second core purpose, the maintenance of financial stability.

On the same day that the Bank of England Bill was introduced into Parliament, the Chancellor launched the new Financial Services Authority, the FSA, which will become responsible for the authorisation and regulation or supervision of in effect all forms of financial services activity in the United Kingdom.

This is an extraordinarily bold and radical step, not attempted on anything like this scale in any other developed financial centre, and the experiment is being watched with great interest by other central banks and regulators from around the world.

But there are very strong reasons for moving away from the traditional model of a separate regulator for each different type of activity—banking, securities, insurance and so on.

Financial innovation and globalisation, driven by an interactive process of new information technology, competition and deregulation, are, unquestionably, progressively blurring the traditional boundaries between different forms of financial intermediation. So regulation based on particular categories of institution has increasingly become overlaid by functional regulation. That has made the whole regulatory structure increasingly complex, both for the regulated firms and for the public at large.

It has made it increasingly complex for the regulators too! There are no fewer than nine separate regulators joining the FSA. The new organisation may look big and complicated, but I have to tell you that the task of co-ordinating the interests and responsibilities of all those separate regulators, across the business of an increasing number of multi-functional groups, was threatening to become bigger still. Firms with complex financial services activities here in the United Kingdom welcome the idea of a 'one-stop regulatory shop', where at present they have to deal with a bewildering array of different regulators for different purposes. A single, over-arching regulator will mean a clear line of responsibility and accountability, and it should also help to bring about greater consistency of regulatory approach.

In relation to banking supervision in particular, there seem to me to be real advantages in separating out the central bank's responsibility for the stability of the financial system as a whole from the supervision of individual banking institutions. In the latter case, we have seen during the twenty or so years that the Bank has had statutory responsibility for banking supervision how the public policy interest in our activities has increasingly focused on consumer protection. That is not at all a natural habitat for a central bank. It may indeed produce a conflict of interest if it causes the central bank to become over-protective of individual institutions, giving rise to moral hazard in the system as a whole.

We were conscious of these tensions in the 'old' Bank, although we found effective, informal ways of reconciling them.

There are therefore powerful reasons for including banking supervision among the responsibilities that are to be transferred to the FSA. The trick will be to ensure that the Bank's capacity to identify and address emerging 'systemic' financial problems—that is, those that may have a significantly disruptive effect on the financial system as a whole, rather than only on individual financial institutions—is not damaged in the process. And the key to that is that the Bank and the FSA should both have a clear understanding of their respective responsibilities, and that they should continuously work very closely together to ensure that they keep sufficiently out of each other's hair—without letting things disappear between the cracks!

Our relationship was formalised during the summer in a Memorandum of Understanding (MoU) agreed between the Bank, the FSA and the Treasury. This defines our respective responsibilities very carefully, and provides for both the Bank and the FSA to exchange information freely and to consult where our interests interact or overlap. It helpfully establishes a high-level Treasury-Bank-FSA Standing Committee, which will provide a forum where a common position can be developed in relation to emerging problems. And as a further means of ensuring that we are aware of each other's concerns, the Chairman of the FSA will become a member of Court, while the Deputy Governor responsible for financial stability will serve on the FSA Board. In the end, the success of these arrangements will depend upon the working relationships between our respective staff at all levels, and it is helpful in this context that our own supervisory staff are moving to the FSA, which will help to ensure that we establish the right working relationships from the beginning. But we shall need to work at these relationships continuously to ensure that they are embedded into the future.

Systemic risk

Relieved of our responsibility for supervising individual banks—and it is a considerable relief I can tell you—the 'new' Bank can concentrate its energies on detecting and limiting systemic financial risk. That is a responsibility of central banks everywhere, and because it involves close monitoring of economic and financial market developments—nationally and internationally—it fits more naturally and comfortably alongside our responsibilities for monetary stability. This responsibility will be overseen by a new, internal, Financial Stability Committee, which in effect parallels the role and procedures of the MPC.

What we specifically mean by 'systemic risk' is the danger that a failure of one financial business may infect other, otherwise healthy, businesses. This could happen in either of two ways: first, through the direct financial exposures that tie firms together like mountaineers, so that if one falls off the rock face, others are pulled off too; and second, by contagious panic that sweeps everyone off the mountainside like an avalanche. The dangers still relate particularly to commercial banking businesses, because banks are still at the centre of payment and settlement systems, and they are still relatively heavily engaged in the maturity transformation of liquid liabilities into less liquid assets as an important part of their core activity. But it is of course clear, in today's world of global finance, that disturbances with the capacity to inflict systemic financial damage and associated economic disruption can originate outside the commercial banking system.

There are certainly things that we can do to reduce the risks—to try to prevent the first climber from falling off the rock face, or to avoid kicking the rock that starts the avalanche.

A key condition, obviously, is maintaining macroeconomic monetary stability. That goes without saying. It gives everyone on the mountainside much the best chance of coming down unscathed!

We can also turn the new information technology to our advantage, using it to make the linkages between the climbers safer, by reducing the risks in payment and settlement systems. A good deal of our attention on the financial stability side of the Bank is focused in this direction.

And we can satisfy ourselves—through micro-prudential supervision and regulation of individual financial businesses—that the climbers are properly trained and equipped, and fully conscious of the risks. This now, of course, becomes the responsibility of the FSA.

Intervention

But however much we try to prevent accidents, we need to be prepared for them to happen. The Bank's concern then becomes to ensure that they do not spread to other parts of the financial system.

This may involve providing liquidity on penal terms, outside the central bank's normal money-market operations, against high quality assets, to a particular institution that does not want to appear in the market because it is under a cloud. Or it may mean standing between an intermediary and the market-place, to facilitate payments or settlements that might not otherwise be completed, which could then cause gridlock. Such involvement would not normally involve the central bank in significant financial risk.

But in more difficult—and mercifully rare—situations, where the failure of one institution could bring down other, otherwise viable institutions, the central bank may need to consider acting in the role of 'lender of last resort' to the failing institution, against poorer quality, less liquid assets, which might expose the central bank to financial loss.

The key phrase here, of course, is where its failure 'could bring down other, otherwise viable institutions'. The central bank safety net is not there to protect individual institutions from failure. It is there to protect the stability of the financial system as a whole. In the absence of a serious systemic threat, the right course would normally be to allow the institution to fail. If any institution felt that it could rely on being bailed out if it ran into real difficulty, that too would introduce 'moral hazard', encouraging excessive risk-taking and financial fragility in the system as a whole. There can be nothing automatic about 'lender of last resort' assistance, and when it is provided, it should always be on the most onerous terms that the borrower can bear; it is not provided to protect the shareholders, who should be looked to first. Nor is it there to protect the management. 'Lender of last resort' assistance, even when it is extended by the central bank, involves the commitment of public money—ultimately taxpayers' money—and it needs to be justified in terms of the damage that would otherwise result to the financial system and to the wider economy. For this reason, the MoU, to which I referred earlier, provides that the Bank should always seek the Chancellor of the Exchequer's explicit prior approval wherever circumstances allow, or at least his tacit prior approval in emergencies, and where the risks are manageable in relation to the size of our capital. These arrangements ensure that we have the capacity to act to limit systemic damage where that becomes necessary; but they rightly make such intervention subject to appropriate authorisation and accountability, by and to both the Chancellor and Court.

Conclusion

Mr Chairman, we have come a long way in the Bank, even since I first joined it some 35 years ago. We tended at that time to explain our role as being the 'banker to the Government and banker to the commercial and other central banks'. And the truth is that our responsibilities, and the extent of our authority, were never very clear.

Today we remain a bank, as we always have been, at the heart of the financial system, as indeed we must in order to carry out our wider functions. But the Bill, taken together with the MoU that I have described, sets out those wider functions much more clearly than ever before, defining our responsibilities, our powers to exercise those responsibilities, and our lines of accountability to the Government, to Parliament and to the public at large. This is a much more precise framework for the Bank's operations, but one that I am convinced is more appropriate to our modern times.

I was delighted to learn last week that I am to be allowed to continue to walk out with this attractive New Lady of Threadneedle Street for the next five years, and I look forward to the challenge of carrying through the very positive changes now being made to the role and structure of the Bank.