Reform of the Bank of England

A new Bank for a new Governor

James Barty

Policy Exchange

Policy Exchange is the UK's leading think tank. We are an educational charity whose mission is to develop and promote new policy ideas that will deliver better public services, a stronger society and a more dynamic economy. Registered charity no: 1096300.

Policy Exchange is committed to an evidence-based approach to policy development. We work in partnership with academics and other experts and commission major studies involving thorough empirical research of alternative policy outcomes. We believe that the policy experience of other countries offers important lessons for government in the UK. We also believe that government has much to learn from business and the voluntary sector.

Acknowledgements

We would like to thank all of the people who have given us their views on the Bank, its historic performance and what could be done to reform it. We would particularly like to thank Dan Conaghan whose book The Bank (Inside the Bank of England) is an excellent read and a great source of information. This project was also enhanced by the panel debate we had with Sir John Gieve and Andrea Leadsome MP on the future of the Bank, which prompted a number of extra lines of enquiry for us. Finally we would like to thank those who have contributed to the Financial Policy unit at Policy Exchange without whose financial assistance this report could not have been produced.

Published by
Policy Exchange, Clutha House, 10 Storey's Gate, London SW1P 3AY
www.policyexchange.org.uk

ISBN: 978-1-907689-35-2
Printed by Heron, Dawson and Sawyer
Designed by Soapbox, www.soapbox.co.uk

Contents

Executive Summary

The appointment of Mark Carney as the new Governor of the Bank of England is to be warmly welcomed. He has three major advantages: First, he already has experience as a central bank governor, gained during both the heat of the financial crisis and in its aftermath as authorities have attempted to repair the financial system. Second, he has experience of financial markets as well as the world of central banking, so he understands how markets work. Third, he is an outsider and is thus well placed to introduce the type of reforms we believe are necessary if the Bank of England is to succeed with its new, greatly enlarged, responsibilities. However, the appointment of a new Governor is only the first part of the solution to challenges facing the Bank. We believe there needs to be wholesale reform of the Bank, both in culture and structure, if it is to succeed in its new responsibilities given to it by the legislation currently going through parliament.

The new responsibilities derive from the changes made by the current government to overhaul the Tripartite system of financial regulation, which had so clearly failed during the financial crisis. Given that many of these failures stemmed from a lack of coordination between the regulatory authorities, the decision to hand back the responsibility for financial stability and prudential regulation to the Bank of England makes a lot of sense. Bringing those responsibilities together with monetary policy means that those coordination problems should not be repeated. However, the increased responsibility of the Bank of England has not been accompanied by any significant reform of its structure or culture. Nor has there been sufficient attention paid to the institutional failures of the Bank of England in the run up to the financial crisis.

“Increasing the Bank of England’s responsibility without addressing the cultural or structural problems at the Bank is dangerous given the errors it made during the financial crisis and its aftermath”

Increasing the Bank of England’s responsibility without addressing the cultural or structural problems at the Bank is dangerous given the errors it made during the financial crisis and its aftermath, and the flaws rightly identified in the recent independent reviews. It is crucial that this reform is done correctly so that one flawed system of regulation is not just replaced with another.

We believe that for the reforms to be successful, the Bank of England itself has to be reformed. Whilst the Financial Services Bill is a long way through parliament, we do not believe it is too late to change things. Moreover, the government has an opportunity, through the appointment of the new Governor, Mark Carney, to ensure that necessary reforms are carried out. We believe the new Governor should make a commitment to turn the Bank into a modern institution that understands financial markets as well as it does monetary economics.

In this paper, we look at the performance of the Bank of England in the run up to, during and after the financial crisis. The Bank failed to spot the crisis because it paid too little attention to financial markets and the risks that were building there. In theory, the Bank had two equal responsibilities, financial stability and monetary policy. In reality, the focus was almost exclusively on the latter at the expense of the former. Much of this reflects the bias of the current Governor who seems to have paid little heed to financial stability, because he saw the Bank's primary task as one of meeting its mandate on monetary policy. The financial stability wing of the Bank was run down and de-emphasised, with catastrophic results. The strong credit growth, excesses in commercial property lending and over reliance on wholesale funding were all identified but nothing was done to reduce the risk in the system. Equally there was little or no analysis of the implications of the credit boom in the Inflation Report until after the crisis was well under way.

As a result the Bank was too relaxed in the run up to the crisis and too slow to react to when the crisis began. It simply was not prepared for the impact of the freezing up of financial markets with its slow response exacerbating the damage to UK banks (with Northern Rock the most high profile victim). Its monetary response was equally poor. The fact that it put its easing of monetary policy on hold, and even considered tightening, in the summer of 2008 because of concerns about inflation, merely underlines that it did not grasp the enormity of the problems in the financial markets at that time.

While we believe the Bank deserves great credit for how it responded after the failure of Lehmans, by slashing rates to 0.5% and undertaking quantitative easing on a scale never imagined, it has returned to type in recent years and in doing so has hampered rather than aided the recovery. In particular, the Bank has failed to understand that, in the aftermath of a financial crisis, the recovery is almost always slow and protracted. The inevitable deleveraging that followed means that the central bank should have been looking to support the financial system and ensure that credit continued to flow. Instead the Bank sought to remove support from the banks as soon as it was deemed possible and, in its financial stability role, has focused on raising capital requirements and liquidity ratios without considering the impact on credit. These measures together have actually exacerbated the deleveraging and stunted credit growth. In effect it has been tightening credit conditions on the one hand, while trying to loosen them on the other through Quantitative Easing (QE). The net result has been a policy failure with broad money and lending growth in negative territory since 2010.

Despite on-going tensions in the funding markets the Bank stuck by its decision to abolish the Special Liquidity Scheme earlier this year, which inevitably resulted in higher funding costs for banks and lending rates for customers. Only in the summer of this year did the Bank seem to finally realise the error of its ways, announcing the Funding for Lending Scheme to give the banks cheap funding and with the FSA announcing that banks could be more flexible on both liquidity and capital. It is better late than never but it still took some prodding from the Chancellor, who had to add an extra element to the Bank's stability mandate that it should also support the government's economic policy. In other words growth as well as stability had to be considered.

The independent reviews commissioned by the Bank concluded that it was too hierarchical and too inflexible in its approach. In particular they concluded that there was too much focus on moral hazard and not enough on supporting the banking system. Yet this is the institution that the government proposes to give unprecedented power to.

We believe that in order to succeed the Bank needs both structural and cultural change. We would start with the Governor. Many have said that being the Governor of the new Bank is a role too big for one man. As currently constituted we believe it is. Sir Mervyn has acted as Executive Chairman, with almost all decisions ending up with him. We believe that was wrong for a Bank primarily focused on monetary policy, still less for one that also has to look after financial stability and prudential regulation.

We propose instead that the new Governor should be more of a chairman with the day to day running of the different divisions left to the Deputy Governors who would in effect be the CEO's of their divisions. This has two key advantages. First, it means that it becomes the Governor's responsibility to coordinate the Bank across the three areas of financial stability, prudential regulation and monetary policy. Second, it frees the Governor up to represent the Bank in all international fields. This will be particularly important in relation to European Banking Union where the Bank will need to make its voice heard alongside the ECB.

We believe it is vital to have cross communication within the Bank, so we also propose that the Deputy Governors sit on each other's decision making bodies. It is bizarre that the current proposals would mean the Deputy Governor of the Prudential Regulation Authority (PRA) not sitting on the Monetary Policy Committee (MPC). In addition we would like to see a senior executive of the Bank sit on the Financial Policy Committee (FPC) with responsibility for non-bank regulation, covering areas like insurance and asset management. There is a risk that these areas will get missed given all the focus on banks and it is vital that their interests are formally represented. We would also propose a joint meeting of the FPC and MPC once a quarter to ensure policy coordination between the two groups.

"It is bizarre that the current proposals would mean the Deputy Governor of the Prudential Regulation Authority not sitting on the Monetary Policy Committee"

The independent reviews highlighted the tendency for the Bank to follow a house view, with a culture that discourages dissent from that view. We think that the correct way to address this is firstly to ensure that there is a majority of non Bank members on the MPC and FPC, so that the Bank team can be outvoted. There was far too little dissent on the MPC in the run up to the financial crisis and a bigger external membership should ensure more diversity. Secondly, we want to see dedicated teams set up to challenge the mainstream Bank view. This is particularly relevant for the FPC and MPC. The central view of both the financial stability and the monetary policy wings of the Bank proved to be wrong to an unacceptable degree in the financial crisis and there have been more mistakes since. We want teams to think of worst case outcomes and try and pick holes in the core view. Only by formalising a culture of challenge and independent thinking will the institutional flaws be overcome.

Throughout the paper we argue that the Bank is light on experience of financial markets, meaning that increasing the number of external members on the FPC might avoid mistakes going forward. If and when Paul Tucker eventually stands down from his post as Deputy Governor for Financial Stability we would like to see him replaced with an external candidate with financial sector experience. We believe it would be a mistake for all three deputy governors to have spent their careers in the Bank.

We also think the Bank needs to encourage more people with financial markets experience to join the Bank whether in the Prudential Regulation, Financial Stability or Monetary Analysis wings. We would like to see secondments from the City and short term contracts to appeal to such people who might not want a career at the Bank. The Bank in turn should seek to place some of its people into financial firms on secondment. This is vital if the culture of the Bank is to be changed and modernised.

Finally we believe the new Governor should be tasked with a mandate to think imaginatively in supporting the government's policy on growth. We trust that in the discussions with Mr Carney this was made a key component of his new role. Recent comments from the Bank that it may be reaching the limits of what it can do to help the recovery are sadly typical of a conservative institution. The only limit to a central bank's power to stimulate the economy through monetary policy is its imagination. The new Governor should start with a mandate to increase credit flow to the economy by extending the recent moves of the Bank on cheap funding and flexibility on capital and liquidity. If that fails or if there is a major shock to the system, such as a euro breakup, the Bank should be prepared to go into new territory potentially cancelling government debt or buying infrastructure bonds to support growth.

The appointment of a Governor such as Mr Carney is but the first step to ensuring that the Bank of England can live up to its new responsibilities. We believe he is well placed to make the kind of changes within the Bank that we are suggesting. We encourage the Chancellor and the new Governor to work together to bring about a fundamental overhaul in both the structure and culture of the Bank to ensure that it can carry out the tasks it has been asked to perform.

Summary of our proposals for reform

1. The role of Governor in the new Bank is too large a role for one person. **We propose amending the Bank's structure so that the Deputy Governors become the CEO's of their areas, with the Governor taking on a Chairman type role, overseeing the Bank as a whole**. The Deputy Governors would have responsibility for all operational decisions within their areas.
2. The Court of the Bank is not sufficiently robust in holding the Executive of the Bank to account. This was most recently illustrated with the very narrow reviews of the Bank's performance during the Financial Crisis. **We propose removing the Executive from the Court and requiring the Executive to account for its actions on a formal basis every year to the Court**. The Chairman of the Treasury Select Committee would have access to those reviews of performance.
3. The Bank needs to ensure better coordination across its divisions to avoid the gaps in policy that emerged in the Financial Crisis. **We propose that the Deputy Governors sit on each other's decision making bodies**. It is bizarre that the Deputy Governor for Prudential Regulation currently is not intended

to sit on the Monetary Policy Committee. We find it equally bizarre that the MPC and FPC are meant to reach their decisions independent of one another. **We recommend that the FPC and MPC meet jointly once a quarter to ensure that policy decisions are better coordinated**.

4. The Bank has a culture that discourages dissent from the house view. **We propose to address this in two ways. First, we believe both the FPC and MPC should have a majority of external members so the internal Bank team can be outvoted. Second, we propose the establishment of in house teams dedicated to challenging the mainstream view**. Their task will be to think of risks to the core view, examine worst case outturns and make recommendations for policy changes.
5. The Bank's lack of expertise in financial markets has cost it, and the UK economy, dear during the Financial Crisis. **We believe the new Governor should seek to hire people with financial markets experience across the Bank**. We would like to see secondments from the City and people employed on short term contracts to attract those not interested in a career in the Bank. The Bank should seek to place some of its staff on secondment to gain financial market experience. **We also believe that a senior executive should represent the non-bank financial sector on the FPC. Finally we argue that the next Deputy Governor for Financial Stability his successor should also be a candidate external to the Bank**.
6. Finally we believe the Bank has been too conservative in its approach to policy. **The new Governor should be given a mandate to support the government's policy on growth. His focus should be on increasing credit flow to the economy** and should be prepared to go into new territory if existing measures are perceived not to be working.

Introduction

It is easy to understand why the Chancellor, George Osborne, wanted to abolish the Tri-Partite system of regulation that so patently failed during the financial crisis. It is also understandable that he should seek to move the bulk of regulation back under one roof at the Bank of England, as the lack of coordination of financial regulation was a major flaw under the previous system. Yet to do so without reforming the Bank of England risks, in our view, creating another system with fundamental flaws. Merely because the Bank of England used to be responsible for regulation, prior to the introduction of the Tri-Partite system, does not mean it is ready to reabsorb those responsibilities. It was not only the FSA and Treasury that failed to spot the crisis coming, the Bank was equally culpable. Moreover, part of the reason why it failed to see it coming was due to the switch in focus under the current Governor, Sir Mervyn King, towards monetary analysis led by academics with little interest in regulation and away from financial stability.

In this paper we will argue that if the reforms proposed by the Chancellor are to succeed the Bank of England itself needs to be reformed, not just in structure but also in its culture. We believe that the Bank has to be much more welcoming of outside expertise particularly from the financial sector, it has to be much more open to criticism both internally and externally and it has to have a better structure, including an overhaul of its governance. We believe the role of Governor has to change, from that of Executive Chairman as it has been under Sir Mervyn, to one of Chairman of the Board, with the Deputy Governors in charge of Monetary Policy, Financial Stability and the Prudential Regulatory Authority becoming the CEOs of their respective divisions. The Court of the Bank of England as currently constituted is, in our opinion, not fit for purpose and needs to be overhauled.

“We believe the role of Governor has to change, from that of Executive Chairman as it has been under Sir Mervyn, to one of Chairman of the Board”

The Chancellor has shown he is prepared to be bold through his appointment of Mr Carney as the Governor of the Bank of England. That appointment is to be welcomed because as an outsider, with experience both of central banking and financial markets, he is well placed to implement the changes we seek. The Chancellor needs to go further though and, working with the new Governor, he needs to introduce structural reform to embed reforms to both the Bank's structure and its culture. The legislation is still going through Parliament and can be amended. Notwithstanding Mr Carney's reputation and undoubted ability we continue to think that those who have characterised the job as being too big for one man are correct. However, it is a role that is not too big for one organisation if properly structured and run.

This paper is broken into five parts. Firstly it looks at the performance of the Bank in the run up to the financial crisis and asks why the Bank did not see the crisis coming. Secondly, we look at the Bank's initial reaction as the financial crisis took hold and look at why it was so slow to react. In part three we look at the measures it has taken since the crisis and ask if it could have done more. In all of those areas it is our belief that the Bank's lack of understanding of financial markets, unwillingness to consult and its bias towards an academic approach were key flaws. In the fourth section we look at the proposals of the government to change the structure of regulation and whether they make sense. Finally we make proposals for reform.

We expect this paper to be controversial as we are questioning one of the key planks of financial reform of the current government. However, we feel it is right to do so, given the extent of disquiet over the performance of the Bank of England in the financial community. It is absolutely vital that this reform of financial regulation works from the very beginning and we believe it is better for the government to correct any mistakes in the initial stages now rather than wait and find out that it has not worked at a later date, with all the costs that might entail.

1

Why did the Bank not anticipate the crisis?

Sir Mervyn King, in his Mansion House speech this summer, said that in hindsight he should have been shouting from the rooftops ahead of the financial crisis.[1] Yet neither he nor anyone else in the Bank did any shouting at all. Was it that the Bank saw the risks but was too complacent or was it instead that its focus was elsewhere and therefore it just did not comprehend the risks being run? We will argue in this paper that it was primarily the latter, stemming from the Governor's lack of interest in financial regulation and the financial sector, which permeated through the Bank. To quote from the excellent book by Dan Conaghan, The Bank[2], "Anything that was remotely connected with financial regulation would be batted away impatiently".

In the reorganisation post 1997, when the Bank was stripped of the bulk of its regulatory responsibilities, it did still retain responsibility for the overall stability of the financial system as a whole. Therefore it was still meant to be taking a keen interest in financial stability. In reality that interest was scaled down as senior regulators were allowed to retire or move on. To quote Sushil Wadwhani, a member of the Monetary Policy Committee (MPC) from June 1999: "In my time at the MPC at the Bank, I was surprised by the lack of interest in issues relating to financial markets. Indeed there seemed to be a deliberate policy to run down resource in the Financial Stability wing"[3]. The Governor was much more interested in focusing resources on Monetary Analysis and all the attention and staffing went into that area.

A Financial Stability Review was written twice annually but its importance was downgraded. It was reported that the Governor told staff to operationalise it; which meant writing and publishing it, and little else. The Governor rarely attended the monthly meetings and indeed was reported to have fallen asleep at one of the meetings he did attend.[4] As if to underline the lack of importance attached to the report he did not even present it to the press when published unlike the Inflation Report when he was always present.

This shift in the culture of the Bank - driven by Sir Mervyn towards monetary analysis carried out by economists, and away from financial regulation - did not improve the Bank's ability to meet the inflation target and actually created a huge blind spot. This meant the Bank was too complacent about the growing credit bubble in 2006 and 2007 and missed the dramatic increase in risky assets on bank balance sheets. In particular, for those of us in the markets at the time, the lack of objection to RBS taking over ABN just as the financial crisis was coming

1 http://www.bankofengland.co.uk/publications/Pages/speeches/2012/587.aspx

2 Dan Conaghan, The Bank: Inside the Bank of England

3 Sushil Wadhwani, The Future of Finance, LSE Report, 2010.

4 Financial Times, May 2012, The Court of King Mervyn, Chris Giles

to the boil was bizarre. The Bank might argue that the responsibility for this lay with the FSA as it was directly regulating RBS at the time; but as we noted above, the BOE had a responsibility for the stability of the financial system and it should have realised that this was creating a very real threat.

In its review of its failures during the crisis the Bank has focused on its inflation forecasting record and its provision of liquidity to the banks. To our mind those reviews were far too narrow in focus and were not allowed to really examine the real issue of why the Bank did not see the crisis coming and whether its overall response (not just in liquidity provision) was appropriate. In this report we want to go that step further and consider the performance of the Bank in the round. To try and focus on specific errors misses the point if we are to consider how the Bank can take on its new role of regulation. We need instead to join the dots.

The run up to the Financial Crisis

Let's start by rewinding the clock to 2006 and 2007 and look at what the Bank was actually saying at the time. The fact that the Bank published its opinions and discussions on a regular basis through its Inflation Reports, Minutes of the Monetary Policy Committee meetings and Financial Stability Reports means that we have a clear record of the Bank's thinking.

The May 2006 Inflation Report is illustrative[5]. Although with hindsight we can now see that credit growth was strong and the financial sector balance sheets were expanding strongly the discussion of credit growth and its potential threat was confined to just 2-3 pages of analysis. The strength of M4, or broad money growth, was noted: "Growth in broad money has risen sharply in the last two years...might imply an increase in medium term inflationary pressures". There was an analysis of excess broad money growth and the implications for inflation, which concluded that "excess money growth may contain useful information about future inflationary pressure." That was it.

Yet both broad money and M4 lending growth had accelerated to more than 12% (see figure 1). The rest of the 40 pages of analysis in the Report paid little or no attention to what was going on in the financial sector. At that point the MPC had voted to keep rates on hold at 4.5% for the last three months and at the May meeting there was only David Walton arguing for a rate rise while there was also one member who wanted to lower rates. Both cases were given a similar weight in the MPC minutes[6]. There seemed to be broad consensus that the right thing to do was to keep policy on hold. Interestingly, at a similar time, July 2006, the shadow MPC were arguing for higher rates with broad money growth one of their key concerns. Indeed Tim Congdon said "M4 money supply growth has been in double digits for nearly two years…I expect above trend growth of demand followed by inflation."[7]

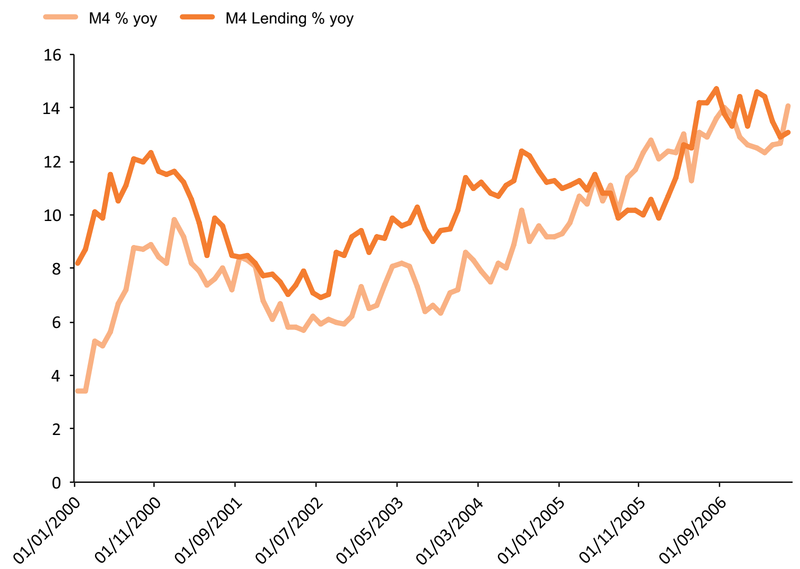
If we turn to the Financial Stability Report published in July of that year we can consider whether there were any concerns raised there. Interestingly the opening paragraph of the report says the following: "*The Bank of England has two core purposes - monetary stability and financial stability. The two are connected because serious disruption in the financial system would affect the implementation and effectiveness of monetary policy, while macroeconomic stability reduces the risk to financial stability.*" In hindsight the first element of that statement was to prove all too accurate. It is a shame that the Bank and in particular the Governor did not pay more attention to it. The report stated that

5 Bank of England Inflation Report, May 2006

6 Bank of England MPC minutes May 2006

7 http://www.economicsuk.com/blog/000360.html

Figure 1: M4 and M4 lending growth % yoy



Source: Bloomberg

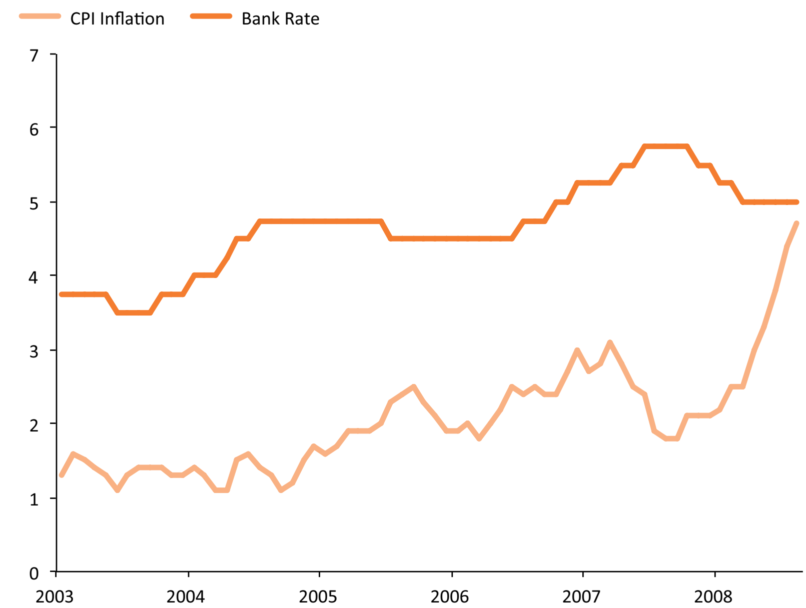
"The UK financial system as a whole has been remarkably resilient over recent years in the face of a number of disturbances.....Several structural developments have helped improve that over time, including high profits and capital, continued improvements in risk management and more sophisticated ways of distributing risk."

The report did note the risk surrounding the large complex financial institutions and that the balance sheets of large UK banks were expanding rapidly. The risk analysis carried out by the Bank suggested that in a worst case scenario a shock to the system might more than wipe out the profits of the UK banks and materially erode capital. It concluded that while it might affect the reputation of the UK financial system it was unlikely to make a material impact on the functioning of the system as a whole. The two main risks identified were a turn in the credit cycle and a fall in asset prices. The Bank also noted the increased exposure to illiquid assets and a rising dependence on wholesale funding.

In many ways the analysis by the BOE was heading in the right direction. It highlighted the risk across the system, it mentioned that risk management of the banks had to continue to improve and it argued that the authorities had to improve their crisis management capability. Indeed, the contrast between the Inflation Report where excess credit growth is treated as a footnote and the Stability Report where at least some of the risks were identified is marked. However, the BOE also took a lot of comfort from the capital held by the banks noting that tier one capital ratios were 7.9% and total capital ratios around 20%. There certainly did not appear to be a concern that the banks were undercapitalised, which seems to have been implied by some bank officials subsequent to the crisis. In addition it concluded that continual resilience was the most likely outcome. In other words though its stress analysis suggested there could be problems such an outturn seemed unlikely to the Bank.

What is striking, albeit with the benefit of hindsight, was the dismissal of the threat of strong credit growth in the Inflation Report at the same time as concerns were being expressed in the Stability Report about the increase in bank balance sheets and their exposure to wholesale funding. There does not appear to have been much in the way of joined up thinking at the Bank, which judging by the comments of officials and others reflected in the likes of Dan Conaghan's book is perhaps not surprising. It seems clear that to get the Governor's attention any regulatory concern had to have monetary policy implications.

Figure 2: CPI Inflation and Bank of England Bank Rate

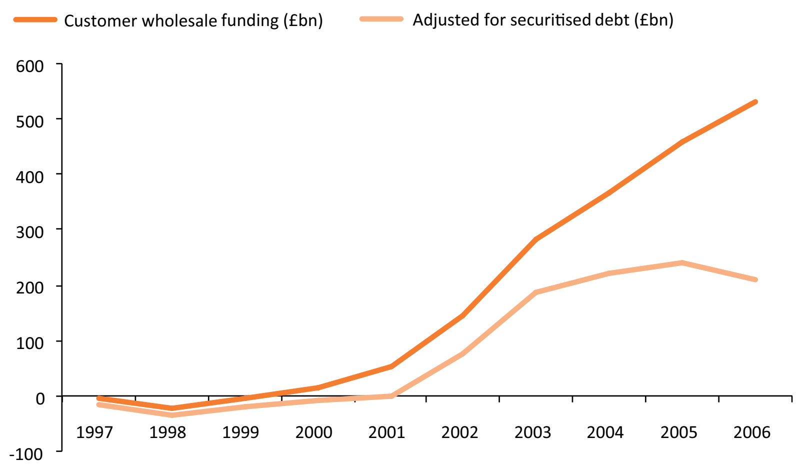


Source: Bloomberg

This was 2006 though and even most of those who claim to have seen the financial crisis coming were only just beginning to become concerned at this point. It is therefore instructive to roll the clock forward a year to May 2007, just before the crisis started, and examine the Bank's thinking at this time. The Inflation Report once again was sanguine. Inflation had been somewhat above target and the Bank had pushed interest rates higher to 5.5% by this stage. It again noted the strong growth of broad money and again concluded that while it might contain some information on the outlook for inflation the relationship was unclear. The only real acknowledgment of the risks from the build up in leverage was the analysis that suggested that the UK personal sector was likely more vulnerable to rate increase because of its higher leverage. There is no analysis of what rising debt levels and, in particular, the increased gearing of the banking sector might mean for the economy and inflation.

The Financial Stability Report of April 2007 noted many of the same risks as its counterpart in July of 2006 and it argued that the risk had "risen slightly", mostly because of the increase in personal insolvencies. However, it also continued to argue that the major UK banks remained highly resilient. One area highlighted as a potential vulnerability was the UK commercial property sector, and where the report noted that some 37% of lending to the non-financial corporates was to this sector. As we now know, many of the losses that UK banks incurred related to this sector. It also noted the sizeable gap between customer deposits and lending, resulting in a growing dependency on wholesale funding, which the Bank estimated at £530bn or 23% of customer loans. They adjusted this for securitised financing, which reduced the gap to £210bn (see figure 3). They noted that on this measure it had stabilised, although again they argued that this was still an area of vulnerability.

Figure 3: Major UK banks' customer funding gaps



Source: Bank of England

What is interesting about both the concerns about reliance on wholesale funding, the increased size of bank balance sheets and the exposure to commercial property, is that nothing seems to have been done about it. This is particularly surprising given that the report on Financial Stability was published a mere few months before things started to go horribly wrong with Northern Rock and then with the other UK banks. Surely the Bank should have been more concerned with the strength of money supply growth, given that the growth in credit driving it was both in worrying areas and causing the underlying state of the banking system to become more fragile. Yet the analysis of money supply in the Inflation Report focused on the deposit side rather than the credit side of the ledger. Moreover, the analysis that was carried out seemed to be exclusively focused on the prospects for inflation, rather than the broader risks to the economy from the growth in credit.

That close to the start of the financial crisis the Bank should have been shouting from the rooftops, as the Governor puts it. There is evidence that some of the vulnerabilities had been identified, but the way the Bank approached the issue was fatally flawed because of its focus on inflation. Far from the two core responsibilities of the Bank having equal weight it is clear, both from the anecdotal evidence and the actual reports of the Bank, that monetary policy was pre-eminent. So all roads led to the effect on inflation rather than the risks to the economy more generally. We will see this continued even as the financial crisis got underway.

The failure of Northern Rock

Despite the concerns noted in the Financial Stability Report about the dependence on wholesale funding the Bank seemed completely unprepared when the run on Northern Rock occurred. We believe this underlines the lack of focus in what was going on in the Financial Stability wing of the Bank. The issues surrounding Northern Rock have been thoroughly discussed, not least in the Treasury Select Committee's Run on the Rock[8], and it is not our intention here to go over the ground of what went wrong in minute detail. Nevertheless, if we look at it from a perspective of the Bank's role in ensuring financial stability its lack of a plan to deal with the issue is all the more remarkable given that the Stability Report of just three months beforehand had highlighted reliance on wholesale funding as a key issue. For the Governor to have spent time writing articles on moral hazard and being reluctant to deal with the issue suggests that he did not grasp the magnitude of the crisis. Even if you assumed, as the Bank did in its April report, that securitised borrowing could continue (which after the crisis began became ever more difficult) there was still a sizeable hole in the funding for UK banks if wholesale funding froze up.

It is illustrative to look at the "Run on the Rock" report of the Treasury Select Committee. The Report is very critical of the FSA for failing to spot the problems Northern Rock was likely to face and for failing to control the bank better. The FSA was clearly too lax in its controls and its analysis of the bank, failing to spot the key flaws in its business model until it was too late. The report was also very critical of the Bank particularly in the discussion of liquidity provision. The key passage from the Report on this is reproduced below.[9]

The points made by Sir Callum McCarthy highlight the key issue that this was a drying up of worldwide liquidity rather than just the actions of one bank. Northern Rock was the most vulnerable of the UK banks but it did not mean that it should not receive liquidity. The academic approach of the Bank and in particular the Governor, was, as the Treasury Select Committee noted, in marked contrast to both the Fed and the ECB. The Fed provided 30 day liquidity with a lower spread to the discount rate. Meanwhile the ECB frontloaded its liquidity provision to the markets. As its officials told the Select Committee they were happy to provide the liquidity as it was a crisis of confidence rather than a credit crisis so moral hazard arguments were not the highest priority.

The problem with the Bank's liquidity provision as Professor Buiter noted in his testimony to the Committee is that it was only against liquid assets like government bonds. He said that when the Bank created the Liquidity Support Facility for Northern Rock "they created what the Bank's discount facility should have been all along – something that lends against illiquid collateral and also lends for longer periods, because the Bank discount window is only for overnight lending."[10]

Sir Mervyn argued in his testimony that the Bank had extended liquidity and that the ECB and the Fed in comparison did nothing much different. Yet, as the committee noted, "Only the Bank of England took no contingency measures at all, during August, in order to protect against moral hazard".

Whether provision of extra liquidity would have saved Northern Rock is difficult to know. Nevertheless, Hector Sants of the FSA told the committee that "it is clearly the case that if liquidity in smaller amounts had been made available

8 House of Commons Treasury Committee, The run on the Rock, January 2008

9 Treasury Select Committee Report – The Run on the Rock, 24th January 2008

10 Page 42, paragraph 85 of The Run on the Rock

The banks' request for additional liquidity in August

In August 2007, the Bank of England was approached by banks arguing that the Bank of England should provide additional liquidity, at no penalty rate. The FSA had transmitted the banks' request to the Bank of England, but refused to state to us whether it had supported the banks in requesting this additional liquidity, on the grounds that conversations between Tripartite members ought to remain private. On 12 September 2007, in advance of his oral evidence on 20 September, the Governor of the Bank of England wrote a letter to the Chairman of this Committee. In that letter, the Governor pointed out that he did not agree with the suggestions for additional measures that others believed the Bank of England should undertake: lending at longer maturities, removing the penalty rate or increasing the range of collateral against which the Bank would be prepared to lend. In the letter, he gave three reasons for his position. First, he stated that "the banking system as a whole is strong enough to withstand the impact of taking onto the balance sheet the assets of conduits and other vehicles". Second, "the private sector will gradually re-establish valuations of most asset backed securities, thus allowing liquidity in those markets to build up". Third, there would be a risk of 'moral hazard'. In essence, this 'moral hazard' argument is that, should the central bank act, and effectively provide extra liquidity at different maturities against weaker collateral, markets would, especially if the liquidity were provided at little or no penalty, take it as a signal that the central bank would always rescue them should they take excessive risk and get into difficulties. Such a signal would lead to ever more risk taking, and the next crisis would consequently be greater than it would otherwise have been. In conclusion, the Governor wrote:

All central banks are aware that there are circumstances in which action might be necessary to prevent a major shock to the system as a whole. Balancing these considerations will pose considerable challenges, and in present circumstances judging that balance is something we do almost daily.

There appears to have been some disagreement within the Tripartite authorities over the weight that should have been placed on the dangers raised by moral hazard. Sir Callum McCarthy told us that:

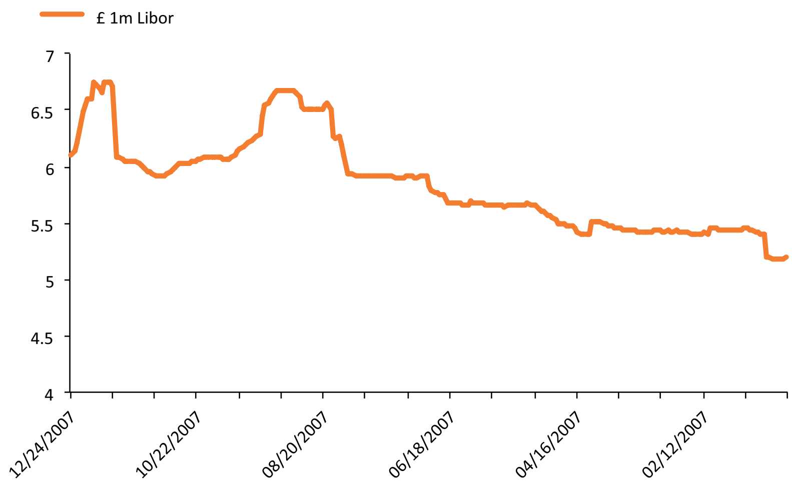
I think that there it is an important question of balance between the issues of moral hazard, which the Governor addressed very clearly in his memorandum to this Committee and what I would call the problem of damaged innocent bystanders in the sense that there is a problem associated with a worldwide liquidity drying up, which affects not only people who have played a part in arguably irresponsible behaviour, which is the Governor's concern, but much more widely in terms of other people who can possibly be harmed by that event ... I think that it is possible for people to have different views, and my own view of the balance between the moral hazard arguments and the other instances is slightly different from the Governor's.

In his letter of 12 September, the Governor explained that banks operating under the reserve scheme system select their own target for the reserves they will hold with the Bank of England at the start of a 'maintenance period'. These maintenance periods run from one Monetary Policy Committee meeting to the next. Should banks require additional funds during this period, they may use, at their request, the 'standing facility', which allows them to borrow all they need against "eligible collateral and [at] a penalty rate of 1% above Bank Rate". Another 'standing facility' allows banks to deposit funds with the Bank of England. In his letter, the Governor pointed out that the banks chose to raise their reserve requirements by 6% in the maintenance period starting 6 September 2007. On 5 September, before the start of the 6 September maintenance period, the Bank of England announced that, if the secured overnight rate had not fallen from its higher than usual level above Bank rate, the Bank would be prepared to offer additional reserves, amounting to 25% of the requested reserves target, before the end of the 'maintenance period'. On 13 September, this criterion was met, and additional reserves were provided. An additional fine-tuning operation occurred on 18 September—following the run on Northern Rock— again offering £4.4 billion, or 25% of the reserves target.

to Northern Rock earlier, then it is quite possible it would not have subsequently needed to apply to the lender of last resort facility". Similarly the BBA said that "had the Bank acted in this vein (of accepting a wider collateral base) at the beginning of August, then many of the problems affecting the money markets in general and Northern Rock in particular might have been mitigated".

Sir Mervyn King, not surprisingly disagreed, arguing that only if market conditions had returned to normal and banks in general had been "willing to lend to others who had illiquid assets" was that likely to have saved Northern

Figure 4: Sterling one month libor



Source: Bloomberg

Rock. He argued that to "get back to where we were in July would have meant injecting a massive amount of liquidity".

We will never know who was right but what is clear in hindsight is that the Bank's decision to focus on moral hazard rather than supplying liquidity was unhelpful. As we noted above the Bank had identified a risk care of the dependency on wholesale funding. However, it had apparently neither lent on banks to close that gap nor developed a strategy to deal with the closure of wholesale funding supply to the UK financial system. All of which suggests it did not take the threat seriously enough.

The Treasury Select Committee were also critical of the delay in getting the eventual support facility in place for Northern Rock. There was a long delay while the Bank tried to see if it could provide a covert facility to Northern Rock to give it liquidity to allow it to continue to function. The Committee argued that it was poor that the Bank had failed to establish whether such a facility would have been feasible under EU regulations in advance, rather than waiting for a crisis to happen to take legal advice.

The attempts to provide a covert facility led to delays in providing the eventual facility that was to provide the support to Northern Rock and allow it to continue to function. The provision of that facility was leaked to the BBC with the result that there was the first run on a UK bank in almost 130 years. The problems were not the Bank's alone but we believe they were certainly aggravated by a focus on moral hazard and an inability to appreciate the risks involved in taking such a stance.

Indeed, the complacency is evident in the following comments made by the Governor about the damage to the UK banking system from the Northern Rock crisis:

> *"I do not believe that in a year's time people will look back and say there was any lasting damage to the British banking system. It is very well capitalised, it is very strong, and, as I*

explained before, although the banks at present are having to pay a bit more for their liquidity than they would wish, they will be able over the coming months to take these vehicles and conduits they have set up back on to their balance sheets and they will be strong."

How wrong could he be? If ever there was a statement showing how much the Bank of England underestimated the crisis to come this was it.

2
The Financial Crisis

The flaws in the way the Bank looked at the world and which hampered its response to the crisis continued to aggravate the situation after the crisis had begun. The fact that it took more than a year after the failure of Northern Rock for the Bank to start to cut rates suggests that it simply did not understand what was going on or what the implications were for the UK financial system and the economy. This is why we feel that the Bank's internal reviews do not ask the right questions by focusing on liquidity and its inflation forecasting record. Indeed, that those internal reviews asked separate questions, rather than the simple one of 'why did the Bank get it wrong' is indicative of the fact that the Bank's thinking is still not joined up today.

Post Northern Rock the Bank focused its initial efforts on supplying liquidity to the banking system. Given a lack of liquidity had brought Northern Rock down that is perhaps not surprising, but in doing so it was missing the bigger picture.

The October Financial Stability Report was less complacent than Sir Mervyn appeared to be in the comments above. It acknowledged that the market turmoil was likely to force balance sheets to expand, as banks would have to take assets back on balance sheet and fund them directly. In particular the originate and distribute model, of which Northern Rock was the foremost exponent, was acknowledged as being exposed to disruption in asset backed and wholesale funding markets. As a result of this happening across the financial system funding was likely to be more fragile than before. It also acknowledged that credit conditions, particularly for high-risk borrowers, were expected to tighten.

The Report noted, as we did above, that the Bank had identified some of these issues, particularly the dependency on wholesale funding, but acknowledged that the "*speed, force and breadth with which these risks combined was not fully anticipated by the authorities or financial market participants*".

Nevertheless, the Report argued that "*the robust UK macroeconomic backdrop and the high profitability and capitalisation of major UK banks provide a strong anchor for the financial system*". While it did acknowledge that there were risks of a more adverse outcome, the central scenario was one where the UK was expected to weather the storm.

One issue that drew no comment in the Report was the RBS acquisition of ABN Amro. While the regulation of the takeover itself was the responsibility of the FSA, it is remarkable that it was not even mentioned given that it resulted in RBS becoming not only bigger but also more involved in many of the products that the Bank of England had raised concerns about in this and previous reports. Just 16 months later RBS was announcing a loss of £28bn, of which £20bn was due to ABN Amro. At the very least the Bank of England should have been asking the question of whether such a takeover was a threat to the UK's financial system.

In the Inflation Report there was at least a discussion of how the events in financial markets might impact on the economy, but the implication was that the effect would be moderate:

> *"In the face of higher funding costs….banks are likely to increase the rates charged on their loans. In addition, they may decide to ration the quantity of credit they are willing to extend at any given price."*

It also noted that the unanticipated expansion of balance sheets would, other things being equal, cause their capital ratios to fall. That could "affect banks' ability and willingness to lend". The Bank also noted that there were additional channels such as falling asset prices and effects on confidence that could impact on the economy.

Interestingly in its discussions on interest rates the MPC had noted that:

> *"a precautionary reduction in Bank Rate could forestall a sharper slowdown in output growth. But it was important not to prevent the slowdown in demand envisaged at the time of the August Report. There was a danger that an unexpected reduction in Bank Rate would be misinterpreted as a signal that monetary policy was focused on supporting the financial system and not on meeting the inflation target."*

Yet the Bank had outlined that, other things being equal, policy was likely to be tighter as a result of the disturbance to the financial markets, which surely must mean that if interest rates were appropriate in August then they were likely to be too high in November. It is also interesting to see the concern about being seen to be supporting the financial system and not focusing on the inflation target. The Bank clearly saw this as undesirable.

The Governor has, in a recent speech,[11] signalled something of a shift here arguing that it might now be sensible to use monetary policy to help ensure financial stability. The speech mostly focused on whether rates should have been higher ahead of the crisis to help prevent it, rather than whether policy should have been adjusted more quickly to limit the impact. The Federal Reserve, in contrast to the Bank of England, was cutting interest rates for exactly this reason in the Autumn of 2007. Indeed by the time of the November inflation report interest rates in the US had been cut by 75 basis points (bp) to 4.5%.

By December though the Bank had shifted its position cutting rates to 5.5% from 5.75%, when it noted that "*conditions in financial markets have deteriorated and a tightening in the supply of credit to households and businesses is in train, posing downside risks to the outlook for both output and inflation further ahead*". In particular the MPC noted that tighter credit conditions had begun to affect firms' spending plans.

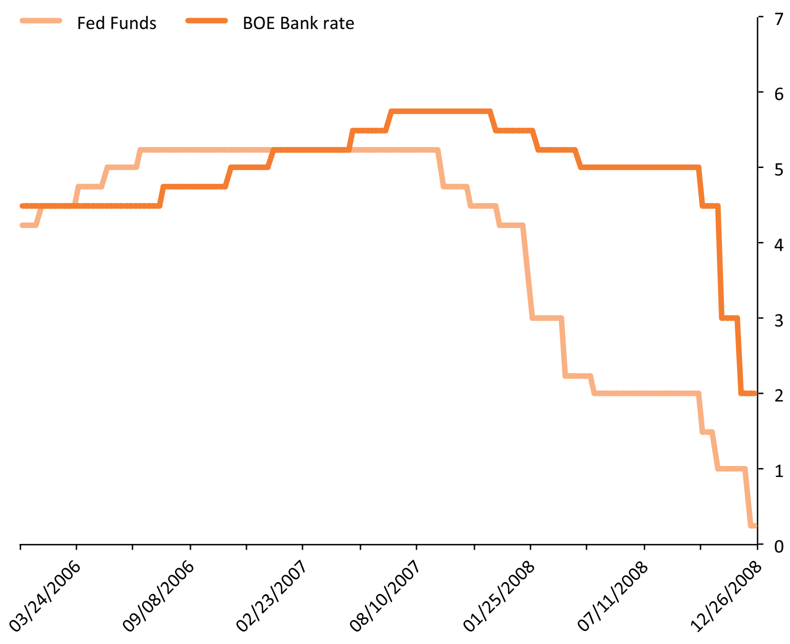
That cut was followed by another in February to 5.25% and then a further one to 5% in April. In the Inflation Reports there was much more focus than before on credit conditions and the Bank was clearly aware of problems that were a threat to the economy. Indeed, in the May 2008 Inflation Report the Bank noted that write downs for the major UK banks had totalled $14bn, most of reflecting sub-prime exposures. [12] It also noted rising spreads on loans and reduced credit availability.

Importantly, the Bank finally responded to the on-going funding problems of the banks by introducing the Special Liquidity Scheme on April 21st 2008. That

11 Twenty years of inflation targeting, The Stamp Memorial Lecture, LSE, 9 October 2012

12 Bank of England Inflation Report, May 2008.

Figure 5: Bank of England Bank Rate and the US Federal Reserve Fed Funds Rate



Source: Bloomberg

scheme allowed the banks to access liquidity through "long term swaps with the Bank to obtain Treasury Bills in exchange for high quality, but currently illiquid, collateral".[13] The latter would include, for example, mortgage debt. The asset swaps would be for a period of one year but renewable at the Bank's discretion for a total of up to three years.

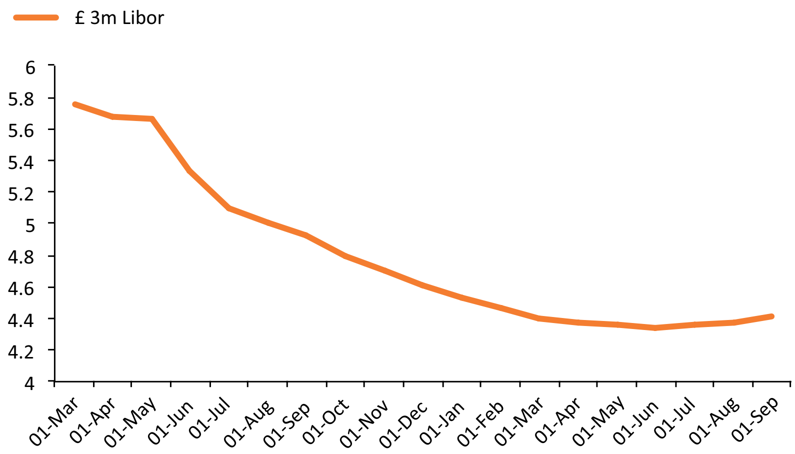
The BOE originally expected to lend out around £50bn under the scheme but in the end the total amount lent was around £185bn, with 32 banks and building societies in the scheme. The bulk of the collateral received was mortgage-backed securities or residential mortgage covered bonds. This scheme was one of the undoubted successes of the Bank during the Financial Crisis. However, it was to undermine the success when at the expiry of the scheme in January 2012 it failed to replace it with anything thereby leading to a rise in funding costs of the banks, which in turn produced a rise in lending rates at time when the economy was still weak.

At the time of the introduction of the scheme it was hoped that the extra liquidity and certainty over funding would allow lending to recover. The central scenario of the Bank was that the risks to financial stability would decrease gradually. According to the Bank's April 2008 Stability Report "The most likely outcome is that market conditions improve in the period ahead, supported by measures to improve market functioning and to bolster confidence in financial institutions." The same report did note that "tail risks"[14] to financial stability remained and the "potential adverse impact on stability if these tail risks were to crystallise has also generally increased." It also noted that mortgage availability had been hit by the closure of the Residential Mortgage Backed Securities (RMBS) market, that commercial property prices were falling sharply and that credit supply had tightened for high risk borrowers.

13 See the Bank of England's Financial Stability Report, April 2008

14 The term tail risk refers to events which normally have a low probability of occurring.

Figure 6: Implied 3 month Libor (derived from futures prices) as of end March 2008



Source: Bloomberg

Given those concerns about tail risks it is perhaps surprising that the Bank of England then put its easing process on hold. Again it was an issue of the primacy of monetary policy over financial stability. The inflation target was under threat from the surge in commodity prices so it took priority again. Yet to do so was incredibly short sighted. The forces that had been unleashed by the onset of the financial crisis were inherently deflationary and were likely to overwhelm any short term increase inflationary pressures. The markets were telling the Bank of England this in the spring of 2008 but it chose not to listen. Indeed, as figure 6 shows the markets were expecting the Bank of England to ease further through 2008.

In its August 2008 Inflation Report, while acknowledging that the risks "*from a more pronounced slowdown in demand on the downside*" had increased, the Bank felt that this was outweighed by the "*possible impact of elevated inflation on pay pressures and inflation expectations on the upside*". The debate at the July Monetary Policy Committee even centred around whether it would be right to raise rates to "*send a strong signal that is was focused on inflation and remained determined to bring it back to target in the medium term*". Although the bulk of the MPC wanted to keep rates on hold only one member, David Blanchflower, actually understood that the real risks were sharply to the downside for activity, care of the credit crunch[15].

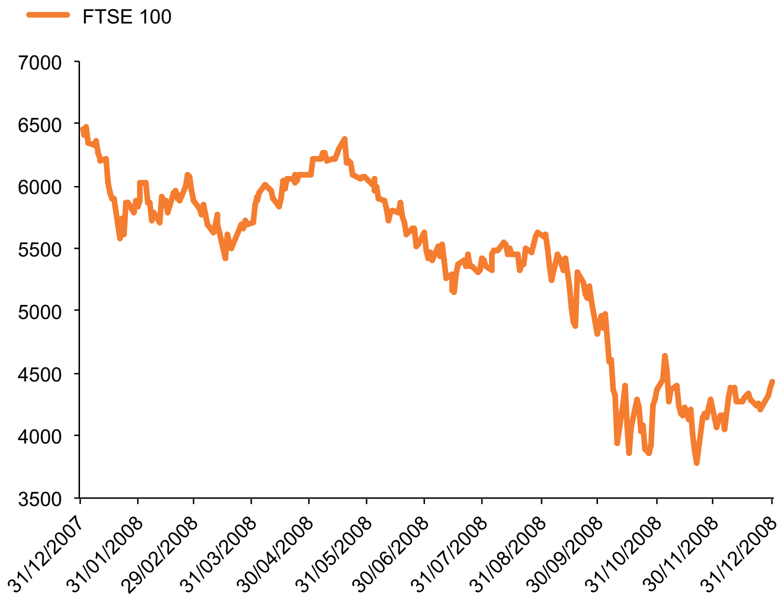
There was no discussion of the possible effects of keeping rates high in exacerbating the financial crisis. Yet the signs were there both in the Bank's Financial Stability Report and in areas such as commercial property prices and the contraction in M4 money supply for private sector corporates. It almost seems that having reacted to its earlier errors in the financial crisis, by cutting rates and supplying liquidity to the banks through the SLS, the Bank now returned to type, putting its monetary analysis ahead of the work on financial stability, not realising that they were just two parts of the same jigsaw at this stage. Indeed, the Bank was now to keep interest rates on hold until after the failure of Lehmans.

Even at the September meeting just prior to the Lehmans crash a rate hike

15 http://www.bankofengland.co.uk/publications/minutes/Documents/mpc/pdf/2008/mpc0807.pdf

was debated at the MPC even if no one actually voted for it. It took the violent convulsions in the market following the collapse of Lehmans to persuade the MPC that policy had to be changed. The rate cut of 50bp, coordinated with the other major central banks, came on the same day as the government had to intervene to recapitalise the major UK banks.

Figure 7: UK Equity Market in 2008



Source: Bloomberg

That recapitalisation of the banks though, made more necessary by the failure of Lehmans, had clearly been in the pipeline for some time. Yet the Bank of England seemed unaware that it was coming. If not how could it have been debating a rate hike? It is worth repeating the opening statement to the October 2008 Financial Stability Report; "*The Bank of England has two core purposes – monetary stability and financial stability. The two are connected because serious disruption to in the financial system can affect the implementation and effectiveness of monetary policy*".

The Bank had just failed to spot a major disruption to the financial system coming and had done little to head it off. To our mind that was simply because it had its focus elsewhere. Everything was subordinated to monetary policy. So when the inflation target came under threat because of rising commodity prices the policy easing that had been underway from the previous December ground to a halt. To keep rates on hold for six months at a time when the crisis was increasing in intensity by the day was a major mistake. While further rate cuts would have been unlikely to prevent the crisis from intensifying given what was already in train they may well have helped to lessen the eventual shock.

Having underestimated the risks in the UK banking system ahead of the crisis the Bank compounded this error by not understanding the risks created by the crisis to the financial system and the UK economy. If it had understood the risks it could surely not have let the RBS takeover of ABN go through without a fight, nor would it have dragged its feet over the easing of monetary policy because of a short term rise in inflation. In our opinion the Bank failed because it simply did not understand what was going on in the financial system. That reflected three factors in our view, first a scaling back of the resources devoted to financial stability, second a general view at the top of the Bank that financial stability had a secondary role to monetary stability and third a bias towards academia over financial expertise. The latter is key, as many market participants were very worried about what was going on particularly after the summer of 2007 but the Bank chose to focus on its own research and expertise rather than try to understand those concerns.

From the point of the Lehmans failure onwards the Bank finally seemed to realise the full extent of the crisis. Its actions thereafter do deserve praise. Immediately after the failure, access to the SLS was extended to give the UK banks access to more liquidity. The Governor led the way in supporting recapitalisation of the major UK banks and put in place Emergency Liquidity Assistance (ELA) for the banks to tide them over while recapitalisation of the banks took place. At least in this regard the Bank had learnt the lessons of the Northern Rock disaster, i.e. get the liquidity in place before the bank runs could start. The ELA allowed RBS and HBOS to draw down tens of billions of pounds. On October 17th RBS borrowed some £36.6bn, with HBOS borrowing peaked at £34.5bn on November 13th.

The facility was backed initially by bank collateral but as the scale of borrowing exploded it sought an indemnity from the Treasury. The total use of the ELA facility peaked at £61.6bn on October 17th (the height of the RBS use), against which some £100bn of collateral had been posted. In the end the facilities had been repaid in total by January of the following year.

The recapitalisation of the banks that followed involved tense negotiations between the Bank, the FSA and the Treasury and the Bank's attitude was according to one insider "destructive" and "obstructive"[16]. The deal was done in the end involving a final package of £500bn. The banks were recapitalised with the government of course taking a majority stake in RBS and a sizeable minority one in Lloyds.

While all this was happening the economy effectively froze and the Bank finally went into overdrive in easing policy. Rates were cut by 150bp in November, 100bp in December, with further 50bp cuts in January, February and March. This took rates down to their current level of 0.5%.

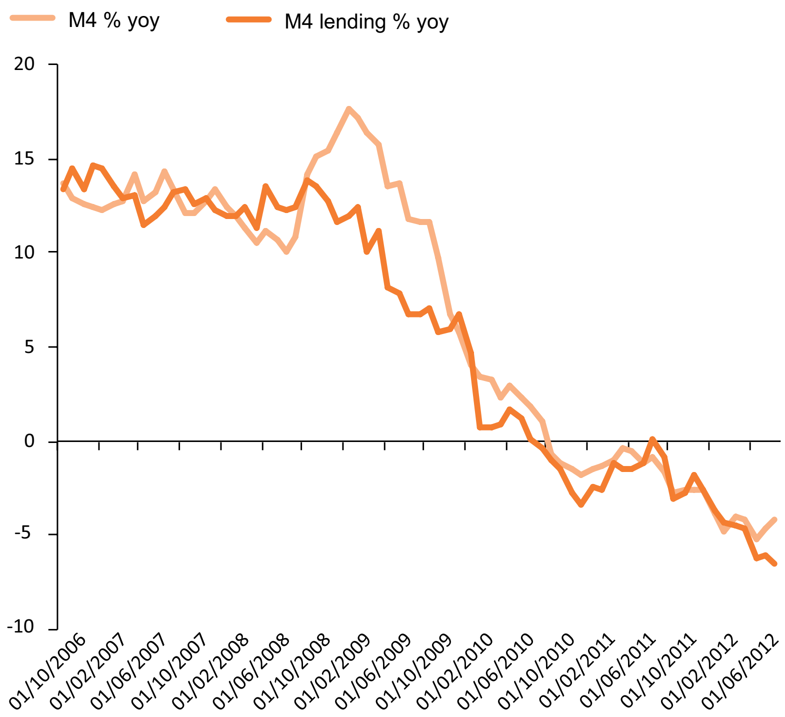
Quantitative Easing

The collapse in the UK economy was becoming ever more evident by the end of 2008 and internally the Bank began to worry that cutting interest rates was not going to be enough. As Mervyn King himself later acknowledged in an interview in the Daily Telegraph in March of 2009, "*for the first time in my life, the amount of money was growing too slowly*". With the money market still largely frozen despite the rate cuts and injections of liquidity the Bank and the Treasury began working on a scheme to pump more money into the economy. The result was the Asset Purchase Facility, which would undertake what is now commonly known as Quantitative Easing.

While we believe the Bank was absolutely right to pursue this process and Quantitative Easing (QE) undoubtedly provided a boost to the economy, the

16 The Bank: Inside the Bank of England – Dan Conaghan

Figure 8: M4 and M4 Lending Growth % yoy



Source: Bloomberg

desire to limit the process to just the buying of gilts again underlined its cautious academic approach. The Treasury had wanted the Bank to focus the purchases on corporate credit to boost credit supply to the economy. The Bank in contrast wanted to boost the money supply and felt that buying gilts was the only way to do this. The Governor, in particular, was said to be opposed to exposing the Bank of England to corporate credit risk. This is typical of the Governor's attitude to risk. Anytime that the Bank took on additional risk that he felt was outside a central bank's normal remit he either sought a Treasury guarantee or resisted doing it at all. The view was that the Bank should not be taking credit decisions.

This is in marked contrast to the attitude at the Federal Reserve which has shown itself much more content to take credit risk onto its balance sheet. In addition to Treasuries, the Fed bought mortgage backed securities and, through its TALF programme,[17] it bought asset backed securities exposed to corporate credit too.

When the Treasury made its announcement on January 19th 2009[18] it stated that the APF would be "*a further step to increase the availability of corporate credit…The Bank will be authorised by the Treasury to purchase high quality private sector assets.*" Those purchases were to be financed by the issuance of Treasury bills. This announcement was part of a series of measures announced that day aimed at boosting corporate credit supply including an extension of the Credit Guarantee scheme, a new facility providing guarantees for asset backed securities and the Asset Protection Scheme.

The paragraph granting the Bank of England the ability to use asset purchases for monetary policy purposes came after the part authorising the purchase

17 Term Asset Backed Loan Facility, http://www.federalreserve.gov/newsevents/press/monetary/20081125a.htm

18 http://webarchive.nationalarchives.gov.uk/+/http://www.hm-treasury.gov.uk/press_05_09.htm

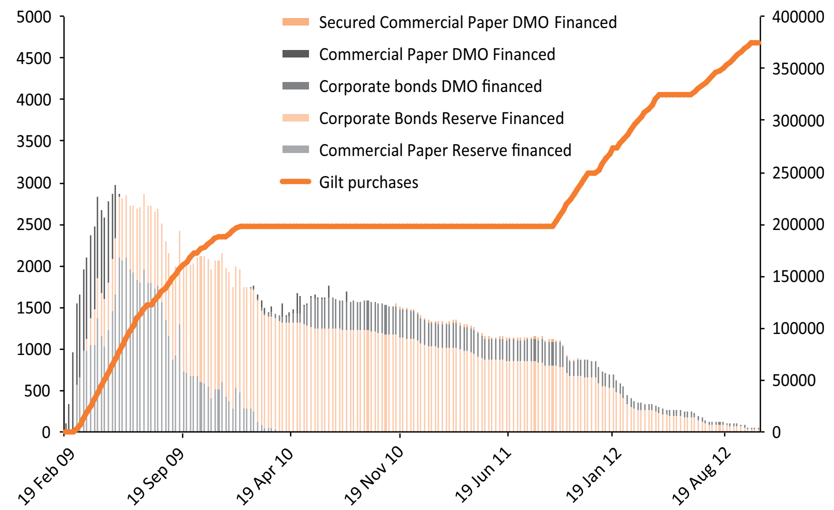
of corporate assets. The Treasury clearly saw the scheme as a measure targeted at increasing corporate credit supply. The Bank did initially intervene to buy corporate assets, with purchases reaching a peak of just £3bn in the months that followed the announcement.

Soon afterwards purchases died down in part as corporate credit markets improved. The Bank's purchases didn't reach anywhere near the £50bn that the Treasury had given it authorisation for. The Bank, and in particular the Governor, was always more favourably inclined towards buying gilts. These were seen as risk free (at least from a credit perspective), more liquid and a more direct route to boosting the money supply. In the latter's case, this was because gilts would be purchased by the creation of central bank money rather than by the issuance of Treasury bills. Shortly after the announcement of the APF the MPC authorised the Governor to write to the Chancellor "to seek authority to conduct purchases of government and other securities, financed by the creation of central bank money using the APF".[19] The Chancellor agreed to increase the size of the APF to £150bn, with £50bn to be used for the purchase of private sector assets and the remainder, up to £100bn, to buy government bonds.

At the March meeting of the MPC it was decided to carry out purchases under the APF of some £75bn. While the Bank said it would continue to purchase private sector assets "it was likely that the purchases of private sector assets over the coming months would be significantly less than the £75bn target for overall purchases. In part that was because the size of the private sector asset markets was relatively small. But, in addition, the first objective of those purchases by the Bank in those markets was to reduce spreads and improve the flow of credit....Given these considerations, the Bank would also need to buy substantial quantities of conventional gilts in the secondary market in order to meet the Committee's objectives for overall asset purchases."

It was clear that the Bank wanted and expected to buy substantially more gilts than corporate bonds. This desire to target the gilt market was aimed at

Figure 9: Bank of England Asset Purchases



Source: Bank of England

19 See Monetary Policy Committee Minutes, 4th and 5th March 2009

boosting the money supply. This was to become the mainstay of the Bank's approach to monetary policy for the next three years. Notwithstanding some early teething problems, when the Bank managed to confuse the markets about which gilts it intended to buy, the programme quickly got underway. By April 9th it had purchased some £26bn of gilts (almost 7 times the peak in purchases of corporate assets). At the May MPC it increased the target for asset purchases by a further £50bn to £125bn. There were two more increases that year of £50bn in August and £25bn in November, both coinciding with the relevant Inflation Reports. That took the total of asset purchases authorised to some £200bn. This represented more than one third of the gilts outstanding at the start of 2009, although the DMO were in the process of targeting a gross issuance of £220bn of gilts for that financial year[20]. In other words the Bank was broadly absorbing the amount of gilts being issued by the Treasury. By the end of January 2010 the Bank had succeeded in buying just under £200bn of assets.

With interest rates at all-time lows, QE became the key channel for the Bank to adjust monetary policy. The initial signs were encouraging. Gilt yields, not surprisingly, dropped sharply and around the same time global equity markets bottomed out and credit spreads began to narrow. The latter reflected the easing of monetary policy from all the major central banks, combined with an effort to sure up the financial positions of banks around the world, but particularly in the US. Financial markets which, up until then, had been pricing the financial equivalent of Armageddon started to relax. How much of this was due to the Bank of England's QE and how much due to the improvement across the rest of the world is a difficult question to untangle.

The Bank's economists did produce some estimates of the impact of the first round of QE undertaken in 2009[21]. That suggested that the £200bn of easing was the equivalent of a cut in Bank rate of 150-300 basis points and boosted the level of GDP by around 1.5-2%. Those effects, it was argued, were likely

Figure 10: Ten Year Gilt Yields

Source: Bloomberg

20 The net issuance, including gilts due to mature in 2009/10, was £203.4bn

21 BOE Quarterly Bulletin 2001 Q3. The United Kingdom's quantitative easing policy: design, operation and impact. By Michael Joyce, Matthew Tong and Robert Woods.

generated by a number of factors since purchases of financial assets by central bank money:

> *"…should initially increase broad money holdings, push up asset prices and stimulate expenditure by lowering borrowing costs and increasing wealth. Asset purchases may also have a stimulatory impact through their broader effects on expectations and by influencing bank lending,* ***although this channel would not be expected to be material during times of financial crisis."*** (our emphasis)

Those estimates of the impact of QE have to be treated with a good deal of caution. First, as MPC member David Miles noted in a speech in October of last year[22] such estimates are bound to be subject to considerable uncertainty as the Bank has not carried out such large scale purchases before. In other words we have a sample size of one.

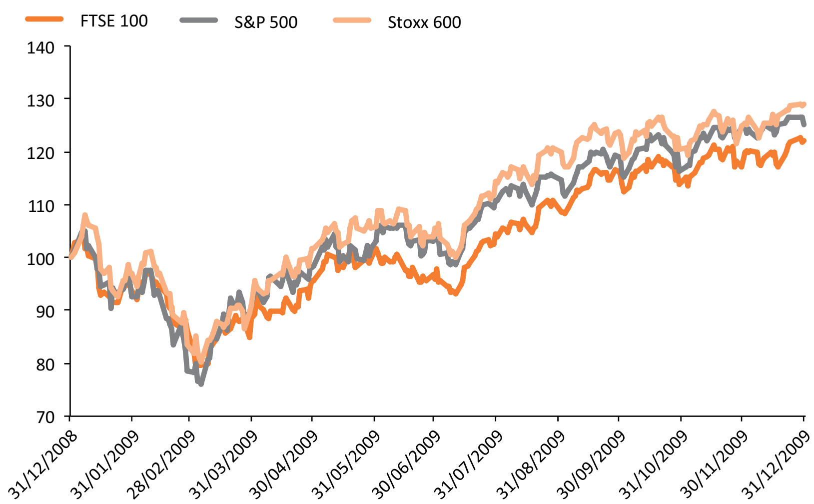
Indeed, Charlie Bean, the Bank's Deputy Governor noted in a speech that:

> *"The truth is that we will probably never know exactly how effective the policy of Quantitative Easing has been, for the simple reason that we can never know with precision what would have happened in its absence."*[23]

What we do know is that gilt yields fell. The Bank put the decline at 100-125 basis points around the time of the announcement. The exact fall is relatively easy to measure but determining how much of this was due to QE is more difficult, as other bond yields were also falling because of what was going on elsewhere in the world. The narrowing of the spread between gilts and bunds (German government bonds) around the announcement is probably the cleanest estimate of the effect of QE and that was a little over 60bp. That is around half of the estimate of the impact the Bank used in its analysis.

The Bank also looked at the effect on corporate bond yields, where investment grade yields fell 70bp and non-investment grade 150bp, with spreads on the

Figure 11: Equity Markets



Source: Bloomberg

22 http://www.bankofengland.co.uk/publications/Pages/speeches/2011/521.aspx

23 Quantitative Easing: An Interim Report. Speech by Charles Bean to London Society of Chartered Accountants, 13th October 2009

latter falling 75bp. It did note here that international spreads fell but by less than the UK. The equity market effect was more uncertain as markets fell initially after the announcements but thereafter began a sustained rally in the UK and elsewhere (see figure 11). The exchange rate effect is somewhat easier to isolate with the pound falling by around 4% on a trade-weighted basis over the six QE announcements.

The Bank's calculations used a drop in gilt yields of around 100bp to estimate the effect on GDP via various models and the drop in corporate yields of 70bp and 150bp to estimate the impact via a wealth effect. The overall estimate across these models suggested that GDP was boosted by 1.5-2% and inflation by ¾%-1 ½%. Using the Bank's econometric models to find a similar effect from reducing base rates came out at 150-300bp.

The Bank has proceeded to use these estimates as a justification for further QE. Yet as we noted for the effect on gilt yields, corporate bond yields and equity markets was muddied by the fact that similar moves were happening elsewhere in the world, even in countries such as Germany that were not undertaking QE. If, for example, we use the 60bp estimated from the narrowing of the gilt-bund spread, instead of 100bp used by the Bank, to isolate the effect of QE the GDP effect drops to around 1%. Also we can argue that the biggest impact of QE was likely to be the first time round because it was unexpected and carried out in unison with monetary easing (including QE) from other central banks. It is much less clear that QE would be as powerful with bond yields at much lower levels.

We believe there is a strong case to be argued that the Bank has put too much emphasis on QE because of the initial success. Indeed, it is arguably typical of the behaviour of the Bank over the last decade or so that it has relied on an academic estimate of the impact of a measure to justify further use of that measure.

The textbook response to rates reaching their zero bound and money supply that is too weak is to increase the money supply and Quantitative Easing is the textbook way to achieve this. Indeed, the speed at which the Bank moved from worrying about inflation to trying to boost the economy is to be applauded. Many had doubts about QE and quite a few worried that it would result in inflation. The Bank realising that interest rates were unlikely to be low enough to support the economy on their own pushed on with this.

The Bank believes, and we agree, that these measures made a substantive difference to stabilising the economy and preventing a much worse collapse in output and employment. They were, of course, helped by the actions of other central banks in stimulating the global economy. As a result 2009 was a turning point and the economy began to bottom out and enter into a gradual recovery.

3

Policy in the aftermath of the Financial Crisis

Unfortunately the Bank began to return to type as soon as the economy appeared to be recovering. It seemed to believe that it had stimulated the economy enough and that now was the time to boost bank capital ratios and wean the banks off central bank support. While it was undoubtedly right that banks had to build capital ratios back up there was always a risk that to do so they would have to curb credit growth thereby undermining the Bank's desire to stimulate the economy via easier monetary policy. Indeed, Lord Turner, of the FSA, had flagged this very issue in this report on the lessons of the Financial Crisis[24]. The Bank seemed to think that QE might be sufficient to offset this via lower long term interest rates and the boost to other asset prices. The truth of the matter though was that without credit growth these other mechanisms would be insufficient to drive the economy forward and so it proved with M4 lending growth contracting from 2010 onwards. As a result despite all the QE pumped into the system M4 money supply has also contracted over the last two years.

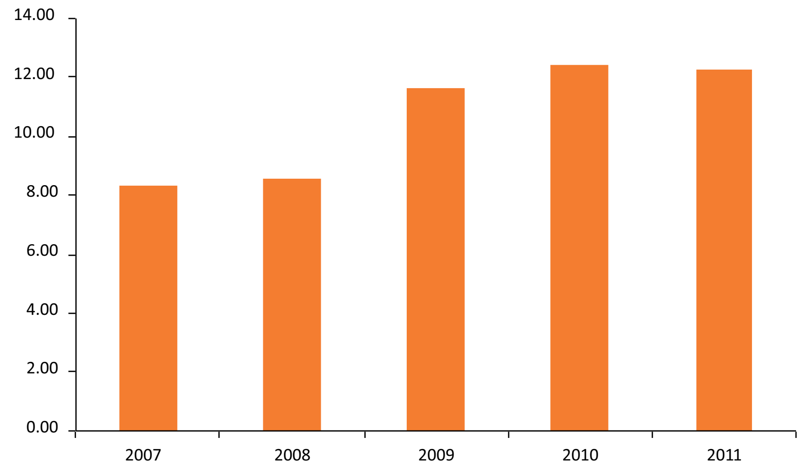
It is not as though the Bank did not see this coming (at least from a financial stability perspective) as can be seen in the December 2009 Financial Stability Report[25]. In that report the Bank argued that banks would have to reduce their leverage further, extend the maturity of their funding and refinance substantial sums as official sector support was withdrawn. The Bank calculated that some £1tn of wholesale funding would have to be refinanced over the following five years, including £178bn from the SLS scheme and £134bn from the Credit Guarantee Scheme.

The report also noted that competition for funding had raised retail bond rates to around 200bp above risk free rates, while in the wholesale markets the cost of long term funding was well above the cost of short term funding. In addition the report noted that the need to acquire up to £600bn of additional high quality assets would cost in the region of 150bp or £9bn. Somewhat understating the issue the report noted that there would be some upfront costs of these steps.

Similar comments were made about capital, with the Bank noting that banks would have to raise £33bn of extra capital merely to meet the higher capital requirements on trading assets and securitisation from 2011 and changes to the definition of core capital. The Bank also ran a simulation looking at what would happen to capital ratios with a 10% return on equity and 4% risk weighted asset growth if only retained profits were used to bolster capital. Capital ratios in such a scenario got stuck around the 8-9% mark. The conclusion was clear, either

24 The Turner Review: a regulatory response to the global banking crisis, March 2009

Figure 12: UK Bank Tier One Capital Ratios



Source: Bank of England

banks had to find other methods of increasing capital or reduce asset growth to raise capital ratios. And that was assuming a 10% return on equity. Only HSBC and Standard Chartered of the major UK banks have achieved that. Barclays averaged around 6.5% in 2010 and 2011 while RBS and Lloyds have actually seen negative return on equity due to the need to continue to write down assets. Not surprisingly it is risk weighted assets and therefore credit growth which has had to take the strain of the need to boost capital.

The Bank had identified what the challenges were going to be and it was right to urge the banks to get their houses into order while market conditions permitted. Sadly for the banks those market conditions did not remain stable for very long. The euro crisis began to erupt in the spring of 2010 and ever since market conditions have made it difficult to obtain both funding and capital. What the Bank did not seem to have was a Plan B if markets did not stay open and the banks were not able to sort this out themselves.

The epitome of this was the closure of the Special Liquidity Scheme in January of this year. The Bank argues that since it had announced that there would be a definitive end date to this scheme, it could not keep it open without damaging its credibility and encouraging banks to think that the Bank would always back down if needed. This smacks of the moral hazard argument all over again. To our mind this only works if conditions have not changed. Given the fragility of the banking system in the aftermath of the crisis it was obvious that the banking system would take a long time to heal itself. If events change so as to mean that the removal of the support mechanism would put the banks back under pressure and the provision of credit potentially curtailed then it should be reconsidered. That is exactly what happened in the Autumn of 2011 when funding markets effectively became frozen again. Yet the Bank stuck to its position of shutting down the Special Liquidity Scheme.

What did we see afterwards? Bank after bank was forced to put their rates up on their lending products as the cost of funding started to rise again. Bank lending also remained very weak and uncertainty about funding cannot have helped in that regard. After six months of this the Bank finally admitted its error by proposing, with the support of the Treasury, the Funding for Lending Scheme, in which banks would be given cheap funding in exchange for commitments to lend. At a time when the economy was very weak such a stance from the Bank of England was, at best, unhelpful, and, at worst, it aggravated the weakness of the economy.

This decision by the Bank was even more bizarre given that the Monetary Policy Committee had voted to increase QE both in October 2011 and in February 2012. Indeed at the time of the first step up in asset purchases (by £75bn) the Committee noted that "Vulnerabilities associated with the indebtedness of some euro-area sovereigns and banks have resulted in severe strains in bank funding markets and financial markets more generally. These tensions in the world economy threaten the UK recovery". The Committee further noted that "The deterioration in the outlook has made it more likely that inflation will undershoot the 2% target in the medium term. In the light of that shift in the balance of risks….the Committee judged that it was necessary to inject further monetary stimulus into the economy".

By the time of the February decision to increase asset purchases by a further £50bn the Committee noted that "the drag from tight credit conditions and the fiscal consolidation together present a headwind". Yet this was exactly the time when the SLS was being shut down.

Moreover, in the December 2011 Financial Stability Report the Bank noted that "UK banks have significant refinancing needs." The Financial Policy Committee, which by now was up and running, said that while UK banks had made significant progress in improving their capital and funding resilience since the height of the crisis "progress has been set back recently and they have been affected by the strains internationally in the bank funding markets." The Committee went on to say that "*Credit conditions could tighten in the United Kingdom if term funding conditions remain strained…There are early indications that banks may be starting to pass on higher funding costs to household and corporate customers through higher prices*."

This is again an example of financial stability wing of the Bank drawing conclusions that were ignored in setting monetary policy. Given that the Governor and his deputies sit on both Committees this is even less excusable. The obvious thing to do would have been either to extend the SLS, or if the Bank felt uncomfortable doing so, replacing it with a different facility. Given the ECB had introduced a long term repo operation[26] offering banks three year money at the refinance rate[27] there was a model already in existence that the Bank of England could have used. Yet it chose to undertake more asset purchases while abandoning the SLS.

Our contention is that while the Bank did a reasonably good job in putting in place the emergency measures to support the economy in the aftermath of the Lehman collapse it then erred by assuming that the banking industry could fix itself without significant central bank help. The conclusions of the work by Reinhardt and Rogoff[28] are that any recovery from a major financial crisis is a long drawn out one and that financial systems repair themselves slowly. To our mind that meant the Bank should have been prepared to step in and support the banking system whenever it came under pressure. By ensuring that the banks did

25 Bank of England, Financial Stability Report, December 2009

26 This is a method of offering banks long term funding in exchange for collateral, such as bonds which the ECB holds against the loans to the banks.

27 The rate at which the ECB lends to banks, similar to Bank rate in the UK.

not have to worry that there would be a risk of a funding gap whenever market turmoil hit, it would have likely encouraged the banks to lend more.

There was a similar issue in the decision to ask banks to ramp up liquidity positions by buying high quality low risk assets. To ask banks to build an increase in liquidity positions as markets were normalising was sensible. As soon as market conditions became stressed though banks should have been told to put this on hold as the central bank should have stepped in to provide that liquidity. The Bank would argue that this is not the role of a central bank and that banks should be encouraged to put themselves on a more sustainable footing. While we agree with that, the exceptional circumstances of current times have to be acknowledged and policy adjusted. The Bank, sadly, continues to fret about moral hazard when we are far from having sorted out the mess the financial crisis has left the system in.

In the summer of last year after a round of lending rate hikes and continued contraction of lending the Bank and the FSA finally changed tack. The Funding for Lending Scheme (FLS) was introduced, giving banks cheap funds if they agreed to lend it on. The Financial Policy Committee recommended that the FSA "make clearer to banks that they were free to use their regulatory liquid asset buffers in the event of a liquidity stress, *especially in light of additional contingent liquidity being made available to the banks by the Bank*"[29] In other words the FPC was happier for banks to run down their liquidity buffers because the Bank was providing liquidity through the FLS. Finally the FSA have also given the banks some flexibility on their capital positions to allow them to increase lending.

"They did not seem to grasp that for monetary policy to be effective the banking system had to be able to both pass on lower rates and lend to businesses and households"

These are all very sensible policies but the Bank should have been implementing them almost as soon as financial conditions started to deteriorate again in spring 2010. It is our belief that the lack of financial sector expertise at the Bank again hampered their response. They did not seem to grasp that for monetary policy to be effective the banking system had to be able to both pass on lower rates and lend to businesses and households. Supporting the banking system whilst it healed itself was vital. Yet the Bank seemed determined to wean the banks off of its support at the earliest opportunity. Post a normal recession such a policy would have been sensible but after the financial meltdown of 2008 the Bank simply misunderstood what was required.

It is of concern that the Governor has argued again that the Bank is near the limit of what it can do to support the economy. In a textbook central banking world perhaps that is the case but as others including the current Federal Reserve Chairman, Ben Bernanke, have argued, there is technically no limit to what a central bank can do. It is this conservative academic approach that the current Governor has engrained into the Bank of England that leaves us concerned that it is not ready to absorb its new responsibilities without a significant change in its culture and staffing.

28 Reinhardt and Rogoff, This Time is Different, 2009

29 Record of the Interim Financial Policy Committee Meeting, 14th September 2012 (our italics)

4
The Reforms

It is absolutely clear that the Tripartite system of regulation failed. Anyone who reads Alistair Darling's book Back From The Brink[30] or Dan Conaghan's The Bank cannot fail to recognise it broke down on numerous occasions. The Tripartite review carried out by James Sassoon was damning arguing that the UK system failed in critical respects. The review suggests that:

> *"The financial authorities did not have clearly defined powers (or responsibilities) to take pre-emptive action in response to the threats to* **systemic** *stability….: the authorities lacked appropriate instruments to mitigate these risks; there was inadequate enforcement of existing prudential regulation; and the authorities were poorly coordinated and inadequately equipped to handle the crisis when it hit".* [31]

Indeed it is worth quoting from that review as concerns the performance of the Bank as it supports many of the arguments we have made earlier in this document. The Review noted that the Bank had, in its Financial Stability Reviews, "identified some of the key emerging risks. Where the system failed was in not translating the warnings into pre-emptive action, particularly in the years 2005-07 as banking leverage soared and asset prices grew." It continues that:

> *"The fact that, in this very period, the Bank of England significantly downsized the resource devoted to monitoring and analysing changes in the structure of the financial system and assessing their implications for its stability, efficiency and effectiveness; that it lost and did not replace critical financial market expertise among its senior executive team; and that it narrowed the focus of its Financial Stability Reviews, meant that the Bank was actually, and mistakenly, lessening its engagement with the markets in the run up to the financial crisis. As Sir Andrew Large, former Deputy Governor of the Bank of England, wrote in the Financial Times on 5 January 2009: "the systemic [scrutiny] role has been underemphasised in recent years.""*

The Review went on to argue that the Bank's "*surveillance and analytical capability needs to be enhanced in support of its statutory financial stability objective. This requires the Bank to be explicitly and continuously engaged with developments in financial markets*". It argued that the Bank should " *be monitoring and assessing developments in UK and global financial markets and considering their implications for financial stability.*"

That Review raised the key question of whether the Bank could be the macro prudential regulator and the FSA the micro prudential regulator separately without risking things slipping between the cracks as was the case with the Tripartite

30 Back from the Brink, 100 Days at Number 11 – Alistair Darling

31 The Tripartite Review, Preliminary Report 9th March 2009

system. The coalition government clearly took the view that it was better for these two elements to be based under the same roof at the Bank of England.

The government has made a number of key changes to financial regulation in the UK. According to HM Treasury's "A New Approach to Financial Regulation"[32]:

> *"The Government's primary objective in reforming financial regulation in the UK is to fundamentally strengthen the system by promoting the role of judgement and expertise."*

It makes three key changes. First, the establishment of the Financial Policy Committee within the Bank to "monitor and respond to systemic risks". Second, the transfer of responsibility for "microprudential regulation of firms that manage complex risks on their balance sheets to a focused new regulator, the Prudential Regulation Authority (PRA), established as a subsidiary of the Bank of England. Third, the creation of a new conduct for business regulator, the Financial Conduct Authority (FCA). The FCA will deal with "issues ranging from consumer protection to market integrity…with a clear mandate to tackle competition issues in the financial services sector."

As the Treasury paper puts it:

> *"A fundamental element of this programme of reform is returning responsibility to the Bank of England for regulating the stability of the financial system. As the UK's macro-prudential authority, the new FPC will be responsible for monitoring the financial sector for potential systemic risks." The PRA will be responsible for "regulating financial firms whose business activities require a significant degree of expert prudential supervision."*

Financial Stability and the Financial Policy Committee

The Financial Services Bill gives the Bank of England primary responsibility for Financial Stability in the new framework stating that the Bank shall "protect and enhance the stability of the financial system of the United Kingdom (the "Financial Stability Objective"). The bill also states that the Court of Directors should "determine the Bank's strategy in relation to the Financial Stability Objective." It is expected to consult both the Financial Policy Committee and the Treasury about that strategy.

The Financial Policy Committee's objective is to "exercise its functions with a view to contributing to the achievement by the Bank of the Financial Stability Objective. The responsibility of the Committee is relation to the achievement of that objective relates primarily to the identification of, monitoring of, and taking action to remove or reduce, systemic risks with a view to protecting and enhancing the resilience of the UK financial system".

There was already an additional responsibility that the need to meet the Financial Stability Objective should "*not require or authorise the Committee to exercise its functions in such a way that would in its opinion be likely to have a significant adverse effect on the capacity of the financial sector to contribute to the growth of the UK economy in the medium or long term*". Despite this the Chancellor felt it necessary to introduce a further objective for the FPC "*to support the economic policy of the government*" in the June 2012 Mansion House Speech[33]. He also said he would make it a legal requirement "*for the FPC to report, for every action it takes, how that action is compatible with economic growth as well as*

32 A New Approach to Financial Regulation, HM Treasury January 2012

33 http://www.hm-treasury.gov.uk/press_47_12.htm

stability." This was introduced after the FPC had seemingly entirely concentrated on making the financial system safer, without much regard as to any impact on growth. In particular we would suggest that the FPC had argued for a build-up in capital and liquidity that was unhelpful in promoting bank lending. It is noticeable that the decisions to ease liquidity and capital constraints have come in the light of that shift in direction from the Chancellor.

The composition of the FPC is to be the Governor, Deputy Governors, the Chief Executive of the FCA, 2 members of the Bank appointed by the Governor, 4 members appointed by the Chancellor and a representative of the Treasury. That would give the Bank a majority on the Committee.

The Treasury can make recommendations to the Committee about the Financial Stability Objective, which the FPC would have to respond to, saying what action it had taken in accordance with that recommendation. Otherwise it is up to the FPC to make decisions on how to meet the Objective.

Its mandate is to monitor "*the stability of the UK financial system with a view to identifying and assessing systemic risks*". It has the power to give directions to the FCA and/or PRA requiring macro prudential measures. The direction "*may not require its provisions to be implemented by specified means or within a specified period, but may include recommendations as to the means to be used and the timing of the implementation*."

It can also make recommendations to the PRA and FCA about the exercise of their functions. These are effectively comply or explain rules, where the PRA and/or FCA would have to implement the recommendations or explain why they felt they could not or should not do so.

The FPC may also make recommendations within the Bank relating to "*the provision of financial assistance to financial institutions (and) the exercise by the Bank of its functions in relation to payment systems, settlement systems and clearing houses*."

"On the whole we think the introduction of the FPC is a significant step forward"

Finally, the FPC can make recommendations to the Treasury to make orders in a variety of areas. It can ask the Treasury to authorise macro prudential measures, require the PRA to undertake prudential regulation or the FCA to exercise product intervention rules.

On the whole we think the introduction of the FPC is a significant step forward. It formalises a role in which the FPC, including the Governor and his deputies, has to take decisions to enhance the financial stability. This puts financial stability at a much higher level within the Bank and the interim FPC has already made some good progress on this front.

What has been disappointing though is that the FPC seems to have inherited the Bank's (or perhaps the current Governor's) conservative approach to things. We have already noted that the FPC initially focused on stability without considering the implications for growth. That has been typical of the Bank's (and Governor's) seeming inability to thread a link between financial stability and monetary policy.

It has also been cautious in its suggested powers of direction limiting them to three areas, a countercyclical capital buffer, sectoral capital requirements and leverage ratios. It chose not to ask for the power to impose loan to value or loan to income restrictions that could be applied to mortgages. The interim FPC acknowledged that "*These tools would naturally apply to new lending flows, perhaps making them* *particularly useful at certain points in the cycle. They also had the advantage of sending a clear and strong public signal of emerging risks to lenders and borrowers.*" It then went on to say that these tools would require a high level of public acceptability because "*they would affect how much individuals and businesses may or may not be able to borrow*." As a result they were not recommended. To our mind this is simply ducking a hard decision. Raising interest rates also impacts on people's ability to borrow and it may be sensible for the Bank to be able to target the housing market directly at times rather than raise rates which would affect other areas of the economy as well.

Having the ability to raise or lower overall capital requirements or restrict leverage is a good tool for the FPC to have but it is also quite a blunt tool, as the banks themselves could decide how to implement it. It may have the effect of simply reducing lending which is capital intensive (like SME lending) or cause assets to be sold which are most easily sold to meet a leverage cap, rather than reduce leverage in the most dangerous areas. Having the ability to change sectoral capital requirements, like for example on commercial or residential property lending is definitely useful. However, it lacks the signalling effect that limits on loan to value or loan to income ratios would have.

The Prudential Regulatory Authority

Moving micro prudential regulation to the Bank of England was something the current Governor has made clear was imposed on the Bank rather than sought.[34] However, given the role of the Financial Policy Committee is to ensure the Financial Stability Objective is met, we believe it makes a lot of sense for the micro-prudential regulator to be under the same roof. It is important to ensure that the gaps between regulators are as small as possible in the new system.

Indeed in the consultation paper HM Treasury argued that:

> "*Establishing the PRA as part of the Bank group – with its statutory objective for financial stability, delivered through a variety of functions, including its central role in the banking system, and its responsibilities for operating the special resolution regime for banks – will be an important part of delivering the necessary change in the operations and culture of the PRA.*"[35]

We are also supportive of the view that previous regulation was too focused on box ticking and did not use enough judgement. A regulator using judgement would, for example, have found it very hard to agree to the RBS takeover of ABN AMRO given the shift in the market environment in 2007. As the Treasury put it in their consultation paper "*The nature and intensity of supervision will depend on the risks posed by each firm; while every firm will be subject to a baseline level of supervision to promote and support their soundness and resilience, supervisory effort and resource will focus particularly on 'big picture issues' with potential systemic impact.*"

The Financial Services Bill sets out the PRA's general objective as "promoting the safety and soundness of PRA-authorised persons". The objective is "to be advanced primarily by -

1. seeking to ensure that the business of PRA authorised persons is carried out in a way which avoids any adverse effect on the stability of the UK financial system, and
2. seeking to minimise the adverse effect that the failure of a PRA authorised person could be expected to have on the stability of the UK financial system."

34 See The Bank: Inside the Bank, Dan Conaghan Part III

35 HM Treasury: A new approach to financial regulation: securing stability, protecting consumers 2012

The intention is that the PRA will be responsible for the prudential regulation of firms, which manage significant risks on their balance sheet. This will include banks, insurers and complex investment firms (such as hedge funds and asset managers).

Clearly the link between the FPC and the PRA will have to be a close one if the Bank is to succeed in its new task.

The Structure of the Bank of England

The Court: The Court is the governing body of the Bank. It manages the Bank's affairs, other than the formulation of monetary policy. It consists of the Governor, the Deputy Governors and up to nine external members. Currently it is chaired by Sir David Lees.
The Executive of the Bank of England: This consists of the Governor, the Deputy Governors and nine others including Chief Economist and Executive Directors in charge of Markets and Financial Stability.

The Monetary Policy Committee: The MPC is responsible for setting monetary policy in order to meet an inflation target set by the Chancellor of the Exchequer. It consists of the Governor, Deputy Governors for Monetary Policy and Financial Stability, two members appointed by the Governor (normally the Chief Economist and Head of Markets) and four external members appointed by the Chancellor.

The Financial Policy Committee: The FPC is responsible for contributing to the achievement of the Financial Stability Objective of the Bank. At the moment it is an interim committee but will become a formal committee of the Bank with the passing of the Financial Services Bill. It is to be composed of the Governor, the Deputy Governors for Monetary Policy, Financial Stability and Prudential Regulation, the Chief Executive of the FCA, two members appointed by the Governor (currently the Executive Directors in charge of Markets and Financial Stability), four external members appointed by the Chancellor and a representative of the Treasury.

The Prudential Regulatory Authority: The PRA is to be established as a separate subsidiary of the Bank with responsibility for prudential regulation of institutions, including banks, insurance companies and asset managers. It will be headed by the Deputy Governor for Prudential Regulation, currently expected to be Andrew Bailey.

Is the Bank up to the job?

From the perspective of this paper the key question is whether the Bank is ready to accept these additional responsibilities in its current form. Many have argued that the world has changed beyond recognition from when the Bank previously exercised regulatory responsibility for the financial system and that the job of the Governor in the newly enlarged Bank is simply too big for one person. We believe that the concentration in power in the Governor in the old Bank of England was undesirable and resulted in less than optimal outcomes. To endow the Governor of the newly enlarged Bank with the same degree of control would be an error.

The Government is running a real risk that in seeking to repair the flaws of the old system it creates a new system with flaws all of its own. The new Bank of England will have an enormous amount of responsibility and, we believe, needs fundamental reform, not just in its structure, but also in its culture, if it is to succeed. We already know that the current Governor did not want the micro-prudential regulation to be allocated to the Bank of England and has let it be known as such. That is not a good start for all those employees moving from the Financial Services Authority. The PRA is to be incorporated as a separate subsidiary in a different building, but it is vitally important that it and its employees feel part of the enlarged Bank and not a poor cousin.

Originally the plan was for it to be headed by Hector Sants, the CEO of the FSA, who was an ex banker. His decision to stand down means that the post has now gone to Andrew Bailey, who is the ultimate Bank insider, having been Executive Director for Banking Services, the Governor's Private Secretary and Head of the International Economic Analysis division. He has been at the Bank since 1985. He was originally moved to the FSA so that he could be a balance to Sants. As a result of Sants' departure we now have all three deputy governors being Bank men through and through and no real balance at the Bank.

One of the key concerns highlighted in this note, which we believe was a major reason for the Bank failing to spot the financial crisis coming, is that it is dominated by insiders who have little or no financial experience. Of the three deputy Governors only Paul Tucker has any outside markets experience and that was on secondment back in the 1980s. This is why the appointment of the new Governor is so important. The new Governor must be committed to opening up the Bank to the outside and recruiting people in who do understand financial markets to work alongside the economists who have largely worked their way up through the monetary analysis division.

If not there is a real risk that the culture of the Bank will remain overly academic and aloof with the result that financial markets are misunderstood and the policy prescriptions end up being incorrect. In particular we worry that the Bank will take a fixed, theoretical approach to policy. We believe the recent emphasis on running down banks access to BOE liquidity and building their capital while relying on QE to boost the economy is a classic example. As we explained above we believe that these three policies were working in opposite directions.

This is not just our view. The recently published reviews of the Bank's performance, though limited in their scope, expressed similar concerns about the state of the institution. Bill Winters in the liquidity review[36] wrote that the Bank was too "*centralised and hierarchical*". He said there was a tendency "*to filter recommendations in such a way as to maximise the likelihood that senior staff will find the recommendation palatable*". David Stockton's review of the MPC 's forecasting of inflation[37] criticised the Bank for its opacity and stated that there was a culture that discouraged independent thought. Indeed he recommended "*embracing a more assertive and experienced staff, [which] would likely require some cultural changes at the Bank*".

In the liquidity review, Winters argued that moving the PRA into the Bank and the creation of the FPC had also led to "*new questions over responsibility for oversight of liquidity operations, both from a strategic and tactical perspective, as each of the MPC, FPC and PRA Board have a direct interest in some aspects of the Bank's liquidity operations*". In other words, coordination is going to be ever more important in the new structure.

Like us, Winters argued that the Bank had to reduce some of its concern as regards moral hazard. He believes that the Bank should accept the fact that some

36 Review of the Bank of England's framework for providing liquidity to the banking system, Bill Winters October 2012

37 Review of the Monetary Policy Committee's forecasting capability, David Stockton, October 2012

of its liquidity facilities would act as tail risk insurance for the banks. Indeed, he stated that the liquidity provision had moved "*away from simply backstopping banks' short-term liquidity needs and towards backstopping the provision of key financial services to the broader economy more generally*". The Bank should acknowledge this and incorporate elements like the SLS and FLS into its Sterling Monetary Framework, which the Bank has been notably reluctant to do.

He criticised the Bank for allowing some of its key liquidity programmes, like the Discount Window Facility, to become stigmatised. Banks would only access the facility in very extreme circumstances "*fearing market, regulatory or political consequences should their use be known. This has probably contributed to the banks' over self insuring rather than factoring in the potential use of Bank facilities into their planning. This is costly to banks and to the broader economy.*" This goes to the heart of our argument that the Bank does not link the impact of its operations with the wider economy. Were it to be more generous with the FLS and the use of other liquidity facilities, credit could be easier for the economy overall. In our opinion such tools are much more likely to be effective in a credit constrained economy than more QE.

The focus of many of Mr Winters' recommendations is for the Bank to "*reduce the reluctance of banks to access central bank facilities.*" He says that it is necessary "*to ensure the right balance is struck between, on the one hand, incentivising banks to appropriately factor in central bank facilities into their liquidity planning, and on the other, avoiding them becoming overly dependent on the Bank for on-going support.*" He also argues that the Bank "*should rely less on penal pricing as a means to manage moral hazard*" and that "*there are a number of non-price costs to bank usage of Bank facilities that act to dissuade banks from becoming overly reliant on Bank facilities*".

Winters thinks that the Discount Window Facility (the Bank's main source of day to day liquidity for the banks) should be altered to encourage regular use. At least some of the drawing of this facility should be at a non-penal rate. He also says that "*The Bank should consider regularising facilities such as the ECTR*[38] *that are currently exceptional. It might do this by combining the ECTR with the Indexed Long Term Repo (ILTR) Facility to create a regular auction facility allowing banks to access funding against a wider collateral pool*". He also believes the Bank should broaden the range of eligible collateral for its facilities.

Winters goes further in stating that the:

> *"SMF should be more explicit in its role in providing a maturity transformation backstop in extraordinary situations where banks appear likely to curtail their maturity provision to their customers. In order to accomplish this, the Bank might consider whether it should extend the maturity of some of its current facilities or develop other facilities that would give banks the necessary confidence to maintain or extend the term of credit provision. This is likely to be necessary as banks seek a new equilibrium in their term funding arrangements. Any liquidity support should be provided on the basis that once the uncertainties currently clouding banks' ability to obtain term funding have reduced, the banks are incentivised to access markets to repay secured borrowings from the Bank."*

All of these recommendations would involve a major about turn in the Bank's strategy in the provision of liquidity. He is effectively saying the Bank should be prepared to give the banks term funding until things have improved enough that they can fund themselves in the markets. We could not agree more. Yet, ever since the financial crisis, the Bank of England has been trying to wean the banks off

38 Extended Collateral Term Repo

Bank support, even if, as in the case of the SLS abolition, it meant higher funding costs for the banks. Winters cites the SLS saying "*the Bank did not fully consider banks' exit from the SLS, most likely as it did not expect financial conditions to remain so unsettled three years after implementation. Banks faced material difficulty refinancing their SLS funding and, as a result, may be reluctant to fully participate in future Bank programmes of a similar nature*". The conclusions of the report support our view that the Bank has been overly preoccupied with moral hazard at the cost of damaging credit provision.

Mr Winters also argues that the Bank "*should coordinate closely with the FSA/PRA and other domestic and international bodes to the greatest degree possible such that policy actions that the Bank pursues to encourage acceptance of Bank liquidity facilities are not effectively offset or made redundant by the actions of others.*" Similarly he says the "*roles of the MPC and FPC in relation to the design and implementation of the Bank's SMF should be clarified*". All of which underpins our view that for the Bank to succeed in its new form it needs to ensure that coordination between the different parts of the Bank be it, MPC, FPC and PRA must be enhanced.

David Stockton's review of the MPC's Forecasting Capability[39] was arguably even more limited than the liquidity review, with an "*examination of actual policy decisions… beyond the remit of [the] report.*" Yet it still provides interesting reading. He noted that the "*lack of systematic, detailed quantitative assessment undertaken by the Bank to interrogate its forecast errors makes assessing the completeness and balance of [the Bank's] explanations of those errors difficult.*" In other words, the Bank had not carried out a proper analysis of why its forecasts were so wrong. He also said that there "*may be too few incentives and opportunities for staff to seriously challenge the MPC about some of the key issues surrounding the forecast*". He argued that the Bank needs to cultivate "*a more assertive and experienced staff, [which] would likely require some cultural changes at the Bank*". Those conclusions underline the Bank's reluctance to admit and examine its mistakes or promote a culture of challenging the received wisdom of senior management.

"The Bank should be prepared to give the banks term funding until things have improved enough that they can fund themselves in the markets"

As for the financial crisis this "*exposed virtually all major macro models as being woefully ill-equipped to understand the implications of this type of event, and the Bank's current forecast model – Compass- has very limited financial detail.*" This is perhaps not a surprise given the lack of interest in the financial sector at the Bank, but highlights that it was a major flaw in the Bank's forecasting. Perhaps if they had better models and understanding of this then policy decisions would have been better too.

Stockton argues that the Bank needs to have greater engagement with external researchers and scholars, whereas the current Governor has shown a marked preference for internalising the research process.

Crucially, Stockton goes beyond the remit of his review to argue that the Bank needs to consider the:

> *"interaction of the forecast process, the monetary policy process, and the financial stability process. The crisis made clear that the development of the economic forecast and the conduct of monetary policy could likely benefit from the intelligence gathered and the analysis prepared as part of the efforts to monitor and respond to emerging financial concerns. Likewise, understanding vulnerabilities to the financial system is likely to be closely linked in many instances to the outlook for the domestic and global economies."*

39 Review of the Monetary Policy Committee's Forecasting Capability, Report by David Stockton October 2012

Again this points to the Bank needing to reinforce its knowledge of financial markets and incorporating it within its decision making process.

Iain Plenderleith's review[40] has slightly less relevance to the running of the Bank today since it was solely concerned with the provision of Emergency Liquidity Assistance in 2008-9. Nevertheless, his analysis also picked up on the fact that the Bank identified some systemic risks prior to the financial crisis but failed to focus on the threat from individual banks. He also noted that, even in 2008, there was "*arguably too little attention directed to the consequences of low-probability (tail) risks (such as a failure of a large complex financial institution)*". He noted that the Bank's ability to identify impending threats in concrete terms was "*made more difficult by the underlap that had developed in the regulatory structure*". This is why it is so important for the PRA to be within the Bank but also equally why all parts of the Bank need to be linked into one another.

While the reviews were limited by the Court of the Bank in their scope they still confirm many of the flaws in the Bank that we have identified. Specifically, they highlight the culture that is centralised, hierarchical and not open to outside criticism. The senior management of the Bank have failed to understand that policy notably towards the financial sector has to be different in the aftermath of the crash. In particular the focus on moral hazard has led to a failure to provide term liquidity on a sustained basis leading to a tightening of credit conditions. There has been a lack of understanding of the linkage between the financial sector and credit conditions, which has led to the Bank supporting a marked build up in liquidity and capital ratios without considering the impact on lending. That has led to the main mechanism for easing monetary policy, asset purchases, being offset by other measures taken by the Bank and the FSA. This is all deeply concerning at a time when the Bank is being handed so much power.

In the section that follows we look at what could be done to reform the Bank to help ensure that the new institution can rise to the challenge of being a successful regulator and a better central bank.

40 Review of the Bank of England's Provision of Emergency Liquidity Assistance in 2008-09, Ian Plenderleith October 2012

5
How should the Bank be reformed?

Reform of the Bank has to go beyond just choosing the right Governor. The structure and culture of the Bank will need to change if it is to succeed. Too many mistakes were made in the run up to the financial crisis and, although the Bank initially responded well as the crisis struck, the flaws in the Bank have led to more mistakes in the following years.

Reforming the structure of the bank

The Financial Services Bill makes two key changes to the Bank. It has created the Financial Policy Committee and it has incorporated the Prudential Regulatory Authority into the Bank as a separate division. The head of the PRA will be a Deputy Governor of the Bank and he and the Deputy Governor for Financial Stability sits on the Financial Policy Committee. The Governor of the Bank of England, however, chairs the Financial Policy Committee and the Monetary Policy Committee and the Deputy Governor for the PRA will report into him. As currently drafted the legislation does not provide for the Deputy Governor in charge of the PRA to sit on the Monetary Policy Committee.

The Governor has been all powerful with his decision being final on all things, other than the vote of the Monetary Policy Committee. However, even there his influence has been very strong, not least because he has kept close control over the input into that Committee from the Bank's staff. That was unhealthy even for a Bank mostly focused on monetary policy, as it allowed one man's predisposition to shape the Bank's thinking. The job of the next Governor in the enlarged Bank is simply too big and too important to allow the possibility of a future incumbent to dominate to such a large extent. Of course, the government could make it clear to the new Governor how it expects him or her to act but we would rather see structural reforms to ensure the Bank is better managed.

In his review Bill Winters argues that while the Deputy Governors are regularly consulted, it is largely at the discretion of the Governor of the day. He suggested that, "*while the Governor should have the final say, he should be required to formally seek the views of his Deputies and those Deputies should be required to record any dissenting views.*" We think this is a good starting point, however we would go further. In our view the new Bank of England is going to be such a big organisation to manage that the role of the Governor needs to change. Sir Mervyn has in effect been both Chairman and CEO, something which is generally not regarded as a good model of corporate governance. Indeed, it is said that every staff appointment in the Bank has to have his sign off.

We believe that the new Governor, Mr Carney, needs to become more of a Chairman, overseeing the coordination between monetary policy, financial stability and prudential regulation. We have highlighted time and again in this report that the Bank has been poor at joining the dots between the different areas of its responsibility. We believe that job should be the Governor's, with obviously help from the Deputy Governors. As a result we would make the Deputy Governors the CEO's of their respective parts of the Bank, enabling the Governor to take an overview of everything the Bank does. They should run those divisions on a day to day basis. The Governor obviously would need to have final sign off on key issues but we think it is vital that he has less involvement in the day to day running of the Bank. This will be particularly important as the Governor will need to represent the Bank in many more places as head of the regulatory arm as well head of the monetary policy arm. The European Banking Authority, for example, is going to be a very important institution going forward given the plans for a European Banking Union. The Governor of the Bank of England and the Governor of the ECB will have to work very closely together to make sure this works. We believe the new Governor will need to be relieved of many of the responsibilities currently held by Sir Mervyn if he or she is to do that effectively.

We also believe that all Deputy Governors should sit on all committees. If the Bank is to coordinate across the different areas properly then the Deputy Governors must be party to the decision making process across all areas of the Bank. We would therefore recommend that the Deputy Governor for Prudential Regulation sits on the MPC as well as the FPC. We also believe there should be a management committee for the PRA, which should include the other Deputy Governors and the Governor. Institutionalising the cross fertilisation of ideas and knowledge across the Bank has to be the way forward. This is the only way to avoid the situation of one part of the Bank spotting something (like the dependence on wholesale funding pre crisis) and the other parts not doing anything about it.

> “If the Bank is to coordinate across the different areas properly then the Deputy Governors must be party to the decision making process across all areas of the Bank”

The Court of the Bank of England should also be changed so that it can hold the executive to account more readily. While the Treasury Select Committee does a good job of this it can only do so irregularly and the disclosure of information to the Committee has to be restricted at times. It is difficult to argue that the Court is currently doing its job well when it signed off the internal reviews that have recently been published. Not only was there much too long a delay before commissioning them (the FSA review was published the Turner review in March of 2009 for example) but to limit the scope of the reviews in the way it did suggests that the Court was too concerned about protecting the Bank's reputation and not focused on learning the lessons from the crisis. After all how could those reviews not investigate the Bank's failure to see the crisis coming?

The Court currently contains the Governor, the Deputy Governors, the Chairman of the FSA and a member of the FPC as well as six independent members. While it makes sense for the Executive of the Bank and the independents to meet, we believe that the Court should be made up purely of non executives. The role of that Court should be to hold the Executive to account. We do not believe they can do so effectively when the executive sits on the Court. The Bank is proposing an oversight committee for financial stability made up purely of non-executive members but that should be extended to all governance of the Court.

The new Court should review the Executive's performance formally on an annual basis for the three areas of responsibility and it would be up to the Court to decide if the Executive had delivered or not. Those reviews should be made available to the Chairman of the Treasury Select Committee on a confidential basis. Such a structure would create a clear governance procedure with the Governor and his team being held to account for their actions.

Another structural change we would introduce would be to ensure that the Bank does not have a majority on either the FPC or the MPC. It is vitally important that the house view can be challenged and if necessary outvoted. A larger group of external members would also allow it to be more diverse. The fact that almost all MPC members have been professional economists is not a plus in our view. There has been a distinct lack of financial market expertise on that Committee in recent years.

We also believe that while it makes sense to have the FPC and MPC as separate bodies, because of their differing areas of expertise, provision must be made for them to interact on a formal basis. In theory this could be left to the Governor and Deputy Governors who sit on both committees. Yet the evidence thus far is not supportive of this being effective, given that QE and rising capital and liquidity requirements have been offsetting one another in the last couple of years. We believe there should be a formal meeting of the two committees every quarter so that the overall effect of the policy measures of the Bank can be considered.

One final change we would make is to develop an idea provided to us by Sir John Gieve at our debate on the Bank of England in September of this year. He suggested having two separate teams at the Bank preparing the forecasts for the MPC to consider. Indeed, David Stockton in his review suggested having a staff forecast. We would tweak this slightly. We think there should be one team producing the core forecast and another looking at what could go wrong. Ideally they would "wargame" worse than expected scenarios and put probabilities on them. There was a distinct lack of non-conformist thinking at the Bank in the run up to the crisis and as the reviews noted arguments are often put in a way to make them palatable to senior management. This is always a risk in large organisations and the only way to stop it is to formalise a process where the conventional view is challenged.

Changing the culture of the Bank of England

These are structural changes which we think will also help change the culture of the Bank, but that needs to be addressed directly. There has been a tendency under the current Governor to put a lot of faith in internal research, conducted by academics. This has resulted in the Bank lacking financial expertise and being too insular in its approach. David Stockton, in his review of the Bank's forecasting performance, suggested more interaction with the outside academic world. We think that the same is true of the financial world. In our opinion the Bank should actively seek to hire people who have financial markets experience, not just in the area of financial stability but also the area of monetary analysis. At the moment there appears to be a one-way door out of the Bank into the City for many of its young, upcoming economists. We would like that door to become two-way. The Bank should consider short term contracts for such people rather than necessarily long term careers and many might even be able to go on secondment to the Bank. David Stockton also argued for more assertive and experienced staff to challenge internal thinking. Where better to go and find them than in a financial sector that is shrinking in size?

In particular in the PRA we have an organisation headed up by a career Bank employee. We believe he should have senior deputies who are experienced in the financial industry. This is not just for banks but also for other areas like Insurance and Asset Management. We have heard a great deal of anxiety from those industries that the Bank does not understand their businesses and needs to be better informed if it is to carry out its regulatory role properly. We believe that it would be a good idea, for example, to ensure that there is a senior executive from the PRA responsible for non-bank financial institutions sitting on the FPC.

Equally we think the Bank should encourage movement between its divisions so that those who, for example, currently specialise in monetary analysis spend time looking at financial stability or prudential regulation and vice versa. This would encourage staff to think about other areas and potentially take a broader view.

This process of change at the Bank needs to start as soon as possible. We believe the new Governor should be given a mandate to change and trust that the Chancellor has given him such a mandate. The Government should also seek to introduce amendments into the Financial Services Bill to make the structural changes that we recommend.

How could a new Governor help the Recovery?

This report has focused on how to reform the Bank of England so that it can do a better job in the future. We have talked about where the Bank has gone wrong and suggested some structural solutions. What we have not done until now is talk about how the Bank, and in particular the new Governor could change policy to aid the recovery and boost growth. Sir Mervyn and some of his senior staff, like Charles Bean, have hinted that policy may have done as much as it can. Lord Turner in part of his bid to be Governor has suggested that policy might have to be more adventurous. In his speech at the Mansion House in October[41] of this year he said:

> *"..quantitative easing alone may be subject to marginal impact…So optimal policy also needs a willingness to employ still more innovative and unconventional policies, and to consider the combined impact of multiple policy levers – monetary policy, Bank of England liquidity insurance, prudential regulation and direct support to real economy lending – which we use to consider quite separately, or else avoid entirely."*

We believe that he is right.

As we have noted time and again Bank of England thinking in the run up to and since the crisis has been too conservative, with little understanding of how policy needs to be different in the current situation. The one exception to this was the aggressive easing of conditions post the failure of Lehman Brothers.

We have argued that the correct focus is one that gets credit flowing again. The introduction of the Funding for Lending Scheme and the decision of the FPC

41 http://www.fsa.gov.uk/library/communication/speeches/2012/1011-at.shtml, Speech by Lord Turner, Chairman, FSA at the City Banquet, Mansion House

and FSA to ease liquidity requirements and be more flexible on capital ratios, are finally steps in the right direction. Indeed, it was these measures that Lord Turner was referring to above. However, we would go further. We fully support Bill Winters' view that the liquidity facilities of the Bank should be made more readily available to the banks so that they could take into account that liquidity support in their lending and liquidity planning. In particular we think the FLS should be much more aggressively extended. We believe there is a case for giving the banks as much low cost medium term funding as they want and it should be made clear that this would remain available until market conditions improved. Of course such funding should come with conditions attached to ensure that they use it to sustain or increase lending.

To achieve that thought the banks also need clarity on capital requirements. Currently they have been told that they have some flexibility on their capital requirements and do not have to continue to build up their capital ratios. Yet all banks know we are moving towards Basle III and, in the UK's case, to capital requirements in excess of those required by Basle III care of the Independent Banking Commission. It should be made clear to banks that, again, any further drive to higher capital requirements would also be a function of the economy and financial system returning to normal. To quote Lord Turner again " *…if we simply demand higher capital ratios, and if banks achieve them through deleveraging, that would be bad for credit supply and bad for economic growth. So we face at least a potential short term trade off between resilience and lending.*" The same is true for liquidity requirements. The more highly liquid low return assets a bank is required to hold the less room it has to lend. Again the recent relaxation of liquidity requirements should be made quasi-permanent until conditions improve sufficiently.

The Bank, through the FPC and the PRA, should make it clear that it would not change this new stance without notice and that the new facilities like the FLS would only cease to operate if conditions were judged to have normalised. That is the only way to avoid the problems highlighted by Bill Winters in his review.

The current leadership of the Bank does not think this is right. Sir Mervyn King in a recent speech[42] said that banks still had "*…insufficient capital. Just as in 2008, there is a deep reluctance to admit the extent of the undercapitalisation of the banking system in many parts of the industrialised world. The verdict is clear – without central bank support banks still find it expensive to borrow.*" He said that, because of this, the Bank, together with the Government had set up the FLS. However, the FLS "can only be a temporary scheme. The window of opportunity must be used to restore the capital position of the UK banking system." The problem with Sir Mervyn's view of the world is that in current circumstances the amount of capital banks would have to have to make them seem a top creditor again in financial markets would be very high indeed. The financial markets see considerable tail risks in the current environment largely because of the situation in the Eurozone.

The banks simply could not raise the amount of capital in the markets necessary to get them to where Sir Mervyn thinks they should be. Once again he is living in a dangerous theoretical world. If the banks feel they are under pressure to raise capital ratios and they cannot raise the capital easily, then they will have no choice but to delever. So, in our view, he starts from the wrong premise. The Bank of England's job should be about making it as easy as possible for banks to move from the current position to one of higher capital while at the same time

42 Speech by Mervyn King, Governor of the Bank of England to the South Wales Chamber of Commerce, 23 October 2012 http://www.bankofengland.co.uk/publications/Documents/speeches/2012/speech613.pdf

continuing to provide credit to the economy. Lord Turner said in his speech that he would not want to start from here, but we have to. Sir Mervyn seems to want to start from another place.

Lord Turner went on to say that "*we need to be ready, if these measures prove insufficient, to consider further policy innovations, and further integration of different aspects of policy – to overcome the powerful economic headwinds created by deleveraging across the developed world economies*."

What could such measures involve? It was suggested by Robert Peston[43], Business Editor of the BBC, after Lord Turner's speech that the Bank speculated that this could mean the Bank of England cancelling the gilts it owns rather than the government repaying them. Sir Mervyn in his speech countered "There has been some talk about the possibility that money created by the Bank could be used to finance additional government spending, or that money could be given away. Abstracting from the colourful metaphor of "helicopter money", such operations would combine monetary and fiscal policies." He argued that to cancel gilts would "run the risk of losing control over monetary conditions." If the gilts were cancelled then the Bank would have no assets to issue to cover the payments on the reserves that we had created. He argued that the Bank would then have to print the money on those reserves and it would spiral out of control.

In normal times the Governor might be right, but in extraordinary times the Bank could simply change the rules – that after all is in their power as a central bank. For example, the Bank could insist on banks retaining a certain level of reserves at the Bank that would offset the reserves created but remunerate them at a zero rate. Or it could place a cap on the amount of reserves it might pay bank rate on. It might also be the case that the banking industry may need to hold more cash like instruments on its balance sheet to meet liquidity requirements. That would likely mean they would have less excess reserves to place with the Bank of England, requiring the Bank to leave more money in the system. Finally it could convert the existing gilts into irredeemable treasury bills yielding bank rate, which would avoid his final concern.

Then there is the question of whether it would be inflationary. QE seems large but the total of £375bn of asset purchases has a duration of around eight years. This would add around £45bn per year[44] permanently to the money supply if the gilts were not to be redeemed each year. This is a considerable number but small relative to the £2.1tn of M4 money supply, barely more than 2%. Again in normal times that would be large but if the banks are still capital constrained the underlying growth of the money supply might be very weak. This is something

In the textbook world money supply is a multiple of high powered money. This is because banks retain a ratio of high powered money to total assets so they can meet demands for liquidity from their customers. Therefore if you increase high powered money, banks would increase their balance sheets by a multiple of this through lending the extra money. In such a way money supply would grow and if you overdid it the result would be a rise in inflation. However, in the modern world money supply is effectively a multiple of capital (because bank balance sheets are constrained by capital ratios), not high powered money, so high powered money creation is not necessarily inflationary if there is insufficient capital to support the extra lending.

43 http://www.bbc.co.uk/news/business-19918332

44 £375bn spread over eight years

which does not appear to have been understood by the Bank or indeed a number of other commentators.

There may also be circumstances where fiscal and monetary policy may need to be coordinated like in the aftermath of a Eurozone break up for example. As the UK's dominant trade partner such a break up could be hugely deflationary particularly if it damaged the balance sheets of the banks again. That might mean that all normal means of stimulating the economy might be swamped and the Bank might well want to provide the government with the ability to spend to offset those deflationary impulses. While direct financing of deficits is illegal under European Union rules the Bank of England could indicate that it would stand ready to buy any debt issued by the UK government in the secondary market. In addition, in such circumstances the Bank would also need to be prepared to provide unlimited lines of credit to the banking system again as it did in the aftermath of Lehman's failure, as it is likely financial markets would once again freeze up.

“It is not enough to say we have done all we can. Central banks can do almost as much as they wish. The job of a good central banker is to work out how much needs to be done”

Central banks have the power to create money to support the economy. The question is how best to use that power. For sure the Governor needs to think about the long run credibility of the Bank but central banks, like the Bank of Japan, can lose credibility by doing too little as well as by doing too much.

For now our suggestion is that the Bank does all that it can to help the banks and the financial sector rebuild itself in the years ahead. That should be the target of its policy. Nothing should be off the table but policy has to be calibrated to the degree of seriousness of the situation. To our mind the Bank has underestimated the seriousness of the current situation and in particular has not understood the implications of the damage to the banking system. It is not enough to say we have done all we can. Central banks can do almost as much as they wish. The job of a good central banker is to work out how much needs to be done.