



Pointmaker

RE-EMPOWER THE BANK OF ENGLAND

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SUMMARY

- In 1997, Gordon Brown reformed the governance of the financial sector. This was set out in the *Tripartite Memorandum of Understanding*.
- The division of responsibilities between the Bank of England and the FSA was designed to allow the Treasury to retain ultimate control. The “divide and rule” principle was applied.
- Gordon Brown’s desire for ultimate control ended in failure. This Tripartite Arrangement has been a disaster.
- The central flaw in the restructuring was the removal of the Bank of England’s role in supervising individual banks. This role was transferred to the FSA.
- This meant that the Bank of England lost its most important weapons in supervising the banking system, having neither influence over, nor information about, the behaviour of banks.
- The Tripartite Arrangement needs to be recast. The FSA should become a subsidiary of the Bank of England. Its relationship with the Bank should be similar to that of the MPC.
- Responsibility for the stability of the financial system as a whole should be entrusted to a third subsidiary, the Systemic Policy and Risk Committee. This would report in much the same way as the MPC.
- The Bank should have responsibility for managing the tensions that would arise between its three subsidiaries.
- Ensuring high calibre appointments to the boards of the three subsidiaries, and to the Court of the Bank, is essential and should be subject to Parliamentary scrutiny (via the appropriate Select Committee).
- The idea of a greater role for EU regulation of UK financial services must be resisted.

THE FLAWED DECISION OF 1997

The decision in 1997 by the Labour Government to give the Bank of England independent control over monetary policy was, at the time, hailed as a master stroke. Gordon Brown has since allowed, and encouraged, this to be thought of as a touchstone of his brilliance.

However it was only part of a wider decision, a decision which reallocated responsibility for the governance of the financial sector as a whole. This was deeply flawed. In fact the new arrangements have proved disastrous. They have contributed to the failure of the regulatory system which we have recently experienced and which is, in turn, a central cause of the catastrophe which has engulfed our economy.

Giving the Bank of England independent control of monetary policy was not a new idea. Nigel Lawson had promoted it when he was Chancellor of the Exchequer but the proposal was blocked by Margaret Thatcher. Nevertheless Gordon Brown carried it into effect with a blaze of publicity to much public acclaim. He introduced it very much as his own plan without, it is said, consulting the Cabinet. This part of the decision was thought to be a prize worth having for the Bank of England because it would free the conduct of monetary policy from the shackles of short-term politics. And everyone agreed, because for many years before then monetary policy had been bedevilled by short term political considerations.

Instead of the Chancellor making decisions on interest rates, this responsibility was entrusted to the Monetary Policy Committee, a new body set up within the Bank of England to do this. This Committee was to consist of individuals nominated by the Government and, to this extent, it could

theoretically have been claimed that the avowed independence was slightly tainted by the risk of having political appointees; but this was a remote risk and easily worth running.

No one quarrelled with this part of the decision. It was the rest that turned out to be the disaster.

It is worth reflecting on what happened, because it has a direct bearing on what needs to be done now. The starting point is that the financial sector must work smoothly if the economy is to prosper. The Government has a duty to ensure that this continues satisfactorily. There are several facets which need to be taken into account: monetary policy is obviously one; the supervision of banks and other financial businesses is another; while other tasks like organising the Government's borrowing programme and managing the nation's foreign exchange reserves are yet other aspects of the duty. Overriding all of these, however, is the need to ensure that the financial system is kept stable. If this breaks down, as we all now know, disaster follows inevitably.

THE TRIPARTITE MEMORANDUM

Under Gordon Brown's decision, the responsibility for prudential supervision of banks and financial institutions was removed from the Bank, and given to the Financial Services Authority (FSA).

Responsibility for the stability of the financial system was ostensibly left with the Bank of England. This was the subject of the now famous *Tripartite Memorandum of Understanding*. Everyone involved must have known how crucial this was. There was much negotiation about the terms of this Memorandum by many clever people. For it

was to govern the working relationship between the Bank, the FSA and the Treasury, and to govern who had responsibility for the stability of the system. Its purpose was to lay down 'who does what'. In the event, however, the result was a messy compromise; even after revision five years ago, the fundamental defect remained.

The Memorandum starts with the assertion that the Treasury, the Bank of England and the FSA are to "work together towards the common objective of financial stability in the UK". It goes on to state that each must have unambiguous and clear responsibilities with a clearly defined role. These are elegant words from a draftsman obviously experienced in compromising power struggles. The Memorandum goes on to deal with the Bank's responsibility thus:

"The Bank contributes to the maintenance of the stability of the financial system as a whole – one of its two core purposes."

And it uses words such as the Bank's responsibility involves "ensuring the stability of the monetary system as part of its monetary policy functions" and, further, "involves maintaining a broad overview of the system as a whole", adding that the Bank is "uniquely placed to do this, being responsible for monetary stability."

So, although the document nowhere states clearly and unambiguously that the Bank has sole, or even main, responsibility for the stability of the financial system, this is the only and obvious inference. The central flaw, however, is that once the supervision of individual banks and the financial institutions was removed from the central bank, it ceased to be in direct touch with them, and was thus no longer in direct touch with what was going on in credit markets. Knowledge

of potential trouble was no longer available. Responsibility for the supervision of individual banks having been entrusted to the FSA, the Bank thus lost not only the access to knowledge but also the most important weapon needed to carry out its duty in respect of the stability of the system; for, not being in direct contact, it no longer had influence, let alone control, over banks' behaviour. This transfer of duties to the FSA thus emasculated the Bank's power over the system as a whole. You cannot ensure stability of the system if you do not know in detail what the banks are doing; and you need the power to restrain rash behaviour.

In several countries the responsibility for monetary policy on the one hand and for supervision of banks on the other is given to separate agencies, the central bank and a separate supervisory authority. Where responsibility for financial stability is entrusted by the Government (or by the constitution in some cases) to the central bank, the basis is that the central bank will have access to continuous and complete information flow from the supervisory agency, and will thus be properly empowered to do the vital stability job.

This was neglected in the new arrangements. The Tripartite Arrangement talks a good deal about flows of information.¹ But it fails to lay down an effective channel and a foolproof continuous flow.

The transfer of the supervisory role to the FSA was at least partly the outcome of long-harboured but unspoken jealousy and suspicion. The Treasury has long been

¹ For example, it states that: "to establish information sharing arrangements to ensure that all information which is or may be relevant to the discharge of their respective responsibilities will be shared fully and freely."

envious of the Bank of England. Viewed from Whitehall the Bank seems grander, with a long and splendid reputation, particularly internationally, and with relationships with other central banks which gave it a special air of authority.

Some of this awkward relationship comes, perhaps justifiably, from the experience of events such as the Johnson Matthey affair in 1984. Johnson Matthey's main business was in the gold market, which was important to the City of London's international position. It had a subsidiary which was a bank, which had lent unwisely and got itself into trouble. The Bank of England considered that the failure of this subsidiary bank, although not very important in itself, could throw Johnson Matthey as a whole into jeopardy and that for this reason the bank had to be rescued. For Johnson Matthey was a big name in the London Gold Market. However, this rescue was going to cost a significant amount of public money.

The then Chancellor, Nigel Lawson, was only told about the emergency early in the morning of the crucial day, and was thus faced with an unattractive *fait accompli* for which he would have to take responsibility. His angry reaction was not surprising, especially as he was misinformed about the amount of public money involved. The Treasury must have felt the Bank had let them down and, understandably, resolved that this should never be allowed to happen again.

DIVIDE AND RULE

The deliberate division of responsibilities between the Bank and the FSA ordained under Gordon Brown's new arrangement would allow the Treasury to retain ultimate control. The divide and rule principle was being applied.

The Governor, Eddie George (later Lord George of St Tudy) was known to be far from content, particularly about the removal of the Bank's supervisory powers and the transfer of the management of the borrowing programme to the new Debt Management Office, which eliminated another direct contact between the Bank and the market; but he was too loyal to engage in public argument about this, even though he knew that insulating the Bank from direct contact with the market was likely to make the Bank's role in relation to stability difficult, if not impossible.

Thus negotiations over the wording of the Tripartite Agreement were not easy. Many iterations of the draft of the Tripartite Arrangement passed between the authorities. However, the responsibility was the Chancellor's. It was his decision in the first place, and it was his responsibility to see to it that the maintenance of financial stability was properly safeguarded. But his desire for ultimate control was decisive; and it ended in failure.

The failure of the Tripartite Arrangement in the event was total. The FSA has explained what happened with Northern Rock, and has pronounced *mea culpa*. It showed up the crucial lack of information flowing from the FSA to the Bank, as a result of which the Bank of England was left in the dark and was thus unaware of the dangers. Hence the first run since Overend Gurney in 1866 and ensuing national disgrace.

Sir John Gieve was the principal individual on the boards of both Bank and FSA, with responsibility for ensuring the flow of information; but as an ex-Treasury and Home Office official he lacked direct experience of the workings of credit markets, which demand constantly alert attention. This allocation of responsibility was a disastrous mistake.

WHAT NEXT?

Tens of thousands of words have been written in newspapers and official reports, including the Turner Report, on what happened and why; and what ought to be done about it. These have provided a smoke screen for the authorities.

As far as regulation is concerned, however, what needs to happen now is relatively simple. The decision to remove the essential powers from the Bank must be reversed. That is why many of the proposals of the Conservative Party, who would restore the Bank of England to its former glory, are right in so far as they go. However, they may be ill-advised when they propose strengthening the FSA *as a separate body*.

Several countries entrust the supervision of banks and other financial firms to agencies separate from their central banks (this is the case, for example, in Germany and Australia). There is logic behind having a separate agency: the task involves having a considerable army of personnel available to go into any bank and examine the nuts and bolts to ascertain whether it has adequate capital, proper levels of liquidity, and is treating its customers fairly. These are tasks which need not necessarily be done by the central bank.

However, a separate agency need not be independent of the central bank. Indeed, there is a strong case for structural connection. The fundamental point, however, is that if responsibility for the stability of the financial system is entrusted to the central bank and the task of prudential supervision of banks is given to another body, there must at least be a foolproof mechanism for the flow of information about what the banks are doing and how sound they are. Otherwise there is a recipe for disaster.

In our case we have learnt by experience that lack of experience and knowledge of markets by key individuals is bound to prevent the flow of information. What the FSA knew, or ought to have known, was not passed on to the Bank.

To overcome the risk of this recurring, the Tripartite Arrangement needs to be completely recast. In the first place, the FSA should become a subsidiary of the Bank of England. Its relationship with the Bank should be analogous to the position of the Monetary Policy Committee (MPC). Secondly, responsibility for the stability of the financial system should be entrusted to a third subsidiary body of the central bank. So the Bank of England would then have within it three separate bodies: the Monetary Policy Committee, the FSA and a 'Systemic Policy and Risk Committee' (SPARC). These would all be separate but subordinate bodies.

The Systemic Policy and Risk Committee

The role of the SPARC would be to oversee continuously the stability of the financial system. It would report regularly (like the MPC does), and if it saw danger signals it would recommend action by either or both its counterparts, the MPC and the FSA.

Having an agency whose remit would be focussed exclusively on the stability of the system is a new concept. But if this crisis has taught us anything, it has shown that just such a body is necessary. And its work needs to be continuous, through good times and bad, to counteract the complacency which naturally develops during a prolonged period of apparent stability. The FSA would remain responsible for supervising individual banks and financial institutions and ensuring that they do their business properly vis-à-vis the market and their retail customers, a job which is necessary to prevent mis-selling of financial

products and services. It can also be the agent for ensuring that banks have adequate capital and liquidity. The information must flow from the FSA to the SPARC, and it would be for the Bank of England in its 'holding company' role to ensure that this happened.

There will be occasions when there is tension between these three bodies. For there will be times when the monetary policy reaction to a weakening economy demands lower interest rates, while at the same time there is also a need to restrain bubble growth in, for example, residential house prices. However, in such a case there can be advantages to enabling a single hand which can resolve the argument.² In the example where there is an incipient house price bubble, the central bank will be able to see from the MPC's advice that low interest rates are the basic requirement for the productive part of the economy; while from the SPARC it will see that the bubble must nevertheless be restrained and this may call for increased capital requirements to be imposed for lending on mortgage. The FSA would enforce the increased requirements recommended by the SPARC.

Again, the weakness of one or more banks might make an interest rate reduction desirable, at a time when inflation indicates the opposite. A balanced decision is most easily reached if there is a body responsible for reconciling the views of MPC and SPARC as well as the FSA.

Appointments to the Bank

The membership of the boards of the SPARC, the FSA, and the MPC, which is obviously crucial, would require the selection of

experienced people of the highest calibre. This would also continue to be the case with the Court of the Bank of England, especially since its authority and the importance of its role would be significantly greater under the construct proposed above. For, while not empowered to override the MPC's interest rate decisions, it would have the responsibility of receiving and then reconciling the recommendations of the three agencies, and ordering the action required.

Any Government inevitably will want to retain the power to make these appointments. To ensure high quality non-political appointments, proposed appointments initiated by the Treasury would be commented on by the Bank of England and then submitted to the appropriate Parliamentary Select Committee for comment, if not approval. This is about as near as we could in practice get to the well-tried US system of "advise and consent"; and while not perfect, it would guard against the danger of appointments being made on the grounds of political correctness.

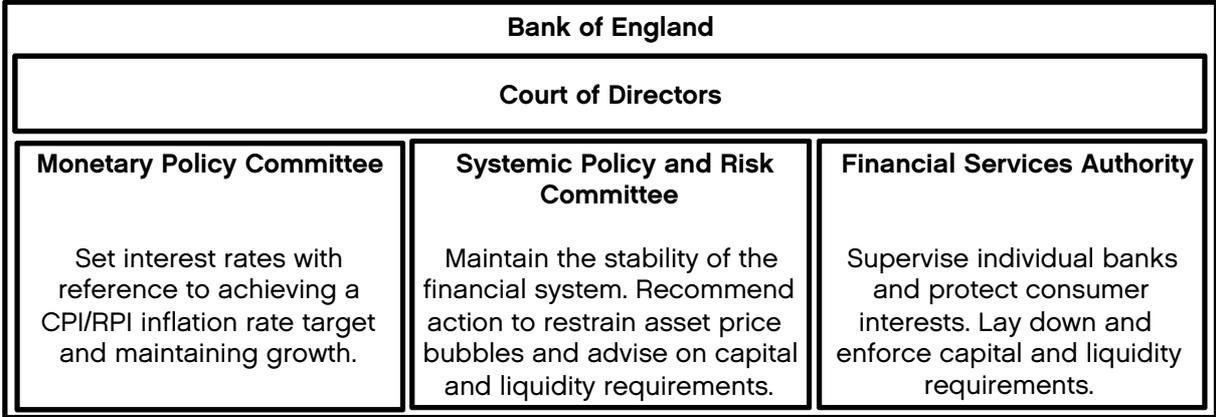
International considerations

These arrangements must take into account that many foreign owned banks are lenders in the UK; so one of the regulatory requirements should be that retail deposit taking, mortgage lending and retail bank lending require a fully capitalised UK local subsidiary or ring-fenced branch. Relying on the home country's capital requirements and regulatory supervision will not achieve the desired outcome.

Ceasing to rely on home-country supervision as far as retail banking business is concerned will be thought to be a step backwards away from global co-operation and integration. Perhaps. But it is necessary to have rules which are effective to prevent the repetition of the kind of disaster presented by the saga of the Icelandic banks.

² In 1997, the MPC was ordered to concentrate on inflation above all else. The fateful consequences of this decision have been explored by Maurice Saatchi in *The Myth of Inflation Targeting* (CPS, 2009).

PROPOSED STRUCTURE



The idea of an EU regulatory body was favoured in the Turner Report. This should not be the chosen option. It is natural that Lord Turner, the Chairman of the FSA, should plead for the continued independence of the FSA; and it is predictable that the EU authorities will seek to intervene and impose more controls. Moreover, an international body may sound superficially attractive in an era of global banking. But when things go wrong, trouble quickly becomes a national problem again, as Professor Charles Goodhart has pointed out.³

The only satisfactory structure is for regulatory power to lie with the lender of last resort. An international agency may, like the Pope, have moral authority; but the central bank has the divisions, both in the provision of funds and the wielding of influence over the banks under its jurisdiction.

The benefits of a strong Bank of England

If the responsibilities for monetary policy, prudential supervision and the need to ensure systemic stability, were all vested in

agencies lodged within the Bank of England, this would achieve several advantages:

- There would be no risk of divided control. Nothing could slip between the cracks as has happened under the Tripartite Arrangement.
- It would facilitate early and decisive action, which is especially important in an era of leaks and rumours.
- It would enable some of the significant risks in global banking to be handled sensibly. This includes the risk inherent in the fact that (since banking is now a global business) most major banks have very large deposit liabilities in currencies other than that of their own home country.
- It would be the best way of deflecting the risk of EU action (which will inevitably incorporate an anti-London bias).

Stability requires that there should always be access to ‘lender of last resort’ facilities, and this means that there needs to be a mechanism for providing ‘last resort’ lending in these various currencies. The best way of ensuring this is not through complex international agencies but by means of

³ See for example, “The Fundamental Principles of Financial Regulation”, Geneva Reports on the World Economy – Preliminary Conference Draft, by Charles Goodhart et al.

direct personal conversations between the central bank governors in Washington, Frankfurt, Tokyo and London. This is what facilitated a satisfactory solution to the Latin American debt crisis in the 1980s. Action can be taken quickly; whereas a new international agency will get in the way of quick practical action.

Under these proposals the central bank would have all available weapons with which to do the job. This would include the power to increase capital requirements for lending to a particular sector, so as to discourage the growth of asset price bubbles. It would also include powers, in the event of trouble, to prevent the remittance of liquidity from a UK subsidiary of a foreign bank back to its parent bank overseas.

The regulation of banks could be done, as it needs to be, with rigour. Many years ago badly managed banks were allowed to fail. Market discipline prevailed and prudence was rewarded. Even now banks which are not large enough to influence the fate of others can still be allowed to fail. But many banks are now so large and so involved with other banks that their failure would endanger the stability of the system. And many have retail depositors with votes, whom the Government does not want to see lose their money in a bank collapse.

So the 'too big to fail' principle now covers many institutions and the public is now relying on this much more, even, than the deposit guarantee regime. This carries the risk of heavy public cost. Only through rigorous supervision can it be established that banks are not conducting their business in a way which disregards the potential

public risk. This is especially so since the cost-free nature of the 'too big to fail' guarantee involves the risk of moral hazard, which can lead to imprudent behaviour by bank managements.

The FSA has to ensure that the public interest is safeguarded; but regulation always tends to diminish the importance of self-imposed prudence. It does not guarantee high-quality banking. It encourages management to rely on the regulations to define required behaviour; and thus, unless designed and applied with skill, actually tends to increase risk-taking. The regulations should therefore be designed to counteract this and could even require remuneration structures for management that favour prudent behaviour and penalise undue risk taking. Regulation should be framed so as to replicate as far as possible the days when prudence in banking was also profitable. Merely increasing required capital is not the answer. Adequate capital is vital, of course, but when capital requirements are too heavy this increases costs, reduces efficiency and does not make badly managed institutions more secure.

It is to be hoped that the Government will accept that the Tripartite Arrangement was a mistake, and that responsibility for the stability of the financial system must be entrusted to an agency with no other role, an agency within the Bank of England which can use its powers to discharge the duty effectively and efficiently.

Only then can we be confident that the financial system will be better able to withstand the next financial crisis.



THE AUTHOR

Sir Martin Jacomb was a Director of the Bank of England from 1986 to 1995. He has held senior board positions including that of Chairman of Barclays de Zoete Wedd; Chairman of Postel Investment Management Limited; Deputy Chairman of Barclays Bank plc; Chairman of the Prudential plc and has sat on the boards of, among others, Rio Tinto plc and Marks & Spencer plc. He is Chancellor of the University of Buckingham.

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The Centre for Policy Studies was created in 1974 in response to an economic crisis, in order to promote free trade and free enterprise. Today, championing the importance of the market is as important as ever as Britain endures another recession, with rising unemployment and falling output.

The CPS believes in regulation that does not inhibit the growth of business; taxes that do not act as a disincentive to work or to investment in the UK; and a leaner more effective state that avoids unnecessary intervention in the economy. Recent publications have both analysed the mistakes of the past, and have laid out an agenda for future economic reform: how to rebuild UK economic competitiveness whilst improving our regulatory regime.

The feeble state of the public finances was examined in *The Price of Irresponsibility* by Brooks Newmark MP and *Uh-Oh, We're in Trouble* by Charlie Elphicke, long before the Government's own predictions revealed just how bad things have become. The causes of the financial and economic crises were analysed on *From Boom to Bust* by Howard Flight and *What Killed Capitalism?* by Andrew Lilico. These papers set out both what should have been done then and what should be done now to restore the free market, and revive the economy. And the long-term damage done to British competitiveness was exposed in John Littlewood's *Labour and the Stock Market*. One of the results of this is that the London Stock Market has now fallen by 26% in real terms since 1 May 1997 – the worst performance of all of the major stock markets in the world (with the exception of Japan).

Most recently Maurice Saatchi made the case for never again allowing the UK to become entranced by the quest for low inflation in *The Myth of Inflation Targeting*. The Bank of England should target not only inflation, but also to support the government in achieving sustainable economic growth. In this paper Sir Martin Jacomb provides more detail on how the Bank of England should be restored and reformed, to ensure the systemic stability that should go hand in hand with low inflation and sustainable growth.

There is an alternative to greater regulation, higher taxes, declining competitiveness and economic decline. The Centre is committed to advocating the policies which will lead once again to an economy that is competitive, productive and innovative.