Bank of England Bill

Bill 62 of 1997/98

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The Bill stems from Gordon Brown's announcement five days after Labour's General Election victory on 1 May 1997 that responsibility for monetary policy would be transferred from the Treasury to the Bank of England; and from his announcement a fortnight later that the Bank of England's responsibility for banking supervision would be transferred to a new Financial Services Authority. The Bill receives its Second Reading in the Commons on 11 November 1997.

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I Summary

On 6 May 1997 the new Chancellor of the Exchequer announced his intention to grant the Bank of England operational responsibility for the setting of interest rates. He subsequently made a statement to the House on 20 May 1997 in which he explained the reasons for his decision and announced that the Bank's responsibility for banking supervision was being transferred to a reformed Securities and Investments Board, as part of a major restructuring of financial services regulation.

The present Bill creates a statutory framework for the transfer of monetary policy to the Bank, although the new system has been operating on a *de facto* basis since May. The Bill falls into three main parts each of which is described in this paper after a general introduction. This paper concentrates on the Bill's immediate provisions and does not attempt to explore the wider economic consequences of the new arrangements.

Part I alters the constitutional structure and the financing arrangements of the Bank. A new Deputy Governor is to be appointed, and a special sub-committee of non-executive directors will have an important oversight role. The Bank's financing - through cash ratio deposits - is to be reformed and placed on a statutory footing.

Part II contains the machinery for setting up a Monetary Policy Committee at the Bank and delegates to it the operational role in setting interest rates subject to the Government's published economic policy. The Treasury retains an 'override' for short-term use in exceptional circumstances. Since this area of the Bill has been operating in practice for six months already, this paper contains extensive material to illustrate precisely how the new system works, as well as notes and background on specific clauses.

Part III transfers the Bank's current responsibilities for banking supervision to a new Financial Services Authority which will also have wider regulatory responsibilities under a forthcoming *Financial Services Act*. This issue is treated more generally in this paper, since the prospective changes to banking regulation are part of more widespread reforms to the style and structure of financial regulation which will be introduced over the next two years.

II Introduction

A. Historical background

The Bank of England was created by the *Bank of England Act 1694* and was given a Royal Charter which has been renewed subsequently. Its immediate purpose was to provide war finance. Michael Collins recounts:

> From the outset it was a London-based, privately-owned bank, although retaining close links with the state throughout its history. This relationship involved both duties and privileges. In particular, the Bank came to act as the government's banker - receiving state revenues, arranging disbursements and servicing public sector debt.
>
> One of the important privileges gained by the Bank in the initial legislation (and subsequently confirmed in periodic re-charterings) was monopoly of joint-stock formation amongst bankers in England and Wales (the Scottish and Irish systems were separate and covered by different legislation). For all the other banks the maximum number of partners was fixed at six. In consequence, throughout the 18th and early 19th centuries other English banks had limited access to capital funds. The privilege was eventually removed in two stages - in 1826 and 1833 - but by that time the Bank was by far the biggest bank in the kingdom and it was to be about fifty years before the business of the largest of the new joint-stock banks was on a similar scale.[1]

The Bank's monopoly of note issuance is a more recent creation. Notes were issued by a variety of banks in the nineteenth century but they circulated on the credit of the issuer and not all would have been accepted at par value. In 1833 Bank of England notes were given legal tender status. The Bank's growing dominance of note issue was then secured by the *Bank Charter Act 1844* which ensured that the note issue of other banks declined. Only those banks which were already issuing notes were to be allowed to continue to do so, and those banks were not allowed to increase their issue above 1844 levels. If a bank ceased to issue notes, then it would not be allowed to resume issuing.

> The Bank's obligation to maintain convertibility under the 19th century gold standard was critical to its evolution as a central bank. It meant, in effect, that the bank's management had to pay close attention to the

1 'Bank of England' in *The New Palgrave Dictionary of Money and Finance*, i pp.164-166

> size of its gold reserves relative to the likely demands to be placed on it. Legal necessity ensured that when they fell towards some (unspecified and - depending on circumstances - variable) minimum, the Bank had to take defensive action to restrict the drain on its reserves. Such action was largely non-discretionary but the bank had powerful reasons for developing methods by which to anticipate and counteract such drains on the reserves.[2]

As Collins explains, the Bank developed various policy devices to control the demand for gold, and in doing so created its own rules as a central bank. By the end of the nineteenth century, the main method of control was an interest rate policy:

> In essence this involved the Bank increasing its discount rate (known as the Bank rate) when the demands on its reserves were high and reducing it when pressure was low. In addition, open-market operations in the form of purchases and sales of securities were used to bring market rates into line through the mopping up of any surplus liquidity in the money markets. It is important to appreciate that this interest rate policy was not perceived at the time as an explicit monetary policy. Whatever its effects on the domestic money stock, Bank rate policy was used by the pre-1914 Bank of England for the much narrower aim of protecting its own reserves. Bank action in protecting the reserves was, therefore, essentially self-interested, a defence to maintain the convertibility of its own notes and the viability of its business. However the importance of the Bank's position meant in effect that its reserve policy - its interest policy - became that of the nation (Committee on Currency and Foreign Exchanges 1918).[3]

The period between the two World Wars saw increasing politicisation of the Bank Rate, and over time a shift in power from the Bank, which on occasions in the 1920s and 30s was able to force rate changes on an unwilling government, towards the Treasury. In *The Bank of England and the Government*, David Kynaston charts the changing balance of power between the Bank and the Treasury over interest rate policy.[4] The power to alter the Bank Rate was not clearly demarcated between the Treasury and the Bank during the 1920s. The Governor had told a Royal Commission in 1926 that the Bank's advice 'was always subject to the supreme authority of Government', but prior to rejoining the Gold Standard in 1925 the Governor had also raised the Bank Rate against the Chancellor's wishes in December 1925.

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[2] Ibid., pp.164-5

[3] Ibid., p. 165

[4] 'The Bank of England and the Government', *The Bank of England: Money, Power and Influence 1694-1994*, Edited by Richard Roberts and David Kynaston (1995), pp. 19-55

Kynaston sees the September 1931 abandonment of the Gold Standard (which we had resumed from May 1925 after a gap of eleven years) as formalising a realisation which already existed that the political context of Bank Rate changes in a period of unemployment and volatility meant that the Treasury was becoming the dominant partner in setting rates. He quotes Governor Norman (speaking in 1937):

> 'When the Gold Standard was abandoned, there took place an immediate redistribution of authority and responsibility, which deprived the Bank of some of its essential functions. Foreign Exchange became a Treasury matter.'[5]

After a brief period of rate volatility, the politically-inspired 'cheap money' policy led to a remarkable period of rate stability. Interest rates remained at 2 per cent from June 1932 till November 1951, with the brief exception of the period from August to October 1939.

The Bank of England was nationalised on 1 March 1946 under the *Bank of England Act 1946* - just two months after the nationalisation of the Bank of France. According to the official history of the Bank:

> The Bank of England Act 1946 has attracted little attention from historians. Its passage did not arouse great public interest or controversy. Until very recently there has seldom been any demand that it should be substantially revised. A very brief piece of legislation, clear and concise in most respects, it has not of itself been considered especially interesting. The Parliamentary Debates about it were often rather contrived. On one side were those in favour of placing practice beyond doubt by giving it statutory form. On the other were those who felt that the best thing to do with a satisfactory state of affairs was to leave it alone. Virtually nobody questioned whether the central monetary constitution of the United Kingdom, as it had mainly evolved over the preceding quarter-century, was in practice the best obtainable, fully fit for pouring into a statutory mould at the start of a brave new post-war world. Almost everyone just assumed that it was so. Other countries had been obliged to enact legislation to set up central banks *ab initio*, often after prolonged public enquiry. In many cases the resulting institutions were accorded stated duties and responsibilities. In the United Kingdom no such need was felt. For the central bank was there already, the evolutionary product of growth over time.[6]

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5 op. cit pp.28-9

6 John Fforde, *The Bank of England and Public Policy 1941-58* (1992), p.4

Although the point about the absence of a debate on alternative Bank structures is interesting, it is hard to avoid the conclusion that the central bank would be a nationalised body. The legacy of wartime controls was obviously a powerful driving force, especially in the hands of a radical socialist government free from any parliamentary constraints upon its action. Furthermore, intellectually, the post-war inheritance was of the need to control the economy and avoid the apparent mistakes of the depression and slump that preceded it. The manifesto of the incoming Labour government included the sentence: 'The Bank of England with its financial powers must be brought under public ownership, and the operations of other banks harmonised with industrial needs'.[7]

Whilst the gold standard endured, the Bank's monetary policy was largely unquestioned by government: it was above politics. But the consensus which successive governments adopted of acknowledging the Bank's expertise in operating the system and of allowing the Bank to get on with it disappeared in the early and middle years of this century. By the 1960s, consensus had been replaced by suspicion of the Bank by Labour governments who disliked the Bank's criticism of its fiscal policies and spending plans. The relationship that has persisted in the last decade or so may, in retrospect, come to be seen as the high-water point of Treasury domination of the Bank. An article in the *Economist* quoted Nigel Lawson (as Chancellor in 1987) saying: 'I make the decisions and the Bank carries them out'.[8]

One year later, in November 1988, the same Chancellor delivered a famous memorandum to Prime Minister Thatcher. Impelled by the 'logic of the institutional change', he suggested giving:

> 'statutory independence to the Bank of England, charging it with the statutory duty to preserve the value of the currency, along the lines already in place and of proven effectiveness for the US Federal Reserve, the National Bank of Switzerland, and the Bundesbank.'[9]

He repeated his proposal subsequently in his resignation speech of October 1989. In December 1993, the Treasury Committee, in its report on *The Role of the Bank of England*, called for a transfer of authority for monetary policy to the Bank from the Treasury, subject to an amended statutory framework and accountability to Parliament. It called for the Bank to reform its internal structures and appoint an

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7 Ibid., p. 5

8 'Liberating central bankers', *Economist*, 10 February 1990

9 Nigel Lawson, *The View from No. 11: Memoirs of a Tory radical* (1992), pp.868, 1059, quoted in David Kynaston, 'The Bank and the Government', in *The Bank of England: Money, Power and Influence 1694-1994*, edited by Richard Roberts and David Kynaston (1995), pp.53-4

independent Monetary Policy Committee, again arguing that 'institutional change would assist the credibility and achievement of price stability'.[10]

The Bank's banking supervisory role, however, has attracted less favourable attention in recent years. The collapse of Barings Bank, coming relatively soon after BCCI, focused these criticisms sharply. The Shadow Chancellor, Gordon Brown, was on the record in 1995 as acknowledging the 'very strong case' for banking supervision to be transferred to a separate banking regulator although even so the suddenness of his announcement of the removal of supervision from the Bank in May 1997 took most observers by surprise.[11]

The authors of a recent work on central banks observe that separation of supervision and monetary policy is taken for granted in many jurisdictions:

> For many Continental bankers it is natural that banking supervision should be the responsibility of a specific separate organisation. It is equally hard for the British to realise that the Bundesbank is not the supervisory body in Germany and that the Federal Reserve shares its responsibilities with several other agencies in the United States. In its relationship with Whitehall, the Bank of England may play a conspicuously more servile role than its German or American counterpart, but within the bounds of the so-called Square Mile it dominates the banking scene in a way no other central bank in the industrialised world can match. True, it no longer rules through an informal system of "nods and winks", but the legislation that has formalised the Bank's authority still gives it considerable flexibility to wield its truncheon - and, likewise, plenty of opportunity to get egg on its face.[12]

They develop the arguments for and against what they term 'overt supervisory responsibility' with reference to the German and Swiss systems later, citing the work of Robert Heller in 1990, an economist who had served on the Federal Reserve Board. Heller found some evidence from the track records of central banks between 1980 and 1987 to suggest that banks which did not have supervisory responsibility were more successful in achieving price stability, although he qualified his findings since other factors might also have been relevant. This, of course, does not imply anything necessarily about the effectiveness of the supervision which banks with joint responsibility exercise. Studies in Switzerland and Australia came to opposed but not very surprising conclusions: both conceded that monetary authorities and banking

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[10] HC 98-I 1993-94, 8 December 1993 para 76

[11] 'Labour urges removal of Bank's supervisory role', *Financial Times*, 18 July 1995; 'Old Lady clings to poisoned chalice', *Financial Times*, 20 July 1995

[12] Marjorie Deane and Robert Pringle, *The Central Banks* (1994), p.8

regulators needed to be in close co-operation, and saw some potential dangers in these authorities being the same body, but the Swiss report came down in favour of separation whilst the Australians favoured a single institutional framework.

Deane and Pringle themselves see advantages for central banks in being able to distance themselves from regulatory failures, - the risk of egg on its face, in their words, or reputation contagion as theorists now style it. They caution though that this does not necessarily translate into substantial advantages for the system of regulation. They end by arguing for a centralised financial regulator to oversee all the financial system but they do not suggest this is a role for a central bank.

B. Election commitments

Pledges were made on the Bank of England in the Labour Party's 1997 General Election manifesto. There was no indication in the manifesto, however, that its responsibility for the prudential supervision of the banking sector was to be transferred to a new regulator.

> We will reform the Bank of England and the Treasury so that we can deliver our commitment to low inflation. The Treasury will receive advice from a new council of economic advisers to make policy-making more effective, open and accountable.
>
> For the Bank of England, we propose a new monetary policy committee to decide on the advice which the Bank of England should give to the Chancellor. The Court should also be reformed to reflect a wider range of interests, including those of industry.

The announcement that operational responsibility for setting interest rates was to be transferred to the Bank of England was made on 6 May 1997 by the new Chancellor, Gordon Brown, at a press conference. This was one of the first actions of the new Labour government, and the announcement preceded the Queen's Speech and the resumption of normal business in the House of Commons. The Chancellor explained his decision, the suddenness of which surprised commentators, in the following terms:

> 17. It has become increasingly clear that the present arrangements for policy-making are not generating the confidence that is necessary. That is one reason why Britain has higher long-term interest rates than most of our major competitors. And the perception that monetary policy

> decisions have been dominated by short-term political considerations has grown.
>
> 18. I am now satisfied that we can put in place, with immediate effect, reforms of the Bank of England to ensure that it can discharge responsibilities for setting interest rates in an effective, open and accountable way.
>
> 19. This is the time to take the tough decisions we need for the long-term interests and prosperity of the country. I will not shrink from the tough decisions needed to deliver stability for long-term growth. I have therefore decided to give the Bank of England operational responsibility for setting interest rates, with immediate effect. The Government will continue to set the inflation target and the Bank will have responsibility for setting interest rates to meet the target. The Government's policy is set out in a letter I sent to the Governor yesterday, the text of which I am releasing now. It is the Government's intention to legislate for these proposals as soon as possible. In the interim, the Governor has agreed to put in place the arrangements that will apply once the legislation has been enacted.[13]

On 20 May 1997, in a statement to the House, the Chancellor of the Exchequer again surprised the City when he announced wide ranging plans to reform the structure of financial regulation and to transfer banking supervision from the Bank of England to an enhanced city regulator based on the existing top-tier regulator, the Securities and Investments Board.

> I have decided to take the opportunity presented by the Bank of England Reform Bill that we will introduce to reform the regulatory system. Responsibility for banking supervision will be transferred, as soon as possible after passage of the Bill, from the Bank of England to a new and strengthened Securities and Investments Board, which will also, as a result of forthcoming legislation, take direct responsibility for the regulatory regime covered by the Financial Services Act.
>
> The Securities and Investments Board will become the single regulator underpinned by statute. The current system of self-regulation will be replaced by a new and fully statutory system, which will put the public interest first, and increase public confidence in the system.
>
> The Governor of the Bank of England will be fully involved in drawing up the detailed proposals. The Bank will remain responsible for the overall stability of the financial system as a whole. The

[13] 'Chancellor announces new framework for monetary policy', HM Treasury release 40/97, 6 May 1997

enhanced Securities and Investments Board will be responsible for prudential supervision.[14]

[14] HC Deb 20 May 1997 cc.507-25

III The Bill, Part I: Constitution, Regulation and Financial Arrangements

A. Court of Directors

Clause 1 provides for the continued existence of the Court of Directors of the Bank. The Bank's 1997 *Annual Report* describes the role of the Court as follows:

> Court is responsible under the Charter of the Bank of England for the affairs of the Bank - that is, setting the strategic direction of the Bank as a corporation, and ensuring in particular that the Bank's resources are effectively deployed in pursuit of its key responsibilities. Court does not take decisions on monetary policy but acts as a source of advice for the Governor on business and market conditions. Court's main meetings are held monthly, but shorter weekly meetings are also held.
>
> Court has delegated to the Executive the Bank of England's powers under the Banking Act 1987 and other supervisory legislation. It is thus not concerned with taking day-to-day decisions on supervisory cases, though it receives regular reports on the operation of the Banking Act and on resources in Supervision and Surveillance.

Clause 1 provides for the Court to consist of the Governor, two Deputy Governors, and 16 Directors: the second deputy Governor is a new creation. All the appointments are made by the Queen. The current directors leave office on the day this Bill is enacted, and a new Court will be appointed in accordance with the Bill. **Schedule 1** goes into more detail on the Court. Its ordinary members are to be appointed for three year terms, but the three officials are to serve for five years. Initially, some of the directors may be appointed for shorter periods to allow for future continuity. The Bank can remove a person from office if they absent themselves from meetings for more than three months without consent, if they become bankrupt, or if they are unable or unfit to discharge their duties. The Court is to meet at least once a month, and the Governor is to act as Chair, or in his absence, the chair of the sub-committee set up under clause 3 (see below).

The Court manages the Bank's affairs, except that it is not responsible for formulating monetary policy (**clause 2**). It is to determine the Bank's objectives and strategy, with the aim of ensuring the effective discharge of the bank's functions. It is also required

to ensure the most efficient use of financial resources, subject to the efficient discharge of the bank's functions.

The Chancellor has made it clear that he intends that the Court should be more representative than it has been in the past. In his Statement of 20 May 1997 in the House he said:

> The Monetary Policy Committee's performance will be reviewed by the Court of the Bank. The Court will be substantially reformed, so that it is able to take account of the full range of industrial and business views in this country, and for the first time it will be fully representative of the whole of the United Kingdom.[15]

Later in the exchanges, he elaborated:

> When the Bank of England was nationalised in the 1940s, no real change was made in the organisation of the Court. It is time to ensure that it represents business and sectoral interests throughout the United Kingdom, and all sections of the United Kingdom. When I studied the composition of the Court of the Bank of England, I found that what Courts had in common was that they always included the chairman of a football club in the English league. I want industry to be properly represented, and I want every region, including Scotland and Wales, to be represented on the Court of the Bank of England.[16]

Clause 3 provides for a special sub-committee of directors. This committee of non-executive directors is given an oversight role for certain specific functions:

- keeping under review the Bank's performance in relation to its current objectives and strategy
- monitoring the attainment of the Bank's financial management objectives
- keeping the internal financial controls under review
- determining the remuneration and pension arrangements of the executive directors of the Court

The Treasury Select Committee plans to take evidence separately from this non-executive committee annually.

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[15] HC Deb 20 May 1997 cc508-9

[16] HC Deb 20 May 1997 c516. At the time of the 1997 Report, the footballing representative was Sir John Hall of Newcastle United.

B. Finance and control

Clause 4 requires the Bank to submit an annual report to the Chancellor. Such a report is already prepared, but the new reports will have to include a separate report, on the matters delegated to them, by the non-executive committee set up under clause 3 (see above). The report is also to include a balance sheet and profit and loss account, and a statement on the remuneration of the Bank's directors over the relevant period. The report must be laid before Parliament by the Chancellor. **Clause 7** contains further accounting provisions. It requires the Bank to maintain proper records and stipulates that the Bank should comply with the statutory accounting requirements which apply to other banks, except where the Bank considers an accounting obligation to be inappropriate. The Treasury can give notice requiring additional accounting information to be published, after consultation with the Bank.

Clause 6 reforms the present Cash Ratio Deposit scheme. Among the sources of income for the bank is a system of cash ratios, whereby banks are required to lodge at the Bank a certain ratio of their eligible liabilities. The Bank pays no interest on these sums which instead provide it with free funding for its various roles including the supervision of banks. The deposits are currently assessed at the rate of 0.35 per cent of eligible liabilities, and have a pure funding purpose: that is, they are not used as an element of monetary control.

This clause, and more particularly **Schedule 2**, places the Cash Ratio Deposit scheme on a statutory footing. The Bill extends the scheme from banks to all credit institutions including building societies. The Treasury will have the power to determine by order what an institution's eligible liabilities are, and to set - after consultation with interested parties - value bands and new ratios for the new scheme. It is not known at present what ratio or ratios will apply, but it is expected to be less than the current 0.35 per cent, partly because the cost of paying for banking supervision will be met by a new financing mechanism imposed by the new banking regulator, the Financial Services Authority (FSA). The new Cash Ratio Deposit scheme is to be the subject of consultation before its introduction, and it is intended that the aggregate burden on financial institutions of both the new Cash Ratio Deposits and the cost of banking supervision (which is already the subject of consultation by the FSA) will be no higher than the present Deposit scheme, and preferably somewhat lower.[17]

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[17] *Bank of England Bill Regulatory Appraisal*, HM Treasury, October 1997

IV The Bill, Part II: Monetary Policy

A. Policy announcement

The new Chancellor, Gordon Brown, announced the transfer of responsibility for monetary policy from the Treasury to the Bank of England at a press conference on 6 May 1997. He explained his decision in the following terms:

> 1. The central economic objectives of the new government are high and stable levels of growth and employment. Our aim therefore is to rebuild British economic strength with a modern industrial base, high levels of investment and a culture of entrepreneurship that, through economic opportunity for all, unlocks British economic potential.
>
> 2. This can only happen if we build from solid foundations of prudent economic management and sound finance. The enemy of growth, and the investment necessary for it, is the instability of short periodic bursts of high growth followed by recession.
>
> 3. So we must break from the short termism of the past - the economic instability that has characterised the British economy not just in recent years but for most of the century. That is why I want British economic success to be built on the solid rock of prudent and consistent economic management, not the shifting sands of boom and bust.
>
> 4. Now is the time for long-termism. This is the time to set the British economy on a new long term course that will deliver high levels of growth and employment through lasting stability.
>
> 5. First interest rates. Over the last few days, I have been scrutinising all the available economic data and taking a view on the economic outlook, informed by the latest Treasury forecast. Having looked at the latest internal information now available to me, my judgement is that we have inherited a situation in which, in the absence of corrective action, inflation will overshoot the Government's inflation target next year. This view, in fact, confirms what the Bank of England has repeatedly advised over recent months, as reflected in the published minutes of the monthly monetary meetings.
>
> 6. I have to make decisions on interest rates the results of which will only be clear eighteen months ahead. In reaching my decision I am influenced by the forecasts I have now received for inflation in 1998.

But I have also been influenced by what we see in the economy today, which affects these forecasts:

- recent rapid growth of consumer spending which has grown by 4 per cent over the last year;

- house prices, which are currently rising at an annual rate of 6 to 9 per cent, and are rising particularly rapidly in the south east;

- the recent pick up in average earnings, which are currently growing at 5 per cent a year;

- and the rate of growth of broad money which has been above its monitoring range for over a year.

8. Against these pressures, I have had to weigh the current strength of sterling, particularly against the Deutsche Mark. And I have also taken into account the subdued level of producer price inflation, disappointing levels of manufacturing activity, the weakness of industrial investment and the reduced optimism about prospects for exports, all of which are associated with sterling's strength.

9. No one should doubt my determination to create the conditions in which British business, and manufacturing, can flourish. But because inflation is the enemy of investment, we must ensure that it is under control, as it has not been so often in the recent past. We want a stable and competitive pound over the medium-term, consistent with our objective of price stability. I am convinced that it is in the interests of industry that our commitment to low inflation is delivered in practice.

10. Looking at all the evidence, I believe that the case for an immediate tightening of policy is conclusive. I have decided to raise interest rates by 1/4 per cent with immediate effect. The Governor has indicated his positive agreement with my decision.

11. Price stability is, as I have said, an essential precondition for the Government's objectives of high and sustainable levels of growth and employment. The question is how to achieve the long-term stability that we seek?

12. As the Prime Minister and I have always made clear, this is a new Government that is going to move beyond the old dogmas of the past, and provide a modern and lasting framework for economic prosperity. I have said on repeated occasions that we must tackle the underlying weakness of the British economy- low investment, skill shortages and inadequate infrastructure - all of which have beset the British economy

in recent years. These problems are themselves some of the underlying causes of inflation.

13. I have also made clear that reform is required to put monetary policy on a stable, long-term footing. In a speech in May 1995 and subsequently in our 1995 policy document, A New Economic Future for Britain, I set out my view of the proper roles of the Government and the Bank of England in economic policy.

14. Government has a responsibility to the public in setting the objectives of economic policy and that means that the Government rather than the Bank of England must set the targets for monetary policy.

15. However, as I have repeatedly made clear since 1995, we will only build a fully credible framework for monetary policy if the long-term needs of the economy, not short-term political considerations, guide monetary decision-making. We must remove the suspicion that short-term party political considerations are influencing the setting of interest rates.

16. As our election manifesto said:

"We will reform the Bank of England to ensure that decision-making on monetary policy is more effective, open, accountable and free from short-term political manipulation."

17. It has become increasingly clear that the present arrangements for policy-making are not generating the confidence that is necessary. That is one reason why Britain has higher long-term interest rates than most of our major competitors. And the perception that monetary policy decisions have been dominated by short-term political considerations has grown.

18. I am now satisfied that we can put in place, with immediate effect, reforms of the Bank of England to ensure that it can discharge responsibilities for setting interest rates in an effective, open and accountable way.

19. This is the time to take the tough decisions we need for the long-term interests and prosperity of the country. I will not shrink from the tough decisions needed to deliver stability for long-term growth. I have therefore decided to give the Bank of England operational responsibility for setting interest rates, with immediate effect. The Government will continue to set the inflation target and the Bank will have responsibility for setting interest rates to meet the target. The

Government's policy is set out in a letter I sent to the Governor yesterday, the text of which I am releasing now. It is the Government's intention to legislate for these proposals as soon as possible. In the interim, the Governor has agreed to put in place the arrangements that will apply once the legislation has been enacted.

20. The main elements of the reforms are as follows. In place of the current personalised system of decision-making, decisions will be made by a new nine-member Monetary Policy Committee, on the basis of a majority vote. This is similar to arrangements in other countries including the USA and other G7 members. In addition to the Governor and two Deputy Governors, nominated by the Government, who will sit on the committee, the Government will also appoint four members of the Monetary Policy Committee from outside the Bank of England.

21. Openness of decision-making will be ensured by the publication of minutes of proceedings and votes of the Monetary Policy Committee. There will be enhanced requirements for the Bank of England to report to the Treasury Select Committee of the House of Commons to explain and be questioned on their decisions. The Court of the Bank of England will review the performance of the Bank of England, including that of the Monetary Policy Committee. The Court will be substantially reformed to make it representative of the whole of the United Kingdom and to take account of the full range of Britain's industrial and business sectors. These changes in accountability and the new breadth of representation on the Court amount to the most radical internal reform to the Bank of England since it was established in 1694 - over 300 years ago.

22. Britain is, in fact, one of the few major industrial nations in which its Central Bank does not have operational responsibility for decisions on interest rates. And our record on inflation and interest rates over recent years is poor, while other countries with independent Central banks have performed better.

23. Taken as a whole, these proposals will ensure that decisions are taken for the long-term interests of the economy and not on the basis of short-term political pressures. This is the way to create the stability we need for higher investment and high levels of growth and employment.

24. The changes I have proposed are the right decisions: the right decisions for business which wants to plan ahead with confidence, the right decisions for families who have suffered enough from the uncertainties of short-term economic instability, and the right decisions for Britain.

25. The specific reforms I am proposing are British solutions, designed to meet British domestic needs for long term stability. Our monetary reforms provide the platform for stability and are the building block for a new economic policy that will equip us for the challenges of the future: one that takes steps to ensure higher levels of investment, for which I will announce new measures in due course, and improving employment opportunity by the modernisation of the welfare state. These measures will be addressed in the coming Budget and future Budgets.

26. But there is, as I have suggested today, a more long term context. In the last century, Britain was industrially pre-eminent. The history of this century has been one of economic decline, not least because of short termism and the pursuit of stop-go economics. I am determined that we make the right preparations for long term national economic success, as we look to the century that lies ahead, so that we can move forward again economically. I am therefore setting in place a long term policy for long-term prosperity. The ultimate judgement of the success of this measure will not come next week , or indeed in the next year but in the long- term. I am convinced that this radical reform, together with measures we will announce to equip our economy for the challenges ahead, creates the platform of stability upon which Britain can build.[18]

[18] 'Chancellor announces new framework for monetary policy', HM Treasury release 40/97, 6 May 1997

B. An Independent Central Bank: the Economic Arguments

One commentator, summarising the findings of a major report on the subject[19], noted:

> "the main argument for an ICB is empirical. Those countries which have experienced the lowest and most stable inflation rates in recent decades are those in which the central bank is charged with maintaining price stability and insulated from the political process... Opponents of ICBs... doubt the direction of causation. Countries where the fear of inflation is greatest may be those that give the most independence [and] denying governments the ability to use monetary policy to stabilise the economic cycle may actually lead to more variable output and higher unemployment".[20]

This article was based upon academic work published at Harvard that year. The data which the original paper tried to explain is shown in the table below.

CENTRAL BANK INDEPENDENCE AND ECONOMIC PERFORMANCE

Country (Index of Central Bank Independence)	Average Inflation 1951-88	Variance Inflation 1951-88	Average Real GNP Growth 1955-87	Variance Real GNP Growth 1955-87	Average Unemploy-ment Rate 1958-88	Variance Unemploy-ment Rate 1958-88	Average Real Interest 1957-88	Variance Real Interest 1957-88
Spain(1)	8.5	27.8	4.2	9.4	n/a	n/a	n/a	n/a
New Zealand(1)	7.6	21.9	3.0	5.4	n/a	n/a	0.39	12
Australia(1)	6.4	20.8	4.0	4.6	4.7	7.0	1.1	18
Italy(1.5)	7.3	34.3	4.0	5.7	7.0	5.0	n/a	n/a
United Ringdom(2)	6.7	23.5	2.4	4.0	5.3	18.0	0.98	15
Finland(2)	6.5	20.0	3.9	6.7	3.5	3.0	n/a	n/a
France(2)	6.1	20.9	3.9	4.0	4.2	10.0	1.1	10.0
Denmark(2)	6.5	11.5	3.3	6.7	6.1	10.0	5.6	10.0
Norway(2)	6.1	11.7	4.0	2.3	2.1	0.3	1.5	11.0
Belgium(2)	4.1	10.8	3.1	4.9	8.0	30.0	3.1	7.0
Sweden(2)	6.1	14.0	2.9	3.3	2.1	0.3	1.0	10.0
Canada(2;3)	4.5	12.8	4.1	4.3	7.0	5.0	2.1	8.0
Netherlands (2;3)	4.2	8.4	3.4	7.0	5.1	31.0	0.38	11.0
Japan(3;2)	4.9	19.6	6.7	12.3	1.8	0.3	2.3	16.0
United States (3)	4.1	10.5	3.0	5.3	6.0	2.0	1.6	6.0
Germany(4)	3.0	5.5	3.4	5.6	3.6	9.0	2.6	3.0
Switzerland(4) 3.2	3.2	6.1	2.7	8.6	n/a	n/a	0.95	4.0

[19] *'Central Bank Independence and Macroeconomic Performance: some comparative evidence'* :Harvard Institute of Economic Research Discussion Paper No 1469

[20] 'A (modest) case for an independent central bank', *Financial Times* , 28 October 1991

The countries' banks with the most independence have the highest index number. The variance figures show the degree to which the rate has differed from an average value: hence the higher the figure the more variable has been performance. The first point to note is that the criteria for judging the degree of independence of the central bank includes factors such as "the tenure of the Governor and the frequency of contacts between the government and bank officials". Clearly this part of the exercise involves a good deal of subjective assessment and another commentator might alter this ranking. Secondly, comparing growth rates over any period depends crucially upon the start and end dates. Thus if a country does particularly badly in the prior year this can affect its overall score later on. Finally there is no attempt in the paper to place value judgements upon the different categories of performance, i.e. growth is not assumed to be more important than inflation, or vice versa.

The table presents a good but hardly overwhelming case for the superiority of ICBs. Inflation tends to be lower, but there is a considerable overlap between countries. There is hardly any evidence that real growth rates or unemployment performance were superior over the period in those countries with more independently constituted banks.

There is, however, a difficulty in treating the issue as a purely empirical one. Quite simply it is necessary somehow to isolate the effect of the ICB from all the other policy influences affecting an economy. One suspects that there are many factors that affect different countries differently. Over the period did Australia and New Zealand share anything with Spain apart from a 'non-independent' bank? One suspects that they did, but perhaps not that much. One must also consider the confusion that exists over the conduct of monetary policy. Many of the underlying monetary relationships are only understood imperfectly, do not always seem to work and seem to change over time. Thus the different economic performance of two countries with central banks of equivalent independence, for example, Belgium and the UK, might be due to a better monetary policy in one country and the effects of the superior policy might have outweighed whatever influence resulted from a particular institutional structure.

More work on the empirical aspects of this question appeared in an IMF working paper.[21] It noted that the results of most studies are that countries with independent central banks tend to deliver better inflation outcomes. One study put the gains at an average of 4 per cent a year, but, for reasons given above, the report finds that "closer examination indicates that the evidence is less than compelling". The paper also points out the extent to which economic performance is affected by both monetary and fiscal policy and the fact that monetary policy impinges upon fiscal policy. For example, in the 1980s in the United States a tight monetary policy operated in tandem with a loose fiscal policy. In such circumstances supporters of independence demand that fiscal policy adjusts in order to preserve the credibility of the monetary authorities.

[21] *Central Bank Independence: Issues and Experience,* IMF Working Paper,WP/91/58

The theoretical case for an ICB is based on academic work which includes estimates for the response of the public to the credibility of policy makers in monetary policy. To put it simply, a government may have a long term policy goal of lowering inflation and increasing output but, at any point in time, in the short run, it has an incentive to spring an inflation 'shock'. An unexpected bout of inflation will reduce the value of its existing public debt and can temporarily increase output if workers' wages respond only slowly to inflation. The public, or financial markets, know this and, hence, demand an interest rate premium for holding the government's debt to compensate for the risk of future inflation. Models of this sort are often referred to as 'political business cycle' models and there are many variations on the same theme. However, they all assume that the interest rate premium is positively related to both the size and number of the inflation 'shocks'. The point is that if monetary policy is taken out of the cycle then there can be no shock and hence the markets will reduce their interest rate premium. Furthermore, because it takes a long time to acquire a reputation for monetary restraint, without an ICB the markets will respond slowly to any stated commitment by a government to a low inflation policy. The establishment of an ICB will speed up this transitional period and thus the benefits can be enjoyed sooner rather than later. An alternative approach is to fix monetary policy by some sort of rule, i.e. fix the currency to a low inflation anchor or to some other non-inflationary base, but retain control by political authorities. If the institutional approach is followed, the key issue becomes how to convince the public both of the independence of the organisation and that it has the appropriate policy objectives.

A second argument against an ICB is that it is sub-optimal. Monetary policy ought to be run according to certain rules (such as monetary targets) rather than according to the objectives of an organisation and its members. According to this argument the institution will have to face pressures in dealing with other groups which will introduce a judgmental element into policy making that is no better than the explicit pressures faced by a political authority. If a formally independent bank were subject to government influence by the back-door, it might lead to worse policy results than a more transparent relationship.

Neither economic theory nor practical experience therefore, provide an unambiguous answer to the advisability of the establishment of an ICB. In fact the evidence, such as it is, only serves to push the question back a stage further. ICBs seem to deliver a certain type of economic result (namely monetary stability) at less cost than other institutional models. Whether or not an ICB is a worthwhile goal boils down, therefore, to the proposition that monetary policy and price stability are the most important policy goals. One author tried to justify this proposition in the following terms:

> To reject giving priority to monetary stability with the argument, based in democratic theory, that a parliament must have the right to set priorities in economic policy even to the detriment of monetary stability

oversimplifies the problem. For this claim is rooted in theoretical reflections that perhaps other objectives might be easier to achieve if some inflation is tolerated and that, on balance, overall welfare might perhaps be raised more by not giving priority to monetary stability. The theories that growth can be stimulated by means of mildly inflationary developments, that there is a trade-off between unemployment and inflation and that a fall in real wages via rising prices is socially more cost-effective than a fall in nominal wages are all based on Keynesian theory and the assumption of existing money illusion. Moreover, distribution effects and the costs incurred by evasive reactions are only considered at the margin of these strategies.

Once the money illusion is absent, because the economic subjects learn and/or inflation grows stronger, these conceptions become increasingly ineffective; this has been shown in theory and was brutally revealed by the international reality of the seventies. Inflation has proved to be a process with its own momentum, and the difficulty of controlling it has been summed up by W. Röpke in a comparison which is, it is true, often felt to be overstated, but which has the advantage of repeatedly being confirmed by real life: "You cannot have a little bit of inflation any more than you can be a little bit pregnant."

A market economy is a system which co-ordinates and collates information with great efficiency. Prices are the most important conductors of information, they are influenced by expectations and themselves influence such expectations. The financial sector plays a particularly important role in this process by creating and safeguarding a dynamic climate of economic competition. Its task is to bring continuity to the accounting of real transactions by preventing inflation; this makes economic sense since the transaction and information costs of preventing inflation do not lower the level of welfare. Over and beyond this, it is the task of monetary stability to create and maintain stable expectations for the future. Such expectations are important, since, bearing in mind money's function as a medium in which to hold wealth, they promote long-term capital formation in the form of money, which is in turn a prerequisite for fixed investments in material assets that tie up savings for long periods of time. Monetary *instability*, by contrast, would add further risks to the already existing market risks; willingness to invest then falls, and financial capital is diverted into investments which tie it up for shorter periods of time. In view of this, one can indeed claim that the decision to make monetary stability a priority objective for monetary policy is of comparable significance to the decision in favour of the rule of law as the basis for social organisation. By ensuring monetary stability the state creates a special kind of

> contractual and legal certainty. This property right to dispose over wealth is protected from the arbitrary incursions of inflation. [22]

C. How independent will the Bank be?

This Section looks at the extent to which the current Bill actually gives the Bank true independence and whether or not the Bank would meet the test of independence set out in the Maastricht Treaty.

Clause 10 of the Bill gives the Bank general operational independence. However, even this authority is circumscribed by reserve powers set out in **Clause 19** which gives the Treasury power to direct the Bank 'with respect to monetary policy if they are satisfied that the directions are required in the public interest and by extreme economic circumstances' (see section D below). Neither of these conditions is defined in the legislation, but the Treasury only has this power for a 28 day period and then the order must be approved by resolutions in both Houses. What the Bank does not get by this Bill is full statutory independence: the Bank decides on the level of interest rates appropriate to meet the government's target for inflation. It would seem as though this reserve power and the overarching Government direction of policy might mean that the constitution of the Bank after this Bill will not meet the Maastricht Treaty requirements.

The key part of the Treaty is Article 14 of the Statute of the European System of Central Banks and the European Central Bank. This frames the requirements in a very broad way, it says:

> ….each Member State shall ensure,….that its national legislation, including the statutes of its national central bank, is compatible with this Treaty and this Statute.[23]

Since much of the role and duties of the ESCB and the ECB are not directly replicated by national central banks there is the opportunity for a good deal of interpretation as to whether or not a national central bank does actually comply. Most attention has focused upon the requirements for independence which state that:

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[22] *The European Central Bank: Perspectives for a further Development of the European Monetary System*, Rolf Hasse, (c.1990) pp 127-8

[23] Article 14, 14.1

> …neither the ECB, nor a national central bank, nor any member of their decision making bodies shall seek or take instructions from Community institutions or bodies, from any government of a Member State or from any other body.[24]

As was mentioned above the residuary powers left to the Treasury imply that the Bank will not yet meet this requirement.

The most specific guidance given in the Statute refers to the terms of employment of the Governor. It says:

> The statutes of the national central bank shall, in particular, provide that the term of office of a Governor of a national central bank shall be no less than 5 years.[25]

This requirement is met in **Schedule 1** of the Bill which sets the Governor's term at five years in duration.

The other interesting economic question arising out of the reorganisation of the Bank is whether the powers ceded to it are sufficient to achieve the economic benefits mentioned in the previous section.

Two arguments have been advanced to suggest that it is not. First, that it is the government that sets the inflation target, and hence can change this target (widen the target band for example) to suit political needs. Secondly, since fiscal policy remains in the hands of the government and because fiscal policy tends to have a more immediate impact on the economy than monetary policy, actual economic performance will still be largely determined by governments with political, rather than economic, priorities. Clearly the bill can only do so much to take politics out of economic decision making. In, for example, a pre-election period, a government could cut taxes knowing that evidence to justify increasing interest rates would not be likely to surface for a further six months. This issue has been looked at in an academic study.

The authors divided independence between political independence, defined as the ability of the central bank to decide on the objective of monetary policy and economic independence, defined as the ability of the central bank to choose the instruments of monetary policy to achieve the objective.[26] They, and a number of other similar subsequent studies, found that it was economic

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[24] Article 7

[25] Article 14, 14.2

[26] 'Institutions and Policies', Grilli, Masciandro and Tabellini, published in *Economic Policy* 1991

independence rather than political independence which is important for achieving low inflation. Goldman Sachs commenting upon this study noted that:

> The important requirement is that once the mandate of the central bank has been decided the central bank is free to vary interest rates to achieve the objective. This is the position that the Bank of England is now in.[27]

[27] Goldman Sachs, *UK Weekly Analyst*, 9 May 1997

D. Notes on Clauses: Part II Monetary Policy

This section explains the main provisions of Part II of the Bill. Since the situation provided for in the Bill has been operating for the past six months - on a *de facto* rather than a statutory basis - the opportunity is taken to illustrate the notes with extracts from documents produced under the process. For this reason, comment is kept to a minimum.

Under s.4 of the *Bank of England Act 1946*, which nationalised the Bank and placed it on its current footing, the Treasury had statutory powers to give directions to the Bank 'in the public interest'. **Clause 10** amends s.4(1) of the 1946 Act to exclude specifically any power for the Treasury to give directions over monetary policy to the Bank (but see also clause 16). This is all that is required to give the Bank operational independence for setting interest rates, but the remainder of the Part sets up the structure in which the Bank is to exercise its responsibilities. **Clause 11** sets down two objectives for the Bank's conduct of monetary policy:

> 11(a) to maintain price stability
>
> (b) subject to that, to support the economic policy of Her Majesty's Government, including its objectives for growth and employment.

These objectives are perhaps noteworthy for their explicitness. Although the references to 'growth and employment' under 11(1)(b) are only instances of economic policy and other policies are not excluded, there is a requirement for these two policies to be recognised in the conduct of monetary policy by the Bank. The Treasury is obliged to provide notice to the Bank on what price stability consists of and what the economic policies of the Government are (**clause 12**). This notice is required at least once a year, and must also be provided within seven days of the Act's first coming into force. The notice must be published by the Treasury, and a copy is to be placed in the Library of the House of Commons.

Price stability is defined by an inflation target. The remit of the Monetary Policy Committee was announced on 12 May 1997 by the Chancellor, and included a precise framework for operating the inflation target. The remit presumably corresponds to the type of guidance which will be issued under clause 12 when the Act is in force.

Remit for the Monetary Policy Committee

In my letter of 6 May I said that the monetary policy objective of the Bank of England will be to deliver price stability (as defined by the inflation target) and, without prejudice to this objective, to support the

Government's economic policy, including its objectives for growth and employment. Tonight, at the Mansion House, I will explain how I intend the new framework for monetary policy to work. This letter sets out the Government's remit for the Monetary Policy Committee and explains how the MPC will be held to account for meeting the target.

The Open Letter system

My intention is to lock into our policy making system a commitment to consistently low inflation in the long term. The real stability that we need will be achieved not when we meet the inflation target one or two months in succession but when we can confidently expect inflation to remain low and stable for a long period of time. To this end, I propose a new more rigorous and more precise framework for achieving the inflation target.

Of course, I have to take into account that any economy at some point can suffer from external events or temporary difficulties, often beyond its control. The framework I propose is based on the recognition that the actual inflation rate will on occasions depart from its target as a result of shocks and disturbances. Attempts to keep inflation at the inflation target in these circumstances may cause undesirable volatility in output.

But if inflation moves away from the target by more than 1 percentage point in either direction I shall expect you to send an open letter to me, following the meeting of the Monetary Policy Committee and referring as necessary to the Bank's Inflation Report, setting out:

- the reasons why inflation has moved away from the target by more than 1 percentage point;
- the policy action which you are taking to deal with it;
- the period within which you expect inflation to return to the target;
- how this approach meets the Bank's monetary policy objectives.

You would send a further letter after three months if inflation remained more than 1 percentage point above or below the target. In responding to your letter, I shall, of course, have regard to the circumstances prevailing at the time.

The thresholds do not define a target range. Their function is to define the points at which I shall expect an explanatory letter from you because the actual inflation rate is appreciably away from its target.

The operational target for monetary policy is an underlying inflation rate (measured by the 12-month increase in the RPI excluding mortgage interest payments) of 2 ½ per cent.

> In setting in place this new framework, I believe we have a better chance of achieving consistently low inflation.
>
> Accountability
>
> The Monetary Policy Committee will be accountable to the Government for the remit set out in this letter. The Committee's performance and procedures will be reviewed by the reformed Court on an ongoing basis (with particular regard to ensuring the Bank is collecting proper regional and sectoral information). The Bank will be accountable to the House of Commons through regular reports and evidence given to the Treasury Select Committee. Finally, through the publication of the minutes of the Monetary Policy Committee meetings and the Inflation Report, the Bank will be accountable to the public at large.
>
> Restatement of the Remit
>
> The inflation target will be confirmed in each Budget. There is a value in continuity and I will have proper regard to that. But I will also need to consider the case for a revised target at these times on its merits. Any changes to the remit will be set out in the Budget.[28]

Clause 13 and **Schedule 3** deal with the composition of the Monetary Policy Committee (MPC) which is to have responsibility for formulating monetary policy within the Bank. The Committee's membership consists of:

- The Governor and the two Deputy Governors of the Bank.
- Two members appointed by the Governor after consultation with the Chancellor; these are to be the executive directors of the Bank with responsibility for monetary policy analysis, and for monetary policy operations.
- Four members appointed by the Chancellor; the Chancellor must satisfy himself before their appointment that they have 'knowledge or experience which is likely to be relevant to the Committee's functions' (c.13(4)).

Schedule 3 sets out further rules for the Monetary Policy Committee. Its members are to be appointed for three years, but the Bank's monetary policy executives must vacate their positions if they cease to hold the necessary posts at the Bank. Otherwise, the members can only be removed (subject to the consent of the Chancellor) if they miss the Committee's meetings for more than three months without consent, become bankrupt, or are unable or unfit to discharge their functions as a member of the

[28] 'Remit for the Monetary Policy Committee', HM Treasury 64/97, 12 June 1997

Committee. The Committee is to meet at least once a month, and at least two of the Governor or his two deputies must be present at each meeting. There is a quorum of six. A representative of the Treasury is entitled to attend and speak at the meetings, but not to vote. The short term of office - compare it to the eight year term to which members of the Bundesbank's Central Bank Council are appointed - might be argued to leave scope for the true independence of the Committee's members to be compromised by such short term considerations as re-appointment. The members of the Federal Reserve's Board of Governors in the US are appointed for fourteen-year terms.[29]

The Monetary Policy Committee currently consists of:

The Governor:	Eddie George
Deputy Governor:	David Clementi
Executive Directors:	Mervyn King
	Ian Plenderleith
Chancellor's Appointees:	Professor Willem Buiter
	Professor Charles Gooodhart
	Dr DeAnne Julius
	Sir Alan Budd

The Bill allows for the creation of a second Deputy Governor, who will then take his or her place on the Committee.

Under **Clause 14** the MPC is required to publish 'as soon as practicable' after each meeting a statement on what action it has decided to take. Where such action includes intervening in the financial markets, the Committee can delay publishing a statement on that action if immediate publication of that fact 'would be likely to impede or frustrate the achievement of the intervention's purpose'. However, a statement on market intervention must be published as soon as its publication would no longer be counterproductive.

In practice most attention will be focused on whether the Committee decides to alter interest rates. At its latest meeting, on 6 November 1997, the Committee decided to raise interest rates. Its statement - which corresponds to the statutory obligation under clause 14 - is reproduced in full below:

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[29] HC 98-II 1993-94, Appendix 20, p. 177

Statement of the Monetary Policy Committee

The Bank of England's Monetary Policy Committee has today voted to raise the Bank's repo rate by 0.25% to 7.25%. The increase takes immediate effect.

The Committee reviewed the latest monetary and economic data and discussed the analysis and inflation projection to be incorporated in the Bank's Inflation Report which will be published on 12 November. It also considered the possible impact of recent financial market volatility.

Inflation has not moderated as much as expected in the light of sterling's appreciation since the autumn of 1996. Domestic demand has remained robust, and the expected impact on external trade, lowering export volumes and raising import volumes, has yet to materialise, so that GDP has continued to grow at an unsustainable rate. The labour market has tightened further, with skill shortages increasingly reported.

Looking ahead, the economy is expected to slow down next year as both domestic demand and net external trade moderate, under the combined impact of past tightening in monetary and fiscal policy, the strength of sterling, and a smaller impact of windfalls on consumption. This will help to reduce inflationary pressures. But, in the Committee's judgment, the balance of risks implies that a modest further increase in interest rates is necessary to meet the inflation target of 2½% in the medium term.

The Committee therefore voted to raise interest rates by 0.25%. The last change in interest rates was a rise of 0.25% on 7 August.

Minutes of today's Monetary Policy Committee meeting will be published on 10 December. Minutes of the meeting held in October will be published on 12 November. [30]

Clause 15 provides for the publication of the minutes of the MPC within six weeks. The minutes must include a record of the votes cast by the members of the committee. The six weeks' delay allowed for means that by the time of publication the minutes should not cause undue movements on the money, foreign exchange or stock markets. However, in a similar manner to the clause which covers the statement on its decision, this clause allows publication of decisions about intervention in the financial markets to be delayed beyond six weeks if the Committee feels publication would impede or frustrate the purpose of the intervention.

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[30] 'Bank of England raises interest rates by 0.25 % to 7.25%', Bank of England, 6 November 1997

Appendix One of this paper reproduces a substantial extract from the minutes of the Monetary Policy Committee's 6-7 August meeting. They were published on 17 September, observing a practice of making the minutes available on the Wednesday following the subsequent meeting. The minutes for the meeting of 6 November 1997, to which the statement printed above relates, will not be available until 10 December. The minutes from 6-7 August, however, relate to another meeting at which interest rates were changed, so they provide an illustration of how the Committee approaches the exercise of its most fundamental power. The minutes start with a summary of the economic information and analysis which was presented to the Committee. Then a second section (see Appendix One) minutes the Committee's analysis of the data presented to it. The crucial paragraphs relating to the decision to increase interest rates are given below:

Minutes of the Monetary Policy Committee (extract)

Having concluded that monetary policy would need to be tightened again, the Committee considered whether to raise interest rates immediately. Arguments for not doing so were the advantages of waiting to gather more information and of avoiding the risk of putting further upward pressure on the exchange rate. The main argument for moving immediately was the need to hit the inflation target. There was also the potential impact on expectations of publishing an Inflation Report that, on unchanged rates, would combine a view that the most likely outturn at the two year forecast horizon was that RPIX inflation would be above the 2½% target with the risks to inflation clearly skewed on the upside. That would create a risk of damaging credibility and so increasing inflationary expectations, and of putting further upward pressure on the exchange rate by causing the market to revise upwards their expected path of interest rates. By tightening by an extra ¼ percentage point immediately and so publishing an Inflation Report showing a central projection around 2½% at the two year horizon, the Bank might be able to reduce inflation pressures and so affect market expectations that some of the upward pressure on sterling would be alleviated. This was the tactical judgment. The Committee agreed that, on balance, it was the better course and that the press notice announcing the move should reflect the nature of the judgement.

66. The Committee then voted unanimously in favour of a ¼ percentage point rise in the Bank's repo rate, to be announced immediately.[31]

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[31] Minutes of the Monetary Policy Committee Meeting on 6-7 August 1997, Bank of England

Clause 17 secures the Bank's ability to obtain information from a wide range of financial institutions to allow it to carry out its monetary policy duties under this Part of the Bill. The Bank is able to issue a notice to an assortment of undertakings, listed in sub clause (3), requiring information of a kind specified in the notice, relating to periods specified by the Bank, to be reproduced at times specified by the Bank.

The institutions covered by this information obligation include authorised banks (currently those authorised under the *Banking Act 1987*) and European-regulated banks which have a deposit-taking branch in the United Kingdom, as well as building societies and a range of other debt-issuing and mortgage institutions. The Treasury is given the power by order to decide what financial affairs are covered by the information production clause, and also to amend the list of institutions to which the clause applies. Before making an order under this clause, the Treasury is required to consult the Bank, the Office for National Statistics, representatives of those who will be affected by the order, and any other appropriate persons.

Clause 18 requires the Bank to publish a quarterly report which is to contain:

> (a) a review of the monetary policy decisions published by the Bank in the period to which the report relates,
>
> (b) an assessment of the monetary policy decisions published by the Bank in the period to which the report relates,
>
> (c) an indication of the expected approach to meeting the Bank's objectives under section 11.

Since 1993 the Bank has published a quarterly *Inflation Report*, and this clause requires a modified version which takes account of the Bank's new operational role in setting monetary policy. The August 1997 *Inflation Report* reflects these new obligations and includes a section of monetary policy over the previous three months. It also reproduces the minutes of the Monetary Policy Committee as an appendix, together with the statements issued by the MPC immediately after each meeting, announcing their proposed actions.

Clause 19 contains reserve powers for the Treasury to conduct monetary policy. These powers are significant in that they provide a limited but statutory exception to the Bank's operational independence. At the same time, the powers can be seen as a necessary political reserve by the executive which retains ultimate political responsibility and accountability for monetary policy.

The Treasury are empowered by order to give the Bank:

> 'directions with respect to monetary policy if they are satisfied that the directions are required in the public interest and by extreme economic circumstances' (c.19(1)).

These directions can only be issued after consultation with the Governor. An order under this clause may modify the provisions of Part II in relation to the Monetary Policy Committee.

The powers are limited in time and are subject to parliamentary approval. The order must be laid before Parliament. If the order has not been approved by a resolution of both Houses within 28 days of its being made, it ceases to have effect. Those 28 days do not include days on which Parliament is dissolved or prorogued, nor periods in which either House is adjourned for more than four days.

Any order under this clause ceases to have effect after three months - from the day it is made - unless an earlier expiry date is contained in the order itself.

The Chancellor told the House on 20 May:

> 'The Government will retain the right to override the operational independence of the Bank in extreme economic circumstances, for a limited period only, and subject to ratification by the House. I would expect this right to be exercised rarely if at all.'[32]

Such an override is far from unique. The *Reserve Bank of New Zealand Act 1989*, is an example, described below in an extract from the bank's bulletin:

> 'the Act gives the Government the right to temporarily change the objective of monetary policy by using the formal and public "override" provision. The override provision represented a balance between explicit recognition that monetary policy is ultimately a Government responsibility, (rather than a responsibility of unelected officials), and the Government's wish to constrain its own scope for monetary policy freedom in the future, and to thereby improve monetary policy credibility. The Act provides such constraints by requiring an Order in Council to depart from the statutory objective. Such Orders in Council

[32] HC Deb 20 May 1997 c509

> are valid for one year only, and hence further Orders in Council must be promulgated to extend the departure from the objective. Furthermore, any use of the override provision which results in a conflict with the Policy Targets Agreement requires the Agreement to be publicly abandoned and a new one negotiated and tabled in Parliament. Thus, the Act ensures that changing the objective for monetary policy involves a major and very public policy endeavour.'[33]

The US Federal Reserve, however, is subject to no existing override: new legislation would have to be enacted before the administration could eliminate or limit its independence in conducting monetary policy. The Bundesbank, also, prevails against the federal government's wishes although the government can ask for a one-off delay of two weeks in the implementation of a decision by the bank of which it disapproves.[34]

E. Accountability

Whilst the Bill secures some accountability of the Bank to the executive and to the public (through the publication of its decisions and appropriate analysis), there is a further issue of parliamentary accountability. The Chancellor told the House on 20 May 1997:

> The Bank will be expected to report to the Treasury Select Committee and to the House. I shall write to the Chairman suggesting that the Bank's annual report be debated in the House, and that the Bank appear four times a year before the Committee to give evidence and answer questions on each of its inflation reports, so that the Bank's performance will be able to be judged by Parliament.[35]

On 18 July 1997, the Chancellor wrote to the Chairman of the Treasury Committee:

> I have proposed that the reconstituted Court of the Bank should review the performance of the Bank, including the Monetary Policy Committee, with particular regard to whether the Bank is collecting the regional and sectoral information it needs. I envisage that the non-executive members of the Court would make an assessment and

[33] Michele Lloyd, 'The New Zealand approach to central bank autonomy', *RBNZ Bulletin*, September 1992, quoted in a Memorandum from the Reserve Bank of New Zealand printed in *The Role of the Bank of England*, Treasury and Civil Service Committee HC 98-II 1993-94, p. 169

[34] *The Role of the Bank of England*, Treasury and Civil Service Committee HC 98-II 1993-94, pp. 178, 139

[35] HC Deb 20 May 1997 c509

> publish a report once a year on the Bank's performance. This report would be laid before Parliament.
>
> The Bank's performance in carrying out its monetary policy functions will also be made more transparent by the publication of the minutes and votes of each meeting of the Monetary Policy Committee, as well as the Bank's quarterly Inflation Report. You may wish to call the Bank to appear before you to give evidence following the publication of each Inflation Report. I also believe the House would welcome the opportunity to debate the Bank's Annual Report.[36]

The Committee intends to hold the Bank responsible for its past actions as well as immediate decisions, by examining the inflation outturn against the inflation target. It will take evidence both from the Chancellor who sets the inflation target, and from the Governor who operates the policy controls to meet the target. It expects to hold at least two sessions specifically on the Inflation Report each year, and will also take evidence from the Governor on the annual report and from the non-executive members of the Court on the Bank's performance. If the override is activated, it would take evidence from the Chancellor and the Governor, and if the inflation target is missed to the extent that the policy framework requires the Governor to write an open letter of explanation, it would take evidence from the Governor.

Whether the Treasury Committee should have any oversight over appointments to the Monetary Policy Committee, and the posts of Governor and deputy Governor, is more controversial. The Treasury Committee has called for it to have a statutory right to hold confirmation hearings, effected by a statutory provision that appointments to these posts could be blocked by a report from the Committee to the House stating its reasons for considering that the candidates do not meet the necessary criteria of competence and personal independence.[37] The Chief Secretary to the Treasury, who appeared before the Committee on 5 November 1997 gave what was judged to be a 'cool response' to this suggestion, and to the Committee's other recommendation that the terms of the members of the MPC be increased from three to four years to increase their independence.[38] The Committee had already indicated, though, that in the absence of statutory provision, in intended nevertheless 'to instigate hearings and make reports to Parliament'.[39]

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[36] Appendix 3, *Accountability of the Bank of England*, Treasury Select Committee, HC 282 1997-98, 23 October 1997

[37] Ibid., paras 46-7

[38] 'MPs unlikely to vet Bank posts', *Financial Times*, 6 November 1997

[39] HC 282 1997-98, para 49

V The Bill, Part III: Transfer of Supervisory Functions

A. Background

Banks in the United Kingdom have hitherto been subject to prudential regulation by the Bank of England, the UK's central bank. The Bank also supervises other money market institutions, and is responsible for managing sales of government debt (gilts) and acting as the government's bank. It also issues banknotes in England and Wales. In the Government, HM Treasury has responsibility for overseeing the Bank of England, and for banking regulation. Although the deposit-taking activities of UK banks are regulated by the Bank of England, when banks sell investment services, they are regulated in that area by a Self Regulating Organisation under the *Financial Services Act 1986*.

The Bank's responsibilities will change substantially under the new proposals. The structure of financial supervision in the non-banking sector is also to change, with the creation of a new super-regulator with responsibilities across the board for a wide range of institutions. A new *Financial Services Act* is to be introduced - a draft will appear in 1998 - and the new regulator, which has been christened the Financial Services Authority, has been created. Unlike Part II of the Bill, whose effects can already be seen operating in practice, the details of the new Financial Services Authority are still being hammered out. Banking supervision is only one part of very wide-ranging structural changes to financial regulation that will occur over the next two years. This section of the research paper points to some of the main themes, but adopts a rather more generalised approach than did the previous section on monetary policy.

B. Plans for reform

For some years the Labour Party has been committed to statutory regulation in the financial services sector, to replace the present self-regulatory regime. It needs to be recognised, though, that the present regime has already become less than fully self-regulatory and the increasing presence of public interest representatives on the boards of some regulators is an instance of this. In a debate on Financial Services Regulation at the end of 1995, Alistair Darling outlined his party's plans for reform:

> We propose to make the SIB directly responsible for the regime broadly covered by the 1986 Act. We do not want to create a Securities and Exchange Commission and we shall not create a bureaucracy. I do not want an organisation run by lawyers. I can say

> that because I am a lawyer and I know what happens when organisations are run by lawyers. We no longer need a distinction between the SROs and the SIB, as that is expensive. One can see the difficulties with pension transfers, for example, on which both the SIB and the Personal Investment Authority make parallel rules.
>
> Under our system, the SIB would still have practitioner input and two separate operating divisions, broadly along the lines of the Securities and Futures Authority and the Investment Management Regulatory Organisation on the one hand and the PIA on the other. I stress that we want to build on what we have and avoid traumatic disruption. The change that we suggest is radical but incremental, and it would be welcomed
>
> I agree with what the Select Committee said about self-regulation: let us end it.... Self-regulation is a misnomer. The present system is rooted in statute. The problem with self-regulation is the public's perception that trade interest dominates, which is extremely damaging.[40]

A pledge to address the regulatory structure was included in the Labour Party's 1997 Business Manifesto.

> The financial services industry is increasingly global. The City of London is established alongside New York and Tokyo as a world financial centre. It and the rest of the financial services industry are now major employers and earners of income from overseas.
>
> As the guardians of other people's money there needs to be effective supervision and regulation of the industry. Good regulation, as well as guaranteeing probity, can also be a source of competitive advantage for the industry. Building on the present arrangements, we would give the Securities and Investment Board direct responsibility for the regulatory regime covered by the 1986 Act. We would also bring the sale of mortgages within this regulatory framework.[41]

Pledges were also made in relation to the Bank of England, although there was no indication that its responsibility for the prudential supervision of the banking sector was to be transferred to a new regulator.

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[40] HC Deb 14 December 1995 cc1184-85

[41] *Labour's Business Manifesto: Equipping Britain for the future*, April 1997

On 20 May 1997, in a statement to the House, the Chancellor of the Exchequer surprised the City when he announced wide ranging plans to reform the structure of financial regulation and to transfer banking supervision from the Bank of England to an enhanced city regulator based on the existing top-tier regulator, the Securities and Investments Board.

> The question of prudential supervision, of course, concerns not just the Bank of England but the reform of the Financial Services Act 1986. Financial services lie at the heart of a modern, dynamic economy. The effectiveness and competitiveness of all our industries depend on the availability and efficiency of the increasingly wide array of financial products and services, from pensions and insurance to securities and derivatives. Our standard of living depends on them, particularly in retirement. Financial services are often complex and long-term. Products, markets and advice must therefore be fair, honest and transparent, and command confidence.
>
> It has long been apparent that the regulatory structure introduced by the Financial Services Act is not delivering the standard of supervision and investor protection that the industry and the public have a right to expect.
>
> The current two-tier system splits responsibility between the Securities and Investments Board and the self-regulatory organisations, together with the recognised professional bodies. This division is inefficient and confusing for investors, and lacks accountability and a clear allocation of responsibilities. Reform is long overdue to simplify the delivery of financial services regulation, and this was a key commitment in our business manifesto. At the same time, it is important to preserve the beneficial aspects of the current Act, including practitioner involvement and differential levels of regulation for wholesale and retail business. I can announce today that work is to start immediately on the legislation needed to simplify and reform the regulatory system at an early opportunity. I am announcing our intentions in advance to give the SIB and the self-regulating bodies the opportunity to work with us on the detailed implementation of our proposals to ensure the smoothest possible transition to the new regime. I am confident that the simpler system we are proposing will reduce compliance costs, and increase public confidence in the regulatory regime.
>
> Simply reforming the Financial Services Act 1986 is not enough in itself. In today's world of integrated global financial markets, the financial services industry transcends geographical and political boundaries and the regulatory response must meet this challenge. The

United Kingdom financial services industry needs a regulator which can deliver the most effective supervision in the world.

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

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

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

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

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

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

> As the House will already be aware, Sir Andrew Large, the current chairman of the SIB, has decided to step down. I should like to take this opportunity to pay tribute to him, and thank him for his contribution to financial regulation over the past years.
>
> It is crucial to the success of these reforms that we have a new chairman with the stature and calibre to implement them quickly and smoothly. Because of the importance I attach to drawing on the Bank of England's expertise in these areas, the Governor and I have asked Howard Davies, the deputy Governor of the Bank, to be the first chairman of the enhanced Securities and Investment Board, responsible for integrating the supervision of banking and financial services. I am pleased that he has agreed. He is, of course, already a member of the SIB, and he will take over as chairman when Sir Andrew Large steps down. Two new Deputy Governors of the Bank will be appointed in due course.[42]

On the same day, the Chancellor wrote to Sir Andrew Large, Chairman of the Securities and Investments Board outlining his plans and asking the SIB to develop an implementation plan for the merging of the existing Self Regulating Organisations and the Bank of England's supervision division. Sir Andrew was asked to produce the plan by the end of July 1997 and to pay attention to both immediate logistic and organisational questions and to the final organisational architecture.

The reforms will require two major pieces of legislation. The present *Bank of England Bill* transfers banking supervision to the Securities and Investments Board, formalises the Bank's newly acquired role of administering monetary policy, and makes changes to the Bank's Court of Directors. In the longer term, the *Financial Services Act* will have to be reformed in order to achieve the new regulatory structure and its statutory underpinning. That Bill is to be published in draft form in the summer of 1998, and the changes are expected to take effect in late 1999 or early 2000.

The key **elements** of the new structure are:

- The two-tier regulatory system of the Securities and Investments Board and self-regulating organisations is to be replaced by a single regulator based on an enhanced Securities and Investments Board.

- Responsibility for banking supervision will be transferred from the Bank of England to the new SIB.

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[42] HC Deb 20 May 1997 cc509-11

- Self-regulation will be replaced by a 'new and fully statutory system'.
- Practitioner involvement will be retained.
- Wholesale and retail markets will continue to be subject to different levels of regulation.

The key **reasons** given for the changes are:

- The present system is not delivering the standards of investor protection or supervision which both the industry and the public is entitled to.
- The two-tier system splits responsibilities and is confusing for investors and lacks accountability.
- The distinctions between different types of financial institution and the products which they offer is increasingly blurred: this calls for a move from supervision which is based on institutional types.
- The financial services sector is increasingly global, and the UK needs a regulator which is structured appropriately to regulate multinational firms effectively.

The Chancellor's plans took the sector by surprise: the measures proposed are more extensive than had been trailed, and were announced before consultation, although there will be consultation on their implementation. The *Financial Times* was broadly approving of the new plans, but warned of potential dangers ahead.

> 'In broad outline the proposals are welcome. The two tier-structure for regulating non-banks, set up under the 1986 Financial Services Act, proved cumbersome, costly and often ineffective….One of the most serious indictments is that many thousands who were mis-sold pensions are still waiting up to ten years later for compensation, despite the efforts of the SIB to secure justice for them.' [43]

The *Independent* quoted approving comment by the Consumers Association: 'This announcement is good news. We are pleased to see the end of the current two-tier system which we regard as unwieldy, at times incomprehensible and not easily understood by consumers'.[44] Other approving voices were cited by *The Times*:

[43] 'All change for the super-SIB', *Financial Times*, 21 May 1997

[44] 'Brown signals overhaul of City regulation', *Independent*, 21 May 1997

> 'The City - including the existing watchdogs - generally welcomed Mr Brown's proposals, although there was a feeling of breathlessness at the speed with which the Government has moved. Peter Ellwood, chief executive of the Lloyds TSB group said: "We are supportive of this move for banking supervision. It reflects what is happening on the ground where most financial institutions are now selling banking and insurance."
>
> Sir Peter Davis of Prudential said: "We welcome this news, which reflects our long-held view." And the Association of British Insurers, was pleased by the attempt to simplify a "cumbersome and expensive" system.' [45]

It is as easy, however, to find opposing reactions. The *Guardian* cited the following examples:

> 'Concern was growing last night that the Government's plans to set up a super-regulator to oversee the City would create a bureaucratic monster.
>
> The watchdog could eventually have a staff of up to 2,000, an annual budget of £150 million and take on the responsibility for about 7,000 member firms, ranging from one-man bands to global banks.
>
> Nick Durlacher, chairman of the Securities and Futures Authority, while welcoming the scheme as restoring public confidence, said: "It's a very large body. We have to make sure it does not become too bureaucratic."
>
> Leading insurer Royal & Sun Alliance also expressed reservations and warned the Chancellor "not to throw the baby out with the bath water". Head of group corporate affairs Mike Jones added: "A lot of good work has been done on devising the rules in force and the benefits are starting to come through."
>
> The most ferocious attack on the plan came from the European credit ratings agency Ibca which said it would result in duplication of effort and the new super watchdog risked becoming a "huge and unresponsive bureaucracy."

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[45] 'One watchdog to monitor all City dealings', *The Times*, 21 May 1997

> Managing director Robin Monro-Davies said the decision to merge UK banking supervision and securities regulation was "a mistake and had not been undertaken in this shape in any other major banking centre."'[46]

The Bank, including its present Governor, had made its opposition clear to a transfer of banking supervision from the Bank in the past. At the time of the announcement, it became apparent that the Bank had barely been kept informed of the new Government's plans. The *Financial Times*, reported the Governor telling Bank staff 'that he had not been consulted about the decision to strip the Bank of its traditional supervisory powers'.[47] Mr George was also reported to have considered resigning over the move, although perhaps only in passing.[48] The Bank's official response, which quotes the Governor in a press release issued on the day of the Chancellor's announcement, is studiously guarded. It notes that the Bank was only informed of the decision on the previous day.

> "What matters is not the Bank's position but the whole structure of financial regulation and what is best both for depositor, investor and policy-holder protection, on the one hand, and for systemic stability, on the other.
>
> We have never argued that banking supervision for the purpose of depositor protection must necessarily be undertaken in the central bank. We have recognised that changes in financial markets are blurring traditional distinctions between banks and other financial intermediaries. Nevertheless, banks remain of special systemic importance, because of their unique role as providers of liquidity, to both depositors and borrowers, including their central role in payments and settlements, and because their resulting unsecured exposures to each other make them particularly vulnerable to contagion from elsewhere in the system. For these reasons it will continue to be important under the new arrangements that the central bank is able to monitor, through the new regulatory body, the financial condition of individual institutions, as well as that of the system as a whole."[49]

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46 'Brown's monster surprise', *Guardian*, 21 May 1997

47 'Bank to lose supervisory role', *Financial Times*, 21 May 1997

48 'Governor thought of quitting over Bank proposals', *Financial Times*, 22 May 1997

49 'Transfer of banking supervision', Bank of England press release, 20 May 1997

C. The Financial Services Authority

The Financial Services Authority (FSA) is the re-named Securities and Investments Board. With the passage of the *Bank of England Bill* and a new Financial Services Act it will acquire statutory responsibility for a wide range of institutions including banks, building societies, insurance companies, financial advisers and investment management companies. It will seek to assimilate many of the functions of the existing regulators in advance of the statutory grant of such powers, so in many areas there will be a single regulator in advance of legislative reform. The *Bank of England Bill*, however, will give it its first new statutory powers; when the Act comes into force, banking supervision will formally pass from the Bank of England to the new regulator and its chairman, Howard Davies, former deputy Governor of the Bank.

A form of prospectus was issued by the FSA on 28 October 1997. It describes in outline how the Authority will operate and at what stage the key changes will take effect. The document sets out the FSA's aims:

> **To protect consumers of financial services**
> The FSA will:
> - set, promote, monitor and enforce high standards of integrity, financial soundness, fair dealing and competence for those it regulates, in order to protect and secure fair treatment for investors, depositors and policyholders;
>
> - aim to ensure that consumers receive clear and adequate information about services, products and risks;
>
> - acknowledge consumers' responsibility for their own decisions, while aiming to ensure that they are not exposed to risks that they should not reasonably be expected to assume.
>
> **To promote clean and orderly markets**
> The FSA will:
> - promote fairness, transparency and orderly conduct in financial markets, looking in the first instance to the markets and market participants to set and enforce high standards in this area;
>
> - take action where such standards are inadequate or are ineffectively enforced.
>
> **To maintain confidence in the financial system**
> The FSA will:
> - set, promote, monitor and enforce high standards of financial soundness and probity for financial services businesses, in order to contribute to the

> soundness of the financial system as a whole and to promote consumers' and financial institutions' confidence in its strength and integrity;
>
> - aim to ensure, in co-operation with the Bank of England, that the failure of individual financial institutions does not undermine the overall stability and soundness of the financial system.
>
> The FSA will pursue these aims in an efficient way and will aim to ensure that the costs of regulation are proportionate to the benefits.[50]

A Memorandum of Understanding has already been signed between HM Treasury, the Bank and the FSA with the following guiding principles:

> – clear *accountability*. Each institution must be accountable for its actions, so each must have unambiguous and well-defined responsibilities;
>
> – *transparency*. Parliament, the markets and the public must know who is responsible for what;
>
> – *no duplication*. Each institution must have a clearly defined role, to avoid second guessing, inefficiency and the duplication of effort. This will help ensure proper accountability;
>
> - regular *information exchange*. This will help each institution to discharge its responsibilities as efficiently and effectively as possible.[51]

The residual responsibilities of the Bank, as outlined in the Memorandum are for the stability of the monetary system; the infrastructure of the financial system including the payments systems; a broad overview of the financial system as a whole; the ability to undertake support operations in exceptional circumstances to prevent systemic failures, subject to the normal division of responsibilities; and, efficiency and effectiveness of the financial sector including its international competitiveness.

Banking regulation is currently funded under the Cash Ratio Deposit (CRD) scheme. Part I of this Bill puts that scheme on a statutory basis and also extends its applications from banks to some other deposit-taking institutions. With the transfer of banking supervision from the Bank, however, it could not be expected that CRDs raised by the Bank would finance the supervisory operations of another institution. Instead, banks will help fund the operation of the Bank through the new statutory Cash Ratio Deposits provided for by clause 6, and will separately pay for the costs of

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[50] *Financial Services Authority: An outline*, FSA, 28 October 1997, Appendix 1

[51] Ibid., Appendix 2

their regulation by the FSA. The FSA has issued a consultation paper, *Paying for banking supervision*, which outlines an interim charging regime to ensure banks fund the costs of their supervision.[52] A longer-term scheme will be the subject of later consultation. It is intended that the combined cost of the new regime and the reformed CRDs will not exceed the cost to banks of the present CRD scheme.

D. Part III: Notes on Clauses

By **clause 21**, the functions of the Bank of England under the *Banking Act 1987* are transferred to the Financial Services Authority. The 1987 Act is a substantial statute which sets out how banks are to be authorised, and gives strong powers to require information to the supervisor. The clause also gives the FSA the functions of the Bank under s.43 of the *Financial Services Act 1986*, which relate to the supervision of wholesale operators in the sterling, foreign exchange and bullion markets. These institutions previously were recorded on a list maintained by the Bank of England, and were exempted from the provisions of the *Financial Services Act* but subject to supervision by the Bank.

Many of the other clauses (including **clauses 22, 23** and **Schedules 4** and **5**) in this Part support this major change by amending other statutes which refer to the Bank and which specify certain relationships between the Bank and other bodies. Where appropriate these functions previously exercised by the Bank are transferred to the FSA. **Clause 24** stipulates that the FSA will not act on the Crown's authority, and that its employees will not be Crown servants. Where legislation confers immunity to regulatory staff, additions need to be made to extend that immunity to FSA staff (**clause 25**). The immunity extends to acts in the discharge (or purported discharge) of the Authority's functions, so long as they are not done in bad faith. **Clause 26** and **Schedule 6** allow the FSA to charge for supervising bodies - other than banks - formerly regulated by the Bank, including the money market institutions. **Clauses 28** and **29** amend the composition of the Board of Banking Supervision and the Deposit Protection Board to replace references to the Bank's powers to appoint their members with references to the FSA, as appropriate.

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[52] Consultation Paper 3, Financial Services Authority, October 1997

VI The Bill, Part IV: Miscellaneous and General

A. Notes on Clauses

Clauses 33 and **34** transfer the responsibility for the registration of gilts in the National Savings Stock Register to the Bank. The Bank of England already maintains a gilts register, but the National Savings Stock Register provides a service for the small, private investor. According to the Economic Secretary to the Treasury, the effect of this change will be limited to internal efficiency: the service to investors will be unchanged:

> "It is 'business as usual' as far as customers are concerned. Gilts will still be able to be bought and sold by the private investor in the same way as via the NSSR now and for the same charges. Essentially this move is about a change of location for the administration of the service. National Savings will be writing to all its gilt customers in the near future to inform them of the change. There will be no job losses in National Savings as staff will be transferred to tasks elsewhere in the Blackpool office.
>
> Economies of scale in combining the NSSR gilts function with the Bank of England Register and the creation of one centre through which private investors can buy and sell gilts is a sensible evolution, from which taxpayers and customers alike will benefit."[53]

Clause 35 amends the *Companies Act 1989* to make clear that the Treasury's powers to make regulations on the dematerialisation of securities apply to bearer securities. A dematerialised security is one which exists as a computer record rather than in the material form of, say, a share certificate. Bearer securities, which are not widely used in the UK, are not registered in the name of any person.

Clause 37 restricts the disclosure of information gathered by the Bank in the course of fulfilling its monetary policy functions or its Cash Ratio Deposit scheme. Contravention of this clause and its associated **Schedule 7** is an offence, punishable either on indictment or summarily.

Clause 38 creates offences of failing to supply information or supplying false or misleading information to the Bank as required under clause 17(1) - for the purposes

[53] 'Bank of England Bill proposes change to National Savings Stock Register', National Savings release 40/97, 28 October 1997

of formulating monetary policy - and para 9 of Schedule 2 - cash ratio deposits. Failure to supply information is liable to a fine not exceeding £2,500. The supply of false or misleading information is punishable on indictment by imprisonment for up to two years (or a fine, or both); on summary conviction, it leads to imprisonment for up to three months (or a fine of up to £5,000, or both).

Clause 45 provides for the Act to come into force on a day to be appointed by the Treasury. A date of April 1998 is estimated in the FSA's recent outline.

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VIII Appendix One

This Appendix contains a complete reprint of the Minutes of the Monetary Policy Committee from its meeting of 6-7 August 1997. The Minutes are published about five weeks after the meeting to which they refer, that is, on the Wednesday after the following meeting. In this case, this means they were published on Wednesday 17 September.

As described in the main body of this paper, Clause 15 of the Bill requires the MPC to publish its minutes within six weeks. The minutes must include a record of the votes cast by the members of the committee. The six weeks' delay allowed for means that by the time of publication the minutes should not cause undue movements on the money, foreign exchange or stock markets. However, the clause allows publication of decisions about intervention in the foreign exchange markets to be delayed further if the Committee feels publication would impede or frustrate the purpose of the intervention. At the 6-7 August meeting, the Committee did not make an explicit decision to intervene in foreign exchange markets, although it decided intervention was worth contemplating. The minutes, as published, start with a summary of the economic information and analysis which was presented to the Committee. That section, which runs to nine pages, is omitted here. The second section minutes the Committee's analysis of the data presented to it. It is reproduced in full below, taken from the Bank of England's internet site, where all the MPC's reports are also published (http://www.bankofengland.co.uk/mpcmtg.htm). The minutes are also printed in the Bank's quarterly *Inflation Report*.

[Stick on goes here]

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31.10.97

97/111 The Nuclear Explosions (Prohibition and Inspections) Bill [HL]
31.10.97
[H.L. Bill 63 of 97/98]

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05.11.97
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