7 HOW SHOULD THE BANK OF ENGLAND BE ORGANISED?

If the question were asked 'what went wrong in the Northern Rock affair and the subsequent banking crisis?', the answer would have to be 'almost everything'. The key players in British officialdom committed blunder after blunder. Serious mistakes in banking policy – such as regulators' failure to manufacture sufficient liquid assets for the banks (described at the start of Chapter 6) – had been made in previous years. Nevertheless, in early 2007 British banks were profitable and solvent, and had complied with regulations. In August and September 2007 the breakdown in the wholesale money markets left a handful of UK specialist mortgage banks, including Northern Rock, badly placed. While their managements had been too ambitious, their condition ought not to have been terminal. Difficult negotiations about their fate, and about banking regulation in the large, were needed between the UK banking system on the one hand and the Tripartite Authorities on the other. But these should have been private and low-key, and should have been kept out of the headlines and the wider political debate. There was no need for a huge quarrel leading to the slashing of banks' market capitalisation by tens of billions of pounds and a severe downturn in economic activity. The contrast between the Bank of England's successful handling of the secondary banking crisis in the mid-1970s and the small banks crisis in the early 1990s, and the Tripartite Authorities' (and particularly the Bank of England's) handling of the banking traumas of 2007 and 2008, could hardly be more extreme.

Had the banks cut their cash and liquidity too much?

But the actions of individuals must always be set within a larger institutional and historical context, and in many respects the recent turmoil in British banking (and of course in banking elsewhere) was an accident waiting to happen. The six decades from the end of World War II had been characterised by gradual but relentless measures towards the liberalisation of banking systems from government restrictions, as well as by the globalisation of both finance and its regulation. The Bank of England – like other central banks – had allowed banks to economise on their cash and liquid asset holdings to an extent that would have been considered astonishing in the early post-war years. The UK's commercial banks believed that the skimpiness of the cash on their balance sheets was not particularly risky. In the middle years of the current decade they complied with the Basel rules on solvency, while their relations with both the FSA and the Bank were cordial.

The implicit assumption was that – as long as their businesses had adequate capital and their assets were of good quality – the Bank of England would readily exchange part of their assets for cash, probably on first-resort terms but on last-resort terms if necessary. Their low holdings of cash and liquid assets ought therefore not to cause serious trouble. As noted in Chapter 5, this assumption became untenable in August and September 2007 because of King's initial refusal to ease collateral requirements in repo operations, Darling's decision (on King's advice) to block the Northern Rock–Lloyds TSB takeover attempt and by the run on Northern Rock which soon followed. (Of course, the recent banking crisis has been global in impact. But regulatory trends in other countries have been similar to those in the UK and it serves the immediate argument to focus on the UK.)

King worked in tandem with Alistair Darling, the Chancellor of the Exchequer, in the crisis period. As both men were aware, the Bank of England was constrained by the small size of its capital, which was under £2 billion. If the Bank of England lent £30 billion to Northern Rock, if Northern Rock was unable to repay the loan and if the shortfall were, say, £3 billion, the Bank of England would be 'bust'. As the bankrupting of the Bank of England would be an apparently cataclysmic event, King had to make sure that he had an indemnity against loss for any large loan that his institution extended.[1] That indemnity could come only from the Bank's shareholder, the government itself, and would require a legal contract between the Bank and the Treasury. In any negotiations the Treasury would be 'in the driving seat'. The Bank's low capitalisation and consequent vulnerability to loss on assets of any kind, along with his Currency School views, made King nervous about last-resort lending. He clearly favoured the transfer of his organisation's banking functions to either the Treasury or to entirely new agencies with no track record whatsoever.

The Treasury, however, employed few people with any meaningful banking experience, and key officials and ministers regarded last-resort lending as an abuse of 'government money'.[2]

1 Alex Brummer, *The Crunch*, Random House, London, 2008, p. 77.

2 In the legal action that followed the nationalisation of Northern Rock, Mr John Kingman – the second permanent secretary at the Treasury in charge of the nationalisation exercise – proposed a new doctrine. This was that, because 'government money' had been 'injected' into Northern Rock, a proper 'return' should

The details of the banking system's cash operations and capital rules, which are technical subjects of great complexity, became politicised. Public discussion of banking regulation favoured the reinforcement of deposit insurance and an attenuation of the Bank of England's lender-of-last-resort role, despite the mixed international record of deposit insurance schemes and the irrelevance of such arrangements in a world where all banks are solvent. Whereas King has claimed that central bank lending on terms that were too easy may cause moral hazard in banks' asset selection, a large academic literature backed up by decades of practical experience emphasises that deposit insurance systems increase moral hazard on the part of depositors and are a menace to responsible banking.

What must be done to restore good relations between the state and Britain's banks, and to re-establish a healthy financial system?

be earned on that money, if necessary at the expense of the shareholders. It was claimed that the loan was risky and involved 'public subsidy', even though it was provided at above-market rates. It was then proposed that the state could appropriate a return, over and above the interest due on the loan, to compensate for the alleged risk (witness statement of John Kingman, in action between Northern Rock claimants and HM Treasury, 31 July 2008, clause 139). The question of how this 'return' was to be determined, and whether it would be valid if it did not arise from a prior contractual arrangement voluntarily reached between Northern Rock and the Tripartite Authorities, raised fundamental uncertainties about the property rights of Northern Rock shareholders. These uncertainties, which must now worry any potential investor in the UK banking system, had never arisen in previous last-resort episodes in which the Bank of England had been operating more or less autonomously from the Treasury.

How should the Bank of England organise its lending activity?

Chapter 5 reviewed the lender-of-last-resort function in some detail. The present discussion needs only to complement that review in the light of the Northern Rock affair and its sequel. The first point can hardly be controversial, that relationships between the Bank of England and the commercial banks suffered severely from a lack of contractual certainty. In the summer of 2007 the banks had no legal justification for believing that the Bank of England would accept mortgage-backed assets in repo operations. But they did have good reasons, arising from experience and practice over many decades, for expecting the Bank to be lenient in difficult conditions. Some bankers could remember the acute money market shortage which followed the UK's expulsion from the European Exchange Rate Mechanism in September 1992, when the Bank had without fuss taken a huge range of assets in overnight repo activity.

As noted in Chapter 3, a core proposal in the Bank of England's 2006 Red Book on money market operations was that so-called 'settlement banks' should have the unlimited capacity to borrow against eligible collateral.[3] On 26 October 2006, Ian Bond, the Bank's head of financial crisis management, gave a workshop presentation to the British Bankers Association which, in the light of later events, might be described as offering a false prospectus. Bond said that banks' unlimited capacity to borrow was to be usually at a penalty rate, but not always. In fact, 'Following major operational or financial disruption, we can reduce the penalty

3 The phrase 'settlement banks' included both the clearing banks and a number of non-clearing banks which, because of changes in technology, carried out extensive settlement business. See footnote 19 on page 60 above.

– if necessary, to the point at which we are lending at Bank Rate.' The thinking was that this would 'reduce the risk of a short-term liquidity problem developing into a full-blown crisis'.[4]

When a liquidity problem arose in August 2007, the Bank was less obliging. Instead of preventing a full-blown crisis, the Bank's actions were largely responsible for causing one. King's hard-line attitude towards government securities as repo collateral and the payment of a penalty rate in standing facilities practically disowned the remarks made by a senior Bank official, in an open forum with many bankers present, less than a year earlier. As the last chapter showed, in the late summer of 2007 the Bank of England undoubtedly broke the spirit of Bagehot's rules. Bagehot was right to complain in *Lombard Street* in the 1870s that the lender-of-last-resort function was 'unimposed, unacknowledged and denied'. In the early 21st century that function must now be acknowledged and spelt out in a legally binding contract. The doctrine of 'constructive ambiguity' is hocus-pocus and has failed.[5]

4 Ian Bond, 'Managing a bank-specific crisis: a UK perspective' (mimeo), BBA workshop presentation, 26 October 2006, Bank of England, London, pp. 4–5.

5 On 2 April 2008 Paul Tucker, the Bank of England's executive director for markets, gave a speech on 'Monetary policy and the financial system', in which he said, 'a Social Contract between the banking system and the authorities', in which banks could borrow on last-resort terms if they had a cash problem, had been in place 'for well over a century'. But he judged that since the summer of 2007 it had been 'toxic' for banks to borrow from the central bank, in the way suggested by the contract (see the article in *Bank of England Quarterly Bulletin*, 2008 Q2 issue, 48(2), p. 205). He did not specify, however, whether a legally binding contract and 'a Social Contract' came to the same thing.

Repurchase activity and other types of asset acquisition

Chapter 5 distinguished between first-resort and last-resort loans, between cash provided to banks on a repurchase basis with a clearly specified payback date and amount, and cash provided with some uncertainty, even if very slight, about repayment. A further distinction now needs to be developed. The central bank can inject cash into the banking system not by making a loan or buying assets on a repo basis, but by purchasing assets outright. Indeed, the dominance of repo arrangements in the Bank of England's open market operations is a recent development which began in the 1990s, at least partly as a by-product of the UK's expected adhesion to the European single currency project. Outright purchases by the Bank were the historical norm in the relief of cash shortages. Of course, one effect of such purchases is that the Bank assumes the risk of default on any assets it acquires. The Bank must therefore pay attention to the quality of these assets and needs to discuss with the commercial banks the asset types that are eligible. As explained early in Chapter 6, such discussions were a constant feature of the interaction between the Bank and the UK's banking system until the end of the twentieth century.

The contemporary focus on repo transactions is appropriate if the central bank's task is deemed solely to be the setting of an interest rate to keep inflation in line with its target. It is appropriate, in other words, if the central bank is concerned only with monetary stability. But – as emphasised throughout this monograph – financial stability is also a recognised part of a typical central bank's remit. In a repo transaction a commercial bank receives cash in exchange for an asset, but agrees to hand back that cash at a relatively early date (usually only a few weeks) when the asset returns to its own balance sheet. The bank does own extra cash, but only on a temporary and provisional basis. By contrast, when the central bank buys assets outright from a commercial bank, that commercial bank owns the cash, full stop. The question needs to be asked, 'if the entire banking system has inadequate cash, perhaps with the shortage manifesting itself by high inter-bank rates, which type of central bank deal – the repo transaction or the outright asset purchase – is likely to be more effective in eliminating the shortage?' The answer surely is that outright purchases are almost certain to be better.[6] The cash held by a bank from a repo agreement has to be paid back fairly quickly to the central bank, whereas the cash arising from an asset sale (i.e. a permanent sale to the central bank) has to be put to work elsewhere in the banking system or perhaps even loaned out to non-banks. Of course, when a bank flush with cash seeks to place it with another bank, then that expands the inter-bank market. Repos can create an excess supply of cash in the banking system only if conducted on an immense scale and perhaps not even then; direct asset purchases ought to be able to establish an excess supply of cash with little difficulty.[7]

6 The truth of this observation is demonstrated by the huge expansion of the Bank of England's balance sheet that followed the adoption of repo as the main type of open-market operation in the late 1990s. This expansion had no clear effect in narrowing the differential between the policy rate and the inter-bank rate, except in the overnight market.

7 This statement assumes that a meaningful positive extra return is available on assets other than a commercial bank's balance at the central bank. In Japan in the late 1990s and early years of the present century banks had enormous balances at the Bank of Japan, but did not behave as if they had an excess supply of cash (they were constrained to some extent by lack of capital). The author advocated the resumption of occasional outright asset purchases by the Bank of England in an article, written jointly with Brandon Davies, on 'A simple plan to unclog the interbank market', *Financial Times*, 22 October 2008.

Late 2007 and 2008 were marked by a breakdown in the UK inter-bank and wholesale money markets, and a large differential between the Bank's policy rate and inter-bank rates. The problems were international in scope and stemmed to a considerable extent from mistrust between banks, as they doubted each other's solvency. But the blockages in the inter-bank market were also partly attributable to central banks' excessive reliance on repo operations and their hesitation in making genuine asset purchases from the commercial banks. Indeed, it was striking that banks' large capital-raising efforts appeared to make little impression on the differentials between the policy rate and inter-bank rates. The message is that central banks – including the Bank of England – must again be prepared to conduct large outright asset transactions with commercial banks, with the intention of altering the amount of cash truly in commercial banks' ownership. This has significant implications for central bank organisation, to which the discussion will return in the next section. But a related point may now be inserted into the discussion.

It was shown in Chapter 3 that banks have a functional requirement to hold cash to meet deposit withdrawals in their branch networks and obligations to settle debts with other banks. Banks' demand to hold cash is partly a matter of technology and institutions, but – from time to time – their equilibrium ratio of cash to assets may be boosted by fears that counterparties in the settlement system (i.e. banks, mostly) are unable to meet their commitments. Further, these fears may spread to the non-bank public, who can be worried (as the Northern Rock affair showed) that they 'will not get their money back'. The non-bank public therefore also comes to have a higher equilibrium ratio of cash to deposits. Suppose that the central bank is confident that all the settlement banks are solvent, that the banking system is sound and that the fears are (in Roosevelt's words in the closing phase of the USA's Great Depression) 'of fear itself'. Then it must react by increasing banks' cash holdings so that the ratio of cash to assets rises to the new equilibrium level and banks do not shrink assets.

If banks shrink assets, their liabilities must fall. Since banks' liabilities are dominated by deposits, and since deposits constitute most of the quantity of money, a major decline in banks' assets is virtually certain to lead to a drop in the quantity of money. If the quantity of money falls, damaging impacts on output and employment are almost inevitable, and in the extreme a self-reinforcing process of so-called 'debt deflation' may be initiated.[8] It follows that, in emergency conditions, the central bank must accommodate changes in the equilibrium ratio of cash to deposits, in order to keep the quantity of money and wider macroeconomic conditions fairly stable. The principle is recognised as good practice in most treatises on central banking. According to Humphrey, 'The result [of a panic] is a massive rise in the demand for base money – a rise that, if not satisfied by increased issues, produces sharp contractions in the money stock and equally sharp contractions in spending ... [T]he lender of last resort must be prepared to offset falls in the money multiplier arising from panic-induced rises in currency and reserve ratios with compensating rises in the monetary base.'[9] In the Great Depression in the USA, and in the 1990s in Japan, the central bank balance sheet rose enormously

8 The classic statement of the debt-deflation process was in a 1933 Irving Fisher article, 'The debt-deflation theory of great depressions', *Econometrica*, 1, 1933, pp. 337–57. Fisher's account of the process assumed a monetary theory of the determination of national income.

9 Thomas M. Humphrey, *Money, Banking and Inflation*, Edward Elgar, Aldershot and Brookfield, USA, 1993, p. 16.

relative to GDP, largely to counterbalance the effect of falls in the money multiplier on the quantity of money.

The central bank must have strong capital resources

The argument of the last section was that, from time to time and certainly when a run is threatened or under way, the central bank should have the ability to purchase assets outright (which adds risk), and to expand its balance sheet quickly and perhaps very significantly (which also adds risk). The extra risks fall on the central bank's capital. A key conclusion follows from this: if the central bank is – by itself, without the support of another agency of the state – to play a substantive role in maintaining financial stability, it must have capital resources strong enough to handle a major crisis. The quantification of the central bank's optimal capital requirement is an interesting and quite new subject, to which no settled body of theory relates. One line of approach would be to suggest that central banks should hold capital equal to some fraction of the banking system's balance sheet total and/or nominal GDP. Further, if over a period of several years the central bank's capital has declined relative to either variable, its ability to perform a lender-of-last-resort role is likely to be impaired.

At their foundation central banks were usually very large relative to the rest of the banking system. In Britain, for example, the Bank of England was by far the largest banking institution throughout the eighteenth century and remained so until the late nineteenth century. The doctrine that the Bank of England should act as lender of last resort developed when it was a heavyweight organisation, in terms of capital and hence of its ability to add assets. This remained true, although to a lesser extent, during the first three quarters of the twentieth century. At the end of 1973, just ahead of the secondary banking crisis of 1974–76, the Bank of England's capital was over £300 million, while the non-deposit liabilities (which would have been mostly capital) of the London and Scottish clearing banks were just under £850 million.[10] The Bank of England launched the 'lifeboat', asking the clearing banks to accept possible losses for the greater good of the system. The clearing banks agreed to perform this role, but – not surprisingly – they wanted the burden shared with the Bank of England. In a meeting on 27 December 1973, between the clearing bank chiefs, led by Sir Eric Faulkner of Lloyds Bank, and the governor and deputy governor of the Bank of England, the Bank said that it would cover 10 per cent of any losses in the support operation.[11] With the total of inter-bank loans in the lifeboat scheme estimated to have reached £1.3 billion, it seems that the Bank drove a hard bargain. As it happens, final losses on the lifeboat itself were negligible, although the Bank had heavy losses in a distinct support operation for Slater Walker Securities. But the Bank evidently could have absorbed a loss of £50 million or so phased over a few years, without extreme political embarrassment. According to Reid, who analysed the Bank's annual reports and accounts in the relevant period, the losses totalled about £100 million.[12]

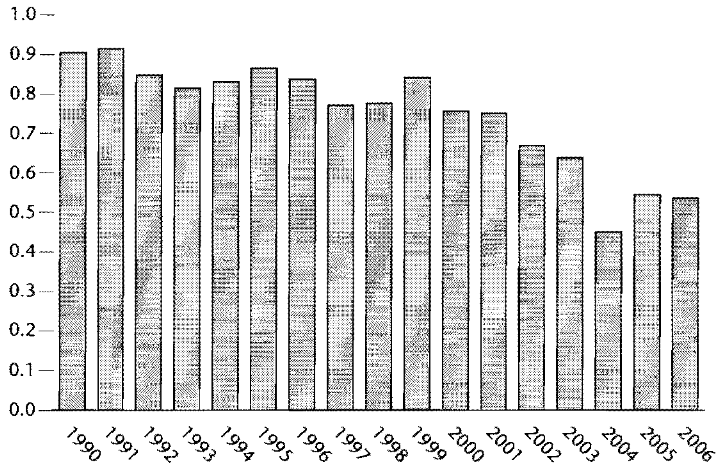
The numbers may seem small by today's standards, but it needs to be remembered that national income has risen manyfold since the early 1970s. With nominal GDP in 1973 at £74.0 billion,

10 *Bank of England Quarterly Bulletin*, Bank of England, London, June 1974, Tables 5, 8/2 and 8/3.

11 Margaret Reid, *The Secondary Banking Crisis*, Macmillan, London, 1982, p. 16.

12 Ibid., pp. 190–91.

Figure 5 **How much capital do the Bank of England and UK banks have?**
Ratio of Bank of England's capital to non-deposit liabilities (mostly equity and bond capital) of UK banking system, %



At end-2006 the Bank of England's capital of just under £1.9 billion was little more than 0.5% of the combined equity and bond capital of the UK banking system.

the Bank of England's capital of £300 million was about 0.4 per cent of GDP. The Bank's capital in the early 21st century would bear the same relationship with GDP if it approximated to £6 billion. In fact, the number is little more than £2 billion. The contrast between the Bank's capital strength today and 35 years ago is even more extreme if the comparator is the balance-sheet size (and so the potential risk) of the UK's banking system, since banks have grown faster than GDP almost continuously over the last 25 years. In February 2007 the Bank's capital was £1.86 billion, while the UK banking system's sterling non-deposit liabilities (which would have been largely equity and bond capital) amounted to £346.9 billion. Whereas in 1973 the Bank's own capital resources were about a third of those of the clearing banks, which were dominant players in the commercial banking system, at present they are a mere 0.5 per cent of all UK banks' total capital. As Figure 5 shows, the decline in the Bank's capital relative to that of the UK banking system has been unremitting over the last fifteen years. The message must be that the Bank of England's ability to take risks on to to its own balance sheet – its ability, in other words, to act as lender of last resort – is severely constrained relative to a quite recent past within the memory of many bankers still alive today. The contrast with the situation historically, when the lender-of-last-resort role was evolving in the nineteenth century, is even more pronounced.

The case for privatising the Bank of England

Some financial commentators might object that the meagreness of the Bank of England's capital is of no importance. The Bank of England is owned by the state and is accountable to the Treasury. At the end of the day it has the full fiscal resources of the British government behind it. As long as the Treasury endorses its decisions, it can therefore expand or contract its balance sheet at will. In any case, because it is in public ownership, it cannot at present make substantial last-resort loans without the Treasury's approval. On this view a call for the expansion of the Bank of England's capital appears to misunderstand its constitutional position and to be a red herring.

Here we come to perhaps the most controversial proposal in this chapter. Not only should the Bank of England have the capital to act freely and efficiently as a large-scale lender of last resort, but also it should be privatised. Two strong arguments for privatisation emerged from the banking crisis of 2007 and 2008. First, the Bank's lack of financial resources obliged it throughout the crisis to confer with – and invariably to defer to – the Treasury. Although this had been implicit in its constitutional status since nationalisation in 1946, the Bank operated with a fair degree of autonomy from the Treasury in the first big post-war crisis in the 1970s. In Reid's words in her classic account of *The Secondary Banking Crisis*,

> It is a long-standing joke, not quite unconnected with genuine rivalry, that the Treasury sees the Bank of England as its 'East End branch', while it is itself, of course, regarded by the Bank as its 'West End branch'. There is no doubt that, in the response to the fringe banking crisis, the decision-making rested overwhelmingly at the east end of the axis.[13]

By contrast, in the Northern Rock affair the Treasury's officials were more salient at key meetings than those of the Bank of England, largely because the Treasury pulled the purse strings. This might not have mattered if Treasury civil servants had had a good grasp of banking realities, but their banking knowledge and experience were usually negligible.[14]

13 Ibid., p. 19.

14 John Kingman was the Treasury civil servant in charge of the Northern Rock negotiations in late 2007. His career since leaving Oxford in 1991 had been mostly at the Treasury, with no time in banking and finance apart from a directorship of the non-commercial European Investment Bank. Newspaper stories reported on his friendship with Robert Peston, the BBC journalist who had a series of 'scoops' on official policy towards the banking system, starting with that which caused the run on Northern Rock in September 2007: see, for example, Christopher Leake, 'BBC man's intriguing web of friendships behind the scoop that shocked the banking world', *Mail on Sunday*, 12 October 2008.

The setting of deadlines for early repayment of Northern Rock's last-resort loan was a particular folly. In previous last-resort episodes the Bank, working largely by itself, had not hurried the repayment of its support facilities, but instead had given the borrowing bank time to reorganise its affairs and so to achieve the highest return from its assets. But, on 28 September 2007, the Treasury sought the European Commission's opinion on whether the British state's support of Northern Rock broke EU state aid rules. Such rules specified a six-month time limit on government help for a private sector business, unless certain criteria were satisfied. Since the Commission was expected to deem that the support was state aid (and in the end did so), the Treasury imposed on any investor in Northern Rock a requirement that the last-resort loan be repaid within six months. This was wholly unrealistic and was a key reason why no private sector investor decided to buy the bank.[15] The pressure on Northern Rock for rapid repayment of the loan was also destructive in another sense, in that it both undermined the demand for housing and reduced the amount of money in the economy. Amazingly, in November 2008 – after more than half of the initial loan of almost £30 billion had been repaid – Darling became concerned that, in the words of the *Sunday Times*, Northern Rock's 'dash for cash has helped destabilise the UK's housing market'.[16] Had he not been the minister responsible in late 2007 for determining the timing of the loan's repayment?

The clumsiness of officialdom in the Northern Rock affair

15 One of the potential bidders for Northern Rock in late 2007 was the Olivant consortium. It wanted five years to repay the Bank of England loan. Brummer, op. cit., p. 171.

16 'Darling seeks delay on Rock repayment', *Sunday Times*, 16 November 2008.

contrasted with the Bank of England's adroit handling of particular cases not only in the secondary banking crisis, but also in the small banks crisis in the early 1990s. In the small banks crisis the Bank had often kept loan facilities in place for several years, whatever the EU's rules.[17] Central banking is best done by central bankers, not by civil servants from the finance ministry. But central bankers can take charge only if they have control over the financial levers. If the central bank were privately owned, a management appointed by shareholders – and not semi-retired civil servants overseen by supposed 'experts' with partisan attitudes and dependent on politicians' favour – would take the key decisions.

But the second and more fundamental justification for privatising the central bank is that any last-resort loans would then be from one private sector agent to another. Media prattle about 'government money' was a recurring theme throughout the banking crisis and hampered sensible discussion of the underlying issues. Many people seemed to think that the government was 'spending' money on Northern Rock and other British banks in the same way that it spent money on roads and hospitals. But

17 The European Commission's Decision, which appeared on 5 December 2007, specifically exempted a lender-of-last-resort loan from the EU's state aid rules. This may have been why no one thought to invoke these rules in the secondary banking crisis or the small banks crisis. The question raised is, 'why was the Treasury so keen to seek the Commission's verdict on the Northern Rock facilities?' The trouble was that the Northern Rock package included a state guarantee on its deposits as well as the loan from the Bank of England. The Commission's view was that, while a lender-of-last-resort loan is not in itself state aid, the deposit guarantees given to Northern Rock were state aid and that the six-month deadline did therefore apply. But when banks across the EU faced runs in the autumn of 2008 a number of governments extended deposit guarantees to their entire banking systems, without seeking the Commission's permission or bothering themselves about state aid rules.

a payment of money can have a wide variety of legal significations and the true meaning may need to be specified carefully. The lender-of-last-resort loan to Northern Rock was just that, a loan that had to be repaid. It was not a grant or an item of direct government expenditure; it was also not an injection of equity capital, on which the government was entitled to seek a return over and above the interest payments on the loan.[18] One of the most ugly consequences of the crisis has been the politicisation of banking, with all sorts of populist and irresponsible pressures on the banking industry. No doubt some of this would continue if the Bank of England were privately owned, but a privatised Bank of England would be better able to keep banking matters out of the public spotlight. Crucially, a loan from the Bank of England to a commercial bank could be viewed as another kind of inter-bank transaction, of interest not to the wider world of politics and the media, but only to the private parties involved

The capital of a privatised Bank of England

Which private agents would provide the Bank's capital? Fortunately, an example is already to hand, the Federal Reserve system in the USA. When the Fed was founded Congress was anxious that it might become a creature of the central government in Washington, which would encroach on the powers that remained at state level. So neither the federal government nor state governments became shareholders in the new organisation. Instead

18 The much-heard phrase 'an injection of government money' is a media simplification and has several meanings. See note 2 above for the use of this phrase to lead to the doctrine that 'the government should seek an extra return on its money', with the consequent threat to the property rights of banks' shareholders.

the capital was subscribed by member banks themselves. At the outset the subscription to the Fed was set at 6 per cent of member banks' own capital, a number which was criticised as 'arbitrary' and 'no more than a guess at what the capital requirements of the reserve banks would be'.[19] Nevertheless, the 6 per cent figure still applies. Half of it must be paid in, while the other half is subject to call by the Fed's board of governors.

Another approach to the topic would be to judge from the historical record the maximum size of central bank exposures during financial crises and to assess the implied requirement for capital. Until the recent troubles, UK experience over the last century or so would have given only limited insights on this front, because there had been relatively few major financial crises. At any rate, in the secondary banking crisis of the mid-1970s, the amount of 'exceptional' lending was about £3 billion or, at most, 4 per cent of GDP.[20] In the latest crisis, estimating the amount of exceptional lending is more problematic, since the Treasury has invested in banks' preference shares and so assumed part of the Bank of England's traditional lender-of-last-resort role, but a figure under 4 per cent of GDP would be too low.[21] Assuming that any future emergency ought to be not much more than twice as bad as the secondary banking crisis and the latest episode, a reasonable suggestion is that a privatised Bank

19 Ray B. Westerfield, *Money, Credit and Banking*, Ronald Press, New York, 1938, p. 386.

20 Reid, op. cit., p. 192.

21 At the time of writing (November 2008) about £10 billion of the Northern Rock loan, the sums implicit in the Bradford & Bingley nationalisation and the government's offer to subscribe to preference capital issues are outstanding. For the author's view on the government's investment in the equity of UK banks, see note 25 to Chapter 5 above.

of England might need – in very extreme circumstances – to be able to acquire assets equal to a maximum of about 10 per cent of GDP. Some of the assets might be risky, including possibly some claims on the private sector with meaningful default risk, but the central bank ought so to conduct its operations that its maximum loss on bad assets in any two- or three-year period is 0.5 to 1 per cent of GDP. In a crisis it ought to be highly profitable in operational terms, i.e. from high net interest receipts, because of the large size of its balance sheet. On this basis central bank capital equal to 1 per cent of GDP ought to be sufficient to deal with any problems in the banking system which might arise in crisis conditions. In the UK today 1 per cent of GDP would be roughly £15 billion.

What about the relationship between the central bank's capital and the capital of the commercial banking system? HSBC includes the old Midland Bank and is headquartered in London, although it is in reality a Hong Kong Chinese bank. If half of HSBC were included in 'the British banking system', the system's total capital would have been about £200 billion before the government-imposed recapitalisation exercise in October 2008. The system's capital in early 2009 may be of the order of £250 billion. If the Bank of England were capitalised on the same lines as the Fed (i.e. 6 per cent of banks' own capital), the implied figure is £15 billion, virtually identical to 1 per cent of GDP. So both approaches – an estimate of maximum balance sheet exposure relative to GDP during an emergency and the adoption of the same basis as the Federal Reserve – point to a desirable capital for a privatised Bank of England of roughly £15 billion.

For much of the time the capital will be unused, in that the Bank's balance sheet will be much less than ten times capital.

Indeed, if all went well, the full capital would never be needed.[22] The American arrangements – in which only half of the due capital has in fact been called – could be copied in this country. To some extent the central bank's capital and the deposit insurance agency's fund serve an overlapping purpose, since both are available to help a commercial bank in trouble. As far as the commercial banks are concerned, an investment in the central bank is surely far more attractive than an obligation to pre-fund a deposit insurance agency. Since the UK coped well for decades until the 1980s without a system of deposit insurance, the intention of the current proposal is that – as far as possible – the task of maintaining financial stability should be concentrated at the Bank of England. The hope would be that effective deployment of its lender-of-last-resort powers would minimise calls on the deposit insurance backstop. It is true that in some circumstances banks' difficulties may be insolvency rather than illiquidity. If so, calls on the deposit insurance fund might become unavoidable. The deposit insurance agency should, however, be housed in the same building as the Bank of England, and in the UK and elsewhere the deposit insurance agency and the central bank should always work together.[23]

22 Each member bank would have a claim on the Bank of England equal to, say, 3 per cent of its capital, plus an obligation to subscribe a further 3 per cent in certain conditions. If the Bank were facing losses because of a systemic crisis, that might justify the calling of the 3 per cent from *every* member bank. Alternatively, in extreme circumstances the central bank might use the threat to call capital from *one* misbehaving but recalcitrant member bank as a means of bringing it to heel.

23 In the USA the Federal Reserve and FDIC have to work closely together in bank rescues, even if the relations between them are sometimes fraught. Further complexity arises from possible interventions by the Office of the Comptroller of the Currency. Irvine Sprague, chairman of the FDIC for over eleven years to 1986, said in a 1986 book that 'the incredible tangle of jurisdictional overlap' justified 'a major restructuring of the agencies – consolidation'. Sprague, *Bailout*, Beard Books, Washington, DC, 1986, p. 231.

Central banking and debt management

A few words need to be added here about the type of assets that the Bank is to buy from the commercial banks when it does make outright purchases. Since the Bank ought to avoid risk as far as possible, the obvious assets for the purpose of open-market operations are government securities. It follows that at all times the commercial banks ought to hold a liquidity cushion in the form of government securities.[24] As was shown early in Chapter 6, this was true throughout the twentieth century, except at its very end. Further, the Bank has to ensure that the government issues a sufficiently large quantity of Treasury bills and short-dated gilts to meet the banking system's needs. By implication, the Bank must be involved in the management of the public debt and, in particular, it has to monitor the debt's maturity profile. As was also shown in Chapter 6, the failure of the British government, and more specifically of the Debt Management Office (DMO), to issue significant quantities of short-dated government securities in the middle years of the current decade goes a long way to explain British banks' disastrous foray into structured finance products. They bought triple-A mortgage-backed paper as a form of liquidity largely because official policy had caused a shortage of their traditional liquid assets.

Given the DMO's mistake, King's requirement in August 2007 that banks use government securities in repos was to add insult to injury. Nevertheless, as ever it has to be said that errors in policymaking reflect background institutions and recent history, and should not be blamed solely on individuals. The decision to withdraw debt management from the Bank of England's remit,

24 Eligible bills also have a role, but the discussion would become complicated. See note 6 to Chapter 6 above.

and to place it with a DMO uninterested in monetary policy, was taken in 1997 by a government that had only just been elected. None of the politicians in that government had any meaningful in-depth technical knowledge of debt management or could argue with Treasury officials who resented the extent of the powers (i.e. to set interest rates) being handed over to the newly independent Bank of England. So the responsibility to manage the public debt was taken from the Bank in an arbitrary and misjudged bureaucratic carve-up. Debt management needs to be integrated with the rest of monetary policy again, and the Bank of England must have a major influence over the instrument composition and maturity structure of the national debt. Of course, it has to work with the Treasury, since the debt is the government's and the minimisation of debt-interest costs is a valid objective of public policy. But – since debt-interest costs are a transfer from one group of citizens to another – the minimisation of debt-interest costs is far less important than maintaining the stability of the banking system.[25]

25 According to a section on the Debt Management Office's website, it has eight strategic objectives for 2008/09. Debt management matters to the central bank both because it affects the availability of assets suitable for inclusion in banks' assets (i.e. financial stability) and because it impacts on the rate of growth of the quantity of money (i.e. monetary stability). (When a bank acquires a claim on the government, the government's bank deposit increases in the first instance. But – when the deposit has been spent – that expands the deposits held by the private sector, which are money.) Neither financial nor monetary stability was mentioned in the DMO's eight strategic objectives. The relationship between debt management on the one hand and financial stability and monetary stability on the other is often misunderstood or even denied. (For a perhaps surprising example, see Stanley Fischer, 'Modern central banking', in Forrest Capie et al., *The Future of Central Banking*, Cambridge University Press, Cambridge, 1994, pp. 262–308, especially p. 302 and p. 304.) The case for integrating debt management with monetary policy is made in David B. Smith, *Cracks in the Foundations?*, Economic Research Council, London, 2007.

The central bank and banking regulation

Chapter 3 showed that banks do their utmost to minimise cash holdings, even though they must always have at least some cash among their assets. Subsequent chapters have demonstrated that, if the central bank is to help them in the minimisation of their cash holdings, they need at all times to have a buffer of assets that can be sold outright – quickly, with little fuss and with almost complete certainty about their nominal value – to the central bank for cash. Clearly, the central bank must have information about commercial banks' cash holdings and the likely pattern of cash movements in and out of their central bank balance over the next few weeks, and also about the size and composition of the buffer of liquid assets that are available for sale, perhaps to it.

In an extreme crisis, with a major run on a particular bank's cash holdings, a commercial bank may lose all its original cash and be forced to sell its liquid assets to the central bank for cash, and yet may lose all that cash too: we are talking about an extreme crisis, but this is roughly what happened with Northern Rock. The central bank then has no option. It must either lend, on last-resort terms, to the bank in question or persuade strongly placed commercial banks to take its place via an inter-bank facility. If the deed is not done on its own balance sheet, but via a support line in the inter-bank market, it may have to give a guarantee on that line.[26] Of course, the central bank can be confident of repayment (and/or that its guarantee will not be called) only if it knows that the borrowing bank is solvent. Not only must the bank's assets be

26 In the small banks crisis in the early 1990s the Bank of England once guaranteed a bank's liabilities without the bank itself being told! (witness statement of Ian Bond, in the action between Northern Rock claimants and HM Treasury, 31 July 2008, clause 29).

of high quality and with a clear margin of collateral, but also the figure for the bank's equity capital in its latest accounts must be correct. It follows that the central bank must have information about the troubled bank's loan and securities portfolios, the basis on which its accounts were prepared and a host of other details.

More succinctly, the central bank's lender-of-last-resort role presupposes an extensive and continuous exchange of information between it and the commercial banks to which it may, in certain circumstances, have to lend. From the beginning of the Bank of England's assumption of the lender-of-last-resort role in the nineteenth century until 1998 the Bank was responsible for the supervision of commercial bank balance sheets and the regulation of the banking system. The logic of the arrangement was so obviously blessed by experience and is so clear cut in its practical rationale that it is puzzling that any alternative could even have been considered.[27] The transfer of banking supervision and regulation from the Bank of England to a new and untried institution, the Financial Services Authority, in the 1998 Bank of England Act and the 2000 Financial Services and Markets Act was wrongheaded. At that time central banking and the regulation of the commercial banking system had been separated in some countries, such as Germany, but these countries did not generally have an outstanding record in the provision of banking services. The Bank of England's powers as a bank supervisor and regulator need to be restored. If lender-of-last resort loans are to be extended only to solvent banking institutions, the Bank of England needs to know enough about their businesses to be certain that they are in

27 The question was discussed in paras 83–103 of the first volume of the Treasury and Civil Service Committee's report *The Role of the Bank of England*, HMSO, London, 1993.

fact solvent. By extension, the Bank of England needs to employ a sufficient number of people of sufficient seniority, qualifications and experience to discharge its duties as banking regulator.

A possible criticism of the proposal is that, if the regulatory role of a privatised Bank of England were to be reinstated, it would have to be done by statute and a privately owned body would have virtual police powers over the British banking system.[28] But the UK financial sector had a long record of self-regulation under the law until the 1980s. Further, there is nothing new about a private body enforcing by-laws on a group of individuals or companies that have voluntarily agreed to accept its jurisdiction in certain matters. The self-generation of regulation by market institutions has a long tradition, not least in financial markets. Of course, if the central bank is oppressive in bank regulation, the owners of the commercial banks can register their protests in various ways, not least by switching their capital abroad. A privately owned Bank of England would not want to alienate its shareholders and its key stakeholders, namely the UK commercial banking industry.

Checks and balances in a system with a privatised Bank of England

The remainder of this chapter will offer some remarks on how a privatised Bank of England might be organised. It should be reiterated that, despite having private shareholders, the Bank's functions and operations would still to a large extent be specified in a parliamentary statute. On the monetary stability front, that

28 In the USA before the founding of the Federal Reserve the clearing-house associations carried out bank examinations to check loan quality. C. Arthur Phillips, *Bank Credit*, Macmillan, New York, 1921, pp. 302–9.

would of course be inescapable. More awkward questions might seem to arise with regard to financial stability. Would a privatised Bank of England have a meaningful incentive to maintain financial stability? If it were owned by the banks, might it not be a soft touch (on such matters as access to central bank credit, rules on capital, and so on) and allow them to take undue liberties in the conduct of their businesses?

The answer is provided partly by historical experience. The Bank of England was privately owned from 1694 to 1946, and it was recognised as a different kind of institution from other banks, as a central bank rather than a commercial bank, from about the 1860s to 1946. These were the years in which it established a reputation as both a staunch defender of monetary stability (mostly by its adhesion to the gold standard), and as the guardian of the safety of bank deposits in Britain and so of financial stability more generally. Conflicts had arisen in the early nineteenth century between its maintenance of the two kinds of stability and its profit-making responsibilities to shareholders, but after Bagehot's work its special position was understood. No insuperable conflicts arose from the late nineteenth century until 1946 between private ownership and the Bank's delivery of financial stability. Similarly, in the USA the Federal Reserve has been able since the mid-1930s to reconcile its ownership status with an acceptable record on financial stability. In recent decades the worst solvency problems among US deposit-taking institutions have occurred not in commercial banking, but in the savings and loans industry (i.e. in specialist housing finance intermediaries), in the state-sponsored mortgage guarantee businesses known colloquially as Fannie Mae and Freddie Mac, and in investment banks such as Lehman Brothers. None of these entities was supervised by the Fed.

Indeed, a case can be made that a central bank owned by the commercial banks ought to have a benign incentive structure. Chapter 3 discussed banks' almost unremitting efforts over the long run to lower their ratios of cash and liquid assets to total assets, and also their ratios of capital to assets, and argued that 'low-ratio banking' (as it might be termed) cut the cost of services, including loan margins, to banks' customers. With the Bank of England owned by the UK's leading banking groups, they would press for the ratios to be as low as possible, while remaining consistent with balance-sheet safety. As explained in Chapter 4, one result ought to be narrow loan margins that benefit companies, homeowners and other borrowers. The banks would also be keen to formalise lender-of-last-resort arrangements with the Bank of England and to put them on a definite contractual basis, so that the misunderstandings of the summer of 2007 do not recur. In summary, the commercial banks would want the Bank of England to act, more explicitly than it now does, as a bank that – from time to time – can expand its balance sheet aggressively and so prevent misplaced worries about solvency poisoning inter-bank relationships.

On the other hand, both the banks and the Bank of England would have a strong interest in the continuation of safe banking. Since the commercial banks would be the Bank's shareholders, they would want its operations to be profitable. If heavy losses were recorded because assets of poor quality were purchased in support operations or because last-resort loans were made to genuinely insolvent banks, prudent and risk-averse banks would have to provide extra capital to cover the Bank of England's shortfall. The banks would have to work together, at least to some extent, like the members of a club. Lazy and incompetent central banking could allow risky and irresponsible commercial banking. The cautious banks would want the Bank of England to monitor and restrain risky behaviour by a rigorous system of peer review. Over the last few years Lloyds TSB is widely thought to have been more solid and risk averse than, say, the Royal Bank of Scotland or HBOS, and its aversion to risk has helped it to weather the crisis better than its rivals. The structure of regulation over the last decade, however, did not penalise irresponsible behaviour until a major crisis was under way. If a more explicit system of club rules had been in place, the crisis might not have happened.

In the sort of world being discussed here the greater the Bank of England's success, the less it would appear in the news. Its balance sheet in normal conditions would have only trivial claims on the banking system. On the liabilities side of the balance sheet it would have capital (equal, as discussed, to about 1 per cent of GDP), the note issue (perhaps 3 per cent of GDP), banks' own balances for clearing purposes (say 0.25 per cent of GDP, if that) and the government's balance (again 0.25 per cent of GDP, if that), while government securities of about 4.5 per cent of GDP and a tiny working balance of notes would constitute all of its assets. Repo items can be ignored, as they cancel out in any meaningful sense. The profits on the note issue and the government's own balance (i.e. the interest earned on the government securities, to the extent of 3.25 per cent of GDP in the illustration) would of course be returned to the government. The distribution of the income on the Bank's own capital, and banks' own cash reserve balances, would be largely a matter for the shareholders (i.e. the commercial banks). But arrangements could to be made, first, to ensure that the top central bankers receive incomes not much different from those of senior executives in the banking industry (perhaps on a long-term bonus arrangement that kicks in as more years free of crisis and with on-target inflation are recorded) and, second, to retain teams of officials that collectively have thousands of years of central banking expertise. In the USA 95 per cent of the Fed's profits are returned to the state, apparently with only limited incentive arrangements for the staff. In the author's view central bank staff should have strong incentives to perform well. The USA's misplaced reliance on a too-extensive deposit insurance system also muddies the waters.

What would happen if there were a big crisis? With capital at 1 per cent of GDP, the aim would be that the Bank of England could add last-resort loans to its assets up to a limit of 10 per cent of GDP. Alternatively, it ought to be able to purchase securities to the same extent and with the same objective (i.e. the maintenance of financial stability) in view. The Bank must be able to do this on its own initiative, without any reference to politicians or civil servants. Since the UK banking system's own capital would not usually be much in excess of 10 per cent of GDP, and good regulation should ensure that banks are solvent anyhow, the likelihood of a systemic crisis blowing the whole system away – and so requiring an appeal to the state – ought to be negligible.[29]

29 What if, without good reason, people became concerned that a solvent banking system was insolvent and started to convert deposits into notes on a very large scale (say, 20 or 30 per cent of GDP)? (The cancellation of inter-bank lines, as in 2007 and 2008, might have much the same effect on the banks, since each individual bank would feel that its cash was being drained.) Then the central bank should extend loans to the banks to replace the lost deposits and the system can wait for the deposits to return. The deposits will return when people realise that the banks are in fact solvent, and miss the interest paid and transactions convenience of having their wealth in the form of bank deposits rather than cash. But – clearly – if the central bank's balance sheet ballooned to 20 or 30 per cent of GDP, the circumstances would be extraordinary, and the central bank would need to review the matter with the government and legislature. As noted in the

It has to be admitted that, in a full-blown crisis in which the prices of assets (such as houses and commercial property) widely used as bank collateral fell by between (say) 30 to 50 per cent in a one-year or two-year period, any central bank would have difficulty maintaining financial stability. If a crisis of this sort occurred, the proposed system – in which the central bank is owned by the banking system, and is responsible for both monetary and financial stability – would have failed. The Bank of England's senior executives, including its governor, deputy governors and so on, would be sacked without any long-term bonuses being paid. Of course, the losses to them, in terms of both reputation and money, would be severe. The threat of that ought to encourage the Bank's management team both to supervise and regulate the banks with great care, and to achieve a satisfactory degree of macroeconomic stability. As with any well-designed constitutional order, a privately owned central bank would be subject to checks and balances, and these checks and balances could be tweaked with experience to improve the outcomes. It is difficult to believe that the proposed system – which recalls the Bank of England's own past success – could lead to a disaster worse than the UK banking debacle of 2007 and 2008.

Central banking in a liberal financial system

The proposed model, a privately owned central bank with extensive responsibilities for both the regulation of the banking system

text (pp. 142–3 above), King has denied that the central bank can provide long-term finance to banks. It is precisely in crisis circumstances – when the system is solvent, but a run develops because of 'the fear of fear itself' – that King's doctrine is most dangerous.

and the management of the public debt, may appear to concentrate too much power in one place. But – emphatically – this would be central banking for a free society. Because the Bank of England would be in private ownership but subject to statute, its governor and senior executives would answer simultaneously to shareholders with money at stake and to democratically elected politicians. If the Bank's officers abused their powers, they could quickly be brought to heel. Chapter 5 argued that the era of constructive ambiguity in last-resort lending must end, and advocated instead a clear contractual framework for transactions between the central bank and the rest of the banking system. The result would be a better balance of power between them, which ought to prevent arbitrary and dictatorial behaviour by the governor of the Bank of England in a financial crisis. Whether King was too hostile towards the banks in late 2007 and 2008 can be debated. But, without question, many senior executives in the banking industry resented the treatment they received.

The current UK arrangements are distinctly illiberal. A government agency, the Financial Services Authority, has more or less unlimited regulatory powers. A case can be argued that, in the bank recapitalisation exercise of October 2008, those powers were seriously misapplied. No one knows whether the current downturn in the UK economy will be long lasting, but the UK's banks were mandated to raise large amounts of capital and so to anticipate the loan losses of a severe recession. Given the trauma then prevailing in financial markets, the banks' own shareholders did not have the funds available to subscribe for all the new shares. The government was able to buy large equity stakes in Royal Bank of Scotland, HBOS and Lloyds TSB at prices beneath asset value per share, implying massive dilution of existing shareholders' assets. The government's actions may have been legal, but they challenged private property rights and insulted the rule of law.

The proposed system would be voluntary, in that financial organisations could choose whether or not to have a relationship with the Bank of England. There is nothing inherently coercive in an arrangement whereby commercial banks receive services from the central bank (which helps them run the payments system and provides last-resort lending), and in return submit themselves to a set of club rules. All contracts are a mixture of give and take, and this relationship would have to be subject to contract. As long as the club's rules (on asset composition and solvency, among other matters) are enforced in the same way for all its members, the commercial banks ought to be able to work closely and amicably with the central bank.

The aim would not be to achieve desired outcomes by forcing the central bank and the banking industry to behave in certain ways. On the contrary, the intention of privatising the Bank of England, and returning to it powers that it once exercised with great success, would be to facilitate the wider promotion of a liberal financial system. Within that system the main players would be free to make most key choices according to their own interests, but – as in Adam Smith's system of natural liberty – with socially beneficial results. To repeat, the proposal is, above all, about the organisation of central banking in a free society.