



House of Commons
Treasury Committee

**Banking Reform: Government and
Financial Services Authority
Responses to the Committee's
Seventeenth Report of
Session 2007-08**

Fourteenth Special Report of Session 2007–08

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The Treasury Committee

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The current staff of the Committee are Colin Lee (Clerk), Sian Woodward (Second Clerk and Clerk of the Sub-Committee), Adam Wales, Jon Young, Jay Sheth, and Cait Turvey Roe (Committee Specialists), Phil Jones (Committee Assistant), Caroline McElwee (Secretary), Tes Stranger (Senior Office Clerk) and Laura Humble (Media Officer).

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Fourteenth Special Report

The Treasury Committee published its Seventeenth Report of Session 2007–08, *Banking Reform*, on 16 September 2008, as House of Commons Paper No. 1008. The Government response to this Report was received on 20 October 2008, and is appended below. We are also publishing the Financial Services Agency response, received on 22 October 2008, as Appendix 2.

Appendix 1: Government Response

The Government welcomes the report of the Treasury Select Committee, and thanks the Committee for their work. The advice of the Committee has been invaluable in developing and taking forward the Banking Bill as it currently stands before the House of Commons.

Much has changed in the short period since the Committee reported on 16 September. The Government has taken decisive action to support the banking sector in the steps announced on 8 October and 13 October, and has also resolved problems facing particular institutions using powers granted in the Banking (Special Provisions Act). This demonstrates the need for permanent legislation to ensure the financial stability of the UK. The Government hopes that Members of the Committee will continue to provide ongoing advice and scrutiny as the Bill goes through the Parliamentary process in the months ahead.

The case for change

1. The separation of regulatory responsibilities from the continuing responsibility for liquidity support to secure financial stability has created uncertainty within the Bank of England. As we have noted, the Governor has interpreted this as meaning the Bank was not to engage with individual institutions. This interpretation placed the Bank in a no-man's-land. (Paragraph 10)

The Government notes the Committee's view. The Government remains firmly committed to its regulatory model, with the Financial Services Authority (FSA) as single regulator of the financial system. This is in the interests of market participants, who will continue to have a single regulatory point of contact, and the Authorities, who will benefit from an uncomplicated flow of information from a single source. The FSA, as regulator, should continue to engage directly with individual institutions on an ongoing basis. Going forward, the Bank of England, as the Authority responsible for the implementation of the Special Resolution Regime (SRR), will have direct responsibility for firms once they are placed into the SRR. The Bank of England, with its new statutory responsibility for financial stability, and supported by the new Financial Stability Committee, will also consider systemic factors affecting financial stability.

2. The overall case for legislative action in the field of banking regulation is compelling. The authorities must be able to deal with failing banks effectively and with an adequate range of options. The responsible authorities require access to the information which must drive their actions. An effective statutory depositor protection scheme which commands the confidence of consumers is needed in order to reduce the likelihood of disorderly bank failure following a retail run and thus to reduce in turn the requirement for extra-statutory guarantees by the Government. (Paragraph 11)

The Government welcomes the Committee's support. The Government agrees that access to information and effective depositor protection arrangements are important. The provisions set out in the Banking Bill empower the FSA to collect information relating to financial stability for use by all the Authorities (the FSA, Bank of England, and the Treasury) as well as the Financial Services Compensation Services (FSCS), and facilitates the sharing of such information between the Authorities. The Bill also improves the legal framework for the FSCS to allow for faster and more efficient payouts. The FSA has also recently announced measures to enhance the compensation scheme—including an extension of the protection to cover £50,000 per depositor per bank—and is currently consulting on further increases and changes to the scheme (*Financial Services Compensation Scheme: Review of Limits*, 3 October 2008).

3. There are a number of sound reasons why the Government needs to proceed with legislation on banking reform in the near future. Undue delay increases the risk that the weaknesses of the current unsatisfactory legal framework may again be exposed by a new crisis or that momentum might be lost as memories of events since August 2007 fade. However, these factors need to be balanced against several areas of concern arising from the timetable currently proposed. (Paragraph 17)

4. We are not convinced that it will be possible for the Government to prepare a polished and complete Bill in time for publication in October. There remains a lack of clarity about the purpose and precise details of some of the key proposals for inclusion in the Bill. It will be very difficult for the Tripartite authorities to undertake a full and thorough consideration of this Report and of responses to the July consultation documents, respond to the new proposals made and give due weight to them within the timetable for publication of the Bill currently proposed. (Paragraph 18)

5. It is vital that each House of Parliament is able to give full and thorough consideration to a Bill which is likely to be highly complex and to give rise to a number of fundamental issues relating to the economic well-being of the United Kingdom and to property rights. The success of the new framework will be crucial to confidence in the United Kingdom financial sector and to its competitive position. Some of the most important issues arise from the consultation document published on 22 July which we have not had an opportunity to take evidence on or consider in

detail. It will be particularly important for each House of Parliament to have an opportunity to take account of the concerns of organisations and individuals about the proposals in that document. (Paragraph 19)

6. The case for early implementation of the new legislation must be established separately from the case for early Royal Assent. We recommend that the Government, in its response to this Report, set out the proposed timetable for the implementation of the new legislation and the reasons for that timetable. (Paragraph 20)

7. We are concerned about whether the Government's preparations for the new legislation are sufficiently advanced for the new legislation to be in place when the relevant provisions of the Banking (Special Provisions) Act 2008 lapse on 22 February 2009. (Paragraph 22)

The Banking Bill was introduced to Parliament on 7 October 2008, after an extensive period of engagement with a wide range of stakeholders, starting in October 2007, and including three formal consultations. The Government has taken the results of these consultations, and the findings of the Committee's report, into account in finalising the provisions of the Bill.

The Government agrees that extensive Parliamentary scrutiny will be extremely important. The Government is aware of the time constraint imposed by the expiration of the powers provided by the Banking (Special Provisions) Act on 20 February 2009. We will work with Parliament to ensure that Parliamentarians have as much opportunity as possible to consider the detailed provisions of the Bill.

The Government has also recently announced the creation of an expert liaison group to help prepare new secondary legislation for the special resolution regime and monitor its effectiveness. This group will include relevant experts from the financial markets and financial services trade bodies who will be able to update the Authorities on the effectiveness of the tools.

In the light of recent events, however, it is more important than ever that the Government have permanent powers to address bank failure. The Government intends to implement the legislation as soon as possible following Royal Assent, while noting the need for appropriate secondary legislation in a number of areas. Should either Royal Assent or implementation of the Bill be delayed beyond 20 February 2009, then the Government's contingency option would be to extend the relevant provisions of the Banking (Special Provisions) Act via an emergency one-clause Bill. This would not be the Government's preferred option.

8. It is important that new legislation relating to financial stability is not seen as a panacea for the failings within the Tripartite arrangements which were highlighted by the Northern Rock crisis. The Tripartite authorities must also ensure that

practical steps are taken that respond to the actual failings evident during that crisis in parallel with the creation of the new legislative framework. Our recommendations in this Report are concerned with such practical measures as well as with the content of the forthcoming legislation. (Paragraph 29)

The Government notes the Committee's comments. The Bill is one part of the Authorities' wider response to the current situation, which includes the immediate market support action announced on 13 October, including the recapitalisation support provided to RBS, Lloyds TSB and HBOS. In addition, the Authorities have taken broader steps including the development of a credit guarantee scheme, an extension to the Bank of England's Special Liquidity Scheme, and the FSA's increase of the deposit protection limit of the FSCS to £50,000. In the wake of Northern Rock, the FSA is also implementing its supervisory enhancement programme, and at the recent request of the Chancellor, is also conducting further reviews, including of liquidity regulation and remuneration.

As set out in the Authorities' January and July consultation documents *Financial Stability and Depositor Protection*, a number of rule changes, and operational improvements will also be taken forward by the Authorities and a revised tripartite Memorandum of Understanding will be published in due course.

Avoiding the "nuclear option"

9. We note the Minister's characterisation of the Special Resolution Regime as the "nuclear option". One of the principal challenges for the Financial Services Authority under the new arrangements will be to ensure that the need for the use of the Special Resolution Regime is kept to a minimum. (Paragraph 30)

The Government agrees that the special resolution regime (SRR) should be used only in the rare cases where a bank failure has become unavoidable, and that it is important that the Authorities, including the FSA, work effectively together with market participants to avoid such circumstances arising. It is also important to note that the primary responsibility for the conduct, success, or failure of banks rests with the management of the firm in question.

The conditions which must be met, before entry into the SRR are defined on the face of the Bill in Clause 7:

- the first condition, set out in subsection (2), is that, in the opinion of the FSA, the bank is failing, or is likely to fail, to satisfy its regulatory threshold conditions (as provided in the Financial Services and Markets Act 2000);
- the second condition, set out in subsection (3) is that, in the opinion of the FSA, it is not reasonably likely that action taken by or in respect of the bank that will enable the bank to satisfy the threshold conditions, having regard to timing and other relevant circumstances.

10. We welcome the publication of the Financial Services Authority's internal audit report on the Authority's regulation of Northern Rock, and that report's frank discussion of the Financial Services Authority's weaknesses in regulating Northern Rock. We welcome the confirmation that report provides for our own conclusion that the failure of Northern Rock, while a consequence of the actions and inactions of Northern Rock's board, also illustrated systemic failure by its regulator. (Paragraph 38)

As the Committee notes, the FSA internal audit report provided a valuable insight into weaknesses in Northern Rock's supervision. The Government has full confidence in the Financial Services Authority (FSA) and welcomes the strong commitments it has made to a continuing programme of supervisory enhancement. Additional action is also being taken to enhance supervisory oversight of banks, led by the FSA, including on the important issues of liquidity regulation and remuneration.

11. Heightened supervision must be considered as a distinct and separate state of supervision, segmented from both normal supervision and from the Special Resolution Regime. (Paragraph 48)

12. We do not view the Memorandum of Understanding as the appropriate vehicle for publishing detailed information for banks about heightened supervision. We recommend that the Financial Services Authority be placed under a statutory duty to prepare, and consult on, a Code of Practice for Heightened Supervision, in order that all firms that are potentially to become subject to heightened supervision will know what is expected of them, and what they can expect in return. This Code of Practice should require the Financial Services Authority to specify targets to be met by any firm that is subject to heightened supervision in order for that firm to be able to be removed from a state of heightened supervision. (Paragraph 49)

13. We agree that the decision to make a firm subject to heightened supervision is a regulatory matter, and should only be taken by the Financial Services Authority. However, senior management at the Financial Services Authority must be aware of the danger of regulatory forbearance when considering which firms should be subject to heightened supervision, and must ensure by both internal vigilance, and the use of the analytical resources of the Bank of England where needed, that this danger does not manifest itself. (Paragraph 50)

14. The Financial Services Authority must ensure that there is sufficient information available to the Bank of England on financial institutions subject to heightened supervision in order that the Bank may properly fulfil its functions in relation to the Special Resolution Regime. The Bank of England in turn must ensure that it has the appropriate expertise such that it can request the information it needs from the Financial Services Authority to fulfil its role in relation to firms subject to heightened supervision. (Paragraph 51)

15. The authorities need to balance competing considerations when deciding whether to disclose to the markets and consumers whether an institution has become subject to heightened supervision. While such a disclosure might be proper in ensuring that consumers are fully informed as to the safety of the deposits they make with financial institutions, such a disclosure might also lead to a rapid weakening of the institution by prompting a depositor run on the bank, leading to it entering the Special Resolution Regime where it might not otherwise have done so. We recommend that the Code of Practice on heightened supervision that we recommended earlier contain a clear set of guidance to both financial markets and the public about the circumstances, if any, in which information will be disclosed on financial institutions subject to heightened supervision. (Paragraph 53)

16. We recommend that the Code of Practice on heightened supervision contain guidance in order to minimise the number of people, both within the Tripartite authorities and within the affected financial institution, who know of the firm being subject to heightened supervision, and the policy response being requested by the Financial Services Authority. We further recommend that the Tripartite authorities consider whether further tools or procedures should be used to guard such confidential data. (Paragraph 56)

The Financial Services Authority (FSA) supervises regulated institutions on a case-by-case basis, and has the power to escalate or reduce the nature and intrusiveness of that supervision according to the particular circumstances of the firm in question. ‘Heightened supervision’ is not a separate regime or set of powers, but a range on the continuum of normal supervisory arrangements, where a potential threat to compliance with threshold conditions has been identified. Defining ‘heightened supervision’ as a disclosable statutory state would create significant risks to financial stability, through the resulting loss in market confidence in banks which otherwise might, through regulatory intervention and the provisions of liquidity assistance, be returned to full health.

Pulling the trigger

17. The current trigger mechanism, where two conditions have to be met, highlights the importance of the threshold conditions (and how they are imported into the Financial Services Authority’s Handbook) being right. We therefore recommend that each of the Tripartite authorities be subject to a statutory duty to consult each other on a regular basis about the matters to which the threshold conditions applying to banks and building societies refer. (Paragraph 59)

The Banking Bill provides a statutory duty for the FSA to consult the Bank of England and HM Treasury before deciding that the general conditions for entering the SRR are met.

18. We welcome the confirmation by the Financial Services Authority that it will be independent from the Government in deciding whether and when a financial

institution in difficulty ought to be made subject to the Special Resolution Regime. (Paragraph 60)

19. We remain concerned about the potential for regulatory forbearance by the Financial Services Authority, leading to a late activation of trigger for the Special Resolution Regime, and a potentially sub-optimal outcome overall. However, we accept the dangers of a dual trigger, and the muddled lines of command that a dual trigger would entail. We are also concerned about the uncertainty such a system could create for financial institutions. We therefore agree with the current proposal that the Financial Services Authority be granted the sole responsibility for the pulling of the trigger to make an individual firm subject to the Special Resolution Regime. (Paragraph 68)

20. We are concerned at the proposed absence of explicit powers in primary legislation for the Bank of England to recommend the pulling of the trigger to the Financial Services Authority. The draft legislation only refers to Bank of England participation alongside the Treasury in a consultation initiated by the Financial Services Authority. We recommend that the Bank of England be given a power enshrined in primary legislation to recommend that a financial institution be brought within the Special Resolution Regime. The legislation should also mandate that such a recommendation by the Bank of England to the Financial Services Authority be formally replied to by the Financial Services Authority in any case where the financial institution is not brought within the scope of the Special Resolution Regime within the Bank of England's recommended timeframe. The power of the Bank of England to make such a recommendation would be in addition to the current proposal for the Financial Services Authority to have a duty to consult the Bank of England and the Treasury on any pulling of the trigger. (Paragraph 69)

21. It is important that the recommendations of the Bank of England relating to the pulling of the trigger, and any reply by the Financial Services Authority, be written bearing in mind the possibility that those documents will be made public at an appropriate point. Knowledge that such publication would take place at an appropriate time would be an important factor in countering the tendency towards regulatory forbearance. We envisage three scenarios when publication of the documents or of information about the documents would be appropriate:

- In a case in which a financial firm is placed in the Special Resolution Regime in the timeframe envisaged by the Bank of England in its recommendation, we see no need for publication of that recommendation, although we recommend that the existence of such a recommendation in relation to the firm concerned be reported in the ensuing year;
- We recommend that, in a case in which a financial firm is placed in the Special Resolution Regime following a recommendation by the Bank of England, but where that recommendation has not been followed in full—for example, where the timetable proposed in that recommendation is not

followed—such a recommendation and the reply by the Financial Services Authority be published immediately after the entry of the financial institution into the Special Resolution Regime;

- **In a case in which the Bank of England has made a recommendation, but the Financial Services Authority has decided not to act upon it, and the financial institution concerned subsequently meets its threshold conditions, we recommend that the fact that a recommendation has or recommendations have been made, but not implemented, be reported without reference to the financial institution or institutions concerned. (Paragraph 70)**

We agree with Committee that the FSA, as the regulator of firms, should be the lead Authority in deciding when a bank is failing. The Banking Bill requires the FSA to consult with both the Treasury and the Bank of England before deciding to trigger the SRR. As part of this process, the Bank of England or the Treasury can make whatever recommendations they believe appropriate to the FSA. In practice the Authorities will work closely together both before and during the exercise of the SRR. The Government does not agree, however, that the process by which the Authorities discuss individual cases should be prescribed on the face of primary legislation.

22. The markets and the public must know about any decision by the Financial Services Authority to pull the trigger. We assume that the formal pulling of the trigger will be accompanied by the implementation of the initial preferred option within the Special Resolution Regime. Although it is clear to us that the tools available to the Tripartite authorities for handling a future banking crisis should be more varied and more sophisticated than those available in September 2007, there remains a very real danger than the exercise of the new powers, particularly the first exercise of the new powers, will be widely perceived as a repeat of the Northern Rock saga rather than as an effective means of preventing such a repeat. We recommend that the Tripartite authorities, in response to this Report, state whether the proposed new legislative framework allows for any delay in the publication of the decision to pull the trigger. We further recommend that the Tripartite authorities give very careful consideration to means of reducing the potential adverse impact on markets and the public from such an announcement of a decision to pull the trigger. In any public communications the consumers' rights, protections and any remaining risks need to be clearly explained. (Paragraph 73)

As the Committee notes, formal entry into the SRR will need, in all circumstances, to be simultaneous with the exercise of the relevant stabilisation option, because of the need to avoid any period of uncertainty which might fatally undermine confidence in the bank in question.

23. In our Report in January we emphasised the importance of clear communications during a crisis. The terms Emergency Liquidity Assistance and Lender of Last Resort facility have unfortunate overtones in the context of the purpose of reassuring the public. The circumstances under which such assistance might be provided are far

wider than those seen recently in the case of Northern Rock. We therefore recommend the adoption of the term Special Drawing Facility rather than Emergency Liquidity Assistance, as a more neutral and less alarmist description of central bank lending to financial institutions in relevant cases. (Paragraph 75)

24. Use of a Special Drawing Facility is not one of the tools of the Special Resolution Regime. We accept that such a Facility may be used in a variety of circumstances where use of the Special Resolution Regime would be inappropriate. We recommend that the revised Memorandum of Understanding on Financial Stability provide further information on the range of circumstances in which a Special Drawing Facility would be considered by the Tripartite authorities and on the relationship between the use of a Special Drawing Facility and the Special Resolution Regime. (Paragraph 78)

25. We welcome the Financial Services Authority's decision to consult on the rules concerning the disclosure of a central bank support operation. However, the consultation paper has left unanswered the fundamental question of whether, even with the proposed new clarification of those rules, it would be possible for a covert operation to occur. We therefore recommend that, in response to this Report, the Tripartite authorities explain whether they consider that a covert operation would ever be used in the future, and, if so, in what broad sets of circumstances. (Paragraph 81)

As the Committee notes, it may not always be possible to operate covert provision of liquidity assistance in all circumstances. The Government remains of the view that timely disclosure and transparency are key to maintaining market confidence over the long-term. However, in circumstances where such disclosure would cause substantial damage to a firm receiving liquidity support, there are clear public interest reasons for delaying such disclosure.

The Government has therefore taken steps, laid out on the face of the Bill, to address some of the channels through which early disclosure could occur; by ending the requirement for the Bank of England to publish a weekly return, and for firms receiving liquidity support to register charges at Companies House. Both of these provisions are in keeping with the Government's commitment to ensuring transparency where possible, while ensuring that unnecessary disclosure of liquidity assistance is reduced.

The "nuclear" options

26. The proposed special resolution objectives are cast in very general terms and placed in no order of priority, and the Tripartite authorities are only to be required to "have regard" to those objectives. From our scrutiny of the Northern Rock crisis, it is apparent to us that there will be situations in which the pursuit of one objective might conflict with the pursuit of another. We recommend that the legislation require that, when a Tripartite authority exercises a power under the Special

Resolution Regime, that authority publish, or record for subsequent publication as appropriate, an assessment of the reasoning behind its decision. (Paragraph 89)

27. We welcome the commitment by the Tripartite authorities to publish a draft of the Code of Practice relating to the Special Resolution Regime at the time of introduction into Parliament of the forthcoming Bill. That should enable proper consideration to be given both to the proposed content of that Code of Practice and to the appropriate balance between what should appear in primary legislation and what can properly be contained within the Code of Practice. (Paragraph 92)

28. We recommended in January that responsibility for operation of the Special Resolution Regime be given to the Bank of England and we therefore very much welcome the proposal to grant that role to the Bank of England. We also welcome the clarification that the Financial Services Authority will have a distinct and continuing supervisory role in relation to any bank that is subject to the Special Resolution Regime. (Paragraph 96)

The SRR objectives place, on the face of the Bill, the core purposes of the SRR and the tools within it. In practice the Authorities will work closely together both before and during the exercise of the SRR, as has been demonstrated by the Authorities recent actions to stabilise the banking sector. The Government does not agree that the process by which the Authorities discuss individual cases should be prescribed on the face of primary legislation.

We welcome the Committee's support for giving responsibility for operation of the SRR to the Bank of England. The Government will publish a draft Code of Practice in due course.

29. The Bank of England will need to maintain a highly-qualified complement of staff able to apply the Special Resolution Regime to an individual institution at short notice. We welcome the indications by the Governor of the Bank of England that a permanent team of staff will be established. We expect that this team would include staff with commercial banking experience, and have the ability rapidly to draw upon a larger team of outside experts in times of crisis. During non-crisis periods, we would expect the core team to prepare contingency plans, conduct exercises based on up-to-date risk assessments and consider best practice from other jurisdictions and industries to assist with the successful implementation of the Special Resolution Regime in a crisis. (Paragraph 98)

30. We have not had an opportunity to take evidence on the detailed proposals relating to the Treasury's role in the Special Resolution Regime. We agree that the Treasury has a legitimate interest in the selection of a special resolution tool that has implications for the public purse and welcome in principle the limitations on the Treasury's role to matters relating to public funds, compliance with international obligations and the use of temporary public ownership. (Paragraph 101)

The Government welcomes the Committee's support for its proposals.

31. Although we have rehearsed the main elements of the new Special Resolution Regime in this chapter and have identified some important areas of concern, including about the funding of the Regime, the partial transfer powers and the possible implications of the proposed abridgement of property rights, we have not been able to take detailed evidence and reach substantive conclusions on the provisions for the new Regime in the time available. This reinforces the importance of the conclusions and recommendations about the timing of the forthcoming legislation that we set out in chapter 2 of this Report. (Paragraph 123)

The Government notes the Committee's comments.

Deposit Protection

32. The Financial Services Authority is committed to consulting about an increase in the compensation limit under the Financial Services Compensation Scheme from £35,000 to £50,000. Consumer awareness of the limit, even in the wake of the Northern Rock crisis, remains limited, suggesting that an increase in the limit may have a limited effect on consumer confidence. The additional cost to the banking industry of funding a higher limit must be justified by the Tripartite authorities before any such change is made. We believe that other characteristics of the Financial Services Compensation Scheme are as important to its effective working as the compensation limit itself—most notably speed of payout, data requirements, whether coverage is by authorised bank or by brand, and whether payments are made on a gross or net basis. (Paragraph 130)

The FSA announced an increase in the compensation limit for deposits to £50,000 on Friday 3 October. The increase took effect on Tuesday 7 October. As set out in the January and July consultation documents, the Government recognises the importance of other factors besides the compensation limit in giving consumers confidence that their deposits remain safe and accessible. The FSA has published a consultation paper (*Financial Services Compensation Scheme: Review of Limits*, 3 October 2008) which, in addition to compensation limits for bank depositors, also covers:

- compensation limits for other sectors
- switching compensation to a per brand or per account basis; and
- the issue of protection for temporary high balances.

Other work, and future consultation, by FSA will cover further faster payout issues, including:

proposals covering payment of compensation on a per account or per brand basis;

- moving to a gross rather than net payout;
- the introduction of a single customer view (a reliable and consistent view of eligible aggregate customer deposit position with an institution)

- simplification of the eligibility criteria for the FSCS compensation.

33. The speedy administration of compensation payments by the Financial Services Compensation Scheme is absolutely critical in building confidence in the scheme because quick payment would minimise disruption to customers' access to funds. This is a desirable objective in its own right, but also contributes significantly to reducing the risk of a retail bank run. We recommended in January that customers should not be without access to funds for more than a few days, but the banking industry argue that even seven days is far too little time. We believe that the resistance of the banking industry is unhelpful. Greater confidence in the efficiency of the deposit protection arrangements would directly benefit the banks, because customers would be less inclined to join a bank run. The Tripartite authorities must stand firm in their determination to introduce tough deadlines for processing compensation payments. (Paragraph 134)

34. We are surprised at the inability of most banking groups' IT systems to take a "single customer view" of accounts held with them. The banking sector views achieving such an objective as prohibitively costly. We reiterate the point we made in January that the ability readily to identify insured depositors (and the magnitude of payouts to which they are entitled) is an essential prerequisite to speedy disbursement of compensation to a failed bank's depositors. Customers will have little confidence in a bank that is unable even in a non-crisis period to work out the extent of deposit protection that its depositors enjoy. The Tripartite authorities and the Financial Services Compensation Scheme must ensure that a bank's inability to calculate individual compensation payouts immediately does not jeopardise the proposed seven-day payout target. (Paragraph 141)

The Government agrees with the Committee on the importance of the speedy administration of compensation payments in maintaining confidence in the FSCS, and remains committed to a target of seven days for people to get access to at least some of their protected deposits, with the remaining balance in the following few days. The Banking Bill includes provisions to require a bank liquidator, under the new bank insolvency procedure, to work with the FSCS to ensure either that depositors' accounts are transferred to a new bank or that they receive their FSCS compensation. The Bill will also confirm that the FSCS has the power to outsource its work in processing and deciding claims to other people (including to the bank liquidator).

The Government also agrees on the importance of being able quickly to identify eligible claimants and calculate the amount of the compensation to which they are entitled. The Banking Bill includes new powers to enable the FSA to obtain the information the FSCS may require to help speed up compensation payouts. The FSA is also working with banks to consider options for, and alternatives to, "single customer view" solutions which will deliver the same outcomes, and it will consult further in due course.

35. Currently, some banking groups operate multiple deposit-taking institutions under a single Financial Services Authority registration, and depositors with savings spread across these institutions would only receive deposit protection up to £35,000 in total. It is unreasonable to expect customers to know whether their institution has an individual or a shared banking licence. In an insolvency, creditors seek recourse to the legal entity concerned, so deposit protection would be afforded by reference to the registered bank. One way to resolve this difficulty would be for the Financial Services Authority to require each banking brand to possess its own banking registration. We recommend that the Financial Services Authority consult on this suggestion at the earliest opportunity, or find an alternative way to clarify what deposits are protected. (Paragraph 145)

36. We highlighted the problem of net compensation payments in our Report in January, and we believe that netting a depositor's liabilities against assets is, in general, unfair to consumers and undermines whatever contribution is made by the guarantee to financial stability. Net payments would also be slower to administer in a crisis situation, where speedy payout would be essential. We welcome the decision of the Financial Services Authority to consult about a move to gross payments, and look forward to speedy implementation of provision for gross payments. (Paragraph 148)

The Government notes the Committee's recommendation. The FSA has now raised the compensation limit for depositors to £50,000, and is now consulting on switching compensation to a per brand or per account basis (*Financial Services Compensation Scheme: Review of Limits*, 3 October 2008). The FSA will also, in due course, consult on a switch to gross payments.

37. In January we set out the case for introducing an element of pre-funding into the deposit protection arrangements for banks. We welcome the advance in the Government's position since then, in that it has agreed at least to make legislative provision for the introduction of pre-funding. However, we believe that there are risks associated with making such provision without a clear timetable for its implementation. One risk is that delay will cause uncertainty within the banking industry. A second, and very important, risk is that implementation will be delayed to the point where the opportunity to build significant reserves will have passed before the onset of the next financial crisis. We recommend that, at the time the legislation is published, the Government set out a proposed timetable for the implementation of pre-funding. We envisage that industry levies would initially be relatively low, but would escalate over time, and particularly as the economy moves through the economic cycle and the health of the banking sector improves. We further recommend that the Financial Services Authority be granted a power to postpone or suspend levies for the banking sector as a whole at a time of financial crisis. Finally, we recommend that the Financial Services Authority be granted the power to vary contributions according to its assessment of the risk profile of individual institutions. Through this mechanism, the Financial Services Authority

would have an additional lever for encouraging prudent behaviour by deposit-taking institutions. (Paragraph 159)

The Government notes the Committee's views. The Banking Bill allows for flexibility in the design of arrangements for pre-funding. The FSA already has the power to introduce a risk-based system for calculating the levies for individual firms and will continue to have that power if pre-funding is introduced. The Government is not proposing to introduce pre-funding at this stage.

38. Although we recognise that United Kingdom depositors of European Economic Area banks have an “entitlement” to the benefits of home-state deposit insurance, this does not necessarily amount to a guarantee of the same strength as that afforded by the Financial Services Compensation Scheme. Few United Kingdom depositors with European Economic Area banks are aware of the risks that they might be taking, and the potential inconvenience that they might face if their bank were to fail. We recommend that the Financial Services Compensation Scheme take responsibility, in cases in which the European Economic Area bank in question had opted to top-up, for providing compensation to United Kingdom depositors on the same basis as for United Kingdom banks. The Financial Services Compensation Scheme would then claim reimbursement itself from the home-state deposit protection scheme of the failed bank, acting as it does when it takes the place of insured depositors in the winding-up of a United Kingdom bank. (Paragraph 165)

The Government notes the Committee's recommendation that the FSCS should provide compensation for depositors at UK branches of a failed EEA bank and recover the cost from the home State deposit-guarantee scheme of the bank concerned. That is one possible way in which the FSCS could act as the single point of contact for UK depositors which the Government proposed in its September 2008 paper *Financial stability and depositor protection: cross-border challenges and responses*. The Commission is bringing forward proposals to amend the EC Deposit-guarantee Schemes Directive.

In the very recent case of the failure of the Icelandic bank Landsbanki, the Government has taken action to ensure that UK retail depositors do not lose any money, and is now working with the Icelandic authorities, and the bank itself, to ensure that the Icelandic compensation scheme honours its obligations under the current DGSD and that the position of UK creditors is resolved.

39. We welcome the proposals in the 1 July consultation document for the reform of banknote issuance by Scottish and Northern Irish banks, which appear to have successfully responded to concerns about previous proposals while also ensuring that notes issued by these institutions are as safe as those issued by the Bank of England. (Paragraph 169)

The Government welcomes the Committee's support for its proposals and provisions to effect these changes are included in part VI of the Banking Bill.

Strengthening the Bank of England

40. We agree with the Governor of the Bank of England's proposition that the duties and obligations imposed upon the Bank relating to financial stability must flow from the powers and instruments at its disposal. (Paragraph 173)

41. We broadly support the measures proposed in the January and 1 July consultation documents relating to liquidity operations, which should facilitate an enhancement of the security and effectiveness of Bank of England lending. We recommend that the Government clarify which of the proposed changes it is proposed to extend to lending by other central banks and the rationale in each case. (Paragraph 176)

42. Although we have not considered the proposed framework for the oversight of payment systems in detail, we support an approach based on unified regulatory responsibility in this instance and welcome the allocation of regulatory powers to the Bank of England. (Paragraph 178)

43. We recommend that the Government, in its response to this Report, state whether it is intended that any future recommendations by the Bank of England to the Financial Services Authority about the Authority's rules for prudential regulation will be made public, and, if so, when and in what circumstances. (Paragraph 179)

44. One advantage of granting formal powers to the Bank of England relating to the initiation and the operation of Special Resolution Regime—as recommended by us earlier in the former case and as proposed by the Tripartite authorities in the latter case—is that this will reinforce the importance of the Bank giving due importance to its knowledge and understanding of individual financial institutions in the exercise of its other financial stability functions. (Paragraph 180)

The Government welcomes the Committee's support for measures in the Banking Bill that strengthen the Bank of England's role in relation to financial stability in the UK. We agree that it is important that the Bank is provided both with a statutory responsibility for contributing to the maintenance of financial stability, along with the necessary powers and tools to deliver on this. Consequently, the Banking Bill:

- gives the Bank of England a new statutory objective for financial stability;
- establishes a new Financial Stability Committee as a subcommittee of Court;
- establishes the Bank of England as lead authority for the special resolution regime (SRR);

- provides the Bank of England statutory immunity as a monetary authority and in pursuit of its financial stability objectives;
- as part of the measures to permit short-term nondisclosure of the provision of emergency liquidity, remove the requirement for the Bank to publish a weekly return; and
- gives the Bank of England a statutory role in overseeing inter-bank payment systems.

These measures, alongside the Bank's existing responsibilities for liquidity support to the financial sector, and for market monitoring and risk assessment in both the UK and international contexts, provide the Bank of England with a comprehensive and coherent package of tools for contributing to the maintenance of financial stability in the UK, working together with the Treasury and the Financial Services Authority, each with their own clearly defined roles.

As stated in the response to the Committee's report *The Run on the Rock*, the Government is considering when and how it is appropriate to put into the public domain information relating to recommendations made by one Authority to another concerning financial stability. There may be clear and overriding public interest and financial stability reasons for delaying any public disclosure of such information. In any case, it would not be appropriate to place provisions relating to the internal communication of the Tripartite into primary legislation.

45. We welcome the proposal to enable the Bank of England to obtain information relevant to its financial stability functions. We recommend that the legislation be prepared to place beyond doubt that the Bank's powers apply to any firms or category of firms of its choosing and that the term "request" does not imply that the Financial Services Authority will have any discretion as to whether such information is to be collected and provided to the Bank. (Paragraph 181)

The Bill provides that the Financial Services Authority shall collect information on factors relating to the stability of the UK financial system. This information will be important to the work of all of the Tripartite Authorities, particularly the new Financial Stability Committee of the Bank of England, and the FSA will share it as appropriate.

46. We note the proposal to grant the Bank of England statutory immunity from liabilities in damages arising from acts or omissions in carrying out its responsibilities in relation to financial stability and its other central bank functions, a proposal which follows in part from the proposed additional responsibilities of the Bank, but would apparently apply to a broader range of responsibilities. We recommend that the Government state, in its response to this Report, whether it is intended that such immunity would have retrospective effect and, if so, why. (Paragraph 182)

The Bank of England shall have immunity in its capacity as a monetary authority, including its functions in respect of financial stability. The Government does not intend that the statutory immunity provided to the Bank of England shall have retrospective effect.

The Committee sets out, in recommendations 47 to 67, a wide range of detailed recommendations on the Financial Stability Committee of the Bank of England. The Government welcomes the Committee's continuing interest in these matters and its considered suggestions regarding the role, make-up and structure of the Financial Stability Committee. The Government sets out its legislative proposals for the Financial Stability Committee in the Banking Bill which are explained below.

The Government notes that appropriately, as a sub committee of the Court, detailed matter relating to the practical operation of the Financial Stability Committee will be for the Court of Directors to determine.

47. The proposed “financial stability functions” of the Bank of England represent an amalgam of existing central bank functions (in some cases facilitated by new powers) and new responsibilities, some of which are likely to be rarely undertaken. The Bank of England will face a significant management challenge in ensuring a coherent approach to these functions, a challenge to which we expect the new Financial Stability Committee to play a key role in responding. (Paragraph 183)

48. The House of Commons should not be invited to consider and approve arrangements for the Financial Stability Committee as they stand—with proposals of uncertain origin and with the purpose and composition of the Committee yet to be determined. (Paragraph 199)

49. For reasons we make clear in the following section, we do not believe that it is appropriate to establish the Financial Stability Committee as a Sub-Committee of the Court and with a predominantly non-executive character. However, if such a model were to be pursued, then it flows logically and necessarily from such a constitution of the Financial Stability Committee that:

- the Committee should have a non-executive majority;
- the Committee should not be a party or be perceived as being a party to executive decision-making, and its role should be confined to that of a forum for taking soundings prior to decisions taken elsewhere by executives and for subsequent internal accountability of those decisions; and
- the Committee should be chaired by a non-executive member of the Court. (Paragraph 202)

50. We do not believe that a Financial Stability Committee which is constituted as a Sub-Committee of the Court and is thus inhibited from assuming decision-making authority will significantly enhance the credibility, authority or efficiency of the performance of the Bank's financial stability functions. (Paragraph 203)

51. We recommend that the Financial Stability Committee be established in statute with a status comparable to that of the Monetary Policy Committee. We further recommend that the new Financial Stability Committee be designated in statute as the body with overall responsibility for the discharge of the Bank of England's financial stability functions, including responsibility for—

- a) liquidity operations which are not in the ordinary course of the Bank's business, including future policy decisions on schemes comparable to the Special Liquidity Scheme and on the provision of a Special Drawing Facility;
- b) functions of the Bank of England relating to payment systems;
- c) the formulation of the policy positions of the Bank of England relating to prudential regulation;
- d) direction of the Bank's analytical work relating to financial stability, including approving the Financial Stability Report, horizon-scanning for trends and potential risks, and determining priorities for data collection relating to individual firms or types of firms; and
- e) direction of, and decision-making in relation to, the Special Resolution Regime. (Paragraph 206)

52. We recommend that the Financial Stability Committee be given the power to delegate its functions to executives of the Bank. We envisage that the Committee would delegate certain functions on a continuing basis and certain functions in specified circumstances, including where decisions need to be taken in an emergency and it is not practical for a meeting to be convened. (Paragraph 207)

53. We recommend that the methods of proceeding of the Financial Stability Committee be determined by the Court from time to time—on the recommendation of the Governor of the Bank of England in the first instance and thereafter on the recommendation of the Financial Stability Committee itself. Although we do not consider it appropriate for the decision-making processes of the Committee to be set out in statute, we expect that the Committee would proceed on the basis that the most important decisions would be determined by a vote of all those voting members present at a meeting wherever practical. (Paragraph 208)

54. The principle of transparency is much less applicable to the Financial Stability Committee than to the MPC; it would not be appropriate for statutory requirements to be established for the publication of minutes of all meetings. During 'normal' times, we would expect the minutes of the Financial Stability Committee to be published, albeit with certain confidential material omitted. When that Committee was reaching decisions about how to handle a crisis, it would clearly not be

appropriate for minutes to be published. It will nevertheless be important to ensure that individual members of the Financial Stability Committee are accountable for their own views and positions, through periodic appearances before the Treasury Committee and by other means. (Paragraph 209)

55. We recommend that the composition of the Financial Stability Committee be determined by statute. We further recommend that the Committee be composed of nine voting members, of whom five should have other relevant executive functions within the Bank. (Paragraph 210)

56. If the Financial Stability Committee is granted an executive role in statute along the lines we propose, we recommend that the Financial Stability Committee be chaired by the Governor or, if he or she is not present, by the Deputy Governor for Financial Stability. (Paragraph 211)

57. If the Financial Stability Committee is to have the executive authority that we propose, we do not believe it is appropriate for the Committee to be composed in part of non-executive members drawn from the membership of the Court. This is first and foremost because we believe that there needs to be a clear institutional separation between the executive functions of the new Committee and the internal accountability functions of the Court, for reasons we discuss in more detail in the next section of this Report. In addition, while it might be appropriate for some non-executive members of the Court to have current market involvement, it is inevitable that such members of the Financial Stability Committee would be seen as facing a conflict of interest in reaching a decision on, for example, a future equivalent of the Special Liquidity Scheme. If such members were to withdraw from decisions in which they might be perceived as having a conflict of interest, the balance of the composition of the Committee as a decision-making body would be disrupted. Finally, the commitment required for effective participation in an executive Financial Stability Committee would be greater than that which could reasonably be required from non-executive members of the Court. (Paragraph 212)

58. We recommend that the Financial Stability Committee have four 'external' voting members who would not have other executive functions within the Bank, and who would not be non-executive members of the Court. While the 'external' positions would not be on a full-time basis, such membership would need to be the principal remunerated employment of those concerned and would be incompatible with current participation in financial markets. We do not believe that it is appropriate for the Financial Stability Committee to include members who are current participants in financial markets. It would, however, be important to ensure that the 'external' members together possess a combination of recent experience of financial markets, analytical expertise, knowledge of legal or accountancy matters relevant to the Special Resolution Regime and international experience. There would need to be flexibility about the duration and terms of membership to attract those expecting to resume careers within financial markets at the conclusion of their

membership. We believe that there should not be an absolute prohibition on combined 'external' membership of the Monetary Policy Committee and of the Financial Stability Committee, although each would be the subject of separate competitive appointment processes and there would need to be an awareness of time constraints in considering any such combined membership. (Paragraph 213)

59. We recommend that the processes for appointments to positions involving membership of the Monetary Policy Committee, as recently reformed, be followed for appointments to other executive positions within the Bank of England bringing membership of the Financial Stability Committee and to 'external' membership of the Financial Stability Committee. We expect that the Treasury Committee would hold appointment hearings with those appointed to the Financial Stability Committee. (Paragraph 214)

60. We recommend that the Chief Executive of the Financial Services Authority or his or her representative be granted the same rights to attend, speak, but not to vote, at meetings of the Financial Stability Committee as the representative of the Treasury. (Paragraph 215)

61. We recommend that section 2 of the Bank of England Act 1998 be amended to provide that the Court's functions do not include the formulation of financial stability policy or the use of the Bank's balance sheet for liquidity operations not in the ordinary course of the Bank's business. (Paragraph 227)

62. We recommend that the Non-executive Directors Committee of the Court be placed under a statutory duty to perform an internal accountability function in relation to the financial stability work of the Bank, including requirements to review the information collected by the Financial Stability Committee, and to report separately on the performance of that duty. (Paragraph 228)

63. If the Court were to assume the strategic role separate from the work of the Financial Stability Committee that we propose, and if the accountability functions were to be delegated explicitly to the Non-executive Directors Committee, we would support the proposal to reduce the statutory minimum number of meetings of the Court. (Paragraph 229)

64. We welcome the proposal to reduce the size of the Court, which follows our own recommendation to that effect. We recommend that the Government clarify, in its response to this Report, which executives are envisaged as members of the Court in addition to the Governor and the Deputy Governors. We believe that there is certainly a case for the Finance Director of the Bank to be a member of the Court in line with general corporate practice. (Paragraph 230)

65. We recommend that, in advance of the completion of the Commons stages of the forthcoming legislation, the Government, after consultation with the current Court,

publish proposed criteria for selection of members of the Court. In the case of the Chairman, we expect that these would include current or very recent experience of the financial services industry at a high level. We also expect to hold an appointment hearing with the first Chairman of the Court appointed under the new legislation. If the Court's role is separated from executive responsibility for decision-making in relation to financial stability functions as we have proposed, we see no reason why current market involvement should be a barrier to membership. Indeed, it would be helpful for some members of the Court to have such involvement. (Paragraph 231)

66. We recommend that the Chairman of the Financial Services Authority have the right to attend the Court and the Committee of Non-executive Directors, as a non-voting member in each case. (Paragraph 232)

67. We recommend that the Court ensure that it has the resources available to it to perform its functions effectively, including if need be through some staff resource not currently employed by the Bank of England. (Paragraph 233)

The Government agrees that the main functions and structure of the Financial Stability Committee should be set out in the Banking Bill and the Committee's conclusion that it would be inappropriate for the details of the Financial Stability Committee's decision-making process and other procedures to be set out in primary legislation.

The Banking Bill provides for the creation of the Financial Stability Committee:

- as a sub-committee of the Bank of England's Court of Directors;
- with seven members: the Governor and Deputy Governors of the Bank of England and four non-executive directors of the Court of the Bank of England, appointed by the Chair of the Court;
- with a Treasury representative, who shall not vote, but will, in all other respects, be a full member of the Financial Stability Committee. Other non-voting members may be appointed;
- chaired by the Governor, when present;
- in which non-executive directors will have to declare any possible conflict of interest and will not participate in any decisions that would produce such a conflict. These arrangements mirror those that are in place for current directors of Court;
- with functions which will include:
 - making recommendations to the Court of Directors about the nature and implementation of the Bank of England's strategy in relation to financial stability;
 - providing advice about decisions to be taken in respect of individual institutions in the special resolution regime, and more generally to monitor the Bank's use of the powers conferred on it in relation to the special resolution regime; and
 - monitoring the Bank's oversight of inter-bank payment systems.

- to which additional functions may be delegated by the Court of Directors; and
- which may delegate any of its functions, apart from that of making recommendations concerning the Bank's financial stability strategy, to two or more of its members..

The Government considers it appropriate that, as the Court is ultimately responsible for the affairs of the Bank of England (other than monetary policy), for the Financial Stability Committee to be a sub-committee of it, and accountable to it.

The primary function of the committee will be advisory, providing an effective source of expertise and guidance to the Bank's executives and staff on the execution of the policy levers it has, relating to financial stability such as the SRR.. It will also advise Court on the overall strategy for developing and implementing the Bank's financial stability objective. The legislation is appropriately flexible, allowing for the role of the Committee to evolve, and for Court to delegate further responsibilities to it, for the purpose of pursuing the Financial Stability Objective..

The committee will be chaired by the Governor, which is appropriate given the committee's function relates to one of the core responsibilities of the Bank—financial stability—for which the Governor has primary executive responsibility. The committee will have a non-executive majority, ensuring there is the external challenge and expertise to enable the committee to carry out its advisory function effectively.

The Government also welcomes the Committee's support for proposals to modernise and reform the Court of Directors of the Bank of England in order to help prepare the Bank of England for its enhanced role in protecting financial stability. The Banking Bill will reduce the size of Court to twelve, comprising the Governor, two Deputy Governors and nine non-executive Directors. Of course it will be possible for other executives of the Bank to attend, including the finance director. The Court will continue to have a majority of non-executives, one of which will chair Court (this is in line with current practice—since 2003 the Governor has delegated the chairmanship of Court to one of the non-executives). The frequency of meetings of Court will be reduced from monthly to at least seven each calendar year. The FSA Chair will continue to sit on Court.

The Banking Bill will also implement the changes to future appointments to the Monetary Policy Committee that the Chancellor set out in his letter to the Treasury Select Committee on 19 June 2008. All appointments made by the Government to the Monetary Policy Committee will be for a maximum of two terms. Governors and Deputy Governors will serve a maximum of two five-year terms in these posts with external members of the Committee limited to serving a maximum of two three-year terms in these roles.

The Government will start a recruitment exercise for non-executive directors of the Bank of England The Government notes the Committee's intention to hold an

appointment hearing with the first new Chair of Court and with appointees to the Financial Stability Committee.

68. There is no consensus about what financial stability means, how it should be measured and how the balance should be struck between the pursuit of a financial stability objective and other public policy objectives. There is no indication that a new statutory objective for the Bank of England would be accompanied by matching objectives for the Financial Services Authority and the Treasury. Above all, the Bank of England, while being endowed with certain financial stability functions and powers, is not being granted a coherent set of instruments in order to influence financial stability. Insofar as such instruments are available at all, they are available to the Financial Services Authority. We noted earlier that the duties and obligations imposed upon the Bank relating to financial stability ought to flow from the powers and instruments at its disposal. We consider that the proposal to give the Bank of England a high-level objective of contributing to the maintenance of financial stability runs the risk of giving the Bank of England responsibility without power and creating false expectations about the Bank's role. (Paragraph 249)

69. Notwithstanding our conclusion relating to a single high-level objective along the lines currently proposed, we see merit in establishing a statutory framework that seeks to identify the policy aims underpinning the legislative changes relating to the Bank of England. In part this can be done by establishing objectives relating to the exercise of the Bank's powers under the Special Resolution Regime, as is proposed in the current draft Clauses, and by regulatory objectives relating specifically to the Bank's role in overseeing payment systems. In part, this can be achieved by setting out general and enduring objectives relating to the Bank's performance of its financial stability functions. We propose two broad objectives which accord with the nature of the Bank's financial stability functions. The first objective should relate to the priority accorded to financial stability work within the Bank and the prerequisites for the Bank to carry out that work effectively, and could be along the following lines:

“To accord due importance to financial stability functions in the Bank's organization and in its deployment of resources, in particular ensuring that—

- i. the Bank carries out its regulatory responsibilities relating to payment systems in a manner which contributes to the maintenance of an orderly financial system;**
- ii. the Bank has high quality analytical capacity to contribute to understanding and awareness of financial stability issues; and**
- iii. the Bank has at all times the resources and expertise to perform its financial stability functions on a continuing basis and to perform the functions relating to the second objective when required to do so.”**

The second objective should relate specifically to the Bank's role in responding to crises in a way which minimises their spill-over effects and thus the damage caused to the United Kingdom financial system and its reputation and to the United Kingdom economy more generally and could be along the following lines:

“To respond to threats to the effective and efficient operation of financial markets relevant to the exercise of the Bank's financial stability functions in a way that—

i. regard to the economic costs (including the costs to public funds) associated with instability of institutions in financial markets; and

ii. contributes to confidence in financial markets, and in particular to public confidence in the stability of the banking system.” (Paragraph 250)

70. Two objectives of the kind we have outlined would pave the way for the Court to develop a more detailed operational remit for the Bank. We believe that the remit should be prepared on the presumption that it will not be changed on a regular basis and the remit should not seek to set analytical priorities, which should remain an executive function. In setting the financial stability remit in the first instance, we would expect the Court to have particular regard to:

a) The importance of ensuring that the Bank maintains and develops its capacity to analyse the structure of financial markets and identify market developments and possible market developments that could affect future financial stability;

b) The need for the Bank to contribute effectively to international activities relating to financial stability;

c) The recruitment and retention of suitable staff and the development of opportunities for staff at all levels to engage with the functioning of financial markets and enhance their understanding of those markets at all times and not just at times of financial instability, which could be achieved in part by the development and maintenance of stress-testing capacity; and

d) The development and maintenance of effective working relationships and communications with the Financial Services Authority and the Treasury. (Paragraph 251)

The Banking Bill gives the Bank of England a statutory objective for financial stability, giving it a similar level of prominence as the Bank's objective for Monetary Policy. The Government considers this approach is appropriate, providing the necessary flexibility, as the requirements of financial stability are context-specific, and liable to vary as the

operation of global financial markets change—unlike in the case of monetary policy, which can be set out in clear operational terms through an inflation target. This approach also reflects that fact that responsibility for creating conditions to maintain financial stability in the UK rests with a number of institutions, including the FSA and the Treasury, as well as international organisations and market participants

As mentioned above, these changes will provide the Bank of England with coherent package of tools for maintaining financial stability in the UK, working together with the other tripartite authorities: the Treasury and the Financial Services Authority, each with their own clearly defined roles for ensuring financial stability. These tools include the Bank of England’s existing responsibility for liquidity support, their new role as lead authority in the special resolution regime and their oversight of payment systems—placed onto a more formal, statutory footing in the Banking Bill.

71. While it is appropriate for the Treasury to be consulted by the Court about the financial stability remit and changes to it, we recommend that the forthcoming legislation place beyond doubt that exchanges of letters between the Treasury and the Court are solely for purposes of consultation. (Paragraph 253)

72. We recommend that the section 4(1) of the Bank of England Act 1946 be amended to provide that the general direction giving power of the Treasury in relation to the Bank of England may not be exercised in relation to financial stability functions. Any exercise of Treasury powers in relation to the Bank of England’s financial stability functions ought to be exercised in accordance with the specific provisions for the Special Resolution Regime or in accordance with the arrangements for certain liquidity operations discussed elsewhere in this Report. (Paragraph 254)

Clause 216 of the Banking Bill amends Part 1 of the Bank of England Act 1998. New Section 2A(2) provides that the Court of Directors must consult the Treasury before setting the Bank of England’s financial stability strategy.

The Banking Bill also sets out the responsibilities of each Authority in respect of the special resolution regime. In addition, the Bill requires the Treasury to issue a Code of Practice for the special resolution regime, which will provide more detail on the operation of the SRR by the Authorities. The Government agrees that the Treasury’s role in the SRR should be exercised in line with these provisions.

The Bank of England Act 1946, as amended by the Bank of England Act 1998, provides for the independence of the Bank of England with respect to monetary policy, and the Banking Bill includes provision so that this should continue to be the case.

The role of the Treasury and the Tripartite arrangements

73. The proposals to be contained in a revised Memorandum of Understanding between HM Treasury, the Bank of England and the Financial Services Authority

will be of fundamental importance in assessing whether a clearer allocation of responsibilities and better arrangements for handling a crisis are likely to be achieved. We recommend that the Tripartite authorities publish the revised Memorandum of Understanding in draft form at an early stage of the passage of the forthcoming Banking Bill through the House of Commons to enable interested parties to comment on the new Memorandum before it is finalised. (Paragraph 256)

74. We recommend that the revised Memorandum of Understanding describe the responsibilities of the Financial Services Compensation Scheme in relation to financial stability and provide for representation of the Scheme on the Standing Committee on Financial Stability. (Paragraph 257)

75. One of the themes underlying both our recommendations in January and the subsequent proposals of the Tripartite authorities is the importance of defining more clearly the responsibilities of each of the Tripartite authorities in relation to financial stability. It is of vital importance that this approach is applied to the Treasury as much as to the Bank of England and to the Financial Services Authority. We welcome in principle the proposed legislative provision to delineate the Treasury's role under the Special Resolution Regime, although we have not been able to take evidence on the details of that provision. We believe that proposals for the provision of a Special Drawing Facility should originate with the Bank of England, as the lead authority responsible for such Facilities, although the Chancellor of the Exchequer retains ultimate authority for decisions on any such proposals by the Bank of England. We consider that it is essential for the new Memorandum of Understanding clearly to delineate the precise roles to be played by the Chancellor of the Exchequer, the Bank of England—and the role of the Financial Stability Committee within the Bank of England—and the Financial Services Authority in relation to such decisions. (Paragraph 263)

76. We do not consider that it would be practical or appropriate to set out all of the functions of the Treasury relating to financial stability in statute. However, we recommend that the revised Memorandum of Understanding set out the principles underlying the extent and limit of the Treasury's role in relation to financial stability. One of those principles should be that the Treasury must ensure that decisions are taken by the relevant authority operating at arm's length from the Government, subject only to the Treasury's duties relating to the proper use of public funds and compliance with international obligations. In order to ensure that the responsibilities of the Financial Services Authority and of the Bank of England relating to financial stability are seen to be exercised independently of the Treasury except where the Treasury has conveyed its legitimate interest, we further recommend that the revised Memorandum of Understanding establish a formal and recorded method of communication for any Treasury involvement in the exercise of those responsibilities. There should be a presumption that all such involvement should be expressed in written form and should be made public either at the time or when the immediate requirement for confidentiality has passed. (Paragraph 265)

The Government recognises the importance of clear lines of responsibility and decision-making processes, and has committed to publishing a revised Memorandum of Understanding covering the roles of the tripartite Authorities in preserving financial stability. Recent events have shown the Authorities working effectively together to act both generally, and in relation to individual firms, to support the stability of the financial system.

The Government believes that it would be appropriate to wait until the current period of financial market instability has passed before finalising the new Memorandum of Understanding. This will allow lessons learned from the current situation to be fully reflected in the new arrangements.

77. We note the claims from participants in the work of the Standing Committee on Financial Stability that it has become a more effective mechanism for communication between the Tripartite authorities since the second half of 2007. We also note the proposals to distinguish more clearly between the Standing Committee's role in 'normal' situations and its role in 'crisis' situations. We consider aspects of crisis management later in this chapter, but we believe that it is of vital importance that the Tripartite Standing Committee not be perceived as a sleepy backwater in normal situations which must begin its work almost from scratch in a time of crisis. The Committee must assume a central and continuing role in the financial stability work of the authorities at all times, and it is with this proposition in mind that we make some of the specific recommendations in this chapter. (Paragraph 268)

78. We believe that it is essential that, if the Tripartite Standing Committee is to function effectively, it must have distinct staffing arrangements to ensure appropriate levels of continuity and expertise. We recommend the establishment of a small central secretariat for the Standing Committee on Financial Stability, including staff drawn from the Treasury, the FSA and the Bank of England as well as from other organisations. This secretariat would play a crucial role in ensuring the capacity of the Committee to undertake the functions identified in this Report. We would expect all three Principals on the Standing Committee to have a say in the appointment of the Head of the Secretariat. (Paragraph 270)

79. It is important that mechanisms for external communications in a financial crisis are established in advance, and are not simply a response to a crisis. We propose two means of improving the Tripartite approach to external communications:

- **The appointment of a member of the secretariat of the Tripartite Standing Committee with relevant expertise in communications; and**
- **The enshrining within the revised Memorandum of Understanding of a commitment by each of the Tripartite authorities and of the Financial Services Compensation Scheme to be seen to be acting in unison with**

collective responsibility for communicating with the public and speaking with one voice in activities relating to the ongoing resolution of a financial crisis.

- **Although we attach importance to the need for a united response in the resolution of a crisis, we do not believe that this should be incompatible with distinct accountability for the exercise of the functions of the individual authorities. (Paragraph 272)**

80. We recommend that the Tripartite Standing Committee undertake regular exercises testing the new legislative powers when implemented in a variety of different scenarios. (Paragraph 273)

The Government agrees with the Committee that the Standing Committee must work at all times to ensure that it effectively scrutinises risks to the financial system, identifies problems and designs and implements solutions rapidly and decisively in crisis situations. The Standing Committee has engaged in many exercises on both financial crisis management and business continuity over recent years (as set out in the Bank of England's *Financial stability report* of April 2007). These exercises identified areas for improvement, and work programmes needed to strengthen the tool kit. A clear lesson was that prioritisation and resourcing needs to be considered appropriately. Future exercises will test a range of relevant scenarios, including the possible use of new powers provided by this Bill.

The secretariat for Standing Committee is currently provided by the Treasury. The Treasury will consider whether additional staffing is required for this function. The Government notes that, in the last year, the Bank of England, FSA and Treasury have all significantly increased resources in the area of financial stability in response to recent events. The Authorities will need to consider what an appropriate steady state level of staffing should be.

The Government agrees with the Committee that external communications remain important. The Authorities maintain a communications protocol to ensure effective work in this area, and will consider whether this needs to be strengthened.

81. We recommend that the Tripartite Standing Committee undertake and publish a five-yearly review of the adequacy and fitness for purpose of the legislative framework for financial stability, which should incorporate a review of the terms of the Memorandum of Understanding. (Paragraph 274)

The Standing Committee has undertaken reviews of its function in recent years and it is right that it continues to do so. As discussed above, the Government will, in due course, review the Memorandum of Understanding, and it may be appropriate in future for the Memorandum to be considered as part of wider Standing Committee reviews.

82. Although we understand that the fact that meetings of the Standing Committee on Financial Stability in times of crisis have taken place may need to remain confidential, we believe that greater openness about regular meetings in normal times would be beneficial. We recommend that the Standing Committee hold a pre-announced meeting at Principal level to review policy at least once every year and meet in scenario-testing mode to test operational decision-making in a future crisis at least once every year. We further recommend that a meeting at Principal level in the latter mode be convened within three months of any new Principal taking up his or her post. (Paragraph 275)

83. We recommend that the new Memorandum of Understanding provide for regular joint topic and best practice reviews and joint Reports. Such Reports should be published even if in an edited form. (Paragraph 276)

84. We recommend that the Tripartite authorities jointly publish an annual report on the activities of the Tripartite Standing Committee and on liaison between the Tripartite authorities, including activities in the fields identified in this chapter. (Paragraph 277)

The Government agrees with the Committee that principal-level meetings of the Standing Committee should continue to occur on a regular basis. Regular pre-arranged meetings of principals now take place, and the Government anticipates they will continue to do so. Previous exercises and simulations have also included principal-level elements and will continue to do so.

The Government is of the view that the Tripartite Authorities are already able to produce reports and discussion papers on activities where appropriate. The FSA and the Bank of England already publish regular assessments, such as the Bank of England's Financial Stability Report and the FSA's Financial Risk Outlook. In producing any reports on activities, the Authorities must pay close attention to the need for commercial confidentiality. For this reason, Standing Committee documents generally remain confidential.

85. We intend to establish a regular programme for scrutiny of financial stability issues, including through appointment hearings and regular hearings with the Tripartite authorities about their financial stability work. (Paragraph 278)

The Government looks forward to continuing to work with the Committee on financial stability issues.

Appendix 2: Financial Services Authority Response

1. In this Memorandum the Financial Services Authority (FSA) responds to those recommendations in the Committee's Report which are directed to the FSA.

2. This Memorandum does not respond to the recommendations which are directed at the Tripartite Authorities collectively or which are covered in the Banking Bill. The Committee will of course be aware that, following consideration of responses to the consultation papers published in July 2008 and the Committee's report, the Government published the Banking Bill on 7 October 2008.

3. We agree with the Committee that we need to continue to strengthen the way we regulate to minimise the likelihood of needing to invoke any of the resolution tools in future. The new powers must clearly be the last resort. Amongst other initiatives, we have committed to a Supervisory Enhancement Programme in response to the findings of the Northern Rock Internal Audit report.

4. We use the phrase "heightened supervision" as a colloquialism to help explain how we work in practice in certain situations. "Heightened supervision" refers to the fact that we have a risk-based approach to regulation. As part of that approach, when we identify that the risk a firm poses to one of our statutory objectives changes – particularly where a firm's ability to meet the Threshold Conditions is threatened – we will intensify our supervision. This could involve an increase in the number of staff looking at that firm; in the number of visits and meetings (especially with senior management); or a change in the frequency (or type) of information that they provide to us. All these are aspects of our supervisory regime already. And there will be closer cooperation with our Tripartite colleagues and the FSCS.

5. The FSA, Treasury, Bank and FSCS have worked closely and constructively during the period of the crisis, most recently on addressing the problems with HBOS, Bradford & Bingley and Icelandic banks, and the bank recapitalisation plan. Key to this successful partnership has been clarity of responsibility: the FSA for supervision of and decision-making in relation to individual firms and for seeking private sector solutions; and the Bank for the provision of liquidity and, increasingly, for the resolution of banks once the Treasury has decided to use resolution powers under the Banking (Special Provisions) Act. This experience will provide a solid foundation for the future once the new banking legislation comes into force.

6. So "heightened supervision" conveys the fact that – in most cases – there would not be a cliff edge over which a bank drops from so-called 'normal' supervision into the resolution regime (there could, though, be circumstances in which a bank does need to be placed straight into the resolution regime due to an unexpected but devastating event, such as the discovery of a massive fraud).

7. This form of risk-based regulation underpins our whole regulatory approach, and as such we do not recognise “heightened supervision” as a concept separate from the existing ways in which we respond to changes in risks posed by any firm. By extension, the term “heightened supervision” does not imply a separate set of objectives for the FSA. Our goal remains the same: to reduce the risks to our four statutory objectives, and that the firm should continue to meet its Threshold Conditions. Those objectives are the basis of our regime.

8. We do not believe that defining such a state is necessary or beneficial. Indeed we believe it would be counterproductive. It could limit the flexibility of the FSA to respond to the risks a firm poses without providing any additional benefit to firms. In fact, which events demonstrate, a defined state of “heightened supervision” which was communicated to a firm could be used by wholesale market counterparties as a trigger event for closing out contracts with the firm, perhaps precipitating the instability we are seeking to avoid. Public recognition of the state would certainly heighten the risk of a retail run. We also recognise that information about a firm’s position must be treated with appropriate confidentiality.