

## Andrew G Haldane: The Bank and the banks

Speech by Mr Andrew G Haldane, Executive Director, Financial Stability, Bank of England, at Queen's University, Belfast, 18 October 2012.

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In the light of the financial crisis, there is much to explain. Doing so is not just important for reasons of accountability to the public. Explaining and understanding errors of the past is absolutely essential if policymakers are to learn lessons for the future. To misquote someone none of you have ever heard of, those who forget the errors of the past are doomed to repeat them.

During the course of its 318-year history, the Bank of England has had plenty of crisis experience. And encouragingly, on my reading of history, there is evidence of it having learnt from this experience. In response, radical reform of the Bank's policymaking framework has been commonplace. There are few better examples than the radical reform of the Bank's transparency and accountability practices over the past twenty-five years.

Those reforms are continuing to the present day. A wholly new framework for financial stability policy is being put in place in the UK, perhaps the most radical in the Bank's history. I will discuss that framework later on. This framework can be seen as an evolutionary response to crisis experience, not just this crisis but a great many previous ones. It is impossible to know if this framework will proof us against future crises. But in remembering those errors of the past, it gives us a fighting chance of not repeating them.

So I want to take you on an historical journey charting the Bank of England's role in financial crises and its response to them. Now, I know what you are thinking. The evolution of financial stability in the UK viewed through the lens of the Bank of England sounds deadily dull. So I am going at least to try to add a touch of colour to the events and personalities of the time.

### The very beginning

Let's start at the very beginning. The Bank of England was put on earth, way back in 1694, to do none of the things it does today – namely, preserving monetary and financial stability. Instead, it was a confection of the then monarchs, William III and Mary II, to pay for their war debts. At the time the Bank was little more than a branch, with a mere twenty staff.

Pretty early in its life, however, the Bank began to involve itself in the business of banking. It began to grow its balance sheet by taking deposits from and extending loans to other banks, typically by the practice of “discounting” bills of exchange. The Bank also issued its own notes which, due to the implicit backing of the government, circulated as currency with the public.

At this stage, the Bank was far from being the nationalised, policymaking body we know today. Rather, the Bank was a quasi-private bank conducting its business for quasi-commercial ends. Other banks at the time were engaged in similar commercial pursuits, including often issuing their own notes. Except, of course, they lacked the government as guarantor.

This made for a competitive, and at times rather antagonistic, relationship between the Bank and the commercial banks. This strained relationship lasted for the whole of the 18th and a good chunk of the 19th centuries. Was the Bank friend or foe, collaborator or competitor? The commercial banks did not know. And the Bank – private in name but public in finances – was itself in a state of mild schizophrenia.

These psychological flaws were exposed in the middle of the 19th century. By then, the Bank had been granted monopoly rights to issue currency. Quite literally, this cut the commercial banks out of a lucrative money-making scheme. This did little to ease competitive tensions between the Bank and the banks.

This tension bubbled over in the famous case of Overend and Gurney Bank. In the early part of the 19th century, Overend had grown rapidly to become the largest discount house in London. If not too big to fail, it was certainly large enough to look after itself – as the Bank found out in 1860.

Two years earlier, the Bank had abolished the right of other banks to come to it for cash by discounting bills. The banks took umbrage. With Overend and Gurney playing the role of shop steward, they collectively withdrew £1.6 million from the Bank over three days in an attempt to bring the Bank, if not to its knees, then at least to its senses. Dark, anonymous messages were sent to the Bank, presumably not by Twitter, warning: “Overends can pull out every note you have”.<sup>1</sup>

In the event Overend eventually caved, returning to the Bank the notes they had withdrawn apologetically – or at least semi-apologetically, as the notes actually came back cut in half. Six years later in 1866, when Overend and Gurney asked the Bank for an emergency loan of £400,000, the answer was “No”.

The Bank won this battle, but was to lose decisively the war. Overend and Gurney failed. The City shook. Panic took hold. The Bank was forced to lend £4 million – ten times the initial sum – to support other banks. There was a chorus of disapproval. The Bank’s role in crisis management would never be the same again.

### **Supporting the financial system**

Criticism of the Bank’s role in the Overend crisis came prominently from Walter Bagehot, then-editor of *The Economist* and Bank-of-England basher of his day. He lambasted the Bank’s acting “hesitatingly, reluctantly and with misgiving”.<sup>2</sup> Henry Gibbs, Governor of the Bank from 1875 to 1877, highlighted the Overend experience as “the Bank’s only real blunder”.<sup>3</sup>

Yet the Bank had also learned from this experience. It had discovered that its role could be neither commercial nor competitive. Instead its role was as guardian of the financial system as a whole, protecting banks from what is today called systemic risk. In Bagehot’s words, the Bank should act as last resort lender to solvent institutions against good collateral at a penalty rate. It has done so ever since.

The Bank did not have to wait long to put its new-found role into practice. On Saturday 8 November 1890 the Bank Governor of the day, William Lidderdale, summoned his Directors. This itself aroused suspicion. Bank directors were never seen at work at the weekend. They typically departed for the country around Friday lunchtime. (Let me tell you, things have changed for Bank of England Directors since then.)

What Lidderdale told his Directors was electric. There were serious liquidity problems at another big and famous bank, Baring Brothers and Company. But the Bank had not the faintest clue as to Barings’ true financial position. To rectify that, Lidderdale ordered an accountant’s report on Barings to be brought to him with immediate effect. And with that, he departed to London Zoo with his son.

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<sup>1</sup> Kynaston (1994) Vol. 1. p200.

<sup>2</sup> Bagehot (1873).

<sup>3</sup> Wood (1999).

The accountant's report showed a solvent but illiquid Barings. Back from the Zoo, Lidderdale began to construct a financial "lifeboat" for Barings, with a contribution from the Bank but also from the commercial banks. This was the system acting in support of the system. The lifeboat was launched and Barings was saved, in what has become known as the "crisis that never became a drama".<sup>4</sup>

The Bank's lifeboat has since been re-launched on more than one occasion. A second financial lifeboat – different in detail, but identical in principle – was launched by the Bank of England in the early 1970s. Then, it was intended to save the small banks rather than the large. It, too, steadied some sinking ships.

Third time, however, was not so lucky. On 24 February 1995, it was Barings Bank who were again knocking on the Bank of England's door for help. Bank Directors were again summoned on a Saturday. I myself was caught by a TV crew entering the Bank on that Saturday morning, arousing suspicion something was amiss.

In fact, I had not been recalled to save the day. (I believe I was filmed wearing a tracksuit.) And I was as blissfully unaware of Barings' problems as most of the rest of the world. (I was at the Bank completing a research paper on "A Structural Vector Autoregressive Model of the Monetary Transmission Mechanism".) Life was easier then.

Nick Leeson, at the time a despised and corrupt rogue-trader, today a much-admired reality-TV star and after-dinner speaker, had put a huge hole in the Barings boat. Over the weekend, then-Governor Eddie George tried hard to assemble a lifeboat. All visits to London Zoo were cancelled. But the lifeboat failed and with it Barings. That Barings was allowed to fail, and did so without rupturing the system, is a key lesson for today, to which I will return later.

So what does this tell us about how the Bank of England's role had evolved on entering the 20th century? The Bank now spoke and acted as steward of the financial system, marshalling its own and others' financial resources to keep the financial system panic-free. The Bank was at the frontline of crisis management.

But these episodes also contained lessons. When the first Barings crisis came, the Bank had been reactive and backfoot. It had been blindsided by the risk to its own and the financial system's balance sheet. The Bank was finding its feet as a crisis-container. But in attitude and expertise, it was a world away from being an effective crisis-preventer.

### **Supporting the economy**

Fast forward to the start of the First World War. William Lidderdale had been replaced as Bank Governor by Walter Cunliffe. Cunliffe was not what would these days be called an equal opportunities employer. The Bank's staff rules were stifling and sexist – although were ahead of their time compared to other City firms. The Bank went 150 years without employing any women at all. When they did, it was to do the work of 15–18 year old boys, sorting and listing returned notes. On getting married, women at the Bank were required to resign their position. The Bank was "Old Lady" by name but "Young Lady" by nature.

Cunliffe's greatest achievement was his contribution to solving the financial panic of 1914. On Friday 24 July, the City woke to the threat of war as Austria made an ultimatum to Serbia. There was a worldwide scramble for the safety of cash. Mass-selling led to stock markets closing in Europe, then New York, then Australia.

London was not exempt. By 31 July, the London Stock Exchange had closed for the first time in its near 150-year history. Panic soon spread to the money markets, sucking liquidity and

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<sup>4</sup> Roberts and Kynaston (1995).

life out of the financial system. Unable to finance themselves, lending by the banks began to drain away, starving the economy of credit and causing it too to crater. This was truly a credit crunch.

Cunliffe's plan, hatched with the Treasury, was to lift the liquidity burden on the banks by purchasing the IOUs they were holding from overseas borrowers which had become understandably illiquid on the outbreak of war. These bills were bought by the Bank and stored in its vaults, in what became known as the "cold storage" scheme.<sup>5</sup> By freeing the banks' balance sheets in this way, the cold storage scheme was intended to stimulate credit.

It was only a limited success, with the banks still fearful about making new loans because of the rising risk of default by overseas borrowers. In response, the government announced an extension to the scheme, with the government effectively insuring the banks against the credit risk on these assets too. It worked. Within a couple of months, money market conditions had stabilised and credit was once more flowing. Cunliffe's cold storage plan had averted a credit crisis.

The cold storage scheme was a piece of clever financial engineering by the Bank, designed to support credit and the wider economy. In the past few years, with credit growth and the economy weak, the Bank has been in the vanguard of creating new pieces of machinery to serve a similar end.

In 2008, the Bank introduced a Special Liquidity Scheme, or SLS, to help finance UK banks' legacy asset portfolio. Over £180 billion of support was provided to the banks and has since been repaid.<sup>6</sup> The SLS bears more than a passing resemblance to the first phase of the cold storage scheme.

In June this year, the Bank announced a second scheme, the Funding for Lending Scheme, or FLS. It provides liquidity support to UK banks on terms which depend on their lending to the UK economy, thereby acting as a direct incentive to stimulate new lending. The FLS bears some resemblance to the second phase of cold storage.

The SLS and FLS may be less famous than JLS, the London R&B boy-band. But they are an important recognition of the Bank's role in supporting credit intermediation. That role began in the early part of the 20th century with schemes like cold storage. The Bank's role had expanded beyond its own doorstep, on which the banks stood, to the doorsteps of households and companies up and down the country seeking credit.

## **Supporting financial infrastructure**

Yet one thing at least had stayed the same: in 1914, the Bank had only acted when jolted into doing so by war. Its role was still as crisis-container rather than preventer. During the 1920s and 1930s, the Bank of England became Montagu Norman's Bank. And Norman set about changing that.

Norman was not Cunliffe's greatest fan and the feeling was clearly mutual. "There goes that queer-looking fish with the ginger beard again", Cunliffe is said to have observed about Norman. "Do you know who he is? I keep seeing him creep about this place like a lost soul with nothing better to do."<sup>7</sup> Nor would Norman necessarily have ingratiated himself to today's army of Bank economists. "You are not here to tell us what to do, but to explain why we have done it" is the way Norman rebuked the Bank's Chief Economist of the day.<sup>8</sup>

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<sup>5</sup> Roberts, Reading and Skene (2009).

<sup>6</sup> John, Roberts and Weeken (2012).

<sup>7</sup> Boyle (1968) p105.

<sup>8</sup> Ahamed (2009) p233.

Norman saw the Bank's role in expansive terms, as provider not just of emergency help but as builder of infrastructure and supporter of industry. The Bank became part of the post-war reconstruction effort. Having spent 200 years tending to its back garden, the Bank began to explore pastures new.

To take one example, in 1928 the Lancashire cotton industry was on its knees. These problems risked ricocheting back to the financial system, with at least two of the big five UK banks up to their neck in cotton.<sup>9</sup> A plan was conceived involving consolidating the industry into a Lancashire Textile Corporation. This was to be financed with debt and shares issued and supported by – you've guessed it – the Bank of England.

It was a bold and cunning plan. Unfortunately, it flopped. The share issue by the Corporation in 1931 was a resounding failure, leaving the underwriter with a large chunk of the shares. The Bank ended up having to support the market.<sup>10</sup> It, too, found itself up to its neck in cotton.

Undaunted, the stage had nonetheless been set for the Bank's on-going involvement in financial infrastructure. This came not a moment too soon. In the immediate post-war period, the UK faced pressing financial infrastructure problems – the so-called "Macmillan gaps". These gaps referred the inability of small firms to finance themselves with long-term loans. If these gaps sound strangely familiar, then they should.

The post-war Bank set about closing these Macmillan gaps with gusto. In 1945 it set up two new financing entities – the Finance Corporation for Industry (FCI) and the Industrial and Commercial Finance Corporation (ICFC). These were financially supported by banks and institutional investors, providing a platform for the supply of longer term funding and venture capital finance to small firms.

In 1973, the two corporations combined to form Finance for Industry (FFI). During the early 1980s, the company was rebranded as Investors in Industry, commonly known as 3i. In 1987, the entity went public as 3i Group. This was not a flop. Arguably, 3i and its predecessors were one of the largest feathers in the Bank's post-war cap, helping support generations of new businesses and start-ups.

And those MacMillan gaps? Regrettably, the crisis has re-opened them. Today, small firms are once more starved of finance, including many here in Northern Ireland. Once again, the quest is on for a new financial infrastructure to help close these gaps.

Through the 1980s and 1990s, there were further examples of the Bank stepping in to close structural financial gaps. When the UK's high-value payment system started creaking in the early 1980s, the Bank designed and built a new, bullet-proof system. Given the Bank's somewhat chequered record on gender diversity up to that point, it was rather unfortunately named CHAPS. And indeed still is.

In 1993, the Bank stepped-in to rescue a flagging project to upgrade the securities settlement process in the UK. The Bank designed and built a new, safety-first, system which again exists to this day. Fortunately, we did not call this one BLOKES, but rather the gender-neutral CREST.

Most recently, in the light of the crisis, the Bank has been at the forefront of the debate about re-organising the structure of banking, with a ring-fence or firewall between the basic retail and investment banking sides of the business. This structural approach is increasingly finding favour both in the UK (through the proposals of the Vickers Commission) and internationally (for example, through the Volcker proposals in the US and the recent Liikanen proposals in Europe).

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<sup>9</sup> Sayers (1976).

<sup>10</sup> Sayers op cit.

For the past half-century, the Bank's structural agenda has become a central feature. But at the time it marked a radical departure from the Bank's past. Designing what are in effect financial public goods is a front-foot activity. The Bank had grown a new limb, augmenting its crisis-management right arm with a crisis-prevention left arm.

### Stitching it all together

So far, I have made no real mention of monetary policy. That is because, for much of its life up to the early 1970s, monetary control at the Bank of England was pretty simple. It came care of fixing the exchange rate – first to gold under the Gold Standard and latterly in the post war period to the dollar. With the demise of the dollar standard in the early 1970s, however, the exchange rate anchor had been tossed overboard. At the Bank of England, as elsewhere, the search was on for a new nominal anchor.

Into this vacuum stepped Andrew Duncan Crockett. Crockett joined the Bank in 1966 as a graduate entrant, just before the break-up of the Bretton Woods dollar standard. He set to work on the biggest problem of the day, locating a new nominal anchor. In so doing, he began working alongside another young(ish) new Bank entrant, Charles Goodhart.

The result was a joint paper published in the Bank's *Quarterly Bulletin* in June 1970. It was titled "The Importance of Money".<sup>11</sup> Re-reading it now, it was a prophetic piece of work. In the UK, it laid some of the analytical foundations for what, during the late 1970s and 1980s, became monetarism. More than that, the paper placed commercial bank money and credit at the centre of the macro-economy. It could as well have been titled "The Importance of Credit" or indeed "The Importance of Banks".

After a successful spell at the IMF, Crockett returned to the Bank of England in 1989. In 1994, he then became General Manager of the Bank for International Settlements, the central banks' central bank. In central bank circles, change was in the air. Monetary policy was embarking on a path which targeted inflation and which, unlike monetarism before it, downplayed money and credit. And the regulation of banks, long the preserve of central banks, was in many countries being hived off to separate regulatory agencies.

What happened next was truly extra-ordinary. Whether by coincidence or causality, the world experienced the largest banking bubble in history. Between 1990 and 2007, global bank balance sheets rose by a factor four. On the eve of the crisis they had reached around \$75 trillion, or almost 1.5 times the annual output of the entire planet.

At the Bank for International Settlements, Andrew Crockett saw trouble brewing. In 2000, he gave a speech calling for a "macro-prudential" approach to regulation.<sup>12</sup> Crockett argued that central banks needed to look at, and act on, developments across the whole financial system if systemic risk was to be headed-off. Credit booms, the like of which was occurring for real at the time, sowed the seeds of that systemic risk.

The rest is of course history, as pre-crisis credit boom turned to shuddering bust. Or rather it would be history were it not for the fact that this crisis, whose seeds were sown in the credit boom, is still with us. Output in the UK is still well below its 2007 level. The so-called Great Recession in the UK is already as severe as the Great Depression of the 1930s.

In response, the policy framework has, once more, been radically augmented. Macro-prudential policy is the next big thing. It is now widely acknowledged as the missing policy link during the pre-crisis period, the essential bridge between monetary policy and regulation. As I discuss below, this bridge is now being constructed through new frameworks in the UK and internationally.

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<sup>11</sup> Goodhart and Crockett (1970).

<sup>12</sup> Crockett (2000).

## The Bank tomorrow

So where does all of this leave the Bank today and, indeed, tomorrow? In the light of the crisis, we are moving to a wholly new structure for financial policymaking in the UK. In many important respects, this can be seen as building on the lessons of history. To illustrate that, let me set out some of its main features.

First, there is to be a radical shift in the organisation and approach to supervising individual financial institutions. The UK will move to a so-called “twin-peaks” regime. That means in practice separating the safety and soundness aspects of the regulation (so-called prudential) from the consumer protection aspects (so-called conduct). The prudential part will from next year sit in the Bank of England in a new Prudential Regulatory Authority, or PRA.

This is much more than deck-chair rearrangement. Accompanying this change will be a root-and-branch change in our approach to supervision. There will be a focus on the big risks – the Barings of yesteryear, the RBS of yesterday. Supervision will be front-foot, testing for stress before it strikes and visits to the zoo need to be cancelled. It will be also tolerant of bank failure – Barings Mark 2 rather than Mark 1 – so that market discipline can work its magic.

Second, during the course of the crisis, there has been a radical, if underplayed, rethink of the Bank’s approach to supplying liquidity to the banking system.<sup>13</sup> While not quite a change on the scale of the Overend and Gurney crisis, this allows banks to access the Bank’s facilities against a much wider range of collateral. The Bank’s liquidity menu is now crystal clear, from which banks can now themselves choose.

Third, an entirely-new piece of policy machinery has been introduced – new not just for the UK, but internationally too. In the UK, this is called the Financial Policy Committee or FPC. It was put on earth to do macro-prudential policy, to act as the bridge, to provide the missing link, to monitor the punchbowl before it is emptied and before aspirin needs administering. A year on, the FPC is doing just that.

Most recently the FPC has been navigating a particularly hazardous course. The financial system and economy are suffering the hangover from hell. The FPC’s task is to keep the system safe in the face of heightened risks of a relapse, while at the same time keeping the banks’ credit arteries open to support the economy. Both objectives are steeped in the Bank’s history – and both objectives are embodied in the FPC’s remit.

The FPC has a remit, too, to strengthen the structural fabric of the financial system, including through improved financial infrastructure. That objective has a place deep in the Bank of England’s heart – from Lancashire cotton mills of the 1930s, to 3i of the post-war years, to CHAPs of the 1980s, to Vickers of the past few years.

Supporting and executing these new responsibilities will be a massive task. First and foremost, it will require the Bank to have a rich and diverse set of skills. Historically at least, the Bank has been skills-rich but diversity-poor. But I am pleased to say that, too, has been changing for the better. This year’s graduate intake has close to a 50/50 gender split. One in seven of the intake is drawn from ethnic minorities. Only a fifth come from Oxford or Cambridge.

The PRA’s arrival next year will broaden further the diversity of the Bank’s skills and experience – legal, accountancy, banking, insurance. The Bank’s policy committees, meanwhile, bring diversity of experience and expertise to the decision-making table, from academe and the private sector.

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<sup>13</sup> Bank of England (2012).

There has been a transformation, too, in the Bank's approach to external communications and transparency. Think back twenty years. Then, there were no quarterly *Inflation Reports*, no six-monthly *Financial Stability Reports* and certainly no press conferences to accompany both. Twenty years ago, there were no minutes of the deliberations of the Bank's policy committees (today, the MPC and FPC).

Back then, press interviews were rare and scripted to within an inch of their life. In the past year, Bank officials gave around 65 speeches and over 200 press interviews. In Montagu Norman's day, the combined total was one. The days of "keeping the Bank out of the press and the press out of the Bank"<sup>14</sup> are well and truly gone.

Earlier this year, the Governor gave the Bank's first live peacetime radio address to the nation for 73 years. The Bank Tweets, fortunately with rather less vigour than your average Premiership footballer. Soon we will have, for the first time in history, published minutes of the Bank's Court of Directors. The Governor has appeared before the Treasury Committee on no less than 47 occasions since he took office.

In 2011, a word search of "Mervyn King" in the press revealed more hits than "Kylie Minogue". To my knowledge, this is the first time a sitting Bank of England Governor has topped the Aussie pop princess in the media opinion polls. Given its new responsibilities, the Bank cannot fail to remain in the public's eye in the period ahead. Transparency and accountability will remain the watchwords – and rightly so.

## Conclusion

When pressed by the Macmillan Committee in 1930 to explain the Bank's actions, Montagu Norman replied: "Reasons, Mr Chairman? I don't have reasons, I have instincts".<sup>15</sup> I suspect such an answer would work less well with today's Treasury Committee, to say nothing of today's media.

All public policymakers have an obligation to explain. And all policymakers have an obligation to learn from past crises and past mistakes. That is the only way credibility can be built: not the avoidance of crises and mistakes, which is impossible, but the recognition by the public that, when they do happen, the crises are contained and the mistakes are honest ones.

The Bank of England is embarking on the latest chapter in its 318-year history. We cannot avoid a crisis but, as with Barings in 1890, we can endeavour to prevent it becoming a drama. We will certainly be doing our best to prevent it becoming a tragedy like that of the past few years. If nothing else, this new chapter will have learnt from, and will build on, the lessons of history.

Thank you.

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<sup>14</sup> Capie (2010) p50.

<sup>15</sup> Boyle op cit p327.

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