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ORIGINAL ARTICLE

The Bank of England, operational independence and the financial crisis

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Abstract The Bank of England played a key role in the management of the 2007–2008 financial crisis, a decade after being granted independence, and has since become an increasingly powerful monetary and financial actor. However, most accounts of the financial crisis in the UK have tended to approach the management of the crisis in terms of unified state action. This paper argues that this approach is limited as it ignores how the conflicts and tension between the now independent Bank of England and the British government shaped the response to the crisis. It is argued that we need to have a clearer understanding of how states and central banks interrelate in order to understand both the management of the crisis and the implications of the emerging monetary and financial order. Specifically it is argued that central banks and other state agencies engage with finance differently and face different problems in doing so and thus develop potentially conflicting strategies. Central banks, as distinct from other state agencies, should be perceived as key structural actors in order to understand the development of the crisis and the implications of the post-crisis regime.

Keywords Bank of England · Monetary policy · Global financial crisis · British state · New labour · Central bank independence

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Introduction

It has been over 10 years since the Global Financial Crisis shook the UK, leading to a run on a British bank, sweeping government bailouts, the steepest recession in 60 years and a wave of regulatory reforms. The Bank of England has emerged from this as an increasingly powerful and resolutely independent institution. Granted independence 10 years prior to the crisis with a limited purview over monetary policy, the Bank of England has now gained powers over financial supervision and "macro-prudential" policymaking with only limited additional accountability to elected officials. Despite this development, little research has been done into how the independence reforms of 1997 shaped the policy outcomes of the 2007–2008 financial crisis and the subsequent reforms. This article seeks to make a step towards filling that gap.

The British response to the crisis of direct recapitalisation of banks and the provision of liquidity backed by treasury guarantee quickly became the paradigm adopted by other European governments (Quaglia 2009, see also Hodson and Mabbett 2009). Little work has been done to show how the relationship between the independent Bank of England (BoE) and the British government shaped the options available and the development of this policy approach. There is a tendency to see the BoE operating in tandem with other state agencies, especially the Treasury, and for the crisis response to be seen as a unified state strategy (see for example Thain 2009; Watson 2009; Hodson and Mabbett 2009; Goodhart 2011). However, there is growing evidence and reference to the presence of conflict between the BoE and the Treasury over the management of the crisis (Brown 2010; Darling 2011; Conaghan 2012; Balls 2016). While concerns were raised in the central bank independence debates as to how independent central banks would react in crisis (Bowles and White 1994; Berman and McNamara 1999; Elgie 2002), until now these have not been addressed.

The primary goal of this article is to address this gap in the literature by investigating the relationship between Bank of England (BoE) and the British Treasury from 2007–2010. By drawing out the complications of the relationship between the BoE and the Treasury this paper argues that rather than being a unified response, the policy package was instead the result of a series of conflicts and compromises over the respective roles of the Treasury and the BoE. Alongside this key empirical claim, this paper also presents the case that the reason for this conflict was not simply due to institutional or ideational factors but that there are deeper structural reasons why finance ministries and central banks would come into conflict in crisis. Put simply, central banks—monetary authorities and creditors—engage with finance differently from finance ministries—political authorities and debtors.

The article begins by briefly outlining why finance ministries and central banks approach the problem of financial governance from different perspectives. This opens points of conflict over monetary, fiscal and regulatory policy. These are then situated within the British context, highlighting the deeper implications of the independence of the Bank of England from 1997. The third part then utilises

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this framework alongside documentary analysis and interviews with policy makers in 2016 and 2017 to provide a more nuanced and complete narrative of the management of the financial crisis in the UK. The closing section looks forwards to how this shapes our understanding of the Coalition reforms of 2010–2015.

Central banks and finance ministries

The core claim of this article is that to understand the development of the crisis response in the UK and the development of the post-crisis reforms we need to disaggregate the state. Specifically we need to differentiate between central banks and their respective finance ministries with regards to financial and monetary governance. This deeper structural analysis then sheds new light on the implications of operational independence for the crisis and beyond. The approach adopted here emphasises the different ways in which central banks and finance ministries engage with financial actors, practices and systems, and shape their policy preferences and capabilities (see also Braun 2016). Central banks and finance ministries face structurally different problems both in crisis and in everyday financial management. This stems from their dissimilar mode of engagement with financial markets.

Central banks play an important role within financial markets as issuers of the "best money" of a monetary system (Mehrling 2000, p. 366) independently of their role and position within state institutions. A central bank draws its position and power from its role as a systemic creditor, as the bankers' bank, and not from its relationship to the state. As Capie (2010) puts it "central banks emerged from commercial banks. Any central bank that was a central bank from its inception was modelled on one of these ancestors" (p. 1). The maintenance of this position requires the central bank to actively manage markets for the means of payment between commercial banks and provide facilities such as 'lender of last resort' in order to preserve the credit structure at the top of which it sits (see Goodhart 1995).

Finance ministries are by their nature political agencies drawing their position and power from their role in the state "as the historically specific condensation of the 'political' in capitalism" (Burnham 1995, p. 93). Which in turn depends upon its ability to maintain its legitimacy as the institutional embodiment of the 'general interest'—an intrinsically contested concept both within the state and without. This requires state agencies to undertake a range of functions and operations to maintain the social order and this increasingly has led state managers to take an interest in economic and financial affairs through their finance ministries. Thus finance ministries tend to face a broader set of concerns than the central bank.

While the central bank is primarily concerned with the credit structure and money supply of an economy, finance ministries are concerned with the need to maintain political legitimacy though broader economic and social management strategies. Central banks and finance ministries approach the questions of monetary and financial stability from different standpoints. For the finance ministries, financial and monetary stability are the means for securing economic benefits both in terms of economic growth and stability and in terms of their ability to raise funds on financial markets. Central banks, on the other hand, approach monetary and financial stability

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as ends in themselves. Economic stability and growth are important as they not only ensure that creditors remain solvent as debts are repaid but also because they shape the demand for and provision of credit and thus the money supply. Additionally, since the politicisation of central banking in the early 20th century and the drawing of central banks into state structures, economic growth and stability is also a key means for justifying any state-granted privileges. In practice however, this means that questions of monetary policy, fiscal policy and financial regulation remain regular points of conflict between finance ministries and central banks.

Monetary policy

Money market operations are the key tools used by central banks to shape financial practices and thus the supply of credit to the economy. At the same time, they serve to regulate the underlying tendency of finance to overextend credit, which would risk either inflation or crisis as debtors' default. Central banks set the immediate and future costs of extending credit via their control over reserves, enabling them to curb exuberance and ease tension in a dynamic and temporal fashion (see Fontana 2003). The strategy adopted for doing this, however, is not necessarily in keeping with the political needs of the finance ministry or the state more generally, often leading to attempts by state managers to exert influence or control over central banks by nationalising them and situating them within state structures.

Fiscal policy

While central banks engage in financial markets as systemic creditors and market managers, finance ministries are also key market actors as the issuers of the "best credit" in the form of government bonds (Mehrling 2000). Deficit financing, however, involves the creation of state debt in exchange for deposits, and thus acts as a monetary expansion just as any extension of credit does. Thus, while a central bank may be able to affect the money supply indirectly through monetary operations, a finance ministry can affect it directly by simply issuing debt—assuming there is a bank willing to buy it.

State debt enables further monetary expansion, being yield-bearing and almost immediately convertible into reserves due to the privileged position of the state as a debtor (Bell 2001). And with the development of market-based banking and repo[1] markets this secondary effect became pronounced as a single asset can now be used to fund multiple transactions (Gabor and Ban 2016). A side effect of this transformation however means that increasingly financialised capitalism is dependent upon the market value of high-grade assets for funding and revenue (Hardie et al. 2013), linking any fall in value to sudden contractions in the effective money supply. Thus

[1] A repo or repurcahse agreement is when an asset is sold with an agreement to repurchase it at a set price on a set date. In essence, providing means of secured borrowing for financial actors. See Gabor (2016) for a fuller explaination and its impliations.

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the credibility and the size of the state finances are of critical concern for the central bank, as rising instability within sovereign debt markets would threaten the stability of the credit structure.

Regulatory policy

In a similar manner, the contestation over regulatory policy stems from the limits to a central bank's power to shape financial activities. Just as the central bank is limited in its ability to shape state fiscal decisions, it is limited in its ability to shape the lending activities of banks. This is pertinent when we consider crisis management and the lender of last resort function. To prevent the contagion of financial crisis from one institution to another and preserve the systemic integrity of the financial system, central banks must regularly act as lenders (or dealers) of last resort (Mehrling 2011). Yet this function provokes moral hazard by effectively underwriting the funding of banks (Goodhart 1988). Central banks then face a trade-off between intervening in crisis to maintain the stability of the money supply, and the credibility of future interventions and warnings. This can only be mitigated by adequate legal tools. So central banks must also rely on regulatory and supervisory powers to prevent the misuse of a private bank's money-making powers. The tools and tactics available to the central bank as regulator and supervisor, just as in fiscal and monetary policy, however, depend to a greater or lesser extent on the position of the central bank in relation to their finance ministries and other state agencies.

Operational independence

In 2007–2010, the potential conflict over the direction of monetary, fiscal and regulatory policy occurred, in the UK, within the confines of the operational independence granted in 1997. This had involved "placing at one remove the political character of decision making" over monetary policy (Burnham 2001, p.128) by returning it to the Bank of England. It also meant stripping the BoE of its role as the states banker and banking supervisor, placing these roles with separate agencies. The implication of this was that while the BoE regained autonomy over monetary policy, it lost almost all its power to affect fiscal or regulatory decisions.

The core change in 1997 was that while the government would set an inflation target, how this was to be met was the purview of the BoE. For state managers this was beneficial as it meant binding political opposition to the government's economic strategy (Dellepiane-Avellaneda 2013) with a view to increasing credibility with global financial markets (Brown 2001). Meanwhile for the BoE this offered an opportunity to extract itself from political considerations regarding its policies (George 2001). Furthermore, while the government technically maintained the ability to direct the BoE in crisis, this was practically impossible, as although:

> "the Treasury's always had powers under the [1946 Bank of England Act] to direct the Bank … that always seemed terribly nuclear. … [and] if we were to direct the Bank we needed to know [precisely] what we were directing

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them to do." [A capacity that the Treasury did not possess]. (interview, ex-Senior Treasury Official C, June 2017)

Thus, while the British government may have been able to set the overall direction of monetary policy, the actual management of money markets was and remains de facto the sole purview of the BoE—as long as any action can be legitimised in terms of either the 'general interest' or the 2% inflation mandate. In essence, this left the British state with little scope to address divergent preferences over money market operations in crisis, in exchange for increased economic legitimacy in general.

Another key part of the 1997 reforms was the separation of the Gilt-Edged department from the BoE and the creation of the new "Debt Management Office" of the Treasury. This stripped the BoE of its role as the market manager for state debt. Combined with the transfer of the government's operational accounts to RBS and Citibank in 2008, the BoE was left with little scope for direct engagement in state fiscal affairs having only the management of the "ways and means" account and the gold reserve (Bank of England 2009a, p. 20). Thus, unlike the 1920s and 1930s when the BoE could directly engage with the British government over "appropriate" and "correct" fiscal management, the BoE now had to rely on policies of "externalisation". By giving regular briefings, speeches and comments on fiscal and regulatory policy it would utilise its position as an independent authority to shape and direct the policy debate (Burnham 2017) with no guarantee that the desired decisions would be made.

Finally, the regulatory reforms that accompanied the operational independence saw the BoE stripped of its supervisory powers and responsibilities as part of a process consolidating nine different supervisory bodies into a single Financial Services Authority (FSA). This, for the first time, separated the banking supervision aspect of financial stability from the market management aspect. This separation of banking supervision was a contentious point within the BoE (Conaghan 2012). For some such as Mervyn King (then Deputy Governor), it was welcomed as it boosted the BoE's credibility as a monetary authority. Political intervention was minimised and the potentially conflicting financial stability concern was externalised (Balls 2016, p. 301). However, this also cost the BoE important intervention powers and left it almost entirely dependent on the FSA for the mitigation of any moral hazard caused by its operations. This combined with the loss of debt management operations meant that the BoE in 2007 had little operational capacity outside of money market management in the pursuit of its objectives.

Thus, the BoE entered the 2007 financial crisis with limited competencies compared to previous eras but with almost complete independence with regards to monetary policy and money market operations. The argument presented here is that these reforms were significant in shaping how the BoE approached the financial crisis but are not significant in explaining how and why the tensions between the BoE and the British state evolved over the crisis. To do this, the reforms have been situated within the deeper structural tensions between central banks and states in general, and thus how these reforms left the BoE isolated. The implications for this in terms of the BoE's money market strategy and its relationship

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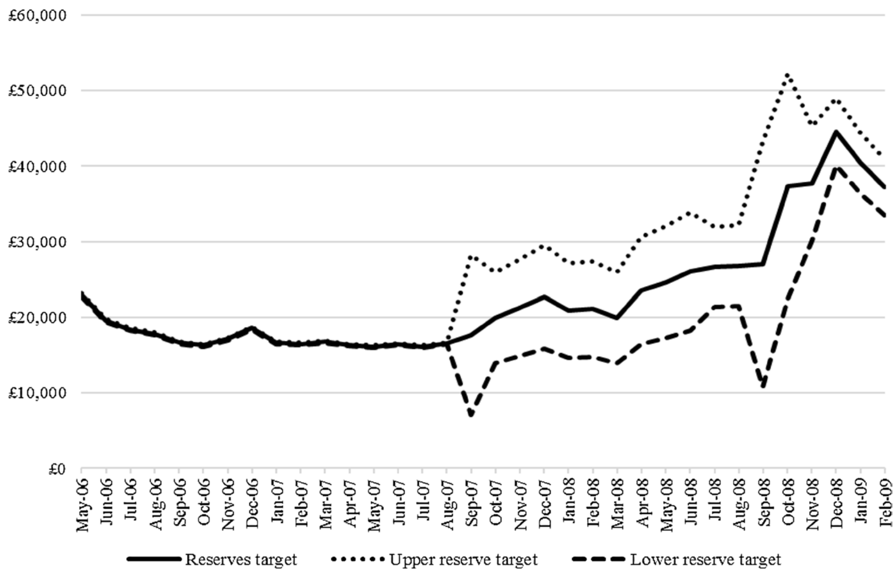

Fig. 1 Average Reserve Targets and Margins in millions: May 06–Feb 09 (Bank of England 2016)

with the Tripartite Authorities provide the starting point for understanding the development of the crisis response and the post-crisis reforms.

Managing the crisis

The context of operational independence for monetary policy alongside severely reduced operational competence in both financial stability and government debt management left the Bank of England with only one set of tools to achieve its objectives—money market management. These operations had been under review since 2003 and in 2006 had been largely reformed as the Sterling Monetary Framework (SMF). The core strategy of this approach was the use of market discipline as the primary tool for ensuring financial and monetary stability.

The SMF operated via two corridor systems: one around endogenously set reserve targets (Fig. 1) and another around the base rate for reserves (Fig. 2) (Bank of England 2006). Every month each clearing bank submitted a target level for its reserves in the forthcoming period (the space between monetary policy meetings), which the BoE would then provide to the market through Open Market Operations, via repos at or around the base rate (Bank of England 2006). Over each period, banks would then need to average their target within a margin of ± 1% by borrowing or lending out funds. Deviation from this margin resulted in sizable penalties. This incentivised banks to lend reserves when market rates were above the base rate and to borrow when they were below, resulting in a fluctuation in the Sterling Overnight Index Average [SONIA] around the base rate. This fluctuation was then contained by the Standing Facilities which were the rates at which the BoE itself was willing

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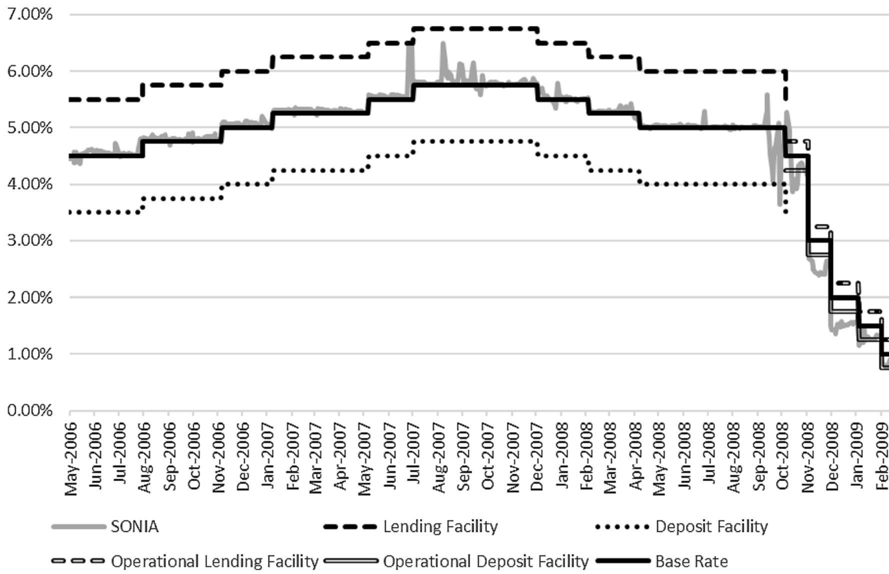

Fig. 2 Bank Facility Interest Rates and the SONIA: May 06–Feb 09 (Bank of England 2016)

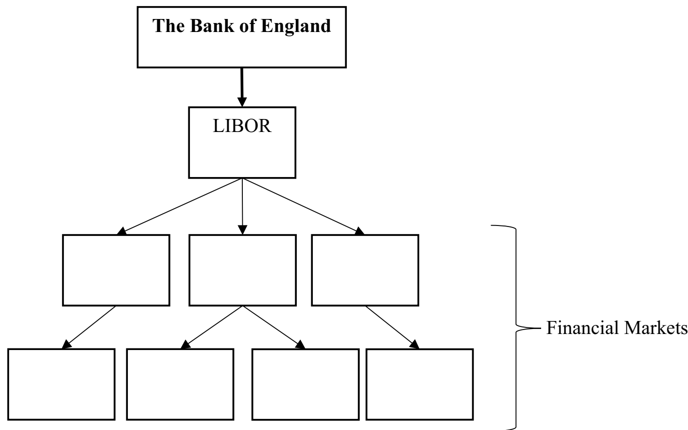

Fig. 3 Bank of England Market governance strategy before 2008

to lend or take reserve deposits overnight. Thus, changes in the base rate would set the overnight cost of reserves which in turn served as a benchmark for all other asset markets.

The BoE both created the market for reserves and set its limits, relying on the appropriate pricing of risk and fears of penalties to set the terms for all other markets (see Fig. 3). This transition mechanism relied entirely on market discipline and fear of losses with a limited safety net of the Standing Lending Facility

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to prevent market exuberance. Meanwhile the FSA provided assurance that key institutions were stable through a complex set of risk assessments determining credibility and solvency (McPhilemy 2013). Both systems of governance relied heavily on the credibility of these rules. Thus the BoE had effectively committed to not manage markets inorder to prevent bank failures.

This did not mean that the BoE ceased to have an interest in financial stability. In fact, this was still a key concern for the BoE, as a sudden rupture in financial activity would drastically effect its ability to govern the money supply and its position as a monetary authority. By 2007 the BoE had begun to warn of:

> some significant downside risks over the medium to long term: the aggressive search for yield had continued, with a further relaxation of lending criteria and a rapid build-up of complex, potentially illiquid, financial instruments. … a possibility that financial risk was being underpriced (Bank of England 2007a, p. 19)

However, these were seen as risks on the medium to long term and were not at the forefront of debates. In fact, in 2006 the Tripartite Standing Committee of the Treasury, FSA and BoE was presented reports from both the FSA and the BoE that concluded that the British system was, if anything, over capitalised (interview, ex-Senior Treasury Official B, May 2017).

So when the crisis broke on British shores in September 2007 with the collapse of the British bank Northern Rock (NR), the BoE's response was to utilise this opportunity to enforce market discipline on what it perceived to be as over-buoyant markets and to maintain its credibility by letting NR fail. This involved the use, or lack thereof, of monetary policy to ease liquidity pressures while still pressuring and penalising banks that had overexposed themselves, invoking "moral hazard" whenever challenged by state officials to change course. This hard-line approach ceased to be credible however with the collapse of Lehman Brothers a year later. Following this, the old market-based strategy was no longer viable and so the BoE sought a new one in the form of a revised SMF and the launch of the Asset Purchase Facility. This in turn forced the BoE to seek a new settlement with the Treasury on the management of fiscal and regulatory policy. It is to each of these periods we now turn.

Period 1: 2007–2008

The management of the financial crisis in the UK can be split into two periods. The first, from early 2007 to September 2008 saw the collapse of NR and the development of the British paradigm of state-backed recapitalisation in an environment of limited central bank intervention. The BoE opted to enforce 'the rules of the game' rather than intervene to bail out banks or markets; much to the despair of the British government.

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The credit crunch

With the interbank funding market freezing up due to turmoil in the US housing market in early 2007, NR found it increasingly difficult to source term funding at a profitable rate, effectively facing a "creditor run" (Shin 2009). The market responded to NR's subsequent profit warnings by rapidly increasing the cost of hedging and insuring its assets and liabilities (Hamalainen et al. 2012, pp. 83–85), creating a vicious cycle. In response, the FSA, acutely aware of the risks facing NR's highly leveraged strategy, began to seek a solution in August 2007. The proposal was that either (i) NR would restructure its funding to overcome the immediate shortage of term funding, (ii) involve the arrangement of takeover by a stable bank or (iii) that the BoE would provide funding, underwritten by the Treasury (Treasury Select Committee 2008, p. 36).

A fourth option of the BoE mitigating the crisis via money market operations, such as increasing the availability of term funding at the medium and long-term marks or by expanding the range of collateral that was accepted in funding operations, was rejected outright by the BoE as risking "moral hazard" by implicitly underwriting money markets. To reinforce this stance on 12 September, Mervyn King, the governor, wrote a letter to the Treasury Select Committee detailing the BoE's stance on moral hazard and why it would be inappropriate for them to act:

> [T]he provision of … liquidity support undermines the efficient pricing of risk by providing ex post insurance for risky behaviour. That encourages excessive risk-taking, and sows the seeds of a future financial crisis. So central banks cannot sensibly entertain such operations merely to restore the status quo ante. Rather, there must be strong grounds for believing that the absence of ex post insurance would lead to economic costs on a scale sufficient to ignore the moral hazard in the future. … If central banks underwrite any [banking activity] that threatens to damage the economy as a whole, it encourages the view that as long as a bank takes the same sort of risks that other banks are taking then it is more likely that their liquidity problems will be insured ex post by the central bank. The provision of large liquidity facilities penalises those financial institutions that sat out the dance, encourages herd behaviour and increases the intensity of future crises. (Bank of England 2007d)

Thus, the BoE continued to pursue a hard monetary policy, raising the base rate in July despite pressure from the Treasury and key financial actors to do otherwise (Darling 2011; Treasury Select Committee 2008; Brown 2010). The BoE insisted on treating NR as an individually failing bank which, as a solvent but illiquid institution, could access emergency liquidity support from the BoE at a penalty rate (Court of the Bank of England 2007b).

But the BBC broke the story of NR seeking emergency assistance before it was formally announced (BBC 2007), sending depositors and markets into panic and sparking a bank run. This further increased NR's financial difficulty and transitioned what was a liquidity problem into one of undercapitalisation as reserves were drained to cover deposit withdrawals. This risked insolvency as the cost of funding skyrocketed (Shin 2009). In order to stop the bank run, the Chancellor announced a

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series of increased deposit guarantees (HM Treasury 2007a, b) and underwrote an unlimited stream of funding for NR, provided by the BoE (HM Treasury 2007c). The BoE consented but charged a further penalty rate and froze the original collateralised scheme (Court of the Bank of England 2007a) in effect exacerbating the solvency problem that NR was now facing, while resolving the liquidity problem, and leaving all risk and cost with the Treasury.

This left NR on state-backed life support and although "option ii" of finding a buyer was still pursued the only formal bid was rejected by the BoE as it was based on them continuing to provide funding for the foreseeable future (Treasury Select Committee 2008). So with market conditions worsening towards the end of 2007 the decision was made, reluctantly, to nationalise NR (Darling 2011, pp. 55–6). This involved the full absorption of risk, funding and cost into the Treasury; with the full repayment of the funding extended by the BoE (plus interest) scheduled by 2010 (HM Treasury 2008).

This clash over the direction and use of monetary policy ultimately set the terms of the initial crisis management. The BoE's focus on maintaining the credibility of its stance and hedging against any future instability caused by moral hazard directly conflicted with the government's preference for monetary easing in an attempt to minimise the costs of the crisis and any potential social conflict, especially in providing scope for resale of NR. Instead the BoE's insistence on pursuing its commitments and minimising moral hazard forced the costs onto the Treasury. This led the Chancellor to seek legal advice as to whether he could compel the BoE to act differently (Darling 2011, pp. 57–8). Meanwhile the Treasury was seeking to prevent further turmoil as the liquidity crisis threatened both an economic contraction and bank insolvency as losses increased.

That is not to say that the BoE did not engage in any policy changes, simply that these changes, such as the provision of Emergency Liquidity Support (ELS) to NR, largely adhered to the "Bagehot Principle" of lending freely against adequate collateral at a penalty rate in times of crisis (see Goodhart 1988). For example, with the introduction of the Special Liquidity Scheme[2](SLS), the BoE was clearly willing to provide liquidity[3]. What it was not willing to do was to ease market pressure by doing so at a reduced cost. Instead, "the purpose of the Scheme [was] to finance part of the overhang of currently illiquid assets by exchanging them temporarily with more easily tradable assets" (Bank of England 2008g) at a significant haircut[4] and interest rate—"Mervyn was still of the view that it should be so high that you

[2] Which enabled reserve banks to deposit high-grade but illiquid securities at the BoE for a year in exchange rolling nine-month Treasury Bills of equivalent value (minus a 'haircut' and a fee) (Bank of England 2008h).

[3] Especially considered alongside the offer of four additional £10bn in 3-month repos (against investment-grade assets, including mortgage-backed securities, but at a penalty rate of at least 100 basis points) immediately after the run on NR (Bank of England 2007b, c)—which received no market interest (Bank of England 2007f, g, h, i) the addition of outright purchases of gilts to the SMF toolkit (Bank of England 2008c).

[4] Haircuts refer to the difference between the value of an asset and the money lent against it. For example, a haircut of 25% on an asset worth £100 would mean only £75 was lent against it.

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wouldn't want to touch it with a barge pole" (interview, ex-Senior Treasury Official A, February 2017)—and thus entirely in keeping with the existing market-based strategy.

The exception to this was the changes to the reserve-averaging component of the SMF. The BoE's response to the market turmoil was to pump liquidity at overnight and 1 week maturities into the market to prevent the SONIA from becoming excessively volatile (Bank of England 2007e). This meant that there was excess liquidity in the market compared to the reserve targets. Thus the margins for the period were expanded (*ibid.*). Furthermore, despite the return to normal liquidity allocation in the following months, the margins remained expanded (see Fig. 2). This effectively reduced the costs for those holding excess liquidity to shore up market credibility or for those facing slight funding shortages in volatile markets. Alongside this, the shift of weighting of long-term funding from 30 to 40% (Bank of England 2007e) and the inclusion of some investment-grade mortgage-backed securities as part of the collateral pool for OMOs (Bank of England 2008d) reduced the uncertainty of term funding, but not the cost. In short, the BoE was willing to allow some measure of market dysfunction in the allocation of reserves but only on a temporary basis, contracting the space provided in the reserve margins in early 2008 (Bank of England 2008e)—despite pressure from the Treasury and key financial actors to ease the pressure on banks as they sought recapitalisation.

In essence, the BoE's strategy was to maintain the pressure on banks to adjust their strategies by penalising them if they could not find sufficient funding via the market, thus maintaining the market as the main disciplinary tool and shoring up the credibility of the BoE's monetary rules. Thus the BoE to an extent welcomed the economic contraction—in the face of an oil and energy price spike—as a means of dampening inflationary pressures. The BoE argued that:

> [T]he rate of increase of other prices and domestic costs, notably pay, must remain low.… [so] we [The BoE] believe that a *slowdown in the economy this year, creating a margin of spare capacity, will be necessary to dampen price and wage pressures* and ensure that we fulfil our remit by returning inflation to the target. (King 2008 *emphasis* added)

In other words, the market contraction, problems of undercapitalisation and bank solvency were not considered of concern for the BoE. Instead the BoE saw these facts as a beneficial market discipline on financial actors and an overheating UK economy. This market discipline would enable the BoE to curtail pressure on the money supply and thus maintain the credibility of sterling. The problems of individual bank solvency and credibility sat externally with the FSA, the Treasury and with the banks themselves. Thus it is not surprising that the crisis management of HBOS, Lloyds TSB and RBS in autumn 2008 resembled a more streamlined repeat of NR.

The fall of HBOS and RBS

2008 saw the steady failure of several US hedge funds and the attempted recapitalisation of British banks through unprecedented rights issues. However, the losses

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Table 1 Rights Issues from UK Banks in first two quarters of 2008 derived from (London Stock Exchange 2017; Rights Issue Review Group 2008, p. 51)

Issuer	Price (p)	Size £m	Take-up	Start date	End date
Bradford and Bingley plc	55	455.2	27.84%	13/04/2008	18/07/2008
HBOS plc	275	4159.00	8.29%	05/04/2008	27/06/2008
The Royal Bank of Scotland Group plc	200	12,246.00	95.11%	28/03/2008	15/05/2008
Barclays plc—Open offer	282	4000.00	19%	29/06/2008	22/07/2008
—Placing	296	500.00	N/A	04/07/2008	

expected were much greater than those announced and many of the recapitalisations left the underwriters picking up the tab (see Table 1). The BoE however remained resolute in its stance, holding interest rates at 5% once the SLS secured market liquidity. This was in the face of an energy price hike (Bank of England 2008b) leading inflation to reach over 5% in September—two points above the banks mandated target. Resolution then rested upon recapitalisation at a time when market funds and private capital were scarce, due in part to the BoE's tight monetary stance. By August "both RBS and HBOS were struggling to raise money…[and] The plans were being drawn up for the recapitalisation"(interview, ex-Senior Treasury Official A, February 2017).

Before anything could be done, however, Lehman Brothers filed for bankruptcy on 15 September, generating a collapse in markets. The response was a series of ELS facilities, the closure of a UK bank, the merger of two of the largest UK banks and a programme of bank recapitalisation, based on the NR model, which set the precedent for Europe and beyond. It became apparent that HBOS would not be able to last without significant support and so the government stepped into secure support in the form of a takeover from Lloyds TSB on 18 September. By 1 October neither the new Lloyds–HBOS conglomerate nor RBS could raise funds on the market and had to turn to the BoE for ELS with an effective penalty rate of 2% (see Plenderleith 2012). The BoE again ensured that banks would remain liquid, but did so in a manner that did not ease the problem of undercapitalisation.

Facing markets unwilling to lend to or invest in problem banks, the Treasury decided to take it upon itself to recapitalise the banks. It offered unlimited funding to any bank that the FSA considered to be adequately capitalised while offering capital in exchange for equity to ensure that any bank would be able to revitalise itself and meet this condition (Darling 2008). Furthermore, the BoE was relieved of its loans to HBOS and RBS as Treasury funds were used to repay them (Bank of England 2009a). In short, the Treasury once again stepped into replace the BoE as lender of last resort as well as investor of last resort by substituting its credit for that of failing banks, thereby socialising their debts.

Yet the key impact of the collapse of Lehman Brothers was to change the nature of the crisis. A core argument of this paper is that the different positions that finance ministries and central banks assume within capitalism shape their relationship with

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finance and their preferences. The root of this being the need for the central bank to manage money and credit relations as a monetary authority against the finance ministry's broader needs as a political authority. The collapse of Lehman Brothers was a critical turning point for the BoE as it risked provoking a crisis of money in general as money markets went into disarray. It became untenable to maintain the hard-line market discipline approach as markets began to devour themselves. This forced the BoE alongside central banks internationally to relax their monetary stance and engage in a sudden process of policy innovation. While this change in stance could be seen as the BoE ceding to the Treasury's preferences, it also opened up new points of conflict as the BoE became dependent upon the credibility of both the Treasury's fiscal stance and the regulatory regime.

Period 2: 2008–2010

The collapse of Lehman Brothers provoked a sudden contraction in money markets and an international credibility crisis with banks facing sudden funding and solvency problems. While the immediate need for bank recapitalisation and funds was met via the Treasury bailout (Bank of England 2008f, p. 359), the systemic needs of capitalism were not. For while the product was there, the contraction in credit, and thus money, meant that the means of circulating it were not. Firms could not realise their goods, and thus could not pay their debts, risking a further deterioration in bank balance sheets in a downwards spiral.

The BoE responded to this by drastically reducing the base cost of credit to almost 0% between September 2008 and March 2009, reducing the cost of rolling forward payment and the amount of profit/income required to make payments. Alongside this, the margin for reserves was expanded once more and a reform of the monetary regime initiated. The limits of market discipline had been met and the BoE now had to step forward and do what it had previously sought to avoid—underwrite the markets. This took the form of a revised SMF and the announcement of Quantitative Easing (QE) via the Asset Purchase Facility (APF) and exposed BoE to the British government's fiscal and regulatory policies.

The (New) sterling monetary framework

In October 2008, amid market turmoil after Lehman, the BoE launched a new Sterling Monetary Framework. This comprised a rebranded "Operational" Standing Facilities (OSF) with a tighter corridor of ±25% (see Fig. 1) and open to a wider range of participants (Bank of England 2008a). An attempt to assert more control over the overnight money market by reducing the penalty of overnight assistance and the range of actors that could access the facilities, limited the scope for the market to deviate from the base rate. Alongside this, the BoE also launched the Discount Window Facility (DWF) as part of its standard operations. This facility allowed

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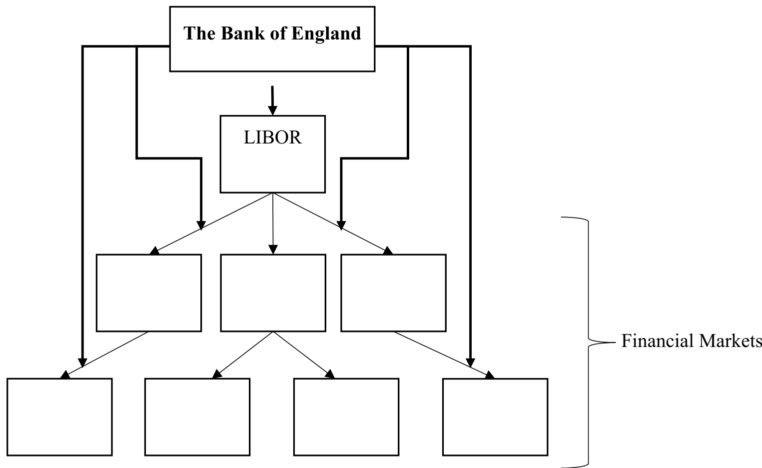

Fig. 4 Bank of England governing Strategy from October 2008

reserve banks to temporarily swap any asset on their balance sheet for more liquid UK government debt at a set ratio and interest rate (Bank of England 2008a). Unlike the Special Liquidity Scheme, the DWF was to be a permanent fixture of BoE operations (see Fisher 2012) effectively setting the minimum funding terms for markets and at a lower fee than the SLS[5]. While there had been interest in developing a programme similar to the DWF prior to the crisis (Interview, ex-Senior BoE Official B, May 2017), its implementation alongside the OSF represented a significant shift in Bank policy. The BoE moved away from the idea of efficient market discipline of the 2000–2008 period to what could be termed 'bounded market discipline'. The BoE now tightly set the conversion rate between sovereign debt and reserves via the OSF and then set the minimum terms between all other assets and sovereign debt via the DWF (see Fig. 4).

This change in strategy meant that while the BoE was now complicit with the British government's demand for looser monetary policy, it was also exposed to both the need for regulatory reform and the government's fiscal credibility. The bounding of markets by the DWF meant that the BoE could no longer utilise 'market discipline' as its core governing strategy but instead became increasingly reliant on regulatory and supervisory frameworks. Similarly, the linking of financial assets to sovereign debt in the DWF directly linked the entire system to the government's fiscal position. Thus in an attempt to maintain the credibility of the money supply, the BoE sought to become increasingly involved in regulatory and fiscal debates. This became particularly pertinent with the initiation of quantitative easing in 2009.

[5] The SLS fee ranged from 52 to 197 basis points (averaging at 85) (authors calculation from Bank of England (2016)) and the DWF is staggered from 50 to 100 basis points (Bank of England 2008a).

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Quantitative easing

In October 2008, after it became clear that the "effective zero lower bound" of interest rates was going to be met, a special team was put together inside the BoE to investigate alternative options (Interview, ex-Senior BoE Official A, December 2016). The result was a plan for QE. By February 2009, although markets had stabilised, a severe credit contraction was causing a recession as households and firms could not find funds to maintain their expenditure, causing a negative spiral. Banks were still unwilling to lend due to the cost and availability of funding in bearish markets alongside a downwards shift in risk appetite with low expectations for economic growth (Bank of England 2009e). This became self-fulfilling as demand for credit fell due to declining house prices and fears of unemployment made firms and households reassess their expenditure (Bank of England 2009f). This spiral risked the inflation rate drastically undershooting its 2% target (Bank of England 2009g). In response, the BoE began its programme of QE through the APF.

The APF operated by purchasing financial assets in exchange for reserves with an initial limit of £50bn in March 2009 before expanding to £200bn a year later. This would expand the money supply by driving up the price of financial assets and thus lowering the cost of credit. This was to function via three different economic mechanisms—Active Management, Circulation and Direct Purchase as well as by shaping agents expectations (Benford et al. 2009). Active Management meant that as the market supply of assets was reduced, their price would rise and thus their yield would fall. So firms would need to invest in higher risk, higher yield assets such as commercial debt or increased high-street lending. Alongside this, the purchase of assets from a broad range of counterparties (Bank of England 2009d) meant that firms were left with funds to be reinvested in other assets, leaving another firm with funds to be reinvested, etc., bidding up a range of assets beyond the initial purchase (Dale 2009). This Circulation effect would then cause a second wave of Active Management as asset prices rose encouraging investment (Bank of England 2009h). Finally, the Commercial Paper Scheme (Bank of England 2009c) and Commercial Bond Scheme (Bank of England 2009b) would directly purchase up to £50bn of corporate debt, directly injecting funds to non-financial firms.

While theoretically the BoE did not need permission to engage in this operation, Outright Purchases being added to the SMF in October 2008 as part of a reform planned since 2006 (Bank of England 2008c), meant the size of the scheme posed serious risks.

> [T]here was a view, which I have some sympathy with, that if there were to be losses on these asset purchases they could be very large relative to the Banks capital, which is a tiny amount really. So do you want the MPC to be always worrying, "Oh gosh if we do another £10bn of this and gilts yields go the wrong way slightly we've wiped out the Bank's capital"? … if that concern's there [QE] might end up being a very small scale one because you're concerned about that happening, and you didn't want that. (interview, ex-MPC Member, January 2017)

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In order to prevent this risk the BoE negotiated that the APF would be a special purpose vehicle fully indemnified by the Treasury, thereby allowing the BoE to conduct its policy freely without fears of facing its own crisis of undercapitalisation. The result was that the Treasury gained the power to limit the BoE's use of this facility as "in a sense it wasn't in any material sense owned by the Bank, but was formally." (interview, ex-Senior BoE Official A, December 2016). The reality however was that the Treasury not only provided extensions to the facility when requested but if anything was left wanting as the commercial paper and corporate bond facilities remained relatively underutilised, meanwhile bearing all of the financial risk.

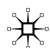
Thus while the evidence on the success of the APF in stimulating credit expansion and economic activity is ambiguous (compare for example Lyonnet and Werner 2012, with Bridges 2012), its implementation signalled a further shift in BoE strategy. The APF meant the almost complete removal of market discipline from the BoE's tool box. For not only did the unilateral injection of reserves mean that the reserve-averaging scheme had to be abandoned (Bank of England 2009d), thereby removing the disciplinary aspect of the SMF, but the BoE was now directly involved in both setting the terms of markets and actively steering their development. This implicitly underwrote the value of key assets, especially UK sovereign debt. This in turn provoked moral hazard both on the part of the Treasury, which could now effectively monetise its debt, and the financial sector, which could now take risks with the knowledge that the BoE would step into secure markets. Simultaneously, the entire structure of the BoE's monetary policy was now predicated on the credibility of UK sovereign debt. The prolonged effectiveness of the APF was predicated on drastically reducing the supply of UK sovereign debt to the market, so any move towards fiscal expansion would then immediately offset much of its impact. Thus the BoE, as expected, became increasingly concerned with the direction of both regulatory and fiscal policy, being structurally dependent upon the viability of both but with no direct control or influence—opening new space for conflict with the Treasury.

Renewed conflict with the treasury

The result of Lehman then was to force the BoE to abandon the 'market discipline' governing strategy in order to maintain its credibility as a depoliticised monetary authority. The resulting change in the SMF and the adoption of the APF, while resolving the conflict with the Treasury over monetary policy—a position where the BoE was dominant—left the BoE exposed to the government's fiscal policy and the FSA as the financial regulator and supervisor. The BoE's response was to begin a strategy of externalisation (Burnham 2017)—often in direct conflict with the Treasury.

Fiscal policy

As noted above, APF and DWF involved a structural change shift in the BoE's relation to the government. Now the BoE was dependent not only on the government adopting a particular fiscal stance for the efficacy of one of its headline programmes but also the structure of its 'normal' operations was hinged on the value



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of UK's sovereign debt. At the same time, the British government was adopting a policy "determination to invest and grow our way out of recession" (Darling 2009a) while the UK faced an impending credit rating downgrade shortly after the implementation of the APF (Reuters 2009b) and rising fears over European sovereign debt levels shook gilt markets.

The BoE's response to this, after the implementation of the APF, was to seek an assurance from the Treasury that it would take into consideration the needs of monetary policy in its debt management strategy and that it would not seek to monetise its debt via the APF[6]:

> that the Government's debt management policy remain consistent with the aims of monetary policy. It should not alter its issuance strategy as a result of the transactions that are undertaken through the Asset Purchase Facility for monetary policy purposes (King 2009b).

The Treasury's response however was somewhat contradictory stating that:

> our annual decisions about gilt issuance will continue to be informed by a number of factors including; the size of the annual financing requirement; supply-side considerations including the Government's risk preferences; *investors' demand for gilts; the shape of the yield curve; and other financing market conditions*. (Darling 2009b – emphasis added)

In other words, directly responding to the effect of the APF on gilt markets, but on the basis that 'the Government will not alter its issuance strategy as a result of the asset transactions undertaken by the Bank of England for monetary policy purposes.' (*ibid.*). Thus, while:

> the DMO then took pains to explain that they would try and set longer terms plans and stick to them and not respond opportunistically to favourable movements in the interest rate curve as they arose when the Bank did QE. … [But] the meetings that the DMO held with market participants, buyers in the primary markets … are fora where the DMO says "what would you like?" and of course they were all saying "well you know we'd like a lot more longer-term debt". Subtext – the Bank had bought it all. So who knows … how much of the extra long-term issuance was because of that, which in turn was because of what the Bank was doing, *but certainly there was extra long-term issuing* so it would have acted to undo QE. (interview, ex-Senior BoE Official A, December 2016, *emphasis* added)

Alongside this attempt to directly shape the management of the government's debt strategy, the BoE also shifted its overall narrative on fiscal matters into a more confrontational rhetoric. The BoE began 2009 by praising the government for responding to the collapse of Lehmann Brothers "decisively and boldly with large fiscal injections" (King 2009c); while noting that "In the medium term we need to see a rebalancing of the economy in the UK" in a coordinated fashion

[6] A stance the BoE sought to structurally enforce by refusing to buy bonds involved in government auctions (Reuters 2009a).

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with other international players (Gieve 2009). By March and the announcement of the APF, the tone changed and was now a call for 'a clear exit route by which the extraordinary level of official financial support will be unwound as conditions return to normal … [and] a credible commitment to implement the longer term reforms.' (King 2009a). And in June:

> There will certainly need to be a plan for the lifetime of the next Parliament, contingent upon the state of the economy, to show how those deficits will be brought down if the economy recovers to reach levels of deficits *below those that were shown in the* [recent] *Budget figures*. (Mervyn King, Treasury Select Committee 2009, Q.5, *emphasis* added)

Which, after the expansion of the APF to £200bn in October, became a "need—now widely accepted—to eliminate the large structural fiscal deficit" (King 2009e).

This was a narrative largely at odds with the Treasury's stance in the buildup to a general election in which government policy was to 'not put the recovery at risk by reckless cuts to public spending this year' but instead should aim to halve the deficit over the next 4 years (Labour Party 2010a, pp. 3–4). But a narrative entirely in keeping with the BoE's new structural position and needs in managing domestic money markets. The key point here is that the different structural positions of the Treasury and the BoE vis-a-vis money and finance led to conflicts over both key elements of the crisis management strategy and the fiscal direction post-crisis. Furthermore, the reform in BoE strategy and the perceived incompetence of the FSA led the BoE to seek enhanced powers in the emerging regulatory regime to secure its ability to manage money.

Regulatory reform

Northern Rock had triggered a wave of regulatory reforms culminating in the 2009 Banking Act. Within the debates around this initial process the BoE had sought to minimise its potential exposure to financial stability concerns—'I just do not believe that one institution—a central bank—can manage in today's world both monetary policy and the entire range of financial supervision.' (Mervyn King, Treasury Select Committee 2008c, Q.90) The BoE sought to limit the debate to what powers were to be given to the BoE rather than general discussions of responsibility:

> The key thing is not so much the general words; the key thing is to decide what powers, if any, the Bank of England should be given in this area. Once you have answered that question, I think we can find some words to describe it (Mervyn King, Treasury Select Committee 2008b, ev.7)

The Treasury's stance was that the BoE must accept a financial stability role and act upon it (Treasury Select Committee 2008a). Thus, the Banking Act created a statutory mandate for the BoE 'to contribute to protecting and enhancing the stability of the financial systems of the United Kingdom' and that in doing so the 'the Bank shall aim to work with other relevant bodies (including the Treasury and the Financial Services Authority)' (2009 Banking Act, .238 (1)).

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At a time when the BoE was becoming dependent upon legal means to curb financial excess, it was also being legally bound to a new financial stability mandate but with no new powers. Or as the governor put it '[t]he Bank finds itself in a position rather like that of a church whose congregation attends weddings and burials but ignores the sermons in between' (King 2009d). The FSA was rapidly losing credibility as a financial regulator, openly admitting that it was largely to blame for the financial crisis (BBC 2009) and attracting large amounts of criticism for its lack of action from the press and politicians (Financial Times 2009, The Telegraph 2009):

> So although the system continued to work through 2009, 2010, the interests of all the authorities were aligned to ensure there were [no] future crisis. … the issue of a) who was really in charge in a crisis wasn't really resolved and the issues around whether the Bank of England could instruct the FSA weren't resolved either, or at least they weren't resolved to the satisfaction to the Bank of England' (interview, ex-Senior Treasury Official C, May-2017)

However the broader review of the regulatory architecture was placed under the direction of the FSA's chairman Adair Turner (Financial Services Authority 2009) and the Treasury continued to push for a significantly empowered FSA, with the BoE left for now to systemic surveillance, with the option of a 'macro-prudential' toolkit being developed later (HM Treasury 2009). This policy path was hardly surprising given that the Tripartite structure of the Treasury, FSA and BoE had been a flagship policy for the New Labour Government since its inception (Darling 2011) and that the BoE had been unwilling to comply with the Treasury's requests for financial stability action in the recent past.

The BoE's response, once it had become clear that it would have to shoulder responsibility for financial stability while losing its ability to utilise market discipline as a tool, was that the BoE must be fully empowered to be able to manage financial stability: 'with two objectives—macroeconomic stability and systemic financial stability—we need to complement Bank Rate with another tool' (Bean 2009). Specifically, prominent BoE staff focussed on the 'broad consensus that our traditional policy instruments need to be augmented by a "macro-prudential" toolkit' (King 2009d). This should fall under the purview of the BoE, not the FSA, given 'effective delivery of a financial stability mandate requires a rich and subtle understanding of the structure of the domestic and international financial system, and how developments in one part are transmitted to others' in the same way that monetary stability does (Tucker 2009).

The BoE sought to have itself empowered as an independent regulatory authority which would then 'cooperate' with the FSA. This, in a context where the opposition Conservative party had completed a review advocating the abolishment of the FSA and the full empowerment of the BoE (Conservative Party 2009). Despite this, the regulatory agenda pursued by the New Labour government, culminating in the 2010 Financial Services Act, was to solely empower the legal tool kit of the FSA, leaving the BoE uncertain regarding its future role and powers. The FSA then began a 'hard' regulatory agenda and narrative in an attempt to restore its credibility (The Telegraph 2009). This strategy was undermined by the arrival of a general election

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in May 2010 bringing in a new coalition government that was more amenable to the BoE's requests.

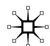
To summarise. 2007–2010 was characterised by two periods of tension between the Treasury and the BoE. In both of these periods, the BoE and the Treasury conflicted due to their differing positions in relation to both money and finance. In both, the Treasury was concerned with maintaining its political legitimacy as an economic manager either seeking to contain the impact of the financial crisis or to retain influence over financial regulation and the option of fiscal expansion. The BoE however was opposed to both of these stances in its attempt to maintain credibility as a monetary manager; initially dependent upon market discipline and thus hard monetary policy, then after Lehman the transition to embedded market management created a dependency on both fiscal austerity and regulatory credibility—neither of which were forthcoming.

Conclusion

With the election of the Conservative party led coalition government in May 2010 the strategies of the Treasury and the BoE were once again coincident. In fact, the incoming chancellor George Osborne was actively concerned with developing a positive relationship with the governor, creating the impression that the BoE could have whatever it wanted with regards to financial regulation (interview, ex-Senior Treasury Official B, May 2017). Alongside this, a plan of fiscal austerity was enacted which proposed more radical action to reduce the deficit than that of the outgoing government, which was then subsequently endorsed by the governor (The Guardian 2010, 2011). Both were quickly enacted.

These reforms however raise important questions as to how the next crisis is to be managed with the BoE as the sole agency responsible for financial stability. Emerging relatively victorious from the crisis, the BoE has become increasingly willing to publicly comment on current affairs such as Brexit. While attracting criticism that the BoE is overstepping its mandate, this has served to enhance the BoE's position as an authority on economic as well as monetary and financial matters. When the next crisis arises, this leaves the BoE with a large amount of power to shape the direction of the response through its control of both the monetary and regulatory tools. Meanwhile the Treasury is left bearing the cost as the ultimate backstop to the deposit guarantee scheme and with the precedent of socialisation of debts as a policy response. However, the BoE is no longer able to easily externalise financial stability concerns and is now deeply embedded in the management of financial markets and thus the ongoing 'One Bank' project of Governor Carney may leave us with a very different BoE to that of 2007.

However, as this article has argued, to assume that the preferences will be, or are, aligned and that a "state" strategy will be launched to deal with future crises is highly problematic. Central banks and finance ministries assume different structural positions with relation to money and finance, and thus face different problems with potentially divergent solutions. As this article has shown, the resulting tensions and conflicts then played an important role in shaping crisis responses after the BoE's



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operational independence and in shaping the initial period of reforms post-crisis. Thus these differing structural positions play an important role in understanding crisis management strategies as well as shaping how finance develops and is structured in 'peacetime'. How these conflicts and tensions are to now play out in a situation of both enhanced power and increased responsibility for the BoE as both monetary and regulatory authority raises the important question of 'to what ends will a future crisis be managed'?

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