

Systemic Policy Partnership

INDEPENDENCE OF THE FINANCIAL POLICY COMMITTEE

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Evidence for an inquiry of the House of Commons Treasury Committee

Introduction and conclusion

This note provides evidence relevant for the inquiry by the House of Commons Treasury Committee into the independence of the Financial Policy Committee (FPC), and the process for appointing the members of the FPC, the Monetary Policy Committee (MPC) and the Court of the Bank of England (Court).

It reaches the conclusion that some improvements could be made which would both enhance the FPC's policy delivery capacity and ensure greater impartiality on the part of the members of the committee. These are

- Revision of the provision that permits members of Court to be members of the FPC
- Stricter qualifications for membership in the FPC to prevent conflicts of interest arising from engagements in the financial sector
- Arrangements to reduce the intertemporal conflicts of interest arising from the revolving door; this would involve increasing the length of the term and raising the age at which members join the policy committees
- Introduction of explicit procedures to manage any trade-offs that arise with respect to financial stability and monetary policy
- Drawing lots to select members of the FPC (and other policy committees) from a pool of vigorously-vetted and highly-qualified candidates

Independence of the Financial Policy Committee

The Financial Policy Committee is a statutorily based committee of the Bank of England's Court of Directors responsible for identifying, monitoring and taking action to remove or reduce systemic risks to the United Kingdom's financial system. It has a secondary objective of supporting the Government's economic policy. Its independence, like the independence of the MPC or any other policy committee is not an end in itself. It is a mechanism to permit effective policy delivery.

The rationale for independence for the FPC differs in some important respects from that for the MPC. In the case of monetary policy, decision makers need to be shielded from the undue influence of politicians who are subject to a different set of incentives and have a shorter time horizon. It is easier to give the MPC functional independence because it can be given a clear, quantifiable objective that the central bank can achieve as long as the country's public finances are soundly managed.

The FPC has to be shielded from two sources of influence – financial and political. The financial industry has a strong incentive to shape the FPC's recommendations since they can radically

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alter both the overall profitability of the industry and its allocation. No equivalent incentive exists in the case of the MPC. In addition, the FPC needs to be shielded from undue political influence for the same reasons that the MPC does.

It is also more difficult to provide the FPC with the appropriate degree of independence. First, the type of expertise that members need often resides with financial industry participants, who are subject to potential conflicts of interest, both concurrent and intertemporal through the “revolving door”. Second, it is more difficult to hold the FPC to account. This is because there are important tradeoffs with other public policy goals, because the FPC’s objective is not subject to any form of simple, quantitative measurement and because its success or failure depends on actions of others. The FPC does not control many of the tools needed to deliver financial policy; it simply has the power to recommend action by others.

One important interface is with monetary policy, which is the prerogative of the MPC. Unlike the FPC, the MPC is not a committee of the Court, and rules for membership differ. There are no explicit mechanisms for coordinating the policy decisions of the two committees, but there are extensive implicit ones arising from common chairmanship (the Governor) overlapping membership of Bank of England officials and support for both committees provided by the Bank. It would be desirable to have explicit arrangements to identify, evaluate and manage trade-offs in this area, as well as in others.

Conflicts of interest

The Bank of England has well developed codes of conduct for all its policy committees and for Bank of England staff.² They are among the most rigorous that exist and are broadly fit for purpose in dealing with concurrent conflicts of interest.

One anomaly that currently exists is the provision that members of Court can serve on the FPC. This creates a potential conflict of interest, or at least the appearance of one, and reduces the effectiveness of oversight by Court of the FPC. Although dual membership in the two bodies would foster information flows, the disadvantages outweigh the advantage.

A more insidious and possibly more intractable conflict of interest arises from the “revolving door”. Members of the committees may use the experience they obtain on the policy committees to enhance their subsequent careers. Members of policy committees have noted such behaviour on the part of their peers. It is made worse by the fact that the terms of office are short and turnover on the committees is high.

There are several methods for dealing with this problem. One is to impose cooling off periods on members. Such provisions are common in central bank codes of conduct that apply to ex officio internal members, but they are less common for external members. The code of conduct for FPC members applies for three months after they leave the committee. This addresses the problem, but does not solve it. The difficulty with this approach is that such provisions, if too draconian, will deprive individuals of the right to pursue a trade.

A second way to deal with this problem is to extend the length of the term of office. In this way the door continues to revolve, but at a slower speed.

Still another way to deal with the conflict of interest is to set a minimum age for membership or to use qualifications that achieve the same end. This was common in the past. For example, the US constitution imposed an age floor of 35 years for the president of the United States at a time when life expectancy was under 40 years. The effective age floor for the position of consul was even higher (41 years) under the Roman constitution of the first century BC. Given modern life expectancy the age floor today would be well above the normal retirement age. Introducing an age floor or qualifications that have the effect of raising the age of those selected to serve on the FPC would help.

Appointment process

The effective delivery of public goods requires appropriate institutions, procedures and people. No matter how well designed the institutions and procedures are, the delivery of public goods

² See for example <http://www.bankofengland.co.uk/financialstability/Documents/fpccoc.pdf>

will be hampered if the right people are not in place. The experience of Thailand is a case in point. The Bank of Thailand Act of 2008 separated the position of governor and the chairman of the board, and the procedures for selecting incumbents meant that they held different views on appropriate policies and engaged in public debate on them. Owing to the operation of the procedures for appointing the governor and the chairman of the board, individuals with different views on policy were appointed to the two posts. The public airing of differences of opinion between them was detrimental to the central bank's reputation and policy delivery.

The UK has a very well articulated, professional and transparent set of procedures for making public appointments. They derive ultimately from the Crown Appointments Act of 1661 that makes such appointments a royal prerogative and therefore, given the UK's form of government, accords the relevant minister a more significant role than in other political systems. In the case of the Bank of England, the challenge is to reconcile the need for impartiality and independence with the need for accountability and legitimacy.

The difficulty with the arrangements now in place is that whenever one decision-maker has the final say on the appointment of an official, there is a risk that the decision will be skewed by the individual's own interests or policy preferences. This is the essential insight of public choice theory. A variety of techniques exist to correct the distortions that arise, including the use of "double key" decision making as in the United States where appointments to the Federal Reserve board by the President must be confirmed by the Senate. However, in the case of this country, the arrangements sometimes lead to gridlock and discourage qualified individuals from seeking public office. This is not simply because of the current divisiveness and partisanship but also because parliamentary procedures prevent individual senators from blocking legislation but permit them to block decisions on appointments. Senators sometimes use the confirmation process tactically to achieve other objectives.

Another way to check the undue use of ministerial influence is to draw lots to determine which member of a pool of highly qualified candidates will be appointed. The technique has been used for centuries to ensure fairness. It was employed in ancient Rome to allocate functions among Questors and in the 18th century to appoint professors at the University of Basle. It is not more widely used today because it reduces the scope for patronage; those who have the power to appoint also often have the power to block the adoption of procedures that would deprive them of this prerogative.

For the technique to work, it is important for all those in the pool of candidates to be well qualified. In fact using the procedure tends to increase the number of such candidates. This is because it is more likely that qualified people will put their names forward since failure to secure an appointment is not a sign of disfavour or of a public judgment that the person is not up to scratch.

In the case of the FPC, the technique could be used together with the current open and robust procedures for drawing up long list of potential candidates and then giving Parliament the opportunity to vet and veto names going into the pool. The relevant minister would then draw lots, after which a crown appointment would be made.