Mervyn King, the Governor of the Bank of England, was interviewed by Robert Peston, BBC Business editor, for a File on 4 special on Northern Rock to be broadcast tonight at 8pm.

<u>TRANSCRIPT OF INTERVIEW for FILE ON FOUR</u>

<u>ROBERT PESTON interviewing MERVYN KING</u>

RP: For a number of months the Bank of England had been warning the City and banks that some of the investments they made might not be so splendid – and there might be a liquidity problem. What prompted the Bank that there was a potentially big problem looming?

MK: Well we'd been through a decade of extraordinarily low interest rates and that had encouraged people to invest in more risky and exotic instruments in order to earn the sort of rates of return to which they had become accustomed before we moved into a low inflation, low interest rate era. And people managed to persuade themselves that perhaps they weren't taking such large risks and they were persuaded to buy and take onboard these new and complex financial instruments, which turned out to be both riskier and much more opaque than the investors had originally understood. And we said that because these instruments were both riskier and more opaque and complex, it was quite possible that one day the markets in those instruments would become illiquid. And hence, the ability to sell the instruments and realise cash would be diminished. And many banks were taking risks by building their strategy on the assumption that the markets in these instruments would remain continuously open and they would always be able to buy or sell them. And on the 9th of August the liquidity in those markets just dried up.

RP: Was the severity of the crisis on August the 9th worse than anybody here could have expected?

MK: I think that's very hard to judge because when you identify risks you don't always put a precise number on how bad it would be. But I had spoken in June at the Mansion House dinner about the real risk of the liquidity in these markets drying up - and it did dry up. And at that point the banks realised that they were exposed to what we call maturity mismatch: they'd borrowed short to lend long. And the scale on which they've done that turned out to be much greater than they had anticipated, but I think it's worth recognising that this wasn't a major issue for the banking system as a whole. Many institutions will now realise losses, many of these complex vehicles that were created, into which the instruments were sold, will close down and be sold off, some people will lose money. But that often happens when financial markets turn down. The regulators around the world have said, and they still maintain this today, and I think they're right, that for the major banks in the world, they have the ability to cope with this crisis - not without losing money, not without losing bonuses and in the case of some individuals not without losing their jobs - but nevertheless, it isn't a threat to the banking system as a whole.

RP: Given your warning at the Mansion House, was what happened within the range of outcomes that you thought might happen?

MK: I think it probably was though, as I say, when you think about what could go wrong in the financial system there's almost an infinite number of outcomes that could occur. But the idea that it would be difficult to convert some of these instruments into cash was very much one that we had flagged over many years. One of the lessons for us in all this is that we need to find much more effective ways of making people listen when we flag risks in advance.

RP: One of the things that happened in 1997 was that the Bank of England got a lot more authority over interest rates and inflation – but you gave up the direct supervision of financial institutions to the Financial Services Authority. If you'd been making these warnings back in the 80s, would you have had more impact?

MK: I think that's impossible to judge, and the world itself has also changed a lot over the last 10 or 15 years. But I think what we have to do is to learn how to make these warnings more effective in forcing banks and supervisors and others to take these warnings seriously by trying to find some way in which people have to feed back and react to them. That's an important lesson for us. We did raise warnings, we did point out there were risks but many of the people who suffered those risks, they were conscious I think of many of those risks but they decided that they were prepared to take them. And I think for big banks they were able to take some of those risks because they knew that if the markets became illiquid they might loose money but they'll be able to balance that against the profits that are made on other kinds of banking activity. The problem that faced Northern Rock was that it didn't have any other real kind of banking activity and although the risks it took were not dissimilar in nature from the risks that other bigger banks took, they were much more serious for Northern Rock because essentially it was just a mortgage bank.

RP: Was August the 9th a big day at the Bank of England? Were you aware of what had happened within banking markets?

MK: Well certainly we couldn't have said with certainty that the events over the next couple of months would pan out as they did, no, but it was certainly an important day there's no question about that. And it began with the revelation of losses in a major French Bank's investment funds and it followed with a very large injection of liquidity by the European Central Bank. And many people were surprised by that and asked a question, well what do they know that we don't? So in markets that day there was a very big disturbance, and almost immediately contacts between the Central Banks around the world started and we would not normally be in daily contact, regular contact, yes, but not daily contact. But from that day onwards daily contact pretty well started.

RP: So that was the beginning of this saga?

MK: You can you can date it both from then and looking back very clearly that was the beginning of the saga. Though of course, the problems which evolved were created by actions taken well before the 9th of August, in terms of the risks that the banks took and the failure to take out insurance to deal with them. The problems were created by the failure to take the appropriate action before the 9th of August.

RP: August the 14th was the day that regulators and the Bank of England learnt about Northern Rock's problems. Do you remember what you thought when you learnt that Northern Rock had this issue?

MK: No and it was it was not a meeting I was involved in, it was a meeting of the deputies in the three institutions: FSA, Bank and Treasury, at which the FSA relayed to the Treasury and the Bank of England the news that in their judgement Northern Rock did face potentially serious problems. And of course there was always a hope - as you know looking back things looked clearer, but at the time looking forward nothing was inevitable. I think it was clear that Northern Rock was a bank that was running out of money, but there was always a hope that it might find it from somewhere, maybe it would be able to sell some of its mortgages, maybe it would be able to persuade someone to lend to it. There were a number of ideas that were floating around, very few ever materialised.

RP: When did you think it was likely they would have to draw on the Bank of England's lender of last resort facilities?

MK: Well not long after we heard about their difficulties, because in talking about how they might get out of it, it became clear that Northern Rock was already facing a bank run. Not the kind of bank run that you and I might normally think of, in which the retail depositors queue on the streets to get their money back, but a bank run nevertheless in which the wholesale funders, other banks or money market funds lending to Northern Rock. When the loan that they made for 1 week or 1 month came up they just did not rollover the loan and bit by bit the funding, the wholesale funding to Northern Rock, started to ebb away.

RP: At that stage how much did you estimate Northern Rock would have to find, in order to cover these borrowings from the money markets that were not being replaced?

MK: Well we thought that it was of the order of about 30 billion pounds was the amount that they would have to find, they might have found a bit of that from various sources, very short term overnight borrowing. But I think it became clear quite quickly that the bulk of that funding, say 20 to 25 or 30 billion pounds, would have to come from the Bank of England. You might have hoped that in times gone by the big banks might have been willing to club together to lend, but it would not have been reasonable to expect them to do it in August when they themselves were having to accumulate liquidity to meet their liabilities to fund obligations or the Special Investment Vehicles which they'd setup in order to place these complex financial instruments, so it became clear that Northern Rock required a very, very large sum of money.

RP: Now Adam Applegarth has explicitly said to the Treasury Select Committee that if Northern Rock had had access to the European Central Bank's liquidity provision that he didn't think they would have had the same difficulties – that Northern Rock was a victim of how you supply liquidity to the market. Is that fair?

MK: Well I don't want to accuse anyone of being misleading, but I find that very hard to square with the facts. If you look at what the European Central Bank lent to banks through their auctions that they conducted, relative to the size of the banking system they lent an average of 230 million pounds per bank participating in their auctions. Northern Rock needed something closer to 25 billion, 100 times larger than the average amount which the European Central Bank was lending to banks through their auctions. The scale of the funding that was needed was staggeringly large.

RP: You must have run through the range of options open to you. Why did you not just let Northern Rock collapse?

MK: Well it's its true that in some countries there is a system in which it's possible to intervene pre-emptively and take the retail depositors out of the bank and transfer their accounts to another bank. And its very attractive to have that facility because if we'd have had that power that is something that I'm sure we would have exercised or the FSA would have exercised at the point when we gave the lender of last resort support to Northern Rock, because that would have prevented a retail run on the bank. We don't have that power in Britain. We need it. That's one of the lessons of this. So to allow Northern Rock to fail would have meant to put the bank into administration. And once the bank had gone into administration the retail depositors would have been locked into it into a process while the administrator of the banks sold off the assets and worked out how to repay the various creditors. And the retail depositors would have been unsecured creditors, on a par with all other creditors, and it would have taken them easily a year or possibly more to get their money. That, after all, is exactly what happened in the case of BBCI and later Barings, but this was a bank with a large number of depositors it would have been a very difficult operation. It would have been deeply unfair on the retail depositors to allow them to suffer in that way, so again we need a system in this country in which we can prevent the retail depositors from being trapped. The United States has a system, Canada has a system, other countries have a system - that's why we could not allow Northern Rock just to fail.

RP: Was there a moral hazard issue in terms of how you dealt with Northern Rock? Unlike Countrywide they didn't have backstop insurance. Had Northern Rock's management made a silly mistake?

MK: Well I don't think we go into this trying to punish people for judgements that they made before. What we want to do is to give incentives for people to behave properly, so in judging the interest rate at which we lent to Northern Rock we asked ourselves the question: "At what interest rate would they have to pay in borrowing from us today that would make them regret not having taken out an insurance policy as Countrywide did before the 9th of August?" If we had lent to Northern Rock at no penalty rate at all then they would have said, well that's terrific, it would have been a waste of money to take out insurance before the 9th of August. It is very important that we give incentives to banks to make them realise that it pays them, it's profitable, to take out insurance before the risk actually crystallises. And that's the basis on which all insurance systems operate. If you always compensate people ex post when the risk arises no one would ever take out insurance ex ante.

RP: This was a bank suffering a wholesale run. Your view was that 20-30 billion would be withdrawn over some months. Was it possible to deal with that through normal money market operations?

MK: No the scale of it was absolutely impossible. And I think the difficulty we faced was either we could try to carry out some money market operation or auction of liquidity where we tried to rig the auction in such a way that Northern Rock got all of it, such that at the overall scale of the auction would not have looked out of place. But the press by that stage had become very adept at discovering which banks were accessing our facilities. And its easy in 1hr to ring round all the banks that access our facilities, so it wouldn't have been possible to keep it secret and therein lies the tale because it was not the fact that we lent to Northern Rock that was the problem, it was the fact that the retail depositors learnt that fact and realised for the first time that there was something wrong with their bank. So I think trying to do it in that way would merely have alerted the retail depositors and the result would have been the same. So could we have had an auction that was sufficiently large that all the banks would have got 20 to 30 billion and Northern Rock wouldn't have been noticed in that process? Well, that would have been an auction on a scale 50 odd times that which any other Central Bank had engaged in. And I'm absolutely convinced that the first question you would have asked on that day is: "What on earth must have happened to the entire British banking system to have merited an auction of that size?" We were doing this not to bail out the British banking system, which didn't need bailing out, but actually to get money into one institution that needed it. And there is a difficulty in doing that when, the retail depositors, once they learn of this fact, then, because of the absence of a framework for deal dealing with retail depositors, then have an incentive to carry out another bank run on the bank.

RP: As a separate issue, in early September there was a lot of pressure from other banks for you to provide liquidity in different kinds of ways – by exchanging other kinds of assets for funds, and by borrowing for a longer period. You judged it wasn't appropriate to do that. Why did you take that view?

MK: Well the role of the Bank of England is not to do what banks ask us to do; it's to do what's in the interest of the country as a whole. And we took the view that bailing out those banks that have taken the biggest risks will provide no incentive in the future to avoid this happening all over again. And I remember very clearly being telephoned by more than one bank and being told: "We got out of the market in these strange instruments two years ago, and the financial press we said we weren't very exciting and we weren't growing as quickly as other banks and we made less profit. Our time has now come - the other banks that did take the risks are having to accumulate liquidity and cutback on their lending in order to do so. But now, because we were more prudent in the past, now we can expand. If you bail out the banks that took the risks then you'll undermine any incentives that we had to be prudent." And so it is important to give incentives to banks to behave prudently and if they take risks to recognise that they have to bear the consequences of those risks, because they had made the profits in the years leading up to this year. So it is important to ensure the incentives are there for banks to realise that they have to take the consequences of the risks that they undertake. That is what happens in any other industry.

RP: A few days after the run on Northern Rock you then did provide a 3-month facility, and say that banks could swap mortgage assets for this money. And you did charge slightly more than the best rate for it, and in the end it wasn't taken up, but what was your thinking?

MK: Well the thinking was that after the run on Northern Rock, and the impact of the television pictures, it became evident that many of the funders of British banks around the world were no longer fund willing to fund British banks, so we felt that, provided the banks were willing to pay the penalty rate, that we should make sure that they did have access to the liquidity. But they weren't being bailed out because they were having to pay more for the money than if they had taken out the insurance beforehand, so those banks that had behaved prudently were not having to pay as much money for this special liquidity as the banks that really needed it and that facility was there for those banks that really needed the money. As it turned out no one really did need the money, but if they had been willing to borrow they could have had it at the penalty rate.

RP: What a number of banks said to me was that it would have looked like desperation to borrow from you, and there would have been a stigma attached to it. Their names would have leaked and much worse consequences would have followed, so they didn't dare borrow.

MK: Well that is one of the consequences of failing to take out insurance beforehand. And if you don't take out insurance and then you want to be bailed out you really have to be prepared to be visibly as someone who didn't take out insurance and now needs the facility, but the question of stigma is an important one and its one that we'll be looking at, over the coming months, to try to ensure that in our operations banks can access our facilities at the rate that we charge without suffering an additional penalty in the form of a stigma. But I don't believe that actually the banking system as a whole needed that money. And if you look at the position now towards the end of October compared with the position in August all the major banks in this country have very much more liquidity than they did then. There has been a very significant increase in the liquidity position of all our major banks.

RP: The chairman of one big bank said to me he was very concerned about the impact of the pictures of the run on Northern Rock. His bank is dependent on overseas funds to an extent. And he said that in the aftermath of the run… well he describes them as 30 year olds with Harvard MBAs in Wall Street or Dubai who control pools of money, these people decided they were not going to place their money with UK banks. I mean how serious do you think it got at that stage?

MK: I don't think it lasted very long at that stage, that was very much an instinctive reaction. But it does show the need to be careful about whose money you depend on.

And it'll be nice to feel that prudently managed banks didn't feel that their immediate survival depended on the bunch of people who thought no more deeply about the banks to which they lent than looking at pictures on television. Because the balance sheets of the banks had not changed. And I think that the lesson in this is that in recent years a number of banks - not all banks by any means - but a number of banks decided to grow quickly on the basis of this wholesale funding, from wherever they could find the money, and they didn't think clearly about whether the liabilities they had to the people who provided the money could easily be matched by the sales of assets in which the money was invested and they were taking a risk. And if you take risks you need to cover those risks, or take out insurance, and if you don't then one day that risk will materialise and you'll pay the price. And it's not the role of the Central Bank to bail out people who takes unnecessary risks. In just the same way as the government doesn't bail out manufacturing companies that take risks and their product fails.

RP: Northern Rock and members of the Treasury Select Committee have said you weren't consistent. The weekend before the provision of the lender of the last resort facility, Northern Rock was in negotiations with Lloyds TSB, to sell itself to that bank. But that a condition imposed by the potential buyer was that the Bank of England should guarantee that if certain funds were withdrawn you would replace them. And you refused. Then only a few days later you provided support to Northern Rock. Why wasn't that an example of double standards?

MK: Well that's not what happened; let me tell you what happened. On the weekend before we granted the facility to Northern Rock, I was asked whether if a certain retail high street bank were to make an offer or a bid for Northern Rock whether we would be prepared to lend that bank 30 billion pounds, at the bank rate, for about 2 years. And I think what that did was to demonstrate that our original view that it was not possible to save Northern Rock without a large injection of money on that scale was clearly right and I understand perfectly well why the bank wanted that facility. But I said to the Chancellor: "Well look this is not something which a Central Bank can do, they don't normally finance takeovers by one company for another let alone to the tune of 30 billion pounds, which is rather a large amount of money." So I said: "This is a matter for government, but you have to recognise that if you were to make available such a facility to one bank, you would have to make it available to any other potential bidder and therefore it will become public." And I don't think it took the Chancellor very long to recognise that not only was this something which Central Banks don't do, it's also something that governments don't do.

RP: You have thought about depositors' insurance over many years. And some years ago you came to the view that there were risks in not providing certainty to depositors about their money – and also the issue about how quickly depositors can get their money in a crisis. So in the week that you were providing the loan to Northern Rock, presumably you were aware that there was a risk that retail depositors will take fright. Did you say to the government at that stage, I think it'd be a good idea if you're prepared to provide 100% protection, because of the risk of this run?

MK: When we discussed whether or not such a facility should be made, I gave my independent advice to the Chancellor and he thought we should grant the facility. When the bank run started I made very clear my view - that the only way to stop the bank run was to give a government guarantee and that was the argument that I made and that was the only argument that I wanted to make at that stage. I thought considerations of a takeover bid were irrelevant at that point because it takes many weeks in this country to organise a takeover bid and to get to the point where the shareholders of quoted a company have voted to decide that it's company A or company B that is going to buy their company. And so the only way to stop the run quickly was to put in place a government guarantee and that was the one point that I made.

RP: But did you pre-emptively say to the Chancellor: "Before – or at the same time as - we announce the lender of last resort facility we also ought to announce a 100% guarantee?"

MK: Well I don't want to go into all the conversations that took place and I think one thing that is worth pointing out is that it was not inevitable that there would be a retail run, it was certainly a risk but there was no easy way of predicting how the retail depositors would react. If they had all reacted in the view that now that the lender of the last resort facility's there, it's safe to leave the money in, then there wouldn't have been a retail deposit run. These things are very fragile. Once the run starts it was then rational for other people to join in, but it could have gone either way at the outset, it was not inevitable that depositors would queue up on the street to take their money out.

RP: Was it a risk worth taking?

MK: Well what was the alternative? The bank had run out of money.

RP: Wasn't the alternative that at the moment that you put the lender of last resort facility in place you also announced 100% protection?

MK: That was the alternative yes.

RP: But why didn't that happen until Monday night?

MK: Well I think a lot of things were going on very quickly. The facility was agreed on the Thursday, it then was announced early on the Friday morning. The Chancellor and I then went to the ECOFIN meeting. Over the weekend a lot of debates took place about a range of issues: the bid, a guarantee, people had different views to what the right answer might be, as the Chancellor made clear at the Treasury Committee. The view that I expressed to him was that we needed a government guarantee, but of course one of the practical problems of doing this, and the reason why it could not be done in a matter of hours, was to workout what the phrase there is a government guarantee actually meant. And the lawyers had to be consulted and in all of the aspects of this, it's very natural and understandable that government has to consult their legal advisors before knowing what they're able to say and what the words actually mean. And it did in fact take quite sometime to workout precisely what, in very detailed terms, the government guarantee actually meant.

RP: But did you make a formal recommendation earlier in the week that the Treasury then turned down? Was it the Treasury's view that you had to suck it and see before giving a guarantee?

MK: I think, I think there were a range of possibilities were on the table, which included a government guarantee, but many other possibilities were on the table. They were all being examined and the lawyers had a lot of things to say over the weekend and people were spending a good deal of time trying to work out what form such a guarantee would take that could be made sensibly in a way that didn't create further problems down the road. And even once the guarantee had been made on the Monday; there were still unresolved questions about precisely what was being guaranteed. And I think its very natural and understandable that the lawyer said, well hang on a minute, make sure you know exactly what it is that you're guaranteeing before you go on television and tell people. And the chancellor did, I thought, went out and tried very hard by appearing on television to reassure the depositors, without going further than his legal remit, to make a guarantee until it had actually been finally drawn up.

RP: So there wasn't a moment in which on the Monday or Tuesday before the lender of last resort facility was put in that you formally gave advice to the Chancellor that he should provide the 100% guarantee and they said no?

MK: No, there was there was never a moment like that at all. There were always a range of options and I think one of the things that it is worth trying to remember, if you look back now certain events appear inevitable, but very few were inevitable. And at the beginning of that week I think we were clear that we would be likely to have to extend lender of last resort support, but it wasn't inevitable and it was really only on the Thursday, when we actually did it, that we knew that it was inevitable so we had to do it. The timing of it wasn't decided until that day and a lot of other questions then naturally followed from it. When you're actually in one of these situations and dealing with it in real time there are always lots of options and nothing seems inevitable - it's not easy to predict the future. Looking back certain things seem a lot clearer.

RP: In your long and illustrious career is this – in terms of the pressure on you as an individual – one of the most stressful and biggest things you have had to deal with professionally?

MK: Well I think the reaction to it has been, yes. I don't think the events leading up to the decision were the most stressful in my career, no. But I think that the media storm that followed, anyone who's been through that will tell you that it's a stressful period, but you learn a lot about yourself and others around you and how to cope with it. But it was certainly a difficult time for everyone concerned. And I think in many ways the… what was so difficult to predict was the impact which the television pictures sent around the world of people queuing in the street would have on sentiment and opinion. I don't think that was something which was entirely easy to predict. I've said I didn't think the run itself was inevitable though it was clearly a risk, and had been flagged, but the consequences of the run in terms of what it would mean on television was something that was hard easily to imagine it in advance. And in my judgement, it was the consequences of that which meant that people felt so strongly for a period, but as time goes by I think they're beginning to see it in perspective. The British banking system has not collapsed, it's come through, and we will come out of this with new legislation, which will give the regulators an opportunity to intervene pre-emptively, earlier than we were able to on this occasion, with better deposit insurance arrangements and with a better focus in the future on the regulation and management of liquidity. I believe that by the time we get to the middle of 2008, people overseas will look back at this and say well we learnt ourselves a lot of lessons about our own banking systems from what happened in the UK. And actually, they have now got probably the best framework for the management of banks in place because they've put in new legislation and the banking system is inherently very strong.

RP: Given that you only use the lender of last resort facility where you think that there is the risk of serious damage to the economy, and indeed potentially systemic damage to the banking system, what was the risk that you were pre-empting Northern Rock by providing this facility?

MK: What we were worried about was that if the depositors in Northern Rock had suddenly found that all their deposits were frozen for an indefinite period because the bank had literally run out of money and had been put into administration, then depositors in a range of other banks in the UK might have said: "Gosh, could that happen to my bank, are my deposits safe?" And they might well have been a run on a range of smaller to medium sized banks for by people who took their money out and put it in two or three very big banks that they thought were safe. And this was a potential systemic risk that would have caused immense damage to the structure of the banking system, because a range of institutions, a large number, might have found themselves victims of people who felt nervous about whether their deposits were safe because they had seen a bank in which the retail depositors got trapped.

RP: How fragile do you think the banking system still is?

MK: Things have improved significantly since August, when the crisis began. We're not back to normal in terms of a number of important financial markets, but things are improving. And I think that most people expect that we have several more months to get through before the banks have revealed all the losses that have occurred, have taken measures to finance their obligations that result from that. But we're going in the right direction. And so there is always in a period like this the possibility that a shock from outside the UK, one from the world economy, might create further fragilities but that's… To some extent there are always risks, there are always fragilities. What I would say is that the situation now is in my view different from that in August though it's not without risk.

RP: Is it possible do you think to remove the stigma from a rescue operation of this sort given the world in which we live where it's almost impossible to keep anything secret?

MK: Well I think the phrase you used there is it possible to remove the stigma from a rescue operation? And I think the answer has to be that if someone needs rescuing and you can't keep its secret then, is it better to rescue them or are they going to say: "Please don't rescue me because I don't want the stigma of people knowing that I need rescuing". That is the dilemma and I think the answer to that is pretty clear. If you're drowning, you'd prefer someone to rescue you than to demonstrate that you can't swim by drowning. And I suspect that when the problems are serious enough the problem of stigma becomes less important.

RP: Is there anything that you could do to modify the way you provided help in order to make it slightly easier – is the current institutional framework quite right?

MK: Well we shall certainly review the way we conduct all our operations, whether it's normal money market operations, or special auctions, or standing facilities. All of these we will review extremely carefully and maybe we can find improvements which will make it easier to operate in the future. But we will it do both within the Bank of England and also by talking to the market and the banking system about the lessons they've drawn from this episode. Because the most important thing in the end is that we all learn the lessons from this episode.

RP: Hindsight's a wonderful thing - reviewing the events since August the 9th do you think there is anything you or the bank would have done differently?

MK: I think there are many things we might have done differently, I think we would have tried much harder to make sure that people understood and took account of the warnings that we made in the years leading up to August this year. I think we would have put much greater weight into our arguments, public weight into our arguments, for the need for banks to take greater account of liquidity and for that to be incorporated into international regulation as well. I think we would have pressed even harder than we did, and we did press pretty hard, to inject some urgency into the need for new legislation to enable there to be a procedure for pre-emptive intervention in banks and the reform of deposit insurance. I think that in terms of the way that we operated in August, I wish I had communicated earlier than I did during the month of August…

RP: What do you mean by communicated?

MK: I think people probably felt that I was not out there explaining what the Bank of England was doing in the way that some other Central Banks were. I was conscious of the problems that could arise if all Central Banks were crying disaster and I wanted not to exaggerate the position and I think I would have encouraged the earlier setting up of a joint team between the FSA and the Bank to deal with the problems of individual institutions. Now we didn't do that, because the memorandum of understanding that we were given in 1997 made it very clear that the Bank of England should not get involved with individual institutions. And in some cases that's right, but when there's a liquidity problem, I think it's inevitable that we get involved.

RP: And when was that joint team setup over the summer?

MK: Well that was later in August. And in the end it was more a question of collaboration among the tripartite authorities.

RP: But on the narrow point of the use of your money market facilities and the way that you rescued Northern Rock, you feel that looking back on it, you behaved in a rational way and that that is not something you think you would have done differently in retrospect?

MK: That that is right and I've thought about it very deeply, I feel that the attitude we adopted towards both our money market operations where we tried to keep the overnight interest rate close to bank rate, and were as successful as that as any other Central Bank and more so than some. I think the way we did our money market operations could not have been changed in a way that would have helped Northern Rock and I think that we did feel strongly that it would not be right to bail out imprudent banks, we didn't do that. And in the end we had to take an action to protect not the shareholders in Northern Rock, not the managers, but the retail depositors. And so far no retail depositor in this country has lost a penny in this episode.

RP: Why didn't either you or Callum McCarthy appear in public on the Friday, Saturday or Sunday and talk about how you felt that Northern Rock was basically sound? You've both got particular authority and insight.

MK: For the very simple reason that at that point in the absence of a government guarantee it was actually rational to queue up and take your money out. And it would have been dishonest for us to have pretended otherwise. I thought the Chancellor was extraordinary successful in giving what reassurance he could given that at that point he didn't know how far he could go in giving a government guarantee.

RP: You couldn't stand up and say you've got nothing to worry about because if you'd have been in their position you would have taken the money out too?

MK: Well I wasn't in their position, but I think it would not have been possible to say to them: "You have complete reassurance, don't worry, you can go home." It would it would have been dishonest to have said that.