RESEARCH PAPER 08/19
19 FEBRUARY 2008

Banking (Special Provisions) Bill

Bill 73 of 2007-08

This Bill gives effect to the Government's plans to take the Northern Rock Bank into public ownership.

Timothy Edmonds

BUSINESS & TRANSPORT SECTION

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Summary of main points

Northern Rock Bank, once regarded as one of the best and most efficient mortgage lenders in the country, got into severe financial difficulties in September 2007. It was forced to seek emergency funds from the Bank of England. Its normal source of mortgage funding was via the wholesale credit markets, however, during the summer of 2007, the impact of a worldwide 'credit crunch', cut off Northern Rock's normal credit lines.

Whilst effectively keeping the bank afloat, the Government tried to find a permanent, private sector buyer for the bank. It failed. Neither of the two remaining bidders could meet government conditions respecting the profile of repayments of public loans or a satisfactory sharing of likely risk and future profits.

This Bill is the consequence of that failure. It provides for a mechanism by which the Treasury can nationalise the Northern Rock Bank. The Bill includes powers for the transfer of ownership, sets out conditions (and a time limit) under which such powers may be exercised and deals with the manner in which compensation for existing shareholders will be calculated.

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I Northern Rock Bank: rise and fall

A. Northern Rock

The Northern Rock bank (NRB) was one of several[1] building societies which de-mutualised in 1997. Then members of the society benefited to the extent that they were given 500 shares (some individuals received two allocations) worth about £1,500 on flotation (and £6,250 at the share's peak in early 2007).

It was the seventh largest building society with assets of £13.7 billion. It had a 2% share of the total mortgage market but was already seeking to expand this, taking a 9.7% share of new lending in 1996. In 1997, it was described as "arguably the most efficient lender in the business".[2] The new bank differed from some of its contemporaries. It had a business plan which focussed upon mortgage lending "the aim is to create a virtuous circle in which lower costs lead to more attractive offers for savers and borrowers"[3] rather than diversifying into associated activities such as estate agency or insurance. Also, fatally, its funding strategy relied more heavily on wholesale market instruments – securitisation – than retail (savers) deposits.

NRB became a very successful company. It joined the FTSE 100 and had expanded rapidly in the mortgage market as the table below shows:

Northern Rock: Profits, Turnover and Mortgage Lending 2002-2007
£ million

	2003	2004	2005	2006	2007 H1
Annual Profit (£ million, before tax)	387	435	494	627	296
Residential Lending (Mortgages)					
Total Mortgage Lending Outstanding (£million)	na	48,662	62,257	77,292	87,393
Market share (Gross Lending, %)	5.4	6.8	8.1	8.3	9.7
Market share (Net Lending, %)	7.7	11.2	14.5	13.4	18.9
Market Share (Overall stock, %)	4.8	5.5	6.4	7.1	7.6
Funding (totals, £million)					
Retail (deposits)	16,343	17,290	20,104	22,631	24,350
Non-retail	16,976	19,740	22,253	24,240	26,710
Securitisation	15,700	22,090	31,156	40,226	45,698
Covered Bonds	0	1,339	3,830	6,202	8,105

Notes: Na - not available

Sources: Annual Reports: 2004-06, see: http://companyinfo.northernrock.co.uk/investorRelations/corporateReports.asp
2007 Interim Results (to 30 June 2007), published 25 July 2007:
http://companyinfo.northernrock.co.uk/investorRelations/results/stockEx070725.asp

1 The others that year were Halifax (now part of the HBOS group), Woolwich (taken over by Barclays) and the Alliance & Leicester.
2 Financial Times 2 September 1997
3 ibid

NRB's interim results were published on 25 July 2007. The summary from the Chief Executive said:

> Operationally NRB had a good first half in 2007. Mortgage lending has been particularly strong with a gross market share of 9.7% and a net market share of 18.9%, helped by improvements in retention of home moving customers, keeping customers coming to the end of their product deals and a strong mortgage market. Credit quality remains robust.
>
> The outlook for the full year is being impacted by sharp increases in money market and swap rates seen in the first half. This has resulted in a negative impact on net interest income as mortgage pricing in the market generally has lagged behind increases in funding costs in the year to date. Action has been taken with changes in our swap transaction policies to minimise exposures in the future to significant changes in interest rates.
>
> We are pleased to have achieved approval for use of our Basle II rating systems. This means that the benefits of Basle II enable us to increase our 2007 interim dividend by 30%. Going forward our dividend payout rate increases to 50% of underlying EPS from around 40%. Future capital planning, including the reduction of capital hungry assets, will allow us to return capital to shareholders through a share buyback programme.
>
> The medium term outlook for the Company is very positive"[4]

In period leading up to the 'troubles', press comment had focussed upon the profit warnings given by NRB; the mistake acknowledged by the bank in not ending fixed rate mortgage rates sooner; the scale of the promised share buyback and the likely fall out from higher rates of 'bad loans'. A representative article, typical of many at the time, summarised the views of city analysts on NRB ahead of their summer results:

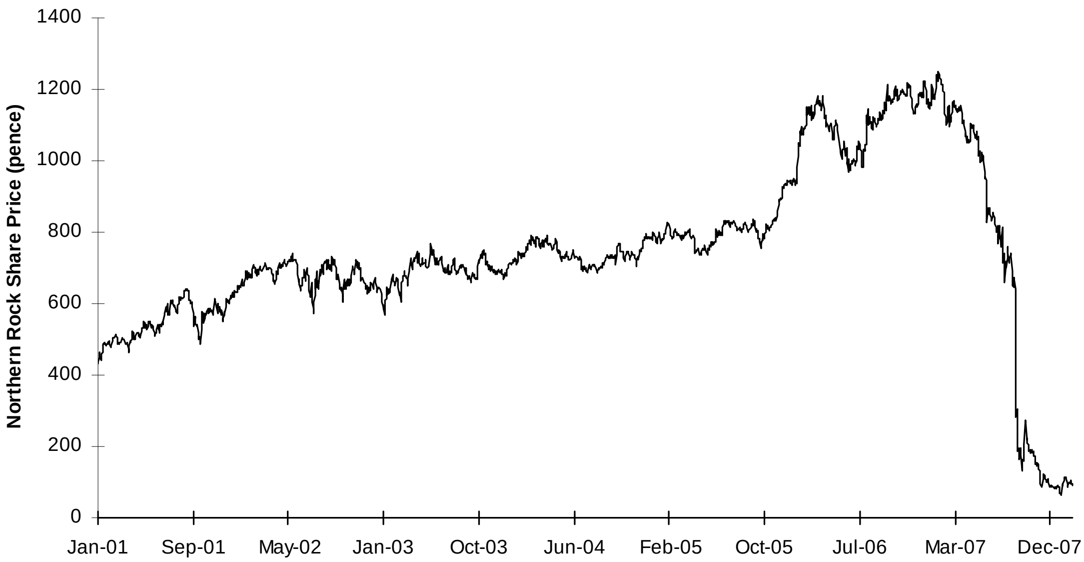
> JAMES Rainbow, divisional director and investment manager at Wise Speke, said: "It is no surprise that Northern Rock's first half results show little change to the guidance given with the profit warning last month.
>
> "There are a number of eye-catching headlines with record gross lending and a 24% increase in return on equity at the forefront. Northern Rock looks good value but the next 12 months will be tough.
>
> "Higher interest rates have already hit margins and a slower housing market is an obvious concern. If Northern Rock can get through this period relatively unscathed, it will go a long way to restoring shareholder loyalty and the management's reputation which, until last month, was much respected."
>
> MIKE Trippitt, analyst at Oriel Securities, said: "It's probably a positive story. There are still a lot of unanswered questions, but it's a stock that is trading on

4 Adam J Applegarth, Chief Executive NRB, more financial results can be accessed from NRB website at: http://companyinfo.northernrock.co.uk/investorRelations/results/stockEx070725.asp (ret'd 11 October 2007)

> around seven times next year's (forecast) earnings that's going to produce pretty strong double digit growth and a decent yield."
>
> COLLINS Stewart banking analyst Alex Potter said the "mismanagement of rate risk" had heavily impacted margins and would likely lead to a reduction in the consensus market forecasts for 2008 profits.
>
> CITIGROUP analysts raised concerns over Northern Rock's arrears levels, despite the lender's assurances its credit quality was "robust". [5]

There are two things that strike one reading through many NRB press articles of the time. First, none predicted the manner of NRB's downfall. The possibility that NRB could simply not borrow was envisaged by no commentators prepared to commit to print. Secondly, there are concerns about the long term profitability and soundness of NRB simply because of its tight credit margins and the expected likelihood of future interest rate rises. One thing that has been stressed by Government spokesmen, as public sector support for the bank increased, is that NRB is 'sound', with a credit worthy mortgage book; hence, the risk of NRB becoming unprofitable was low. This was not the universal view in July and the fact that the NRB share price had declined from over £12 to just over £8 in six months reflected this uncertainty. A table showing the rise and decline of the NRB share price is shown below:

Northern Rock Share Price 2001-2008



B. Credit crunch

a. Introduction

It may be too early to yet be able to give a definitive account of the cause of the problems which caused NRB to ultimately need to seek public help. Almost by definition

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[5] *Steady Rock has sights on long term*, Newcastle Journal, 26 July 2007

with financial crises, until they break mainstream opinion is near silent. Financial crises are particularly affected by confidence and sentiment: until that confidence is lost or that sentiment turns, all is serene and fine. After confidence is lost, there is no shortage of informed opinion to say how the crisis arose and how it was always an accident waiting to happen. This section concentrates upon the factual events in the crisis and on the developing 'conversation' between the authorities jointly responsible for managing the financial system. Economic factors are touched on only briefly. Colleagues in the Economic Policy Section can give more help to Members and their staff on this aspect (X 4324).

b. Economics

The cause of the current troubles is generally sourced with the US mortgage market, in particular the 'sub-prime' market. Foreclosures and repossessions of such mortgages rose sharply during 2007 and, despite a long term expectation that this would cause problems; this eventually impacted on world credit markets, apparently to their surprise. The linkage between a mortgage foreclosure in Chicago and queues in northern England high streets is complicated. At its simplest, bundles of American mortgage assets were sold to investors (mainly investment banks) and then used to supply credit in the money markets more generally. When the valuation of the original 'bundles' declined (i.e. when foreclosures mounted) so did the value of the derived securities held by financial institutions world wide. Short of capital, such institutions, cut back on their own lending, in particular on inter bank loans which provide much of the short term liquidity that keeps the financial industry afloat. Furthermore, a new more cautious approach to risk resulted in existing credit becoming more expensive – interest rates rose. A detailed analysis was published by the Monetary Policy Committee in its September minutes.[6] (Note this was before the NRB crisis became fully public.) A simpler account appeared in a memorandum (written before the crisis broke) from the Governor of the Bank of England in advance of an appearance before the Treasury Select Committee. The Governor commented:

> Why have developments in one part of the US mortgage market proved so important for a wide range of financial markets? Sub-prime mortgages are one type of loan that banks have parcelled together into securities backed by the cash flows from those loans – a process known as securitisation. Those securities have been sold by banks to investors.
>
> They have also been sold to investment vehicles, many of which have been established by the banks themselves. Many of these vehicles have financed their purchases by issuing short-term commercial paper.
>
> Securitisation of loans has separated the information held by loan originators from those exposed to the risk of default – investors in asset-backed securities or commercial paper. The unexpected losses sustained on assets backed by US sub-prime mortgages have highlighted the potential costs to investors of uncertainty about the types of loans underlying the assets they purchase. So for

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[6] MPC Minutes meeting 5 & 6 September: http://www.bankofengland.co.uk/publications/minutes/mpc/pdf/2007/mpc0709.pdf (ret'd 11 October 2007)

the time being the markets in these instruments have either closed or become very illiquid. Vehicles financed by short-term commercial paper are holding assets which can no longer be traded in liquid markets. They now find that they have borrowed short to lend long – normally thought of as a function of banks.

As a result of this maturity mismatch, vehicles set up by banks and others are now finding it extremely difficult to obtain funding through asset-backed commercial paper. The markets are now withdrawing short-term funding from such vehicles, a process not unlike a bank run. Many investment vehicles have been forced to shorten the maturity of their commercial paper, making their borrowing even more short-term and their maturity mismatch even greater.
[…]
The vehicles can be taken back onto banks' balance sheets. Banks as a whole are well capitalised and should be able to do this. Moreover, the funds that were directed to asset backed securities and commercial paper will now be available elsewhere. In the end, that funding will come back to the banking system, although between banks the distribution will differ. So the adjustment period may be awkward and, during it, banks are placing a premium on holding assets which can quickly be turned into cash.

The increase in demand for liquid assets during the adjustment period is one reason why, in all the major economies, yields on liquid assets like government securities have fallen. It also helps to explain why the compensation needed for banks to lend to other banks over periods longer than overnight has risen and why the volume of inter-bank lending has been increasingly concentrated at shorter maturities. Since the beginning of August, the spread between interest rates for 3-month inter-bank lending and central bank interest rates expected over that period has risen in all the major economies. At present, the average spread is 110 basis points in sterling and 90 basis points in dollars. This is the natural economic result of a change in the preferences of banks over the composition of the assets they wish to hold on their balance sheets.

In summary, the turmoil in financial markets since the beginning of August stems from a reluctance by investors to purchase financial instruments backed by loans. Liquidity in asset-backed markets has dried up and a process of re-intermediation has begun, in which banks move some way back towards their traditional role taking deposits and lending them. That process is likely to be temporary but it may not be smooth. During that process, demand for liquidity by the banking system has increased, leading to a substantial rise in inter-bank rates.[7]

The securitisation vehicle owned by NRB is called 'Granite'.

c. Key events in the Northern Rock crisis

9 August, "market disturbance" – Governor Mervyn King.[8]

14 August, privately the FSA disclose concerns about NRB to the Treasury and Bank of England.[9]

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[7] Memorandum from Bank of England to Treasury Select Committee, 12 September 2007 http://www.bankofengland.co.uk/publications/other/monetary/treasurycommittee/paper070912.pdf

[8] In evidence to Select Committee see below Q32

Although rumours about NRB had begun to circulate early in the summer (its share price had fallen, along with a generally declining stock market, 50% from its February peak to £8.00 by the start of August) the first official public indication of trouble came with a report from BBC News on 13 September to the effect that NRB negotiations were ongoing between the Bank and NRB. A market profit announcement from the management of NRB on 14 September confirmed this. It said:[10]

> It has now become clear that the global credit and liquidity markets have not recovered in the early part of September, and that there continues to be a severe liquidity squeeze. In the UK, this is demonstrated by 3 Month Sterling Libor currently running at over 1% higher than Bank Base Rate. In these circumstances, NRB has taken action to preserve liquidity and to maintain margins on its current loan book, while modifying its lending approach to avoid writing new business that is unprofitable in current conditions.
>
> Although NRB expects its new lending volumes to increase once the wholesale funding markets return to more normal volumes and prices, it must now plan on the basis that the wholesale funding markets will not return to historic levels in the short to medium term. In addition, the previously announced decision to dispose of more capital inefficient assets has been suspended but will be resumed once the pricing environment for such assets improves.

As it turned out the crucial problem for NRB was access to funds. On funding it said:

> Global investor appetite in the medium and long term markets, for either senior unsecured or asset backed securities, is currently greatly reduced. […] While NRB has continued to raise new funds, these have been mainly in the short term wholesale debt markets and the amounts raised have not allowed NRB to refinance maturing liabilities as well as to write new business at previous levels. In view of the difficulties NRB has had in accessing longer term funding and the mortgage securitisation markets, the Company has been using its cash and other liquid reserves to support the funding of its business. NRB expects current market conditions to continue for some time.
>
> In light of the above, NRB has concluded that it is important to ensure that additional standby liquidity arrangements are available. Accordingly, NRB has agreed with the Bank of England that it can raise such amounts of liquidity as may be necessary by either borrowing on a secured basis from the Bank of England or entering into repurchase facilities with the Bank of England. Such repurchase facilities would include securities that have prime residential mortgage assets as underlying collateral. The collateral that can be used under this 'Repo' facility is similar in nature to the collateral currently utilised by many Eurozone banks with the ECB. This additional source of funding will enable NRB to adapt its business model in line with the developing market conditions.

With respect to the accepted cause of global problems, NRB sounded confident.

> As announced on 20 August 2007, NRB only has a £75 million direct exposure to the US sub-prime market which is all rated AAA, and a £200 million exposure to

[9] Chancellor's statement HC Deb 11 October c462

[10] NRB Stock Exchange Announcement 14 September 2007.

> the US CDO market, within which there is indirect exposure to US sub-prime. Of the £275 million combined exposure, £193 million is rated AAA. Our combined exposure represents only 0.24% of total assets as at 30 June 2007.
> […]
> The interim dividend will be paid as planned on 26 October 2007.

The announcement of the arrangement with the Bank had little obvious effect on public perceptions. The weekend papers were full of pictures of queues of depositors anxious to withdraw their savings from NRB branches around the country. The NRB internet site 'crashed' due to the volume of hits it was taking over the weekend.

17 September, the Chancellor, Alistair Darling, made a statement on the situation, he said:

> I want to put the matter beyond doubt. In the current market circumstances, and because of the importance I place on maintaining a stable banking system and public confidence in it, I can announce today that following discussions with the Governor and the Chairman of the FSA, should it be necessary, we, with the Bank of England, would put in place arrangements that would guarantee all the existing deposits in NRB during the current instability in the financial markets.[11]

19 September, the Bank of England announced that they would conduct a series of auctions to inject liquidity into the capital markets. This announcement was regarded as a U-turn by many commentators. Some pointed out that had this happened earlier NRB may have been able to avoid its current problems. To date no institution has taken advantage of this facility.

20 September, the Treasury announced extended protections for NRB customers. The press notice of that day stated:

> HM Treasury today confirms that the guarantee arrangements for existing deposits in NRB plc would cover all accounts existing at midnight on Wednesday 19 September. This guarantee covers future interest payments, movements of funds between existing accounts, and new deposits into existing accounts. The guarantee will also cover accounts re-opened in the future by those who closed them between Thursday 13 September and Wednesday 19 September, inclusive.
>
> Since it would otherwise be unfair to other banks and building societies, the arrangements would not cover any new accounts set up after 19 September, other than re-opened accounts as set out above.
>
> In the case of wholesale market funding for NRB plc, the Treasury confirmed that the arrangements would cover:
> existing and renewed wholesale deposits; and
> existing and renewed wholesale borrowing which is not collateralised.
>
> The arrangements would not cover other debt instruments including:

[11] HM Treasury press notice 17 September 2007 http://www.hm-treasury.gov.uk/newsroom_and_speeches/press/2007/press_95_07.cfm (ret'd 11/10/07)

> covered bonds;
> securities issued under the "Granite" securitisation programme; and
> subordinated and other hybrid capital instruments.
>
> The guarantee in relation to NRB plc will remain in place during the current instability in the financial markets.[12]

23 September, press reports indicate that NRB had borrowed 'about £3 billion' from the Bank of England facility.[13]

25 September, after sustained comment and speculation, NRB announce, that they would not pay the interim dividend due the following month; this move retained £59 million within the bank.

1 October the FSA announced an extension to the cover given to NRB depositors under the Financial Services Compensation Scheme (FSCS). The change to the FSCS meant that all deposits up to £35,000 are now covered by 100% protection. Previously 100% of the first £2,000 and 90% of the next £33,000 were covered – a total of £31,700. The new rules can be found in the Compensation section of the Redress part of the full FSA Handbook.[14] More information on the FSCS can be found in another Library standard note.[15]

The NRB share price falls to £1.32.

9 October, the Treasury announced a further extension of support for NRB. A press notice gave details:

> HM Treasury, on behalf of the Tripartite Authorities, can today confirm that the guarantee arrangements previously announced to protect existing depositors of NRB plc will be extended to all new retail deposits made after 19 September, including those made from today. These arrangements will cover all retail deposits, including future interest payments, movements of funds between accounts and term deposits for the duration of their term.
>
> These arrangements will be complemented by additional facilities through the Bank of England. The arrangements and revised facilities have been put in place at the request of NRB plc. They will allow the Company to continue to pursue the full range of its strategic options.
>
> NRB plc will pay an appropriate fee for the extension of the arrangements, which is designed to ensure it does not receive a commercial advantage. As previously announced, the arrangements to protect depositors of NRB plc will remain in place during the current instability in the financial markets.[16]

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[12] HM Treasury Press notice 20 September 2007: http://www.hm-treasury.gov.uk/newsroom_and_speeches/press/2007/press_96_07.cfm (ret'd 11/10/07)

[13] Financial Times 23 September 2007

[14] Specifically Comp 10.2 http://fsahandbook.info/FSA/html/handbook/COMP/10/2

[15] SN/BT/4466

[16] HM Treasury Press notice 20 September 2007: http://www.hm-treasury.gov.uk/newsroom_and_speeches/press/2007/press_104_07.cfm (ret'd 11/10/07)

11 October, in a statement to the House, the Chancellor said:

> Here at home, the FSA will shortly set out proposals for a review of the UK liquidity regime. As the Governor has said, all central banks face problems in providing support to banks in difficulty in a world where markets rightly expect high levels of disclosure and transparency. I can therefore confirm that if it proves necessary to clarify in Europe the legal and practical issues surrounding the way in which such support is provided and disclosed to protect financial stability, we will work with other European countries to provide that certainty. We will now review whether rules about swift takeovers of banks need to be changed.
>
> When problems occur, however, we need to have a system in place that is clear and which reassures depositors. We will introduce legislation in the next Session to establish a new regime. With the FSA and the Bank, I am proposing the principles for the new regime in a discussion document published today. The new regime would mean that depositors would be insulated from a bank that had failed and would provide them with both greater compensation and certainty that their compensation could be paid out quickly. [17]

The Chancellor wrote to the Public Accounts Committee setting out the basis for guarantees to NRB (Deposited Paper 2007/2120).

19 October, NRB Chairman, Dr. Matt Ridley resigned from the NRB Board. He is replaced by Brian Sanderson.

16 November, resignation of NRB CEO Adam Applegarth

16 November, deadline for offers to acquire NRB expires.

19 November, Statement by the Chancellor on the future of NRB in the light of the received bids for the company.[18] The key points from the statement are:

> It is important to be clear about the respective responsibilities of the Northern Rock board and the Government. The board is legally responsible to its shareholders for the future of the company. However, the Government have a wider public interest in maintaining financial stability, which is why we agreed to lender-of-last-resort support in September and subsequent lending by the Bank of England. The Government also have an interest in protecting the interest of the taxpayer. Because of this, the Government have, as a major creditor, a direct interest in the future of Northern Rock. The Government therefore have to agree to any proposals for the future of Northern Rock.
>
> Before turning to our approach, let me deal first with the position on the guarantee arrangements to Northern Rock depositors provided by the Government and, secondly, with the loan facilities provided by the Bank of England to support Northern Rock and to maintain financial stability in general. First, we have made it clear that the guarantee arrangements already announced

[17] HC Deb 11 October c 464
[18] HC Deb 19 November 2007, cc959-961

for depositors in order to safeguard their position will remain in place during the current instability in the financial markets. These guarantee arrangements were absolutely necessary. […] The guarantee will not be removed without proper notice being given to depositors.

Looking ahead, I have made clear that the Government will legislate for a new regime for protecting bank depositors. As the House knows, we have published a discussion paper on this legislation, and I very much welcome the offer of cross-party support for it. But it is important that we get it right. There are many examples, both here and in other countries, of legislation having been rushed through only to be regretted later. The current consultation finishes on 5 December. I will bring forward proposals in the new year when I have also had time to consider the outcome of the Treasury Committee's work, as it has requested.

The second element of support is the Bank of England loan facilities. It is important to remind ourselves of why this support was provided in the first place. Northern Rock got into difficulties because it was almost totally reliant on getting very substantial sums from the securitisation and money markets on a continuous basis
to do its business. When that lending became ever more difficult, it had no option other than to go to the Bank of England. Because of the possible impact on the stability of the wider financial system, it was right that I authorised the Bank of England to intervene. That, too, had cross-party support.

While international financial markets have shown signs of improvement since the sharp credit squeeze in August and September, following the problems that arose in the American housing market in the summer, there clearly remains continued uncertainty in the markets. The rates at which banks are willing to lend to each other also remain high in all the major currencies. […]

The continuing support of the Bank of England has also given Northern Rock an opportunity to consider its strategic options. […] I know that there has been interest in how much support the Bank of England is giving. The Bank publishes its balance sheet every week. However, in common with other central banks, it does not provide details of any operations because it believes that doing so would undermine its ability to provide such support. I understand the frustrations that that can sometimes cause, but to provide what would, in effect, be a running commentary on any operations would be likely to have adverse affects that none of us would want.

Having said that, I can tell the House that Bank of England lending is secured against assets held by Northern Rock, which include high-quality mortgages with a significant protection margin built in and high-quality securities with the highest quality of credit rating. The Bank is the senior secured creditor. The Financial Services Authority has said before, and continues to say, that Northern Rock's main asset base—its mortgage book—is strong and sound.

As with any lender on this scale, we have ensured that the Bank's lending is subject to significant conditions and controls to ensure that our interests are protected, and, in return for that facility, Northern Rock has agreed a number of controls, including not declaring, making or paying any dividend without the prior written consent of the Bank of England, and not making any substantial change to the nature of its business.

I now turn to the next stage. It is in the interests of everyone that the situation with regard to Northern Rock is resolved as soon as possible. […]

It is essential that the public interest is protected. That is why I have published today the principles that will underpin the Government's approach, when assessing proposals from Northern Rock regarding its future.[19] As I have already said, the Government have to agree to any such proposals. The principles make it clear that the Government have a clear duty to protect the public interest, and we will do so. However, I think that the whole House, and particularly Members representing the north-east, will want us to do everything we can within the constraints on us to resolve a very difficult position for Northern Rock.

Let me therefore set out our approach. First, we must protect the interests of the taxpayer. Substantial sums have been lent, and that money has to be repaid at an appropriate time and rate. The Government will consider proposals with a view to reaching the best outcome for the public purse. Secondly, we want to protect depositors. It is essential to do everything we can both to safeguard their interests and to maintain the service provided to them. Thirdly, we will maintain wider financial stability.

As I have made clear all along, the Government will now assess proposals from the company consistent with the approach that I have set out, and we remain closely engaged with the company as the best outcome for its future is assessed. As the company has acknowledged today, any proposals would have to be approved by the Government and, importantly, any proposal can be vetoed by the Government. In that way, the Government can ensure that the public interest is safeguarded. As I have told the House on previous occasions, any outcome must meet EU state aid rules.

It would be quite wrong to dismiss any option now without proper consideration, as some have suggested we do. I continue to believe that it is right to use this time to explore the best outcome for the company and the public interest. I agreed to Bank of England support because I believed it was right to do so. I agreed to continue support to allow Northern Rock the time it needs to consider its strategic options because it was right to do so. […]

12 December, Liberal Democrat Debate calls for the nationalisation of NRB.[20]

14 December, NRB CEO Adam Applegarth is replaced by long time NRB executive Andy Kuipers.

19 December, FSA publishes a consultation document *Review of the liquidity requirements for banks and building societies*.

21 January 2008, Chancellor's statement outlining how the potential private sector rescue of northern rock would proceed and how the competing bids would be assessed.

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[19] Deposited Paper 2007/107

[20] HC Deb 12 December 2997 c371- 418

17 February, the Chancellor announces:

> The Government has today decided to bring forward legislation that will enable Northern Rock plc to be taken into a period of temporary public ownership. The Government has taken this decision after full consultation with the Bank of England and the Financial Services Authority. The Government's financial adviser, Goldman Sachs, has concluded from a financial point of view that a temporary period of public ownership better meets the Government's objective of protecting taxpayers.[21]

d. The Tripartite Framework

Responsibility for the maintenance of the financial system is shared between the Treasury, the Bank of England and the FSA. This is referred to as the tripartite framework.

The relationship between the bodies is governed by a Memorandum of Understanding (MoU) which can be found on the Treasury website amongst other places.[22] Each of the bodies has unique functions. The Bank of England has the following core responsibilities:

i. ensuring the stability of the monetary system as part of its monetary policy functions. It acts in the markets to deal with fluctuations in liquidity;

ii. overseeing financial system infrastructure systemically significant to the UK, in particular payments systems whether based in the UK or abroad. As the bankers' bank, the Bank stands at the heart of the payments system. It falls to the Bank to advise the Chancellor, and answer for its advice, on any major problem arising in these systems. The Bank is also closely involved in developing and improving the infrastructure and strengthening the system to help reduce systemic risk;

iii. maintaining a broad overview of the system as a whole. The Bank is uniquely placed to do this, being responsible for monetary stability and having representation on the FSA Board (through the Deputy Governor (financial stability)). Through its involvement in markets and payments systems it may be the first to spot potential problems. The Bank advises on the implications for UK financial stability of developments in the domestic and international markets and payments systems and assesses the impact on monetary conditions of events in the financial sector;

iv. undertaking, in exceptional circumstances, official financial operations, in accordance with the arrangements in paragraphs 13 and 14 of this Memorandum, in order to limit the risk of problems in or affecting particular institutions spreading to other parts of the financial system.

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[21] HM Treasury press release, 17 February 2008, http://www.hm-treasury.gov.uk/newsroom_and_speeches/press/2008/press_16_08.cfm

[22] http://www.hm-treasury.gov.uk/documents/financial_services/regulating_financial_services/fin_rfs_mou.cfm (ret'd 11/10/07)

The role of the FSA is:

> i. the authorisation and prudential supervision of banks, building societies, investment firms, insurance companies and brokers, credit unions and friendly societies;
>
> ii. the supervision of financial markets, securities listings and of clearing and settlement systems;
>
> iii. the conduct of operations in response to problem cases affecting firms, markets and clearing and settlements systems within its responsibilities, where:
> a) the nature of the operations has been agreed according to the provisions of paragraphs 13 and 14 of this Memorandum; and
> b) the operations do not fall within the ambit of the Bank defined in paragraph 2 above. (Such operations by the FSA may include, but would not be restricted to, the changing of capital or other regulatory requirements and the facilitation of a market solution involving, for example, an introduction of new capital into a troubled firm by one or more third parties.)
>
> iv. regulatory policy in these areas, including that intended to promote the resilience to operational disruption of authorised firms and Recognised Bodies. The FSA advises on the regulatory implications for authorised firms and Recognised Bodies of developments in domestic and international markets and of initiatives, both domestic and international, such as EC directives.

The Treasury has the following role:

> i. the overall institutional structure of financial regulation and the legislation which governs it, including the negotiation of EC directives;
> ii. informing, and accounting to Parliament for the management of serious problems in the financial system and any measures used to resolve them, including any Treasury decision concerning exceptional official operations as set out in paragraphs 13 and 14; and
> iii. accounting for financial sector resilience to operational disruption within government.

An important arm of the system is the Standing Committee on Financial Stability. This is chaired by the Treasury with representatives from all three arms attending. The normal (and extraordinary) modus operandi of the Committee is set out in the following paragraphs from the Memorandum:

> 11. Standing Committee meets on a monthly basis at deputies (official) level to discuss individual cases of significance and other developments relevant to financial stability. Meetings can be called at other times by any of the participating authorities if it considers there to be an issue which needs to be addressed urgently. Each authority is to have nominated representatives who can be contacted, and meet, at short notice.
>
> 12. A sub-group of Standing Committee co-ordinates the authorities' joint work on financial sector resilience to operational disruption and maintains and tests tripartite arrangements for effective crisis management in an operational disruption.

> 13. In exceptional circumstances, for instance where a support operation is being considered, the Standing Committee meets at principals level, comprising the Chancellor of the Exchequer, the Governor of the Bank and the Chairman of the FSA (or senior alternates). The Bank and the FSA are each to assess, from the perspective of their distinct responsibilities and expertise, the seriousness of the crisis and its potential implications for the stability of the financial system as a whole. They will each provide their separate assessments to the Treasury, together with their views on the options available to the Chancellor. Standing Committee may then discuss the appropriate use of measures and ensure effective co-ordination of the response, while respecting the formal responsibilities of the three authorities (subject to paragraph 14).

Paragraph 14 is the section of the Memorandum that is of application to the fortnight from about the second week of September 2007. It deals with a financial crisis:

> 14. In exceptional circumstances, there may be a need for an operation which goes beyond the Bank's published framework for operations in the money market. Such a support operation is expected to happen very rarely and would normally only be undertaken in the case of a genuine threat to the stability of the financial system to avoid a serious disturbance in the UK economy. If the Bank or the FSA identified a situation where such a support operation might become necessary, they would immediately inform the other authorities and invoke the co-ordination framework outlined in paragraph 16 below. Ultimate responsibility for authorisation of support operations in exceptional circumstances rests with the Chancellor. Thereafter they would keep the Treasury informed about the developing situation, as far as circumstances allowed.
>
> 15. In any such exceptional circumstances, the authorities' main aim would be to reduce the risk of a serious problem causing wider financial or economic disruption. In acting to do this, they would seek to minimise both moral hazard in the private sector and financial risk to the taxpayer arising from any support operation.
>
> 16. The authorities maintain a framework for co-ordination in the management of a financial crisis. This includes arrangements that determine which authority would take the lead on particular problems arising and for ensuring orderly communication with market participants and overseas authorities. Each authority would:
> assess the situation and co-ordinate their response within the framework agreed with the other authorities. The form of the response would depend on the nature of the event and would be determined at the time; and where possible and desirable to facilitate a solution to a problem, and hence reduce risks to wider financial stability, encourage negotiations between third parties whose agreement might be beneficial for the reduction or resolution of the issue, in its area of responsibility.[23]

[23] Memorandum of Understanding between HM Treasury, the Bank of England and the Financial Services Authority; http://www.hm-treasury.gov.uk/documents/financial_services/regulating_financial_services/fin_rfs_mou.cfm

C. Treasury Committee sessions

The Treasury Committee had announced an enquiry into financial stability and transparency before the NRB crisis broke and therefore it was under this heading that the Committee pursued enquiries into the crisis.[24]

The Committee's Report, *The Run on the Rock,*[25] was published in January 2008. Its Conclusions and Recommendations[26] included:

- that the 'directors of Northern Rock were the principal authors of the difficulties that the company has faced';
- there was a 'substantial failure of regulation' on the part of the FSA;
- easing of capital restrictions (Basel II) had come "at exactly the wrong moment' and 'it was wrong of the FSA to allow Northern Rock to weaken its balance sheet';
- the current regulatory regime in the UK is 'flawed';
- the Bank of England should have taken a 'more proactive response'; and
- the Chancellor's decision to support Northern Rock had been 'the right one'.

Of relevance to the Bill are the Committee's observations on the option of nationalisation which was one of several options discussed at the start of 2008. The Report says:

> NATIONALISATION AS AN OPTION
>
> 373. One of the potential routes for resolving the problems with Northern Rock has been nationalisation. However, this option has been regarded by the Tripartite authorities, according to Sir John Gieve, as a "Plan B" after a private sector sale.[692] However, in the event that Northern Rock were nationalised, Sir John Gieve told us that "it would be possible to pass many of its activities to other institutions in the private sector".[693] The Governor of the Bank of England told us that nationalisation ought to be regarded as a means of achieving change:
>
> If we were to get to nationalisation (and I stress 'if'), then I think it would be better if it could be used as a means of breaking the log-jam and going into an arrangement which would pass very quickly to a new management team and, ultimately, to a new ownership team.[694]
>
> 374. When we asked the Chancellor of the Exchequer about the compliance of possible nationalisation legislation with the European Convention on Human Rights, he pointed out that consideration of the Human Rights Act would be automatic, telling us that "as you know, legislation has to be compatible with human rights and indeed the Minister introducing the Bill has to sign a certificate to that effect and, if not, they have to say it explicitly".[695] The Chancellor also told us that:

[24] Testimony from the key players can be found in a Library standard note – Northern Rock Bank SN/BT/4478- available from the Library or the intranet site.

[25] HC 56 2007-08

[26] Ibid p145

The Government is legally obliged to obey the law. There is no surprise there. When we introduced the Human Rights Act, I think at the end of the last decade, we were very aware of that and so we have to take that into account, but, …, equally I am quite sure that people who have been buying Northern Rock shares since September were fully aware of its present circumstances.[696]

375. One other aspect of nationalisation preparations we considered was the creation of a team to run Northern Rock after nationalisation. Sir Callum McCarthy, when asked where in the public sector there was expertise to run a nationalised bank, told us "If that eventuality occurred [nationalisation], it would be necessary to find a team to do so".[697] The Government appears to have begun to work on this, because by 12 January 2008, media reports suggested that Ron Sandler had been lined up as executive Chairman of Northern Rock should it be nationalised.[698]

Announcement on 21 January 2008

376. On 21 January 2008, the Treasury issued a statement detailing how it would proceed with offers for Northern Rock. This statement indicated that the current support for Northern Rock would continue until 17 March 2008.[699] To aid a sale of Northern Rock, the Treasury put forward a financing option that would be available to potential private sector parties. The Chancellor explained how this financing option would work:

Northern Rock would raise the funds it needs from investors by selling assets. The Treasury would guarantee payment to these investors in the event that the assets were insufficient to meet its obligations, for which Northern Rock would pay the Treasury a fee. In this arrangement, shareholders and other providers of capital in Northern Rock accept the first risk; with the Government acting as a backstop.[700]

The Chancellor of the Exchequer also explained in his statement to the House why he thought that a purely private sector solution for Northern Rock was impossible:

Whilst conditions [in financial markets[are better now than they were before Christmas they remain difficult and the Government's financial advisers believe that there is no chance of achieving a private sector deal backed entirely with private finance in the near future.[701]

377. The plan set out on 21 November requires approval by the European Commission in line with the State aid rules relating to restructuring of a company that we referred to earlier.[702] The Treasury statement set out what would be required of bidders should they wish to follow this plan:

implementation of the financing structure would require the submission by HM Treasury to the European Commission of an appropriate restructuring plan and the authorisation by the Commission of any state aid which it involves. The company and other relevant interested parties would be expected to assist HM Treasury with the preparation of such a plan. Implementation of the financing structure would follow receipt of the necessary state aid authorisation.[703]

378. The Treasury emphasised that the solution to the financing problem proposed in the statement of 21 January did not rule out the possibility of nationalisation. In his statement to the House, the Chancellor said that "I will only

authorise support for the private sector if the public interest will be better served than through taking the company into temporary public ownership".[704] The market statement by the Treasury outlined what would happen to Northern Rock if it were nationalised because a private sector solution was not forthcoming. The Treasury sought to reassure savers and borrowers that Northern Rock would continue to operate as it did now in the event of nationalisation.[705] However, the management would change. The Treasury stated that, should Northern Rock be brought into temporary public ownership, the company "would be managed on arms' length terms, as a commercial entity, by a newly appointed experienced and professional management team".[706] The Treasury also stated what would happen to shareholders should Northern Rock have to be nationalised:

It is envisaged that any such power would be used to transfer Northern Rock's share capital, including its preference shares, into public ownership. It is anticipated that the remaining Tier 1 and Tier 2 capital instruments would continue in their existing ownership as listed securities. Holders of these capital instruments would remain at risk of first loss ahead of the Bank of England and HM Treasury as providers of secured financial support to the company.[707]

To compensate shareholders for the loss of their shares, the Treasury envisaged an:

assessment by an independent valuer of compensation payable to any holder of securities transferred to HM Treasury. The principles for assessing compensation, which would be set out in the legislation brought forward, would reflect the principle that the Government should not be required to compensate shareholders for value which is dependent on taxpayers' support and the fact that public sector ownership would be an alternative to an administration of the company. Accordingly, the compensation would be assessed by the valuer on the basis, among other things, that all financial assistance to Northern Rock from the Bank of England or HM Treasury (including HM Treasury's existing guarantee arrangements) had been withdrawn and no other financial assistance (apart from Bank of England assistance on its usual terms through standing facilities or open market operations) were made available by them to Northern Rock.[708]

II The Bill

The draft *Banking (Special Provisions) Bill* was published on 17 February 2008. At the time of writing, the Bill was in **draft** form only. It is expected to have a second reading on 19 February.

The Bill has 17 clauses; it is not Northern Rock specific. **Clauses one and two** define the circumstances in which the Treasury can take a financial institution into public ownership. The Treasury can only exercise these powers if either of the following two conditions is met:

(a) maintaining the stability of the UK financial system in circumstances where the Treasury consider that there would be a serious threat to its stability if the order were not made;

> (b) protecting the public interest in circumstances where financial assistance has been provided by the Treasury to the deposit-taker for the purpose of maintaining the stability of the UK financial system.[27]

Initial comments and reaction on clause two reveal some confusion. On the one hand, it is difficult to think when the Treasury would seek to nationalise a bank unless either of the above were present. On the other hand, it might be remembered that the reason for nationalisation of Johnson Matthey bank in 1984 was on the grounds that that bank, although a relatively minor merchant bank in its own right, was an important part of the gold bullion market. Justification for its nationalisation was on the grounds that this particular market (not the whole financial system) needed protection. It is not clear whether Clause 2 would or would not rule out assistance under similar circumstances. If it does not, then it is hard to see what practical constraint this clause provides.

Further, does this clause simply limit the Treasury's action to large (stability threatening) institutions? Is the real effect of this clause to inhibit the Treasury from acting in a similar way against a relatively small bank or building society, where a collapse would not threaten the stability of the whole financial system?

Clause 2 continues with a long list of subsidiary conditions:

2 (3) & (4) the Bank of England has provided financial assistance to such an extent that (i) the Treasury have assumed a liability in respect of the assistance, (ii) the liability is of a kind of which the Treasury are expected to give relevant notice, and (iii) the Treasury have given relevant notice of the liability. The level of such assistance is set at £250,000 and the Treasury has published minutes of this assistance on 21 September, 11 October and 21 January.

2 (5) Gives retrospective force to any such notice, "It is immaterial whether the notice or announcement mentioned in subsection (3) is given or made before or after the passing of this Act".

2 (8) limits the jurisdiction of the intended Act to one year from the passage of the Act.

Clauses three, four and five deal with the mechanism by which ownership of a bank will be transferred.

Clause three (and Schedule 1) sets out the details of the 'transfer orders', the instruments by which the Treasury would effect any transfer.[28] It specifies that the shares may be transferred to the Bank of England, a Treasury nominee, a company either wholly owned by either the Bank or Treasury, or to any other company. Schedule 1 includes a provision for the forced transfer of shares.

Clause 4 gives the Treasury rights to any 'subscription rights' that would otherwise be due to Northern Rock.

[27] *Banking (Special Provisions) Bill,* clause 2

[28] Available in draft on the Treasury website at: http://www.hm-treasury.gov.uk/consultations_and_legislation/banking/banking_specialprovision_bill.cfm

Clause five sets out the terms under which shareholders will be compensated:

> 5 (4) In determining the amount of any compensation payable by the Treasury by virtue of any provision in an order under this section, it must be assumed.
> (a) that all financial assistance provided by the Bank of England or the Treasury to the deposit-taker in question has been withdrawn (whether by the making of a demand for repayment or otherwise), and
> (b) that no financial assistance would in future be provided by the Bank of England or the Treasury to the deposit-taker in question (apart from ordinary market assistance offered by the Bank of England subject to its usual terms).
>
> (5) For the purposes of subsection (4).
> (a) the references to the provision of financial assistance by the Treasury to the deposit-taker include any case where the Chancellor of the Exchequer announces that the Treasury (whether acting alone or with the Bank of England) would, if necessary, put in place relevant guarantee arrangements in relation to the deposit-taker (as well as any case where any such arrangements are put in place, whether or not following such an announcement);
> (b) ordinary market assistance means assistance provided as part of the Bank's standing facilities in the sterling money markets or as part of the Bank's open market operations in those markets.

The Treasury statement made clear that the final valuation "will be determined by an independent valuer"[29] albeit constrained by the provisions of the Act.

Reaction to the announcement that NRB would be nationalised from some of the larger shareholding groups has varied between "stunned" and "shocked and appalled".[30] The task of the valuer will be to plot a path between the claim, made often by the Chancellor, that Northern Rock is sound, with a valuable mortgage book, and the fact that without the elements specified in the Bill it could not function; which implies the 'fire sale' that the original support action was designed to avoid. This is a genuine conundrum. The Executive Chairman elect of the new NRB, Ron Sandler, is quoted in the Financial Times (19/2/08) as saying that the aim is to reinvent Northern Rock as a "profitable, vibrant and sustainable business". Clearly success would enable the government to float off NRB at a later date with the chance of a profit; existing shareholders believe they have some rights over that profit. Hanging over the whole compensation process is the threat of legislation on behalf of shareholders' groups, one representing small shareholders (staff, public recipients of demutualization shares) and the hedge fund shareholding groups such as RAB Capital.

Northern Rock shares were suspended on Monday morning, 18 February, standing at 90 pence.

The clause also includes another retrospective application of the legislation:

> 5 (6) It is immaterial whether the announcement mentioned in subsection (5)(a) is made before or after the passing of this Act.

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[29] HM Treasury PN16/08 17 February 2008
[30] *Fury over Rock nationalisation*, Financial Times 18 February 2008

Clauses six, seven and eight, repeat the share provisions above for other property. **Clause nine** gives further provisions regarding the compensation process.

9(1)b reiterates the role of the independent valuer, however, the preceding sub paragraph establishes constraints to this independence:

> 9 (1) An order under section 5, 7 or 8(6) may in particular make provision.
> (a) for the manner in which any compensation or consideration is to be assessed, including provision as to methods of calculation, valuation dates and matters to be taken into, or left out of, account in making valuations;

9 (1) e does, however, introduce a further independent entity into the process:

> for enabling persons to apply for decisions relating to the assessment of any compensation or consideration to be reviewed by the Financial Services and Markets Tribunal or a tribunal appointed by the Treasury for the purposes of the order;

Clause ten gives the Treasury the discretionary power, by regulations, to vary any tax consequences occasioned by the exercise of the transfer order, for example a capital gains tax liability.

Clause eleven gives the Treasury the power to make any alterations to building society legislation that would otherwise limit the ability of the authorities to provide equivalent support and assistance to societies.

The remaining clauses are general and consequential in nature.

‘Notes on clauses’ have been published by the Treasury, however they have not yet appeared on the website.