



## Northern Rock: Treasury Committee evidence sessions

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This note records Treasury Select Committee evidence sessions held at the time of the Northern Rock crisis. Other aspects of the crisis, including information on the 'credit crunch' and on the tripartite arrangements for financial supervision can be found in a separate standard note (Northern Rock & Financial Supervision SN/BT/4478).

### Contents

A.	Northern Rock	2
B.	Key events in the Northern Rock crisis	2
C.	Treasury Committee sessions	5
	1. The Bank of England	5
	2. Financial Services Authority	13
	3. Northern Rock	23
	4. The Treasury	34

## A. Northern Rock

The Northern Rock Bank (NRB) was one of several<sup>1</sup> building societies which de-mutualised in 1997. 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. Even in 1997 it was described as “arguably the most efficient lender in the business”.<sup>2</sup> 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”<sup>3</sup> rather than diversifying into associated activities such as estate agency or insurance. Also its funding strategy relied more heavily on wholesale market instruments – securitisation – than retail (savers) deposits.

## B. Key events in the Northern Rock crisis

**9<sup>th</sup> August**, “market disturbance” – Governor Mervyn King.<sup>4</sup>

**14<sup>th</sup> August**, privately the FSA disclose concerns about NRB to the Treasury and Bank of England.<sup>5</sup>

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**, ‘leak’ of secret negotiations between the Bank and NRB.

**14 September**, a market profit announcement from the management of NRB on confirmed the discussions with the Bank. It said:<sup>6</sup>

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.

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<sup>1</sup> The others that year were Halifax (now part of the HBOS group), Woolwich (taken over by Barclays) and the Alliance & Leicester.

<sup>2</sup> Financial Times 2 September 1997

<sup>3</sup> ibid

<sup>4</sup> In evidence to Select Committee see below Q32

<sup>5</sup> Chancellor's statement HC Deb 11 October c462

<sup>6</sup> NRB Stock Exchange Announcement 14 September 2007.

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.

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<sup>th</sup> September**, the Chancellor, Alistair Darling, announces government guarantees for all NRB deposits.<sup>7</sup>

**19<sup>th</sup> 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. At the time of writing no institution has taken advantage of this facility.

**20<sup>th</sup> September**, the Treasury announce extended protections for NRB customers.<sup>8</sup>

**23<sup>rd</sup> September**, press reports indicate that NRB had borrowed 'about £3 billion' from the Bank of England facility.<sup>9</sup>

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<sup>7</sup> HM Treasury [press notice 17 September 2007](#)

<sup>8</sup> HM Treasury [Press notice 20 September 2007](#)

**25<sup>th</sup> 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<sup>st</sup> October** the Financial Services Authority (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.<sup>10</sup> More information on the FSCS can be found in another Library standard note.<sup>11</sup>

The NRB share price falls to £1.32.

9th October, the Treasury announced a further extension of support for NRB.<sup>12</sup>

**11 October**, in a statement to the House, the Chancellor announced new legislation to improve the regulatory system in the UK.<sup>13</sup>

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

**16 November**, resignation of N. Rock CEO Adam Applegarth

**16 November**, deadline for offers to acquire N. Rock expires.

**19 November**, Statement by the Chancellor on the future of N. Rock in the light of the received bids for the company.<sup>14</sup>

**12 December**, Liberal Democrat Debate calling for the nationalisation of NR.<sup>15</sup>

**14 December**, Northern Rock CEO Adam Applegarth is replaced by long term NR executive Andy Kuipers.

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

**21 January 2008**, Chancellor announces how the potential private sector rescue of NRB would proceed and how the competing bids would be assessed.<sup>16</sup>

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<sup>9</sup> Financial Times 23 September 2007

<sup>10</sup> Specifically Comp 10.2 <http://fsahandbook.info/FSA/html/handbook/COMP/10/2>

<sup>11</sup> SN/BT/4466

<sup>12</sup> HM Treasury [Press notice 20 September 2007](#)

<sup>13</sup> [HC Deb 11 October c 464](#)

<sup>14</sup> [HC Deb 19 November 2007 c959](#)

<sup>15</sup> [HC Deb 12 December 2997 c371- 418](#)

<sup>16</sup> [HC Deb 21 January 2008 cc1207-10](#)

**17 February, (Sunday)** the Chancellor announced that the Government has decided to nationalise Northern Rock.<sup>17</sup> The draft *Banking (Special Provisions) Bill* published.

**18 February**, NRB shares were suspended.

**19 February**, the *Banking (Special Provisions) Bill* had its second reading in the Commons.

**21 February**, the *Banking (Special Provisions) Bill* received Royal Assent.

## **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. Testimony from the key players can be found in the evidence sessions held by the Committee and which are summarized below. Note the extracts from the evidence sessions below are drawn from the uncorrected transcripts.

### **1. The Bank of England<sup>18</sup>**

The Governor was asked (Q2) why he had provided liquidity to the market (19 September) having previously refused to do so because it “undermines the efficient pricing of risk by providing ex post insurance for risky behaviour”.

*Mr King:* I think the events of last weekend and the impact on the confidence that people have in the banking system generally could have been shaken by the scenes that were seen on television. I do not think there is any fundamental reason to doubt that but, as I said in the statement I sent to you, the balance of judgment between how far you extend liquidity against a wider range of collateral on the one hand and being concerned to limit the moral hazard on the other, to limit the ex post insurance, is a judgment that we are making almost daily in the febrile circumstances of the time. The operation yesterday was carefully designed and judged. It does not give ex post insurance, it is limited in size, it is limited in amount to each individual bank, and that provides a strict limit on the extent to which there is some ex post insurance, so we have balanced the concerns about moral hazard against the concerns that arose at the beginning of this week about the strains on the banking system more generally.

The point was then put to him (Q3) “that if you had undertaken the same steps as the ECB and the Fed then we would not have had the NRB problem”? The Governor rejected this saying that there was no evidence that there was a market, as opposed to a public, solution to NRB’s liquidity problem:

The real problem facing NRB has been that the assets side of its balance sheet suddenly became highly illiquid, and one has to ask the question who would have lent or who would have bought the assets from NRB? Well, they tried and did not find any

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<sup>17</sup> HM Treasury [press release, 17 February 2008](#)

<sup>18</sup> Treasury Select Committee 20 September 2007, witnesses Mervyn King (Governor), Sir John Gieve, Deputy Governor for Financial Stability, Kate Barker and Andrew Sentence, External Members on the Monetary Policy Committee and Paul Tucker, Markets Director.)

buyers. At that point I think it was clear that in one form or another **NRB** required as a backstop a lender of last resort. The natural place to look for a lender of last resort is the central bank. You could ask whether the market could have been the lender of last resort for **NRB**. I think the only circumstances in which that would have been feasible would have been when we had gone back to normal circumstances and banks had already financed the taking back onto their balance sheets of the conduits and vehicles that they now expect over a period to take back onto their balance sheets and were once again in a frame of mind to be willing to lend to others who had illiquid assets. To do that I think would have meant to inject a massive amount of liquidity in order to get back then to where we were in July. The Federal Reserve and the ECB have gone nowhere near that far at all.

Asked (Q4) about the Bank's handling of the crisis, how it became so public and transmitted such panic, the Governor replied:

One of the major considerations during August was there was no reason to believe that it was inevitable that **NRB** or any other bank would get into difficulty. There were clearly liquidity problems; they might or might not have been resolved. To have announced at that stage either a liquidity injection on such a scale that all the banks would have had their immediate liquidity difficulties dealt with or to have announced at that stage a guarantee for depositors in every bank would undoubtedly have been a signal that the authorities were deeply concerned about the entire UK banking system. That is wholly unfounded.

[...]

The most important point I want to make is to ask yourselves how would the Bank of England have dealt with this in earlier years. How would it have dealt with this in the 1990s? The first way it might have dealt with it was to invite the directors of **NRB** and prospective purchasers into the Bank or the FSA for a weekend to see if that could be resolved and a transfer of ownership agreed over the weekend such that the depositors in **NRB** would have woken up on Monday morning to find themselves depositors of a larger and safer bank. That is not possible because any change of ownership of a quoted company - and **NRB** is a quoted company - cannot be managed except through a long and prolonged timetable set out in the Takeover Code. The second way in which the Bank would have preferred to do it in years gone by, and did do it in the 1990s, and the way that I would have wanted to do it on this occasion, is to have acted covertly as lender of last resort, to have lent to **NRB** without immediately publishing that fact, publishing it after the operation had been over so that you and others could hold us accountable for the operation itself. As a result of the Market Abuses Directive in 2005, we were unable to carry out a covert lender of last resort operation in the way that we would have done in the 1990s. There is a great tension between asking companies to disclose things which may affect the decisions of shareholders and on this occasion asking them to disclose something which actually undermined the ability to carry out an operation which I believe was in the interests of everyone connected with the company. We were forced back to doing it in a covert way.

Sir John Gieve responded to the suggestion (Q8) that the Bank (and FSA) had been asleep:

I do not think I was asleep at the wheel. [...] the FSA took the lead with **NRB** in looking to see if there was a private sector solution but a private sector solution was not available, could not be mounted, and as a result we then moved on to our offering a liquidity facility to them. We knew when we did that that the announcement of that would have two effects: a good effect because it would show they had a new source of finance but a bad effect because it would send the market a signal that they really

needed a new source of finance. In the event we knew that there was a risk that that balance would go the wrong way and it did.

**Q9 Chairman:** Someone should have seen the risks that **NRB** were taking. It does not seem to me as if anyone took any concern about it, so we have one company with a bad business model which ends up threatening the financial stability of the country and therefore your role as Deputy Governor and as an ex officio member of the FSA seems to me crucial here. Should that not have been spotted?

*Sir John Gieve:* The first people of course who are responsible for the business model and the decisions of **NRB** are the **NRB** board. Secondly, of course the FSA through their supervision team have been keeping closely in touch with **NRB**, as with other banks, throughout. You are saying should someone have stepped in and prevented them running the business they ran?

**Q10 Chairman:** No, what I am saying to you is a wonky business is in existence that may jeopardise financial stability; you have an obligation to ensure that you are up to the mark in seeing that and taking anticipatory action. That is what I am saying. I am not saying you should interfere. Mr Tucker, everybody was saying that **NRB** was almost a basket case.

[...]

**Q12 Chairman:** Governor, I am not getting much comfort from the answers I am getting here. There is an obfuscation going on. There is a simple issue here.

*Mr King:* Let me try and put it simply: what happened on 9 August was that there was a realisation of an event that we had been warning against for a long time which is that the markets and the securities that many banks and others had been creating suddenly dried up. In the Mansion House speech in June I said very clearly the liquidity of markets in complex instruments is unpredictable. The problem for **NRB** was that if that eventuality materialised they would end up with a massive maturity transformation on their balance sheet. At that stage it was clear that at some point a lender of last resort might be necessary. My basic point to you this morning, as I started earlier, is that the interaction between different pieces of unconnected legislation made it almost impossible for us to conduct the lender of last resort option in the way that we would prefer. I am willing to go through the other events and explain what happened.

The Governor, in response to further questions (Q14) about the lender of last resort role, continued his explanation about the limiting effects of legislation upon the Bank's freedom to act.

*Mr King:* There are certainly question marks over it but the question marks are not because we cannot in theory act as a lender of last resort but because in practice we are hemmed in by this interaction between these four pieces of legislation. **Firstly**, you cannot transfer the ownership of a bank over a weekend because of the **Takeover Code**.

**Secondly**, the ability to conduct covert support, which would avoid the risk of creating concern among depositors, is ruled out because of the **Market Abuses Directive**. once retail depositors have become concerned - and it was not obvious that the announcement of the lender of last operation would result in people wanting to take money their out, it could have gone either way - once that run had started people were not behaving illogically in joining it and wanting to take their money out also because of the two other pieces of legislation.

**First**, there was the way in which when banks are put into **administration** retail depositors find their deposits frozen and they cannot access them, even in a solvent bank, and that is not something that any depositor would want to take a risk on and,

**lastly**, that the **deposit insurance** is less than 100% for most of the deposits.

He continued (Q14):

We now require a serious reform of deposit insurance, of the administration of banks, of the clash between the wish for transparency of companies to their shareholders, the tension between that and how it applies to banks when in difficulty, and the length of time it takes to deal with transfer of ownership of banks. Those four things are fundamental. If any one of those had not been there, there would not have been the problem with the lender of last resort operation. It required all four to be there to prevent us acting in the way that we wanted to do.

Later, the Governor re-iterated this theme (Q19):

Our system for dealing with insolvency of banks and deposit insurance is markedly inferior to other countries. That has been true under governments of all parties in this country. I think this was the unintended consequence of different pieces of legislation coming together and it needs to be acted on speedily because the guarantee that we have in place now for the banks cannot be a permanent solution; we will need an exit route.

He was asked (Q21) why these legislative constraints had not been discovered before:

*Mr King:* Some of them we had realised and discussed before and that had come out of, exercises; on some of them work is already going on, as I understand it, to think of the legislation; and others are much more recent. I think the problem in the Market Abuses Directive which prevented my first preference course of action here, which was to be a covert lender of last resort, is it only came into effect in 2005, the wording in it is ambiguous.

The Committee asked about the working of the Tripartite framework (Q15) “Who was in the lead in this crisis and did that change in the past few days”?

*Mr King:* No, each party in the tripartite authority has separate responsibilities and if you ask me how would this have played out if we had not had the Memorandum of Understanding, I do not think it would have made any difference to the substantive problems we faced and I think it would actually have made it harder to manage the process. The great virtue of the MoU is that it does not change the instruments available to the authorities in any way. What it does do is to clarify responsibilities, everyone knows what their job is, and it enables us to know and to practise beforehand how we communicate with each other.

[...]

**Chairman:** When you talk about everybody knows their own job, Governor, I have to ask you this question because it has been in the public press: are you your own man? Were you lent on in this situation? Is that why you did the U-turn in the past seven days?

*Mr King:* No, I can assure you that the operation we carried out was designed in the Bank. Of course in these circumstances I want to discuss it with Callum McCarthy and the Chancellor. It would be very odd if they were to have woken up and found we had done this and they did not know anything about it, so of course we discussed it, but I give you my personal assurance that I would never do anything unless I thought it was the right thing to do. The independence of a central bank is not just about legislation; it is about having people in the central bank who will do what is right for



the country in their job and not do what people ask them to do, whether it is the banks or whether it is politicians.

The Governor was repeatedly pressed on the question of 'who was in charge during the crisis' (Q23 - 25).

*Mr King:* We are each responsible for the various responsibilities that we have been given under the MoU. The final decision on whether to put taxpayers' money at risk obviously belongs with the Chancellor, you would expect that. I do not have the authority to put taxpayers' money at risk. The responsibility for the design of the operations in markets that we carry out is our responsibility at the Bank and the judgment about individual institutions is that of the FSA.

[...]

**Q27 Mr Fallon:** Would it not have been easier to have handled this affair if you were still in charge of banking supervision?

*Mr King:* I honestly believe not. I think that now there is a much more formalised and legalistic framework of supervision, which is not a consequence of the division between authorities but of the evolution of the financial system.

[...]

My own view for what it is worth is that the MoU worked well and it is very sensible to have the responsibilities laid down so that you know what we are accountable for. The problems in this case were quite different. They came from the inherent logic of the economic position that **NRB** found itself in and the various constraints that were placed on the ability of the authorities to take action.

The Governor expanded on his view that the Bank should not be responsible for banking supervision later in the session (Q90).

*Mr King:* No, I do not accept that the MoU was "unworkable in a crisis"). One of the very good reasons for taking supervision away from the Bank of England was that it was becoming more and more impracticable to regard banks as being part of the financial system that could be regulated independently of a wider range of financial institutions. The whole process of supervision now is much more formal, much more legalistic, much more international. I think it is a full-time job. It takes up all the energies of senior people to do that. In the event of any crisis like this it is inevitable that those responsible for supervision, those responsible for central banking activities and the Government have to work together irrespective of where they are actually located, so even if two of those had been in the Bank of England we would still have had to work with the Government so having all three people there I think is crucial. The MoU in my experience has ensured very effective, speedy communication. Callum McCarthy, the Chancellor and I have talked regularly and frequently. We have a team of deputies under us who speak even more frequently. I do not believe that the communication or the effectiveness of the tripartite arrangements have been in any way responsible for this. Indeed in my experience it has enhanced it. I just do not believe that one institution - a central bank - can manage in today's world both monetary policy and the entire range of financial supervision.

The fact that the interim results of NRB (published 21 July) had been read by neither the Governor nor Sir John Gieve, even though the interim statement revealed that "the FSA had allowed it to weaken its balance sheet by widening its Basel II waiver and thus enable it to pay a 30% increase in its dividend"? (Q34) was probed in detail:

**Q36 Mr Fallon:** It was the bank that was most exposed to the freezing of the wholesale markets because of its particular business model and it produced interim results on 25 July and you did not read them?

*Sir John Gieve:* No, I did not. Remember this was 25 July. At that point the markets were disturbed but the events of 9 August had not happened, and I do not as a member of the FSA board try and second-guess the teams who actually carry out the supervision, who of course would have been in close contact with NRB or indeed with any other bank.

**Q37 Mr Fallon:** So neither you nor the Governor realised how exposed NRB was until the middle of August? Is that the position?

*Sir John Gieve:* Can I just say that in our Financial Stability Report in April, for example, we identified the increasing wholesale funding of banks as a potential risk if markets became less liquid. That was one of the warnings we gave, so I was concerned in a general way about the growth of wholesale lending. Did I know the details of NRB's position before this blew up? No, I did not.

**Q39 Mr Fallon:** For four months nobody at the Bank realised the implications?

*Sir John Gieve:* The implications of what?

**Q40 Mr Fallon:** Of the fact that NRB would be exposed if the wholesale markets froze.

*Sir John Gieve:* I think NRB has the most developed wholesale funding model among the mortgage banks in Britain. There was a detailed knowledge in the FSA of the positions of the individual banks. Did we foresee that the way that events would unfold exactly in terms of the freezing of the mortgage securitisation market and the impact on term money markets? No, we did not see exactly how it would come through. At the point of April - this is before the events - we identified that there were vulnerabilities in the system but we did not see exactly the path that they would lead back to NRB. And I do not think anyone did.

Later questions about the extent of 'hands –on' monitoring did little to lessen Sir John's discomfiture:

**Q131 Chairman:** Okay. John Gieve, you say you were alerted to the NRB situation on 14 August. How many days have you been at the Bank since 14 August? Has every day been a strenuous day for you?

*Sir John Gieve:* No, I was not at the Bank on 14 August. I was away for two weeks in August, first at a family funeral and then for a week in France.

**Q133 Chairman:** So from 14 August you were away until the beginning of September?

*Sir John Gieve:* No, I was back at the end of August. I was in touch with the office. I discussed with the Governor whether I should return. At that stage he thought that was not necessary. I therefore came back at the beginning of September and of course I have been there since.

Questions followed about 'stress testing of NRB, questions which were repeated more relevantly to the FSA in their session (see below). The Governor was then asked about the importance he placed on 'moral hazard' and why he appeared to be more attached to it than other central bank leaders (Q54):

*Mr King:* If you look at what the ECB and the Fed have done in their market operations they have not provided complete ex post insurance, they have not put

sufficient liquidity into the banking system to enable the banks immediately to take back onto their balance sheet all the risky conduits and vehicles that they have created without incurring a cost. All banks around the world will pay a price for what has happened. What I want to do is to make sure that when they get liquidity from central banks they pay a price for it and do not get it free. The banking system as a whole can afford to do this. If I thought there was a risk to the British banking system as a whole and that the capital that the British banking system has was inadequate to take this onto their balance sheets, I would be out there putting liquidity in at a lower price to stabilise the British banking system. That is not necessary. If you always provide ex post insurance you can be quite sure that in five or ten years' time another crisis will come. That is exactly what we have seen in the last 20 years. The one thing I do not want to do is to find myself five or ten years down the road saying, "Why did I take the easy option? Why did I do that? Why did I sow the seeds of a future crisis?" The whole regime of monetary policy that we have put in place has been to demonstrate that taking the easy option and giving in in the short run without looking to the long-run consequences of those actions is damaging. Every manufacturing company I go out and meet around the country every month has come to realise that the short-term option which they wanted ten to 15 years ago - a cut in interest rates at the first sign of a problem - is not the way to go; it is having a stable framework. We need to put that view back into the financial system.

The Governor was pressed further:

**Q86 Peter Viggers:** How severely do you think the principle of moral hazard has been compromised since you wrote us your rigorous and lucid letter?

*Mr King:* I hope that it has not and I do not believe that it has but, as I said, this is a balancing judgment. When I listened to the banks I do not believe that they felt that offering them an ability to bid for liquidity at a 100 basis point premium over bank rate was something that they regarded as entirely generous, so I think there is still a fair chunk of restriction against moral hazard in what we have done

The Committee then turned their attention to the question of a 'white knight' bidder for NRB.

**Q74 Mr Mudie:** There is a suggestion that TSB walked away from the table because you were unwilling to give that guarantee. I heard that it took you about nine days to get legal opinion, which I find alarming.

*Mr King:* I am sorry, this is complete nonsense.

**Q75 Mr Mudie:** Why did TSB walk away?

*Mr King:* I have no idea what bid discussions were going on. I knew that there were some bidders interested. When I was asked last Sunday what the terms on which a bid could be completed were, I confirmed very quickly that we would roll over the lender of last resort facility to any bidder. I am absolutely in favour of having a bid as a long-run solution to NRB if that can be achieved. I did not oppose a bid, I supported it, but last Sunday, Mr Mudie, only a Government guarantee would have stopped that run. A bid would not have done it nor would any other solutions.

**Q76 Mr Mudie:** Let us just be clear. TSB were still at the table until last Sunday when they got word from you that the legal advice you had got meant you could not be the lender of last resort?

*Mr King:* No, not at all. I was asked by the FSA whether in the event of someone bidding - and this was a generalised proposition, not a particular institution ---

**Q77 Mr Mudie:** Who asked you?

*Mr King:* Callum McCarthy at the FSA. He said in the event of a bid being made would it be the case that the lender of last resort facility that had been put in place the previous Friday would be extended and rolled over to a bidder, and I said yes.

Later, there were further questions about the role of the authorities in assisting, or hindering, a rescue (Q108)

**Mr Love:** Can I just turn to Sir John because there is unhappiness at NRB, there is unhappiness with the suitors; where did it go wrong and what responsibility does the FSA or other authorities have for it going wrong?

*Sir John Gieve:* Firstly, as a member of the FSA board I will give you an answer, but of course Callum McCarthy and Hector Sants will be coming here to speak for the FSA, rather than as a non-exec. Two things: firstly we were alerted first to the position of NRB on 14 August but it was not obvious to them or to us at that point that they were going to require government assistance. There were two things that they were actively exploring, one was a possible merger or takeover, and the other was raising money both through short-term money markets and by actually securitising their debt. They were still hoping to securitise some debt and thus relieve their liquidity pressures right into September, and it was only when that proved impossible that it became clear that they needed another source of liquidity. In terms of the crisis, the key question that underlies your questions is was it worth on Friday announcing that the Bank was making a facility available or should we have said at the same time that the Government guaranteed all the deposits? We did realise there was a risk that, if you like, the shock effect of an announcement would overwhelm the positive effect of saying the Bank was standing by with some money. We knew that was a risk but we thought that it was not an overwhelming risk and it was worth taking that step, so actually the guarantee which proved essential in the end came out on Monday. If we had known it was going to be essential on Monday we might well have offered it on Friday but that was not certain at that stage.

**Q116 Mr Brady:** Just a very quick point of clarification really to Sir John. You said that if you had realised what the consequences would be when you announced the facility on Friday you might also have announced the Government guarantee then. The Governor has told us that the question of the guarantee was not discussed until Sunday. Can you make it clear whether there was any consideration at all on Friday or before that as to whether a guarantee ought to come at the same time as the facility was announced?

*Sir John Gieve:* We had of course discussed what would happen if the negative news of the announcement outweighed the positive news, and obviously a Government guarantee was one of the possibilities - and I think this is what the Governor was saying - it was a formally discussed as an action and whether we should take the action now or tomorrow on the Sunday. We did realise that simply announcing that there was a new source of funds for NRB might not be sufficient to restore confidence, but we thought there was a reasonable chance that it would, and in any event it was the right thing to do. They were having to make a profit warning and I think for them to make a profit warning without having clarity on their sources of funding would have been disastrous.

## 2. Financial Services Authority<sup>19</sup>

The Chairman asked (Q155) for an FSA view on 'moral hazard':

Sir Callum McCarthy: I think that there it is an important question of balance between the issues of moral hazard, which the Governor addressed very clearly in his memorandum to this Committee and what I would call the problem of damaged innocent bystanders in the sense that there is a problem associated with a worldwide liquidity drying up, which affects not only people who have played a part in arguably irresponsible behaviour, which is the Governor's concern, but much more widely in terms of other people who can possibly be harmed by that event.

**Q156 Chairman:** So you agree 100% with the Governor?

Sir Callum McCarthy: No, the Governor's document was his document. I am saying it is a question of balance.

**Q157 Chairman:** I am asking if you agree 100% with the Governor on that subject.

Sir Callum McCarthy: I think that it is possible for people to have different views, and my own view of the balance between the moral hazard arguments and the other instances is slightly different from the Governor's.

[...]

**Q160 Chairman:** What is the difference between your view and the Governor's?

Sir Callum McCarthy: The question that I was trying to explain, Chairman, is the balance between the moral hazard arguments, which are clearly important, and equally the importance of making sure that when there is a liquidity problem there is a means of dealing with it.

**Q161 Chairman:** So I can take from that that you would have dealt with it in a different way from the Governor?

Sir Callum McCarthy: No, I do not have the responsibilities that the Governor has; I do not have the requirement to weigh up the general monetary policy questions that the Governor has to weigh. I have a different set of responsibilities.

The FSA were asked whether they agreed about the significance of the four pieces of interlinking legislation identified so strongly by the Governor (Q167):

Sir Callum: I agree with him that each of those four problems are significant problems. I would add that when we conducted a particular exercise with the Treasury and the Bank in February we had identified in particular the problem of having a means of dealing with banking problems and the need to deal with the question of bank insolvency problems and also the question of the compensation arrangements.

[...]

**Q170 Chairman:** Let me focus on the Market Abuse Directive because the Commission came out with a statement that was contrary to what the Governor said. Was it flashing up in red lights to the tripartite body that the Market Abuse Directive was an impediment and something had to change there?

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<sup>19</sup> Evidence Session 9 October, Giving evidence were Sir Callum McCarthy, FSA Chairman, and Mr Hector Sants, FSA Chief Executive;

[...]

Mr Sants: If I might just explain a little bit further. As Sir Callum has indicated, each individual judgment has to be situation specific. It was certainly known to us both during any war-games and, of course, generally during the course of our normal business that there would be certain sets of circumstances which would require disclosure. The disclosing circumstances revolve around, of course, the extent of the support being offered and the relevance of that support to the long-term viability of the company and in terms of the knowledge in the market place at that given point, and so, of course, the nature of support which came into penalty would have an impact on its future profitability and so forth. So there are a set of inter-related circumstances which means that a support operation of that type needed to be disclosed at that time.<sup>20</sup>

The Directive was also discussed later in the session.

**Q264 Mr Brady:** In answering questions earlier about the Market Abuse Directive specifically, I think it was Mr Sants who was saying that the inhibition appeared to arise really on the part of the responsibilities on the Board of NRB rather than the regulatory authorities or the Bank. Would that be accurate?

Mr Sants: The initial responsibility as to whether disclosure should be made undoubtedly rests with the board of a company, and in this particular case they felt disclosure should be made. We have, as you say, no reason to challenge that conclusion they had reached, that is absolutely right, and I would repeat the point I made earlier.

**Q265 Mr Brady:** Is it your view that under Article 7 of the Directive, which exempts central banks from its provisions, that that exemption is---

Mr Sants: Does not apply to these circumstances.

**Q266 Mr Brady:** So there was no impediment on the Bank acting as a covert lender of last resort, except that it would not remain covert because of disclosure from NRB?

*Mr Sants:* Correct, in relation to the circumstances they were in and concerned as to the implication of that facility in terms of its magnitude and implication for their profits forecast, and of course I repeat this is all a moot point once the leak had occurred. A more general point here might well be that it is very difficult going forward to imagine in modern society that it would be that easy to keep a covert operation of that size covert for any length of time anyway. There are other obligations here, particularly to credit agencies.

**Q267 Mr Brady:** So do you think it would be sensible to look at changing the disclosure rules or not?

*Sir Callum McCarthy:* I think the point that we both have been trying to make is, quite apart from the legal obligations, there are fundamental practicalities which are at least as important as the legal concerns.

The Committee turned to the role of the FSA as regulator:

**Q188 Mr Fallon:** Could we turn now to the events leading up to this fiasco. In your letter you admit that you had not carried out a full risk-assessment of NRB since February 2006. That is 18 months ago. Why was that?

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<sup>20</sup> Evidence Q 172

[...]

Mr Sants: I will be happy to answer that. There are two points to make, first of all. The full arrow assessment, even for high impact firms under close and continuous supervision, of which NRB is one, is not done at a frequency greater than every 12 months or so in terms of normal practice.

[...]

Between 12 and 18 months. The most frequent assessment we would do would be 12 to 18 months. What we do, however, is engage very closely with specific thematic issues of concern, and NRB were regularly visited by supervisors, roughly speaking (and I do have a full list here), on two to three months or so intervals.

**Q191 Mr Fallon:** [...] when was the next full assessment due?

Mr Sants: The next full assessment due would have been three years after the one in question, and, in my opinion, that is inadequate.

**Q192 Mr Fallon:** You are dealing with a bank which is lending quadrupled from 25 billion to 100 billion, that was taking one in five of the mortgage market, and you only did a full assessment every three years.

Mr Sants: As we lay out in the statement we put before you, I completely agree with you. I think there are lessons to be learnt here with regard to our supervisory practice and I think we do need to look back over our engagement with this particular company and do a lessons-learned exercise, particularly with regard to particular areas. I think we need to look into our assessment of probability with regard to the set of scenarios that actually did develop. We did have this organisation as a high-impact organisation, but in terms of the probability of it getting into difficulty we had it as low-probability, and there was no question, of course, looking at the way events transpired, that that probability analysis has been proved to be incorrect, so we had some serious lessons to be learned in terms of the way we went about measuring our probability, and linked into that, which I think links into your point about the Arrow risk assessment, which I completely agree with, is that we need to look more carefully at the stress testing issues in relation to this company.

I think the question is not: did we understand the NRB business model? I think we did completely understand the NRB business model and I would not, by the way, agree with your analysis of how the NRB business model worked, but what I would agree with absolutely is that we did not engage in our supervised process in a way to my satisfaction with regard to the stress testing scenarios, because the stress testing scenarios which they were operating with did not envisage the set of circumstances that transpired in August, which was complete closure to them of all reasonable funding mechanisms, including the repo market.

I have to say, I do not think any reasonable professional would have anticipated that set of circumstances, but I think as a regulator we should have engaged with that in an extreme stress test. Indeed, we had been saying over the previous period, in anticipation of market conditions declining, that we wanted firms to take a more extreme view of their stress testing; and we had that engagement with NRB in July when we went to visit them with regard to their stress test and pointed out that we were not comfortable with their scenarios, but, regrettably, as is apparent to us all, that was rather late in the day. So, we take the view that we should look at our supervisory practices and we agree with you to that point.

**Q193 Mr Fallon:** How many were supervising NRB?

Mr Sants: In terms of direct supervision it, it would be three, which is standard practice for high impact firms, and, of course, they are drawing on groups of specialist

individual in the area such as stress testing and risk-management and these areas would also contribute to the visit programme.

[...]

**Q196 Mr Fallon:** Why were they allowed a waiver under the Basle II Directive? Why were they allowed a waiver in June?

Mr Sants: The Basle II waiver is standard procedure of the implementation of the CRD and was the standard procedure we were going through with any bank who wished to apply for one at that stage. The actual change in their regulatory Basle II surplus at that point as a result of that waiver was only some 30 million, which I do not think in the context of the problem that we are talking about is significant, but that was basically a standard process. It should not be seen as a one-off special exercise on their behalf.

The FSA denied that they had been slow to inform the other members of the Tripartite (Q199-200):

**Mr Fallon:** Why was there a five-day gap from 9 August to 14 August before you alerted the Treasury?

[...]

Mr Sants: If I can maybe amplify a little bit. Certainly as of the ninth we were in regular discussion with NRB in monitoring their liquidity, but if you look at their liquidity availability in terms of days, which is a way of looking at their liquidity regime, you are not actually looking at a significant deterioration in their profile until well over 14 August. So we properly identified that, because of their dependence on securitisation, which required them in general to do around five billion of securitisation in a quarter, with the closure of the markets this was potentially an at-risk firm, but the actual deterioration in the profile does not occur until well into September and, indeed, it was not until 10 September that they reached a conclusion that securitisation was not going to be possible. They were actually in negotiation, as you know from our memo, with a number of banks about the possibility of doing underwritten securitised transactions during that period. So, in terms of alerting the Treasury to the fact that we anticipated a significant issue with NRB, which was done by myself on 15 August, I would say that was very early to alert them to specific concerns about a specific firm in the light of the liquidity information we had available and not in the light of our knowledge of the business model. So I think we very quickly identified that that business model was at risk. Also in passing, whether we had told the Treasury on the fifteenth or a few days earlier would not have made any difference to the set of circumstances that transpired.

The FSA chairman was called upon to explain his statement that NRB was 'extreme'.

**Q201 Mr Fallon:** When did you first come to the conclusion that NRB's business model was extreme?

[...]

Sir Callum McCarthy: In terms of its reliance on securitisation in terms of the overall balance sheet, that was something that was well-known. I do not know what time in the last two years, three years I became aware of it, but it was well-known that that was a particular feature.

**Q203 Mr Fallon:** You were in charge of supervising NRB, you were aware that its business model was extreme, yet over the last two years nothing was done to prevent this particular crisis.

Sir Callum McCarthy: No, that is not a description of events that I would recognise. I have tried to explain that my comment on "extreme" related to the overall balance



sheet of NRB. The particular problem, as Hector has explained, related to the short-term funding, and the short-term funding is a problem which has been acute but has been caused by the fact that they had access to securitisation, to covered bonds, to commercial paper and had high quality assets to repo, and they did that in euros, in dollars, in sterling, and all those markets, including the repo market, closed and that is an exceptional, indeed unprecedented, set of events to have occurred for the duration and severity that has occurred. I absolutely accept, as Hector has said, that we did not identify the probability of that happening.

Hector Sants was asked about the robustness of the 'stress tests' done on the NRB business model. He accepted that they were deficient (Q210):

Mr Sants: I agree with you. As I said before, if you look at the type of stress test NRB was using, they were not anticipating closure of the securitisation market and the repo market. The only set of circumstances actually which they had in which those type of closures occurred were operational failures rather than market failure and, as I said earlier, I think that type of scenario should be in a stress test; and we would like to see more extreme stress tests and we were making those points, as you kindly point out, in the document in question, and it is incumbent on us to make sure that we carry that through with all the major firms that we regulate, and I think that lessons learnt point, as I have said before, needs to be picked up in our supervisory practices

The Committee then examined the role and work of the FSA's Risk Committee (Q212) which looks at specific market risks and communicates them to the FSA regulators. It also discovered that an IT project that would produce electronic 'Fact Books' is not yet up and running, indeed (Q219) "It is one of these projects which is rolling away gently in the background".

The FSA confirmed (Q228) that NRB has a 'good quality loan book', despite its innovative lending criteria.

Sir Callum McCarthy: If I look at the assets of NRB, of course we were concerned to look at its record. If I look at, for example, the three month arrears figure, although it has increased slightly over the last year, it is still running at less than half the industry average. NRB has no exposure to the sub-prime market because it laid off all that exposure to another institution. If you take the particular 125%, which actually has got some limits within it which have to be recognised, the record of bad debts and arrears on that was also very limited relative to the industry average. The loan to value is not excessive. So, in all those respects, we believe that it is correct to say that the loan book was a good quality loan book.

However, the Committee probed deeper into the FSA's knowledge of 'Granite' the NRB's funding vehicle (Q231):

**Chairman:** You are aware that the NRB funding was carried out through off-balance sheet special purpose vehicles, a lot of that funding?

Mr Sants: Yes.

**Q233 Chairman:** Was it clear to the FSA that that was just a means of shifting the risk into unregulated entities beyond the view and the scope of the FSA?

Mr Sants: As Sir Callum has indicated, we need to be here careful that we do not inadvertently stigmatise wholesale funding operations as necessary bad for banks. In order to have a securitisation programme which, once a securitisation is done, creates long-term secure funding, you need a special purpose vehicle which provides the avenue.

**Q234 Chairman:** Were you aware it was done through a Channel Island subsidiary?

Mr Sants: Yes.

**Q236 Chairman:** What was the subsidiary in the Channel Islands?

Mr Sants: Granite.

**Q240 Chairman:** That was actually established under charity law and actually owned by a Channel Island subsidiary of the Law Debenture Corporation. Does that not seem a totally artificial construction to shift liability and avoid responsibility? Did the FSA not smell a rat?

Mr Sants: It is possible with regard to the Granite structure. We would probably have to come back to you with the detail of that proposition. I am not totally convinced. We might be talking at cross purposes here, so let me give you a written reply with regard to the Granite structure.

The Committee returned to a theme raised in its previous session; how far should the authorities have gone to curb a financial institution that was growing fast on an extreme business model (Q246)?

Mr Sants: I think relative to the funding issue which was the cause of the problem that they have put themselves into, it does not seem to me that the particular market share increase in those few months was a trigger that we should have been particularly concerned about. I do think we should have been concerned around the stress testing issues that I referred to earlier. So, I am more than happy to indicate, I think there are some significant lessons to be learned, but I am not sure that the market share point is particularly the critical point in terms of identifying the driver that led to their problems and the scenario that we should have envisaged.

**Q247 Mr Love:** I am not absolutely clear. At any stage in your discussions with NRB did you highlight the strategy they were pursuing? Did you say there might be significant risks involved in it? Did you try in any way to discourage them from being as aggressive as they turned out to be? What role did you play? Obviously you were monitoring them. Were you advising them and did that advice include: "Hey guys, this could be very risky for you"?

Mr Sants: Yes, but as I have said earlier, I think the intensity of that dialogue, at the time of the original arrow visit and subsequently, should have been more forceful. I think those points were being identified by July when we were engaging in the discussion around their stress test, but obviously at that point in time events overtook the firm. I want to be clear here, and I know you are questioning the FSA, but let us remind ourselves, it is the Board's responsibility to run a company prudently and the stress test scenarios are designed by the Board, not by us. We do not give prescriptive stress tests to firms; we think it is the job of firms to identify the right set of stress for themselves, but I agree with you, yes, we should have been in more intensive dialogue with the company earlier.

Later, further questions put a new slant on the question about NRB's business model (Q315):

**Mr Dunne:** The business model of NRB was heavily reliant, as we know, on the wholesale markets and you have just touched on commercial paper. The commercial paper market is of a one to three-month duration typically. For a bank as significant as this with long-term obligations stretching out many years in the mortgage market, do you think it is wise for funding sources to be so reliant on the short end, and is this not one of the fundamental tenets of bank practice that you do not borrow short to lend long?

*Mr Sants:* To some degree of course, that maturity transformation does have its uses but actually in the context of NRB the figures do not suggest that it was an outlier in respect of its dependency on very short-term funding. We have discussed previously the fact that - and I am happy to go back over the ground if you would like me to - its bigger risk factor was its dependence on the use of the securitisation products which was the market that froze. The actual percentage of its funding which was dependent on three months or under was not a particular outlier, and also just to remind us again, I think it is important to remember that it did not actually fail to fund itself in this period. What happened was its maturity shortened back into the overnight period to the point at which the Board thought it prudent to seek the lender of last resort facility, and we are all aware of the regrettable consequences of that in terms of consumer confidence, but it was not actually an outlier in respect of short-term funding ratios, it was an outlier in respect of overall wholesale funding, as Sir Callum indicated earlier, which included the securitisation component.

**Q316 Mr Dunne:** If it is not an outlier, does that not suggest that there are many other banks that are overly dependent on short-term sources of funding and if these dry up there could be contagion across the sector?

*Mr Sants:* I tread very carefully in this space, but of course, as I have mentioned before, it was specifically the short-term funding failure which was the problem here, it was the absence of the securitisation market, which is a widespread phenomenon, and we need to remind ourselves they were offering good-quality paper, this was not a NRB-specific problem, and it is because they are an outlier in that respect that they put themselves in a position where they became concerned. As a general point, you are right, and now we are back to our stress testing point, it has to be right that our banking sector gives proper consideration to having a diversified set of funding sources across the whole spectrum of maturity which it properly gives consideration to even in extreme circumstances so that they can remain funded for a reasonable duration of time. I am mindful of the other point earlier, that we are not a regime that guarantees there are no failures and we need innovation in financial markets. To say that we should not have had securitisation would not be a good conclusion to draw from this.

The Committee returned to the functioning of the tripartite system. The FSA reiterated that lessons had been learnt about their supervisory role and accepted responsibility for the crisis. Sir Callum outlined in some depth the co-operation between the separate arms of the Tripartite as the crisis developed (Q253)

Sir Callum McCarthy: [...] from 9 August we set up a daily, and sometimes more frequently than daily, meeting, which was a telephonic meeting, of the Bank, the Treasury and the FSA. We exchanged information - I believe that information exchange has worked well - we identified problems and we have agreed actions.

**Q254 Peter Viggers:** I put it to you that, whilst you have the duty of supervision, many of the actions that need to be taken by government lie elsewhere and that real action in seeking to find a solution only emerged after 16 August when you set up a project team with the other two regulatory bodies?

Sir Callum McCarthy: No, I think it was appropriate. I think Hector gave an account of the developing liquidity problems. I do not believe that it was a mistake not have to set up those project teams before 16 August and I think that there was no indication that the date of 16 August was too late a date.

[...]

**Q260 Peter Viggers:** Do you think that lessons have been learned about the tripartite method of supervising banks and building societies?

Sir Callum McCarthy: I think that one of the things that we need to do is undoubtedly to look at the lessons of the tripartite arrangements, and I am particularly concerned about issues affecting financial compensation and the need to have a bank insolvency route which enables us to deal with a bank in difficulty in a way which gives clarity and certainty to its customers so that the probability of the anxieties that led to the queues for NRB is something that we can deal with. So I think those are very real issues.

Another Member of the Committee continued this theme. Having first likened the FSA (Q271) to:

Herol "Bomber" Graham of the financial services industry, a medium ranking British boxer who could not punch, who was the very antithesis of hard-hitting but upon whom it was impossible to lay a glove

he continued (Q272):

**Mr Simon:** I was not asking who is responsible for supervising the institution; I was asking who is responsible for this crisis, this fiasco, this debacle? Which of the tripartite authorities ultimately was responsible the most?

*Sir Callum McCarthy:* I am afraid that, rather like the Governor who answered the question, (I believe correctly) by saying here are the responsibilities of the Bank; here are the responsibilities of the FSA and here are the responsibilities of the Chancellor and the Treasury, I will give the same answer.

**Q273 Mr Simon:** Do you think the tripartite arrangements work?

*Sir Callum McCarthy:* I think that they do work. If I look at the exchange of information which has taken place between the FSA, the Bank and the Treasury, I think that that exchange of information has been clear. I think that each of us has discharged our responsibilities.

**Q278 Mr Simon:** Relations between the FSA and the Bank have been described recently as "poisonous". What do you say about that?

*Sir Callum McCarthy:* I would say that I have a good and clear relationship with the Governor. I believe that Hector and senior colleagues work effectively and well with their opposite numbers in the Bank, and it is a description which I in no way recognise.

*Mr Sants:* I would say absolutely not true.

The Committee then turned to the issue of the initial reluctance of the Bank to provide liquidity in the market. Was this delay justified (Q285)?

*Mr Sants:* I think it is logically true and I have already indicated that, and I would agree with you, from the narrow question of would we be in the position we are now

in with regard to NRB, it clearly is the case that if liquidity in smaller amounts had been made available to NRB earlier, then it is quite possible it would not then have subsequently needed to apply to the lender of last resort facility. In terms of that narrow question of that particular institution, for the reason I have just said, clearly the public markets were closed to it. Its problem was a liquidity problem - we have discussed that - and therefore if it had been able to find a source of liquidity prior to applying for a lender of last resort facility then it might not have needed to have done that, and that absolutely has to be case.

Probing the negotiations amongst the tripartite participants Mr Mudie asked (Q287):

did at any time the FSA, as part of that, raise the question of the central bank putting some liquidity into the system generally? Yes or no? I think we are entitled to know what the FSA's view is. You have been hauled over the coals today for a situation which was maybe somebody else's creation, so did you at any time during these arrangements as the crisis developed say this could be sorted if you come off your high moral platform and just do what the Fed did or the ECB did?

*Mr Sants:* We clearly are very aware of our responsibility to interface with the market. I think you rightly point out that the majority of the market held the view you have just described and we very properly made sure, as the banks expected us so to do, that those views were communicated on to the Bank on a regular basis.

The Chairman continued (Q293):

**Chairman:** Following Mr Mudie's point, were you just an interface or did the FSA support the banks in their plea for additional liquidity?

*Sir Callum McCarthy:* We made it quite clear to the Bank of England the strength of feeling that was being expressed, but I would say that I believe that that was well-known to the Governor.

**Q294 Chairman:** Okay, so let us get a straight answer, Sir Callum, we are looking for one this morning, give us one. Did you support the banks in their plea for more liquidity?

*Sir Callum McCarthy:* In terms of the position of the FSA, the responsibility for making decisions on monetary policy (of which this is one) lies with the Bank and it is for them to make ---

**Q295 Chairman:** Sir Callum, this is getting absurd, it really is, because here we have a situation where some people are saying if you had put extra liquidity in would not have had this run and we would not have had deckchairs outside the 76 NRB branches. We are just asking you in terms of an orderly and efficient market (which is your responsibility) did you support the banks in their plea for more liquidity? Give us a "yes" or give us a "no" or say "we are not going to answer", but make it simple.

*Sir Callum McCarthy:* Of those three choices, Chairman, I am afraid I am not going to answer

Regarding support for any private sector buyer of NRB:

**Q335 Chairman:** Let us make it simple: did you agree no support or did you agree the terms of the support? That is really what we are looking for. It is a "yes" answer or a "no" answer or "no answer".

*Sir Callum McCarthy:* The tripartite decision was that it would be wrong to advance assistance to the bidding bank. It was subsequently made clear after the lender of

last resort facilities had been made available to NRB that those facilities would remain available to a bidding bank, if there were a bidding bank.

**Q336 Chairman:** So you were in agreement with the Bank of England on those two issues regarding the parameters which should be offered, namely the bidding bank receiving support and the terms of that support; you were at one with them?

*Sir Callum McCarthy:* We explained what would be required if things were to go forward.

**Q337 Chairman:** So you were at one with them, Sir Callum, you were at one with the Bank on that?

*Mr Sants:* It was not our decision.

**Q338 Chairman:** This is a "no answer" again. This is getting really, really unsatisfactory. You are one of the Tripartite Authorities but what seems to us here, Sir Callum, is that you are crawling into your den and you are not answering anything, and if we want to sort out this issue and this problem for the future we really need to know what one of the eminent authorities thinks, so is that another no answer?

*Sir Callum McCarthy:* I am trying very hard, Chairman, to answer your questions as clearly as I can. The FSA does not have a balance sheet which enables us to offer assistance and so what we did, which is what we are required to do, was to try and identify what would be needed, and a decision was taken that it was inappropriate to proceed on that basis.

**Q339 Chairman:** The reason why I am asking this, Sir Callum, is very simple, the authorities did not agree to do this and, as a result, the taxpayer is now at risk for £9 billion secured on mortgages which the Bank would never normally accept as adequate collateral, so other than lending to, say, a bank that came in - and from the name of the bank that came in it indicates that they are one of the world's largest and best capitalised banks - the taxpayer has this risk now. If you are interested in orderly markets and seeing them function effectively you should have a view on it, Sir Callum.

**Q340 Chairman:** If you are not going to answer the question tell us and then it is on the record.

*Sir Callum McCarthy:* I do not think I have anything else to say.

Towards the end of the session the Chairman of the Committee tried to summarise the key evidence (Q364):

**Chairman:** [...] can [I] try and sum up what you have said to us this morning you would say the lessons learned are: the FSA needs to push the extreme stress testing in banks; is that correct?

*Sir Callum McCarthy:* Yes.

**Q365 Chairman:** So there was an element of supervisory failure in that?

*Sir Callum McCarthy:* In terms of not pushing it further than we did, we should have done more, yes.

**Q366 Chairman:** So it was inadequate, that is fine. There is also low consumer confidence in the authorities; you have said that. I picked that up as I went along.

*Mr Sants:* As was demonstrated by the events surrounding the announcement of the lender of last resort facility.

**Q367 Chairman:** Okay. There are problems with the Financial Services Compensation Scheme deposit protection; that is correct?

*Mr Sants:* Yes.

**Q368 Chairman:** Okay. The three-year period between the full regulatory analysis of "high impact" firms is too short?

*Mr Sants:* Yes. [...] Three years should have been a shorter period.

**Q372 Chairman:** Thank you. Basle II liquidity requirements need modernised; is that correct?

*Mr Sants:* Basle II and liquidity is a different point. The overall international liquidity regime needs modernising.

*Sir Callum McCarthy:* Something which we are already working on.

**Q373 Chairman:** Okay. You perhaps took a different view from the Governor on the four pieces of legislation?

*Sir Callum McCarthy:* Sorry, I think the main difference which we have discussed is whether the problem of a covert lender of last resort is a legal problem or a practical problem, and we would place greater emphasis on the practical problems whilst not neglecting the legal consequences.

**Q374 Chairman:** So perhaps you had a different view.

*Sir Callum McCarthy:* A slight difference of emphasis.

**Q375 Chairman:** That is fine. In terms of supporting the banks for more liquidity and in takeovers supporting the bidding bank and the terms of supply, that question remains unanswered here?

*Sir Callum McCarthy:* Yes.

**Q376 Chairman:** The tripartite system in your opinion worked, everyone played their part?

*Sir Callum McCarthy:* Yes.

### 3. Northern Rock<sup>21</sup>

The bulk of the questions put to the NRB witnesses concerned their business model and the way they carried on business. Since the focus of this note is upon the 'political', supervisory and institutional aspects of the crisis the following account is not totally representative of the Committee's interest that day.

The Chairman of the Committee began (Q389) by asking how NRB had monitored its risk?

**Chairman:** Were you aware of the risks to the business at any time? When did you start becoming aware of the risks to the business?

*Dr Ridley:* I was fully aware of the risks throughout. We have a Risk Committee and we are continually assessing the risks to the business and stress testing against different risks. We were aware earlier in the year of the risk of tightening in the credit

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<sup>21</sup> Evidence Session 16 October, Giving evidence were Dr Matt Ridley, NRB Chairman, Mr Adam Applegarth, Chief Executive, Sir Ian Gibson Senior non-executive Director, Sir Derek Wanless, non-executive Director, available at; <http://www.publications.parliament.uk/pa/cm200607/cmselect/cmtreasy/uc999-iii/uc99902.htm>

markets and we expected that our good credit quality and our diverse funding platform would stand us in good stead under those circumstances.

**Chairman:** So when were you aware of the risks? What date did you really start discussing the risks to the business?

[...]

**Dr Ridley:** I started discussing it with the Chief Executive on 10 August, the day after the markets first froze, and during the next few days we discussed it in increasing detail as it became clear that this freezing was less and less and likely to be temporary.

Later (Q437):

**Mr Breed:** Sir Derek, [Chairman of the Risk Committee] were you entirely happy that during that period of time the Risk Committee operated satisfactorily and reviewed its risks so that it could ensure that the bank could continue to trade?

*Sir Derek Wanless:* The Risk Committee and the Board discussed the strategy on a continuing basis. I am perfectly happy, yes, with that.

**Q438 Mr Breed:** You are satisfied that you had the right strategy for that particular period between March and August?

*Sir Derek Wanless:* We talked from the time about the funding strategy, which was an annual look at all of our funding sources, about both retail and wholesale funding, and we talked about the ways in which that strategy was robust against many circumstances.

**Q439 Mr Breed:** Were you in contact with the FSA?

*Sir Derek Wanless:* I was not personally in contact with the FSA. The Risk Committee is a Board Committee which meets three times a year.

**Q440 Mr Breed:** The FSA did not contact you or talk to you about the risk profile of the bank?

*Sir Derek Wanless:* The FSA at this stage were talking extensively to the executive about the ICAAP process and Basle II and the executive were talking to the Board on a regular basis on where that process had got to.

Later the whole risk profile of NRB was questioned (Q401):

**Mr Fallon:** Your business model, Dr Ridley, was described by the FSA Chairman as "extreme". You were borrowing 75% of your funding from the capital markets; you failed to insure against any increase in the inter-bank rate; you failed to hedge the period between taking out a mortgage and its completion, because presumably you thought rates had peaked. This was not banking; this was a heavily leveraged bet on interest rates was it not?

*Dr Ridley:* I think it is worth clarifying what the funding side of our balance sheet was. It is true that we had a smaller retail deposit book than many other institutions, although there are many like us overseas. As the Chairman of the FSA also said, in terms of the short and medium term wholesale funding, as a ratio of our balance sheet assets, we were not an outlier. Most of our wholesale funding was in the form of securitised bonds and covered bonds, which are long-term funding. The average maturity is longer than the average life of a mortgage on our books.

**Q402 Mr Fallon:** But why did you not see the risk of capital markets closing to you? Why did you not insure against the danger of illiquidity?



*Dr Ridley:* We saw that there was a risk of tightening in the credit markets and we prepared for that. What we did not expect was that there would be no flight to quality in that process. In other words, we expected that as markets became tighter and as pricing for risk changed that low-risk prime UK mortgages (and we have below half the industry average of arrears on our mortgage book) and such a low-risk book would remain easier to fund than sub-prime mortgages elsewhere. That is why we were very determined to keep the credit quality of our book high, in order to be able to attract funding.

**Q403 Mr Fallon:** But a very high proportion of your funding was dependent on the capital market, a much higher proportion than other lenders?

*Dr Ridley:* We were dependent on, as I said, the wholesale markets but also the securitisation market and the covered bond market. We deliberately diversified our funding platform so that we would have those three different types of funding and indeed a diversified programme within the wholesale funding, and geographically we had programmes in the United States, Europe, the Far East, Canada and Australia. That was deliberately so that if one market closed we would still have access to others. The idea that all markets would close simultaneously was unforeseen by any major authority.

[...]

**Q405 Mr Fallon:** But it was your duty as Chairman and as a Board to ensure that your bank was liquid.

*Dr Ridley:* We reviewed liquidity regularly and we reviewed our policy on liquidity and our policy on funding regularly.

[...]

**Q407 Mr Fallon:** So you are the Chairman of a bank that ran out of money and that caused the first bank run in this country for 150 years; you have had to borrow billions of pounds of public money from the Bank of England; you have damaged the good name of British banking; why are you still clinging to office?

*Dr Ridley:* I would like to say that what has happened has been extremely distressing to us, as it has been to our other stakeholders, shareholders, employees and creditors. In view of what has happened I am extremely keen to try and turn the situation round and develop a stable future for Northern Rock. I am working night and day to achieve that. I serve at the behest of the Board and if they think that they can do better by asking for my resignation, it will be available to them.

The question of resignations was touched upon later (Q535) and the NRB Chairman resigned three days after the hearing. Questions were also asked about NRB's stress testing procedures and the FSA's role and advice on them (Q454)

**Mr Todd:** [...] The FSA did not do a full stress test on you in late 2006/early 2007 and actually combined their stress-testing exercise with their Basle II exercise with you; is that correct?

*Mr Applegarth:* It is indeed, and as part of Basle II, which is a two and a half year process, you have to run a whole series of stress tests, including for example a 40% house price fall. Of course I read the FSA evidence, but what was not stress-tested was the event that was deemed implausible of the global markets all freezing at the same time, with rapid speed and for a long duration.

**Q455 Mr Todd:** No, the FSA have not said that they alerted you to that possibility, however, they did - quoting Mr Sants - say that they had advised you that you needed to take into account more extreme scenarios than the ones you were presumably

using at the moment. Did you a) take any note of what that they said and b) if you did, what in concrete terms did that suggest to you?

*Mr Applegarth:* Yes of course we did because we had to satisfy them in order to get our Basle II approval. The extra tests they asked us to do were primarily to do with credit, such as the example I gave of the 40% house price fall. What we did not stress test and did not foresee was what was deemed implausible, which was the rapid and long-lasting closure of global markets. That was not stress-tested, no.

**Q456 Mr Todd:** But nevertheless I think it is fair to say the FSA did not feel that your stress testing model was adequate at the time they reviewed you under the Basle II process?

*Mr Applegarth:* There are always things you can do better and that was a continual process and had been for the previous ten years with them.

The decision to first increase the NRB share dividend, then maintain that it would be paid only to cancel it, was raised on a number of occasions. (Q398).

**Mr Fallon:** Mr Applegarth, why was it decided a month after the first profits warning, as late as the end of July, to increase the dividend at the expense of the balance sheet?

*Mr Applegarth:* Because we had just completed our Basle II two and a half year process and under that, and in consultation with the FSA, it meant that we had surplus capital and therefore that could be repatriated to shareholders through increasing the dividend.

**Mr Fallon:** Was that not exactly the wrong time to weaken the balance sheet?

*Mr Applegarth:* No, what hit us was a liquidity squeeze, not a credit crunch, and really dividends and capital are to do with credit. It was a global liquidity squeeze that hit us.

**Mr Fallon:** You do not now regret that decision?

*Mr Applegarth:* It was a very sound decision. It had no relation to what hit us. What hit us was the freezing of global liquid markets.

The focus of later questioning was whether there had been official pressure on NRB not to make a distribution (Q704)

**Chairman:** Dr Ridley, did you think it was appropriate to offer a 14.2 pence dividend to shareholders, almost £60 million in total, whilst the bank was under Treasury protection?

*Dr Ridley:* We kept the position of the interim dividend under continuous review from the time that we announced it at the end of July until we took the decision to not pay it. That was a decision that had to be a careful balance of judgement between on the one hand---

**Q705 Chairman:** Your announcement was Tuesday 25 September but a couple of days before it you were still saying you were going to pay it out. There was a bit of a brouhaha in the press that day. What changed your mind about paying it out then?

*Dr Ridley:* We were taking continuous advice and listening to all parties, including the FSA and others, and we were having to balance the judgement between, on the one hand, paying cash out of the business and, on the other hand, our obligations to shareholders.

**Q719 Mr Dunne:** Picking up the Chairman's comment about the decision to reverse the dividend, did you have any discussions with the Bank of England which helped you change your mind?

Dr Ridley: No. The discussions about the dividend we had were with the FSA and with other advisers.

**Q720 Mr Dunne:** Were there any discussions with someone from the Treasury or the Chancellors office?

Sir Ian Gibson: On the day that the Board reached the decision not to pay the dividend there were discussions on a broad range of issues, including the dividend, with the tripartite group. The Treasury was there, the FSA was there and the Bank representative was there too.

**Q721 Mr Dunne:** So would it be fair to characterise your decision that part of the contributory reasons to changing your decision on the dividend was because you had been leant on by the authorities that were providing the bank facility?

Sir Ian Gibson: No, it would not be fair to characterise it like that.

**Q722 Mr Dunne:** How would you characterise the nature of those discussions with the tripartite members on the dividend?

Sir Ian Gibson: They wished to understand in detail what the Board's thinking was at the point at which we were having those discussions with them, where we stood on dividend, where we believed shareholders' expectations were, what we believed the view of rating agencies might be in the case of pay or not pay, and what we saw as any potential risk to our regulatory capital. We explained our thinking to them on those fronts and explained the process that the Board was then going through in terms of its review over whether or not to pay the dividend.

**Q723 Mr Dunne:** So the Board changed its view rather than was persuaded to change its view?

Sir Ian Gibson: I think the chairman characterised it well, which is that we must as a Board or as a sub-committee of the Board have discussed the dividend payment almost daily - I do not have my notes with me but very frequently during that period. I noticed the Chairman of this Committee's comments during that period, for example. We looked at a whole bunch of comments that were made. You said it was a matter of public interest. There were lots of comments that the Board talked about every day in saying "What should we take account of here?"

Turning aside from the specifics of what NRB did, or not do, the Committee looked at the crisis in a wider context (Q474):

**John Thurso:** Mr Applegarth, listening to you all here today, you sound like frightfully reasonable chaps who have been the ghastly victims of some unforeseeable financial tsunami, yet the plain fact is you are in charge of the only bank that has had a run on it for 150 years. Do you actually accept you have done anything wrong?

*Mr Applegarth:* I feel great regret for the anxiety our retail customers have seen. It was a good business model but, clearly, it could not deal with the unforeseen global freezing of the liquid markets. [...] I do not think we are the only ones, as evidenced by the number of banks who had to approach the ECB for exactly the same type of borrowing facility ---

**Q476 John Thurso:** None of them has lost their brand; none of them is up for sale; none of them is, frankly, destroyed by what has happened. You are the only real, serious casualty. Was it a question of the way you were running the bank? Was it a question of the way we regulate? What caused this?

*Mr Applegarth:* I think the fundamental cause was the speed and duration and the global nature of the liquidity freeze, heightened for us by the fact that we did not have

access to the same type of borrowing facilities that have been available for American banks from the US Reserve and for the European banks from the ECB.

**Q477 John Thurso:** So there was nothing you could have done to mitigate this risk?

*Mr Applegarth:* No.

**Q478 John Thurso:** No action you could have taken that could have mitigated this risk?

*Mr Applegarth:* No.

Several members of the Committee asked about current public support of NRB (Q 494):

**Peter Viggers:** And how much public money has been advanced to Northern Rock?

[...]

*Dr Ridley:* I think the sums involved that have been reported of around £13 billion are approximately correct.

**Q496 Peter Viggers:** And what conditions in terms of management were put on the company on that money being advanced?

[...]

*Dr Ridley:* No particular conditions.

**Q498 Peter Viggers:** So this amount of public money was advanced to the people who had put the bank in this position without any management controls being put on you at all?

*Dr Ridley:* The authorities recognised that it is for the Board, and through the Board responsibility to its shareholders, to run its own business.

Sir Ian Gibson: Could I comment there, Chairman. The FSA in particular but also the Bank are at present involved, as you would expect, in a considerably closer relationship with all the executives of the bank and they have been visitors to and demanders of information from the bank in considerable detail since before the issue of the facility and right through including today, and therefore whilst the management of the bank remains with the executive and the supervision of the executive with the Board, we would not suggest that the authorities are not involved in considerable detail in overseeing what we do.

**Q500 Peter Viggers:** Has a formal structure been put in hand which would prevent you from taking certain executive decisions without the FSA's authority?

*Dr Ridley:* I would not say a formal structure has, but there are regular and formal links which enable the authorities to consult with us and us with them on every decision.

**Q501 Peter Viggers:** One specific question: Countrywide, a US mortgage bank, relied in a similar fashion to Northern Rock on short-term funding but chose to take out insurance against liquidity drying up. Is liquidity insurance available here? Did you consider it and why did you not take it out?

*Mr Applegarth:* I think the first thing to say is that our funding platform is broader than Countrywide's in that we have the four funding vehicles. We did have some insurance in place but clearly it was inadequate to cope with the retail run. It was not the same volume of insurance as Countrywide had put in place but we did have swing-land and standby facilities put in place. They were smaller because we have a more diverse funding platform.

[...]

**Q504 Chairman:** Do you think you will have to go back to the Bank of England?

*Dr Ridley:* We are talking continuously to the Bank of England.

**Q505 Chairman:** But my question is do you think you will have to go back to the Bank of England for more?

*Dr Ridley:* We put in place a second facility about a week ago, as was announced by them and by us, which gives us the opportunity to draw down on that until February.

This area of questioning was returned to later (Q 589):

**Jim Cousins:** I would now like to ask you, Dr Ridley and Mr Applegarth, about the guarantee to depositors, which of course was given by the Treasury, and subsequently of course extended to new deposits that had been created. What was asked from you in return for this guarantee to depositors? [...]

Mr Applegarth: The first guarantee was for existing customers and that was later clarified to include customers returning to their account. That was important to us, because that allowed us to refund penalties to the customers, and that facility is still available until the end of October to make sure that customers who paid a penalty have not been disadvantaged. For new customers, in order for us not to be advantaged versus our competitors, we have to pay a fee for each new deposit coming to us to make sure that we are not at a commercial advantage versus our competitors, who do not have such a guarantee for new customers.

**Q593 Jim Cousins:** I am talking here about the Treasury, the Government's guarantee to depositors. What implicit understandings were reached between the Treasury, the Government and yourselves at the time that the deposits were guaranteed?

Mr Applegarth: For the facility and guarantee to be in place we had to provide a viable business plan, which is extremely closely monitored and scrutinised - that is where the "implicit" comes from - to make sure we are performing as per the plan we had to provide to make sure we are viable and solvent for the facility and guarantee to be given. The only explicit requirement for the guarantee is for the new depositors.

**Q594 Jim Cousins:** Can I stop you? I want us to be clear about this. I am not talking about the facility guarantee that was given by the Bank. I am talking about the guarantee to depositors which was given by the Government.

Mr Applegarth: It is to do with new deposits and it is the fee we have to pay to attract new deposits.

**Q595 Jim Cousins:** What implicit understanding was reached between you and the Government at the time that guarantee to depositors was given?

Mr Applegarth: It is the same as we had to put in place for the facility to be granted, which was the delivery of the viable and solvent business plan.

**Q596 Jim Cousins:** So there were no additional requirements asked of you in exchange for the guarantee to depositors?

Mr Applegarth: For existing customers, no. For new customers, yes.

**Q597 Jim Cousins:** At the time the guarantee to depositors was given, was any indication given to you that that guarantee might in any way be time limited?

Mr Applegarth: Yes. The form of words used was "during the current financial difficulties".

**Q598 Jim Cousins:** What did you understand by that phrase?

Mr Applegarth: The foreseeable future, during the period when markets were dislocated.

**Q599 Jim Cousins:** Let us be clear about this. The lending facility is clearly time-limited at February 2008. Is the guarantee to depositors subject to any such time limit?

Mr Applegarth: It does not have such an explicit time limit. The phrase of words used both in the public announcement and to us was "during the current financial difficulties".

Another line of questioning looked at whether the Bank had been too slow to provide support and, in particular, whether its failure to confirm that support would be transferred to any firm which bought out NRB (Q 574):

**Mr Dunne:** You have not given me a date yet when you discussed the lender of last resort facility. Could you do that, and could you tell me whether or not the third party approached the Bank of England to secure a similar facility?

Mr Applegarth: Yes, we had been talking with the Bank of England from the middle of August in terms of what if, what would be a backstop facility, so we were talking, as you would expect, because it is a prudent thing to do to put a backstop facility in place in case of all the other actions in place. That would have been the middle of August.

Dr Ridley: Can I just interject there? In my first conversation with the Governor of the Bank of England on 16 August the lender of last resort was mentioned as a theoretical possibility at that stage.

**Q577 Mr Dunne:** What I am trying to get to is that the decision to provide that facility was taken after it was too late, after you had had a run on the bank. Why was that decision not confronted before the run on the bank, either by yourselves or a third party?

Mr Applegarth: It was actually taken before the run on the bank. It was the announcement of the facility being leaked that actually was the start of the run. The run effectively started on 14 September. Our corporate activity ceased on 10 September and therefore between the 10th and the leak late on the 13th, that was when we were putting in place the lender of last resort. We had intended to announce that on the following Monday but clearly, the leak meant we had to rapidly accelerate and therefore our communication plans had to be rapidly accelerated and they were not as smooth as they would have been had there been a Monday announcement.

**Q578 Mr Dunne:** Had a third-party acquirer been granted the facility, in your opinion, would that have prevented the run on the bank?

Mr Applegarth: Had a facility been granted, I am led to believe that we would have had a bid to consider and I suspect that, had an offer been made with a big retail brand, then the run would not have taken place, yes.

**Q579 Mr Dunne:** So with hindsight, you would be recommending that the Bank of England consider relaxing its arrangements; the moral hazard argument that prevented that decision from being taken would have stopped the run on the bank.

Mr Applegarth: I have a little difficulty understanding the moral hazard argument. All I know is from Northern Rock's point of view, and avoiding the shock and the huge distress of a retail run, it would not have taken place, in my view, for what it is worth, if we had been able to announce an offer with a big retail brand.

Deficiencies in the support available to NRB were highlighted on several occasions (Q 529):

**Chairman:** [...]It does seem a wee bit unreal to us as a Committee that you are the only bank in this country to have precipitated a bank run in 140 years, so there really

must be something deeper at stake here. If I could extrapolate from your point, at the end of the day I think you are blaming the Bank of England because you did not get a credit line early on?

*Mr Applegarth:* We certainly did not have access to a facility that is available to European banks and American banks, and that would have helped us, but it was a sensible and prudent thing to do to put the backstop facility in place. Ironically, it was the announcements and the leaking of the backstop that caused the retail run and it was the retail run that reduced our liquidity.

More pointedly, the NRB appeared to regret the fact that they did not have access to facilities offered by the ECB (Q584):

**Mr Dunne:** Had the facility existed, as we have discussed earlier, in the US or the Continent to have covert funding lines available to you, would we have avoided the run on the bank?

*Mr Applegarth:* I think if we had been able to borrow on the lines that we did, which is basically using our mortgage and our mortgage assets as collateral, which is what they do across in - I will just take the ECB as an example. The ECB has had over 150 institutions borrow on a similar line and, because it is not public, then clearly you have not had the shocking retail run that we have had to experience. So I suspect the answer is yes.

**Q585 Mr Dunne:** You had no mechanism available to you because you were not regulated by the ECB to be able to approach them yourselves as an alternative?

*Mr Applegarth:* No. We have a branch across in Ireland and had we had more time, we might have been able to put in place the legal documentation and provide the collateral through the Irish branch. The trouble is that would have taken two or three months and in trying to put the backstop facility in from the Bank of England, we were trying to put a sensible and prudent backstop in place that we thought we might not have to draw down on because we were actually still funding - not fully funding, and duration was noticeably shorter but we were still funding until 13 September, but I think it would have been a gamble to have relied on getting documentation and collateral in place through the Irish branch. Had we done that a year ago, then we would have been able to do that, but we had not.

Later, in a question about what the management had learned from their experience, Dr Ridley returned to this theme (Q 407):

*Mr Applegarth:* [...] I think an additional lesson to be learned is that we had already begun the process of diversifying by geography and product all our funding streams. Had we had more diverse retail funding, including in particular funding through a branch within the euro zone, that would have allowed us access to the ECB facilities and not simply to be dependent on the UK facilities. That is an additional lesson for me.

**Q609 Mr Mudie:** That is something that I have some sympathy with. If you had realised earlier your Irish connection to Europe, and used it, do you think if you had had the facility European banks had and which the Bank of England later on, after your run, actually gave British banks, would you have gone through this crisis?

*Mr Applegarth:* It seems to have worked in Europe. Within Europe there are a number of business models that actually have a greater dependence on wholesale funding than we do and they have not had the same issues we have had, so I would suspect so, yes.

NRB were questioned on their view of the workings of the tripartite arrangement (Q 546):

**Mr Simon:** Dr Ridley, we hear talk about an inquiry or even a public inquiry into the tripartite arrangements. Were there to be such a "dodge-the-blame" fest what would be the main things that you could imagine yourself telling it?

*Dr Ridley:* The tripartite arrangements are not really a matter for me obviously; they are for the Government and for those institutions. As far as we understand it, we were perfectly clear that our supervisor was the FSA and it was the FSA that we were to keep informed about our position and through them they would inform the Treasury and the Bank of England. Additionally, we felt it important to get our view directly to the Bank of England as soon as we could about what would help avoid a disaster for ourselves.

**Q547 Mr Simon:** Get your view to them?

*Dr Ridley:* In addition to speaking to them through the FSA, it was our view that it was important to speak to them directly, and the FSA knew about that and that was quite above board.

**Q548 Mr Simon:** When did you start speaking to the Bank directly?

*Dr Ridley:* I spoke to the Governor of the Bank of England on 16 August.

**Q549 Mr Simon:** Were you speaking to the Treasury directly as well?

[...]

*Dr Ridley:* During the period of the retail run we were speaking to them but I cannot remember when the exact first contact was.

**Q553 Mr Simon:** So initially you were speaking directly to the Bank from the 16th, not at that stage to the Treasury, although later, and generally felt yourself to be communicating with the Treasury via the FSA?

*Dr Ridley:* Correct.

**Q554 Mr Simon:** When talking to the Bank and the Treasury, did you feel you were speaking to different beasts, to whom you had to speak in a different way?

*Dr Ridley:* Inevitably, they have different responsibilities and there were different issues to discuss with them.

**Q555 Mr Simon:** Did you get the sense that there was a poisonous relationship between the two of them?

*Dr Ridley:* No.

**Q556 Mr Simon:** When the FSA were here, they were very clear that the tripartite arrangements had worked admirably well. Do you think that the tripartite arrangements worked extremely well and successfully and ought to be admired and perhaps recommended as a model throughout the world?

[...]

*Dr Ridley:* As I said, it is up to them how their arrangements worked among themselves. As I have said, we were quite clear that we had a good communications link with the FSA, with the Bank and later with the Treasury.

**Q558 Mr Simon:** How did their arrangements work for you? How did they work for the country?

*Dr Ridley:* Inevitably, as we have discussed, the leak of the announcement of the facility and the effect that had on our retail depositors was not a happy outcome. I am not here to blame that on the particular tripartite arrangements. That is about events.

[...]



Mr Applegarth: I was trying to suggest that perhaps one of the issues - and I have to say that I would like to agree with big chunks of BBA letter that they circulated to you, particularly the globalisation aspect, because if each individual geographic area acts on its own, you will get dislocations in actions and facilities between different geographic areas. Because this was a global issue, the tripartite being judged against a global issue is somewhat unfair but I think there are major lessons to be learned in how you tie up each of the different geographic areas.

More generally, Sir Derek Wanless was asked to compare the system of bank regulation now with that in the 1990s (Q 682)

**Chairman:** Sir Derek, when you were chief executive of NatWest the Bank of England supervised you. What was the difference in approach between the Bank of England supervision and the FSA's now?

Sir Derek Wanless: The supervision in the 1990s was a good deal more informal. The procedures which exist under the FSA tended not to be there at that time and there was a good deal more personal discussion.

**Q683 Chairman:** Would you say they monitored liquidity and funding more in the Nineties?

Sir Derek Wanless: No.

The NRB Board were asked what legal advice they had received as to whether or not covert support or mergers were possible under the ruling legislation (Q621)?

**Mr Brady:** The Governor of the Bank was very clear with us that the freedom of manoeuvre the Bank had was severely constrained by EC legislation, including the Market Abuses Directive, the Takeover Code and some other things. Could you talk us through the discussions you had with the Bank and the FSA specifically about the disclosure requirements relating to the lender of last resort?

Mr Applegarth: We were in the process of taking legal advice about whether such a facility would have to be covert or overt. The Board had not actually made that decision but our advisers were, I think, giving us clear advice that it would have to be overt and the FSA told us that their view was the same. So both our legal advisers and the FSA came to the same guidance for us.

**Q622 Mr Brady:** So you had both come to that conclusion independently. It was not that Northern Rock was saying "We will have to disclose this even if others want it to remain covert"?

Mr Applegarth: I think that is fair, yes.

[...]

**Q624 Mr Brady:** You say that a covert facility would not have been possible - not possible because of the legal or regulatory requirements or not possible for the purely practical reason that it simply would have come into the public domain by one means or another?

Mr Applegarth: I think both of those. Firstly, the legal advice that we were getting that it was most probably announceable, and that was the FSA's view as well, and secondly, and secondly, because there were so many people involved, in practical terms it would have leaked, and having seen what has happened since 13 September and what has got in the public domain, I think that is a pretty strong probability.

#### 4. The Treasury<sup>22</sup>

Questions about how successfully the tripartite authorities had handled the NRB crisis dominated proceedings:

**Q749 Chairman:** [...] Considering that we have had the first bank run in the United Kingdom for about 140 years, how successfully do you think the tripartite authorities have handled this situation?

Mr Darling: [...] Obviously, I am happy to go into further details there as you want but my view of this is that fundamentally the structure we have in this country, where you have the Financial Services Authority which is responsible for the prudential supervision of individual institutions, is right. We have the Bank of England which is responsible for the stability of the financial system. I would take a great deal of persuading that you should merge these two. I think that would be very problematic and certainly I do not think anyone would argue we should go back to where we were ten years ago when we had seven or eight different regulators. I think there are lessons to be learned in relation to the interface between the Bank and the FSA. Both of those institutions, the FSA when they came to see you a couple of weeks ago, and the Bank of England in its Financial Stability Report which it published this morning, recognize that there are lessons to be learned in the way that we dealt with this in this country as well as there being international lessons of course as well.

Mr Fallon later asked for clarification of who was in overall charge of the tripartite system (Q753). The Chancellor said that it was his responsibility and outlined what had happened in the build-up to the crisis:

Mr Darling: Ultimately it is the Chancellor. As I said in the House of Commons a couple of weeks ago, I am pretty clear about that. There are discrete responsibilities. As I said, the FSA on prudential supervision and the Bank in relation to financial stability through its market interventions, but the whole point of having a committee is to allow all three institutions - because the Treasury is the backstop, if you like, in all these things - to be intimately involved. I said that I was first told specifically of Northern Rock on 13 August; a great deal of work was being done by the FSA and the Bank between the 15th and the time that ultimately Northern Rock had to come for specific lender of last resort facilities.

**Q754 Mr Fallon:** But for a month the three of you could not agree on the safe haven option, you could not agree on a covert rescue operation, and when the bank run started, you then took four days to put in place proper saver protection.

Mr Darling: No, none of that is true. Firstly, in relation to what happened during that month, as the Governor told you when he appeared before the Committee, whilst we were told there were concerns about Northern Rock at the first tripartite committee on the 14th and, as I said, the Treasury and I were formally told on the 15th, at that stage it was by no means certain that all was up with the bank. Northern Rock was able to get finance; it was finding it progressively more difficult but initially it was able to get access to finance. That is why the FSA, as they have said in a memorandum to you, were working closely with the Northern Rock bank to see whether or not they

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<sup>22</sup> Evidence session 25 October 2007. Giving evidence were Rt Hon Mr Alistair Darling MP, Chancellor of the Exchequer, Mr Nicholas Macpherson, Permanent Secretary to the Treasury, Mr Mark Neale, Managing Director, Budget, Tax and Welfare, Mr Richard Hughes, Team Leader, Comprehensive Spending Review, Treasury, and Mr Clive Maxwell, Director, Financial Services, Treasury

could help the securitisation, they could help get additional funds. On 29 August the Chairman of the Financial Services Authority, Callum McCarthy, wrote to me formally drawing my attention to the fact that he thought Northern Rock then had quite real problems. I think it was the following Monday that the tripartite committee, the Governor, the Chairman and myself, met. We agreed two things. One is that, because of the systemic importance of maintaining Northern Rock, we would have to support that bank but, in addition, it was agreed that where it might be appropriate, generalised support to the whole market would be made, and indeed a couple of days later, the Bank of England did put £4 billion into the system. I just want to emphasise to you that during that four-week period there was a great deal going on.

The problem was that by the beginning of September it was widely known in the market that Northern Rock was very exposed and they were willing to pay to get the facilities but they were simply drying up. In relation to the covert support, the safe haven point, by which I presume you mean another company, there was one slight expression of interest from an institution but that never came to anything. There was one more specific interest, although after two or three days that went away as well, although they did reappear after the bank had got facilities. In relation to covert support, we were clear from the time it became pretty certain that Northern Rock had severe problems that, if necessary, it would be able to get lender of last resort facilities. The problem was - and I said this in the House last week - that that I was always very sceptical whether or not you could do this covertly simply because today's market conditions are very different.

The Chancellor was asked whether a "triangle of indecision and dithering" (Q756) could have exacerbated the crisis:

Mr Darling: Northern Rock did not say on 14 August "We are going to run out of money." What happened was the FSA said on 14 August it believed that, because of Northern Rock's particular business model, because of its exposure, it was the concerned about it in general. That problem began to crystallise at the end of August, when it was clear that this was not just a generalised worry or a suspicion but that actually Northern Rock was running into quite substantial problems. As I said to you, during that period prior to the end of August and after that until the middle of September, extensive efforts were made to try and resolve the problem with Northern Rock. Remember, Northern Rock is and remains the property of its shareholders and it is run by its directors. We were trying to work with them to try and resolve this position because as time went on we became increasingly concerned about that. In relation to the general problem that we faced, I said right at the start that I think there are lessons to be learned, both in terms of the regulation, because if you look at Northern Rock, look at the exposure it had and realise just how dependent it was on being able to get funds on a daily basis, if that line of funding dried up, as it did, what was its fallback position? The answer in Northern Rock's case is that they did not have a fallback position. Other institutions like Countrywide in the United States did have standby credit lines to banks. Northern Rock did not appear to have that sort of safeguard. Work was being done but I am in no doubt that in relation to what we need to learn from this, firstly, I have mentioned I think internationally surveillance. We have international institutions which could be used far more effectively, and that is something that we started work on when we met in Washington last weekend. In relation to the position domestically, the FSA have said, and it is right, that they do need to look at their procedures and how they regulate things. The Bank of England has said today that, having regard to what happened over that period in August and September, it too needs to ask itself how it would intervene, whether in a general

sense or a particular sense, because it does worry me; I think central banks do need to be able to intervene in ways that sometimes, in the public interest, are not overt.

Mr Simon (Q759) asked whether it might have been the structure of the tripartite system which was at fault:

Mr Darling: You can always improve structures and you can always make changes but before you do, you need to work out what the problem was in the first place. The general problem was the fact that liquidity dried up. The next problem was that you were dealing with an institution, Northern Rock, which was hopelessly exposed. Let us deal with those two problems first of all. One is a generalised problem. I think there needs to be better international surveillance, there needs to be better regulation to stop banks from hiding things off-balance-sheet, and there needs to be questions asked on the precise role of what credit rating agencies do. There are all sorts of things you need to do there.

The second thing in relation to Northern Rock, I am quite clear that regulators need to start looking far more at liquidity and not just solvency. They tend to be more concerned about solvency. Northern Rock is and was solvent and it is unusual. Mr McFall was asking about banks in the past. BCCI, for example, was insolvent; Barings became insolvent. With this bank that was not the problem; it was the fact that you could not get ready cash. In relation to how the bank and the FSA and ourselves react to those things, yes, there are lessons to be learned. I think the FSA needs to have more visibility of what the consequences might be on an institution like Northern Rock on the wider system and, as the Governor himself has said in the report published by the Bank of England this morning, the Bank of England needs to focus more on what happens if a particular institution gets into trouble on the wider stability of the system.

Mr Love tried a variation on this theme; did the tripartite arrangements need to be strengthened and communication improved? (Q830):

Mr Darling: There are two things. One is, the way I would interpret it, and rather more than that, the way I understand it, is that the Bank is very clear that it too has lessons to be learned, both in terms of how it intervenes and also the extent of its interventions. As I said right at the start of this, I think in answer to the Chairman's point, I think there are questions that we have to ask ourselves in relation to the precise responsibilities, particularly at the interface of where the FSA and the Bank operate. I am pretty clear that firstly, I will not take anything away from the fact that the Chancellor of the day is responsible for whatever happens but I think what we do need to do is to make sure that both the FSA and the Bank have very clear responsibilities and that, if there is any dubiety or any uncertainty as to who is doing what, that we sort that out.

**Q831 Mr Love:** You have talked on a couple of occasions, and in answer to this question you mentioned the interface. One of the things that the Bank has admitted to is perhaps poor communications between the tripartite parties. Do you think that is solely responsible for the problems that arose or is it more than just communication that needs to be looked at?

Mr Darling: Communication can always be improved. As I said in reply to an earlier question, I am not sure it was the committee itself or the structure of the committee that was the problem. We have to ask ourselves at each and every stage what are the problems that we need to try and fix? The problem I identify in relation to the tripartite arrangements is that I think there does need to be some clarification as

between what the Bank does and what the FSA does and the fact that there is inevitably an overlap between the two. The Bank of England is not responsible for the prudential supervision of individual banks. However, when a problem arises in any individual bank, it could have wider systemic implications. That is one of the things that we need to look at and obviously, the converse of class applies so far as the FSA is concerned. It is in that area, especially in relation to early warnings, because obviously what we are trying to do here is to stop this problem arising in the first place rather than intervening, that we need to look at closely. I shall not repeat it at length but the other problems too are the international problems and also the fact that every single director of every single financial institution should really be asking themselves "What is critical to my business and if it goes wrong what do I do about it?" If the answer is "I don't know," they should start thinking again very rapidly.

Mr Breed (Q780) asked whether the tripartite authorities should have anticipated the crisis earlier:

**Mr Breed:** Chancellor, earlier on in the meeting you said that you first became aware at the beginning of August of the problems with Northern Rock, yet we were told by the FSA that they were concerned much earlier in the year, had issued a warning about the business model, and indeed, had even put them under close supervision. Are you saying that the tripartite authorities had not been advised by the FSA of their concerns over Northern Rock and that the first time they issued that to the other parties was the beginning of August?

Mr Darling: I think 14 August was the first time that the FSA formally said when looking at this problem - and remember, I think the week before, when problems had arisen in France, people started focusing on these things. On the 14th, which I think was a Monday, was the first time they said, "We think Northern Rock might have a problem." You are right that the FSA and I suppose more generally the Governor of the Bank of England have raised concern about these things. The only observation I would make is that, whilst there has been generalised concern expressed about this aspect of the banking system, I do not think anybody expected a complete freezing of liquidity which, as far as I am aware, is completely unprecedented in modern times.

**Q781 Mr Breed:** But two members of the tripartite authority were concerned and they did not bother to tell the third part.

Mr Darling: I think in the normal course of events what the FSA and what the banks say is publicly available. I do not think they were keeping it from anybody. It was a more generalised concern. I think what was unforeseeable when you think about it is this: people start to default on their mortgages in one or two American states; within days it spreads throughout the United States and then across the world. I do not think that had been foreseen before.

[...]

Mr Darling: [...]The problem that confronted us [in August] was whilst the institutions right across the world had lots of money, they simply stopped lending to each other. That is what was unusual in the present situation and that particular set of circumstances was not specifically envisaged by the FSA or anybody else this year. What the FSA were saying is that in relation to one or two institutions - and I think they had had discussions with Northern Rock, as you might expect, about these things - they had a more generalised concern. This is one of the things, and as I said to you, questions do have to be asked in relation to the regulator, the FSA, and all of us. When you get a general concern, how quickly do you move from dealing with that

general concern to actually saying, "Look, here are half a dozen things you ought to be doing"?

**Q785 Mr Breed:** I agree with that. Would it have been preferable for [the FSA] to have alerted you before 14 August?

Mr Darling: In hindsight, it would have been much better, would it not, if the FSA when first looking at Northern Rock had said, "Hold on, what exactly is your fallback position?" and when Northern Rock said, "We haven't got one" they did something about it?

The Chairman asked (Q750) why there had been a delay in announcing changes in the depositor protection scheme for NRB customers:

Mr Darling: If we go back to the night of the 13th, that is, the Thursday night before the announcement was made, you will recall that I think it started to appear in the early evening news bulletins on the BBC that Northern Rock had sought facilities. Our intention was to make a statement, in common with market practice, at seven o'clock the next morning. The reason for that is the directors of Northern Rock had, understandably, decided they had to issue a profits warning and that it would have been disingenuous not to have mentioned that they were going to the Bank of England for facilities but the stories started to appear in the BBC and, of course, the queues started to appear outside some Northern Rock branches the next day. I frankly do not think that the issue of a guarantee or the extent of the cover under the depositors' scheme was an issue on Friday. It suddenly became an issue over the weekend, which is why I decided that we would put a guarantee in place on the Monday. Guarantees, as you know, are by no means unproblematic and, as you have seen with Northern Rock over the last few weeks, the nature and extent of the guarantee is quite a complicated thing. I think the issue of a guarantee or people's concern about whether or not they could get all of their money out did not really become an issue until over the weekend. Frankly, on the Friday - and indeed, it has been the case ever since - people could always get their money out of the bank, as they can today if they want to do it, but I think I was very clear by the weekend that, unless I went further than what I had been saying from Friday through to Sunday, and said, to put the matter beyond all doubt, "We will guarantee the retail and also the wholesale deposits", their problem would have continued but the guarantee itself was not an issue on the Friday morning when those queues started to build up.

Mr Dunne asked the Chancellor for his view on the timeliness of the Bank's response in providing liquidity in the market (Q771):

Mr Darling: No, I am not aware of any evidence that we have that would demonstrate that had it been done a week or two weeks earlier, that would have sorted out Northern Rock's problem. The problem is Northern Rock would have had to have got this money itself. The other banks, especially the larger ones, were sitting on these things. The other thing I would say is if you look now, two months later, it is interesting that, although the Fed and the ECB and the Bank of England here took different positions, the overnight interbank rates are pretty close to each other, despite the fact that they took very different approaches.

The liquidity issue was also picked up by Mr Mudie (Q808 &9):

**Mr Mudie:** Chancellor, when the sub-prime issue arose in the States, the Fed and the ECB took policy decisions on putting liquidity into the market. The Bank of England

took the opposite stance. Who took that decision? Was it solely the Bank of England or did they consult you and did you have a say in that policy decision?

Mr Darling: The decision was taken by the Governor but having spoken to me about it.

On a related point, the question of lender of last resort facilities was raised. Mr Todd whether the facility could have been established more quickly: (Q795)

**Mr Todd:** There is one other possible framework, which is that the lender of last resort facility could have been put in place rather more rapidly than it was, giving less time for a leak to occur. Northern Rock have claimed that it took some time to put this in place; they had a plan to communicate to their customers about it; that was foreclosed by the leak that took place. Another approach, as I said, would be to concertina that negotiating process into a much narrower period.

Mr Darling: We actually did it quite quickly. As I said before, it is the directors who are running the bank and they did not actually come to the Bank of England and say, "Look, we actually now need facilities" until the week in question, and once they had agreed to come, there was no problem whatsoever. It was not like filling out a form for a personal loan or anything like that. They were able to get the facilities when they wanted them.

**Q796 Mr Todd:** They say they kicked off on 10 September and they were intending to announce a week later, which I must admit gives a huge opportunity for a leak.

Mr Darling: My recollection is they did want a longer period but I think two things went against that. Firstly, it would have been astonishing if you could have kept that quiet for a week. Secondly, their own legal advisers - and directors have fiduciary duties. This bank was trading. They had to issue a profits warning because the last profits forecast they had made had turned out to be wildly optimistic and they have had to suspend payment of a dividend in the meantime. The profits warning requirement drove that as much as anything else but my understanding is they would have had some difficulty issuing a profit warning without mentioning the fact that they were also seeking facilities from the Bank. These are things we really do need to look at. We cannot have a situation where you can only provide support at such a cost that nobody is actually going to take it. That flies in the face of the whole concept of lender of last resort.

Mr Macpherson: Further evidence of the difficulty of keeping these things secret is provided by the general liquidity facility which was available through August. You will recall that one clearing bank had access to it. It was supposed to be secret but it was in the newspapers the next day with a subsequent effect on the share price. It is really, really difficult.

Mr Darling: Can I just say for the sake of clarity that the reason that bank got the facility is not because it was in trouble but simply it was squaring its books at the end of the day. This is the point I was making, that people did a phone round and only one person said "I can't comment."

Mr Breed asked whether NRBs CEO's claim that "I am led to believe that we would have had a good to consider and I suspect that, had an offer been made with a big retail brand, then the run would not have taken place" was accurate (Q789)

Mr Darling: I assume you are quoting from him when he said "I am led to believe." It sounds as if the thing was rather contingent but my understanding of what happened is this. There were actually two institutions. One showed a slight interest but it never really progressed further than a general inquiry. There was a second interest which

was raised with the FSA and at one point they asked what would we do if they asked for support - and it was very substantial support; it could have been as much as £30 billion - to be given at commercial rates by the Bank of England. Our initial reaction was twofold. One is that the Bank of England does not normally provide, in effect, investment help for a perfectly viable bank. The second point is that there would also be a state aid issue, I think. The third one is, if we were going to do this, we would almost certainly have to say to banks at large, "If we are making this facility available, who else might be interested in that?" However, in the event the matter was not pursued.

Mr Brady returned to the claims made by the Bank in its evidence, that an interaction between separate pieces of legislation prevented covert action to help NRB (Q833):

**Mr Brady:** [...]Can I take it you disagree with the Governor's assessment that it is legislation that hamstrung him and prevented that action from taking place?

Mr Darling: I will say again to you what I said, I think, on the floor of the House, that I will look at the four pieces of legislation he was concerned about. One is the Market Abuse Directive, which is the disclosure of inside information. The other was the Takeover Code, which might, on one view, preclude something happening over the weekend. Then there is the insolvency legislation, which, I readily agree with him, is something that we need to look at, especially in relation to deposit protection. The fourth thing is the compensation scheme, which again, not only do I agree with him but we are already trying to resolve that. What I did say, and I said this on the floor of the House on 11 October, was that the issue before us prior to 13/14 September was not whether or not the Market Abuse Directive said that we could not do something.

The issue was twofold. One is the directors were being advised that they had to make a profit warning and also my belief - and maybe because I am a politician I think of these things first - that someone is going to leak this and, as I say, sadly, I was right. I will look into all these things and if there is a problem with the Market Abuse Directive and it could be that there is a problem, that is clearly something we need to resolve but what I would say to you is, if there had been a realistic chance of rescuing this bank over a weekend, I would have done it and happily seen whoever was challenging us in court but that did not arise.

**Q834 Mr Brady:** I recognize this is something you are still looking at but if there is a problem with the Market Abuse Directive, do you think that is more likely to have arisen in terms of obligations placed on the company in terms of disclosure, or on the Bank in terms of what it was able to do?

Mr Darling: I think that Directive bites on both. It is basically designed to stop people from doing things and hiding the full extent of what they are doing to people that have a legitimate interest, like their shareholders but, like all these Directives, they do not just bite on the company concerned; I think they bite on other institutions and almost certainly public institutions as well. If it is a problem, we clearly need to deal with it. It is one of the things I will cover when I publish my proposals at the beginning of the year.

In response to questions from John Thurso (Q840 & 841) the Chancellor admitted that market risk had not been monitored well enough by either companies or by the market as a whole ("people are re-pricing the risk and that is what is causing the difficulty") and that there was a much greater role for the FSA to educate regulated businesses about business model



risks. Mr Thurso then asked about what precedent actions taken to assist NRB will set (Q836):

**John Thurso:** Chancellor, the support given to Northern Rock gives the impression that no bank with retail depositors can be allowed to fail. Is that actually the case?

Mr Darling: The position is as I set out in my statement of 11 October, which is that judgement has to be exercised as to whether or not the failure of an institution, no matter what sort of financial institution it is, would result in systemic damage to the financial system. It does not mean that we would intervene in every case. For example, the Bank did not intervene in relation to Barings in 1994.

**Q838 John Thurso:** So the fact that the Northern Rock depositors are being protected on this occasion is because not protecting them would have rocked the system?

Mr Darling: It is the system that we were concerned about. Mr Macpherson has just reminded me of course that BCCI did have retail depositors but the judgement was taken there that it would not cause the systemic problems that I believe would be caused this time.

**Q839 John Thurso:** So, to be absolutely clear, the fact that it has happened on this occasion is not a precedent that any other institution should feel able to rely on?

Mr Darling: Each case will be assessed on its merits.

Mr Cousins asked (Q848) whether consideration had been given to what would happen in the event of NRB bankruptcy:

Mr Darling: No because at the moment that is not an issue. My concern would always be, in the event of the bank being unable to find some way out, that we protect the depositors. The opportunity is now there to make sure that suitable arrangements can be made. I very much hope the directors will use this opportunity to try and find a way to enable the bank to carry on in one shape or form but that has to be a matter for them at the end of the day.

**Q849 Mr Cousins:** Chancellor, just to sum up. There is no drop dead date - to use your own phrase.

Mr Darling: Correct.

**Q850 Mr Cousins:** The tripartite committee has not considered what action it would take in the event of Northern Rock's bankruptcy?

Mr Darling: Because that issue has not arisen. The FSA have always said, and continue to say, that the bank is solvent. What you said in relation to the drop dead rate is absolutely correct, however, since I dare say the bank will follow these proceedings with great interest, that does not mean that I do not regard it as being a matter of urgency and I think a matter of weeks and months is what we are talking about. They need to come forward with a proposal because self-evidently they need to find a long-term solution for the problems they have got.