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House of Commons
Treasury Committee

The run on the Rock

Fifth Report of Session 2007–08

Volume I

Report, together with formal minutes

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The Treasury Committee

The Treasury Committee is appointed by the House of Commons to examine the expenditure, administration, and policy of HM Treasury, HM Revenue & Customs and associated public bodies.

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Nick Ainger MP (*Labour, Carmarthen West & South Pembrokeshire*)
Mr Graham Brady MP (*Conservative, Altrincham and Sale West*)
Mr Colin Breed MP (*Liberal Democrat, South East Cornwall*)
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The Reports and evidence of the Committee are published by The Stationery Office by Order of the House. All publications of the Committee (including press notices) are on the Internet at www.parliament.uk/treascom.

A list of Reports of the Committee in the current Parliament is at the back of this volume.

Committee staff

The current staff of the Committee are Colin Lee (Clerk), Sïan Jones (Second Clerk and Clerk of the Sub-Committee), Adam Wales, Jon Young and Jay Sheth (Committee Specialists), Lis McCracken (Committee Assistant), Caroline McElwee (Secretary), Tes Stranger (Senior Office Clerk) and Laura Humble (Media Officer).

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Summary

Overview

The period from Friday 14 September 2007 to Monday 17 September saw the first run on the retail deposits of a United Kingdom bank since Victorian times. We analyse the causes and consequences of the run on Northern Rock, and the lessons to be learnt from it. We emphasise the advantages of legislative change on a cross-party basis and make proposals for such change, and for reforms of the Tripartite arrangements, on that basis.

Northern Rock and its regulation

The directors of Northern Rock were the principal authors of the difficulties that the company has faced since August 2007. The directors pursued a reckless business model which was excessively reliant on wholesale funding. The Financial Services Authority systematically failed in its regulatory duty to ensure that Northern Rock would not pose a systemic risk.

Handling the support operation and stopping the run

The Chancellor of the Exchequer was right to view Northern Rock as posing a systemic risk to the financial system and to authorise the Bank of England's support facility. However, the Tripartite authorities did not prepare adequately for that support operation. Those authorities and Northern Rock ought to have strained every sinew to finalise the operation and announce it within hours rather than days of the decision to proceed with the operation. The Tripartite authorities at deputies level failed to plan in advance for the announcement of the Government guarantee on Northern Rock deposits that proved necessary to stop the run.

Dealing with failing banks

We recommend a series of measures for handling 'failing' banks in an orderly manner and in a way that insulates taxpayers and small depositors from the risk of banks failing. We recommend that a relevant authority be given power to acquire information relating to individual financial institutions and to take action in relation to an institution in specified circumstances. We also propose a special resolution regime for failing banks to enable smooth administration of such a bank to be combined with arrangements to ensure that insured deposits are safe and accessible.

Depositor protection

A deposit protection scheme must be simple and transparent. The "co-insurance" model of deposit protection—whereby small depositors stand to lose some of their money in the event of a bank closing—is discredited. Ensuring the speedy release of funds under any scheme is of critical importance, and we propose measures to provide for this. We recommend the establishment of a Deposit Protection Fund to be funded by participating institutions.

Lessons learned

There was a significant failure of the Tripartite arrangements in September 2007, and lessons must be learned from that failure. The financial system in the United Kingdom would not be well-served by a dismantling of the Tripartite arrangements. However, the current arrangements lack a clear leadership structure or a strategy for effective communication with the public.

Reforms

A single authority ought to be given the new powers for handling failing banks, together with responsibility for the Deposit Protection Fund. There is a need for ‘creative tension’ within the regulatory system, and so these powers and responsibilities should not be granted to the Financial Services Authority. We propose the creation of a new post of Deputy Governor of the Bank of England and Head of Financial Stability. We set out how this new post and the accompanying Office will relate to the existing responsibilities of the Bank of England and to the other Tripartite authorities.

1 Introduction

The run on the Rock

1. At 8.30 pm on the evening of Thursday 13 September 2007 the BBC reported that Northern Rock plc had asked for and received emergency financial support from the Bank of England.¹ The terms of the funding facility were finalised in the early hours of Friday 14 September and announced at 7.00 am that day.² That day, long queues began to form outside some of Northern Rock's branches; later, its website collapsed and its phone lines were reported to be jammed.³ The first bank run in the United Kingdom since Victorian times was underway.⁴ In this Report we examine what caused the run on the Rock, the consequences of that run for Northern Rock itself and for wider financial stability, the way the events were handled by public authorities and the lessons to be learned.

The conduct of our inquiry

2. Early in 2007 we identified financial stability as a matter of growing importance meriting greater scrutiny. On 1 February 2007, we took evidence from representatives of HM Treasury, the Financial Services Authority (FSA) and the Bank of England on the operation of the Memorandum of Understanding between them on co-operation in the field of financial stability.⁵ In March 2007, we announced our intention to conduct a series of inquiries on the theme of "Transparency in Financial Markets and the Structure of UK plc".⁶ We published a Report on Private Equity as part of that thematic approach in July 2007, including consideration of issues of economic risk and financial stability.⁷

3. On 20 September we were due to take evidence from Mervyn King, Governor of the Bank of England, and other members of the Monetary Policy Committee (MPC) of the Bank of England on the MPC's August 2007 Inflation Report.⁸ Less than a week before that session, the run on Northern Rock occurred. At that meeting, we decided to start an inquiry on Financial Stability and Transparency, and we subsequently published terms of reference for the inquiry in October 2007.⁹ We took oral evidence at nine sessions in total. We took evidence from the following witnesses on two occasions: Rt Hon Alistair Darling MP, Chancellor of the Exchequer, the Governor of the Bank of England and Sir John Gieve, the Bank's Deputy Governor with responsibility for financial stability, and Sir Callum McCarthy, Chairman, and Mr Hector Sants, Chief Executive, of the FSA. We also

1 www.bbc.co.uk/blogs/thereporters/robertpreston/2007/10/16/index.html

2 Qq 580, 1668

3 Qq 345, 678

4 For a discussion of previous bank runs, see Box 1.

5 HM Treasury, Bank of England and FSA, *Memorandum of Understanding between HM Treasury, the Bank of England and the Financial Services Authority*, 22 March, 2006; Treasury Committee, Oral Evidence, Thursday 1 February 2007, *Financial Stability*, HC (2006–07) 292–i

6 Treasury Committee Press Notice No.36, Session 2006–07

7 Treasury Committee, Tenth Report of Session 2006–07, *Private equity*, HC 567–I, paras 1, 35–66

8 Treasury Committee Press Notice no. 74, Session 2006–07

9 Treasury Committee Press Notices no. 83 and 88, Session 2006–07

heard evidence from then members of the Board of Northern Rock plc, from academic experts,¹⁰ from ratings agencies,¹¹ from a panel of senior investment bankers,¹² from PricewaterhouseCoopers, from a panel of investors,¹³ and from Ms Loretta Minghella, Chief Executive of the Financial Services Compensation Scheme. We also received a range of written evidence which is published with this Report.

4. We undertook three visits as part of this inquiry. In late November, we visited Stockholm to discuss lessons of the Swedish banking crisis in the early 1990s. In mid-December, the Chairman and Mr Michael Fallon visited Washington DC, principally for discussions about the Federal deposit protection scheme. A list of relevant meetings during these visits is included in Annexes 1 and 2. In early January, we visited Frankfurt and Brussels for meetings at the European Central Bank (ECB) and the European Commission respectively.

5. We also held informal meetings with Mr Andrew Gracie of Crisis Management Analytics Ltd about stress testing and related issues and with Mr Paul Tucker, Executive Director, Markets, and other Bank of England officials about the Bank of England's money market operations. We are most grateful to all those who assisted us during our visits and in the course of our inquiry more generally, and in particular to Professor Geoffrey Wood of CASS Business School, City University, who acted as a Specialist Adviser.

The role of our inquiry

6. In giving evidence to us on 20 September 2007, the Governor of the Bank of England emphasised the important role that this Committee could play in preventing a repetition of the banking problems that had arisen.¹⁴ This was partly because legislative change was likely to be required and partly because of the value of a cross-party approach.¹⁵ In evidence to us, and subsequently on the floor of the House, the Chancellor of the Exchequer stated that he would await the findings of our inquiry before finalising the Government's proposals.¹⁶ In December, the Governor of the Bank of England confirmed his view that the Government was right to wait for our Report before finalising its proposals.¹⁷ Early in January 2008, the Chancellor of the Exchequer told us that he would give full consideration to our proposals before publishing legislation after Easter and emphasised the importance that he attached to obtaining a consensus on that legislation.¹⁸ **We welcome the Government's commitment to taking full account of our Report before making its legislative proposals in response to the run on Northern Rock. We consider it crucial**

10 Professor Willem Buiter, London School of Economics, and Professor Geoffrey Wood, CASS Business School, City University

11 Fitch Ratings, Moody's and Standard and Poor's

12 Goldman Sachs, Deutsche Bank, UBS and Citigroup

13 The National Association of Pension Funds, the Association of British Insurers, the Investment Management Association and Hermes Equity Ownership Service

14 Qq 4, 149

15 Qq 19, 58

16 Qq 747, 762; HC Deb, 19 November 2007, col 959

17 Qq 1631, 1640

18 Qq 1751–1752

that, insofar as possible, measures in this area are taken forward on a cross-party basis. This Report is being agreed unanimously and we believe that it forms the basis for cross-party agreement on such legislative proposals.

Our two Reports

7. In view of the range of evidence received and the diverse issues considered, we have decided to produce two Reports arising from this inquiry. The current Report relates to the events surrounding the run on Northern Rock and the lessons arising from it, including lessons giving rise to recommendations for early legislative action. The second Report will cover wider issues relating to Financial Stability and Transparency, including an analysis of the causes of the closing of certain markets on 9 August and of the longer term national and international action that might be needed. That second Report will also set out how we will take forward our own continuing work relating to Transparency in Financial Markets.

Box 1: 1866 and all that

The most notorious bank run in British history took place in May 1866 at the time of the collapse of Overend, Gurney & Co. The early 1860s saw a speculative boom, fuelled in part by the banking sector reducing its liquidity ratios.¹⁹ Overend, Gurney & Co. was not a retail bank, but a discount house whose deposits largely came from other banks. In the early 1860s, the company expanded from its core business in well-secured Bills of exchange into riskier investments, such as shipyards and shipping lines, with inadequate collateral.²⁰ Walter Bagehot observed that the company made losses “in a manner so reckless and so foolish, that one would think a child who had lent money in the City of London would have lent it better”.²¹ Towards the end of 1865 and in early 1866, there was a severe tightening of monetary policy and several businesses to which the company had lent collapsed.²² An attempt by the company to stave off bankruptcy by converting from a private partnership to a limited liability company failed to attract sufficient new capital. The share price fell rapidly, encouraging depositors to withdraw funds. On 9 May 1866, after an inspection of the company’s books suggesting that it was close to bankruptcy, the Bank of England declined to give support.²³

The following day, Overend, Gurney & Co. suspended cash payments, sparking “terror and anxiety” so that “a run commenced upon all the banks, the magnitude of which can hardly be conceived”. About midday on 10 May, “the tumult became a rout. The doors of the most respectable Banking Houses were besieged ... and throngs heaving and tumbling about Lombard Street made the narrow thoroughfare impassable.”²⁴ The Bank of England lent £4 million on that day, and secured the support of William Gladstone, the Chancellor of the Exchequer, for suspension of the Bank Charter Act to enable it to lend more in the days that followed.²⁵ The run was brought to a conclusion, but, during the three weeks following Overend’s demise, as many as ten banks suspended cash payments, and Walter Bagehot criticised the Bank of England for lending “hesitatingly, reluctantly and with misgiving”.²⁶

Scottish banks had been largely unaffected by the crisis of 1866,²⁷ but were central to the events of 1878. A severe monetary tightening in the second half of that year contributed to the collapse of the City of Glasgow Bank, which had in any case been engaged in fraudulent activities. Other Scottish banks underwrote its outstanding note issue, but not its deposit balances, and the closing months of 1878 saw a run on a number of British

19 M Collins and M Baker, *Commercial Banks and Industrial Finance in England and Wales, 1860–1913* (Oxford, 2003), pp 85–89

20 G Elliott, *The Mystery of Overend & Gurney: A Financial Scandal in Victorian London* (London, 2006), pp 2–4

21 W Bagehot, *Lombard Street: A Description of the Money Market* (London, 1873; 1908 edition), p 19

22 *Commercial Banks and Industrial Finance in England and Wales*, pp 85–86; *The Mystery of Overend & Gurney*, pp 96–146; W T C King, *History of the London Discount Market* (London, 1936), pp 245–251

23 *The Mystery of Overend & Gurney*, pp 158–179

24 *History of the London Discount Market*, p 243

25 *The Mystery of Overend & Gurney*, pp 183–184; *Lombard Street*, p 193

26 *Commercial Banks and Industrial Finance in England and Wales*, p 87; Q 855; A J Schwartz, “Real and Pseudo-Financial Crises”, in F Capie and G E Wood, *Financial Crises and the World Banking System* (London, 1986), p 17

27 *The Mystery of Overend & Gurney*, p 189

banks. Several banks failed, although the banking sector as a whole responded by strengthening liquidity ratios, and legislation was passed in 1879 which provided for compulsory, independent audit of banks.²⁸

The events of late 1878 were described in 2003 as “the last time there was to be a general run on commercial bank deposits in England”, and it was a modest run indeed compared to that which followed the collapse of Overend, Gurney & Co.²⁹ There have been subsequent bank failures, but none caused a run. In 1890, Barings suffered a crisis of liquidity; the Bank of England decided that Barings was still solvent, and agreed to advance liquidity having secured agreement from other banks that they would share any losses.³⁰ On 5 July 1991, the Bank of Credit and Commerce International (BCCI) was closed, causing substantial losses for many depositors, including local authorities, but this did not cause a run or any systemic problems.³¹ On 26 February 1995, Barings became insolvent as a result of “unauthorised dealings” by its chief trader in Singapore, but its closure did not have wider adverse effects for the banking system.³²

28 *Commercial Banks and Industrial Finance in England and Wales*, pp 91–97

29 *Ibid.*, p 80

30 *History of the London Discount Market*, pp 305–308

31 Treasury and Civil Service Committee, Second Report of Session 1991–92, *Banking Supervision and BCCI: The role of local authorities and money brokers*, HC 26, paras 1–3; Q 838

32 HC Deb, 27 February 1995, cols 693–694; Treasury Committee, First Report of Session 1996–97, *Barings Bank and International Regulation*, HC 65–I, paras 5–8; Qq 836–838

2 Northern Rock's business model

The importance of Northern Rock in the North East

8. Northern Rock plc is headquartered in Gosforth, Newcastle upon Tyne, and was, until its demotion, only one of two FTSE 100 headquartered in the North East. In its 2006 Annual Report, Northern Rock had recently reaffirmed the importance of the North East for its headquarters:

Our commitment to creating employment opportunities in the North East of England was once again demonstrated by the commencement of a £40m redevelopment of the original Head Office building in Gosforth, Newcastle upon Tyne and detailed negotiations for a £60m office at Rainton Bridge, Sunderland. Completion of both schemes is planned for 2008.³³

9. A geographical distribution of the branch network is outlined in Table 1, which shows the concentration of Northern Rock's branches in the North East.

Table 1: Geographical distribution of Northern Rock branches

Geographical area (as defined by Northern Rock website)	Number of branches
North East	21
North West	10
London	9
South West	6
Scotland	5
West Midlands	5
South East	5
Yorkshire	4
East Anglia	3
Northern Ireland	1
Wales	1

Source: Northern Rock website

10. At year-end 2006, Northern Rock had 4,811 full-time employees and 1,125 part-time employees.³⁴ A recently opened contact centre will have subsequently increased the number of employees at Northern Rock. The Northern Rock Community Report also notes that the majority of Northern Rock's staff were women.³⁵ The Northern Rock workforce, in general, have higher qualifications than average for the overall workforce in

³³ Northern Rock, Annual Report 2006, p 31

³⁴ Northern Rock, Annual Report 2006, p 72

³⁵ Northern Rock, Community Report 2006

the North East. Such qualifications have been boosted by the introduction of a Modern Apprenticeship Scheme for trainee clerical staff.³⁶ Dr Matt Ridley, Chairman of Northern Rock, highlighted that 3,500 jobs had been created by Northern Rock since its demutualisation in 1997.³⁷ The regional development agency for the North East, One NorthEast, states that:

Northern Rock is a substantial contributor to the £7.9bn financial and business services sector in the North East, which includes companies in banking, financial services, insurance, contact centres, accountancy and legal services.³⁸

11. In 1997, at the time of its demutualisation, Northern Rock set up the Northern Rock Foundation. Northern Rock plc pays out 5% of its pre-tax profits to the Northern Rock Foundation through a Deed of Covenant.³⁹ According to Northern Rock's 2006 Annual Report, since 1997, the Northern Rock Foundation had received £175 million from Northern Rock Plc.⁴⁰ As with Northern Rock, the Northern Rock Foundation has remained rooted in the North East. The Northern Rock Foundation's trustees committed to a policy for 2006 of 'funding activities exclusively in the North-East and Cumbria'.⁴¹ In 2006, the Northern Rock Foundation awarded £27.1 million over 352 grants.⁴² In the same period, the Northern Rock Foundation also lent £1.1 million over 8 loans.⁴³ The importance of the Foundation is also reflected in the fact that should Northern Rock be taken over, it will have a 15% of the share capital at that time.⁴⁴ The Foundation is not the only reason for the strong support for the Northern Rock in the North East. Northern Rock has been a key sponsor of sporting clubs in the region, including Newcastle United Football Club and the Newcastle Falcons Rugby Union club.

Assets

12. Northern Rock plc was formerly a building society; it demutualised on 1 October 1997.⁴⁵ At the end of 1997, Northern Rock had assets on a consolidated basis of £15.8 billion.⁴⁶ By the end of 2006, its consolidated balance sheet had grown more than six-fold so that the value of its assets was £101.0 billion, comprised mainly of secured lending on residential properties.⁴⁷ Mr Adam Applegarth, the then Chief Executive of Northern Rock, told us that Northern Rock had been growing its assets "by 20% plus or minus 5% for the

36 Northern Rock, Annual Report 2006, p 31

37 Q 531

38 One NorthEast, News Article, 18 September 2007

39 Northern Rock Foundation, Accounts of the Trustees, p 9

40 Northern Rock, Annual Report 2006, p 33

41 Northern Rock, Annual Report 2006, p 33

42 Northern Rock Foundation, Accounts of the Trustees, p 6

43 Northern Rock Foundation, Accounts of the Trustees, p 7

44 Qq 716-717, Northern Rock, Annual Report 2006, p 93

45 Northern Rock Annual Report 1998, p 25

46 Northern Rock Annual Report 1998, p 31

47 Northern Rock Annual Report 2006, p 59

last 17 years”.⁴⁸ This pace of growth led to Northern Rock entering the FTSE 100 in September 2001.⁴⁹

13. Northern Rock described itself 2006 in its Community Report as “a specialised lender, whose core business is the provision of UK residential mortgages funded in both the retail and wholesale markets”.⁵⁰ As of end 2006, 89.2% of its assets were residential mortgages.⁵¹ This level of growth could have led to a weaker set of assets being held by Northern Rock. Mr Applegarth was keen to stress that such a weakening of asset quality had not occurred. He pointed out that Northern Rock’s arrears for the last 15 years had consistently been around half the industry’s average.⁵² On top of this, he said that analysis undertaken as part of the Basel II process had shown that Northern Rock’s “last 18 months lending is actually better quality than the previous two to three years”.⁵³ Dr Matt Ridley, the then Chairman of Northern Rock, also told us that Northern Rock, while introducing sub-prime borrowers to a third party, did not hold such sub-prime loans on its balance sheet.⁵⁴ Mr Sants said that Northern Rock “had high quality assets—there is no suggestion here this is an organisation taking on poor quality assets”.⁵⁵ The Governor of the Bank of England, Mervyn King, was also supportive of the quality of the asset book of Northern Rock, telling us that:

What I would say about Northern Rock (and this is the tragedy of Northern Rock) is that most of the staff that worked in Northern Rock on the lending side, all the evidence shows, did an excellent job in appraising the loans that they were making, and that they monitored very carefully and they did not lend money to people who should not be borrowing from them. The lending side was handled extremely well.⁵⁶

Liabilities

14. However, in order to achieve this level of growth in assets, the company changed the structure of its liabilities. Northern Rock began to borrow more money from the wholesale markets, adopting an ‘originate to distribute’ model of funding. In the ‘originate to distribute’ model banks no longer hold loans to maturity but instead sell on loans to investors. In our Report on Financial Stability and Transparency we will consider further the transition from the ‘originate to hold’ model of banking to the ‘originate to distribute’ model.

15. In 1999, Northern Rock adopted an ‘originate to distribute’ model and began to parcel up mortgages and use them as collateral for further funds, a process known as “securitisation”.⁵⁷ As part of this process, a separate entity was created called Granite,

48 Q 684

49 FTSE Press Release, ‘FTSE confirms Regular Reshuffle’, 12 September 2001

50 Northern Rock, Community Report 2006 p 9

51 Northern Rock, Annual Report 2006 p 82

52 Q 423

53 Q 424

54 Q 393

55 Q 195

56 Q 1696

57 Q 524

which was based in Jersey. Granite was carried on Northern Rock's balance sheet and set out in its accounts. Mr Applegarth explained Granite's role to us:

Granite is our securitisation vehicle and accounts for roughly 50% of our funding. The way securitisation works is you borrow against a pool of mortgages. The bond holders, the people who are lending the money against it, they carry the risk and therefore there can be no risk from those loans to [Northern Rock]'s balance sheet, so even though it is shown in our balance sheet, it has to be a separate legal entity. The separate legal entity is a master trust.⁵⁸

The Financial Services Authority stated that "The structure of the Granite securitisation meets industry norms and there is nothing to suggest that the Granite structure is not functioning as intended".⁵⁹ We will consider whether there is any significance to the position of Granite as an entity based offshore when we report shortly on Financial Stability and Transparency.

16. Another funding strategy introduced by Northern Rock in 2004 was the use of 'covered bonds'.⁶⁰ The Bank of England provided the following explanation of a covered bond:

In recent years, UK banks and building societies have increasingly chosen to use limited liability partnerships (LLPs) for funding and risk transfer of assets. The main difference between securitisations through SPVs [special purpose vehicles] and LLPs is that, in the latter structure, the banks themselves (rather than the SPVs) continue to hold the assets and issue the so-called covered bonds which are secured against them. The LLP effectively only comes into operation in case the issuing bank defaults, thereby providing additional security to investors in the bonds.⁶¹

Mr Applegarth outlined the overall funding of Northern Rock:

50% was securitisation, which had an average life of three and a half years; 10% was covered bonds, which had an average life of about seven years; and of our wholesale borrowings, which is 25%, half of that had a duration longer than one year and the other half was less than one year's duration.⁶²

17. While wholesale funding to Northern Rock grew markedly, there was no correspondingly rapid growth in its retail funding. On a group basis, retail deposits and funds made up £9.9 billion of the liabilities of Northern Rock at the end of 1997.⁶³ By the end of 2006, retail deposits and funds had only grown to £22.6 billion, compared with the six-fold increase in Northern Rock's assets.⁶⁴ This means that, as a proportion of the total liabilities and equity of Northern Rock, retail deposits and funds had fallen from 62.7% at

58 Q 694

59 Ev 223

60 Q 524

61 Bank of England, 'Proposals to modify the measurement of broad money in the United Kingdom: a user consultation' Stephen Burgess and Norbert Janssen, Quarterly Bulletin, Q3 2007, pp 409, 411

62 Q 516

63 Northern Rock Annual Report 1998, p 48

64 Northern Rock Annual Report 2006, p 91

end-1997 to 22.4% at end-2006. This figure is low when compared to other banks that were previously building societies: at the end of 2006, Alliance & Leicester's proportion was 43% and Bradford & Bingley's was 49%, for example.⁶⁵ Dr Ridley confirmed Northern Rock's position in relation to its retail funding, stating that "we had a smaller retail deposit book than many other institutions, although there are many like us overseas".⁶⁶

The events of 2007

The increase in Northern Rock's market share in the first half of 2007

18. In the first half of 2007, Northern Rock continued to expand its business at a rapid rate. In that period, its loans to customers underwent a net increase of £10.7 billion.⁶⁷ The Chancellor of the Exchequer characterised this period as one in which Northern Rock "had aggressively expanded its market share".⁶⁸ Professor Willem Buiter of the London School of Economics was critical of this expansion:

I like healthy growth but it is hard to believe that the quality of the asset portfolio and the ability to vet the credit-worthiness of your borrowers does not suffer when you take 20% of the net increase and 40% to 50% of the gross increase in activity in this half year period, so I think they were an organisation that was clearly engaged in high-risk behaviour.⁶⁹

19. Dr Ridley denied that the expansion of Northern Rock's mortgage lending activities in the first half of 2007 was a departure from the trend of the preceding decade.⁷⁰ Sir Derek Wanless, Chair of the Risk Committee of the Board of Northern Rock, also contested the notion that this period of continued expansion saw an aggressive approach. He claimed Northern Rock had only 10% of the market in new lending, but conceded that this was 19% of new lending after repayments.⁷¹

Northern Rock's change of strategy

20. Northern Rock's continued expansionary lending policy required the continued success of its funding strategy at a time when there were indications of potential problems on the funding side. In its April 2007 Financial Stability Report, Sir John Gieve told us that the Bank of England had "identified the increasing wholesale funding of banks as a potential risk if markets became less liquid".⁷² When questioned as to whether Northern Rock had acknowledged those warnings, Dr Ridley told us that both the FSR and similar warnings in the Financial Service Authority's Financial Risk Outlook had influenced

65 Alliance & Leicester 2006 Annual Report and Accounts, page 49 and Bradford and Bingley 2006 Annual Report and Accounts, page 43

66 Q 401

67 Q 244

68 Q 749

69 Q 854

70 Q 445

71 Qq 465–471

72 Q 37

Northern Rock's board decisions.⁷³ Mr Applegarth also told us that in March 2007 the company had “picked up the warning signs that the US sub-prime position was meaning a tightening in pricing and therefore we slowed down the rate of growth and we gave new guidance against our profits for the year, recognising the tightening in pricing”.⁷⁴ Mr Applegarth then outlined to us the change in strategy being adopted by Northern Rock in the first half of 2007, and announced in its 2007 interim report. On the asset side, Mr Applegarth stated that the company was seeking to sell its commercial lending, unsecured lending and commercial buy-to-let operations.⁷⁵

21. On changes to Northern Rock's funding side, Sir Derek Wanless pointed out that the company had started obtaining retail funding from Denmark, and that Northern Rock “had [retail funding] products in the UK, too, which were being successful”.⁷⁶ Mr Applegarth told us that Northern Rock had “increased [its] liquidity by £2.3 billion at the half-year stage”,⁷⁷ in other words by 30 June 2007.

22. Mr Applegarth also outlined the changes over the last decade that Northern Rock had carried out to try and strengthen its funding platform:

we have worked very hard over the previous decade to try and diversify our funding platform by geography and product. That is why we moved to having four funding platforms—retail cash deposits, covered bonds, securitisation and traditional wholesale—and it is why in each of those markets we look to diversify by geography. So for securitisation for example not only did we tap the UK but we tapped Europe, the Far East and America. If you look at traditional wholesale, we tapped American, European, Asian and Australian markets. [For] cash deposits ... we moved across to Ireland and across to Denmark, so we broadened our funding platform to try and increase stability.⁷⁸

Northern Rock's funding crisis

23. In the middle of this change of strategy, on 9 August 2007, Northern Rock's traders noted a “dislocation in the market” for its funding.⁷⁹ This dislocation was the result of a global shock to the financial system, with the American sub-prime mortgage market as its centre. We will examine the causes of this dislocation, and its wider effects beyond the direct impact on Northern Rock, in our forthcoming Report on Financial Stability and Transparency.

24. Two aspects of this worldwide liquidity squeeze appeared to surprise Northern Rock, and overcome the attempts highlighted above to combat the tightening in credit markets. One was the absence of a so-called “flight to quality”. Dr Ridley told us that:

73 Qq 412-413

74 Q 427

75 Qq 690-692

76 Q 447

77 Q 491

78 Q 463

79 Q 429

What we did not expect was that there would be no flight to quality in that process [of a tightening in credit markets]. 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.⁸⁰

Mr Applegarth told us that Northern Rock had wrongly “believed that high-quality assets and transparency [were] the way to maintain liquidity”.⁸¹ Sir Derek Wanless told us that Northern Rock’s “first line of defence [was] good credit quality”.⁸²

25. Secondly, Northern Rock had not foreseen all its funding markets closing simultaneously, as happened after 9 August. Dr Ridley explained:

We deliberately diversified our funding platform so that we would have ... 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.⁸³

The idea of all markets closing to Northern Rock was repeatedly characterised to us by Northern Rock officials as “unforeseeable”.⁸⁴

26. One aspect of Northern Rock’s financing raised by the Governor of the Bank of England in a speech was Northern Rock’s lack of insurance against the troubles it faced. He referred to Countrywide, a bank in the United States that had faced difficulties due to the United States sub-prime crisis:

Countrywide had paid millions of dollars each year to big banks as a liquidity insurance policy so that, in the event of difficulty, they would provide it with long-term loans. So on August 17 Countrywide was able to claim on that insurance and draw down \$11.5bn of committed credit lines. Northern Rock had not taken out anything like that level of liquidity insurance. So when it came to the Bank of England for support, it was important that liquidity was not provided free.⁸⁵

Mr Applegarth explained that Northern Rock had taken out insurance, but that he felt its wide funding base did not merit purchasing too much insurance:

80 Q 402

81 Q 693

82 Q 656

83 Q 403

84 Q 648, 656

85 Speech by Mervyn King, Governor of the Bank of England at the Northern Ireland Chamber of Commerce and Industry, Belfast on Tuesday 9 October 2007

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-line and standby facilities put in place. They were smaller because we have a more diverse funding platform.⁸⁶

And in his written evidence, Mr Applegarth went on to outline the size of the insurance taken out by Northern Rock:

Northern Rock had a standby loan facility of £750 million and a \$775 million bilateral swingline facility in place to support its US Commercial Paper programme—making a total of \$2.3 billion. This was proportionately slightly greater cover than Countrywide in the US, given relative size of both lending programmes and balance sheets, including securitisation.⁸⁷

27. Northern Rock continued to find some funding, even after 9 August. Mr Applegarth told us that “we were actually still funding—not fully funding, and duration was noticeably shorter, but we were still funding until 13 September”.⁸⁸ In fact, Mr Applegarth told us that Northern Rock had, before 13 September, “two or three months’ worth of liquidity”.⁸⁹ Despite this, on 16 August, the possibility of the Bank of England giving emergency support was first discussed as a “theoretical” possibility by the Governor of the Bank of England in conversation with Dr Ridley.⁹⁰ At this point, the intention of Northern Rock was not to use such a Bank of England facility, but to have it as a “backstop”.⁹¹ Mr Applegarth explained that “The problem we had was you could not tell how long the markets were going to be closed and it was a reasonable and proper thing to do to put a backstop facility in place”.⁹² We consider later the negotiations on the support facility “backstop” and the attempts to find a “safe haven” or buyer which were made at the same time. We also consider later the causes of the retail run on the bank, but one consequence of that run was set out by Mr Applegarth: “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”.⁹³ The run thus created a situation in which State support for Northern Rock was not a backstop, but an everyday necessity, and where Northern Rock had become reliant on exceptional, State-backed financing.

Responsibility for the problems at Northern Rock

Responsibility of the Board of Northern Rock

86 Q 501

87 Ev 232

88 Q 585

89 Q 488

90 Qq 574-575

91 Q 585

92 Q 490

93 Q 529

28. In its evidence to us, the Board of Northern Rock acknowledged that the company's funding strategy had been looked at and discussed by the Board. Part of the oversight of the liquidity strategy of Northern Rock was conducted by its Risk Committee, chaired at the time by Sir Derek Wanless, a non-executive member of the Board of Northern Rock.⁹⁴ Sir Derek Wanless told us that "We looked as a Board at the issues of our funding strategy and what the risks were".⁹⁵ He went on to defend the role of the Board and the Risk Committee, telling us "The Risk Committee and the Board did [their] job, in my view, properly through this period".⁹⁶

29. However, several witnesses highlighted to us the responsibility of the Board of Northern Rock for the events which engulfed Northern Rock in August and September 2007. The Governor of the Bank of England told us that "it was the business strategy that was fatally flawed in this episode where, once those markets had closed in mortgage backed securities, they were absolutely unable to finance their wholly illiquid assets".⁹⁷ And Professor Buiter noted in his written evidence that given that Northern Rock knew the Bank of England's collateral policies—which we consider later in this report—"its funding policies were reckless".⁹⁸

30. On 30 August 2007, Sir Ian Gibson, senior independent director at Northern Rock, asked for, and received, agreement by each member of the Board of Northern Rock to resign should such resignations be needed.⁹⁹ These were not used at the time, according to Dr Gibson because stakeholders in Northern Rock felt that it was more important to weather the immediate crisis.¹⁰⁰ Dr Ridley announced his resignation on 19 October 2007 and was replaced by Mr Bryan Sanderson CBE who joined the Board as Chairman.¹⁰¹ Then on 16 November 2007, four non-executive directors, including Sir Derek Wanless, retired from the Board of Northern Rock.¹⁰² At the same time, three other directors of the company—David Baker, Keith Currie and Andy Kuipers—stood down as Board members, although they remained as officers of the company.¹⁰³ Mr Applegarth's resignation was also announced, but he was not then expected to leave the company until January 2008.¹⁰⁴ However, on 13 December 2007, it was announced that Mr Applegarth had left Northern Rock, and that Mr Kuipers, who had stood down from the Board on 16 November 2007, was to replace Mr Applegarth as Chief Executive.¹⁰⁵

31. The directors of Northern Rock were the principal authors of the difficulties that the company has faced since August 2007. It is right that members of the Board of

94 Q 631

95 Q 633

96 Q 650

97 Q 1696

98 Ev 329

99 Q 536

100 Q 536

101 Northern Rock Press Release, 19 October 2007

102 Northern Rock Press Release, 16 November 2007

103 Northern Rock Press Release, 16 November 2007

104 Northern Rock Press Release, 16 November 2007

105 Northern Rock Press Release, 13 December 2007

Northern Rock have been replaced, though haphazardly, since the company became dependent on liquidity support from the Bank of England. The high-risk, reckless business strategy of Northern Rock, with its reliance on short- and medium-term wholesale funding and an absence of sufficient insurance and a failure to arrange standby facility or cover that risk, meant that it was unable to cope with the liquidity pressures placed upon it by the freezing of international capital markets in August 2007. Given that the formulation of that strategy was a fundamental role of the Board of Northern Rock, overseen by some directors who had been there since its demutualisation, the failure of that strategy must also be attributed to the Board. The non-executive members of the Board, and in particular the Chairman of the Board, the Chairman of the Risk Committee and the senior non-executive director, failed in the case of Northern Rock to ensure that it remained liquid as well as solvent, to provide against the risks that it was taking and to act as an effective restraining force on the strategy of the executive members.

Responsibility of the shareholders

32. The shareholder base of Northern Rock reflects Northern Rock's demutualisation in October 1997. At that time, 500 "free shares" were issued to both 'borrower' and 'saver' members of Northern Rock.¹⁰⁶ A significant number of Northern Rock's employees were also represented in the shareholder base of Northern Rock: Dr Ridley told us that around 75% of employees at Northern Rock were also shareholders.¹⁰⁷

33. The Board of Northern Rock emphasised to us that the business model of Northern Rock had been transparent to shareholders. Sir Ian Gibson told us that:

the risk information about [Northern Rock's] model was very clearly in the market and has been for a very long time. It is a very clear presentation of the company that is given in our annual report. It is a very straightforward business. It is essentially a UK mortgage-only business, which some would see as a weakness, others would see as a strength. It depends on your point of view. The data surrounding that has been transparent to all for a considerable period, not just this year but year on year.¹⁰⁸

34. When questioned as to whether there should have been an earlier announcement from Northern Rock on the state of its business model, Sir Ian Gibson was swift to point out that Northern Rock had taken advice both from the FSA as the UK Listing Authority and from Northern Rock's own legal advisers, and that Northern Rock was "fully satisfied that we did follow the best advice and follow[ed] it to the letter".¹⁰⁹ **The business model of the Board of Northern Rock was clearly stated. It is unfortunate that the shareholders who acquired their shares as part of demutualisation and the staff of Northern Rock have suffered significantly from the fall in the value of Northern Rock shares. However, it is not possible to make a distinction between types of shareholders in the circumstances of Northern Rock. In a market environment shareholders as a whole must be viewed as**

¹⁰⁶ Northern Rock website, <http://companyinfo.northernrock.co.uk/shareholders/unclaimedShares.asp>

¹⁰⁷ Q 605

¹⁰⁸ Q 744

¹⁰⁹ Q 744

taking a risk from which they sought a reward and for which they are now paying a price.

3 The regulation of Northern Rock

Northern Rock's regulation as a high impact firm

35. According to Mr Sants, Northern Rock was treated by the Financial Services Authority, as “a high impact bank, under close and continuous supervision”.¹¹⁰ The Financial Services Authority outlined the importance of the ARROW process:

Our framework for assessing the risks to our objectives posed by individual firms is called “ARROW”. Full ARROW risk assessments are an integral part of this supervisory process; they are intensive stocktakes of individual firms and are supplemented by a number of other monitoring techniques. We have designated Northern Rock and more than a hundred comparable businesses as high-impact firms.¹¹¹

However, Northern Rock, despite being a high-impact firm, was not scheduled to have another ARROW impact assessment until three years after its most recent assessment.¹¹² Its regulatory period was due to run from January 2006 until January 2009.¹¹³ Mr Sants acknowledged that this proposed interval between assessments was “inadequate”.¹¹⁴ The FSA nevertheless stressed that, while there was a significant gap between full ARROW review, a “close and continuous” relationship remained:

This [close and continuous supervision] is characterised by very regular dialogue with the firm on the full range of supervisory issues, through ad hoc meetings and regular telephone conversations and email traffic. Our workstreams in supervising Northern Rock over the last two years have included: reviewing strategic and business developments through discussions with the firm; attendance at results presentations; monitoring the market; assessing the ongoing validity of our risk assessment; monitoring financial data, supervisory returns and management information; reacting to specific requests from the firm—such as the Capital Requirements Directive (CRD) waiver request which was a major workstream during this period; and undertaking the formal review process which sets the capital requirements of the firm on the basis of the risks identified by the firm and the FSA. We also carry out thematic reviews—projects to review practices in a range of firms in a specific area of their business. Northern Rock was subject to thematic reviews in the same way as other similar firms.¹¹⁵

36. Mr Sants told us that 3 members of the FSA's staff were assigned to the direct supervision of Northern Rock.¹¹⁶ However, Mr Sants went on to explain that the number of

110 Q 194

111 Ev 224

112 Q 191

113 Ev 224

114 Q 191

115 Ev 225

116 Q 193

FSA staff who would come into contact with Northern Rock would have been higher, observing that:

you have coverage supervisors, you have the relationship with the bank and then you have a series of specialist teams who regularly visit the bank on particular issues. So, the question, for example, of stress testing would be addressed by a specialist team who come and visit to look at the stress test, and that was the visits that were carried out in this case in April and May 2007 and, indeed, we also have teams looking at the securitisation process and so forth during that period. So, if you are asking the question about the total number of people involved in the FSA engaged with Northern Rock, you would have a much higher number [than 3].¹¹⁷

Potential warnings

37. Two potential signals of the vulnerability of Northern Rock prior to its problems were identified during our inquiry. The first was the rate of growth in Northern Rock itself to which we have already referred.¹¹⁸ Professor Wood expressed his surprise that the FSA had missed this signal from the rapid growth of Northern Rock:

The FSA ... was asleep on the job; that is manifestly right. A very clear signal of a bank running a big risk is rapid expansion. Northern Rock was giving that signal quite clearly; it really is remarkable that [the FSA] missed it.¹¹⁹

Although Mr Sants acknowledged that Sir Callum McCarthy had characterised Northern Rock's business model as "extreme" and accepted that "you should always be concerned where you see market share growth and the question always has to be asked, therefore, around the conduct around that", Mr Sants did not regard the recent growth in Northern Rock as a critical issue.¹²⁰ He stated that:

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.¹²¹

38. However, the Chancellor of the Exchequer noted that it was reasonable for regulators to look at companies that appeared to be expanding quickly. He told us that:

I have said before that regulators should concern themselves not just with institutions that do not appear to be doing terribly well but also with institutions that

117 Q 205

118 See paragraphs 12 and 18.

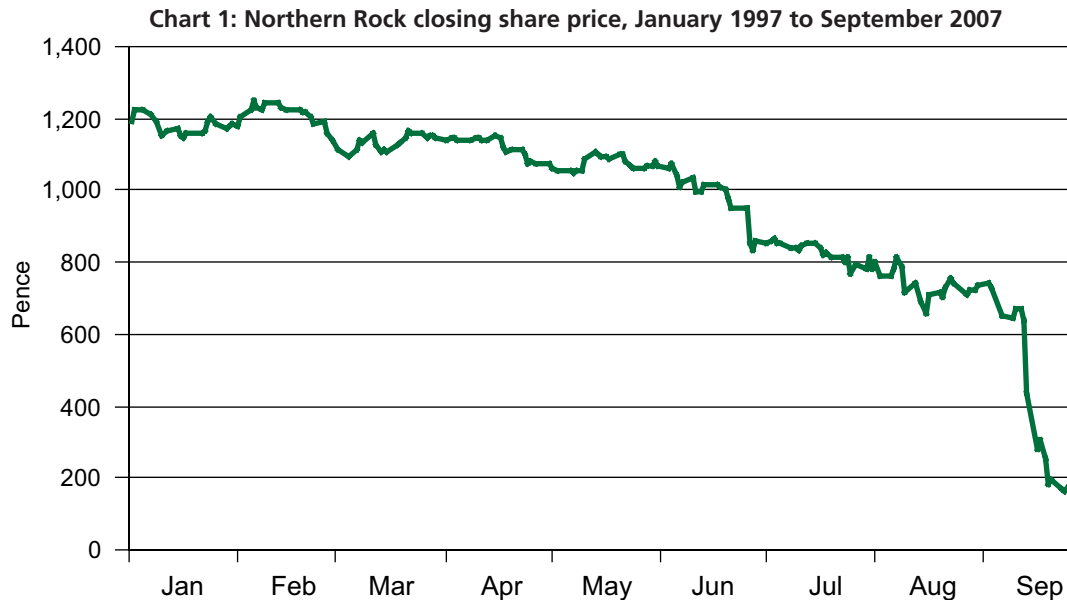
119 Q 855

120 Qq 245–246

121 Q 246

do appear to be doing terribly well because, if they are out of line, it may be they are doing a very good job but they ought to just be sure that that is the case.¹²²

39. The second potential warning signal was the fall in Northern Rock's share price, especially in comparison to other banks, after the profits warning issued in late June 2007, and well before the announcement of the Bank of England support operation.¹²³ The extent of this fall is apparent from Chart 1.



Source: Northern Rock website

40. As Professor Buiter noted in his written evidence, "There is some information surely in the fact that Northern Rock's share price had been in steep decline since February of this year, well before the financial market turmoil hit".¹²⁴ The British Bankers' Association (BBA) also highlighted the fall in the share price:

During the course of 2007, the market had become increasingly aware that there were issues surrounding Northern Rock's business model ... In its profit warning of 27 June 2007, Northern Rock stated it was suffering from a 'structural mismatch between LIBOR [London Interbank Offered Rate] and bank base rates' and its share price fell by 10% on that day. This was therefore a very clear signal both to the market and to the authorities that Northern Rock was experiencing increasing difficulties in respect of its funding as the 'credit crunch' speedily impacted inter-bank lending arrangements generally. By mid-July the share price was some 30% lower than at the start of the year.¹²⁵

Mr Applegarth ascribed the fall in the share price to:

122 Q 840

123 Northern Rock website, www.northernrock.co.uk

124 Ev 326

125 Ev 295

The tightening of the credit markets, so you saw the price of funding increase, you saw a slowdown of our lending in the second quarter and therefore clearly people were assuming that in volume terms our profits would be lower over the next two years than had previously been the case, and indeed that was confirmed when we did a pre-close statement to the market at the end of June.¹²⁶

Mr Sants said that share prices were monitored by the Financial Services Authority:

Yes, I think that share prices are indicators of a variety of different potential issues and should be scrutinised by regulators. Share prices also, may I say just in passing, impact retail confidence as well, so there is a variety of the reasons why we should be properly focused on the share price. Clearly we saw acceleration of that trend with the profits warning, to use a colloquial term, and we significantly intensified our regulatory engagement with Northern Rock at that point. I completely agree with you that share prices should be closely monitored by regulators, and they are.¹²⁷

41. The Chancellor of the Exchequer summed up the criticism of the Financial Services Authority's monitoring of the potential signals of vulnerability at Northern Rock by stating:

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.¹²⁸

42. The FSA has acknowledged that there were clear warning signals about the risks associated with Northern Rock's business model, both from its rapid growth as a company and from the falls in its share price from February 2007 onwards. However, insofar as the FSA undertook greater "regulatory engagement" with Northern Rock, this failed to tackle the fundamental weakness in its funding model and did nothing to prevent the problems that came to the fore from August 2007 onwards. We regard this as a substantial failure of regulation.

The Basel II waiver

43. When adopting the Basel II requirements for capital adequacy, a bank may choose to adopt certain 'advanced approaches' to their management of credit risk. The Basel Committee on Banking Supervision explains the choice faced by banks under the Internal Ratings-Based Approach to the management of credit risk:

The Committee has made available two broad approaches: a foundation and an advanced. Under the foundation approach, as a general rule, banks provide their own estimates of PD [probability of default] and rely on supervisory estimates for other risk components. Under the advanced approach, banks provide more of their own estimates of PD [probability of default], LGD [loss given default] and EAD

126 Q 525

127 Q 314

128 Q 785

[Exposure at default], and their own calculation of M [Effective maturity], subject to meeting minimum standards.¹²⁹

The adoption of an advanced approach requires a waiver from the Financial Services Authority.¹³⁰ On 29 June 2007, Northern Rock was told by the FSA that its application for a Basel II waiver had been approved.¹³¹

44. Due to this approval, Northern Rock felt able to announce on 25 July 2007 an increase in its interim dividend of 30.3%. This was because the waiver and other asset realisations meant that Northern Rock had an “anticipated regulatory capital surplus over the next 3 to 4 years”.¹³² Mr Applegarth explained how Northern Rock had achieved this waiver. The company had come to the end of a two and a half year process, during which period Northern Rock had undergone several stress tests, a matter we consider further later in this chapter.¹³³ As well as this, in order to obtain a Basel II waiver Northern Rock had to “show that [Northern Rock could] dynamically manage scorecards from new lending all the way through to arrears and possessions and put that information back into [Northern Rock’s] front end score cards”.¹³⁴ Mr Applegarth explained that the waiver had led to a dividend increase because:

when you get your Basel II approval, the relative risk weighting of certain assets in your balance sheet changes. So what we had, because of the quality of the loan book, was you saw our risk weighting for residential mortgages come down from 50% to 15%. That clearly required less capital behind it, so that links to why we were able to increase the dividend.¹³⁵

45. Mr Sants was keen to point out that the waiver was “basically a standard process” and not “a one-off special exercise on [Northern Rock’s] behalf”.¹³⁶ Sir Callum McCarthy strongly rejected the notion that the Basel II waiver process was a “a box-ticking exercise”.¹³⁷ He also thought that “the change [from the Basel II waiver was] immaterial to the problem” at Northern Rock.¹³⁸ Mr Sants pointed out that, while the crisis at Northern Rock was one of liquidity, the Basel II waiver was related to the capital held by Northern Rock.¹³⁹ **The Basel II waiver, and the dividend increase this allowed to Northern Rock, came at exactly the wrong moment. While we accept that Basel II is a capital accord and the problems at Northern Rock that soon became all too evident were ones of liquidity, it was wrong of the FSA to allow Northern Rock to weaken its balance sheet at a time**

129 Basel Committee on Banking Supervision, International Convergence of Capital Measurement and Capital Standards: A Revised Framework, Comprehensive Version (June 2006), para 245, p 59

130 Financial Services Authority Handbook, BIPRU 1.3, Applications for Advanced Approaches

131 Northern Rock’s Interim Results, for six months until 30 June 2007, p 14

132 Northern Rock’s Interim Results, for six months until 30 June 2007, p 15

133 Q 454

134 Q 538

135 Q 689

136 Q 196

137 Q 220

138 Q 220

139 Q 220

when the FSA was itself concerned about problems of liquidity that could affect the financial sector.

The regulation of liquidity

46. The problems affecting Northern Rock were those of liquidity and funding, rather than solvency.¹⁴⁰ The FSA defines liquidity risk as:

the risk that a firm, although balance-sheet solvent, cannot maintain or generate sufficient cash resources to meet its payment obligations in full as they fall due, or can only do so at materially disadvantageous terms.¹⁴¹

Northern Rock operated under the Sterling Stock liquidity regulatory regime,¹⁴² which was introduced in 1996.¹⁴³ The FSA in its discussion paper outlines the purpose of the regime:

The objective of the regime is to ensure that a sterling stock bank has enough highly liquid assets to meet its outflows for the first week of a liquidity crisis, without recourse to the market for renewed wholesale funding, to allow the authorities time to explore options for an orderly resolution.¹⁴⁴

The FSA went on to explain the potential weakness of this regime. While ‘shock’ or short term liquidity stresses were well catered for, the Sterling Stock liquidity regulatory regime coped less well with ‘chronic’ liquidity stresses of long duration.¹⁴⁵ This is exemplified by comments made by Dr Ridley that:

There were sharp reductions in liquidity after 9/11 in 2001. That lasted for a matter of days. Our model was extremely robust in those conditions. What was not expected was that all global markets would shut down and remain shut down for as long as they have.¹⁴⁶

47. Following the events in August, and the crisis centred on Northern Rock, the Financial Services Authority published in December 2007 a discussion paper entitled *Review of the liquidity requirements of banks and building societies*. The Bank of England fully supported the publication of this discussion paper.¹⁴⁷ However, this emphasis on liquidity regulation appears to be new found. Professor Buiter suggested to us that “the FSA is an institution that thinks more about capital adequacy and solvency issues than about liquidity issues”.¹⁴⁸

140 Ev 297

141 Financial Services Authority, Discussion Paper 7/07: Review of the Liquidity Requirements for Banks and Building Societies, December 2007, p 8

142 Northern Rock Annual Report 2006, p 51

143 Financial Services Authority, Discussion Paper 7/07: Review of the Liquidity Requirements for Banks and Building Societies, December 2007, p 32

144 Financial Services Authority, Discussion Paper 7/07: Review of the Liquidity Requirements for Banks and Building Societies, December 2007, p 32

145 Financial Services Authority, Discussion Paper 7/07: Review of the Liquidity Requirements for Banks and Building Societies, December 2007, p 33

146 Q 417

147 Q 1608

148 Q 860

The Chancellor of the Exchequer told us that liquidity regulation appeared to have been less important to regulators:

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.¹⁴⁹

48. The Governor of the Bank of England accepted that liquidity regulation would have to be taken “much more seriously”.¹⁵⁰ The Governor felt that the interest in liquidity regulation had declined over a long period. He informed us that in the “1950s and 1960s as much as 30% of the assets of a bank had to be held in liquid assets”, but that now “it is not much more than about 1%”.¹⁵¹ But he warned, using the arguments of Professor Charles Goodhart, that there was “no single number in measuring liquidity that will tell you the true story” of a bank’s liquidity position.¹⁵² The Governor went on to say that “It is no good just looking at the amount of liquidity you have got for the next two weeks, or the next four weeks, you need to look at a range of numbers and apply a qualitative judgment as to whether or not the institution has adequate liquidity”.¹⁵³ In achieving a new regulatory regime for liquidity, the Governor expressed the following hope:

If we had a system of proper liquidity regulation, although Northern Rock would have shown up as doing very well on the capital side, it would have looked very flawed on the liquidity side, and that would have been picked up.¹⁵⁴

49. The demutualisation of Northern Rock from a building society to a bank also changed the liquidity regulatory regime under which Northern Rock operated. The regulatory regime for building societies is set out in the FSA’s discussion paper:

Building societies must hold appropriate amounts both of total, and of short term, liquidity. The society’s board has to set a range (expressed as a percentage of banking liabilities) within which total liquidity will be maintained—as a result, actual liquidity falls typically between 15% and 25%. The rules do not set a hard minimum for total liquidity, but the range, like other aspects of the policy, is reviewed, and may be challenged, by the supervisor. [The FSA] do, however, set out—as guidance—a matrix of asset types suitable to be held as liquidity by building societies of varying size and complexity. For short-term (up to eight days) liquidity, [the FSA] set a hard minimum for all societies: 3.5% of banking liabilities, and require this to be met from a much narrower list of high quality marketable assets (though not quite as narrow as eligible collateral).¹⁵⁵

149 Q 759

150 Q 1657

151 Qq 1680-81

152 Q 1657

153 Q 1657

154 Q 1691

155 Financial Services Authority, Discussion Paper 7/07: Review of the Liquidity Requirements for Banks and Building Societies, December 2007, p 35

The Building Societies Association, stated that “Building societies are explicitly prevented from having as high a proportion of wholesale funding as Northern Rock”.¹⁵⁶ And the FSA discussion paper states that “In practice, building societies’ natural caution means that most target to hold liquidity—total and short-term—well above their policy or regulatory minimum”.¹⁵⁷ When asked whether Northern Rock would have found itself in such difficulties if it had remained a building society, Mr Adrian Coles, Director-General of the Building Societies Association, replied “Had Northern Rock stayed a building society, it may or may not have been a successful institution but it would not have come to the sticky end that it appears to have come to in the way that it has”.¹⁵⁸

50. Unlike capital regulation, there is no international set of regulatory requirements for liquidity, apart from requirements under Pillar 2 of Basel II.¹⁵⁹ The Governor of the Bank of England expressed the regret that:

at the time when the Basel capital regime was being negotiated the Bank of England did start an initiative to begin a parallel Basel liquidity adequacy regime, and it never got off the ground; other central banks were not so enthusiastic. It is a shame, but maybe we need to get back that.¹⁶⁰

51. However, the Governor did say that the Bank of England and the FSA “have been pressing that case [for agreement on liquidity regulation] internationally for quite some time”.¹⁶¹ The FSA’s discussion paper notes that some international activity on liquidity regulation had begun at the start of 2007. The Committee of European Banking Supervisors had been asked by the European Commission to look into both member countries’ liquidity risk regulatory regimes and other factors affecting liquidity risk. The timeframe for this work has been extended given recent developments in international financial markets.¹⁶² The Basel Committee on Banking Supervision had also begun a stock-take of national regulatory regimes for liquidity at the start of the year, and has now been asked to accelerate this work by the Financial Stability Forum, and it was to include “a first assessment of lessons learned from these events and recommendations for the future direction of work on a new international agreement on liquidity”.¹⁶³ It has been suggested that reform of the regulatory regime for liquidity should await such an international agreement. The BBA recommended to us that:

Regulation of liquidity in cross-border banking groups is best managed according to a set of principles proportionally applied by the home state regulator, recognising that in the complex world of liquidity management there is no one-size-fits-all

156 Ev 304

157 Financial Services Authority, Discussion Paper 7/07: Review of the Liquidity Requirements for Banks and Building Societies, December 2007, p 35

158 Q 1569

159 Ev 298

160 Q 1682

161 Q 103

162 Financial Services Authority, Discussion Paper 7/07: Review of the Liquidity Requirements for Banks and Building Societies, December 2007, p 14-15

163 Financial Services Authority, Discussion Paper 7/07: Review of the Liquidity Requirements for Banks and Building Societies, December 2007, p 14

answer. Any reform to the regulatory liquidity requirements in the UK should wait until the [Basel Committee on Banking Supervision] review is complete to ensure that it is aligned with any consequent international developments. Liquidity management has global ramifications—a UK centric solution may be counter productive.¹⁶⁴

In its discussion paper, the Financial Services Authority states that “We would still prefer to develop our policy in line with any emerging international consensus”.¹⁶⁵

52. The current regulatory regime for the liquidity of United Kingdom banks is flawed. That regime did not prevent the problems that arose in relation to Northern Rock in 2007. We welcome the publication of the Financial Services Authority’s discussion paper on this issue, and acknowledge the possible benefits of an international consensus on the best way forward. But in light of Northern Rock, reforms of the United Kingdom’s system of liquidity regulation cannot wait for international agreement.

Stress testing

53. One of the tools used to test the preparedness of financial companies for shocks to their business models are ‘stress tests’. An IMF working paper provides the following explanation of a stress test:

At its simplest, a stress test is a way of revaluing a portfolio using a different set of assumptions. The object of a stress test is to understand the sensitivity of the portfolio to changes in various risk factors. The assumed changes in risk factors are usually made large enough to impose some “stress” on the portfolio.¹⁶⁶

54. Mr E Gerald Corrigan, Managing Director and co-Chair of the firmwide Risk Management Committee of Goldman Sachs, explained the nature of stress testing in relation to financial models:

models by definition are backward and not forward-looking. That is a reality that we all have to deal with. The way we try to deal with it, with a great deal of impetus from the regulatory side, including the FSA in London, is by trying to enhance scenario analyses, stress-testing and things like that to allow us to try better to look at what we call the tails of these frequency distributions which are the essence of these models. I think we have become better at that. Do I think we are as good as we could be? No.¹⁶⁷

55. One of the technical problems in stress testing is the need to cope with ‘fat tails’. This concept is explained in a paper by Bridget Rosewell and Paul Ormerod. Companies use statistical models based on the assumption of normal distributions to estimate the

164 Ev 298

165 Financial Services Authority, Discussion Paper 7/07: Review of the Liquidity Requirements for Banks and Building Societies, December 2007, p 4

166 International Monetary Fund, ‘Stress Testing Financial Systems: What to Do When the Governor Calls’ by Matthew T. Jones, Paul Hilbers, and Graham Slack, IMF Working Paper WP/04/127, July 2004

167 Q 1183

likelihood of an event occurring, and thus what risk a business model is running. However, such assumptions may be invalid:

If we use the normal ... distribution to estimate probabilities, it seems that institutions such as Northern Rock could not have reasonably anticipated such extreme outcomes. If this analysis is sufficient, then the risk is indeed very unusual and regulators would not expect organisations necessarily to be robust to this situation.

However, the problem lies in the extreme tails of the distributions. This is exactly the same problem which arose in the collapse of Long Term Capital Management. The data may appear to be normally distributed, but more careful inspection shows that the tails are fatter i.e. there are more extreme observations in the data than the normal distribution allows. Rare events are not as rare as you might think. The bulk of the data follows a normal distribution. It is the extremes which do not.¹⁶⁸

The FSA acknowledged that the overall understanding of tail risk was weak. Sir Callum McCarthy told us that:

I think the analysis of tail risks is an extraordinarily difficult issue. By definition you are saying that you expect events which happen very infrequently, that is what you are examining, and anybody who claimed they had a full understanding of the risks associated with tail risks would be open to misleading.¹⁶⁹

Mr Sants then explained to us that this risk around the tail of probability distributions meant that a more nuanced approach to risk management was required than just using past data:

It is also undoubtedly the case with regard to financial markets, as others have said to you, that relying solely on historical statistical analysis as a method of predicting the future via modelling is not a sufficient way to discharge your responsibilities as a board of directors. You do need to take into account the likelihood that the future will not reflect the past and circumstances will not repeat themselves in the way they have in the past. That is why we continue to reiterate the statements we made in the earlier part of the year which are even more appropriate now than they were, that firms need to seek to run full scenario tests, understand the circumstances under which their business models have come under pressure regardless of whether or not that type of modelling looks particularly probable from a tail risk analysis. They should run their businesses to take into account those risks and, as we said earlier, we do not feel that it was the case that all institutions were taking that approach to risk management in the early part of the year. We believe that recent events and supervisory engagement mean that they are much more focused on this point, but it is still a key factor that they need to properly focus on.¹⁷⁰

168 Paul Ormerod and Bridget Rosewell, 'How Extreme is the Current Gap between Libor and Base Rate?' available at www.dur.ac.uk, October 2007

169 Q 1546

170 Q 1547

56. The FSA was aware of some deficiencies in the stress testing being undertaken by financial firms. In its 2006–07 Annual Report published in June 2007, the FSA highlighted the findings of a review of ten firms’ stress testing practices, stating that the conclusion of this review was that “Most firms had practices that went some way to meeting our requirements but further improvements were needed, particularly where firms were not fully taking into account severe but plausible scenarios when making strategic or risk management decisions”.¹⁷¹ In May 2007, after this review had been undertaken, a separate review of Northern Rock’s stress-testing was undertaken as part of its Basel II waiver programme.¹⁷² This review led to the conclusion by the FSA in July 2007 that the FSA were “not comfortable with [Northern Rock’s stress test] scenarios”.¹⁷³ Mr Sants later strengthened this position, telling us that the FSA had pointed out to Northern Rock in July 2007 that it was “very unhappy with [Northern Rock’s] stress testing scenarios and asked them to do ‘further distinct liquidity tests and scenario tests’ and give greater consideration to the impact of accelerated cash flows from a trigger event in a liquidity crisis”.¹⁷⁴ Mr Applegarth identified the extra stress tests asked for by the FSA as “primarily to do with credit, such as the example ... of the 40% house price fall”.¹⁷⁵ The extra stress tests were not focussed around an event “deemed implausible, which was the rapid and long-lasting closure of global markets”.¹⁷⁶ Sir Derek Wanless said that these additional stress tests had been considered by the Board of Northern Rock, as part of the Basel II waiver programme:

It [Basel II accreditation] is an assessment of Northern Rock’s own model so [the FSA] made an adjustment to capital in respect of credit concentration risk, which was their major concern. [The FSA] also mentioned pension risk, securitisation risk and stress-testing, in that order of priority.¹⁷⁷

Sir Derek Wanless told us that Northern Rock’s “stress tests at the time were sufficient”,¹⁷⁸ and that Northern Rock was

going through a process at the time of scenario stress-testing which involved looking at 20 scenarios which the Board had signed off. Fifteen of those scenarios involved liquidity risk, including two where securitisation became a particular problem. What did not happen was that we stress-tested the scenario of what has actually happened, which is, as we said earlier, that there was an unprecedented and unpredictable change in the market basis.¹⁷⁹

171 Financial Services Authority Annual Report 2006/07, p 18

172 Qq 207-208

173 Q 192

174 Q 1524

175 Q 455

176 Q 455

177 Q 459

178 Q 639

179 Q 636

57. Mr Sants pointed out that “it is the Board's responsibility to run a company prudently and the stress test scenarios are designed by the Board, not by [the FSA]”.¹⁸⁰ However, Mr Sants appeared to accept that there had been a failure of the FSA’s stress testing regime in regards to Northern Rock:

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 [repurchase agreement] 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.¹⁸¹

58. Professor Buiters told us that “the [FSA] seem to have done not even the kind of liquidity stress-testing that I would have expected them to do, partly because the FSA is an institution that thinks more about capital adequacy and solvency issues than about liquidity issues”.¹⁸² However, Professor Buiters noted that:

One could have expected that they would have looked at the consequences of some of the markets in which Northern Rock was funding itself simply closing. What happened of course in the case of Northern Rock is that all of the markets in which it funded itself closed, something which had never happened before, so you would have had to have an ultra stress test to capture that.¹⁸³

The BBA also noted that in itself stress testing was a useful tool for regulators, but that it had been inappropriately applied in the case of Northern Rock:

Since the beginning of 2005 banks have been required to undertake stress testing and scenario analysis, to have in place contingency funding plans and to document them adequately. Under Pillar 2 of Basel II, banks are required to assess regularly and regulators to review their liquidity funding plan in a stressed situation. The FSA had reviewed Northern Rock's stress testing processes in May 2007 and has already accepted that there are lessons to be learnt about the level of its supervisory engagement with stress testing. So although they are still novel and the execution of the new Pillar 2 stress testing processes failed in the case of Northern Rock, regulators do have the right policy tools to quiz banks about their stressed liquidity plans.¹⁸⁴

59. If the Financial Services Authority was “very unhappy” with the stress testing conducted by Northern Rock, it appears to have failed to convey the strength of its concerns to the Board of Northern Rock, and to secure remedial action. Although the Board of Northern Rock undertook some stress testing of its own business model, it proved to have been thoroughly inadequate. It was the responsibility of the Financial

180 Q 247

181 Q 192

182 Q 860

183 Q 860

184 Ev 297-298

Services Authority to ensure that the work of the Board of Northern Rock was sufficient to the task. The Financial Services Authority failed in its duty to do this.

Qualifications of senior directors

60. The FSA's handbook states that under the 'Fit and Proper test for Approved Persons':

The FSA will have regard to a number of factors when assessing the fitness and propriety of a person to perform a particular controlled function. The most important considerations will be the person's:

- (1) honesty, integrity and reputation;
- (2) competence and capability; and
- (3) financial soundness.¹⁸⁵

61. The FSA Register states that Mr Adam Applegarth, Chief Executive of Northern Rock from 1 December 2001, held three "controlled functions" (CF) at Northern Rock, that of CF1 Director, CF3 Chief Executive and CF8 Apportionment and Oversight, until 13 December 2007 for his CF 1 and CF 3 roles, and until 31 October 2007 for his CF 8 role.¹⁸⁶ However, when we asked Mr Applegarth when he qualified as a banker, he replied "I am not a qualified banker".¹⁸⁷

62. Sir Callum McCarthy said that the Board of Northern Rock had met the FSA's "authorisation criteria, including the criterion of competence".¹⁸⁸ Sir Callum McCarthy also told us that:

We authorised, as we authorise non-executives and executives of major banks, all those people. We took a view on the overall corporate governance, and I would point out that for example the Risk Committee or the Liabilities and Assets Committee of Northern Rock was actually chaired by an extremely experienced banker. We looked at all that. We will of course, whatever the shape that Northern Rock evolves into—and there has been an announcement this morning in relation to that—wish to look at the continued authorisation that we have granted, as we do with all people.¹⁸⁹

63. We are concerned that the Chief Executive of Northern Rock was not a qualified banker, although of course he has significant experience. The Financial Services Authority should not have allowed nor ever again allow the two appointments of a Chairman and a Chief Executive to a "high-impact" financial institution where both candidates lack relevant financial qualifications; one indication that an individual has been exposed to the relevant training is an appropriate professional qualification. Absence of such a qualification should be a cause of concern. We therefore recommend

185 FSA Handbook, FIT 1.3.1

186 FSA Register, www.fsa.gov.uk/register

187 Q 666

188 Q 360

189 Q 358

that the FSA undertake an urgent review of the current qualifications of senior directors in financial firms (especially of those firms deemed to be “high-impact”) and ensure that the current approved person regime requirements are adequate, and respond to us on this by June 2008.

Conclusions

64. The overall regulation of Northern Rock by the Financial Services Authority has been roundly criticised during our inquiry. The Chancellor of the Exchequer outlined the role of the Financial Services Authority:

When you think about it, at the moment the FSA regulates hundreds of institutions. Some of those concerns [such as about stress testing] they will raise, they will deal with and they will never come back and trouble anyone again. [The FSA] have to exercise a judgement as to whether or not there is a particular concern that is so great, that is not going to be resolved, that then leads to a systemic problem.¹⁹⁰

65. Professor Wood told us that “the FSA does not seem to have carried out its job with the skill and diligence that one might have expected”.¹⁹¹ Professor Buiters argued that:

The FSA did not properly supervise Northern Rock. It failed to recognise the risk attached to Northern Rock's funding model. Stress testing was inadequate.¹⁹²

Sir Callum McCarthy told us that “I think there are things which the FSA had responsibility for which, as we have both [Mr Sants and Sir Callum McCarthy] made clear, were not done well enough”.¹⁹³ The Chancellor of the Exchequer also noted that “the FSA have said, and it is right, that they do need to look at their procedures and how they regulate things”.¹⁹⁴ We note that the Financial Services Authority has acknowledged that the time periods between comprehensive regulatory review of Northern Rock were “inadequate”.

66. The FSA did not supervise Northern Rock properly. It did not allocate sufficient resources or time to monitoring a bank whose business model was so clearly an outlier; its procedures were inadequate to supervise a bank whose business grew so rapidly. We are concerned about the lack of resources within the Financial Services Authority solely charged to the direct supervision of Northern Rock. The failure of Northern Rock, while a failure of its own Board, was also a failure of its regulator. As the Chancellor notes, the Financial Services Authority exercises a judgement as to which ‘concerns’ about financial institutions should be regarded as systemic and thus require action by the regulator. In the case of Northern Rock, the FSA appears to have systematically failed in its duty as a regulator to ensure Northern Rock would not pose such a systemic risk, and this failure contributed significantly to the difficulties, and risks to the public purse, that have followed.

190 Q 787

191 Q 863

192 Ev 328

193 Q 354

194 Q 756

4 The events of August and September

Introduction

Overview of this chapter

67. This chapter examines the events of August and September 2007, principally in relation to Northern Rock plc. This chapter also considers some wider issues relating to the money market operations of the Bank of England, which are intertwined with developments relating to Northern Rock. We will report on the wider aspects of the events of August and September, including their causes and consequences and the international dimension, in our forthcoming Report on Financial Stability and Transparency.

68. In this chapter, we examine events and decisions in August and September in considerable detail and reach conclusions. We believe that a full understanding of those events and decisions and an analysis of mistakes made during that period are essential if the correct lessons are to be learned. We seek to draw out those lessons and make recommendations for the future in the ensuing chapters.

Northern Rock's problems and Tripartite awareness of them

69. Soon after inter-bank and other financial markets froze on 9 August, it became evident that Northern Rock would face severe problems if the markets were to stay frozen for long. The problems were especially severe for Northern Rock because its funding model required mortgage-backed securities and plain mortgages to be securitised, and its next securitisation was scheduled for September 2007.¹⁹⁵

70. The then Chairman and Chief Executive of Northern Rock first discussed these problems with each other on Friday 10 August.¹⁹⁶ On the same day, the FSA contacted the financial businesses that it perceived might be at risk from the freezing of financial markets. One of these was Northern Rock.¹⁹⁷ Northern Rock replied to the FSA on the next working day, Monday 13 August, alerting the FSA to the potential difficulties that Northern Rock would face if the market freeze continued.¹⁹⁸ Thereafter, the FSA and Northern Rock were in twice-daily telephone contact.¹⁹⁹

71. On Tuesday 14 August, the first discussions on Northern Rock took place between the Tripartite authorities at deputy level—Mr Sants, Sir John Gieve and a senior Treasury official.²⁰⁰ The Governor of the Bank of England was alerted on that day.²⁰¹ On Wednesday 15 August, a more detailed conversation took place between the FSA and the Treasury, and

195 Qq 3, 8, 12

196 Q 391

197 Q 1523

198 Qq 568, 586–587

199 Q 568

200 Q 32

201 *Ibid.*

the Chancellor of the Exchequer was informed about Northern Rock on that day.²⁰² On Thursday 16 August, the then Chairman of Northern Rock spoke directly to the Governor of the Bank of England by telephone, and the possibility of a support operation was discussed.²⁰³

72. On Wednesday 29 August, Sir Callum McCarthy wrote formally to the Chancellor of the Exchequer indicating that the FSA believed that Northern Rock “was running into quite substantial problems”.²⁰⁴ On Monday 3 September, the Tripartite Committee met at the level of principals—the Chancellor of the Exchequer, the Chairman of the FSA and the Governor of the Bank of England.²⁰⁵ The decisions taken then and subsequently are considered in detail later in this chapter.

The three options pursued

73. Between 10 August and mid-September, Northern Rock and the Tripartite authorities essentially pursued a three-fold strategy to extricate Northern Rock from its difficulties. The three options pursued were:

- i. Northern Rock resolving its liquidity crisis through its own actions in short-term money markets and by securitising its debt;²⁰⁶
- ii. Northern Rock obtaining the “safe haven” of a takeover by a major retail bank;²⁰⁷
- iii. Northern Rock receiving a support facility from the Bank of England guaranteed by the Government.

74. There was considerable overlap between consideration of the three options. The prospects for a market solution through the money markets, including by securitisation, were pursued until 10 September.²⁰⁸ The search for a private “safe haven” which would preclude the need for a Bank of England liquidity support operation was started on 16 August and continued until 10 September.²⁰⁹ The possibility of a Bank of England support operation was raised as early as 16 August.²¹⁰

75. In the account that follows, we consider in turn three elements of the story in August and September that in fact took place to a considerable extent in parallel. First, we consider the Bank of England’s money market operations in August and September and the extent to which they might have assisted Northern Rock to liquify its assets without resort to a take-over or to the resources of the State. Next, we examine the prospects for a private sector “safe haven” option. Finally, we consider the support operation, the run that

202 Qq 200, 751, 754

203 Qq 548, 574

204 Qq 754, 756

205 Q 754

206 Qq 108, 200, 611

207 Q 613

208 Q 200

209 Qq 571, 577

210 Q 574

followed news of that operation, and the issue of a general guarantee to Northern Rock depositors. Although this chapter includes an assessment of the judgements reached by the Tripartite authorities in August and September, consideration of the wider lessons from the crisis is reserved for a later Chapter.²¹¹

The Bank of England's money market operations until 20 September

Money market reforms

76. The Bank of England undertakes money market operations to enact the decisions made by the Monetary Policy Committee regarding movements in interest rates. The Bank of England has recently changed its money market operations, and we as a Committee have monitored that process. At his reappointment hearing in October 2005, Paul Tucker, Executive Director for Markets at the Bank of England, told us that the Bank of England's Money Market reform project was continuing and that "So far, everything internally is going pretty well".²¹² Asked whether sterling overnight interest rates would exhibit lower levels of volatility, he replied that "The announcement that we are going to do something about this has helped to make a difference and some interim reforms that we introduced between March and August of this year have also brought the amplitude down".²¹³

77. On 29 June 2006, we questioned Mr Tucker again on the money market reforms, and how he would measure his success. He replied:

We have four objectives. The first is to reduce the volatility of our overnight money market rate from where it has been. Relative to many markets abroad, for as long as the Governor and I can remember, our overnight money market rate [volatility] has been unusually high, especially unusually high for a great global financial centre. I want to put emphasis on this, because this is the key objective, and it has made the sterling money markets a relatively unattractive place unless you were already an expert. That was the first objective. I will come back to that. The second was to give the banking system more flexibility in managing their liquidity, both as a system and at the level of individual banks ... In terms of how I would measure it, the first one is straightforward; we would measure simply the day-to-day volatility of the overnight money market rate relative to the past and relative to that in the euro area and in the dollar money markets. So far, and we are only six weeks into this thing, it is much lower than in the past and in line with the dollar area and the euro area. But I rather agree with what is implicit in your question, this is something to look back on after a year rather than to declare a victory after six weeks. The second objective, in terms of making the system more flexible for their liquidity management, I think we can be reasonably confident that is achieved. Historically, very few banks have banked with the Bank of England and participated in our operations; that has roughly tripled and,

211 See chapter 7.

212 Treasury Committee, oral evidence, Thursday 13 October 2005, The Monetary Policy Committee of the Bank of England: appointment hearings, HC (2005-06) 525-II, Q 50

213 Treasury Committee, oral evidence, Thursday 13 October 2005 The Monetary Policy Committee of the Bank of England: appointment hearings, HC (2005-06) 525-II, Q 51

in terms of the share of the sterling banking system, now accounts for about 90% of banking activity out there. That has given far more banks direct access to our balance-sheet (a); (b) for the first time ever, banks can borrow from us on demand during the day, at a penalty rate, against high quality collateral, in unlimited amounts; and (c) rather than having to balance their books with us at the end of each day, now they target an average balance over a month and that gives them much greater day-to-day flexibility in their liquidity management.²¹⁴

78. On 28 June 2007, as part of our inquiry into the May 2007 Inflation Report, we questioned Mr Tucker on how the money market reforms had settled in. He replied:

There were four objectives. The first and by far the most important was to reduce volatility in short term money market rates, so the market in which we implement monetary policy. I am very glad that that has been successful. Volatility is much lower in short term money market rates and I hope it stays that way. The second objective was to improve the ability of the Bank through its operating system to inject liquidity into the banking system in normal conditions and in stress conditions. I believe that to be the case in normal conditions. I believe it to be the case in stress conditions but we thankfully have not yet been tested on that, but our apparatus is much better than it was in the past.²¹⁵

The banks' request for additional liquidity in August

79. In August 2007, the Bank of England was approached by banks arguing that the Bank of England should provide additional liquidity, at no penalty rate.²¹⁶ The FSA had transmitted the banks' request to the Bank of England,²¹⁷ but refused to state to us whether it had supported the banks in requesting this additional liquidity, on the grounds that conversations between Tripartite members ought to remain private.²¹⁸ On 12 September 2007, in advance of his oral evidence on 20 September, the Governor of the Bank of England wrote a letter to the Chairman of this Committee. In that letter, the Governor pointed out that he did not agree with the suggestions for additional measures that others believed the Bank of England should undertake: lending at longer maturities, removing the penalty rate or increasing the range of collateral against which the Bank would be prepared to lend. In the letter, he gave three reasons for his position.²¹⁹ First, he stated that "the banking system as a whole is strong enough to withstand the impact of taking onto the balance sheet the assets of conduits and other vehicles". Second, "the private sector will gradually re-establish valuations of most asset backed securities, thus allowing liquidity in those markets to build up". Third, there would be a risk of 'moral hazard'. In essence, this 'moral hazard' argument is that, should the central bank act, and effectively provide extra liquidity at different maturities against weaker collateral, markets would, especially if the

214 29 June 2006 Bank of England May 2006 Inflation Report , HC 1185-i-ii, Q 81

215 HC 568-I, Session 2006-07, 28 June 2007 Bank of England May 2007 Inflation Report, Q 23

216 Qq 83–84, Ev 295

217 Q 288

218 Qq 295–6

219 Ev 216

liquidity were provided at little or no penalty, take it as a signal that the central bank would always rescue them should they take excessive risk and get into difficulties. Such a signal would lead to ever more risk taking, and the next crisis would consequently be greater than it would otherwise have been. In conclusion, the Governor wrote:

All central banks are aware that there are circumstances in which action might be necessary to prevent a major shock to the system as a whole. Balancing these considerations will pose considerable challenges, and in present circumstances judging that balance is something we do almost daily.²²⁰

80. There appears to have been some disagreement within the Tripartite authorities over the weight that should have been placed on the dangers raised by moral hazard. Sir Callum McCarthy told us that:

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 ... 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.²²¹

81. In his letter of 12 September, the Governor explained that banks operating under the reserve scheme system select their own target for the reserves they will hold with the Bank of England at the start of a 'maintenance period'. These maintenance periods run from one Monetary Policy Committee meeting to the next. Should banks require additional funds during this period, they may use, at their request, the 'standing facility', which allows them to borrow all they need against "eligible collateral and [at] a penalty rate of 1% above Bank Rate".²²² Another 'standing facility' allows banks to deposit funds with the Bank of England. In his letter, the Governor pointed out that the banks chose to raise their reserve requirements by 6% in the maintenance period starting 6 September 2007. On 5 September, before the start of the 6 September maintenance period, the Bank of England announced that, if the secured overnight rate had not fallen from its higher than usual level above Bank rate, the Bank would be prepared to offer additional reserves, amounting to 25% of the requested reserves target, before the end of the 'maintenance period'.²²³ On 13 September, this criterion was met, and additional reserves were provided. An additional fine-tuning operation occurred on 18 September—following the run on Northern Rock—again offering £4.4 billion, or 25% of the reserves target.

220 Ev 217

221 Qq 155, 157

222 Ev 216

223 Ibid

The response of other central banks

82. Meanwhile, other central banks were reacting in different ways to the unfolding turmoil. On 17 August the US Federal Reserve announced a change to the Reserve Banks' usual practices "to allow the provision of term financing for as long as 30 days, renewable by the borrower".²²⁴ Additionally, the Federal Reserve reduced the 'primary credit rate' spread above the Federal Open Markets Committee (FOMC)'s target federal funds rate by 50 basis points. The 'primary credit rate' is not the main interest rate normally followed by economic commentators, but is rather the interest rate charged to those banks approaching the Federal Reserve's discount window for short term liquidity. This 'discount window' is similar to the UK 'standing facility' outlined above, but accepts a much wider range of collateral. Professor Buiter said that "at the US discount window you can discount anything, including cats and dogs, in principle".²²⁵ On 18 September, the FOMC agreed to a 50 basis point cut to the federal funds rate, to 4¾ percent. The US had begun to cut interest rates in reaction to the crisis. At that time, the FOMC explained that "today's action is intended to help forestall some of the adverse effects on the broader economy that might otherwise arise from the disruptions in financial markets and to promote moderate growth over time".²²⁶ Further 25 basis point cuts would be made to US interest rates on 31 October and 11 December.²²⁷

83. The European Central Bank (ECB) intervened swiftly to counter tensions in the euro money market in August. The ECB did not inject additional liquidity over the full August maintenance period running from 8 August to 5 September, but it did alter the time pattern of its supply of funds. On 9 August, in response to unusually high spreads in the euro money market between the overnight rate and the ECB policy rate (see chart 2), the ECB 'frontloaded' their supply of credit for the August maintenance period, injecting €94.8 billion, which along with further operations in the following weeks, achieved the aim of returning overnight rates to the policy rate. This additional liquidity was then drained from the euro money market before the maintenance period ended on 5 September, thus ensuring that the average liquidity supply across the month remained unaffected. When we visited the ECB in January 2008, its officials told us that their August frontloading operation was necessary to offer comfort to the euro money market at a time of heightened tension. Their view was that, because this was first and foremost a crisis of confidence rather than a credit crisis, moral hazard arguments were not the highest priority. This was not a situation where the ECB was "bailing out" any particular banks, but, in the ECB's view, rectifying a generalised lack of confidence. The ECB argued that an overall collapse of the market due to a lack of confidence required from them a strong signal that they would step in to provide whatever liquidity the market desired.

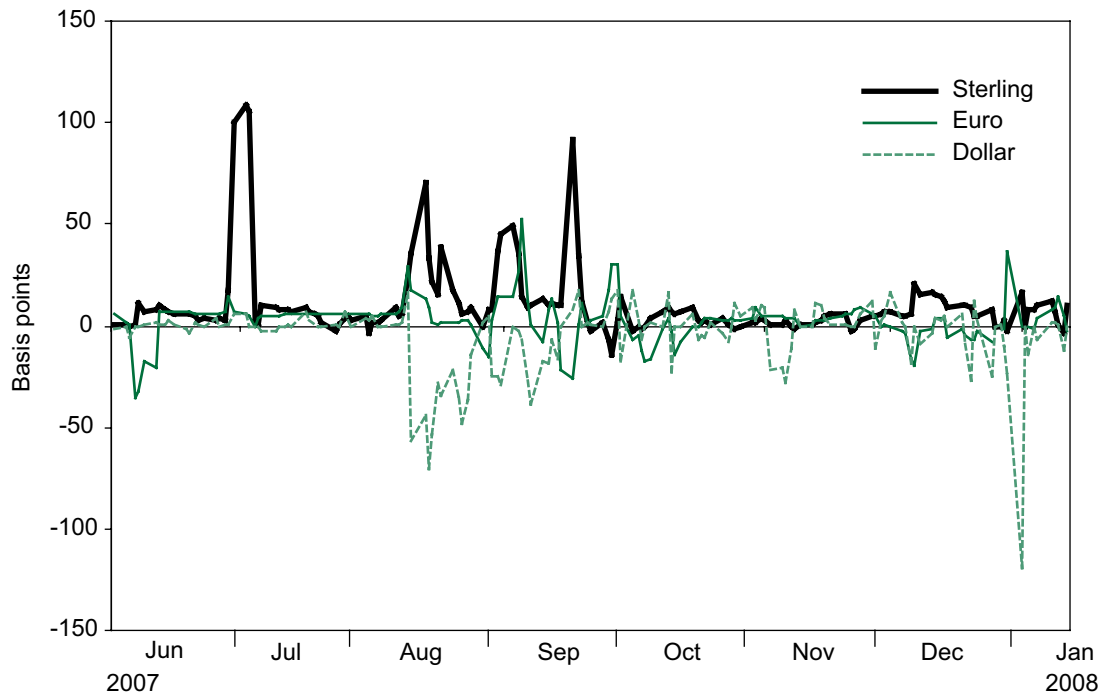
224 Press Release, Federal Reserve Board, <http://www.federalreserve.gov/newsevents/press/monetary/20070817a.htm>

225 Q 884

226 <http://www.federalreserve.gov/newsevents/press/monetary/20070918a.htm>

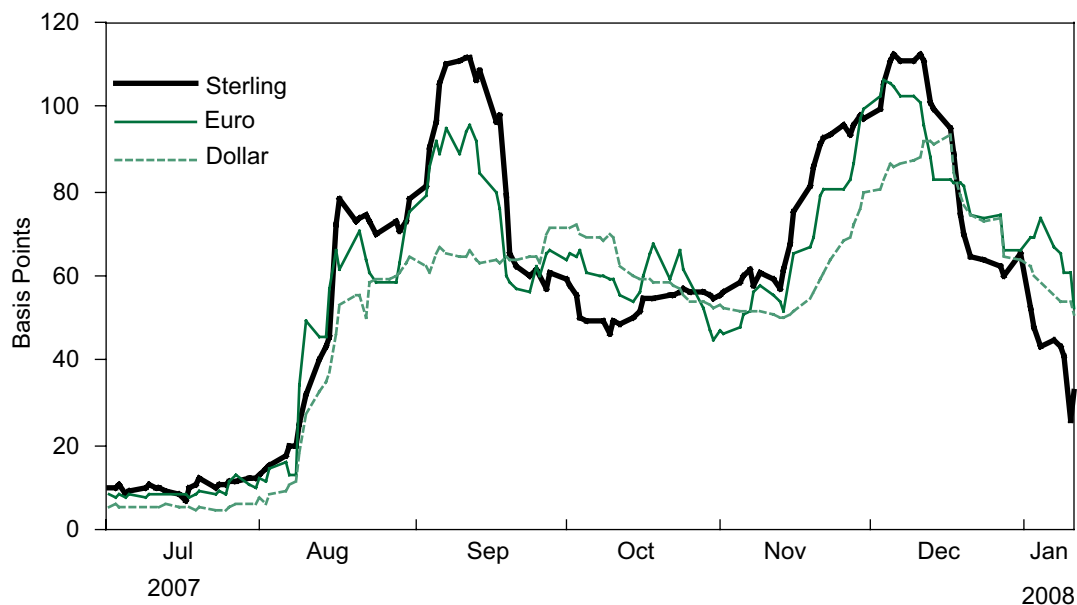
227 <http://www.federalreserve.gov/newsevents/press/monetary/20071031a.htm>,
<http://www.federalreserve.gov/newsevents/press/monetary/20071211a.htm>

Chart 2 Overnight rates – Sterling, Euro and Dollar*



Source: Bloomberg/Bank of England
 *Overnight Libor spreads over policy rates

Chart 3: 3-month rates – Sterling, Euro and Dollar



Source: Bloomberg/ Bank of England
 * 3-month Libor spreads over comparable overnight index swap rates

Comparing the Bank of England’s response with other central banks

84. Questions have been raised as to whether the Bank of England was too slow in accepting the need for additional liquidity, both at different maturities, and against a wider range of collateral, when compared with other central banks. As outlined above, other central banks apparently reacted faster to the problems developing in international capital markets. The turmoil in money markets around the world was manifested in the spreads

between the overnight rates (the rate that banks were willing to lend to each other) and central banks' policy rates. In common with other central banks, the Bank of England's primary objective is ensuring stable overnight money market rates in line with its policy rate, although the Bank seemed reluctant to act in August, when overnight rates deviated significantly from the policy rate. The action of the ECB on 9 August succeeded in bringing euro overnight rates back into line with policy rates, whilst sterling overnight spreads continued to rise, peaking on 13 August, and then remaining unusually high throughout the Bank's August maintenance period (see chart 3).

85. Professor Buiters argued that the Bank of England's approach was too restrictive when compared with other central banks.²²⁸ He told us that:

I think the Bank of England made policy errors, even given the existing framework, in its management of liquidity. Its demands for collateral were too strict—stricter than any other central bank that matters, much stricter than those of the ECB and stricter than those of the Fed—and its demands for collateral at its discount window, the so-called standing lending facility, were also way too strict. Basically they would discount only stuff that is already liquid: UK government securities; European Economic Area government securities; a few international organisations' debt like the World Bank; and then, under special circumstances, US Treasury bonds. All that stuff is liquid already so all the Bank offered at its discount window was maturity transformation, not liquidity transformation, and that was absolutely no good. When they created the Liquidity Support Facility for Northern Rock they created what the Bank's discount window should have been all along—something that lends against illiquid collateral and also lends for longer periods, because the Bank discount window is only for overnight lending.²²⁹

86. However, not all witnesses supported the approach taken by the Federal Reserve and the ECB in August. Professor Wood disagreed with Professor Buiters' point that the Bank of England should have been involved in liquidity transformation, telling us that he thought the Bank's refusal to engage in liquidity transformation "was exactly the right thing to do".²³⁰ Professor Wood was unsupportive of the immediate actions of the ECB and the Federal Reserve:

It seems to me therefore that the Bank of England's behaviour in being very reluctant to take securities that they would not normally take, except when the crisis got really bad, from Northern Rock and refusing to accept them from other institutions for some considerable time was exactly the right thing to do. The casual lending on almost anything that the Federal Reserve and the ECB did almost immediately seems

228 The Bank of England has not always been so unwilling to flex its collateral requirements. In response to widespread financial panic and bank runs in 1825, for example, the Bank deviated from its normal practice and made advances on government securities, instead of limiting itself to the discounting of commercial bills, which, at the time, carried lower risk.

229 Q 854

230 Q 856

to me to have been an error of judgment and is likely to bring problems in the future.²³¹

87. The Chancellor of the Exchequer pointed out that, despite the more proactive approach taken by the Federal Reserve and ECB, banks in the US and Eurozone also got into difficulties:

in the United States they did make money available. It did not stop three or four institutions from . . . I think in fact three or four institutions have actually had to close down in the United States and have been taken over by other banks. In Europe some of the smaller German banks got into difficulties. So it is not just a problem for here.²³²

88. Defending the actions of the Bank of England, the Governor was keen to explain that, contrary to the “myth” propagated by commentators, the actions of the ECB and Federal Reserve were “all remarkably similar”:

One of the points most people fail to understand . . . is that the European Central Bank has not increased the amount of liquidity at all since the beginning of August. It has redirected some of the liquidity that it would have done at one-week term to three-month term, but the total amount of liquidity that it extends to the banking system is absolutely the same now as it was in June and July before the turmoil began in August. That is not readily understood by many people. The amount of liquidity that we are extending to the banking system is almost 30% higher. I do not put enormous weight on that. I think what we have is a system, which I prefer, in which the banks can choose their own reserves targets. If they say they would like to hold more reserves with the Bank of England we readily supply it on demand. That is why we are supplying 30% more now than we were. Equally, the Federal Reserve has not raised the total amount of liquidity very much. There is a certain myth in all this that goes around and we take our share of the responsibility for not explaining it properly, but it is not easy to get across these points²³³

89. The Bank of England, the European Central Bank and the Federal Reserve each pursued a different course of action in response to the money market turmoil in August 2007. Only the Bank of England took no contingency measures at all during August, in order to protect against moral hazard, that is, the fear that an injection of liquidity would offer incentives for banks to take on more liquidity risk, secure in the knowledge that the Bank of England would step in to resolve future liquidity crises. The European Central Bank appeared to attach far less weight to the moral hazard argument than the Bank of England. Instead, it adopted a proactive approach in resolving what it saw as a practical problem of a faltering market resulting from banks losing confidence in each other. Although the European Central Bank injected no net additional liquidity in August, it did alter the timing and term profile of its regular

231 ibid

232 Q 770

233 HC 139-I, Session 2007-08, Bank of England November 2007 Inflation Report, Q 18

operations, front-loading its credit supply towards the start of August, and draining this liquidity before the end of the maintenance period. In doing so, the European Central Bank appeared to satisfy the immediate liquidity demands of the Eurozone banking sector, whilst UK banks' sterling demands went unmet. We are unconvinced that the Bank of England's focus on moral hazard was appropriate for the circumstances in August. In our view, the lack of confidence in the money markets was a practical problem and the Bank of England should have adopted a more proactive response.

90. We accept the Governor's comments that the Bank of England injected additional liquidity into the money markets in September, when the ECB and Fed did not. This was not a decision on the part of the Bank, but a consequence of banks being able to choose their reserve requirement for each maintenance period. The Bank of England should set out, in its response to this Report, the rationale for having a voluntary reserves system, rather than a system that stipulates reserves requirements for each bank.

Would extra liquidity have saved Northern Rock?

91. As discussed earlier in this Chapter, the funding crisis at Northern Rock was one of the availability of liquidity.²³⁴ During our inquiry we examined whether a more generous liquidity regime could have prevented the run at Northern Rock, and supported Northern Rock through the closure in markets.

92. When asked whether Northern Rock might have avoided falling into trouble if the liquidity approach adopted by the European Central Bank (ECB) had been applied by the Bank of England, Mr Applegarth said that "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".²³⁵ The assertion that some European retail banks were more dependent on wholesale funding than Northern Rock was, however, called into question by what we learned at the ECB. The view from the ECB appeared to us to be that no Euro-zone bank was as dependent on wholesale funding as was Northern Rock.

93. Mr Sants told us that "it clearly is the case that if liquidity in smaller amounts had been made available to Northern Rock earlier, then it is quite possible it would not then have subsequently needed to apply to the lender of last resort facility".²³⁶ The BBA considered that "had the Bank acted in this vein [of accepting a wider collateral base] at the beginning of August, then many of the problems affecting the money markets in general and Northern Rock in particular might have been mitigated".²³⁷

94. The Governor of the Bank of England dismissed the suggestion that a market-wide liquidity intervention could have assisted Northern Rock. He told us that:

234 See Chapter 2

235 Q 609

236 Q 285

237 Ev 296

You could ask whether the market could have been the lender of last resort for Northern Rock. 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 go back to those circumstances quickly and get back to where we were in July would have meant injecting a massive amount of liquidity. The Federal Reserve and the ECB have gone nowhere near that far at all.²³⁸

This point of view was supported by Professor Buiter. Responding to the suggestion that market wide injections of liquidity could have helped Northern Rock by helping the overall market, he stated that:

That would take an enormous amount of money injections. We know for instance that despite all the money that the Fed and especially the ECB have put into these longer terms markets, the actual spreads of three months LIBOR and the euro equivalent and the dollar equivalent over the expected policy rate is no smaller in euro land today than it is here, so it really may take a large injection of liquidity to get an appreciable result if the market is really fearful.²³⁹

Professor Buiter admitted that an injection of additional liquidity by the Bank “would have had a beneficial impact on the system” but doubted “whether it would have been enough to save Northern Rock”.²⁴⁰ Professor Wood agreed, saying “I do not see how giving a small amount of liquidity earlier to Northern Rock would have been much help since the problem, as we have seen, has been the shortage of a large amount of liquidity”.²⁴¹ The Chancellor of the Exchequer accepted the Governor’s argument against increasing overall market liquidity in order to help Northern Rock. He told us that:

Bear in mind that, as of about a week ago, they [Northern Rock] told the Committee they have had to borrow about £13 or £14 billion from the Bank. To get that sort of money into the hands of one institution you would have to put many more billions of pounds into the market generally. Given that the problem was not lack of capital but was instead particular problems of liquidity for Northern Rock, the Governor’s very firm view was that that was not the right thing to do.²⁴²

95. We cannot know whether an open market liquidity operation of the kind asked for by a number of banks in August would have prevented Northern Rock’s need for emergency support from the Bank of England in September. It is most unlikely that any such lending operation in September, following the stigmatisation of Barclays which we deal with later, could have been of a sufficient scale to ensure that Northern Rock could

238 Q 3

239 Q 873

240 Q 879

241 Q 873

242 Q 764

have received the liquidity it then required. Such an operation would also have raised severe ‘moral hazard’ concerns, signalling to the banking sector as a whole that public sector support would be made available in the event of any bank facing distress.

A U-turn by the Bank?

96. As we have already noted, the Bank of England liquidity support facility for Northern Rock was formally announced on 14 September 2007, after its premature disclosure by the BBC on 13 September 2007. Around this time, the spread between 3-month interbank rates and 3-month expected policy rates remained unusually high (see chart 3). On 19 September 2007, the Bank of England announced that it planned to “to conduct an auction in which it [would] provide funds at a 3-month maturity against a wider range of collateral, including mortgage collateral, than in the Bank’s weekly open market operations”.²⁴³ Representatives of the Bank of England then came before us on 20 September 2007 to give evidence. When asked why this apparent change of policy had occurred, with the Bank of England now offering lending at a longer maturity against a wider range of collateral, the Governor said:

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 announced 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.²⁴⁴

However, the ‘penalty’ rate of interest was maintained. The Governor explained the reasoning behind this:

I think that is appropriate and it is appropriate because of the circumstances in which we are providing it, with the realisation of risks that the banks themselves took in full knowledge of what the consequences would be. The one thing I would like to say at the end is if these same problems were seen in the banking system today and they had been the result of some completely different cause, say a major terrorist attack, we would be injecting liquidity at absolutely zero cost because that would not be the result of the risks that the banks themselves took. The reason for the penalty rate now is not a punishment it is not to blame anybody; it is simply to make sure that when people think about the risks they are taking in the future they do so in the knowledge that it is costly to take risks.²⁴⁵

97. **The fact that the European Central Bank accepted a wide range of collateral, including relatively illiquid assets, certainly assisted European banks, throughout the**

243 <http://www.bankofengland.co.uk/markets/money/documentation/statement070919.pdf>

244 Q 2

245 Q 115

period of turmoil. The broadening of acceptable collateral by the Bank of England in September similarly assisted UK banks. The Governor depicted the Bank's decision as being finely balanced between giving the banks the liquidity they wanted and moral hazard. If the Bank were always to accept a wider range of collateral, banks would have an incentive to alter their asset portfolios away from the safest classes and towards higher-risk classes, and we consider this moral hazard argument to be important. Nevertheless, with the benefit of hindsight, we have concluded that the Bank of England should have broadened the range of acceptable collateral at an earlier stage in the turmoil.

98. The usual penalty rate was charged on the 3-month operation announced on 19 September. The penalty rate should not be viewed as a punishment for recalcitrant banks, but rather a reminder to banks to manage their liquidity risks in an appropriate manner.

Possible reform to the Bank's standing facilities

99. Professor Buiter suggested that one potential response to the problems at Northern Rock that the Bank of England might have made, would have been to change the requirements of its standing facilities. These standing facilities allow banks to borrow or deposit unlimited amounts at a rate 100 basis points above the Bank's main policy rate, with the Bank accepting as collateral the same assets as it does for its other routine money market operations, namely UK and foreign government bonds. Professor Buiter proposed that the Bank should extend the list of collateral acceptable for the standing facility, in order to permit borrowing by banks against more illiquid asset classes:

“When [the Bank of England] created the Liquidity Support Facility for Northern Rock they created what the Bank's discount window [standing facility] should have been all along—something that lends against illiquid collateral and also lends for longer periods, because the Bank discount window is only for overnight lending”.²⁴⁶

Professor Wood, however, added a cautionary note to Professor Buiter's suggestion:

I do not think it is necessarily correct that we should want to give liquidity support to an individual institution if the rest of the market is in good order. That suggests that individual institution is fundamentally deficient and should be closed. The lender of last resort operation should go to the market as a whole when the market is short of liquidity. If an individual institution needs it, and the rest of the market is fine, there is something wrong with that institution.²⁴⁷

100. The Bank of England is reviewing, over the next year and in consultation with banks, the other Tripartite authorities and other central banks, elements of its money market operations.²⁴⁸ **We recommend that the Bank of England, in its response to this Report, set out the rationale behind the design of its standing facilities, and any changes to them that it is considering making.**

246 Q 854

247 Q 867

248 Q 1608

UK banks' access to foreign central banks

101. Although banks are regulated and supervised at the national level, many banks conduct their business across borders, and some have access to the credit supplied by more than one central bank. Typically, a bank will be able to gain access to central bank funding in any country in which they operate. Thus, a UK-registered bank with operations in the Euro-zone would have been able to access ECB funding throughout the turmoil and take advantage of the ECB's more generous collateral requirements, and its willingness to adjust the timing of its credit supply. Many UK-registered banks do have such access to the ECB lending facilities, although the ECB told us that there had been no significant change to these banks' borrowings during the period of turmoil. When Northern Rock encountered funding difficulties, one possible solution might have been to make use of ECB liquidity, via the Northern Rock operation in Ireland.²⁴⁹ Northern Rock did not do this, however, and Mr Applegarth outlined the problems in achieving such a funding stream:

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 ... 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.²⁵⁰

Mr Sants, the Chief Executive of the PSA, explained why it might have been worthwhile for Northern Rock to approach the ECB. He said that "If [Northern Rock] had been set up to access the ECB liquidity provision it could have tendered different types of collateral to that which it would have been able to so do in the UK".²⁵¹ Professors Wood and Buitier supported the appropriateness of Northern Rock looking to this funding stream.²⁵² Professor Buitier encouraged all British banks capable of arranging the facilities to ensure they had funding lines not only from the ECB, but also from the US Federal Reserve.²⁵³ Professor Wood told us that it was prudent from the point of view of individual banks to ensure such funding arrangements were available from "other central banks [that] give out liquidity too generously".²⁵⁴

102. The BBA argued for greater coordination between central banks on the range of collateral that each accepts:

We believe that a range of additional instruments such as sterling certificates of deposit (CDs) and commercial paper (CP) should be accepted in the weekly and monthly money market operations, and that the Bank should also review the range of collateral, including non-Sterling, it is prepared to accept during stressed conditions, both as to the type of instrument (eg mortgage backed securities), and to

249 Q 585

250 Q 585

251 Q 331

252 Q 882

253 Q 884

254 Q 884

maturity ... Ensuring greater consistency between the range of collateral that can be deposited with the central banks in the major financial centres (the Bank of England, the Bank of Japan, the ECB, and the US Federal Reserve) is also desirable from this perspective.

103. There are many circumstances where UK banks might be able to participate in money market operations conducted by the European Central Bank and the US Federal Reserve, although the fact that such operations would neither be conducted in sterling, nor accept sterling-denominated collateral, is a significant obstacle to UK banks extending their use of these facilities. In these circumstances, the Bank of England's policy on money market operations cannot be reviewed in isolation from those of other central banks. In view of the fact that some, but not all, UK banks have access to the money market operations provided by foreign central banks, the review of the Bank of England's money market operations should be informed by an awareness of the case for closer alignment of the Bank of England's money market operations with those of the European Central Bank and of the Federal Reserve.

Stigmatisation

104. An increasing problem faced by financial institutions in their use of central bank funds has been that of 'stigmatisation'. Stigmatisation occurs where individual financial institutions fear damage to their reputations from accessing special operations, such as the Bank of England's 3-month term auction announced on 19 September, because application for the funds might mark out that institution as weak in some way, and therefore a poor counter-party risk.

105. The problem of stigmatisation crystallised in August, when it was reported that a major UK clearing bank had need to call on the Bank of England's standing facilities on two separate occasions. The clearing bank borrowed £314 million on 20 August and a further £1.55 billion on 29 August, at penalty rates, and found itself the centre of intense scrutiny as investors and the media searched for signs of weakness following the start of the turmoil in the capital markets. In this case, the use of the standing facility appears to have been unrelated to any overall liquidity issues, instead being the result of a technical breakdown in the system used by banks to clear and settle money market transactions. A member of the bank's staff was reported as saying "in these challenging times the dramatisation of such situations is of no help to markets, their members or their customers".²⁵⁵ The Chancellor of the Exchequer drew attention to the "feverish speculation" surrounding these incidents:

You may remember at that time that another large bank had, for wholly technical reasons, borrowed money from the Bank of England overnight simply because the settlement system had not cleared everything, and there was no end of speculation. Remember, there was a lot of feverish speculation at that time and people were phoning up banks on a daily basis, saying, 'Have you been to the Bank of England?'

²⁵⁵ *Barclays reassures after more borrowing*, Financial Times, 31 August 2007

so we are not talking about the comparative calmness we have got now, but we were talking about a very feverish time.²⁵⁶

The British Banker's Association noted its concern about the wider issue of the stigmatisation of all unusual borrowing from the Bank of England, stating that:

We are also concerned about the adverse publicity which now accompanies any application for borrowing from the Bank of England. This stigma should be removed by separating the Bank's day to day lending from its crisis management role. The Bank of England should recognise the need at times to strike the right balance between transparency and confidentiality in order to maintain an orderly market.²⁵⁷

106. The fear of stigmatisation may well have been one of the reasons why the Bank of England received no bids at all for its term auctions held on 26 September and 2, 10 and 17 October.²⁵⁸ But stigmatisation is not a problem unique to the UK. In our recent visit to the United States, stigmatisation was also raised as an issue for policy-makers there. The Governor of the Bank of England confirmed the global nature of the problem to us, stating that:

A key lesson that central banks around the world have taken from the recent turmoil is that, in stressed conditions, any bank that is seen to come to the central bank to borrow—whether in regular standing facilities against high-quality collateral or against wider collateral in a discount window or support operation—can become stigmatised in the market. It important that, in future, banks have a means of accessing the central bank when necessary. So over the next year, and in consultation with the banks, the other Tripartite authorities and other central banks, we will be reviewing this element of our money market operations. In due course we shall publish a revised 'Red Book' that describes our operations in the sterling money markets.²⁵⁹

107. **'Stigmatisation', whereby financial institutions will not approach the central bank for assistance for fear of being regarded by the market as weak, appears to be a substantial problem in money markets across the world. Although this problem is not unique to the UK, we recommend that the Bank of England place particular emphasis, in its further reforms of its money market operations, on measures to deal with stigmatisation.**

The decisions on the "safe haven"

Overview

108. On 16 August, Northern Rock began its pursuit of a "safe haven", acting "behind the scenes" and with its advisers to encourage an offer for the company to be made.²⁶⁰ In

256 Q 1769

257 Ev 294

258 www.bankofengland.co.uk/markets/termauctions/index.htm

259 Q 1608

260 Qq 571, 732

accordance with its responsibilities under the Memorandum of Understanding, the FSA “encouraged and closely monitored discussions that took place between Northern Rock and potential acquirers”.²⁶¹ The FSA set out “the requirements from a potential bidder that would have to be satisfied” and “what would have to be done if a private sector solution was to be pursued”.²⁶²

109. Two institutions showed an interest in acquiring Northern Rock. One only showed “a slight expression of interest ... that never came to anything”.²⁶³ The second institution, which was a major high street retail bank,²⁶⁴ showed “more specific interest” for a period of two or three days, but no firm offer was made.²⁶⁵ Northern Rock ceased its pursuit of a “safe haven” on Monday 10 September.²⁶⁶ The discussions prior to the abandonment of this option were the subject of conflicting evidence.

The financial support required

110. The first conflict in evidence relates to the nature of the financial support required by the high street bank that considered making an offer for Northern Rock. Mr Applegarth implied on several occasions in evidence that the lending facility sought by the potential buyer was similar in nature to the support facility subsequently granted by the Bank of England to Northern Rock itself. First, he referred to the possibility of the facility being “granted to a major high street retail bank ahead of us having to get the facility”.²⁶⁷ Second, he stated that that bank wanted “a backstop facility in case the markets remained closed for X months to make sure they had sufficient liquidity to cover the liquidity issues we had”.²⁶⁸ Third, he said that “a facility similar to the one we got was not available to the main high street bank at the time”.²⁶⁹ Mr Applegarth also indicated his belief that the Bank of England had refused the request for financing, and criticised the decision to refuse such financing.²⁷⁰

111. The Governor of the Bank of England stated that the request was in the form of “one pretty vague telephone call, which came to Bank officials and then passed to me, originating in [the] FSA”.²⁷¹ The Governor confirmed that he had not been party to conversations between the FSA and the potential bidder for Northern Rock.²⁷² The Chancellor of the Exchequer stated clearly that the financial support requested was in the form of a loan, which “could have been as much as £30 billion ... to be given at commercial rates by the Bank of England”.²⁷³ The Governor also described the request as one to

261 Q 257

262 Q 322

263 Qq 749, 754

264 Q 588

265 Q 754

266 Qq 571, 577

267 Q 588

268 Q 614

269 Q 680

270 Qq 617, 579

271 Q 1665

272 Qq 1715–1717

273 Q 789

“borrow about £30 billion without a penalty rate for two years”.²⁷⁴ Both the Chancellor of the Exchequer and the Governor indicated that they had an instinctive reluctance for the Bank of England to act as commercial lender to a going concern.²⁷⁵

112. The Chancellor of the Exchequer and the Governor also told us that there was a potential legal barrier to the provision of the financial support that was enquired about. The Governor received legal advice that such lending on commercial terms would constitute State aid under European Community competition law.²⁷⁶ Both he and the Chancellor of the Exchequer concluded that, were such lending to be made available to one high street bank, a matching facility would also have to have been offered to other potential bidders.²⁷⁷ The Governor advised against accepting the financing request; the Chancellor accepted that advice, and the tentative approach was not followed by a formal offer.²⁷⁸

How smoothly a takeover could have been accomplished

113. The Governor of the Bank of England laid great stress on the legal difficulties faced in modern circumstances in accomplishing a smooth takeover of a bank that is a quoted company:

The first way [the Bank of England] might have dealt with [the problems at Northern Rock] was to invite the directors of Northern Rock 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 Northern Rock 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 Northern Rock is a quoted company—cannot be managed except through a long and prolonged timetable set out in the Takeover Code.²⁷⁹

He subsequently added that “whatever accelerated deal one tries to bring about, the shareholders must be given proper time to consider a bid and others must be given a chance to make their counter bids”.²⁸⁰ During the period when bids were under consideration, he argued that depositors might be tempted to withdraw their funds.²⁸¹ The FSA also stated that any takeover “would have been done in the conventional fashion through the normal framework”.²⁸²

114. Mr Applegarth was firmly of the view that the initial stages of a takeover could have been accomplished more smoothly and could therefore have prevented a run. First, he said

274 Q 1665

275 Qq 789, 1665

276 Q 1665

277 Qq 1665, 789

278 Qq 1665, 789

279 Q 5

280 Q 1672

281 Q 107

282 Q 258

that the run “would not have taken place, in my view ... if we had been able to announce an offer with a big retail brand”.²⁸³ He subsequently said:

Clearly it would have been impossible to get a completed transaction over a weekend, but it is my view that, had you had an announceable offer over the weekend with a major high street brand, that would have provided sufficient confidence so a run did not happen.²⁸⁴

115. The Governor of the Bank of England gave a somewhat different picture of what would have happened in such circumstances, drawing upon his conclusion that any financial facility to one potential buyer would have to have been made available to other potential buyers:

The idea that if [the Chancellor of the Exchequer] stood up and said, ‘I am willing to lend £30 billion to any bank that will take over Northern Rock’—that is not the kind of statement that would have helped Northern Rock one jot or tiddle. It would have been a disaster for Northern Rock to have said that.²⁸⁵

Conclusions

116. The FSA, the Governor of the Bank of England and the Chancellor of the Exchequer all indicated that they actively sought or favoured a solution to Northern Rock’s problems prior to the run through a private sector takeover. The Chancellor of the Exchequer stated that a merger “would have been by far the best option”.²⁸⁶ However, witnesses from each of the Tripartite authorities were equally adamant that no firm offer was made.²⁸⁷ While an indicative approach was clearly made, this was subject to the provision of a support facility, which the Tripartite authorities were not prepared to provide at that stage. The Chancellor of the Exchequer concluded that, “as the days went by, it was increasingly obvious that people just did not want to know”.²⁸⁸

117. Professor Buitert strongly supported the Chancellor of the Exchequer’s rejection of an offer based on a large loan on commercial terms to a potential private sector buyer: “They [would not be] protecting financial stability. They would be protecting the shareholders of the company wishing to take over Northern Rock.”²⁸⁹ He also remarked that:

If it is true that they wanted up to ... £30 billion, in continued financial support to finance a takeover, then I think the Treasury and the Bank—this was a joint decision—were absolutely right to refuse it. This would be the socialisation of

283 Q 579. See also Q 613.

284 Q 679

285 Q 1665

286 Qq 257, 3, 790

287 Qq 324, 1665, 788

288 Q 790

289 Q 870

banking, and that might be a good idea but I do not think that is what this was about.²⁹⁰

118. **With the benefit of hindsight, the financial support enquired about by a potential buyer of Northern Rock prior to 10 September may conceivably have represented a better deal for the taxpayer than the financial support that has been provided since 14 September. Unfortunately we received conflicting evidence from Northern Rock and the Tripartite authorities over the details of the support facility requested by the potential bidder for Northern Rock. This unresolved conflict prevents us from drawing any firm conclusion on whether a safe haven was possible. What also remains unclear is how proactive the Tripartite authorities were in pursuing this option. Clearly the amount and type of State aid was a major factor but equally so was the question of whether the Takeover Code inhibited Tripartite attempts to facilitate a private sector solution for the troubled bank. In any event, it needs to be borne in mind that the consequences of any announcement that might have been made relating to a potential takeover would have been unpredictable. Furthermore, it is not evident that the State could, or should, underwrite a safe haven option, where a single, presumably profitable, bank received State support (in the form of a lending facility) to undertake, or at least announce the takeover of Northern Rock.**

The support operation, the run and the guarantee

The decision in principle on support

119. On Monday 10 September, Northern Rock abandoned its attempts at securitisation and its pursuit of a “safe haven”.²⁹¹ Discussions about the Bank of England support option had already taken place before this time. The idea had been mooted when the then Chairman of Northern Rock spoke to the Governor of the Bank of England on 16 August.²⁹² Northern Rock envisaged the operation as a “backstop” facility that would only be drawn down should the other possible funding avenues—in other words, Northern Rock’s own actions by securitising its debt or Northern Rock obtaining the “safe haven” of a takeover by a major retail bank—prove inaccessible.²⁹³ It appears that a decision in principle that Northern Rock would be granted a support facility should neither securitisation or a takeover prove possible was taken at a meeting between the Chancellor of the Exchequer, the Chairman of the FSA and the Governor of Bank of England on Monday 3 September.²⁹⁴ The final decision was that of the Chancellor of the Exchequer, but his decision was taken on the basis of a joint recommendation of the Governor of the Bank of England and the Chairman of the FSA.²⁹⁵

120. An insight into the likely basis of the advice given to the Chancellor of the Exchequer in early September was provided by the Governor’s evidence to us on 20 September. On

290 Q 869

291 Qq 577

292 Q 574

293 Qq 195, 488–490, 529

294 Q 754

295 Q 763

that occasion he drew attention to two substantial weaknesses in the legal framework for dealing with failing banks as it stood at that time. First, were Northern Rock to be unable to honour its funding commitments, depositors would not receive their deposits in full beyond £2,000, with only 90% of funds being reimbursed between £2,000 and £35,000.²⁹⁶ Second, in the event of Northern Rock being declared insolvent and entering into administration, depositors would find their funds frozen, with the prospect of a long delay before their deposits were (even in part) reimbursed.²⁹⁷

121. We consider the weaknesses of the existing legal framework for handling failing banks, and why those weaknesses were allowed to persist, later in this Report.²⁹⁸ At this stage, we are only concerned with the decision that the Chancellor of the Exchequer faced in early September. He was faced with the clear weaknesses in the framework for handling failing banks as it then stood. He was also conscious that, had Northern Rock been allowed to fail, there was a substantial risk that the spectacle of depositors unable to access their funds in Northern Rock would lead depositors with other banks to lose faith in the banking system as a whole, the so-called “contagion” effect:

The reason that we decided to offer lender of last resort facilities was because we believed that there was a wider systemic risk to the financial system. Now, that is the only consideration and that has always been the case as far as lender of last resort facilities are concerned, and I believed there was a serious risk of contagion and, therefore, we offered that support ... I do not agree with ... the proposition that we should have let the bank go under.²⁹⁹

122. The Chancellor of the Exchequer’s decision in the first half of September to make a support facility available to Northern Rock should the need arise was the right one. Had he chosen not to do so, there would have been a significant risk of substantial disadvantage to Northern Rock depositors and a very real prospect of “contagion”, whereby the public would lose confidence in the security of holdings across the United Kingdom banking system. In view of the weaknesses of the legal framework for handling failing banks at that time, the Tripartite authorities were right to view Northern Rock as posing a systemic risk. Had any other decision been taken, it is quite possible that the events that unfolded from mid-September onwards could have been more damaging to consumers and to the United Kingdom financial system than those that have actually taken place.

Consideration of a covert operation

123. When he gave evidence to us on 20 September, the Governor of the Bank of England emphasised his personal preference for a covert support operation. Having previously explained why a weekend takeover was not possible—a matter we considered earlier—he went on to say:

²⁹⁶ Q 14. For the amounts available under the deposit protection arrangements at that time, see Q 345 and para 212.

²⁹⁷ *Ibid.*

²⁹⁸ See Chapter 5

²⁹⁹ Q 1782

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 Northern Rock 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.³⁰⁰

At the same session, he also confirmed that a covert operation was his “first preference” and that he had “pressed strongly for the ability to conduct a covert operation”, but had been advised that it was not possible.³⁰¹ Sir Callum McCarthy also told us that a covert operation “would have had some attractive features”, but “was not a practical possibility”.³⁰² The idea of a covert operation was abandoned on Tuesday 11 September, the day after it became evident that prospects of a private sector solution had failed and that a support operation would be necessary.³⁰³ Witnesses identified two factors which acted as obstacles to such a covert operation—the requirement upon the Board of Northern Rock to make an announcement to the stock market about their situation and the practical difficulties associated with the possibility of a leak of a covert operation.

124. Northern Rock was a public listed company and, as such, had obligations to disclose relevant information to the stock market. Its last formal announcement to the stock market had been made in late July when Northern Rock’s mid-year results were announced. These included an increased dividend and a seemingly healthy financial position, at least in relation to capital adequacy.³⁰⁴ Sir Ian Gibson indicated that the Board was very conscious of its legal position in relation to disclosure:

From ... 14 August onwards ... we consulted legal advisers, the UK Listing Authority, the FSA, later the Tripartite [authorities], in terms of what was appropriate to disclose at what point, either about other party discussions or about discussions with the Bank of England or about the trading circumstances of the company, and we are fully satisfied that we did follow the best advice and follow it to the letter.³⁰⁵

Sir Ian went on to say that consideration was given as to whether on-going discussions with the Bank of England about the support operation ought to be disclosed:

Once we were in discussions with the Bank of England, our guidance from all involved, including clearance with the UK [Listing Authority], was that those discussions be not made public because there are circumstances, and we have certainly seen the results of those circumstances, that mean it is not appropriate in the view of the listing authority or the FSA that certain of those discussions are taken to the market³⁰⁶

300 Q 5

301 Q 21

302 Q 177

303 Q 1620

304 Northern Rock plc Interim Results, 6 months ended 30 June 2007

305 Q 744

306 Q 745

125. However, it appears that, at some stage, legal advice was received that the Board of Northern Rock would have a duty to disclose a support operation in the context of Northern Rock's wider financial condition soon after the operation was embarked upon. The Governor explained this first on 20 September:

It was during this particular crisis with Northern Rock where I found it hard to believe that a public policy intervention that was in the interests of everyone in Northern Rock [a covert operation] could not go ahead because of a legal responsibility to disclose. There is wording in that [European Union] Market Abuses Directive which would give you the impression that in a case of financial distress it would be possible not to disclose but we had to take legal advice. I would say this occurred in the period between about 22 August and the date on 9 September when it became clear that we were discussing seriously doing the lender of last resort operation and we were advised finally that it could not be covert.³⁰⁷

At times on that occasion, the Governor of the Bank of England appeared to imply that the legal position arising from the Market Abuse Directive was clear cut: "the ability to conduct covert support ... is ruled out because of the Market Abuses Directive".³⁰⁸ Later during the same session, he conceded that the relevant wording in the Directive was "ambiguous".³⁰⁹

126. The final decision that a covert operation was not legally possible was based in part on advice received by the Board of Northern Rock. Mr Applegarth told us:

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 ... The legal advice that we were getting [was] that it [the support facility] was most probably announceable.³¹⁰

Sir Callum McCarthy also told us that, "in the particular circumstances, the Northern Rock Board took the view that they had to make an announcement".³¹¹ This view was supported by the Governor of the Bank of England:

Northern Rock were very keen to make a public statement that they had the facility because their view was that they did not want the covert operation, they wanted it to be overt because they believed that the sign of reassurance of having a facility from the Bank of England would help them and, in fact, that is what would prevent a retail run in their view.³¹²

127. Although legal advice about the duty to disclose was received by the Board of Northern Rock, both Northern Rock and the Bank of England indicated that the FSA had

307 Q 62. See also Q 109.

308 Q 14

309 Q 21. See also Q 22.

310 Qq 621, 624

311 Q 173

312 Q 1650

legal advice to the same effect, which was made available to the other Tripartite authorities. In reporting the legal advice given to the Board of Northern Rock, Mr Applegarth said that

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.³¹³

When the Governor of the Bank of England gave evidence for the second time in December, he also emphasised that the FSA was the source of the decision that a covert operation was not possible:

The final resolution of whether there could or could not be a covert operation was reached on the Tuesday before the facility was given. It was a decision by the FSA, supported by the Tripartite legal advice, on two grounds, one under the listing requirement, which the FSA is responsible for, and Northern Rock's obligations as a listed company and, secondly, under the Market Abuses Directive, and we were advised by the FSA that under both it would require Northern Rock, not the Bank, to make a public statement to the fact that it had the facility ... The legal advice was clear ... It was the FSA's advice, but it was taken by the lawyers involved in the Tripartite arrangements. There were lawyers from all three bodies.³¹⁴

The FSA's oral evidence implied a somewhat more passive role for the FSA and the legal advice of the Tripartite authorities, Sir Callum McCarthy stating that "we believed there was no legal basis for preventing" the Board of Northern Rock making a public announcement,³¹⁵ and "we saw no reason to disagree with the Board's view that it was necessary for them to make an announcement".³¹⁶

128. A subsequent written submission from the Tripartite authorities clarified the relationship between legal advice for Northern Rock and the legal advice of the FSA:

It is in the first instance for a listed company to consider its disclosure obligations, in conjunction with its advisers. Within the framework of the Tripartite arrangements and the Financial Services and Markets Act 2000 it is the responsibility of the FSA as the UK Listing Authority to supervise listed companies in this respect ... The question of whether Northern Rock, as a listed company, was subject to specific obligations to disclose was an issue for the company itself, and for the FSA as the UK Listing Authority. It was the view of the FSA that, once the company had obtained emergency liquidity support, an announcement would have to be made if the market was not likely to be misled, given previous statements made by the company. Hence there was no reason to dissent from the view taken by the directors of the company, on the basis of their own legal advice, that an announcement should be made.³¹⁷

313 Q 621. See also Q 624.

314 Qq 1650–1651

315 Q 173

316 Q 175. See also Q 264.

317 Ev 218

129. Since we first took evidence from the Governor of the Bank of England, some evidence has emerged that calls into question whether the Market Abuse Directive requires disclosure in the circumstances faced by Northern Rock. Professor Buiter told us that:

There is nothing in the ... Market Abuse Directive to prevent covert support to banks in trouble. On the day [the Governor of the Bank of England] ... said it, the statement was contradicted by a spokesman for the Commission, and every lawyer I have talked to since then says that they have no idea where that interpretation came from.³¹⁸

130. Article 6 of the Market Abuse Directive states the following:

1. Member States shall ensure that issuers of financial instruments inform the public as soon as possible of inside information which directly concerns the said issuers ...
2. An issuer may under his own responsibility delay the public disclosure of inside information, as referred to in paragraph 1, such as not to prejudice his legitimate interest provided that such omission would not be likely to mislead the public and provided that the issuer is able to ensure the confidentiality of that information ...³¹⁹

131. During our visit to Brussels in early January 2008, we were told by Commission officials that there was no intention that the Market Abuse Directive should act as a barrier to covert support operations. Indeed, our attention was drawn to part of Article 3 of the relevant implementing Directive which we were told was phrased partly in order to permit appropriate action:

Legitimate interests for delaying public disclosure and confidentiality ... For the purposes of applying Article 6(2) of Directive 2003/6/EC, legitimate interests may, in particular, relate to the following non-exhaustive circumstances ... negotiations in course, or related elements, where the outcome or normal pattern of those negotiations would be likely to be affected by public disclosure. In particular, in the event that the financial viability of the issuer is in grave and imminent danger, although not within the scope of the applicable insolvency law, public disclosure of information may be delayed for a limited period where such a public disclosure would seriously jeopardise the interest of existing and potential shareholders by undermining the conclusion of specific negotiations designed to ensure the long-term financial recovery of the issuer.³²⁰

132. The relevant provisions of the Market Abuse Directive and the implementing Directives have been implemented in United Kingdom law through changes to the FSA

318 Q 889

319 Directive 2003/6/EC of the European Parliament and of the Council of 28 January 2003 on insider dealing and market manipulation (market abuse), Article 6, paragraphs 1 and 2

320 Commission Directive 2003/124/EC of 22 December 2003 implementing Directive 2003/6/EC of the European Parliament and of the Council as regards the definition and public disclosure of inside information and the definition of market manipulation

Handbook.³²¹ Rule 2.5.1 of the Disclosure and Transparency Rules within that Handbook transposes Article 6 of the Market Abuse Directive:

An issuer may, under its own responsibility, delay the public disclosure of inside information, such as not to prejudice its legitimate interests provided that:

- (1) such omission would not be likely to mislead the public;
- (2) any person receiving the information owes the issuer a duty of confidentiality, regardless of whether such duty is based on law, regulations, articles of association or contract; and
- (3) the issuer is able to ensure the confidentiality of that information.³²²

Rule 2.5.2 of the Disclosure and Transparency Rules provides a commentary relating to the first proviso:

- (1) Delaying disclosure of inside information will not always mislead the public, although a developing situation should be monitored so that if circumstances change an immediate disclosure can be made.
- (2) Investors understand that some information must be kept confidential until developments are at a stage when an announcement can be made without prejudicing the legitimate interests of the issuer.³²³

Rule 2.5.3 of those Rules provides a word-for-word transposition of the commentary on negotiations relating to the financial viability of an issuer contained in Article 3 of the relevant implementing Directive cited above.³²⁴

133. Prior to implementation, the Treasury and the FSA said the following with regard to the above text:

Disclosure of inside information can, however, be delayed by issuers to protect their legitimate interests (such as during the course of negotiations), provided that the confidentiality of the information can be ensured during the delay and provided that such delay would not be likely to mislead the public.³²⁵

321 Prior to the implementation of the Market Abuse Directive, the FSA had power under Part 6 of the Financial Services and Markets Act 2000 to make rules concerning the on-going obligations of companies whose securities are admitted to the official list. Its rules made under these powers are known as the Listing Rules. Schedule 1 to the Financial Services and Markets Act (FSMA) 2000 (Market Abuse) Regulations 2005 amends Part 6 of the FSMA to widen the FSA's rule-making powers so that they apply to companies whose securities are admitted to trading on EU-regulated markets based in the UK as well as those admitted to the official list: see HM Treasury, Transposition Note for Directive 2003/6/EC – The Market Abuse Directive.

322 FSA, *FSA Handbook*, DTR, Rule 2.5.1

323 *Ibid.*, Rule 2.5.2

324 *Ibid.*, Rule 2.5.3

325 HM Treasury and FSA, *UK Implementation of the EU Market Abuse Directive (Directive 2003/6/EC): A consultation document*, June 2004, para 2.8, p 11

The Chancellor of the Exchequer noted in oral evidence that the “provisos” setting out the circumstances when an announcement could be delayed made the application of the exemption from disclosure hard to judge,³²⁶ and went on to say:

There is some flexibility [under the Market Abuse Directive] provided you can keep it confidential, and in today’s world that is a big ask maybe, and the second thing is that you have got to be sure that you are not misleading people. Well, you have to ask yourself the question: when do you get to the stage where you might be doing the misleading? ... On one view, there is sufficient flexibility in the Market Abuse Directive to do that [conduct a covert operation], provided, I think I am right in saying, that you can be assured it is kept confidential, but again that is difficult, and also that you are not actually misleading people.³²⁷

134. In the context of the legal position regarding disclosure, the Chancellor of the Exchequer emphasised the importance of the advice received by the Directors of Northern Rock that they would need to issue a profit warning or at least make a statement to the public markets.³²⁸ The Chancellor indicated that the Market Abuse Directive itself was not a material factor in his own conclusion that a covert operation would not be possible.³²⁹

135. By the time of his second appearance before the Committee in December, the Governor of the Bank of England acknowledged that “I gather now that at least on the Market Abuses Directive there is still a difference of view between some interpretations in the UK and some in Brussels but also some differences in interpretation between the original advice we had and the current advice that is being received”.³³⁰

136. A written submission from the Tripartite authorities in mid-January 2008 appeared to support the Governor’s initial emphasis on a clear-cut interpretation of the Directive. That submission described the provisos that we have quoted above relating to confidentiality and not misleading the market as “two overriding conditions” and states that, “as the Directive is currently drafted, neither of these conditions can be waived or disapplied”.³³¹ The submission also states:

News that a financial institution’s financial position is such that it requires emergency liquidity support from the Bank of England is capable of constituting inside information as it is information which could have a significant impact on the institution’s share price. Unless the conditions for delaying a disclosure are met, the information would in that case need to be announced to the market as soon as possible.³³²

The view of the FSA, that we have previously cited, was that, “once the company had obtained emergency liquidity support, an announcement would have to be made if the

326 Qq 1824–1825

327 Qq 1757, 1770

328 Qq 833, 1757

329 Qq 833, 1759, 1765, 1769, 1779, 1820, 1829

330 Q 1650

331 Ev 218

332 Ev, *Ibid*

market was not likely to be misled, given previous statements made by the company”.³³³ In other words, the FSA’s view as Listing Authority was that the emergency liquidity support operation could not be covert on the grounds of the overriding condition relating to misleading the public, regardless of whether or not the information was capable of being kept confidential.

137. On the basis of the texts cited in the preceding paragraphs, we accept that the provisions of the Market Abuse Directive and the implementing Directive relevant to market disclosure in the case of Northern Rock in September 2007 were properly transposed into United Kingdom law. It is evident from the texts of both the Directive and of the FSA Handbook that any decision to delay disclosure, even in the case of an issuer that is in grave and imminent danger, is subject to provisos relating to the need for the issuer to be satisfied that such a delay would not be likely to mislead the markets and that the issuer is able to ensure the confidentiality of that information. The Governor of the Bank of England received legal advice through the FSA from lawyers working for the Tripartite authorities indicating that the Market Abuse Directive was a barrier to a covert operation, even if information could be kept confidential, and, as such, the Governor was justified in regarding the legal interpretation of the Market Abuse Directive shared by the Financial Services Authority and Northern Rock’s legal advisers as a material factor in consideration of a covert operation, although it was not necessarily the leading factor in the final decision that a covert operation was not possible.

138. In explaining why a covert operation did not prove possible, several witnesses indicated that the foremost considerations in their minds were ones of practicality. Echoing views expressed by Sir Callum McCarthy,³³⁴ Mr Sants told us:

We are expressing a view that it seems unlikely in the overall set of circumstances that prevail in the market-place today that keeping an operation of this size and complexity covert for any length of time is realistic, independent of the standing of the Market Abuse Directive.³³⁵

Mr Applegarth was of a similar view:

because there were so many people involved, in practical terms, it [the support operation] would have leaked ... I think that is a pretty strong probability.³³⁶

He also emphasised that the leaking of a covert operation had the potential to be more damaging than the premature disclosure of an overt operation.³³⁷

139. On both the occasions that he gave evidence, the Chancellor of the Exchequer indicated that he was always sceptical as to whether a covert operation could remain

333 Ev Ibid

334 Qq 173, 266

335 Q 268. See also Qq 373–374

336 Q 624

337 Q 681

confidential in “today’s market conditions”.³³⁸ He emphasised the “feverish speculation” which existed in late August and early September 2007, when, for example, an acknowledgement by a major clearing bank that it had used the Bank of England’s standing facility had caused a sharp fall in that company’s share price.³³⁹ He also informed us that he did not seek or take legal advice because he judged a covert operation impossible. As he summed up his position, “My belief was that there was every chance that this was going to leak and I was dead right”.³⁴⁰

140. The Governor of the Bank of England, in his second appearance before us, appeared to accept that the practicality of a covert operation was in doubt. He told us that “I think, from my conversations with central bankers from around the world, they are very conscious of this case [the Northern Rock crisis] and they recognise that, irrespective of what the law says, in practice now it may be extremely difficult for lender of last resort operations to be conducted in the covert way that they were even in the early 1990s”.³⁴¹

141. In the circumstances of Northern Rock in early September 2007, the barriers to a covert support operation were real. Any large scale support operation for Northern Rock would have become known to many market participants. In the febrile and fevered atmosphere of that period, media speculation would have followed. The leaking of news of a support operation that was intended to remain covert for a period of time would have been potentially as damaging as the premature disclosure of an overt operation. The practical risks of a leak are linked to the legal difficulties, insofar as covert support operations only appear to be permitted under the Market Abuse Directive in instances when the issuer can be assured of confidentiality. We consider later in this Report whether there are circumstances when a covert support operation should be considered in future, and what legal and other changes might be necessary to facilitate such an operation.

142. However we also find it unacceptable that the possibilities for covert action had not been properly considered much earlier. Had this issue been clarified, the authorities could have reacted with more despatch which in itself might make covert action a more realistic option. We return to the state of readiness of the authorities and “war gaming” later in this Report.

Preparations for the announcement

143. By Monday 10 September it was evident that a Bank of England support operation for Northern Rock would be necessary. On that day, Sir John Gieve spoke for the first time to the then Chief Executive of Northern Rock about the proposed facility.³⁴² By the following day, it was apparent that that operation would need to be publicly announced.³⁴³ The succeeding days saw preparations put in place for legal agreement on the operation and for

338 Qq 754, 833, 1757, 1825

339 Qq 794, 796, 1769

340 Q 1766

341 Q 1650

342 Q 136

343 Q 1620

handling the announcement and its consequences.³⁴⁴ The Chancellor of the Exchequer argued that the practical arrangements for the emergency liquidity operation were undertaken rapidly:

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.³⁴⁵

144. It was initially decided to announce the support operation on Monday 17 September.³⁴⁶ The Chancellor of the Exchequer implied that this initial timetable reflected the wishes of Northern Rock itself.³⁴⁷ Witnesses from Northern Rock and the FSA confirmed that Northern Rock’s plan was to use the time prior to an announcement on Monday to increase the bandwidth of Northern Rock’s website and to make other arrangements for handling customers and others affected by the announcement.³⁴⁸

145. The plan to announce the support operation on Monday 17 September was only abandoned on the afternoon of Thursday 13 September, in circumstances we consider in the next paragraph.³⁴⁹ In October, with reference to this initial timetable, the Chancellor of the Exchequer agreed that “it would have been astonishing if you could have kept that [the support operation] quiet for a week”.³⁵⁰ **In view of the role that fears of a leak of a support operation had played in the decision on Tuesday 11 September that a covert operation was not possible, the Tripartite authorities were unwise initially to accede to Northern Rock’s request for the announcement of the support operation to be delayed until Monday 17 September. In the light of subsequent events, it seems evident that the Tripartite authorities and Northern Rock ought to have strained every sinew to finalise the support operation and announce it within hours rather than days of the decision to proceed with the operation. A swift announcement would have been assisted by early preparation of such an announcement. In that context, we find it surprising that high level discussions between the Bank of England and Northern Rock about the support facility did not take place prior to 10 September.**

146. On the afternoon of Thursday 13 September, according to the Governor of the Bank of England “rumours in the market started” in relation to the proposed operation.³⁵¹ At 4.00 pm on that day, the Tripartite standing committee met at deputies level and decided to bring forward the announcement of the operation to 7.00 am on Friday 14 September.³⁵²

344 Q 577

345 Q 795

346 Q 577

347 Q 796

348 Qq 623, 675, 681, 345

349 Qq 1615-1616

350 Q 796

351 Q 1668

352 Qq 1668, 750

The Court of the Bank of England met on the evening of Thursday 13 September.³⁵³ The terms of the emergency liquidity assistance were finalised in the early hours of Friday 14 September.³⁵⁴ The announcement was made at 7.00 am that morning in the following terms:

The Chancellor of the Exchequer has today authorised the Bank of England to provide a liquidity support facility to Northern Rock against appropriate collateral and at an interest rate premium. This liquidity facility will be available to help Northern Rock to fund its operations during the current period of turbulence in financial markets while Northern Rock works to secure an orderly resolution to its current liquidity problems ... The FSA judges that Northern Rock is solvent, exceeds its regulatory capital requirement and has a good quality loan book.³⁵⁵

The leak and its effects

147. Before the provision of emergency liquidity assistance by the Bank of England to Northern Rock could be announced formally, the outlines of the operation were reported by the BBC—at 8.30 pm on BBC News 24 and then on other BBC media outlets.³⁵⁶ Several witnesses argued that the premature disclosure of the support operation in this way was instrumental in the run that followed. Mr Applegarth said that the leak “caused immense difficulties”.³⁵⁷ He thought that “it was the announcement of the facility being leaked that actually was the start of the run”.³⁵⁸ The Chancellor of the Exchequer characterised the leak as “clearly very unhelpful”.³⁵⁹ Sir Callum McCarthy told us:

It was extremely unfortunate that the information leaked because it meant that instead of this being put in place as, ‘This is a solvent institution which has a cash flow problem and the Government is stepping in to make sure that it is saved’, it became a panic measure or a response to something that was already in the making. Panic was how it was seen.³⁶⁰

148. In explaining the impact of the disclosure both the then Chairman and the then Chief Executive of Northern Rock contrasted the impact of that disclosure with the likely impact of a planned announcement the following Monday. Dr Ridley said:

Had the leak not happened and we had been able to announce on the Monday the facility with the Bank of England in a measured fashion, with full communication plans in place, undoubtedly there would have been some concern—a lot of

353 Q 184

354 Q 580

355 Bank of England News Release, “Liquidity Support Facility for Northern Rock plc”, 14 September 2007

356 www.bbc.co.uk/blogs/thereporters/robertpreston/2007/10/16/index.html

357 Q 580

358 Q 577

359 Q 792

360 Q 1527

concern—to many of our customers but we think it would have been considerably less than it was in the way that it came about.³⁶¹

Mr Applegarth endorsed this view: “I think the chairman is right in that the probability of a retail run would have been lessened had we been able to do the announcement as we had intended on the Monday”.³⁶² Witnesses from Northern Rock contrasted the effects of the leaked information about the emergency lending facility on the evening of Thursday with the possible effects of a planned announcement on Monday morning. As we have already seen, the planned announcement had been brought forward to the Friday morning even before the BBC reported the planned announcement. **In failing either to make an announcement earlier in the week or to put in place adequate plans for handling press and public interest in the support operation, the Tripartite authorities and the Board of Northern Rock ended up with the worst of both worlds.**

The run on the Rock

149. The run on deposits of Northern Rock which took place between Friday 14 September and Monday 17 September was the central element in the problems that Northern Rock has faced subsequently.³⁶³ The speed and extent of withdrawals meant that the Bank of England’s emergency facility, which had been envisaged as a “backstop”, actually needed to be called upon almost immediately.³⁶⁴ The run started on the evening of 13 September, following, in the Chancellor of the Exchequer’s words, “the fairly dramatic news that a fairly well-known bank had gone to the Bank of England for help” and the run accelerated the following day.³⁶⁵

150. The run gathered momentum in part because of the difficulties encountered by Northern Rock customers in seeking to withdraw their money. Mr Applegarth attributed these difficulties in part to the fact that the support operation had been brought forward:

The probability of a retail run would have been lessened ... had we been able to do the announcement as we had intended on the Monday, to be able to put facilities in place and also to actually improve our ability to get the money to the customers. One of the things we had intended to do over that weekend was to widen the bandwidth on the internet account so you would not have had so much frustration from our internet customers. We would have been able to get the money back to customers better.³⁶⁶

According to Sir Callum McCarthy, the Internet access provided by Northern Rock was “inadequate”, although he emphasised that all those seeking to withdraw funds that way were successful in doing so.³⁶⁷

361 Q 623

362 Q 623

363 Qq 304, 464

364 Q 529

365 Q 1760

366 Q 623

367 Qq 1527, 345

151. While most withdrawals were made through the Internet, by telephone or by post, the most enduring and damaging images of the run were those associated with queues outside Northern Rock's branches.³⁶⁸ Northern Rock did not have a large branch network: it had 72 branches in total, and only four branches in London.³⁶⁹ Many branches had only a couple of counters, because the bank did not normally conduct much of its retail business over the counter.³⁷⁰ Because of money laundering requirements, large withdrawals could take up to 15 minutes to be completed.³⁷¹ These factors together explained why it did not take many customers to seek to withdraw their funds for queues to extend out of the front door and into the street—and into the public consciousness.

152. The Governor of the Bank of England indicated that, once the run had started, and in view of the weaknesses of the legal framework for handling banks in distress, other depositors were behaving rationally and logically in joining the run by seeking to take their money out also:³⁷²

Once the depositors of Northern Rock had heard the bad news and they suddenly realised that Northern Rock needed a lender of last resort facility—this is the problem with an overt operation—once they had seen that there was bad news about Northern Rock, and they could not possibly be reasonably expected to have been sitting at home thinking about the wholesale funding structure of Northern Rock, once they learned that there was concern about Northern Rock it is not that surprising that they thought perhaps it might be safer to take some money out.³⁷³

Mr Applegarth also had no criticism to make of Northern Rock's depositors:

I can understand readily the logic of somebody who has their life savings invested in an institution and who sees pictures of people queuing outside the door and they go and join that queue. That is quite a logical reaction.³⁷⁴

Stopping the run

153. The momentum of the run on Northern Rock deposits once it had begun was caused by two factors. First, depositors were becoming aware that, were the run to continue, Northern Rock would eventually cease to be a going concern.³⁷⁵ Second, public awareness increased of something of which many depositors might previously been unaware—namely, that deposits above £2,000 were not guaranteed in full.³⁷⁶

368 Q 678

369 Qq 345, 792

370 Qq 345, 792

371 Q 1527

372 Qq 14, 1618

373 Q 26

374 Q 677

375 Q 57

376 Q 677

154. In these circumstances, the Governor of the Bank of England stated that the only way to halt the run was to provide a Government guarantee of deposits in Northern Rock.³⁷⁷ The Chancellor of the Exchequer “became convinced” on Sunday 16 September that action along these lines was necessary.³⁷⁸ The announcement of the guarantee took place during a press conference after 5.00 pm on Monday 17 September that the Chancellor of the Exchequer held with US Treasury Secretary Hank Paulson. The Chancellor of the Exchequer informed the public that:

In the current market circumstances, and because of the importance I place on maintaining a stable banking system and public confidence in it, I can announce today that following discussions with the Governor and the Chairman of the FSA, should it be necessary, we, with the Bank of England, would put in place arrangements that would guarantee all the existing deposits in Northern Rock during the current instability in the financial markets. This means that people can continue to take their money out of Northern Rock. But if they choose to leave their money in Northern Rock, it will be guaranteed safe and secure.³⁷⁹

The announcement late on Monday 17 September had the desired effect. The momentum of the run was halted.³⁸⁰

Consideration of the guarantee and the timing of the announcement

155. During our inquiry, we examined in detail the questions of when the Government guarantee of Northern Rock deposits was first considered, whether it should have been announced earlier and whether preparations of such an announcement could have been put in hand at an earlier stage.

156. Participants in the discussions surrounding the liquidity facility to Northern Rock, emphasised the difficulty that they faced in predicting the effect of its announcement. Sir John Gieve told us:

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.³⁸¹

The Governor of the Bank of England told us that he did not view a bank run as “inevitable” on Thursday 13 September, when the date of the announcement of the support operation was brought forward because of market rumours:

377 Qq 46, 57

378 Q 1760

379 HM Treasury press release, Statement by the Chancellor of the Exchequer on financial markets, 17 September 2007

380 Q 1760

381 Q 8

The nature of a bank run is that it is a knife edge: it might happen, it might not. That is exactly why a bank run is so difficult to handle.³⁸²

He emphasised that the provision of the support facility might have had a reassuring effect on depositors,³⁸³ and went on to say: “I do not think anyone could have known with any certainty at all what would have been the consequences on retail depositors of the announcement”.³⁸⁴

157. Sir Callum McCarthy supported the view of the Governor of the Bank of England that the likely effect of the announcement of liquidity support was not “obvious”.³⁸⁵ The then Chairman of Northern Rock also emphasised the unexpectedness of the run:

I think it is worth reflecting that all of us, both here and in the authorities, were surprised by the degree to which the announcement of a facility from the Bank of England—not the use of it but the existence of a facility—and the reassurances that went with it about us being a solvent and profitable business did not have a sufficiently reassuring effect on customers.³⁸⁶

158. In view of the awareness apparent within the Tripartite authorities and within Northern Rock’s Board that a retail run was one possible consequence of the announcement of the Bank of England’s liquidity support, we asked witnesses from the Tripartite authorities about the extent to which a Government guarantee—the device that was used on Monday 17 September to halt the run—had been the subject of prior consideration.

159. Sir John Gieve implied in his evidence in September that the possibility of announcing a Government guarantee alongside announcement of the support facility was at least considered, and was consciously rejected:

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.³⁸⁷

He reinforced the impression of prior consideration of the Government guarantee when he next gave evidence:

382 Q 1617

383 Qq 110, 112

384 Q 113

385 Q 1527

386 Q 623

387 Q 108

When we were planning the lender of last resort support we knew that it might not work and, if it did not, there would then be a choice between either, in a sense, guaranteeing all the deposits of the bank or, alternatively, allowing Northern Rock to go into administration, but we took the view that it was worth trying a classic lending operation first, because that offered the chance that Northern Rock would be able to get through the liquidity difficulties in the short-run and then resume normal operations after that.³⁸⁸

Mr Sants did not appear to attach great importance to the early discussions on the question of a Government guarantee: “I think I may have some vague recollection of it being mentioned by some working group discussion, but that is the extent of it”.³⁸⁹

160. The Governor of the Bank of England was firmly of the view that it would have been “irresponsible” to announce a Government guarantee at the same time that the liquidity support was announced, commenting that, in such circumstances, “It would undoubtedly be said: ‘Why on earth is this being done?’”³⁹⁰ Sir John Gieve said that the decision not to offer a Government guarantee at the same time as announcing the support facility “was a Tripartite decision in which, I think, all three parties were at one”.³⁹¹

161. Once the retail run gathered momentum, the idea of Government guarantee was given fuller consideration by the Tripartite standing committee at the level of deputies.³⁹² Sir John Gieve indicated the timescale on which he considered such a guarantee emerged as an issue:

We did realise that offering a limited collateralised facility was not guaranteed to save Northern Rock. We hoped that it would restore confidence, and I think that was a reasonable judgment at the time, and other people commenting on it at the time thought so too, but I think we did not do enough to reassure the retail depositors, and that became clear on the Friday.³⁹³

Sir John had earlier implied that, in the light of subsequent events, the announcement of a Government guarantee might have been of benefit on that Friday: “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”.³⁹⁴

162. Although, according to Sir John Gieve, a unanimous “decision” had been reached by the Tripartite authorities not to announce a Government guarantee at the same time as the lending facility,³⁹⁵ the Governor of the Bank of England and the Chancellor of the Exchequer both told us that they did not discuss the Government guarantee prior to

388 Q 1620

389 Q 1532

390 Q 47

391 Q 1649

392 Q 1617

393 Q 1622

394 Q 108. See also Q 1646.

395 Q 1649

Sunday 16 September, when discussions took place between those two and the Chairman of the FSA.³⁹⁶ A decision was taken on that day by the Chancellor of the Exchequer to give the Government guarantee. He told us that consideration of the precise terms of the guarantee meant that an announcement was not possible before the markets opened on Monday 17 September, and so the final announcement was made after markets closed on that day.³⁹⁷

163. The Chancellor of the Exchequer argued in October that a decision would not have been possible earlier than the weekend:

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 ... The guarantee itself was not an issue on the Friday morning when those queues started to build up.³⁹⁸

The Chancellor of the Exchequer reiterated this view in January,³⁹⁹ and went further in questioning whether an earlier announcement of the Government guarantee would have had the same effect as did its subsequent announcement:

things were such on the Friday that I suspect that, no matter what I stood up and said in relation to a guarantee, you would still have had the queueing problem because what you had was a dramatic announcement, and this is something that has changed in the last 20 years with 24-hour news, and the queues started to form and the situation just got worse and worse and worse, and I think it was not actually until the Saturday that people started talking about guarantees.⁴⁰⁰

164. Professor Buitert took a rather different view:

If [the Tripartite authorities] were not quite convinced that the public would believe them—and in these days you cannot be sure of that—then the immediate creation of a deposit insurance scheme that actually works and is credible would have been desirable. To wait three days was again an unnecessary delay.⁴⁰¹

165. We accept that the consequences of an announcement of the Bank of England's support operation for Northern Rock were unpredictable. There was a reasonable prospect that the announcement would have reassured depositors rather than having the opposite effect, particularly prior to the premature disclosure of the operation. However, after the premature disclosure of the support, and against the background of the market reaction to Barclays use of lending a fortnight earlier, it seems surprising that the issues were not urgently revisited. It is unacceptable, that the terms of the guarantee to depositors had not been agreed in advance in order to allow a timely

396 Qq 55, 1763–1764

397 Qq 1760–1762

398 Q 750

399 Q 1764

400 Q 1763

401 Q 854

announcement in the event of an adverse reaction to the Bank of England support facility.

166. The Tripartite authorities were conscious during the planning of the support operation that announcement of that operation might have an adverse effect. In light of this, we regard it as a serious error of judgement that the Tripartite authorities at deputies level failed to plan in advance for the announcement of a Government guarantee and failed to raise some of the issues surrounding such a guarantee with the principals prior to Sunday 16 September. We are also concerned that it did not prove possible to announce the guarantee that was decided upon that day before the markets opened the following day. The cumulative effect of these failures was to delay the guarantee until the evening of the fourth day after the run started and thus to make the run on the deposits of Northern Rock more prolonged, and more damaging to the health of the company, than might otherwise have been the case.

5 Dealing with failing banks

Why is it important that banks can fail?

167. We discussed earlier in this Report the notion of ‘moral hazard’. Should it be thought that public authorities would intervene on a regular basis to prop up failing banks, this would encourage banks to partake in risky behaviour, safe in the knowledge that they would be bailed out of any difficulties.

Why banks are special

168. A failure of a manufacturing, retailing or other non-financial firm would see the start of an insolvency process, involving the appointment of an administrator, and the eventual payout of recovered monies to creditors and potentially shareholders, with such payouts prioritised in a predefined way. However, with regard to failing banks, the Governor of the Bank of England stated that “banks are not like other companies”.⁴⁰² Why should banks require a special insolvency regime, different from that which exists for other types of company?

169. Banks are ‘special’, in one sense, because they have become an increasingly important part of modern life. Cash machines, direct debits and debit cards are all an essential part of everyday living for most people. We noted in our Report on *Banking the unbanked: banking services, the Post Office Card Account and financial inclusion* in November 2006 that “People who do not have access to banking services are limited in undertaking a wide range of everyday financial transactions, and those limitations are arguably increasing as such transactions become more sophisticated”.⁴⁰³ Therefore, the failure of a bank and the potential loss of access to banking services, even for a short time, could have a serious impact on the ability of people to live their lives, on top of the potential loss of their deposits held with that bank. This means that for consumers, their banking services are likely to be viewed as ‘essential’. There are precedents for special insolvency regimes in certain other industries in order to protect essential services for consumers. As the Tripartite authorities note in *Banking Reform—protecting depositors: a discussion paper*:

The UK has special administration regimes for the energy, water and railway industries. These ensure that essential services to consumers remain secure and uninterrupted in the event of a company providing those services becoming insolvent.⁴⁰⁴

Because of this need to protect consumers’ access to banking services, it is necessary to ensure that, when banks fail, they do so in a manner which preserves that access.

170. In his account of why a decision was taken to intervene in the case of Northern Rock, the Chancellor of the Exchequer stated that he had made the decision that Northern Rock

402 Q 1630

403 Treasury Committee, Thirteenth Report of Session 2005-06, “*Banking the unbanked*”: banking services, the Post Office Card Account and financial inclusion, HC 1717. para 2, p5

404 Tripartite authorities, *Banking reform - protecting depositors: a discussion paper*, October 2007, Box 3.3, page 13

posed a “wider systemic risk to the financial system” and that intervention was needed as there was a “serious risk of contagion”.⁴⁰⁵ The contagion problem affects banks to a much greater extent than other industries. Should a retailer ‘fail’, this failure would normally be of benefit to other retailers, because it would afford them an opportunity to increase their market share. If a bank ‘fails’, however, customers may begin to worry about the safety of their deposits within other banks, which could lead to widespread bank runs, and thus a risk to the stability of the overall financial system (systemic risk). Reliable functioning of the banking sector is critical to confidence in the economy as a whole. Therefore, the risk of contagion must be accounted for when considering how banks are allowed to “fail”.

171. A final reason sometimes cited as to why banks are not allowed to fail is that they may be classed as “too big to fail”. This concept essentially merges the two arguments above. The institution in question may have many counterparties in the financial system, or be an integral part of the payments system, increasing the risk of contagion from its failure. As well as this, it may have hundreds of thousands of depositors, meaning that its failure could lead to widespread hardship for those customers. But this scale may not in itself pose a new problem for the regulator or the government, different from the two outlined above. The Governor of the Bank of England disagreed that large institutions required a different approach. He stated that:

It is a practical matter. It is much harder to resolve problems with big banks than with smaller ones, but that is a question of effort and scale, not a question of principle.⁴⁰⁶

172. The larger deposit-taking institutions, such as banks and building societies, are ‘special’ organisations in modern life, similar in some ways to utility providers. Banks should be allowed to ‘fail’ so as to preserve market discipline on financial institutions. However, it is important that such ‘failure’ should be handled in an ordered manner, managed in such a way as to prevent further damage to the economy, the financial system and the interests of small depositors.

The potential role of public authorities

173. Public authorities can have two roles in the bank failure process. They can either ensure that, when banks fail, they do so in an orderly manner, or they can provide direct assistance to overcome the problems at the bank. The successful execution of the first role may require reform of the depositor protection system and the bank insolvency regime. The second role may include the injection of capital (by the taxpayer) into the failing firm or the provision of emergency support from the central bank. The remainder of this chapter examines the UK’s existing framework for handling failing banks and suggests principles to which future changes to this framework must adhere.

405 Q 1782

406 Q 1741

Who bears the risk of bank failure?

174. We have concluded that banks must be allowed to fail, and that such failures must be managed in an orderly manner. For the sake of clarity and transparency, it is important that all stakeholders in banks should be aware how the risk of bank failure is distributed. In general, in non-financial companies, shareholders and creditors take on the risk of company failure, but the situation with regard to banks is more complex. If, as happened with Northern Rock, the Government steps in to prevent the collapse of a bank, it takes on a significant risk on behalf of taxpayers. Depositors are treated as unsecured creditors under the existing arrangements, so clearly bear the risk that they could lose the rights to their deposits.

175. In a valuable written submission, Dr Paul Hamalainen of Loughborough University argued that the risks and costs of bank failure should be clearly placed on large depositors, junior bondholders, and shareholders, rather than small depositors or the Government. He criticised the UK's existing arrangements for failing to achieve this in the case of Northern Rock:

An inability to have clear and adequate pre-crisis and post-crisis regulatory mechanisms in place has provided sophisticated investors with time to remove their investments from Northern Rock, thus forcing Northern Rock to continue drawing down funds from the Bank of England. In effect, any potential cost of bank failure is gradually being passed on to the government.⁴⁰⁷

176. The taxpayer has clearly taken on a significant liability in the case of Northern Rock. If the Treasury had not guaranteed deposits, and Northern Rock had entered into administration, that bank's depositors would have become embroiled in a drawn-out process that could have seen them unable to access their funds for several months, a matter we discuss in more detail later. At least in the case of Northern Rock, the firm had positive net assets, so that, if administration had been entered into and assuming no deterioration of assets, depositors should *eventually* have received the full value of their deposits. If another bank were to fail, however, its liabilities might exceed its assets, in which case depositors might not receive the full value of their deposits. This is where a deposit protection scheme can offer assurance to depositors that their money will be safe in the event of their bank failing.

177. In the UK, the Financial Services Compensation Scheme (FSCS) is the compensation scheme of last resort for consumers of financial services. Since its inception in 2001, it has completed 87,000 investment or deposit claims and dealt with the failure of 27 deposit-taking institutions. These failed institutions were all credit unions. Because no UK bank or building society has been in default since 2001, the FSCS has not been required to assist the depositors of any such institution.

178. During the course of inquiry we took evidence from a number of witnesses who argued that, if there had been a failure of a large financial institution, then the FSCS would have been unable to cope. The BBA recognised that, due to "the highly concentrated nature

of the UK deposit base”, failure of one of the largest deposit-taking institutions would not be fully covered by the scheme.⁴⁰⁸ Indeed, the BBA admitted that the FSCS

will not be able to cope with the failure of a systemically significant bank. Such a bank would need to be rescued [by the Government] to effectively protect depositors and limit systemic risk.⁴⁰⁹

179. The BSA Director-General, Adrian Coles, explained that the FSCS was designed to deal with losses of up to £4 billion, as a result of the funding reforms due to take effect in April 2008, and that the FSCS would not be able to help with any losses exceeding that figure.⁴¹⁰ Therefore, if a bank or building society were to fail, and the potential losses to depositors exceeded £4 billion, the Government would need to fund the shortfall to prevent depositors from losing their deposits. Indeed, there was a clear recognition from the BBA that the risk of a large, systemically-important bank failing was underwritten by the taxpayer:

it is self evident that in this current environment it is difficult to envisage the authorities allowing the failure of a retail deposit taker.⁴¹¹

180. The FSA accepted that, even with the revised funding arrangements that will increase the insurance cover to £4 billion annually, the FSCS was still incapable of providing total cover in all instances, and expected that a large-scale failure would trigger the crisis management arrangements set out in the Memorandum of Understanding.⁴¹² Sir Callum McCarthy said that, if there were a very large failure, “that essentially would have to be met in the last resort by Government”.⁴¹³ The FSCS confirmed that, when forecasting their funding requirement for the year ahead, they did not consider the cost of any major institutions failing, because they only levied for firms that they believed were likely to give rise to pay-outs.⁴¹⁴

181. The Governor of the Bank of England was clear that the UK ought to avoid a two-tier insurance scheme, with one for large banks and another for smaller deposit-taking institutions.

I think any such reform to bank deposit insurance ought to cover all banks. That would be the sensible thing. It is a practical matter. It is much harder to resolve problems with big banks than with smaller ones, but that is a question of effort and scale, not a question of principle.⁴¹⁵

408 British Bankers’ Association Response to the Tripartite Discussion Paper: Banking Reform—Protecting Depositors, page 4

409 Ev 299

410 Q1552 Coles

411 Ev 299

412 Ev 233

413 Q1435 McCarthy

414 Q1443

415 Q1741

182. **The taxpayer should not bear the risk of banks failing. Nor do we believe that small depositors should bear such risk. Rather, the risk of failure should be borne by a bank's shareholders and creditors but exclude small depositors. The Government must ensure that the framework for handling failing banks insulates taxpayers and that small depositors should also be protected from the risk of banks failing.**

183. **Although the Financial Services Compensation Scheme is portrayed as offering protection to the depositors of all financial institutions, examination of its funding indicates that it would not be able to cope with the failure of a medium-sized, let alone a major, financial institution. If such an event were to occur under present arrangements, only the Government, using taxpayers funds, would be in a position to protect depositors, as it did with Northern Rock. We are concerned that banks and building societies appear to be viewing the Government's support to Northern Rock as an acknowledgement that no bank would be allowed to fail. The Government must take steps to ensure that its framework for maintaining financial stability does not provide free insurance to banks. We do not believe that a deposit protection scheme should apply solely to the very smallest institutions. All banks and building societies should be covered by a deposit insurance scheme, such that, in cases such as Northern Rock, or an even larger bank, the Government would not be required to step in to protect depositors.**

Prompt corrective action

184. The UK's Financial Services Compensation Scheme (FSCS) is a reactive agency—it only becomes involved in a failing financial institution once that institution is “in default”. The Scheme's funding is also reactive, in the sense that defaults that had not been forecast require the FSCS to levy financial institutions for additional payments. Dr Hamalainen criticised the reactive ethos of the FSCS, both in the way the FSCS was funded and in the slow manner in which depositors were paid following bank failure. He contrasted this with the Federal Deposit Insurance Corporation (FDIC) in the United States, which is pre-funded by banks and aims to reimburse depositors within days of their bank defaulting.⁴¹⁶

185. The reason for the relatively late recognition that a bank was failing in the UK was, according to Dr Hamalainen, because the “fear of law suits from [in this case] Northern Rock stakeholders such as the junior bondholders and shareholders would be too heavy a burden for any one [regulator] to bear”. A solution to this forbearance problem, argued Dr Hamalainen, was a prompt corrective action [PCA] approach such as is taken by the FDIC in the US.⁴¹⁷ Instead of relying solely on the judgment of regulatory authorities, a PCA approach formalises specific tripwires which, when breached, serve as the basis for mandatory action by the authorities. The FDIC's tripwires focus on solvency and increasingly harsh restrictions apply as an institution's solvency deteriorates. These restrictions include increased monitoring, requiring the raising of additional capital, requiring acceptance of an offer to be acquired, and closure of the institution. Dr Hamalainen argued that the UK should consider adopting a similar PCA approach, but use not only solvency tripwires, but also liquidity ones. These tripwires would induce

416 Ev 255

417 Ev 254

increasingly aggressive regulatory action, so that the relevant authorities had a comprehensive structural and legal mechanism enabling them to act early in preventing a bank problem becoming a full-blown crisis. Two additional benefits to the PCA approach, added Dr Hamalainen, were that tripwires placed banks under increased solvency and liquidity scrutiny, and the likelihood that fewer claims would be made on the deposit insurance scheme as a result of earlier intervention by the authorities.⁴¹⁸

186. The BBA accepted that it was important to focus on developing preventive and corrective measures which reduced the likelihood of a distressed bank moving towards insolvency and triggering a call on the deposit scheme. In their view, a more proactive intervention framework would include a range of regulatory indicators, a toolkit of options for supervisory action linked to clearly defined and transparent event triggers, and increased dialogue between the Bank of England and individual banks and the FSA to enhance intelligence-gathering and inform more proactive monitoring and intervention.⁴¹⁹ The BBA indicated that suitable tripwires might include a deteriorating financial position with respect to liquidity, capital, earnings and asset quality; suspected or actual fraud; and a significant growth in business or shift in strategic business planning.⁴²⁰

187. Once a PCA tripwire had been breached, the relevant authorities would need to possess an appropriate toolkit of measures to either rectify the problem, or, alternatively, facilitate an orderly failure. The BBA considered how, initially, low-level triggers might lead to a challenge by the relevant authority to the risk assessment of an institution, then by working more proactively with Tripartite partners to head off, or better manage, a problem which might arise and, lastly, the consideration of a move towards administration. This might enable, for example, the authorities to intervene in a scenario where a bank remained solvent, but a material risk had gone uncorrected or had increased.⁴²¹ This latter point is important. In the US, tripwires alert the authorities not only when a bank is entering a period of distress, but also when a bank radically changes its business model, or pursues an existing business model to an extreme extent. In this way, the relevant authority becomes aware of outliers in the banking industry, even if, at the time, the conduct of those outliers appears to be resulting in high profits and strong growth. The authority would then be in a position to check that the risks being taken had been fully considered, and, if not, secure a suitable response. Such measures might well have been helpful in the supervision of Northern Rock, where triggers based on financial ratios might not have given much warning. An alert triggered by Northern Rock's rapid growth and the business model's reliance on the wholesale market for funding could perhaps have been prompter and more effective. The intent of a PCA approach is not to stifle innovation by preventing firms from conducting their business as they wish, but instead to ensure that the relevant authority knows how each firm is developing and is confident that appropriate risk assessment (bearing in mind the public interest at stake) has been conducted.

418 Ev 253-4

419 British Bankers' Association Response to the Tripartite Discussion Paper: Banking Reform—Protecting Depositors, page p6

420 Ibid

421 Ibid

188. The Chancellor of the Exchequer signalled his approval of the concept of a prompt corrective action approach:

I do think that one of the gaps in the supervisory regime at the moment is that it is not clear that the FSA has all the powers that I think it needs in order to get information from institutions and, crucially, when it looks like an institution is getting into difficulty, I think it needs more powers along the lines of the systems in America and Canada which intervene earlier to help a bank that might be in trouble and perhaps at a later stage even help with restructuring if a bank is getting into real difficulties or a reorganisation, even a merger or acquisition.⁴²²

189. The Chancellor also stressed how the sharing of information between the Tripartite authorities, where appropriate, was an important part of a “PCA” approach:

I think what we need to do is to have better visibility of what institutions are doing re arrangements for looking after the depositors, the systems they may have if they need to pay money out and also to get information and, having got information, to be able to talk to the Bank of England about it because, as you know, there can be difficulties if I get information from you for a perfectly good reason and I cannot then pass it on to somebody else, another supervisor in this case because you are talking about the Bank of England, so it is to clarify the law in some cases where the FSA say there are gaps there, but also to make sure that we have got the information we need when the appropriate circumstances arise so that we can take prompt action.⁴²³

190. The Chancellor then stated that a PCA approach required a strong legal framework:

I think there would have to be clear rules because the law can only operate on the basis of certain things happening. As I said earlier on, I am not in favour of legislation which would give the state the arbitrary power to intervene in a bank when there is no possible justification for doing so. Inevitably, you have to have some degree of discretion because you cannot legislate for every conceivable possibility. You can think of 101 reasons why a bank might get into difficulties and pose a systemic risk. I think it is important that we provide as much certainty as possible, precisely ... we want people to be able to invest in this country with certainty, where they know what the rules are, just as if they invest in America or Canada or wherever they know what the rules are there, and they understand that and they are quite happy with that. We do need a degree of certainty. We cannot just give people blanket sweeping powers but, on the other hand, you do not want to get into a situation where you find the one thing that you had not got down in the Act happens and you are back to square one again.⁴²⁴

Alongside clear rules, the Chancellor said that this approach also required an element of judgement:

422 Q 1753

423 Q 1795

424 Q 1868

What you need is a legal framework. If you take everything that we have been discussing this morning, whether it is in relation to the lending to Northern Rock or supervision, inevitably there has to be a degree of judgment, especially in relation to supervision. For example if you take Northern Rock as it was, there has to be a degree of judgment as to at what point do you intervene. The FSA accepts that perhaps looking at it now they should have said to Northern Rock, ‘You cannot carry on in a situation where you have got no plan B’.⁴²⁵

191. In an interview with the *Financial Times* on 4 January 2007, the Chancellor of the Exchequer suggested that one trigger for prompt corrective action could be the request—such as the one made by Northern Rock—for an emergency support facility:

When certain trigger points are reached or you have offered lender of last resort facilities, you could say that as a condition of that it may be necessary to reorganise or take a particular course of action.⁴²⁶

The Chancellor stressed in that interview that not every bank applying for Bank of England assistance would be subject to intervention, but said that he wanted “no political discretion and very clear ground rules”. The suggestion that an application to the support facility might be a suitable trigger contrasts with the kinds of triggers used in the US by the FDIC. When members of the Committee visited the US, it was made clear to them that the FDIC’s triggers were designed to notify authorities of potential problems well before an institution felt the need to apply for assistance to a central bank as lender of last resort, which, as its name implies, is a “last resort”.

192. We see great merit in the “prompt corrective action” approach adopted in the US and other countries. When a bank or building society shows signs of being in distress, or there has been an unusual change to or extreme development of its business model, it is vital that the relevant authority should not only be in a position rapidly to identify that situation, but also be able to take steps to lessen the wider impact of that financial institution’s difficulty. We do not propose that the relevant authority should have unfettered rights to interfere in the business of healthy institutions, but that, given the public interest in preventing banks from failing in a disorderly way, the relevant authority must have full access to the financial accounts of all FSA-authorized deposit-taking institutions, and the right to undertake additional visits and request additional information as needed.

193. We further recommend that the judgement of the relevant authority, supplemented by a set of quantitative triggers, be used to identify when a bank is either “failing”, at risk of failing, or pursuing a business model that is an obvious outlier within the industry. Once a financial institution has been so deemed, the relevant authority should have a well-defined menu of options for taking action. The purpose of such prompt corrective action would not be to prevent banks failing as such, but to prevent them failing in a disorderly manner.

425 Q 1869

426 ‘Last resort’ loans could be trigger for FSA input, *Financial Times*, 4 January 2008

194. **We do not view a bank’s recourse to the Bank of England in its capacity as lender of last resort as an ideal trigger for prompt corrective action. This option is a last resort, and the relevant authorities must be able to identify a bank as failing prior to this stage.**

A special resolution regime?

195. Earlier in this chapter, we noted the process through which a failing bank would be wound-up in the event of it entering administration. The UK’s current resolution system ranks bank depositors alongside other unsecured creditors, which would mean that a failed bank’s depositors would have to wait months, maybe even years, before receiving their insured deposits through the depositor protection scheme. Banks are treated in insolvency law just as any non-financial firm would be, yet the Governor of the Bank of England argued that “banks are not like other companies”.⁴²⁷

196. Earlier in this chapter we also discussed reasons why banks might be considered ‘special’—including the essential utility of banking services in modern life, and the need to maintain these services. Another reason why banks are ‘special’ is because of the harm to financial stability that a failing bank can inflict. If depositors lack confidence that they will be able to gain speedy access to their deposits in a failing bank (even if they were guaranteed to receive 100% of their deposits), they will have a strong incentive to join a bank run. One potential solution to this problem is the ring-fencing of insured deposits when a bank gets into distress, guaranteeing depositors that their money was safe, and, crucially, rapidly accessible.

197. The Governor of the Bank of England described the UK’s system for dealing with bank insolvency (and deposit insurance) as “markedly inferior to other countries” and “inadequate”.⁴²⁸ He argued that

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.⁴²⁹

The Governor pointed out that the UK authorities were alone in the G7 in being unable to deal with a distressed bank under a special resolution regime, relying instead on normal corporate insolvency laws. He explained that, if a bank entered administration, depositors might have to wait a considerable time to gain access to their funds, so they would have a strong incentive to join a bank run. For that reason, the UK authorities could not allow a bank to fail unless it were clearly insolvent. In turn, the Governor explained, the expectation that the authorities would try to avoid insolvency put a floor under the bank’s share price, and that prevented the authorities from intervening to implement a reorganisation of the bank. The Governor asserted that a “special resolution regime is the most important reform now and it will require legislation”.⁴³⁰ He went on:

427 Q1630

428 Qq 19, 48

429 Q14

430 Q1608

the difficulty of reaching and reorganisation of Northern Rock, which is absolutely, desperately needed, is made much more difficult by the fact that the shareholders can block what seems to be a sensible discussion of reorganisation by the people who are financing the vast bulk of the balance sheet, and it is precisely that problem to which the idea of early, prompt, corrective action and having an agency that can intervene in a failing bank before it reaches the stage of insolvency which is, in my view, so important. It is why all the other G7 countries have introduced a mechanism like that, and the FDIC is perhaps the best.⁴³¹

198. Professor Buiter argued that the current framework's inability to put banks into administration without the deposits being frozen was a "terrible situation" and that "the kind of open-ended breastfeeding of a private institution that goes on at the moment is the worst of all possible worlds".⁴³² He advocated the adoption of a US-style arrangement, where the FDIC can take a threatened bank promptly into public ownership, ring-fence its deposits for distribution to depositors, and re-open the bank immediately to manage its existing activities and commitments, while a longer-term plan is being worked out.⁴³³ This arrangement, known as the Bridge Bank approach, leaves any non-secured creditors with the deposit institution that is in receivership. The FDIC's intention with a Bridge Bank is to sell it to a bidder within two years of its creation and the FDIC has a duty to resolve the problem of the failed bank at least cost to the taxpayer. According to Dr Hamalainen,

The FDIC's experience with the Bridge bank approach is that it can be particularly useful in dealing with deposit institutions that have failed as a result of liquidity problems. This is because, compared to a situation in which asset quality problems have built up over time, a bridge bank gives the FDIC and potential bidders an opportunity to review the bridge bank in a more stable environment and arrange a permanent transaction. The FDIC has also found the bridge bank approach especially useful if the failing deposit institution is large or complex. This is partly because they did not have to negotiate with a failed institution's shareholders and bondholders.⁴³⁴

199. The BBA suggested a range of intervention tools that could be considered, including the suspension of dealing in the distressed bank's shares whilst the situation was stabilised, handing control to the senior management of an acquiring bank or special administrator, and maintaining critical banking functions through a bridge bank arrangement or by one bank assuming operational control of the distressed bank.⁴³⁵ In order to maintain competitiveness, the BBA argued, consumers ought to be able to choose the new institution they wanted to bank with, rather than all accounts (or blocks of accounts) being transferred to a designated institution.⁴³⁶

431 Q1654

432 Q864

433 Ev 328

434 Ev 255

435 British Bankers' Association Response to the Tripartite Discussion Paper: Banking Reform—Protecting Depositors, page 6

436 British Bankers' Association Response to the Tripartite Discussion Paper: Banking Reform—Protecting Depositors, page13

200. Sir Callum McCarthy admitted that there were “certainly things we can learn from the US experience where they have the ability to deal with a failure rapidly and in a way which enables them to take powers to deal with a failing bank”.⁴³⁷ The Chancellor of the Exchequer indicated his support for the concept of a special resolution regime:

we will have proposals in the future ... which will allow us to separate out depositors’ cash and then get it paid out as quickly as we can, should [a bank failure] happen in the future.⁴³⁸

201. **Under the current system, where depositors’ funds can be tied up for months upon the failure of a financial institution, depositors have a clear and strong incentive to join a bank run and withdraw their deposits. This incentive would remain, even if depositors were guaranteed eventually to receive 100% of all of their deposits, if the inconvenience of being unable to access savings for prolonged periods is not tackled. Because of the potential impact of bank runs on financial stability, we recommend that insured deposits at a failing bank be ring-fenced by the relevant authority, to reassure customers that their insured deposits are safe and accessible. This will require a special resolution regime for financial institutions. We note that the Tripartite authorities currently have no means of quickly resolving a failing bank. The new special resolution regime we propose would grant powers for the relevant authority to establish a “Bridge Bank” which would take over and continue to run the failing institution with the aim of quickly returning it to health, and returning it to the private sector, either as a standalone organisation, or as part of another bank. The relevant authority should also have the power to employ a third-party financial institution to manage a failing bank’s deposits, if that would facilitate the smooth administration of the failing bank. In carrying out such an operation, the relevant authority should have an obligation to resolve the situation at least cost to the taxpayer.**

202. The BBA raised concerns about the potential impact that a special resolution regime might have on the cost of funding for UK deposit-taking institutions. If depositors were to be prioritised over other creditors, investing in UK banks would consequently become relatively less attractive. Bank creditors would demand higher interest rates to compensate them for taking on a greater risk that they would not receive repayment of their loan. The BBA argued that “an increase in funding costs could seriously dampen the competitive position of UK banks”.⁴³⁹ The FSA also warned that, if the Government were to change insolvency law, it would have to be very careful because that would change the relative attractiveness of investing in banks. The FSA argued that, before making a particular change, it would be very important to consider the overall effect on the banking system.⁴⁴⁰ **We recognise that the ring-fencing of insured deposits, and transfer of them to a third party, would be to the detriment of other creditors of banks, and that this might serve to increase banks’ funding costs. However, we believe that this is a cost that the banking**

437 Q1451

438 Q1801

439 British Bankers’ Association Response to the Tripartite Discussion Paper: Banking Reform—Protecting Depositors, page11

440 Q1448

industry must bear, because we view a special resolution regime “to be” an essential pillar of an effective system for ensuring financial stability.

203. Following the introduction of a special resolution regime, shareholders would see no change to their ranking position in the event of the winding-up of a bank, because they already occupy the lowest rank. Nevertheless, shareholders will still be affected by the proposals we suggest. Shareholders will, for example, lose the comfort blanket of believing that the State will step in to prevent their company from failing. As we noted earlier, the view of the Governor of the Bank of England was that the expectation that the authorities would try to avoid insolvency put a floor under Northern Rock’s share price, and this prevented the authorities from intervening to implement a reorganisation of the bank.⁴⁴¹ The Governor went on to say that the reorganisation of Northern Rock had been made “much more difficult by the fact that the shareholders can block what seems to be a sensible discussion of reorganisation by the people who are financing the vast bulk of the balance sheet”.⁴⁴²

204. As currently constituted, the putting of a bank into administration need not lead to a ‘fire sale’. The Government’s own guidance notes on the procedure state:

The first objective of the administrator must be to consider rescuing the company. This means rescuing the company as a going concern with all or most of its businesses intact—it does not mean ending up with the legal shell of the company. This new emphasis on company rescue in administration will help to ensure that viable companies are preserved and jobs are safeguarded.⁴⁴³

Nevertheless, there are immediate disadvantages, particularly the freezing of retail deposits. We believe that this issue could have been addressed in urgent legislation and we believe that the issue could now be helpfully addressed to improve the framework for the future.

205. We recognise that shareholders will consider themselves to be disadvantaged by the new powers we propose for the relevant authority. At the moment, bank shareholders appear to be protected from the total collapse of their firm by the State’s unwillingness to allow a bank to fail. Our proposals would remove this taxpayer-funded prop, equalising the status of bank shareholders with that of non-financial firms’ shareholders, who receive no such assistance. Because of the unique nature of banking, bank shareholders cannot be expected to have the sole final say over the direction of their company, if that company has become reliant on State support to continue trading. The relevant authorities should be in a position to undertake a solution in the public interest that may be to the detriment of shareholders.

206. The Government should also consider whether it will be possible, in the event of a bank failure, to endow the relevant authority with the decision-making powers currently held by the shareholders, whilst protecting those shareholders’ financial interest. Any new legislation must clearly set out any changes to the status of shareholders of banks and members of building societies.

441 Q1608

442 Q1654

443 Government Insolvency Service, Administration Guidance Notes

Critical banking functions

207. Earlier we discussed the increasing importance of banking services in modern life. Many people's lives involve an intricate web of direct debits, standing orders, automatic transfers: they rely heavily on being able to withdraw cash from automatic teller machines (ATMs) on demand, and being able to purchase items with debit and credit cards. Any interruption to these essential services can cause acute disruption; a prolonged interruption could cause chronic problems to the functioning of daily life.

208. The BBA accepted that UK consumers had become increasingly reliant on banking services in their daily lives and that provision needed to be made to maintain transactional services in the event of bank failure, to facilitate, for both consumers and businesses, the critical functions of salary payments, cash withdrawals, debit card payments and direct debit payments. However, the BBA also noted that banks provide many other services and that it could be difficult to divide a bank and its personnel between critical and non-critical functions. The BBA argued that business customers, especially those too large to be covered by the deposit scheme, were likely to have more complex needs than private individuals and would be most likely to need more time to transfer to a new provider.⁴⁴⁴ For the BBA, the main issue for private customers was likely to be the need for access to immediate funds, and the BBA argued that the Government ought to be willing to provide automatic emergency funding, via the Bank of England, of individual customers' balances up to around £5,000 per individual. This would reflect around two months' income for an average household, and should therefore allow sufficient time for replacement banking arrangements to be put in place and further payments under the scheme to be made.⁴⁴⁵ The Japanese depositor protection scheme, for example, has provisions for payments of ¥600,000 (approximately £3,000) to cover immediate living costs if full repayment is expected to take a long time.⁴⁴⁶

209. Guy Sears from the Investment Management Association suggested how cash machine withdrawal facilities might be maintained throughout a bank failure:

Given that most people take money through a cash point I presume it is not beyond the wit of man somehow to plug into the cash point system so people can still withdraw money while there is an insolvency up to the limits of the protection ... I presume there must be a way of plugging the Bank of England into [the ATM network] at moments of crisis up to some limit.⁴⁴⁷

210. The UK is increasingly reliant on transactional banking services and any disruption to salary payments, direct debits, standing orders, ATM availability and other banking services would cause profound problems for the banking system as a whole. If a bank were to fail, a smooth transition to a Bridge Bank or third-party bank would be essential. We recommend that, in bringing forward its proposals on

444 British Bankers' Association Response to the Tripartite Discussion Paper: Banking Reform—Protecting Depositors, page 7

445 British Bankers' Association Response to the Tripartite Discussion Paper: Banking Reform—Protecting Depositors, page 7

446 Deposit Insurance Corporation of Japan, A Guide to the Deposit Insurance System, page 9

447 Q1416

improvements to the system of handling failing banks, the Government address the issue of how essential banking services would be maintained.

Lender of last resort

211. A lender of last resort is an institution willing to extend credit when no one else will. In the UK, this role is taken on by the Bank of England, which lends to deposit-taking institutions in emergency circumstances.

212. The measures that we have outlined in this chapter are designed to minimise the need for banks to call on the Bank of England's resources in this capacity. We view such a development as important for two reasons. First, use of such a facility puts at risk taxpayers' money, whereas the risk of bank failure ought to be borne by a bank's shareholders and large creditors.

213. Second, the run on Northern Rock was largely triggered by the announcement of the Bank of England's support operation. The fact that an operation designed to assist Northern Rock should cause yet more damage indicates that the level of stigmatisation now attached to such a facility is such that its effectiveness must now be in doubt. Such operations have been stigmatised for a period to come by the experience of Northern Rock.

214. If a support operation could be conducted covertly, the problem of stigmatisation might be avoided. In Chapter 4, we concluded that, in the case of Northern Rock, the barriers to a covert support operation were real and probably insuperable. These barriers were both practical and legal. Practically speaking, the chances of any large covert support operation going unnoticed by the market for any period of time at all are extremely slim, and it would not take long for the market to establish the identity of the recipient of such emergency lending.

215. In terms of legal barriers, we noted in Chapter 4 that the Governor of the Bank of England received legal advice to the effect that the Market Abuse Directive, as it stands, is a substantial barrier to a covert operation, even if information pertaining to the operation could be kept confidential. However, the Committee learnt on its visit to Brussels that preventing covert operations by a central bank was certainly not the intention behind the Directive. **We recommend that the Government seek to work with the European Commission, European Central Bank and national central banks within the European Union to establish whether the Market Abuse Directive ought be amended, so as to ensure that covert support operations by a central bank are permitted in specified circumstances.**

216. **We further recommend that the Government review the interaction between the terms of the Market Abuse Directive and other aspects of the regulatory regime including the FSA guidelines, to ensure that they do not unnecessarily restrict areas of the discretion otherwise allowed under the Directive.**

6 Depositor protection

Introduction

217. Since 2001, the Financial Services Compensation Scheme has offered protection to depositors (and some other customers) of UK financial firms. The events surrounding Northern Rock in 2007 have raised questions about the adequacy of current deposit protection arrangements. The existence of a deposit protection scheme did not prevent the formation of long queues of depositors outside Northern Rock branches, a sure sign that that bank's customers lacked confidence that their deposits would be protected. The formation of the queues outside Northern Rock branches was, in part, an indictment of the UK's deposit insurance arrangements, arrangements which Professor Buiter decried as "a shambles".⁴⁴⁸

218. Depositor protection arrangements vary widely across countries. Members of this Committee travelled to the United States and Sweden during the course of our inquiry, to learn, amongst other topics, about the schemes in those countries. In considering reform to the UK deposit protection arrangements, the Government can mine a rich seam of experience from around the world. The FSA has already admitted that a US-style system of depositor protection, for example, "would have undoubtedly been of real help in preventing the retail run" on Northern Rock.⁴⁴⁹ The Governor of the Bank of England highlighted some of the attractive elements of deposit protection schemes in other countries:

A model for deposit insurance that draws on international experience would have permanent 100% coverage up to a limit with transparent and widely understood prompt payout commitments.⁴⁵⁰

448 Q 891

449 Q1452

450 Q1608

Box 2: The Financial Services Compensation Scheme

The Financial Services Compensation Scheme (FSCS) is the UK's statutory fund of last resort for customers of FSA-authorized financial services firms. It can pay compensation if a firm is unable, or likely to be unable, to pay claims against it. This will generally be because it has stopped trading and has insufficient assets to meet claims, or is in insolvency. This is described as being "in default".

The FSCS is an independent body and was created under the Financial Services and Markets Act 2000 (FSMA), replacing eight previous compensation arrangements (including the Building Societies Investor Protection Scheme, the Deposit Protection Board, the Friendly Societies Protection Scheme, the Investor Compensation Scheme, the Personal Investment Authority Indemnity Scheme, the Policyholders Protection Scheme, the Section 43 Scheme (which covered business with money-market institutions), and the arrangements between the Association of British Insurers and the Investor Compensation Scheme for paying compensation in relation to Pensions Review cases).⁴⁵¹ The FSCS became operational on 1 December 2001 when FSMA came into force. The FSA is responsible for setting the rules within which the FSCS operates, including on eligibility of claims and compensation limits. The FSCS, as the management company that operates the Scheme, is required by FSMA to be operationally independent. It is not part of the FSA, but accountable to it (and, ultimately, to the Treasury).

The FSCS is free to consumers. It protects deposits, insurance policies, insurance broking, investment business, and mortgage advice and arranging. Since 2001 it has paid out £1.004 billion in compensation to consumers and declared 1800 firms in default, of which 29 were credit union failures. The total number of claims completed for investment and deposit-taking business is 87,000.⁴⁵²

Rationale for deposit protection

219. The FSA told us that the main function of the FSCS was consumer protection, by providing consumers with a measure of compensation in the event of failure of an institution in the financial sector. The FSA also noted that the existence of a compensation scheme helped to reduce the systemic risk that a single failure of a financial firm might trigger a wider loss of confidence. The FSA cautioned that, "while it contributes to encouraging consumer confidence in the markets, the FSCS was not designed, on its own, to be able to deal with all potential failures of financial firms, nor to be a crisis management tool in the event of a large-scale failure"⁴⁵³

220. Professor Wood considered deposit insurance to be a social provision, to protect what used to be called in the banking industry "widows and orphans".⁴⁵⁴ Professor Buiter agreed

⁴⁵¹ *Funding of the Financial Services Compensation Scheme, A Report by Oxera for the FSA, March 2006*

⁴⁵² Ev 230

⁴⁵³ Ev 222

⁴⁵⁴ Q 905

with this view, but added that the “widows and orphans” rationale should extend only to natural persons, and not wholesale or business deposits.⁴⁵⁵ Professor Buiter disagreed with the FSA’s rationale for a depositor protection scheme, claiming such a scheme was purely “social policy” and had no purpose as a financial stability tool.⁴⁵⁶ Sir Callum McCarthy, however, argued that a well-designed scheme, where depositors had confidence that they were covered 100% up to a certain amount, and that they would get a very rapid repayment, would make it “much less likely” that there would be a retail bank run, and that had implications again for financial stability.⁴⁵⁷

Co-insurance

221. Co-insurance is an attempt to share, in the context of deposit protection, the risk of bank failure between the deposit protection scheme and the depositor. Under a co-insurance scheme, depositors receive less than 100% of their guaranteed deposits if their bank fails. In the UK prior to 1 October 2007, for example, the FSCS would cover 100% of the first £2,000 of deposits but only 90% of the next £33,000. Theoretically, introducing co-insurance should reduce moral hazard on the part of depositors, by encouraging depositors to take a keener interest in choosing a financially-sound bank. In 1992, following the collapse of the Bank of Credit and Commerce International (BCCI), the then Government set out the rationale for co-insurance, under a deposit protection scheme which at the time guaranteed only 75% of qualifying deposits up to a value of £20,000:

If depositors expected full compensation for losses, then they too would no longer need to consider the risk associated with the particular banks in which they placed their money. This, in turn, would have serious and potentially damaging consequences for the whole banking system as it would favour institutions which, for example, offered unrealistically high rates of interest, at the expense of more prudent ones. And it would encourage managers who wanted to attract deposits to adopt riskier strategies. The recent experience of US savings and loans institutions shows all too clearly that this is a real—and not simply a theoretical danger.⁴⁵⁸

222. More recently, in a speech made in February 2006, Sir Callum McCarthy warned that

were the FSA to aim to relieve consumers of all adverse consequences, an environment would be created in which they no longer needed to weigh up the reasonableness of their financial decisions. No market can work effectively without involved customers. To relieve consumers of retail financial services of the consequences of their actions would destroy this as an effective market. Consumer responsibility is therefore vital to the effectiveness of financial markets.⁴⁵⁹

455 Q 906; The current scheme covers deposits by businesses with a turnover of less than £5.6 million

456 Qq 907-8

457 Q1431

458 Treasury and Civil Service Committee, Second Report of Session 1992–3, *Banking supervision and BCCI: The implications of the Bingham Report*, HC 250, p 27

459 Speech by Sir Callum McCarthy to the Financial Services Forum, 9 February 2006

Sir Callum noted that, in the US during the savings and loan problems, “it was quite clear that 100% coverage resulted in some distortion of behaviour and some serious moral hazard.”⁴⁶⁰ The London Investment Banking Association also mentioned the US savings and loan problem, arguing that it would be:

important to avoid arrangements that could lead to the kind of costs borne by taxpayers following the losses of US Savings and Loans depositors in 1986-95. In order to address moral hazard issues, in reviewing the UK scheme it will be necessary to consider arrangements that address the risk of depositors simply opting for accounts paying the highest rate of interest.⁴⁶¹

223. Although using co-insurance to encourage consumers to invest their savings in healthy institutions was attractive in theory, several witnesses argued that it did not work in practice. Professor Wood said that, if the purpose of depositor protection were protecting “widows and orphans”, coverage had to be 100%, because it was unreasonable to expect such people to have the time or the knowledge to police their banks.⁴⁶² Professor Buiter argued that if coverage was anything less than 100%, it was still an invitation to have a bank run:

Unfortunately while co-insurance is a good idea for most insurance—you cannot have a run on your life insurance company but you can have a run on the bank—I really would not recommend anything less than 100%.⁴⁶³

224. The Governor of the Bank of England also rejected the concept of co-insurance in depositor protection:

if you have deposit insurance, there is no point having 90%, because that will not stop the bank run, as we saw, it has to be 100% but only up to some limit. In order to prevent banks taking excessive risks on the back of that deposit insurance—the moral hazard risk—it is much more important to have in place the special resolution regime whereby the authorities can get control of a bank that has been taking too many risks, particularly on the liquidity front. That is why ... the FDIC mechanism does naturally go hand in hand with the deposit insurance for banks, but only for banks.⁴⁶⁴

225. Sir Callum McCarthy acknowledged that, at the time of the run on Northern Rock, the fact that the FSCS only guaranteed 100% up to the first £2,000, and 90% of the next £33,000 was a problem.⁴⁶⁵ The FSA said that in making the decision to remove the coinsurance element of £35,000, it was “reflecting a belief that it is probably unrealistic to expect the consumer to have the necessary information and ability to judge funding risk ...

460 Q1425

461 Ev 248

462 Q 913

463 Q 913 (will become *Ibid.* once previous amendment is made)

464 Q 1743

465 Q 345

our current thinking ... is that it is a little too ambitious to expect the consumers to have detailed understanding of funding risk".⁴⁶⁶

226. Not only did witnesses consider the expectation that consumers be in a position to judge the health of banks, they also commented on how the complexity of co-insurance made it hard to explain to customers. Northern Rock explained to us that the scheme's co-insurance element between £2,000 and £35,000, "does not lend to sound bites when you are trying to deal with customers either on the telephone or queuing outside your branch."⁴⁶⁷ Adrian Coles, of the BSA, also cited the complexity of coinsurance as causing difficulty,⁴⁶⁸ as did Gerald Corrigan from Goldman Sachs:

The other point I make for your consideration is that the payout provisions should be very simple and straightforward; in other words, in the United States the payout provision is \$100,000—full stop. As I understand it, the current system here in the UK is a bit more complex than that and it has different layers and percentages. I am a little concerned that that may be a bit of a structured product in its own right.⁴⁶⁹

227. The presence of an element of co-insurance in a deposit protection scheme adds considerable complexity for customers to understand: Northern Rock pointed to the difficulty of explaining the scheme's intricacies to their customers when the bank run occurred. Not only does co-insurance add complexity, it also does not work. Co-insurance implies that a potential depositor would have the means, time and ability to assess the financial strength of an institution through the examination of publicly-available information about that company. We do not believe this to be a realistic proposition. The main way the ordinary depositor can gauge the financial health of a bank is by considering the strength of the brand and whether the bank has a reputation for financial strength. Tellingly, Northern Rock did well on both of these counts. Rather than contributing to financial stability, co-insurance directly undermines it, by offering an incentive to join a bank run. We consider the co-insurance model to be discredited with regard to depositor protection. The moral hazard argument, that banks would offer excessively high rates to customers, on the back of the full deposit insurance for customers, would be mitigated by our proposals for a system of prompt corrective action and a special resolution regime, together with a modest compensation limit, to discussion of which we now turn.

Compensation limit

228. A key consideration for future deposit protection arrangements relates to the limit up to which deposits are guaranteed. The FSA emphasised the importance of striking the right balance between protection for individuals on the one hand, and not encouraging irresponsible behaviour by institutions on the other.⁴⁷⁰ Professor Wood argued that, if the compensation limit were set at a low level, large depositors and other banks might pay

466 Q1429

467 Q 677

468 Q1558

469 Q1254

470 Q 1426

closer attention to those to whom they lent. Also, if it were set at a low level it could continue to be financed by a mutual scheme and thus the taxpayer would have less interest in propping up banks.⁴⁷¹ On the setting of the compensation limit, he added that “basically it is a political decision”, rather than an economic one.⁴⁷²

229. The BBA believed that the existing coverage limit of £35,000 combined with the removal of co-insurance fulfilled the objective of protecting the vast majority of retail depositors. Data collected from BBA members suggested that 96% of consumer savings accounts were covered by a £35,000 limit, “which compares favourably with coverage in other countries”. They argued that any further increase in coverage would undermine longer-term financial stability through increasing scheme costs and by placing emphasis on deposit insurance rather than prudential regulation as the primary mechanism for depositor protection.⁴⁷³ The BBA said that a further increase in the limit to, say, £100,000 would significantly increase costs to industry for a relatively small impact in terms of increasing consumer confidence. Such a move, they added, would primarily benefit business customers—currently the FSCS offers protection for small businesses as well as individuals—and wealthy individuals, whilst providing marginal additional benefit to those consumers most in need of deposit protection, and would leave the UK scheme “significantly out of step with its international competitors and also increase moral hazard”.⁴⁷⁴

230. The Association of British Insurers (ABI) noted that the FSA had to ensure that compensation limits were sufficiently generous to protect ordinary investors, but did not give rise to issues of moral hazard, or distort competition between different products. There had to be a limit to the protection offered, because otherwise financial institutions and consumers would become reckless, thereby, paradoxically, increasing the likelihood of a serious failure.⁴⁷⁵ Research carried out on behalf of the ABI in 2006 suggested that a limit of £35,000 provided full coverage for 98% of cash-only savers, a proportion very similar to the BBA’s estimates noted above. The ABI stated that such an amount would cover the total non-pension savings, across all types of instruments, of over 80% of the population.⁴⁷⁶ A higher level of guarantee, the ABI warned, risked distorting the market by rendering bank deposits more attractive relative to other savings: “That is not necessarily good for the savings industry and the country’s overall propensity to save”.⁴⁷⁷

231. The BSA considered that an increase in the current compensation limit was not necessary.⁴⁷⁸ The BSA’s analysis of the distribution of savings within the building society

471 Q 905

472 Q 909

473 British Bankers’ Association Response to the Tripartite Discussion Paper: Banking Reform—Protecting Depositors, page 3

474 British Bankers’ Association Response to the Tripartite Discussion Paper: Banking Reform—Protecting Depositors, page 4

475 Ev 267

476 *Ibid.*

477 Q 1418

478 Building Societies Association Response to the Tripartite Discussion Paper: Banking Reform—Protecting Depositors, para 10

sector showed that approximately 95% of individuals saving with a building society had balances of £35,000 or less.⁴⁷⁹ The BSA also mentioned the risk of market distortion if the compensation levels for customers of one class of financial services provider were disproportionately high. The BSA argued that, as illustrated by savings and loans organisations in the US during the 1980s, an excessively high compensation limit could cause moral hazard for both firms and customers alike.⁴⁸⁰ Professor Buitter believed that “certainly £100,000 would be way in excess of the widows and orphans criterion”.⁴⁸¹

232. The only evidence we received that argued for the limit to be raised above £35,000 was from the Financial Services Consumer Panel (FSCP). They argued that inflation had significantly eroded the real value of compensation and that the deposit limit should be raised above £35,000. According to the FSCP, consumers who sold their homes, and waited before buying another, were likely to have large sums of money on deposit with banks and building societies.⁴⁸²

233. The setting of an appropriate compensation limit should balance the objective of enhancing consumer confidence through adequate coverage against the implications for moral hazard and the problems of increasing the cost of the scheme. The current limit of £35,000 is easy to remember and covers the vast majority of depositors. The case has not yet been made for any extension above the current limit of £35,000. We do, however, recommend that whatever limit is adopted, it should be indexed to a measure of inflation, but such that the guaranteed limit is always an easily memorable sum.

234. We do not believe that very large deposits held for short periods of time, perhaps in the course of residential property transactions, should be covered by the deposit protection scheme. However, we do think that the concerns raised by the Financial Services Consumer Panel are important, particularly where customers are placing deposits for purely transactional reasons, rather than seeking to earn interest. We recommend that the Government, in its response to this Report, set out what arrangements are available, or might become available, for depositors in such circumstances. One possible solution would be for depositors to invest in a risk-free National Savings & Investment product, and the Government should consider introducing a product targeted at those selling and then buying property, to raise awareness of this option.

Speedy release of funds

235. Under the UK’s existing arrangements, depositors of a failed institution do not gain access to their deposits until the winding-up administration process has been concluded. This could be a matter of weeks in the case of a credit union, or many months, or even

479 Ev 306

480 Ev 307

481 Q 913

482 Ev 219

years, for a larger institution. The BBA believed that the expected speed of payout was an important factor in consumer confidence in the FSCS.⁴⁸³

236. The BSA stated that the potential speed of payout was related to the size of the institution. Payments made by the FSCS to the depositors of credit unions, according to the BSA, have typically taken seven to ten days, but for much larger institutions it was much more difficult.⁴⁸⁴ The FSCS website states that:

After a declaration of default, FSCS aims to process all claims within six months. However, the time this takes depends very much on the type of claim. For example, most credit union claims can be completed within four weeks. For other types of claim it may take longer, depending on how complex it is and on some factors that may be outside of our control, such as waiting for information from third parties.⁴⁸⁵

237. Dr Hamalainen argued that depositors need “to be assured that within one day of bank failure they will have access to their insured deposits”, because the time taken to repay could be thought of as a liquidity risk for depositors. He noted that the prospect of having their deposits inaccessible for up to six months was one of the two main factors “that drove insured Northern Rock depositors to withdraw their money” (along with the co-insurance element).⁴⁸⁶

238. The Governor of the Bank of England argued that “the system of administration for banks which means that retail depositors find their deposits frozen for months on end and they cannot access them is a system which is a direct inducement for retail depositors to take their money out at any sign of trouble”.⁴⁸⁷

239. The BBA stated that it was not feasible to expect customer account data to be exported from one institution to another in the case of a failed bank, due to the diversity and complexity of the systems used by different banks. Speedy payout was best achieved, they argued, through existing bank channels (cheques, cash or electronic). Payments would need to be paid within a few days and facilitated by:

- Deposits being repaid on a gross basis without netting of customer liabilities;
- Arrangements which make it possible for the staff of Bank A (or a special administrator) to take over and operate distressed Bank B’s payment systems.⁴⁸⁸

240. The current arrangements, under which the Financial Services Compensation Scheme could take months, maybe years, to reimburse the depositors of a large failed institution, are completely inadequate. The speed of release of funds is of critical importance. However generous a compensation scheme may be, and however much

483 British Bankers’ Association Response to the Tripartite Discussion Paper: Banking Reform—Protecting Depositors, page 5

484 Q 1556

485 www.fscs.org.uk/consumer/FAQs/Deposit_claims_FAQs/

486 Ev 255

487 Q 30

488 British Bankers’ Association Response to the Tripartite Discussion Paper: Banking Reform—Protecting Depositors, page 5

confidence consumers may have in eventually getting back their deposits, it would still be rational for a depositor to withdraw their funds from a failing bank if there were a prospect of them losing access for more than a few days. There should be a requirement in law that all insured deposits should have to be paid within a few days of a bank failing and calling on the deposit protection scheme. The relevant authority must ensure that banks' information systems and procedures are capable of such a speedy release of funds.

Communication

241. The BBA identified three points that were “essential for consumers to understand” about a deposit protection scheme. The first was clarity regarding their personal situation, including limit levels, any co-insurance arrangements and any offsetting of loans against deposits; the banks, account types and customers covered; and the speed and method of payout. Secondly, there was a requirement for consumer confidence in the banking system's ability to handle failures, which would require the communication of a clear intervention plan. Thirdly, customers ought never to believe a bank is “closed for business”, so website and branch shutdowns had to be avoided.⁴⁸⁹ The BBA said that its members were prepared to support the Tripartite authorities in developing appropriate forms of communication to raise awareness of the FSCS. They believed that this task would be made significantly easier by adhering to an approach geared towards simplicity.⁴⁹⁰ Angela Knight admitted that communications of the FSCS currently lacked “the sort of pulsating clarity which maybe we should be looking at now”.⁴⁹¹ The BSA suggested that the FSCS should prepare standard wording for all firms covered by the Scheme, to use to help inform customers and to help ensure consistency in the provision of information.⁴⁹² Professor Buiters suggested that every branch in the country should have large signs explaining the extent to which customers' deposits were protected.⁴⁹³

242. Ms Minghella, the Chief Executive of the FSCS, told us that the Scheme was aware of the importance of consumers understanding the protection that was available to them in the event of a failure, and said that, when a business did fail, the FSCS took steps to inform every consumer who was affected of their right to claim on the scheme. She also highlighted the Scheme's work with a number of stakeholders, Consumer Advice Centres, Money Advice Bureaux, journalists, and MPs, to try and bring the scheme to general attention in advance of failures.⁴⁹⁴ She agreed that a firm should have an obligation to communicate with its customers about the scheme. She argued that firms currently did have that obligation at the point of giving explanatory information about a product, but she felt that this could be further enforced.⁴⁹⁵

489 British Bankers' Association Response to the Tripartite Discussion Paper: Banking Reform—Protecting Depositors, page 12

490 *Ibid.*, page 5

491 Q 1554

492 Building Societies Association Response to the Tripartite Discussion Paper: Banking Reform—Protecting Depositors, page 8

493 Q 910

494 Q 1427

495 Q 1428

243. Depositors' understanding of the intricacies of the Financial Services Compensation Scheme, prior to the post-Northern Rock changes, was inadequate. We favour as simple and as transparent a scheme as possible. Alongside the removal of co-insurance and the adoption of a simple compensation limit, depositors need to understand that they can maximise their protection by dividing their savings between different institutions. In addition, there needs to be an emphasis on the fact that the compensation limit is per customer, rather than per account. For the scheme to have the maximum impact in protecting financial stability, the details of the scheme must be well-advertised, both in national and regional media, and through the display of posters in individual bank branches.

Identifying insured depositors

The need for identification

244. In the event of a bank or building society failure, the administrator of that institution (or the deposit insurance scheme, bridge bank, or other resolution agent) would have the complex task of identifying those account holders who were eligible for reimbursement of their deposits.

Multiple institutions with one FSA registration

245. As a result of takeovers and mergers, many financial services groups now contain several deposit-taking institutions. In some cases, these individual institutions have maintained a separate authorisation with the Financial Services Authority (FSA). In other cases, the parent group has a single FSA authorisation, covering all their subsidiary firms and brands. The coverage provided under the FSCS differs accordingly:

For people who hold multiple accounts in banks that are part of a larger group such as Halifax Bank of Scotland, if each of the banks is separately authorised by the Financial Services Authority, the FSCS would pay compensation up to the limit of £35,000 per person, per authorised institution.

If each of the banks is not separately authorised but is covered by the parent company's authorisation, the FSCS would pay compensation up to the limit of £35,000 once, irrespective of how many different institutions a person held accounts with.⁴⁹⁶

246. The FSCS website advises its users to telephone the FSA's Consumer Contact Centre if they have a question about how a bank or building society is authorised. Despite the availability of this facility, the BSA commented that "there appears to be public confusion about whether the limit is per account or per deposit-taker, and over the protection where a customer has separate deposits within a financial institutional group".⁴⁹⁷

Joint accounts

496 www.fscs.org.uk/consumer/FAQs/Deposit_claims_FAQs/

497 Building Societies Association Response to the Tripartite Discussion Paper: Banking Reform—Protecting Depositors, page 8

247. An additional complexity for depositors to consider surrounds joint accounts. The FSCS website states that:

The compensation limit of £35,000 applies to each depositor for the total of their deposits with an organisation, regardless of how many accounts they hold or whether they are a single or joint account holder. In the case of a joint account, FSCS will assume that the money in that account is split equally between account holders, unless evidence shows otherwise.⁴⁹⁸

Conclusions

248. **It is important for the relevant authority operating a deposit protection scheme to understand the size and profile of the depositors it is insuring, not least so that that authority can calculate an appropriate funding requirement. Furthermore, an essential prerequisite of the speedy reimbursement of funds to the depositors of a failed institution is that insured depositors can be quickly identified. At present, we doubt that all financial institutions would be able to produce such data at short notice. We recommend that each financial institution (or, each FSA-registered group, where several institutions share one FSA registration) maintain a register of each depositor's insured deposits under the scheme. The existence of a register would greatly simplify the task faced by the relevant authority if a failed bank's depositors were to be ring-fenced or placed under the control of a Bridge Bank. This register must take into consideration individual shares of joint accounts in calculating the extent of coverage. The relevant authority should confirm that every bank and building society is able to produce such a register at a day's notice, so that the authority can be assured that, in the event of a bank failing, the speedy release of funds would not be jeopardised by an inability to identify insured depositors.**

249. **Not only is it important for firms and the deposit insurance scheme to know which depositors are insured, but the depositors themselves must be aware of the extent to which their deposits are insured. We recommend that depositors should be alerted, via a letter from the financial institution, if a portion of their deposits is, or becomes, uninsured. Again, this notification should take into consideration whether the depositor has savings at other organisations within the FSA-registered group which is writing to the depositor, and where a depositor has invested in a joint account.**

Off-setting of loans and mortgages against deposits

250. If a financial institution were to fail, the question arises as to whether any debts owed by a depositor to the institution could be offset against that depositor's savings. The *Frequently asked questions* section of the FSCS website is unambiguous in stating that they could:

498 www.fscs.org.uk/consumer/FAQs/deposit_claims_FAQs/

Amounts owed to the failed firm (for example, loans, mortgage or credit card debts) are taken into account before any compensation is paid. We may also take steps to recover any amounts owed by depositors.⁴⁹⁹

251. **The implication of the statement on the Financial Services Compensation Scheme website is startling: a customer of a bank or building society who had savings, but also a larger mortgage, with the same institution, might receive no compensation through the deposit insurance scheme, but would instead have a smaller balance on their mortgage. We consider that such off-setting of a highly liquid asset (deposits) against a more illiquid liability (mortgage) to be in conflict with the entire purpose of a deposit protection scheme. A deposit scheme's two purposes—to protect depositor's liquid assets, and reduce the incentive for joining bank runs—are both fundamentally weakened by off-setting. It could be argued that off-setting an overdraft might be legitimate, but as a general rule, the widespread off-setting of savings and loans should not be permitted. We expect the Government to re-design the deposit protection scheme so that off-setting of deposits against illiquid liabilities is not permitted.**

Funding

Background

252. The Financial Services Compensation Scheme, is currently funded through annual levies on regulated firms, across five sub-schemes. Alongside deposit protection, the sub-schemes are insurance business, insurance mediation, designated investments and mortgage advice and arrangement. As Table 2 shows, the compensation paid by the FSCS to depositors amounts to a minuscule proportion (0.21%) of total compensation.

Table 2: FSCS compensation paid to depositors since 2001

Year	FSCS compensation paid to depositors (£m)	FSCS total compensation (£m)	FSCS deposit compensation as a percentage of total (%)
01–02	0.02	40.9	0.05
02–03	0.06	194.4	0.03
03–04	0.4	197.6	0.2
04–05	0.23	174.71	0.13
05–06	0.09	201.22	0.04
06–07	1.21	149.47	0.81
Total	2.01	958.3	0.21

Sources: *Financial Services Compensation Scheme Annual Report 2001–02*, p 8; *FSCS Annual Report 2002–03*, p 10; *FSCS Annual Report 2003–04*, p 12; *FSCS Annual Report 2004–05*, p 10; *FSCS Annual Report 2005–06*, p 16; *FSCS Annual Report 2006–07*, p 21.

The maximum levy that the deposit sub-scheme's participant firms can be charged in each year is equal to 0.3% of their deposit base. The Director-General of the BSA, Adrian Coles, told us that this meant that the current extent of support would be about £2.5 billion.⁵⁰⁰

499 Ibid

500 Q 1552

The FSCS explained that each year they prepared a forecast of expected failures, based on past experience and other information available at the time. If a failure were to occur that had not been forecast, the FSCS would charge an additional levy for it at the time, and the industry would be obliged to pay that levy within 30 days.⁵⁰¹

Recent changes

253. In 2005, the FSA commenced a review of the funding model for the FSCS, and on 14 November 2007 announced the changes that it had decided to make.⁵⁰² The revised model, which will come into effect in April 2008, will increase the financial capacity of the scheme for compensation arising from deposit-takers from £2.7 billion to £4.03 billion. The FSA argued that the new model would mean a more “robust, resilient, efficient and cost-effective” scheme.⁵⁰³ The new funding model will include five broad classes: life and pensions; deposits; investment; general insurance and home finance. For the first time, the FSCS will feature explicit cross-subsidy arrangements, so that sub-classes can pick up liabilities from other sectors if that is required.⁵⁰⁴

254. The FSA noted that nearly all in the financial services industry “strongly opposed” its proposals for change, arguing that the current arrangements were fit for purpose, and that introducing greater cross-subsidy between different classes of firms was inappropriate.⁵⁰⁵ The ABI was opposed to the new funding system, believing that cross-subsidy between deposit protection and other parts of the financial sector would increase the risk that difficulties in one sector could be passed onto others, leading to a loss of confidence in financial services as a whole.⁵⁰⁶

255. On 11 October 2007, the Tripartite authorities jointly published a discussion paper on reform of depositor protection, the first stage of a wider process of stakeholder consultation to continue into 2008.⁵⁰⁷ The results of this consultation process may lead to significant changes to deposit protection arrangements, in light of the events surrounding Northern Rock. When asked why the FSA was pushing ahead with funding reform to the FSCS, regardless of the likelihood that changes to the FSCS would be announced in 2008, Sir Callum McCarthy argued that “whatever changes come about from the legislation the Government plans to introduce next year, it would be sensible to make [the funding] changes in the meantime because we did not think there would be any conflict between improvements we are planning to make and had planned for some time and whatever comes out of that legislation”.⁵⁰⁸

256. We regret the FSA’s decision to press ahead in November 2007 with changes to the funding of the Financial Services Compensation Scheme, in view of the FSA’s

501 Q 1442

502 FSCS Funding Review, Financial Services Authority, 14 November 2007

503 Ev 228

504 Ev 227

505 Ev 223

506 Ev 268

507 Tripartite Discussion Paper: Banking Reform—Protecting Depositors

508 Q 1424

knowledge that substantial changes to the Scheme were highly likely in 2008. The FSA's decision to do so pre-empts the Tripartite review of funding issues in relation to deposit protection in which the FSA itself is involved.

Pay as you go?

257. The amount levied for compensation payments by the FSCS is an estimate of the compensation that the FSCS expects to pay based on estimated claims for the 12 months following the levy date, after allowing for fund balances. Levies are normally made once every financial year, although further levies can be made if costs exceed those anticipated.⁵⁰⁹ This system contrasts with the funding regime employed in the US by the Federal Deposit Insurance Corporation (FDIC- see Box 3), which has built up a fund of almost \$50 billion and stands ready to reimburse depositors almost immediately if a bank were to fail. The FSCS system has been referred to as 'ex-post' or 'pay-as-you-go', whilst that of the FDIC is known as 'ex-ante' or 'pre-funded'.

258. Dr Hamalainen pointed to two problems with the 'pay as you go' approach. First, because a 'pay as you go' scheme does not hold sufficient funds to cope with a large bank failure, such a scheme would be unlikely to deliver funds to depositors quickly enough to avoid disruptions to customer service. In consequence, the Government would have to step in to cover the deposit insurance fund's shortfall whilst the levies were being collected from other deposit-taking institutions. Secondly, a 'pay as you go' scheme would be very likely to lead to pro-cyclical problems, where demands for levy contributions were made at exactly the time when deposit-taking institutions were experiencing a period of distress. This, Dr Hamalainen argued, could cause an exacerbated slow down in banking activity during business cycle downturns. In contrast, a 'pre-funded' model could be constructed to allow depositor protection funds to rise during more favourable economic conditions and decrease during less favourable ones.⁵¹⁰

259. Instituting a pre-funded scheme could resolve the problems raised by Dr Hamalainen. When we visited the US and met officials from the FDIC, we were told how the existence of a large, dedicated fund for deposit protection bolstered the confidence of depositors and acted as a brake on depositors rushing to withdraw their money from a bank at the first sign of trouble. Conversely, if a UK bank were to become distressed under the current system, depositors would soon discover that the FSCS lacked sufficient funds for reimbursement, and could not be certain whether the bank would receive any assistance from the State.

260. US stakeholders, including the American Bankers Association, also favoured a system whereby contributions to the fund were adjusted such that banks' paid more in the more profitable years, and less when they had tighter capital constraints. Introducing such cyclicity to the UK deposit protection scheme would remove the paradox whereby, when the FSCS reimburses the depositors of a failed institution, other financial firms, who are also likely to be relatively capital-constrained, are required to pay an additional levy.

509 www.fscs.org.uk/industry/funding/levy_information/

510 Ev 256

Box 3: Funding of the US FDIC

The Federal Deposit Insurance Corporation is an insurance-based system covering deposits up to \$100,000. It currently has a fund of \$49 billion covering US deposits of \$3 trillion. In the case of a failing bank, the FDIC can take control, selling the deposits to a third-party bank (a Bridge Bank), which would take on the customers automatically and enable them to reclaim their money quickly. In the US (in contrast to the UK), depositors are a favoured creditor in the event of a bank failing.

261. Some witnesses argued that, although a pre-funded scheme might suit the US, the UK banking market required a different deposit protection system. The BBA believed that an ex-post funding system was appropriate in the UK due to the concentrated nature of its banking sector, unlike the US which had many smaller institutions and an ex-ante scheme. Witnesses made three primary arguments in favour of ex-post systems in concentrated markets. First, consumer confidence in the viability of an ex-ante fund might be low due to the small size of the fund relative to some single, large member institutions.⁵¹¹ The second reason was that a readily available liquidity pool would not be required because “big bank” failure was much less likely due to risk diversification.⁵¹² The Chancellor of the Exchequer admitted that “I have my doubts as to whether or not we would want to maintain here a standing body that might never be used.”⁵¹³

262. The third argument was that an ex-ante scheme would tie up capital that could otherwise be effectively utilised and would cause an unnecessary drain on the liquidity position of banks.⁵¹⁴ Indeed, it would seem that the main disadvantage of a pre-funded system would be the cost to the industry—costs which would eventually be passed on to banks’ customers. The Chancellor said that:

Of course [a pre-funded scheme] would mean that you would be taking money out of the system at the moment, it would not be free to be lent, and therefore there would be a cost to both savers and borrowers because the banks would have less money available and they would charge more to lend it; so I think there is a trade off. You either take the money out, if you like, up front and, therefore, savers pay by getting less interest rates or those who borrow pay more, or you operate the present system, but that is something which will be part of this consultation that we will look at.⁵¹⁵

263. We believe that the ‘pay as you go’ approach to funding depositor protection, as currently used by the Financial Services Compensation Scheme, has two fundamental

511 British Bankers’ Association Response to the Tripartite Discussion Paper: Banking Reform—Protecting Depositors, page 4

512 *Ibid.*, page 4. Also see Ev 267

513 Q 1755

514 British Bankers’ Association Response to the Tripartite Discussion Paper: Banking Reform—Protecting Depositors, page 4

515 Q 1836

disadvantages. First, it does not create the requisite depositor confidence in the availability of a source of prompt funding, so fails to contribute towards financial stability. Second, a ‘pay as you go’ approach could cause significant pro-cyclicality problems. Such an approach could mean obtaining funding from banks at the worst possible time, whereas a pre-funded model could obtain most of its funding at times of plenty. We have noted the arguments of the British Bankers’ Association that ex-ante funding is not appropriate in the United Kingdom due to the concentrated nature of the United Kingdom’s banking sector. We do not believe that the nature of the banking sector is itself a barrier to the adoption of such a funding arrangement. Objections to an ex-ante scheme appear to be based on the notion that certain United Kingdom banks are ‘too big to fail’. We reject this notion. The principle that must underpin a future scheme is that it should be capable of coping with any foreseeable bank failure. We recommend accordingly the establishment of a Deposit Protection Fund, with ex-ante funding. The Fund would receive contributions from banks and building societies on a regular basis, and be of sufficient size to obviate the need for the Government to step in to rescue a major bank. The establishment of a pre-funded scheme would be a significant cost to the institutions involved, but it seems only right to us that the costs of bank failure should be borne by the industry rather than the taxpayer, as would currently be the case. To ensure that the Fund is adequately resourced from the outset, we recommend that it be financed initially by a Government loan, which would then be repaid over time as banks’ contributions accumulated.

Risk-based contributions

264. Mr Corrigan noted that the FDIC in the US had a risk-based fee system applied to deposit-taking institutions, which, in his view, was “a pretty good idea”.⁵¹⁶ Dr Hamalainen argued that, regardless of the funding model chosen, there should be some consideration of risk-based contributions. He suggested that this could be based on a deposit-taking institution’s probability, and potential impact, of causing a loss to the deposit insurance fund.⁵¹⁷ The BBA argued that the current uniform pricing structure did nothing to force riskier institutions to pay more to the fund to reflect their higher probability of default. The BBA favoured the introduction of a risk-based approach, providing incentives to encourage prudential risk management, so long as this did not distort competition.⁵¹⁸ Experience from other countries suggests that the introduction of such an approach should be feasible. The Canadian Deposit Insurance Corporation, for example, levies contributions from members using risk-based premia. Each year, every member institution is classified into one of four premium categories, based on a system that scores each institution according to a number of factors including capital adequacy, profitability, asset quality and concentration.

265. However, great care would have to be taken in the design of a risk-based system. Banks could be classified as risky for two reasons; these might require a different treatment under the scheme. A bank could be “risky” if it deliberately followed a risky business

516 Q 1253

517 Ev 256

518 British Bankers’ Association Response to the Tripartite Discussion Paper: Banking Reform—Protecting Depositors, page 11

model, in which case it might be argued that it ought to contribute more to a deposit protection scheme. On the other hand, a bank could be “risky” as a result of it being under-capitalised, and forcing it to contribute more than its fair share could drive that bank into deeper trouble. In other words, risk-sharing could push some banks towards prudence, and others towards bankruptcy.

266. In the previous section we recommended the establishment of a Deposit Protection Fund, and suggested how the cost of building up this Fund should be spread over several years. During this initial phase, we recommend that banks’ contributions be based solely on the size of their insured deposit base, in order to minimise complexity. Once the Fund is established, however, there may be a case for the introduction of a system of risk-based premia, whereby each bank contributes according to the Fund’s assessment of the likelihood of needing to compensate depositors. We recommend that the Government, in bringing forward legislation on the establishment of a Deposit Protection Fund, grant powers to that Fund to consult on and introduce risk-based premia once the Fund has been established.

7 Lessons learned

Our inquiry and other reviews

267. Our inquiry, and in particular our analysis of the events in August and September 2007, has been based on the evidence that we have received and our published evidence and other publicly-available information. Although the Governor of the Bank of England told us that he would be willing for the text of a letter of advice he wrote to the Chancellor of the Exchequer to be made public,⁵¹⁹ the Chancellor of the Exchequer told us that the letter contained sensitive information and it was his judgement that it would not be in the public interest to release that letter or the letter he had received from the Chairman of the FSA at present.⁵²⁰

268. The FSA told us that it was conducting its own review of lessons to be learned from its regulation of Northern Rock.⁵²¹ This is intended to be published in March 2008, but may not be published in full.⁵²² **We think it wrong in principle that the Financial Services Authority should be investigating its own failure. We recommend that the FSA ensure that there is an independent component in the analysis of the decision-making of the FSA in relation to Northern Rock.**

The roles of the Tripartite authorities and the overall functioning of the Tripartite arrangements

269. The roles of the Tripartite authorities are set out in the Memorandum of Understanding, signed initially in 1997 by the Bank of England, the Financial Services Authority, and HM Treasury. This memorandum was updated on 22 March 2006.⁵²³ The memorandum states that:

The division of responsibilities is based on four guiding principles:

- clear accountability - Each authority must be accountable for its actions, so each must have unambiguous and well-defined responsibilities;
- transparency - Parliament, the markets and the public must know who is responsible for what;
- avoidance of duplication - Each authority must have a clearly defined role, to avoid second guessing, inefficiency and the unnecessary duplication of effort. This will help ensure proper accountability;

519 Qq 28–29

520 Qq 851–852

521 Q 192

522 Q 1484

523 HM Treasury Website, http://www.hm-treasury.gov.uk/documents/financial_services/regulating_financial_services/fin_rfs_mou.cfm

- regular information exchange - This helps each authority to discharge its responsibilities as efficiently and effectively as possible.⁵²⁴

Under the Memorandum of Understanding, the Bank of England's responsibilities are summarised as contributing "to the maintenance of the stability of the financial system as a whole".⁵²⁵ The FSA's powers and responsibilities stem from the Financial Services and Markets Act 2000, and the FSA has the responsibility of authorising and supervising individual banks.⁵²⁶ HM Treasury has responsibility for the institutional structure of the financial regulatory system, and the legislation behind it.⁵²⁷ In a crisis, the Financial Services Authority would, according to the Memorandum of Understanding, be responsible for "the conduct of operations in response to problem cases affecting firms, markets and clearing and settlements systems within its responsibilities" which it may undertake by "the changing of capital or other regulatory requirements and the facilitation of a market solution involving, for example, an introduction of new capital into a troubled firm by one or more third parties".⁵²⁸ However, the Bank of England would remain in charge of "official financial operations ... in order to limit the risk of problems in or affecting particular institutions spreading to other parts of the financial system".⁵²⁹

270. Some witnesses criticised the division of responsibilities under the Memorandum of Understanding. Professor Buiter argued that:

The very structure of the Tripartite agreement was flawed so I disagreed with the Tripartite agreement before they even started doing anything. The notion that the institution that has the knowledge of the individual banks that may or may not be in trouble would be a different institution from the one that has the money, the resources, to act upon the observation that a particular bank needs lender of last resort support is risky. It is possible, if you are lucky, to manage it, but it is an invitation to disaster, to delay, and to wrong decisions.⁵³⁰

Both Professor Buiter and Professor Wood suggested two potential solutions to this separation. One was to provide the Financial Services Authority with a line of credit from the Bank of England, to allow the Financial Services Authority to provide support for institutions undergoing liquidity squeezes. The other was to return liquidity regulation to the Bank of England.⁵³¹

524 HM Treasury Website, http://www.hm-treasury.gov.uk/documents/financial_services/regulating_financial_services/fin_rfs_mou.cfm

525 Memorandum of Understanding between the Bank of England, Financial Services Authority and HM Treasury, 22 March 2006, Para 2

526 Memorandum of Understanding between the Bank of England, Financial Services Authority and HM Treasury, 22 March 2006, Para 3

527 Memorandum of Understanding between the Bank of England, Financial Services Authority and HM Treasury, 22 March 2006, Para 4

528 Memorandum of Understanding between the Bank of England, Financial Services Authority and HM Treasury, 22 March 2006, Para 3

529 Memorandum of Understanding between the Bank of England, Financial Services Authority and HM Treasury, 22 March 2006, Para 2

530 Q 854

531 Qq 866, 894

271. The BBA was less keen on such a radical reform of the current assignment of responsibilities, arguing that:

Any decision to, for example, move banking regulation in its entirety back to the Bank of England would therefore result in significant co-ordination issues with the FSA for the purposes of, at the very least, securities regulation and conduct of business rules. Alternatively, reducing even further the role of the Bank of England would be disadvantageous to the reputation of the UK overseas.⁵³²

Ms Knight suggested that the resources devoted to financial stability in the Bank of England and HM Treasury were insufficient. She thought that “there is a lot of work being undertaken on financial stability within the FSA but there are not all that many people on that side within the Bank of England, and as far as financial services and the Treasury is concerned, we would like to see that side strengthened as well”.⁵³³

272. The Tripartite authorities defended the division of responsibility for the regulation of financial institutions and the provision of liquidity between two institutions. The Governor of the Bank of England did not believe that “one institution—a central bank—can manage in today's world both monetary policy and the entire range of financial supervision”.⁵³⁴ Mr Sants suggested that the location of the supervisory department for banks would not have “made any difference to the set of circumstances which transpired prior to July, nor would it have made any difference to the information being passed over to the relevant part of the bank with regard to monetary operations during the course of August and September”.⁵³⁵ Sir Callum McCarthy said that “the idea of transferring banking supervision separately from insurance and security supervision is an idea that has severe disadvantages”.⁵³⁶ He also opposed the idea of the Financial Services Authority receiving a credit line from the Bank of England, telling us that:

There is a question about whether the only route providing finance should be via the Bank of England or whether the Government should have other agencies that it could use. I think that is something which is a possible route. I should make clear that I am not arguing for the FSA to have a very large balance sheet. That is the last thing I want.⁵³⁷

273. The Chancellor was also convinced that there was a need for the separate roles of the institutions of the Tripartite arrangement, stating his view 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

532 Ev 295

533 Q 1572

534 Q 90

535 Q 1506

536 Q 1506

537 Q 1519

not think anyone would argue we should go back to where we were ten years ago when we had seven or eight different regulators.⁵³⁸

274. However, the members of the Tripartite authorities did accept there was some scope for change within the current structure. While one of the guiding principles of the memorandum of understanding is the ‘avoidance of duplication’, Sir John Gieve told us that “we have been deliberately careful under the [Memorandum of Understanding] not to get involved in assessing individual institutions because that has been the FSA’s job, but there is a question about whether it would be helpful for us to go a little bit further in drawing out the lessons for particular institutions where that would help the FSA in their task of identifying vulnerabilities”.⁵³⁹ The Chancellor of the Exchequer accepted that “there are changes that need to be made, particularly in the interface between the Bank and the FSA”.⁵⁴⁰

275. One of the ‘guiding principles’ within the Memorandum of Understanding is that of ‘regular information exchange’. When asked to consider how well the Tripartite system had worked in its response to the events of Northern Rock, Sir Callum McCarthy told us that:

If I look at the actual work during the time of the post 9 August problems, I think that the clarity of information between FSA and bank was quite clear and I think that the transmission of information in both directions worked well. From essentially 9 August we set up a daily Tripartite meeting in which we compared notes and information and identified problems. So I think that overall those arrangements worked well.⁵⁴¹

This view was supported by the Governor of the Bank of England, who told us that “my own view, for what it is worth, is that the [Memorandum of Understanding] worked well and it is very sensible to have the responsibilities laid down so that you know what we are accountable for”.⁵⁴²

276. We cannot accept, as some witnesses have suggested, that the Tripartite system operated “well” in this crisis. In terms of information exchange between the Tripartite authorities, the system might have ensured that all the Tripartite authorities were fully informed. However, for a run on a bank to have occurred in the United Kingdom is unacceptable, and represents a significant failure of the Tripartite system. If the system worked so “well”, the Tripartite authorities should take a closer look at the people side of the operation.

277. Although we have concerns about the operation of the Tripartite system, we do not believe that the financial system in the United Kingdom would be well-served by a dismantling of the Tripartite system. Instead, we want to see it reformed, with clearer leadership and stronger powers.

538 Q 749

539 Q 1731

540 Q 757

541 Q 178

542 Q 27

War games and lessons learnt

278. One criticism raised of the Tripartite authorities was that they appeared not to have prepared fully for a crisis such as that which arose in August 2007. We had heard at the time of our session on ‘Financial Stability’ in February 2007 that the Tripartite authorities undertook scenario tests of the financial system, and that these had been useful in understanding how the Tripartite authorities would work together. Mr Sants told us then that:

Particularly through the tests, though, critically, we do all understand better what our relevant roles are and, particularly at the operational level, how it would all fit together in the event of a crisis—that testing it all works is actually the real way to get into the guts of whether it is functioning properly rather than the particulars of the memorandum; and the fact that we have done tests in the last year or two which previously had not been done, I think, is critical to us feeling that it works better.⁵⁴³

279. During the current inquiry we learnt that in 2005 a crisis scenario test at Deputy level identified weaknesses in the legislative framework for failing banks.⁵⁴⁴ In late 2006, after a crisis exercise undertaken at principal level, it was agreed that a work programme was needed to work on these “key issues”.⁵⁴⁵ According to the Governor of the Bank of England, work on this programme had begun at the Treasury by the time of the Northern Rock crisis.⁵⁴⁶ Minutes said that it had been classed as “urgent”.⁵⁴⁷ When questioned whether the Treasury was “dragging its feet”, the Governor downplayed this urgency, and also suggested that it was necessary to ensure that the legislation was right:

I do not believe it has been dragging its feet, no. I could perfectly well have written in June and said, ‘Look, what is going on with this?’, and we asked about it, but I think this is a matter where it was important to persuade people, including you, to look at the experience of other countries and recognise that maybe this is one case where we can learn something from the rest of the world; but to win opinion over and to get new legislation through is not an easy or quick matter and it may not be sensible to rush it. There did not seem at the time any obvious reason for this to be urgent in 2007 as opposed to 2008.⁵⁴⁸

The Chancellor reiterated these points when we questioned why action had not been taken quicker to counteract these deficiencies in the legislative framework. The Chancellor told us that:

As the Governor said, in 2006 it was identified that there were weaknesses, there were things that needed to be done, and work streams were put in place because this is complex. When you see our proposals when they are published at the end of this month, there will be a lot of people who will say, ‘Look, this is very complicated. You

543 Financial Stability’, HC 292-i, Session 2006-07, Q 8

544 Qq 1616, 1632

545 Qq 1632, 1633

546 Q 1634

547 Q 1642

548 Q 1637

need to have a lot of thought about this. You won't have got it right first time', so that work was being carried out, but, as the Governor himself said in December when he appeared before you, at that time, simply because the present situation was not an immediate contemplation, he said that he did not attach that degree of urgency which, with the benefit of hindsight, others are now demanding.⁵⁴⁹

280. The Memorandum of Understanding clearly states that responsibility for the legislative framework rests with the Treasury. Two years ago a weakness in that framework appears to have been identified and by late 2006 had been classed as requiring "urgent" action. Between late 2006 and mid-2007, the measures to rectify this weakness appear to have been pursued by the Tripartite authorities with insufficient vigour. We address methods of dealing with this in Chapter 8.

Leadership

281. One of the criticisms of the operations of the Tripartite authorities is that it appeared to lack a leadership structure. The Memorandum of Understanding states that, when a support operation is being considered:

The Bank and the FSA are each to assess, from the perspective of their distinct responsibilities and expertise, the seriousness of the crisis and its potential implications for the stability of the financial system as a whole. They will each provide their separate assessments to the Treasury, together with their views on the options available to the Chancellor.⁵⁵⁰

The memorandum also states that "Ultimate responsibility for authorisation of support operations in exceptional circumstances rests with the Chancellor".

282. The BBA suggested several weaknesses in the Tripartite command structure. Their written evidence states that there was "no one entity clearly in the lead" and that there was "insufficient clarity in the allocation of roles, responsibilities and authority of the parties to the Tripartite authorities".⁵⁵¹

283. When we questioned the Tripartite authorities as to who was in charge, the Governor's first reply was "What do you mean by 'in charge'? Would you like to define that?".⁵⁵² When we further questioned him as to who was responsible, he replied "We are each responsible for the various responsibilities that we have been given under the [Memorandum of Understanding]".⁵⁵³ Sir Callum McCarthy made a similar point, telling us that:

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

549 Q 1810

550 Memorandum of Understanding between the Bank of England, Financial Services Authority and HM Treasury, 22 March 2006, Para 13

551 Written Ev 295

552 Q 24

553 Q 25

responsibilities of the FSA and here are the responsibilities of the Chancellor and the Treasury, I will give the same answer.⁵⁵⁴

The Chancellor of the Exchequer, however, acknowledged that the ultimate responsibility lay with him. When asked who was in ‘overall charge’, he replied:

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.⁵⁵⁵

284. While we welcome the Chancellor’s admission that he was ultimately in charge of the decision making process relating to Northern Rock, we are concerned that, to outside observers, the Tripartite authorities did not seem to have a clear leadership structure. We recommend that the creation of such an authoritative structure must be part of the reforms for handling future financial crises and this informs the recommendations we make in the next Chapter.

Communications strategy with the public

285. In our evidence session on Financial Stability in February 2007, Jon Cunliffe, then second Permanent Secretary to the Treasury identified that a Tripartite basis for formulating a communications strategy was an important part of dealing with crisis. He stated that:

If you look at the interactions between us—take, for example, the issue of communication to the market in the event of a terrorist incident or pandemic flu—it is a clear case where the authorities need to work together because communication is one of the tools you use to manage a crisis.⁵⁵⁶

Several witnesses argued that the Tripartite authorities had lacked a coordinated, effective communications strategy, especially around the time of the announcement of the support operation in mid-September. The BBA criticised the communications strategy. Their written evidence noted two deficiencies in the communications issued by the Tripartite authorities:

no attention given to the complex and obscure message in the Lender of Last Resort Statement;

a lack of preparedness by the authorities to explain and communicate their Lender of Last Resort statement either at the point at which the leak took place or once the formal announcement had been made the following morning.⁵⁵⁷

554 Q 272

555 Q 753

556 ‘Financial Stability’, HC 292-i, Session 2006-07, Q22

557 BBA Ev 295

Professor Buitter argued that:

Following the announcement of the Liquidity Support Facility, there should have been a joint appearance by the Prime Minister, the Chancellor of the Exchequer, the Governor of the Bank of England, the Chairman of the FSA and the CEO of the FSA, looking solemn and reliable, and intoning jointly: ‘your money is safe’. It might not have prevented the banana-republic-style bank run that started on the 14th, but it was worth a try.⁵⁵⁸

286. Mr Coles also suggested to us that the communications lacked a clear command structure:

It was not clear who was actually in charge of making that communication ... Who is in charge of communication when you have got a crisis problem and where there is a crisis of confidence, which is essentially a communication issue, is a very important improvement that needs to be made to the [Memorandum of Understanding].⁵⁵⁹

287. Professor Wood suggested that some of the terminology used by the Tripartite authorities was inappropriate. He told us that “Calling [the Bank of England liquidity support operation] emergency lending was I suppose asking for trouble”.⁵⁶⁰ And the Building Society Association, while acknowledging that a better communications strategy might not have prevented a run on Northern Rock, also suggested that the terminology used was unhelpful. They pointed out that “[regulators] failed to speak plain English: assurances from the FSA that Northern Rock was, for example, ‘solvent’ cut no ice with the bank’s retail customers because it is not a term that is widely understood by non-technicians”.⁵⁶¹

288. The Financial Services Authority accepted that the communication strategy had been imperfect. Mr Sants told us that “there are significant lessons to be learned in terms of the way the Tripartite authorities communicate around these types of issues, both the terminology and the way we handle the release of the news, and we have already started to learn from those lessons and continue to so do”.⁵⁶² The Governor of the Bank of England, while stating that the communications strategy had been placed under pressure by the premature disclosure of the support operation, acknowledged that “clearly, we need to think further about [the communication strategy]”.⁵⁶³

289. There was no sign of a communications strategy of the Tripartite authorities during the crisis of September 2007. We believe that this was a contributory cause of the run on the bank. The Tripartite authorities must learn the lessons of the failure or absence of a communications strategy between 10 and 17 September. We recommend that the Tripartite authorities revise their communications arrangements for future

558 Buitter Ev 328

559 Q 1574

560 Q 874

561 BSA Ev 305

562 Q 1533

563 Q 1615

crises, to ensure a single, coherent and coordinated message, which was absent in the crisis in September 2007. This message needs to take into account the public's likely reaction, and be in language people can readily understand.

Damage to the Tripartite authorities and UK economy

290. The financial services industry plays an important role in the economy for the United Kingdom. The images of people queuing outside a UK financial institution were therefore damaging to the reputation of UK financial services. When asked to assess this damage, Ms Knight was very critical, telling us that:

I think it has been quite damaging actually. I went out to Brussels in about the middle of September for the first time, and I keep going out there, and also because we are an association where 60% of our members are from overseas, we get the impressions of the industry and of authorities around the world, and London does rather look like its authorities dropped the ball, that when push came to shove and a problem arose other countries managed it and the UK somehow did not. It is because so much of it got played out in the public domain and queues outside banks are immensely visual things. I think that we have to recognise that it has done us damage and that we have quite a lot of work to do to restore that damage.⁵⁶⁴

Professor Buiters in his written evidence stated that:

The way the crisis unfolded damaged the prestige and international standing of the City of London—the financial capital of the world—more than the other leading financial centres. The damage is manageable and remediable, but only if effective steps are taken to correct the many manifest weaknesses of the UK financial system that were brought to light by the crisis.⁵⁶⁵

291. The Chairman of the Financial Services Authority acknowledged that the events around Northern Rock had been “damaging”.⁵⁶⁶ However, the Governor of the Bank of England appeared to be more sanguine about the damage to the UK banking system from the Northern Rock crisis:

I do not believe that in a years time people will look back and say there was any lasting damage to the British banking system. It is very well capitalised, it is very strong, and, as I explained before, although the banks at present are having to pay a bit more for their liquidity than they would wish, they will be able over the coming months to take these vehicles and conduits they have set up back onto their balance sheets and they will be strong. Headlines come and headlines go and even television pictures come and go, and I cannot believe and I do not believe that there is any lasting damage to the reputation of the British banking system, although I fully

564 Q 1603

565 Ev 327

566 Q 152

understand that the impact of the pictures on television last weekend came as a shock to many.⁵⁶⁷

292. The events surrounding the crisis at Northern Rock have been damaging to the financial services industry in the United Kingdom, and for the Tripartite authorities. It is important that the lessons are learnt from this crisis, and that the changes that result from this process are implemented swiftly, given the continuing problems in the world's financial markets and the desirability of ensuring that the damage to the United Kingdom's reputation as a financial centre is minimised.

Tripartite influence on companies receiving support

293. In Chapter 9 we will explore the extent to which State support for Northern Rock was matched by state involvement in the running of Northern Rock. In Chapter 5 we set out a range of additional powers that should reduce the need for future relationships between the Tripartite authorities and a failing bank of the kind seen in the case of Northern Rock.

294. Where Government money is advanced to a financial institution, the Government, should take appropriate management control or should ensure that it has sufficient control over the activities of the company to ensure that taxpayers' interests are not prejudiced.

The audit of high-risk financial institutions

295. We discussed with the auditors of Northern Rock, PricewaterhouseCoopers, their role at Northern Rock. Mr Sexton, head of the UK assurance practice at PricewaterhouseCoopers, outlined the conduct of an audit of a firm:

The audit is performed in accordance with standards and regulations in the UK now issued predominantly by international bodies. It seeks to provide comfort about historical financial information as embodied within the financial statements included in a company's annual report. That is the role of the statutory audit. In the UK we do perform other work at times at the request of companies predominantly in connection with interim announcements. That is also performed in connection with practice guidance issued by the Auditing Standards Practices Board in the UK.⁵⁶⁸

296. Mr Hitchins, a banking audit partner of PricewaterhouseCoopers, explained that the only additional duty of the auditors in relation to the audit of a bank as opposed to another type of company was that there was a "statutory duty to report to the FSA if we [the auditors] become aware of anything that is material to the exercise of the FSA's functions".⁵⁶⁹ Mr Hitchins later explained that the auditor's duty of care towards the Financial Services Authority "is to make sure the information in the regulatory returns is consistent with the information we have audited".⁵⁷⁰ However, Mr Sexton also noted that

567 Q 114

568 Q 1278

569 Q 1279

570 Q 1342

the auditor was not under a duty of care to point out certain aspects of the structure of Northern Rock's liabilities to the Financial Services Authority.⁵⁷¹

297. When asked whether they as the auditors should have picked up on the risks that Northern Rock was taking in its liquidity strategy, the response of the witnesses was that the accounts of Northern Rock accurately portrayed the state of the company. Mr Sexton explained that:

I believe that the audit process as judged by reference to the specifics of Northern Rock in the annual and interim reports—our opinion on the latter was signed on 25 July—discloses very accurate information about liquidity and other structures within Northern Rock.⁵⁷²

One issue we discussed was why the auditors had declared Northern Rock a “going concern”. In its memorandum, PricewaterhouseCoopers laid out why it thought that it was right to accept that Northern Rock was a “going concern”:

In the first instance, the directors are responsible for making the assessment that the bank is a going concern. That is normally taken to mean that an entity is ordinarily viewed as continuing in business for the ‘foreseeable future’ with neither the intention nor the necessity of liquidation, ceasing trading or seeking protection from creditors pursuant to laws or regulations. The ‘foreseeable future’ is usually taken as meaning the next 12 months. As ISA570 observes at para 6 ‘When there is a history of profitable operations and a ready access to financial resources, management may make its assessment without detailed analysis.’ The bank fell into this category. It had traded profitably and it had a track record of ready access to funds at low spreads over LIBOR indicating a willingness by lending institutions to provide finance. In February 2007 there were no indications in the financial markets that the then extant circumstances were to change dramatically. As the relevant auditing standard observes ‘Any judgment about the future is based on information available at the time at which the judgment is made. Subsequent events can contradict a judgment which was reasonable at the time it was made.’ [ISA570 para 7] Obviously the future is by its nature uncertain, and the relevant auditing standard therefore requires the auditor to consider whether there is a ‘material uncertainty’ that ‘may cast significant doubt’ that the company may not be a going concern.⁵⁷³

PricewaterhouseCoopers then discussed whether there was a “material uncertainty” for Northern Rock. They concluded that, having considered the operating plans of the company, external forecasts of the UK domestic mortgage market and the post year-end trading results, “None of these exhibited any features other than to indicate a substantial profit for the bank with every rational expectation that there would be no significant financing difficulties”.⁵⁷⁴

571 Q 1345

572 Q 1301

573 Ev 339

574 Ev 339

298. A second issue we discussed was whether there was a conflict for an auditor between its non-audit and audit work. In its written evidence, PricewaterhouseCoopers stated that of the £1.8 million paid in fees to the auditor by Northern Rock, total audit fees as statutory auditors were £1.1 million, leaving £700000, which was “largely comprised of fees relating to assurance services in connection with the bank’s actions in raising finance”.⁵⁷⁵ These “assurance services” were “comfort letters on the financial information in [the offering] circulars [for securitisation]”.⁵⁷⁶ Mr Sexton while acknowledging that more securitisations meant more money for the auditors for these comfort letters, did not accept that this had been encouraged by PricewaterhouseCoopers:

Under our ethical standards we cannot provide any kind of management input to a company to encourage it to perform one transaction or another. That is completely forbidden under our ethical standards. We cannot create a transaction flow in order to charge fees; it is purely a reaction to the level of transactions that a company may or may not choose to undertake.⁵⁷⁷

As well as this, PricewaterhouseCoopers noted that, for Northern Rock, this balance of fees was actually less weighted towards fees other than those for statutory audits than at other firms. In the case of Northern Rock, the ratio of the auditor’s fees for other work against their fees for statutory audit work was less than one, whereas as Mr Sexton pointed out:

If one looks at the FTSE 100 analysis in the 12 months broadly to 31 December—you will appreciate that year ends are different for different companies—the ratio is of the order of 1.1 to one.⁵⁷⁸

299. A lesson to be learnt from this crisis is that the auditor can only provide an assurance of a snapshot of the past state of the company. We recommend that the accounting bodies consider what further assurance auditors should give to shareholders in respect of the risk management processes of a company, particularly where a company is regarded as an outlier. We are also concerned that there appears to be a particular conflict of interest between the statutory role of the auditor, and the other work it may undertake for a financial institution. For example, PricewaterhouseCoopers received £700,000 in non-audit fees largely comprised of fees relating to assurance services in connection with Northern Rock’s actions in raising finance”. We note the work being undertaken by the accounting boards in respect of this issue and recommend that both they and the FSA give swift consideration to such particular conflicts in financial institutions.

575 Ev 340

576 Q 1293

577 Q 1365

578 Qq 1362-1363

8 Reforms

Introduction

300. We have concluded in the previous chapters that three sets of additional powers are required by the regulatory authorities: those related to ‘prompt corrective action’, the special insolvency regime for banks, and the change of rules around deposit protection. In this section, we deal with how modifications to the Tripartite structure will be required to enable the authorities to operate these new powers.

The Deposit Protection Fund

301. We have already recommended that deposit protection should be pre-funded. This pre-funding will lead to the creation of a Deposit Protection Fund. The creation of such a fund will act as a visible reminder to depositors of the safety of their insured deposits. Because of the need for consumer confidence in the Fund, the location of the fund within the Tripartite structure, or in a new institution, places upon that institution certain responsibilities. In essence, the institution in charge of the Fund would have a responsibility which may be summarised as protecting the Fund. This responsibility will lead to duties for identifying weak financial institutions, failings in the regulatory system, or systemic threats to banks where they are vulnerable to the macroeconomic or overall financial environment.

302. It is obvious from the evidence we have received that the Financial Services Compensation Scheme (FSCS) as it stands is in no position to assist with the failure of a large deposit-taking financial institution. However, it has coped well with the collapse of smaller institutions, such as credit unions. It also engages with insurers, mortgage advisers and Independent Financial Advisors. **The Financial Services Compensation Scheme model works well for all institutions other than large deposit-taking institutions, where systemic risk is more prevalent. We therefore recommend that the Financial Services Compensation Scheme continue to operate under its current regime for all institutions other than large deposit-taking institutions. We also recommend that the authority in charge of the Deposit Protection Fund decide on how such large institutions should be selected. However, in order to prevent discrepancy in the market, we recommend that the insured deposit limit for individuals under the continuing Financial Services Compensation Scheme be equal to that under the Deposit Protection Fund.**

Regulatory powers

303. We have already discussed in Chapter 5 the additional regulatory powers required for ‘prompt corrective action’ and in dealing with bank insolvencies. The question then arises as to where within the regulatory system such powers should reside.

304. In our visit to the United States, we learnt that occasionally a failing bank would raise its interest rates to encourage further deposits at that institution, in the hope that such deposits would see it through its period of weakness. Consumers continued to invest with that bank, sometimes despite knowing it might fail, because of the deposit insurance provided by the FDIC. The regulatory authorities in the United States therefore have the

power, under certain circumstances, to restrict or prevent banks from accepting new deposits to prevent such abuse of the deposit insurance scheme. This is one example of the necessity of the new regulatory powers that would be required to protect the operation of the Deposit Protection Fund. **We therefore recommend that the new regulatory powers relating to banks set out in Chapter 5 of this Report reside with the institution that also controls the Deposit Protection Fund.**

305. We have already concluded that we do not wish to dismantle the current structure of the Tripartite system. We therefore do not support the creation of a new institution similar to the US Federal Deposit Insurance Corporation.

Quis custodiet ipsos custodes?

306. We have concluded that one of the responsibilities of the holder of the Deposit Protection Fund will be to identify regulatory failings that might affect the Fund. One of the elements of the United States regulatory system frequently mentioned to us during our visit as important was ‘creative tension’. The organic growth of the United States regulatory system has led to multiple regulatory agencies with overlapping responsibilities. This overlap, while at a cost of potential duplication of work for financial institutions, has also meant that regulatory authorities have challenged each other over their regulatory decisions and outlook. Regulators in the United States impressed upon us the benefit of having other regulators questioning their work. This ‘creative tension’ between regulators was felt to play an important part in ensuring a more dynamic regulatory environment.

307. Placing the proposed new regulatory powers with the Financial Services Authority would benefit from the synergies of being held by the current regulator. However, such a move would reduce the capability for ‘creative tension’ within the regulatory system. As well as this, there are several other potential conflicts of interest for the Financial Services Authority if it were to assume the additional powers and responsibilities. In such circumstances, a conflict would arise between the role of the Financial Services Authority as regulator and its new role enforcing action on a financial institution that might be in trouble as a result of lax regulation. The second is the conflict between the current requirement under the Memorandum of Understanding of the Financial Services Authority to act to try and find a private sector solution for a failing financial institution, and also be the regulator of the receiving financial institution. Thus, by trying to protect the depositors of one institution, it might place at risk the depositors and shareholders of another by promoting or facilitating a private sector solution.

308. We consider the need for ‘creative tension’ within the regulatory system as of sufficient importance to justify overlooking any possible synergies of co-locating the new powers recommended in this Report alongside the existing powers of the Financial Services Authority. We have concluded it would be inappropriate for the Financial Service Authority to receive the Deposit Protection Fund, or the associated additional powers. As such, this leaves the Treasury and the Bank of England as the remaining candidates for receiving the Depositor Protection Fund and those powers.

The limits of political control

309. We have already concluded that there is a need for banks to be allowed to ‘fail’ so as to preserve market discipline. But they must do so in an orderly manner. One of the other lessons that was emphasised to us in the United States was the potential over-emphasis of politicians on the need to save banks because of political concerns, rather than from an appraisal of the underlying economic arguments of whether a firm should fail. To counter this threat in the United States, the Federal Deposit Insurance Corporation Improvement Act 1991 [FDICIA] contained the ‘systemic risk exception’, which restricted the ability of policy-makers to override the ‘least-cost’ to the taxpayer requirement for bank resolution discussed in Chapter 5. Ms Bair, Chairman of the Federal Deposit Insurance Corporation in a speech in Washington DC, explained how the onerous requirements for the use of ‘systemic risk exception’ curtailed the Federal Deposit Insurance Corporation’s support for preventing losses above the insured amounts:

The systemic risk provisions of FDICIA also significantly raised the bar for policy-makers inclined to favour short-term stability. According to FDICIA, safety net protections can be extended beyond insured depositors only if it can be determined that not doing so would ‘have serious adverse effects on economic conditions and financial stability.’ To invoke the systemic risk exception, FDICIA requires a two-thirds majority of both the Boards of the FDIC and the Federal Reserve, as well as the approval of the Secretary of the Treasury, who must first consult with the President. In addition, the banking industry must pay for the additional cost associated with a resolution pursuant to a systemic risk finding through a special assessment. Because the special assessment is to be proportional to each bank’s liabilities, large banks will bear the greatest burden of paying for the extension of the safety net.⁵⁷⁹

As well as this, we have already concluded [in Cross reference] that support operations will be only enacted ‘as a last resort’. This will further reduce the need for the Treasury to be involved with decisions relating to failing banks.

310. It is right that where taxpayers’ money is being used in a support operation, there should be political responsibility, and that the Chancellor of the Exchequer should make the final decision on whether such operations should be conducted. However, in most instances, regulatory action should and will be taken before such “last resort” support is required. This would be the benefit of a “prompt corrective action” approach. As such, we see no reason for the Chancellor of the Exchequer to be primarily responsible in the decisions that do not require taxpayer support. We have therefore concluded that it would be inappropriate for that the Treasury be the location for the Deposit Protection Fund.

Allocation of the new powers and their relationship to existing responsibilities of the Bank of England

311. The Bank of England is therefore a potential recipient of responsibility for the additional powers in relation to banks in distress that we proposed in chapter 5 and for the

⁵⁷⁹ Remarks by Sheila C. Bair, Chairman, Federal Deposit Insurance Corporation at the Exchequer Club; Washington, DC on March 21, 2007

Deposit Protection Fund that we proposed in chapter 6. In relation to the powers under chapter 5, allocation of these responsibilities to the Bank of England would complement the Bank's existing oversight of liquidity and its money market operations, and would strengthen the involvement of the Bank with the liquidity of individual banks. In relation to the powers under chapter 6, attribution to the Bank of England would make sense given that the Bank of England has experience in handling pools of assets of the kind that would be built up by the Deposit Protection Fund, such as the Cash Ratio Deposit Scheme. Overall, the new powers would dovetail with the existing responsibilities of the Bank of England in relation to financial stability, while at the same time ensuring the 'creative tension' that we earlier said that we wished to see in the regulatory system. Such a change would also respond to the concern of the BBA that downplaying the role of the Bank of England would not be regarded well by the international community.⁵⁸⁰

312. However, we consider that reform of the management structure of the Bank of England will be required in order for the new powers to be carved out effectively within the Bank of England. Such reform will be necessary to ensure that proper weight is given to the increased responsibilities within the management structure, while also maintaining the appropriate priority for the conduct of monetary policy. The events of August and September 2007 have highlighted the need for a Chancellor of the Exchequer to receive authoritative and co-ordinated advice in any future case where financial stability is threatened by difficulties in the banking sector. The reforms must therefore be implemented in a manner that ensures that advice can be given which reflects a full understanding of information available within the FSA and the perspective of the FSA as well as that of the Bank of England.

313. There is also a need to protect the independence of the Monetary Policy Committee of the Bank of England. Professor Buiter highlighted this problem when discussing whether support operations should be conducted by the Bank of England:

The market support will always have to be done by the Bank of England, and you may therefore wish to put the individual institution support there as well. I think there are tensions there with central bank independence because especially individual institution-specific support operations are always deeply and inherently political (with a very small "p") because property rights are at stake and it is difficult to have that done by the same institution that is meant to be non-political. If you were to give banking supervision and regulation, including the lender of last resort knowledge therefore, back to the Bank of England, then you might want to take the MPC out of the Bank of England.⁵⁸¹

Professor Buiter also noted the need for the Monetary Policy Committee to achieve its policy rate by undertaking operations in the money markets. Such operations will remain in the purview of the Monetary Policy Committee, but the same would not apply to other money market operations.

580 Ev 295

581 Q 866

314. We do not consider that it would be appropriate for the Governor of the Bank of England to assume direct responsibility for the exercise of the new powers that we have proposed in chapters 5 and 6 relating to handling failing banks and the new Deposit Protection Fund. We envisage that the exercise of the new powers should rest first and foremost with a person who should have full-time responsibility for that exercise. We are also not convinced that direct responsibility for the new powers by the Governor of the Bank of England is appropriate in view of the Governor of the Bank of England's duties as Chairman of the Monetary Policy Committee.

315. We recommend the establishment of a new post of "Deputy Governor of the Bank of England and Head of Financial Stability". He or she will have direct responsibility for the exercise of the new powers we have proposed in Chapter 5 and for the Deposit Protection Fund. The holder of the new post should have full authority within the Financial Services Authority to meet the requirements of his or her post. We recommend that paragraph 1(2) of Schedule 1 to the Bank of England Act 1998 be amended so that the Deputy Governor and Head of Financial Stability would not be required to work exclusively for the Bank of England. The holder of this new post will have a key role in ensuring that a Chancellor of the Exchequer receives authoritative and co-ordinated advice in any future case where financial stability is threatened by difficulties in the banking sector, and that post-holder would be one of the principal channels of advice to the Chancellor of the Exchequer.

316. An extension of the responsibilities of the Bank of England in the manner we have recommended and the creation of the post of Deputy Governor and Head of Financial Stability must be accompanied by a review of the management structure and lines of responsibility within the Bank of England to ensure that:

- the Governor of the Bank of England's authority and leadership within the new structure of the Bank of England remains clear; and
- there is an appropriate division of management and other responsibilities between the holder of the new post and the other Deputy Governor of the Bank of England.

We recommend that, as part of this review, consideration be given as to whether it would be appropriate for the holder of the post of Deputy Governor and Head of Financial Stability to be a member of the Monetary Policy Committee or whether that position should be assumed by a senior member of Bank of England staff specifically charged with responsibility for the interface between financial stability and monetary policy. We recommend that the Deputy Governor and Head of Financial Stability have an important role in the Bank of England's money market operations, but work will be needed to clarify the distinction between that role, and the role needed to ensure money market operations to enact monetary policy.

317. We recommend that an Office of the Deputy Governor and Head of Financial Stability be created within the Bank of England, including staff seconded from the Financial Services Authority, HM Treasury and other organisations.

Responsibilities of the Office of the Deputy Governor and Head of Financial Stability

Horizon scanning

318. The Office must develop a forward-looking analysis, attempting to identify trends and potential risks to the financial system, and provide a regular update on those risks for the financial community. This role would also include adapting and improving stress-testing techniques, both at the system and individual institution level.

Ensuring that warnings are heeded

319. One aspect of the recent crisis is the apparent lack of attention paid by financial institutions to the warnings of the Financial Services Authority and the Bank of England. The Office of the Deputy Governor and Head of Financial Stability should be charged with ensuring a feedback system is incorporated between financial institutions and the regulatory authorities for issues relating to financial stability. This feedback system will not just be limited to the financial institutions that have absorbed the message, but also whether the Financial Services Authority has taken these messages onboard. This would of course be linked to the horizon scanning function we outline above. We will discuss this further in our Report on Financial Stability and Transparency.

Undertaking analysis and regulatory action to protect the Depositor Protection Fund

320. To protect the Deposit Protection Fund for which it would be responsible, the Office of the Deputy Governor and Head of Financial Stability would identify outlying, weakened or potentially systemic financial institutions, and ensure that 'prompt corrective action', if needed, is undertaken. In more extreme circumstances, the Office would have the power to place an institution in the special resolution regime. Such a role would, of course, see this Office working closely with the Financial Services Authority, and we would expect full information disclosure between the Office and the Financial Services Authority. The expectation would be that, while the Office of the Deputy Governor and Head of Financial Stability would have the power to send inspectors into financial institutions covered by the Deposit Protection Fund and to those to which it is considering extending its protection, it would in the main rely on information provided by the Financial Services Authority, marrying this information with the information the Bank of England also receives via its operations in money markets, and liaison work conducted by the Office.

Crisis management unit

321. We have already concluded that the communications strategy for handling the September 2007 crisis was weak. We therefore recommend that the Office of the Deputy Governor and Head of Financial Stability be given lead responsibility within the Tripartite authorities on ways to ensure that there is clear, coherent and effective communications with the public and the markets in any future financial stability crisis.

322. We recommend, given the potential for a conflict of interest between different functions of the Financial Services Authority, that the Deputy Governor and Office of the Head of Financial Stability be given the role of leading for the Tripartite authorities in relation to the identification of third-party buyers for stricken firms.

323. We recommend that the Office of the Deputy Governor and Head of Financial Stability be given the role of identifying and managing the relationship of the Tripartite authorities with third-party private sector assistance.

Legislative reform

324. One of the lessons learnt from this crisis is that legislation had been in preparation before the crisis hit; but that preparation process was not well-advanced. We recommend that the Office be responsible for identifying weaknesses in the legislative framework for financial stability and crisis management and liaising with the Treasury on the formulation of appropriate legislative responses.

325. To prevent an overburdening of the Deputy Governor and Head of Financial Stability, we recommend consideration be given to the case for each of the tasks outlined above to be assigned to a separate Director within the Office of the Deputy Governor and Head of Financial Stability to be charged with overseeing each task.

Reporting and Accountability

326. We recommend that, in addition to being responsible for the Bank of England's Financial Stability Report, the Office of the Deputy Governor and Head of Financial Stability produce an annual report on its activities and the work of the Tripartite Standing Committee.

Characteristics of the Head of Financial Stability

327. As the focal point for most work to be conducted on financial stability, the 'Deputy Governor and Head of Financial Stability' will require certain attributes. Some of these attributes will relate to the work he or she might have to undertake in a crisis, others to his or her role as one of the principle channels of advice to the Chancellor of the Exchequer. We recommend that the Deputy Governor and Head of Financial Stability should have credibility in the financial markets.

Any appointee to this new post would be the subject of a pre-appointment hearing with this Committee.

Operation of the Tripartite arrangements under the new structure

328. We recommend that there should be at least one meeting of the Tripartite standing committee at the Principal level every six months. We would expect a Chancellor of the Exchequer to ensure that, in any case where financial stability is threatened, he or she would be able to draw directly upon the experience and advice of the Deputy Governor and Head of Financial Stability as well upon that of the Governor of the Bank of England and the Chairman of the FSA.

329. We recommend that formal advice given to the Chancellor of the Exchequer by the other Tripartite authorities in any future circumstances where financial stability is threatened be published as soon as reasonable after the immediate threat has passed, excluding any commercially sensitive information.

Responsibilities of the Treasury

330. The Treasury normally deploys approximately 65 staff to work on financial services, as well as allocating 50% of the department's legal resource to that team. Sixteen of those 65 staff would normally work in the Financial Stability and Risk team. By October 2007, 15 additional staff had been temporarily allocated to work on these issues.⁵⁸²

331. We have already recommended that the Head of Financial Stability be the principal adviser to the Chancellor of the Exchequer on Financial Stability issues. The proposals in this chapter should help to ensure that, in future crises, a Chancellor of the Exchequer receives clear, consistent and authoritative advice. We believe that the reforms outlined in this chapter will reduce the reliance on the Treasury's own resources in future crises. Nevertheless, it is the responsibility of all Chancellors of the Exchequer to satisfy themselves that they and their ministerial team are fully prepared for the roles they could be called upon to play in a future period of financial instability.

582 Memorandum from the HM Treasury,

9 Northern Rock since September

Overview

332. In this chapter we explore developments relating to Northern Rock since the run on its retail deposits in September. We examine the extent of State sector support for the company and the public and parliamentary accountability for that support. We also summarise information relating to the options for Northern Rock. We only took evidence once during the inquiry from the (then) current leadership of Northern Rock. The situation facing Northern Rock and the options under consideration have changed in the course of our inquiry, and have continued to change since we concluded taking oral evidence. In these circumstances, we do not seek in this chapter to reach particular conclusions about Northern Rock’s future, but seek to aid understanding of the company’s continued development.

The Bank of England liquidity facility announced on 14 September

333. The first public sector support for Northern Rock was the liquidity support facility advanced by the Bank of England, authorised by the Chancellor of the Exchequer and announced on Friday 14 September. We have previously discussed the role that the announcement of this facility—together with the premature disclosure of that announcement—played in the run on the Rock.⁵⁸³ Here we are concerned solely with financial aspects of the facility. As was noted before, Northern Rock had hoped to use the facility as a “backstop” and had hopes that the facility would not be drawn down. In fact, because of the loss of retail deposits, Northern Rock was forced to use the facility almost as soon as it became available. It is known that, by late October, Northern Rock had drawn down about £13 or £14 billion from the facility.⁵⁸⁴ Subsequent figures relating to Northern Rock’s borrowing from the State appear to include money available from other facilities that we discuss later.⁵⁸⁵

334. On 19 November, the Chancellor of the Exchequer said the following about the security of Bank of England lending, including the initial facility:

I can tell the House that Bank of England lending is secured against assets held by Northern Rock, which include high-quality mortgages with a significant protection margin built in and high-quality securities with the highest quality of credit rating. The Bank is the senior secured creditor.⁵⁸⁶

The Governor of the Bank of England told us in December that the initial facility from the Bank of England was “securitised against collateral that is in is our possession; we have that in our accounts”,⁵⁸⁷ and then expanded upon this:

⁵⁸³ See paragraphs 143–162.

⁵⁸⁴ Q 821

⁵⁸⁵ See paragraphs 341–343.

⁵⁸⁶ HC Deb, 19 November 2007, col 960

⁵⁸⁷ Q 1703

On the original Bank of England facility there is name-specific collateral, which is already in our possession in our accounts in Euroclear and so on—that is already legally in our possession—there is a margin over the extent of the loan, so that we are a clear margin above the value of the loan.⁵⁸⁸

The deposit guarantees of September and October

335. The initial Government guarantee on Northern Rock deposits was announced on Monday 17 September in circumstances we considered earlier.⁵⁸⁹ The announcement did not take place until late that day even though the decision in principle to provide it had been reached the previous day because, in the Chancellor of the Exchequer’s words, “when I announced the guarantee, I wanted to be pretty clear what exactly I was announcing because people would want to know beyond doubt what the position was”.⁵⁹⁰ The initial guarantee announced on 17 September referred to “all the existing deposits in Northern Rock” and was set for the duration of “the current instability in the financial markets”.⁵⁹¹ As the Chancellor of the Exchequer noted, the terms of the guarantee have gone through several changes since that initial announcement.⁵⁹²

336. On Thursday 20 September, the Treasury modified and clarified the coverage of the guarantee. The Treasury stated on that day that the guarantee “would cover all accounts existing at midnight on Wednesday 19 September”. It was also made clear that the “guarantee covers future interest payments, movements of funds between existing accounts, and new deposits into existing accounts”. In addition, to assist in re-building Northern Rock’s depositor base following the run, the guarantee was extended to “cover accounts re-opened in the future by those who closed them between Thursday 13 September and Wednesday 19 September”. In relation to wholesale deposits, it was stated that the guarantee covered “existing and renewed wholesale deposits; and existing and renewed wholesale borrowing which is not collateralised”.⁵⁹³ The guarantee did not cover other debt instruments such as “covered bonds”, securities issued under the “Granite” securitisation programme and subordinated and other hybrid capital instruments.⁵⁹⁴

337. On 9 October, the guarantee was further extended to all retail deposits made with Northern Rock since 19 September. This additional guarantee was put in place at the request of Northern Rock and was intended to “allow the Company to continue to pursue the full range of its strategic options”. The Treasury also announced that “Northern Rock plc will pay an appropriate fee for the extension of the arrangements, which is designed to ensure it does not receive a commercial advantage”.⁵⁹⁵ The fee was subsequently described

588 Q 1710

589 See paragraphs 153–166.

590 Q 1761

591 HM Treasury press notice 95/07, 17 September 2007

592 Q 1760

593 HM Treasury press notice 96/07, 20 September 2007. On 21 September, the Treasury confirmed that “renewals with Northern Rock plc of existing uncollateralised deposits and wholesale borrowing and retail bonds (in each case up to the same maturity) are covered for the term of the renewal”: HM Treasury press notice, 21 September 2007, “Northern Rock plc RNS”.

594 HM Treasury press notice 96/07

595 HM Treasury press notice 104/07, 9 October 2007

as being one “from which the Treasury will benefit”, which was “set at a higher rate than the interest premium on the additional facilities” that we consider later.⁵⁹⁶

338. On 11 October, the Treasury clarified that the Government guarantee was intended to “supplement, and not replace, any compensation provided by the Financial Services Compensation Scheme (FSCS), which the Financial Services Authority has recently extended to cover 100% of the first £35,000 of deposits”.⁵⁹⁷ In chapter 6 of this Report, we described some of the limitations of the deposit protection available under the Financial Services Compensation Scheme. Most of these limitations do not currently affect Northern Rock depositors, because those depositors have comprehensive cover under the Treasury guarantee. However, we noted in that chapter that there is a power under the FSCS for deposits to be off-set by liabilities such as mortgages.⁵⁹⁸ If such a power existed in relation to the guarantee to Northern Rock depositors, the effect would be that such depositors who also held a mortgage with Northern Rock would not be guaranteed a return on the guarantee in the form of a liquid asset in the event that it were to be invoked. **We recommend that the Government clarify as a matter of urgency whether, in the event of the retail deposit guarantee for Northern Rock being invoked, any payments due to depositors would be off-set against depositors’ mortgages with Northern Rock.**

339. The guarantee would only be engaged in a situation where Northern Rock was itself unable to meet its payments. The Chancellor of the Exchequer told us in October that he was not contemplating the bankruptcy of Northern Rock.⁵⁹⁹ The Treasury liability in the event that Northern Rock entered into administration or was otherwise unable to meet its commitments to depositors relates to the value of deposits in excess of the limit of £35,000 under the FSCS, together with the complete value of any deposits that are not eligible. The Treasury declined our request to provide information on the scale of this liability. Assuming that the value of Northern Rock’s assets exceeds its liabilities—an assumption that we consider later in this chapter⁶⁰⁰—the Treasury would expect to recoup the costs of payments under the guarantee in due course.

340. The guarantee on Northern Rock’s retail deposits was necessary to stop the run on those deposits. The guarantees issued in September and October to categories of wholesale deposits with Northern Rock assisted with the stability of the company during that period and since. One effect of the various Government guarantees issued in September and October has been to reinforce the incentive for the Government to help to ensure that Northern Rock remains a going concern that honours its commitments to depositors.

596 HM Treasury press notice 107/07, 11 October 2007; see paragraph 343.

597 HM Treasury press notice 107/07, 11 October 2007

598 See paragraphs 250–251.

599 Q 848

600 See paragraphs 352–354.

The additional facilities announced on 9 October

341. On 9 October, the Bank of England announced that “additional facilities” would be available to Northern Rock “through the Bank of England”.⁶⁰¹ On 11 October, the Government provided further information about these new lending facilities for Northern Rock, which would be additional to the support facility advanced by the Bank of England in September. The additional facilities were intended to enable Northern Rock to “pursue the full range of strategic options open to it”—options that we consider later in this chapter⁶⁰²—and were limited to the period needed to pursue such options, a process that was to be completed by February 2008.⁶⁰³ Like the facility announced on 14 September, the new facilities would be provided through the Bank of England, but the ultimate risk of default was to be borne by the Treasury rather than the Bank of England:

These facilities are uncommitted and are, therefore, not subject to any specific borrowing limit. They are repayable on demand and will incur a premium rate of interest. The interest premium will roll up and rank alongside the company’s Tier II regulatory capital. The facilities are secured against all assets of the company but in view of the scale and nature of the new facilities, the Treasury has agreed to indemnify the Bank of England should the Bank of England face a deficit having previously made all reasonable endeavors [sic] to recover its claims on the company. The interest premium will therefore be passed to the Treasury.

The Treasury has also indemnified the Bank of England against other liabilities that might arise from the Bank of England’s role in the extended guarantee arrangements and additional facilities.

The company has in turn indemnified the Bank of England and the Treasury in respect of the guarantee arrangements and certain costs and expenses, including our advisor costs. The company has also agreed to the usual range of lender protections typical for facilities of this nature.⁶⁰⁴

The Governor of the Bank of England, in December 2007, explained the difference between these additional facilities and the earlier facility announced on 14 September:

The second facility, introduced in October, is the facility from the Government through the Bank of England to Northern Rock with an indemnity from the Government, and that is entirely at the risk of the Government and, therefore, they determine what happens to it.⁶⁰⁵

342. The Chancellor of the Exchequer emphasised that the Government facilities provided through the Bank of England were “secured against collateral”,⁶⁰⁶ although the Governor of

601 Bank of England News Release, “Northern Rock plc deposits”, 9 October 2007

602 See paragraphs 366–370.

603 HM Treasury press notice 107/07, 11 October 2007

604 *Ibid.*

605 Q 1703

606 Q 822

the Bank of England subsequently noted that the collateral was not the same as the “name-specific” collateral relating to the Bank of England facility of 14 September:

The second facility is basically covered by a floating charge of all the assets of Northern Rock, the whole lot, right down to the paper clips ... [The Treasury] are the ones bearing the risk.⁶⁰⁷

Although these facilities have no “specific borrowing limit”,⁶⁰⁸ Mr Nicholas Macpherson, the Treasury’s Permanent Secretary, indicated that the collateral available against borrowing would exceed the lending provided, as a result of an arrangement known as a “haircut”,⁶⁰⁹ a term defined by Mr Clive Maxwell, Director, Financial Services, in the Treasury:

A haircut is the amount of discount you set against some collateral that somebody provides against a loan, so if you are making a loan to somebody and you take an asset which on the face of it is worth £100, you might apply a haircut to that so that you consider it as being worth £90 because you do not know how much it might be worth in the future. That is how a haircut works.⁶¹⁰

343. Mr Macpherson subsequently explained that “the design of the arrangements and facilities, through ... the premium rate of interest on the facility, the security of the facility against all the assets of the company and the indemnity to the Government for certain costs” reflected the principle of minimising the cost to the taxpayer. He also confirmed that “the interest premium to be paid ultimately to the Treasury ... has been rolled-up and subordinated as tier two debt”.⁶¹¹ The effect of the treatment of this liability as tier two debt is to provide that the Treasury—in relation to the interest premium—does not have the same status of “senior secured creditor” as the Bank of England has in relation to the wider support.⁶¹² In January, we asked the Treasury why it had accepted this lower status, and Mr John Kingman, Managing Director, Public Services and Growth, provided the following explanation: “We took that decision in the context of our wider aim which is to create a period in which there is stability for the bank ... The premium over and above base rate is rolled up.”⁶¹³ In November, the Chancellor of the Exchequer emphasised that the liability for the interest premium in relation to which the Treasury was bearing a higher risk related to “a small amount of money”.⁶¹⁴ In January, Mr Kingman stated: “The amount involved is

607 Qq 1710–1711

608 HM Treasury press notice 107/07, 11 October 2007

609 Q 825

610 Q 826

611 HC (Session 2007–08) 57, Ev 80

612 Tier 2 capital is debt that is subordinated to the majority of other calls on a bank. It is divided into Upper Tier 2 and Lower Tier 2. Upper Tier 2 debt is undated. It must be of a type unlikely to threaten the solvency of the bank. Lower Tier 2 capital is dated, normally with a maturity date of more than 5 years: <http://www.hmrc.gov.uk/manuals/bamanual/bam12045.htm>; for the reference to “senior secured creditor”, see HC Deb, 19 November 2007, col 960

613 Q 1783

614 HC Deb, 19 November 2007, col 964

not gigantic in the context of the sums involved in Northern Rock, it is well under £100 million that we have given that agreement.”⁶¹⁵

The discussions on State aid rules up to early December

344. The three forms of support that we have described—the Bank of England liquidity facility announced on 14 September, the various retail and wholesale deposit guarantees of September and October, and the additional facilities announced on 9 October—were all intended to be of limited duration. The first of these was described on 14 September as being available “to help Northern Rock to fund its operations during the current period of turbulence in financial markets while Northern Rock works to secure an orderly resolution to its current liquidity problems”.⁶¹⁶ The initial deposit guarantee was initially intended to last “during the current instability in the financial markets”,⁶¹⁷ and the Chancellor of the Exchequer confirmed on 19 November that “the guarantee will not be removed without proper notice being given to depositors”.⁶¹⁸ The duration of the additional facilities announced on 9 October was not stated explicitly, although it was designed in part to support Northern Rock’s consideration of strategic options, a process which the Treasury stated on 11 October “will be completed by February 2008”.⁶¹⁹

345. When he gave evidence in late October, the Chancellor of the Exchequer was slightly more precise about the timetable and set out one reason why State support was viewed as time-limited:

We have asked the Northern Rock bank to come back to us with its proposals by the beginning of February and obviously, I am willing to review the situation at that time. We do have a State aid issue in that, as you know, there comes a point where the [European] Commission will say this is going on for too long. I am not sure that is an immediate problem but I really want to get across to the bank that they have a breathing space, if you like; they need to consider their options; they have a new chairman now and they need to consider what the best course of action is for the bank. That is their decision, they are the directors, they own the company but we have given them that breathing space and we have said to them ‘Look, you need to come back by the beginning of February’.⁶²⁰

346. According to the European Commission, “The objective of State aid control is, as laid down in the founding Treaties of the European Communities, to ensure that government interventions do not distort competition and intra-Community trade. In this respect, State aid is defined as an advantage in any form whatsoever conferred on a selective basis to undertakings by national public authorities”.⁶²¹

615 Q 1783

616 HM Treasury press notice 94/07, 14 September 2007

617 HM Treasury press notice 95/07, 17 September 2007

618 HC Deb, 19 November 2007, col 960

619 HM Treasury press notice 107/07, 11 October 2007

620 Q 842

621 http://ec.europa.eu/comm/competition/state_aid/overview/index_en.cfm

347. The Chancellor of the Exchequer subsequently added that the beginning of February was not “a drop dead date”,⁶²² but also went on say:

We have to get State aid clearance for this sort of support and the State aid rules are quite clear, you can do this sort of thing to provide support in times of difficulty like Northern Rock but you cannot do it in perpetuity.⁶²³

Mr Maxwell also stated that:

There are different ways in which you can apply for State aid approval and some of those approvals have certain time limits on them ... Rescue aid, for example, usually has initial limits around six months.⁶²⁴

The Chancellor of the Exchequer then drew attention to the importance of the word “usually” in that last sentence.⁶²⁵

348. On 26 November, following “intensive contacts” between the UK authorities and the European Commission, the Treasury provided the Commission with full details of measures taken to support Northern Rock.⁶²⁶ On 5 December, the Commission announced the following decisions relating to that support:

- The emergency liquidity assistance provided by the Bank of England and announced on 14 September, which was secured by sufficient collateral and was interest-bearing, did not constitute State aid;
- The guarantee on deposits offered on 17 September, as well as the subsequent extension of that guarantee, did constitute State aid; and
- The additional facilities announced on 9 October also constituted State aid.⁶²⁷

The Commission announcement went on to state:

These aid measures can be authorised as rescue aid in line with the Community Guidelines on State aid for rescuing and restructuring firms in difficulty. Under these rules, rescue aid must be given in the form of loans or guarantees lasting no more than six months, although there are certain exceptions to these rules in the banking sector, in order to allow for prudential requirements, which have been applied in this case.⁶²⁸

Having concluded that the measures complied with EU rules on rescue aid, the Commission also stated:

622 Q 843

623 Q 844

624 Qq 845–846

625 Q 846

626 European Commission press release, “State aid: Commission approves UK rescue aid package for Northern Rock”, 5 December 2007

627 *Ibid.*

628 *Ibid.*

The approval of the rescue aid measures has no bearing on whether any future measures taken by the UK authorities to support a restructuring plan would be similarly approved. Any such measures would have to be assessed on their own merits according to the rules on restructuring aid to establish whether aid was involved, and if so whether there was sufficient restructuring to offset any distortion of the competition caused by the aid and to ensure the future viability of the company without further State aid.

... The UK authorities have given a commitment to deliver to the Commission by 17 March 2008 a plan for Northern Rock going beyond the short-term rescue. If a restructuring plan were to involve State aid, it would have to be assessed on its own merits under the rules on restructuring aid.

349. According to the European Commission, restructuring aid must be based on “a feasible, coherent and far-reaching plan to restore a firm’s long-term viability”. The restructuring plan, the duration of which must be as short as possible, must restore the long-term viability of the firm within a reasonable timescale, although there is no specified time limit for completion of the restructuring plan. The general principle used by the Commission in assessing suitability of restructuring aid is that the Commission will allow the grant of such aid “only in circumstances in which it can be demonstrated that it does not run counter to the Community interest”. Such agreement will only be granted if strict criteria are met, and if it is certain that any distortions of competition will be offset by the benefits flowing from the firm’s survival and that, in principle, there are adequate compensatory measures in favour of competitors.⁶²⁹ With regard to the duration of restructuring aid, the Commission has stated:

Where restructuring operations cover several years and involve substantial amounts of aid, the Commission may require payment of the restructuring aid to be split into instalments and may make payment of each instalment subject to: (i) confirmation, prior to each payment, of the satisfactory implementation of each stage in the restructuring plan, in accordance with the planned timetable; or (ii) its approval, prior to each payment, after verification that the plan is being satisfactorily implemented.⁶³⁰

The further extension of the Government guarantee in December

350. On 18 December, the Government granted a further extension of the earlier guarantee arrangements, at the request of Northern Rock, “to the following unsubordinated wholesale obligations, whether now existing or arising in the future:

- all uncollateralised and unsubordinated wholesale deposits and other borrowings which are outside the guarantee arrangements previously announced by HM Treasury;
- all payment obligations of Northern Rock plc under any uncollateralised derivative transactions;

⁶²⁹ European Commission, *Vade Mecum Community Rules On State Aid*, p 27

⁶³⁰ European Commission, *Community Guidelines On State Aid For Rescuing And Restructuring Firms In Difficulty*, (2004/C 244/02)

- in respect of all collateralised derivatives, and all wholesale borrowings which are collateralised (including, without limitation, covered bonds of Northern Rock plc), the payment obligations of Northern Rock plc to the extent that those obligations exceed the available proceeds of the realised collateral for the relevant derivative or borrowing; and
- all obligations of Northern Rock plc to make payments on the repurchase of mortgages under the documentation for the ‘Granite’ securitisation programme.”⁶³¹

The Treasury stated that “Northern Rock plc will pay an appropriate fee for the extension of the guarantee arrangements”.⁶³² The Treasury also gave further information about the duration of the guarantees, clarifying the commitment given in November to give “proper notice” of the removal of the guarantee.⁶³³

As previously announced, the arrangements to protect retail and wholesale depositors of Northern Rock plc will remain in place during the current instability in the financial markets. Reasonable notice, which will not be less than 3 months, will be given by HM Treasury of any termination of these arrangements.⁶³⁴

351. On 18 December, in oral evidence, Sir John Gieve confirmed that the extension announced earlier that day “does widen the scope of the guarantee to pretty much the whole balance sheet, excluding the capital instruments and the Granite securitised instruments”.⁶³⁵ He said that it covered “nearly all the wholesale deposits” of Northern Rock.⁶³⁶ With specific reference to “covered bonds”—a term we defined earlier in this Report⁶³⁷—Sir John said: “part of the announcement today was to cover the liability that may arise if the obligations exceed the proceeds of the realised collateral on those covered bonds”.⁶³⁸ The Governor of the Bank of England characterised the announcement of 18 December as “a natural extension to help the company”.⁶³⁹ In January, asked about the gradual extension of the Government commitment to Northern Rock, the Chancellor of the Exchequer said that the initial commitment in September had been made in view of “a wider systemic risk to the financial system” and, “having offered that support, we need to see that through”.⁶⁴⁰

Security of the overall State commitment

352. On 25 October 2007, the Chancellor of the Exchequer told us, in relation to the State lending to Northern Rock up to that point, “we fully expect to be able to get that money

⁶³¹ HM Treasury press notice, 149/07, 18 December 2007

⁶³² *Ibid.*

⁶³³ HC Deb, 19 November 2007, col 959

⁶³⁴ HM Treasury press notice, 149/07, 18 December 2007

⁶³⁵ Q 1704

⁶³⁶ Q 1705

⁶³⁷ See paragraph 16.

⁶³⁸ Q 1707

⁶³⁹ Q 1712

⁶⁴⁰ Q 1782

back”.⁶⁴¹ On 10 January 2008, when we asked whether he remained as confident about this point, he replied:

Yes, one of my objectives is to make sure we do get our money back. When we reach a conclusion, whatever that conclusion is, one of the priorities, in addition to protecting depositors, is to make sure that we get our money back.⁶⁴²

353. The confidence in the security of State lending to Northern Rock and of State guarantees appears to be based on the view of the Tripartite authorities that the company has balance sheet solvency—in other words that Northern Rock’s assets exceed in value the company’s liabilities, including those to the State. On 14 September, the judgement of the FSA had been that “Northern Rock is solvent, exceeds its regulatory capital requirement and has a good quality loan book”.⁶⁴³ On 25 October, the Chancellor of the Exchequer reaffirmed that “Northern Rock is and was solvent”,⁶⁴⁴ and, on 19 November, he told the House that “the Financial Services Authority has said before, and continues to say, that Northern Rock’s main asset base—its mortgage book—is strong and sound”.⁶⁴⁵

354. On 11 December, Sir Callum McCarthy expanded upon the reasons for the FSA’s continued judgement that Northern Rock was solvent:⁶⁴⁶

We have looked at the assets it has and the demands on those assets and believe that those assets meet those demands. The amount that has come from the taxpayer is secured against the assets of Northern Rock ... We would not deem it solvent unless we believed it could [meet all its obligations within the normal course of its business].⁶⁴⁷

Sir Callum also noted that, without the liquidity that Northern Rock was receiving through the Bank of England, the company “would have failed”.⁶⁴⁸

Reporting and parliamentary accountability

355. The range and extent of State support for Northern Rock has created liabilities for the taxpayer in the form of conditional commitments to future public expenditure. In general, should such liabilities eventually give rise to the need for public expenditure, they would require the authority of an Appropriation Act and possibly also specific enabling legislation.⁶⁴⁹ Many such liabilities are characterised as “contingent liabilities”, in that the commitment only gives rise to expenditure in certain circumstances.⁶⁵⁰ The State

641 Q 822

642 Q 1780

643 HM Treasury press notice 94/07, 14 September 2007

644 Q 759

645 HC Deb, 19 November 2007, col 960

646 Qq 1491, 1511

647 Qq 1500, 1509

648 Q 1509

649 HM Treasury, *Managing Public Money*, July 2007, Annex 5.5, para 1

650 *Ibid.*, para 3

commitments to Northern Rock represent such contingent liabilities, in that it is the intention of the Government that the liabilities will not give rise to an actual charge upon the public purse. In this section, we consider how effectively the Treasury has accounted to the House of Commons for these contingent liabilities.

356. Under the relevant Treasury guidance published in 2007 and contained in a document entitled *Managing Public Money*, there is a general statement that “Parliament expects to be notified of the existence” of any contingent liability when it is entered into.⁶⁵¹ The same guidance also states that, where a liability is entered into with little notice, it should be reported to Parliament “at the earliest opportunity”.⁶⁵² The standard procedure for such reporting is the laying of a minute before the House of Commons, which should, according to the Treasury guidance, “describe the amount and the expected duration of the proposed liability, giving an estimate if precision is impossible”.⁶⁵³ The guidance notes that “sometimes it is not possible to give details of a contingent liability with full transparency” and goes on to state that, “in such circumstances, the department should write to the chairs of both [the Committee of Public Accounts] and the [relevant] departmental committee” to provide on a confidential basis the details that otherwise would have been included in the minute.⁶⁵⁴ The guidance also states that a minute should be laid “if an originally confidential liability ... can be reported transparently”.⁶⁵⁵

357. On 20 September, the Chancellor of the Exchequer wrote to the Chairman of this Committee noting that a contingent liability had been incurred and explaining the circumstances of special urgency which meant that advance notice could not be given of the liability. This letter was published at the time by the Treasury. On 11 October, the Chancellor of the Exchequer wrote again to the Chairman explaining the extension of the contingent liability arising from the announcements of 9 October relating both to the extended guarantee and the additional lending facility.⁶⁵⁶ Neither of these letters contained confidential information. On 22 November, we asked the Treasury whether a minute had been laid before the House of Commons in accordance with its own guidance and whether the Treasury had considered providing further information to the relevant select committee chairmen on a confidential basis.

358. On 26 November, the Treasury for the first time laid a minute before the House of Commons relating to the contingent liability.⁶⁵⁷ This minute provided no new information about the scale of these liabilities; most of it was devoted to an account of the announcement by the Board of Northern Rock that morning relating to a bidder for Northern Rock, an announcement which is discussed further below. In reply to our requests of 22 November, Mr Macpherson referred to the minute of 26 November and went on to say:

651 *Ibid.*, para 1

652 *Ibid.*, para 6

653 *Ibid.*, paras 23–24

654 *Ibid.*, para 28

655 *Ibid.*, para 33

656 Ev 240–241

657 HM Treasury, Departmental Minute: Northern Rock, 26 November 2007

At the time that the guarantees and indemnity were granted, a formal minute was not laid. While I accept that a formal minute would have been preferable, the Chancellor was explicit about the guarantee and resulting contingent liabilities in his oral statement and letters to the chairs of the [Treasury Committee] and [the Committee of Public Accounts], copies of which were placed in the Library of the House. I therefore consider that we have disclosed everything directly to the House—and the market—in a form that took into account the technical, commercial and policy issues.⁶⁵⁸

359. Although Mr Macpherson believes that the Treasury has “disclosed everything”, it has not followed its own guidance, which refers specifically to the provision in the minute or on a confidential basis of the amount or the estimated amount of a contingent liability.⁶⁵⁹ It is known that between £13 and £14 billion had been drawn down from the initial support facility by late October.⁶⁶⁰ In early December, Northern Rock disclosed that it had borrowed £25 billion from the Bank of England.⁶⁶¹ The scale of the contingent liability relating to the guarantee on Northern Rock deposits has not been acknowledged. Sir John Gieve confirmed that it covered “nearly all of the wholesale deposits” of Northern Rock, but the last reported information on the scale of such deposits was that available from Northern Rock’s balance sheet as at 31 December 2006. Similarly, the Treasury has not disclosed information about the scale of the contingent liability relating to all retail deposits that are not covered by the FSCS.

360. On 19 November, the Chancellor of the Exchequer told the House of Commons:

I know that there has been interest in how much support the Bank of England is giving. The Bank publishes its balance sheet every week. However, in common with other central banks, it does not provide details of any operations because it believes that doing so would undermine its ability to provide such support. I understand the frustrations that that can sometimes cause, but to provide what would, in effect, be a running commentary on any operations would be likely to have adverse affects that none of us would want.⁶⁶²

The Bank of England weekly balance sheet to which the Chancellor of the Exchequer referred includes lending to Northern Rock within the category of “Other assets”, and that category is not broken down further. On 16 January 2008, the total value of the Bank of England’s “other assets” was £43,402,237,127, but this amount does not imply that lending to Northern Rock had risen to £43 billion.⁶⁶³ The position of the Bank of England as described by the Chancellor was reaffirmed by the Governor in evidence in December:

I am not going to give a number today, because I do not think the central bank in its role as lender of last resort should be giving a sort of public commentary, minute by

658 HC (2007–08) 57, Ev 80

659 See paragraph 356.

660 Q 821

661 Q 1702

662 HC Deb, 19 November 2007, col 960

663 Bank of England, “Banking Department Statement, 17 January 2008

minute, on the scale of any facilities. What we have said is that if it would help the company itself to reveal the scale of the borrowing, then it is free to do so.⁶⁶⁴

On 21 January 2008, the Chancellor assured the House of Commons that the Bank of England's lending to Northern Rock would be "repaid in full" but gave no indication of when the amount of that lending would be put in the public domain.

361. Under the Treasury's own guidance, Estimates and Supplementary Estimates must include a note giving details of any contingent liabilities in force.⁶⁶⁵ The principle underpinning that requirement is that the House of Commons should be informed at the earliest possible opportunity of any commitment that might give rise to a subsequent request for formal authorisation of expenditure and that does not have a current statutory authority. In view of the fact that the contingent liability had first been acknowledged on 20 September, we asked the Treasury why there was no reference to the contingent liability of that date or any subsequent contingent liability in the Winter Supplementary estimates published on 15 November. In response, Mr Macpherson stated that "we will ... make a note of the contingent liability in the Spring Supplementary Estimates",⁶⁶⁶ which are usually published in mid-February.

362. State support for Northern Rock has involved the Government entering into contingent liabilities on a very large scale. It is important that the Treasury discharges its obligations to the House of Commons—and through the House of Commons to the taxpayer—promptly and fully to report on the extent of such liabilities. The actual level of Bank of England support underwritten by the taxpayer is not specified within the Bank of England return. The Government itself should not have relied upon either the Bank of England or the Northern Rock to be the sole sources on the scale of the State commitment. The House of Commons should be updated about the scale of the commitment on a quarterly basis.

Tripartite influence on Northern Rock's business until December

363. In mid-October, the then Chairman of Northern Rock told us that Northern Rock was being run by its Board.⁶⁶⁷ In late October, the Chancellor of the Exchequer also said that "Northern Rock is and remains the property of its shareholders and it is run by its directors".⁶⁶⁸ He told us that, while he had been consulted over the appointment of a new Chairman, the changes in Board membership were for the Board itself.⁶⁶⁹

364. Witnesses from Northern Rock told us that no particular governance conditions had been attached to State support,⁶⁷⁰ but also stated that the Tripartite authorities, and the FSA

664 Q 1702

665 HM Treasury, PES Paper (2004) 14, Annex D, paragraph 9

666 HC (Session 2007–08) 57, Ev 80

667 Q 493

668 Q 756

669 Qq 804–805

670 Qq 496–497

in particular, were “involved in considerable detail in overseeing what we do”.⁶⁷¹ Until mid-September, Northern Rock had intended to pay a dividend to shareholders that it had announced in July. The then Chairman of Northern Rock confirmed that the Board had listened to the views of the FSA and others before reaching its final decision not to pay the dividend.⁶⁷² On 19 November, the Chancellor of the Exchequer said:

As with any lender on this scale, we have ensured that the Bank [of England]’s lending is subject to significant conditions and controls to ensure that our interests are protected, and, in return for that facility, Northern Rock has agreed a number of controls, including not declaring, making or paying any dividend without the prior written consent of the Bank of England, and not making any substantial change to the nature of its business.⁶⁷³

365. In January, Mr Kingman explained that the Treasury had used its leverage when lending money to Northern Rock to secure control over its business model, but he warned that that level of control could have a detrimental effect, stating that:

We have, as you would expect, lent rather a large sum of money to this bank and taken very significant loan protections, as you would expect in this sort of situation, which means that a whole variety of commercial decisions they have to take require the authorities’ agreement. That is obviously not a fantastically sustainable way to run the business and any solution will have to protect our interests in an ongoing way, but allow genuine commercial decision-making.⁶⁷⁴

In chapter 5 of this Report, we examined the extent to which a relevant authority might be given greater control of the affairs of a failing bank. The Chancellor of the Exchequer indicated that his experience in the case of Northern Rock had led him to favour future provision for “the availability of powers ... to take greater control” in future cases comparable to that of Northern Rock.⁶⁷⁵ We note that a very large commitment was made to Northern Rock without any clear public statement of the safeguards that were put in place to protect taxpayers’ money. We share the sentiment of the Chancellor of the Exchequer that powers should be available in future cases, and it is for this reason that we have recommended that the relevant authority should have the powers of prompt corrective action and the powers for the administration of banks without jeopardising the availability of deposits.

Options for Northern Rock under consideration: September to November

366. In the period between September and November 2007, Northern Rock appears to have searched for a private sector take-over as a solution to its difficulties. On 25 September, Northern Rock announced that:

671 Q 499

672 Qq 704–705

673 HC Deb, 19 November 2007, col 960

674 Q 1784

675 Q 1784

The Company has received a number of approaches regarding a variety of potential transactions, including the possibility of an offer being made for the Company although no price has been referred to. The Company is in preliminary discussions with selected parties but emphasises that there can be no certainty as to the outcome of such discussions.⁶⁷⁶

By 9 October, Northern Rock had announced that it had appointed Citi and Merrill Lynch to advise it on a “range of options for the future of the Company and these discussions [on potential buyers]”.⁶⁷⁷ On 11 October, the Tripartite authorities stated the conditions under which the Tripartite authorities would consider proposals for Northern Rock. These were that proposals protected taxpayers, promoted financial stability and protected consumers.⁶⁷⁸ The Chancellor later confirmed that these conditions would have equal weight when considering proposals.⁶⁷⁹

367. On 12 October 2007, Virgin Group “submitted a non-binding indication of interest” to the Board of Northern Rock.⁶⁸⁰ On 15 October, Northern Rock announced that the company was:

working with a number of potentially interested parties regarding proposals for a variety of potential transactions as well as developing further options to explore with new parties as part of its review of all strategic options in the interests of shareholders, customers and other stakeholders.⁶⁸¹

368. On 31 October, it was announced that the number of advisors to Northern Rock had grown, as The Blackstone Group LP joined Citi and Merrill Lynch. This also meant that Blackstone would not take part in the bidding process for Northern Rock.⁶⁸² On 12 November 2007, Olivant Advisers Limited indicated that it was preparing a bid for Northern Rock. In their statement, they provided an outline of that bid:

Olivant, an independent investment group, today announces that it is preparing a proposal for the Board of Northern Rock. The proposal would involve the immediate introduction into Northern Rock of a core team of Olivant's experienced principals, led by its chairman, Luqman Arnold, to work intensively alongside its existing Board and management, together with a subscription of a minority stake in Northern Rock, intended to ensure Olivant's alignment with the Board and shareholders. Olivant is not proposing an offer for the shares of Northern Rock.⁶⁸³

369. On 14 November, the Chancellor of the Exchequer explained that:

676 Northern Rock Plc, Stock exchange announcement, 25 September 2007

677 Northern Rock Plc, Northern Rock Update: New guarantee arrangements agreed with Treasury, 9 October 2007

678 HM Treasury, 107/07, Extended guarantee and additional facility for Northern Rock plc, 11 October 2007

679 HC Deb, 19 November 2007, Col 969

680 Virgin Group - Statement re Proposal, 12 October 2007

681 Northern Rock Plc, Northern Rock Update, 15 October 2007

682 Northern Rock Plc, Strategic Review Update, 31 October 2007

683 Olivant, Statement regarding Northern Rock PLC, 12 November 2007

We have allowed the directors a breathing space to decide on the strategic options for Northern Rock. That is what they are doing, and it is best that they be allowed to do that, because it is in everyone's interest that we try and find a satisfactory solution.⁶⁸⁴

On 19 November, Northern Rock provided information about the offers that it had already received:

The proposals received by the Company are of two types:

- (i) proposals to invest in the Company (including through an injection of assets as well as new capital); and
- (ii) proposals to acquire parts of the business or assets of the Company.⁶⁸⁵

This announcement also contained a warning to shareholders:

While further analysis and discussion of the proposals is required, based on the information it has so far, the Board of Northern Rock believes that the range of values for the existing equity implied by the proposals is materially below the market price at the close of business on Friday 16 November 2007. The value to shareholders from any of the proposals (and indeed any of the other strategic options available to the Company) remains highly uncertain and will be dependent, among other things, on when and if there is an improvement in market conditions including access to liquidity and the value created, if any, from the run off of the assets and liabilities remaining in the Company following any disposal of all or part of its business.⁶⁸⁶

As well as this announcement by Northern Rock, the Treasury set out the principles that it would use to assess the proposals being put forward for Northern Rock. As well as reiterating the three conditions stated on 11 October 2007, the Treasury also noted that:

Interested parties should not assume at this stage that the current Bank of England loan facilities will be available beyond either any sale or the expiry of the facilities in February. However, the Authorities are willing to discuss any proposals made; any proposal that envisages an ongoing role for the Authorities, beyond their usual statutory and regulatory functions, will be evaluated on its merits against the Authorities' stated objectives. The Authorities expect the costs and risks associated with Northern Rock to be borne to the greatest extent possible by the current and future private sector providers of capital..⁶⁸⁷

370. On 21 November 2007, Northern Rock stated that it had received further offers since 19 November 2007.⁶⁸⁸ On 26 November 2007, Northern Rock declared that, having considered all the offers and conducted discussions with some of the interested parties:

684 HC Deb, 14 November 2007, Col 702

685 Northern Rock PLC – Strategic Update, 19 November 2007

686 Northern Rock PLC – Strategic Update, 19 November 2007

687 HM Treasury statement Re Northern Rock, 19 November 2007

688 Northern Rock PLC – Strategic Review Update, 21 November 2007

And following discussions with the Tripartite Authorities (the Bank of England, HM Treasury and the Financial Services Authority), the Board has concluded that it wishes to take forward discussions on an accelerated basis with a consortium comprising Virgin Group, WL Ross & Co, Toscafund Asset Management LLP and First Eastern Investment Group (the ‘Virgin Consortium’).⁶⁸⁹

Options for Northern Rock under consideration since December

Strategies for Northern Rock’s future

371. Some of the public debate on the future of Northern Rock has concentrated on the issue of ownership. The real decision is whether to wind the business down or attempt to give it a future on a new basis.

Options before the Board of Northern Rock

372. The “accelerated basis” for the discussions with the Virgin Consortium seems to have led to a statement by Olivant on 7 December 2007, in which it disclosed that it had “submitted today further detailed materials in support of its indicative proposal to the Board of Northern Rock plc”.⁶⁹⁰ This intervention appears to have been successful in persuading Northern Rock to consider the Olivant proposal further, because on 13 December 2007, Northern Rock made the following declaration:

Since its announcement on 26 November 2007, the Company has continued to pursue discussions with the Virgin Consortium on an accelerated basis. At the same time, the Company has engaged with other parties, including Olivant, to explore their expressions of interest as part of its review of its strategic options in the interests of shareholders, creditors, customers and other stakeholders of the Company.⁶⁹¹

Nationalisation as an option

373. One of the potential routes for resolving the problems with Northern Rock has been nationalisation. However, this option has been regarded by the Tripartite authorities, according to Sir John Gieve, as a “Plan B” after a private sector sale.⁶⁹² However, in the event that Northern Rock were nationalised, Sir John Gieve told us that “it would be possible to pass many of its activities to other institutions in the private sector”.⁶⁹³ The Governor of the Bank of England told us that nationalisation ought to be regarded as a means of achieving change:

If we were to get to nationalisation (and I stress ‘if’), then I think it would be better if it could be used as a means of breaking the log-jam and going into an arrangement

689 Northern Rock PLC – Update on Strategic Review, 26 November 2007

690 Olivant, Statement regarding Northern Rock Plc, 12 December 2007

691 Northern Rock Update, 13 December 2007

692 Q 1737

693 Q 1738

which would pass very quickly to a new management team and, ultimately, to a new ownership team.⁶⁹⁴

374. When we asked the Chancellor of the Exchequer about the compliance of possible nationalisation legislation with the European Convention on Human Rights, he pointed out that consideration of the Human Rights Act would be automatic, telling us that “as you know, legislation has to be compatible with human rights and indeed the Minister introducing the Bill has to sign a certificate to that effect and, if not, they have to say it explicitly”.⁶⁹⁵ The Chancellor also told us that:

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

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

Announcement on 21 January 2008

376. On 21 January 2008, the Treasury issued a statement detailing how it would proceed with offers for Northern Rock. This statement indicated that the current support for Northern Rock would continue until 17 March 2008.⁶⁹⁹ To aid a sale of Northern Rock, the Treasury put forward a financing option that would be available to potential private sector parties. The Chancellor explained how this financing option would work:

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

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

694 Q 1626

695 Q 1756

696 Q 1866

697 Q 1499

698 BBC News Online, <http://news.bbc.co.uk/1/hi/business/7184813.stm>

699 HM Treasury, Statement Re Northern Rock, 21 January 2008

700 HC Deb, 21 January 2008, col 1208

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

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

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

378. The Treasury emphasised that the solution to the financing problem proposed in the statement of 21 January did not rule out the possibility of nationalisation. In his statement to the House, the Chancellor said that "I will only authorise support for the private sector if the public interest will be better served than through taking the company into temporary public ownership".⁷⁰⁴ The market statement by the Treasury outlined what would happen to Northern Rock if it were nationalised because a private sector solution was not forthcoming. The Treasury sought to reassure savers and borrowers that Northern Rock would continue to operate as it did now in the event of nationalisation.⁷⁰⁵ However, the management would change. The Treasury stated that, should Northern Rock be brought into temporary public ownership, the company "would be managed on arms' length terms, as a commercial entity, by a newly appointed experienced and professional management team".⁷⁰⁶ The Treasury also stated what would happen to shareholders should Northern Rock have to be nationalised:

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

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

701 HC Deb, 21 January 2008, col 1208

702 See paragraph 349.

703 HM Treasury, Statement Re Northern Rock, 21 January 2008

704 HC Deb, 21 January 2008, Col 1208

705 HM Treasury, Statement Re Northern Rock, 21 January 2008

706 *Ibid.*

707 *Ibid.*

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

379. The Treasury noted that "The Tripartite Authorities do not consider that an administration of Northern Rock would meet [their stated] objectives".⁷⁰⁹ The Chancellor in his statement to the House explained why he could not agree with administration:

Administration would mean that control would immediately pass to an administrator who would look to realise the value of the company's assets which, under current market conditions, would amount to a fire sale. It could also exacerbate current market turbulence. And costs would be significant. I have therefore rejected such a proposal.⁷¹⁰

380. In his statement of 21 January, the Chancellor of the Exchequer also referred to the possible implications for fiscal policy of his announcement on that day:

It is for the independent Office of National Statistics to determine whether or not Northern Rock is classified to the public sector in the National Accounts. Any liabilities classified to the public sector would be temporary and backed by significant assets and do not represent any meaningful measure of fiscal sustainability. The Code for Fiscal Stability—underpinned in legislation passed by this House—provides for such situations.

Paragraph 11 of The Code for Fiscal Stability states:

The Government may depart from its fiscal objectives and operating rules temporarily, provided that it specifies:

- a. the reasons for departing from the previous fiscal policy objectives and operating rules;
- b. the approach and period of time that the Government intends to take to return to the previous fiscal policy objectives and operating rules; and

708 *Ibid.*

709 HM Treasury, Statement Re Northern Rock, 21 January 2008

710 HC Deb, 21 January 2008, Col 1208

c. the fiscal policy objectives and operating rules that shall apply over this period.⁷¹¹

We expect to explore the implications for fiscal policy of the Government's decisions relating to Northern Rock in due course.

⁷¹¹ HM Treasury, *The Code for Fiscal Stability*, November 1998, paragraph 11

Conclusions and recommendations

1. We welcome the Government's commitment to taking full account of our Report before making its legislative proposals in response to the run on Northern Rock. We consider it crucial that, insofar as possible, measures in this area are taken forward on a cross-party basis. This Report is being agreed unanimously and we believe that it forms the basis for cross-party agreement on such legislative proposals. (Paragraph 6)
2. The directors of Northern Rock were the principal authors of the difficulties that the company has faced since August 2007. It is right that members of the Board of Northern Rock have been replaced, though haphazardly, since the company became dependent on liquidity support from the Bank of England. The high-risk, reckless business strategy of Northern Rock, with its reliance on short- and medium-term wholesale funding and an absence of sufficient insurance and a failure to arrange standby facility or cover that risk, meant that it was unable to cope with the liquidity pressures placed upon it by the freezing of international capital markets in August 2007. Given that the formulation of that strategy was a fundamental role of the Board of Northern Rock, overseen by some directors who had been there since its demutualisation, the failure of that strategy must also be attributed to the Board. The non-executive members of the Board, and in particular the Chairman of the Board, the Chairman of the Risk Committee and the senior non-executive director, failed in the case of Northern Rock to ensure that it remained liquid as well as solvent, to provide against the risks that it was taking and to act as an effective restraining force on the strategy of the executive members. (Paragraph 31)
3. The business model of the Board of Northern Rock was clearly stated. It is unfortunate that the shareholders who acquired their shares as part of demutualisation and the staff of Northern Rock have suffered significantly from the fall in the value of Northern Rock shares. However, it is not possible to make a distinction between types of shareholders in the circumstances of Northern Rock. In a market environment shareholders as a whole must be viewed as taking a risk from which they sought a reward and for which they are now paying a price. (Paragraph 34)
4. The FSA has acknowledged that there were clear warning signals about the risks associated with Northern Rock's business model, both from its rapid growth as a company and from the falls in its share price from February 2007 onwards. However, insofar as the FSA undertook greater "regulatory engagement" with Northern Rock, this failed to tackle the fundamental weakness in its funding model and did nothing to prevent the problems that came to the fore from August 2007 onwards. We regard this as a substantial failure of regulation. (Paragraph 42)
5. The Basel II waiver, and the dividend increase this allowed to Northern Rock, came at exactly the wrong moment. While we accept that Basel II is a capital accord and the problems at Northern Rock that soon became all too evident were ones of liquidity, it was wrong of the FSA to allow Northern Rock to weaken its balance sheet

at a time when the FSA was itself concerned about problems of liquidity that could affect the financial sector. (Paragraph 45)

6. The current regulatory regime for the liquidity of United Kingdom banks is flawed. That regime did not prevent the problems that arose in relation to Northern Rock in 2007. We welcome the publication of the Financial Services Authority's discussion paper on this issue, and acknowledge the possible benefits of an international consensus on the best way forward. But in light of Northern Rock, reforms of the United Kingdom's system of liquidity regulation cannot wait for international agreement. (Paragraph 52)
7. If the Financial Services Authority was "very unhappy" with the stress testing conducted by Northern Rock, it appears to have failed to convey the strength of its concerns to the Board of Northern Rock, and to secure remedial action. Although the Board of Northern Rock undertook some stress testing of its own business model, it proved to have been thoroughly inadequate. It was the responsibility of the Financial Services Authority to ensure that the work of the Board of Northern Rock was sufficient to the task. The Financial Services Authority failed in its duty to do this. (Paragraph 59)
8. We are concerned that the Chief Executive of Northern Rock was not a qualified banker, although of course he has significant experience. The Financial Services Authority should not have allowed nor ever again allow the two appointments of a Chairman and a Chief Executive to a "high-impact" financial institution where both candidates lack relevant financial qualifications; one indication that an individual has been exposed to the relevant training is an appropriate professional qualification. Absence of such a qualification should be a cause of concern. We therefore recommend that the FSA undertake an urgent review of the current qualifications of senior directors in financial firms (especially of those firms deemed to be "high-impact") and ensure that the current approved person regime requirements are adequate, and respond to us on this by June 2008. (Paragraph 63)
9. The FSA did not supervise Northern Rock properly. It did not allocate sufficient resources or time to monitoring a bank whose business model was so clearly an outlier; its procedures were inadequate to supervise a bank whose business grew so rapidly. We are concerned about the lack of resources within the Financial Services Authority solely charged to the direct supervision of Northern Rock. The failure of Northern Rock, while a failure of its own Board, was also a failure of its regulator. As the Chancellor notes, the Financial Services Authority exercises a judgement as to which 'concerns' about financial institutions should be regarded as systemic and thus require action by the regulator. In the case of Northern Rock, the FSA appears to have systematically failed in its duty as a regulator to ensure Northern Rock would not pose such a systemic risk, and this failure contributed significantly to the difficulties, and risks to the public purse, that have followed. (Paragraph 66)
10. The Bank of England, the European Central Bank and the Federal Reserve each pursued a different course of action in response to the money market turmoil in August 2007. Only the Bank of England took no contingency measures at all during August, in order to protect against moral hazard, that is, the fear that an injection of

liquidity would offer incentives for banks to take on more liquidity risk, secure in the knowledge that the Bank of England would step in to resolve future liquidity crises. The European Central Bank appeared to attach far less weight to the moral hazard argument than the Bank of England. Instead, it adopted a proactive approach in resolving what it saw as a practical problem of a faltering market resulting from banks losing confidence in each other. Although the European Central Bank injected no net additional liquidity in August, it did alter the timing and term profile of its regular operations, front-loading its credit supply towards the start of August, and draining this liquidity before the end of the maintenance period. In doing so, the European Central Bank appeared to satisfy the immediate liquidity demands of the Eurozone banking sector, whilst UK banks' sterling demands went unmet. We are unconvinced that the Bank of England's focus on moral hazard was appropriate for the circumstances in August. In our view, the lack of confidence in the money markets was a practical problem and the Bank of England should have adopted a more proactive response. (Paragraph 89)

11. We accept the Governor's comments that the Bank of England injected additional liquidity into the money markets in September, when the ECB and Fed did not. This was not a decision on the part of the Bank, but a consequence of banks being able to choose their reserve requirement for each maintenance period. The Bank of England should set out, in its response to this Report, the rationale for having a voluntary reserves system, rather than a system that stipulates reserves requirements for each bank. (Paragraph 90)
12. We cannot know whether an open market liquidity operation of the kind asked for by a number of banks in August would have prevented Northern Rock's need for emergency support from the Bank of England in September. It is most unlikely that any such lending operation in September, following the stigmatisation of Barclays which we deal with later, could have been of a sufficient scale to ensure that Northern Rock could have received the liquidity it then required. Such an operation would also have raised severe 'moral hazard' concerns, signalling to the banking sector as a whole that public sector support would be made available in the event of any bank facing distress. (Paragraph 95)
13. The fact that the European Central Bank accepted a wide range of collateral, including relatively illiquid assets, certainly assisted European banks, throughout the period of turmoil. The broadening of acceptable collateral by the Bank of England in September similarly assisted UK banks. The Governor depicted the Bank's decision as being finely balanced between giving the banks the liquidity they wanted and moral hazard. If the Bank were always to accept a wider range of collateral, banks would have an incentive to alter their asset portfolios away from the safest classes and towards higher-risk classes, and we consider this moral hazard argument to be important. Nevertheless, with the benefit of hindsight, we have concluded that the Bank of England should have broadened the range of acceptable collateral at an earlier stage in the turmoil. (Paragraph 97)
14. The usual penalty rate was charged on the 3-month operation announced on 19 September. The penalty rate should not be viewed as a punishment for recalcitrant

banks, but rather a reminder to banks to manage their liquidity risks in an appropriate manner. (Paragraph 98)

15. We recommend that the Bank of England, in its response to this Report, set out the rationale behind the design of its standing facilities, and any changes to them that it is considering making. (Paragraph 100)
16. There are many circumstances where UK banks might be able to participate in money market operations conducted by the European Central Bank and the US Federal Reserve, although the fact that such operations would neither be conducted in sterling, nor accept sterling-denominated collateral, is a significant obstacle to UK banks extending their use of these facilities. In these circumstances, the Bank of England's policy on money market operations cannot be reviewed in isolation from those of other central banks. In view of the fact that some, but not all, UK banks have access to the money market operations provided by foreign central banks, the review of the Bank of England's money market operations should be informed by an awareness of the case for closer alignment of the Bank of England's money market operations with those of the European Central Bank and of the Federal Reserve. (Paragraph 103)
17. 'Stigmatisation', whereby financial institutions will not approach the central bank for assistance for fear of being regarded by the market as weak, appears to be a substantial problem in money markets across the world. Although this problem is not unique to the UK, we recommend that the Bank of England place particular emphasis, in its further reforms of its money market operations, on measures to deal with stigmatisation. (Paragraph 107)
18. With the benefit of hindsight, the financial support enquired about by a potential buyer of Northern Rock prior to 10 September may conceivably have represented a better deal for the taxpayer than the financial support that has been provided since 14 September. Unfortunately we received conflicting evidence from Northern Rock and the Tripartite authorities over the details of the support facility requested by the potential bidder for Northern Rock. This unresolved conflict prevents us from drawing any firm conclusion on whether a safe haven was possible. What also remains unclear is how proactive the Tripartite authorities were in pursuing this option. Clearly the amount and type of State aid was a major factor but equally so was the question of whether the Takeover Code inhibited Tripartite attempts to facilitate a private sector solution for the troubled bank. In any event, it needs to be borne in mind that the consequences of any announcement that might have been made relating to a potential takeover would have been unpredictable. Furthermore, it is not evident that the State could, or should, underwrite a safe haven option, where a single, presumably profitable, bank received State support (in the form of a lending facility) to undertake, or at least announce the takeover of Northern Rock. (Paragraph 118)
19. The Chancellor of the Exchequer's decision in the first half of September to make a support facility available to Northern Rock should the need arise was the right one. Had he chosen not to do so, there would have been a significant risk of substantial disadvantage to Northern Rock depositors and a very real prospect of "contagion",

whereby the public would lose confidence in the security of holdings across the United Kingdom banking system. In view of the weaknesses of the legal framework for handling failing banks at that time, the Tripartite authorities were right to view Northern Rock as posing a systemic risk. Had any other decision been taken, it is quite possible that the events that unfolded from mid-September onwards could have been more damaging to consumers and to the United Kingdom financial system than those that have actually taken place. (Paragraph 122)

20. On the basis of the texts cited in the preceding paragraphs, we accept that the provisions of the Market Abuse Directive and the implementing Directive relevant to market disclosure in the case of Northern Rock in September 2007 were properly transposed into United Kingdom law. It is evident from the texts of both the Directive and of the FSA Handbook that any decision to delay disclosure, even in the case of an issuer that is in grave and imminent danger, is subject to provisos relating to the need for the issuer to be satisfied that such a delay would not be likely to mislead the markets and that the issuer is able to ensure the confidentiality of that information. The Governor of the Bank of England received legal advice through the FSA from lawyers working for the Tripartite authorities indicating that the Market Abuse Directive was a barrier to a covert operation, even if information could be kept confidential, and, as such, the Governor was justified in regarding the legal interpretation of the Market Abuse Directive shared by the Financial Services Authority and Northern Rock's legal advisers as a material factor in consideration of a covert operation, although it was not necessarily the leading factor in the final decision that a covert operation was not possible. (Paragraph 137)
21. In the circumstances of Northern Rock in early September 2007, the barriers to a covert support operation were real. Any large scale support operation for Northern Rock would have become known to many market participants. In the febrile and fevered atmosphere of that period, media speculation would have followed. The leaking of news of a support operation that was intended to remain covert for a period of time would have been potentially as damaging as the premature disclosure of an overt operation. The practical risks of a leak are linked to the legal difficulties, insofar as covert support operations only appear to be permitted under the Market Abuse Directive in instances when the issuer can be assured of confidentiality. We consider later in this Report whether there are circumstances when a covert support operation should be considered in future, and what legal and other changes might be necessary to facilitate such an operation. (Paragraph 141)
22. However we also find it unacceptable that the possibilities for covert action had not been properly considered much earlier. Had this issue been clarified, the authorities could have reacted with more despatch which in itself might make covert action a more realistic option. We return to the state of readiness of the authorities and "war gaming" later in this Report. (Paragraph 142)
23. In view of the role that fears of a leak of a support operation had played in the decision on Tuesday 11 September that a covert operation was not possible, the Tripartite authorities were unwise initially to accede to Northern Rock's request for the announcement of the support operation to be delayed until Monday 17 September. In the light of subsequent events, it seems evident that the Tripartite

authorities and Northern Rock ought to have strained every sinew to finalise the support operation and announce it within hours rather than days of the decision to proceed with the operation. A swift announcement would have been assisted by early preparation of such an announcement. In that context, we find it surprising that high level discussions between the Bank of England and Northern Rock about the support facility did not take place prior to 10 September. (Paragraph 145)

24. In failing either to make an announcement earlier in the week or to put in place adequate plans for handling press and public interest in the support operation, the Tripartite authorities and the Board of Northern Rock ended up with the worst of both worlds. (Paragraph 148)
25. We accept that the consequences of an announcement of the Bank of England's support operation for Northern Rock were unpredictable. There was a reasonable prospect that the announcement would have reassured depositors rather than having the opposite effect, particularly prior to the premature disclosure of the operation. However, after the premature disclosure of the support, and against the background of the market reaction to Barclays use of lending a fortnight earlier, it seems surprising that the issues were not urgently revisited. It is unacceptable, that the terms of the guarantee to depositors had not been agreed in advance in order to allow a timely announcement in the event of an adverse reaction to the Bank of England support facility. (Paragraph 165)
26. The Tripartite authorities were conscious during the planning of the support operation that announcement of that operation might have an adverse effect. In light of this, we regard it as a serious error of judgement that the Tripartite authorities at deputies level failed to plan in advance for the announcement of a Government guarantee and failed to raise some of the issues surrounding such a guarantee with the principals prior to Sunday 16 September. We are also concerned that it did not prove possible to announce the guarantee that was decided upon that day before the markets opened the following day. The cumulative effect of these failures was to delay the guarantee until the evening of the fourth day after the run started and thus to make the run on the deposits of Northern Rock more prolonged, and more damaging to the health of the company, than might otherwise have been the case. (Paragraph 166)
27. The larger deposit-taking institutions, such as banks and building societies, are 'special' organisations in modern life, similar in some ways to utility providers. Banks should be allowed to 'fail' so as to preserve market discipline on financial institutions. However, it is important that such 'failure' should be handled in an ordered manner, managed in such a way as to prevent further damage to the economy, the financial system and the interests of small depositors. (Paragraph 172)
28. The taxpayer should not bear the risk of banks failing. Nor do we believe that small depositors should bear such risk. Rather, the risk of failure should be borne by a bank's shareholders and creditors but exclude small depositors. The Government must ensure that the framework for handling failing banks insulates taxpayers and that small depositors should also be protected from the risk of banks failing. (Paragraph 182)

29. Although the Financial Services Compensation Scheme is portrayed as offering protection to the depositors of all financial institutions, examination of its funding indicates that it would not be able to cope with the failure of a medium-sized, let alone a major, financial institution. If such an event were to occur under present arrangements, only the Government, using taxpayers funds, would be in a position to protect depositors, as it did with Northern Rock. We are concerned that banks and building societies appear to be viewing the Government's support to Northern Rock as an acknowledgement that no bank would be allowed to fail. The Government must take steps to ensure that its framework for maintaining financial stability does not provide free insurance to banks. We do not believe that a deposit protection scheme should apply solely to the very smallest institutions. All banks and building societies should be covered by a deposit insurance scheme, such that, in cases such as Northern Rock, or an even larger bank, the Government would not be required to step in to protect depositors. (Paragraph 183)
30. We see great merit in the "prompt corrective action" approach adopted in the US and other countries. When a bank or building society shows signs of being in distress, or there has been an unusual change to or extreme development of its business model, it is vital that the relevant authority should not only be in a position rapidly to identify that situation, but also be able to take steps to lessen the wider impact of that financial institution's difficulty. We do not propose that the relevant authority should have unfettered rights to interfere in the business of healthy institutions, but that, given the public interest in preventing banks from failing in a disorderly way, the relevant authority must have full access to the financial accounts of all FSA-authorised deposit-taking institutions, and the right to undertake additional visits and request additional information as needed. (Paragraph 192)
31. We further recommend that the judgement of the relevant authority, supplemented by a set of quantitative triggers, be used to identify when a bank is either "failing", at risk of failing, or pursuing a business model that is an obvious outlier within the industry. Once a financial institution has been so deemed, the relevant authority should have a well-defined menu of options for taking action. The purpose of such prompt corrective action would not be to prevent banks failing as such, but to prevent them failing in a disorderly manner. (Paragraph 193)
32. We do not view a bank's recourse to the Bank of England in its capacity as lender of last resort as an ideal trigger for prompt corrective action. This option is a last resort, and the relevant authorities must be able to identify a bank as failing prior to this stage. (Paragraph 194)
33. Under the current system, where depositors' funds can be tied up for months upon the failure of a financial institution, depositors have a clear and strong incentive to join a bank run and withdraw their deposits. This incentive would remain, even if depositors were guaranteed eventually to receive 100% of all of their deposits, if the inconvenience of being unable to access savings for prolonged periods is not tackled. Because of the potential impact of bank runs on financial stability, we recommend that insured deposits at a failing bank be ring-fenced by the relevant authority, to reassure customers that their insured deposits are safe and accessible. This will require a special resolution regime for financial institutions. We note that the

Tripartite authorities currently have no means of quickly resolving a failing bank. The new special resolution regime we propose would grant powers for the relevant authority to establish a “Bridge Bank” which would take over and continue to run the failing institution with the aim of quickly returning it to health, and returning it to the private sector, either as a standalone organisation, or as part of another bank. The relevant authority should also have the power to employ a third-party financial institution to manage a failing bank’s deposits, if that would facilitate the smooth administration of the failing bank. In carrying out such an operation, the relevant authority should have an obligation to resolve the situation at least cost to the taxpayer. (Paragraph 201)

34. We recognise that the ring-fencing of insured deposits, and transfer of them to a third party, would be to the detriment of other creditors of banks, and that this might serve to increase banks’ funding costs. However, we believe that this is a cost that the banking industry must bear, because we view a special resolution regime “to be” an essential pillar of an effective system for ensuring financial stability. (Paragraph 202)
35. We recognise that shareholders will consider themselves to be disadvantaged by the new powers we propose for the relevant authority. At the moment, bank shareholders appear to be protected from the total collapse of their firm by the State’s unwillingness to allow a bank to fail. Our proposals would remove this taxpayer-funded prop, equalising the status of bank shareholders with that of non-financial firms’ shareholders, who receive no such assistance. Because of the unique nature of banking, bank shareholders cannot be expected to have the sole final say over the direction of their company, if that company has become reliant on State support to continue trading. The relevant authorities should be in a position to undertake a solution in the public interest that may be to the detriment of shareholders. (Paragraph 205)
36. The Government should also consider whether it will be possible, in the event of a bank failure, to endow the relevant authority with the decision-making powers currently held by the shareholders, whilst protecting those shareholders’ financial interest. Any new legislation must clearly set out any changes to the status of shareholders of banks and members of building societies. (Paragraph 206)
37. The UK is increasingly reliant on transactional banking services and any disruption to salary payments, direct debits, standing orders, ATM availability and other banking services would cause profound problems for the banking system as a whole. If a bank were to fail, a smooth transition to a Bridge Bank or third-party bank would be essential. We recommend that, in bringing forward its proposals on improvements to the system of handling failing banks, the Government address the issue of how essential banking services would be maintained. (Paragraph 210)
38. We recommend that the Government seek to work with the European Commission, European Central Bank and national central banks within the European Union to establish whether the Market Abuse Directive ought be amended, so as to ensure that covert support operations by a central bank are permitted in specified circumstances. (Paragraph 215)

39. We further recommend that the Government review the interaction between the terms of the Market Abuse Directive and other aspects of the regulatory regime including the FSA guidelines, to ensure that they do not unnecessarily restrict areas of the discretion otherwise allowed under the Directive. (Paragraph 216)
40. The presence of an element of co-insurance in a deposit protection scheme adds considerable complexity for customers to understand: Northern Rock pointed to the difficulty of explaining the scheme's intricacies to their customers when the bank run occurred. Not only does co-insurance add complexity, it also does not work. Co-insurance implies that a potential depositor would have the means, time and ability to assess the financial strength of an institution through the examination of publicly-available information about that company. We do not believe this to be a realistic proposition. The main way the ordinary depositor can gauge the financial health of a bank is by considering the strength of the brand and whether the bank has a reputation for financial strength. Tellingly, Northern Rock did well on both of these counts. Rather than contributing to financial stability, co-insurance directly undermines it, by offering an incentive to join a bank run. We consider the co-insurance model to be discredited with regard to depositor protection. The moral hazard argument, that banks would offer excessively high rates to customers, on the back of the full deposit insurance for customers, would be mitigated by our proposals for a system of prompt corrective action and a special resolution regime, together with a modest compensation limit, to discussion of which we now turn. (Paragraph 227)
41. The setting of an appropriate compensation limit should balance the objective of enhancing consumer confidence through adequate coverage against the implications for moral hazard and the problems of increasing the cost of the scheme. The current limit of £35,000 is easy to remember and covers the vast majority of depositors. The case has not yet been made for any extension above the current limit of £35,000. We do, however, recommend that whatever limit is adopted, it should be indexed to a measure of inflation, but such that the guaranteed limit is always an easily memorable sum. (Paragraph 233)
42. We do not believe that very large deposits held for short periods of time, perhaps in the course of residential property transactions, should be covered by the deposit protection scheme. However, we do think that the concerns raised by the Financial Services Consumer Panel are important, particularly where customers are placing deposits for purely transactional reasons, rather than seeking to earn interest. We recommend that the Government, in its response to this Report, set out what arrangements are available, or might become available, for depositors in such circumstances. One possible solution would be for depositors to invest in a risk-free National Savings & Investment product, and the Government should consider introducing a product targeted at those selling and then buying property, to raise awareness of this option. (Paragraph 234)
43. The current arrangements, under which the Financial Services Compensation Scheme could take months, maybe years, to reimburse the depositors of a large failed institution, are completely inadequate. The speed of release of funds is of critical importance. However generous a compensation scheme may be, and however much

confidence consumers may have in eventually getting back their deposits, it would still be rational for a depositor to withdraw their funds from a failing bank if there were a prospect of them losing access for more than a few days. There should be a requirement in law that all insured deposits should have to be paid within a few days of a bank failing and calling on the deposit protection scheme. The relevant authority must ensure that banks' information systems and procedures are capable of such a speedy release of funds. (Paragraph 240)

44. Depositors' understanding of the intricacies of the Financial Services Compensation Scheme, prior to the post-Northern Rock changes, was inadequate. We favour as simple and as transparent a scheme as possible. Alongside the removal of co-insurance and the adoption of a simple compensation limit, depositors need to understand that they can maximise their protection by dividing their savings between different institutions. In addition, there needs to be an emphasis on the fact that the compensation limit is per customer, rather than per account. For the scheme to have the maximum impact in protecting financial stability, the details of the scheme must be well-advertised, both in national and regional media, and through the display of posters in individual bank branches. (Paragraph 243)
45. It is important for the relevant authority operating a deposit protection scheme to understand the size and profile of the depositors it is insuring, not least so that that authority can calculate an appropriate funding requirement. Furthermore, an essential prerequisite of the speedy reimbursement of funds to the depositors of a failed institution is that insured depositors can be quickly identified. At present, we doubt that all financial institutions would be able to produce such data at short notice. We recommend that each financial institution (or, each FSA-registered group, where several institutions share one FSA registration) maintain a register of each depositor's insured deposits under the scheme. The existence of a register would greatly simplify the task faced by the relevant authority if a failed bank's depositors were to be ring-fenced or placed under the control of a Bridge Bank. This register must take into consideration individual shares of joint accounts in calculating the extent of coverage. The relevant authority should confirm that every bank and building society is able to produce such a register at a day's notice, so that the authority can be assured that, in the event of a bank failing, the speedy release of funds would not be jeopardised by an inability to identify insured depositors. (Paragraph 248)
46. Not only is it important for firms and the deposit insurance scheme to know which depositors are insured, but the depositors themselves must be aware of the extent to which their deposits are insured. We recommend that depositors should be alerted, via a letter from the financial institution, if a portion of their deposits is, or becomes, uninsured. Again, this notification should take into consideration whether the depositor has savings at other organisations within the FSA-registered group which is writing to the depositor, and where a depositor has invested in a joint account. (Paragraph 249)
47. The implication of the statement on the Financial Services Compensation Scheme website is startling: a customer of a bank or building society who had savings, but also a larger mortgage, with the same institution, might receive no compensation

through the deposit insurance scheme, but would instead have a smaller balance on their mortgage. We consider that such off-setting of a highly liquid asset (deposits) against a more illiquid liability (mortgage) to be in conflict with the entire purpose of a deposit protection scheme. A deposit scheme's two purposes—to protect depositor's liquid assets, and reduce the incentive for joining bank runs—are both fundamentally weakened by off-setting. It could be argued that off-setting an overdraft might be legitimate, but as a general rule, the widespread off-setting of savings and loans should not be permitted. We expect the Government to re-design the deposit protection scheme so that off-setting of deposits against illiquid liabilities is not permitted. (Paragraph 251)

48. We regret the FSA's decision to press ahead in November 2007 with changes to the funding of the Financial Services Compensation Scheme, in view of the FSA's knowledge that substantial changes to the Scheme were highly likely in 2008. The FSA's decision to do so pre-empts the Tripartite review of funding issues in relation to deposit protection in which the FSA itself is involved. (Paragraph 256)
49. We believe that the 'pay as you go' approach to funding depositor protection, as currently used by the Financial Services Compensation Scheme, has two fundamental disadvantages. First, it does not create the requisite depositor confidence in the availability of a source of prompt funding, so fails to contribute towards financial stability. Second, a 'pay as you go' approach could cause significant pro-cyclicality problems. Such an approach could mean obtaining funding from banks at the worst possible time, whereas a pre-funded model could obtain most of its funding at times of plenty. We have noted the arguments of the British Bankers' Association that ex-ante funding is not appropriate in the United Kingdom due to the concentrated nature of the United Kingdom's banking sector. We do not believe that the nature of the banking sector is itself a barrier to the adoption of such a funding arrangement. Objections to an ex-ante scheme appear to be based on the notion that certain United Kingdom banks are 'too big to fail'. We reject this notion. The principle that must underpin a future scheme is that it should be capable of coping with any foreseeable bank failure. We recommend accordingly the establishment of a Deposit Protection Fund, with ex-ante funding. The Fund would receive contributions from banks and building societies on a regular basis, and be of sufficient size to obviate the need for the Government to step in to rescue a major bank. The establishment of a pre-funded scheme would be a significant cost to the institutions involved, but it seems only right to us that the costs of bank failure should be borne by the industry rather than the taxpayer, as would currently be the case. To ensure that the Fund is adequately resourced from the outset, we recommend that it be financed initially by a Government loan, which would then be repaid over time as banks' contributions accumulated. (Paragraph 263)
50. In the previous section we recommended the establishment of a Deposit Protection Fund, and suggested how the cost of building up this Fund should be spread over several years. During this initial phase, we recommend that banks' contributions be based solely on the size of their insured deposit base, in order to minimise complexity. Once the Fund is established, however, there may be a case for the introduction of a system of risk-based premia, whereby each bank contributes according to the Fund's assessment of the likelihood of needing to compensate

depositors. We recommend that the Government, in bringing forward legislation on the establishment of a Deposit Protection Fund, grant powers to that Fund to consult on and introduce risk-based premia once the Fund has been established. (Paragraph 266)

51. We think it wrong in principle that the Financial Services Authority should be investigating its own failure. We recommend that the FSA ensure that there is an independent component in the analysis of the decision-making of the FSA in relation to Northern Rock. (Paragraph 268)
52. We cannot accept, as some witnesses have suggested, that the Tripartite system operated “well” in this crisis. In terms of information exchange between the Tripartite authorities, the system might have ensured that all the Tripartite authorities were fully informed. However, for a run on a bank to have occurred in the United Kingdom is unacceptable, and represents a significant failure of the Tripartite system. If the system worked so “well”, the Tripartite authorities should take a closer look at the people side of the operation. (Paragraph 276)
53. Although we have concerns about the operation of the Tripartite system, we do not believe that the financial system in the United Kingdom would be well-served by a dismantling of the Tripartite system. Instead, we want to see it reformed, with clearer leadership and stronger powers. (Paragraph 277)
54. The Memorandum of Understanding clearly states that responsibility for the legislative framework rests with the Treasury. Two years ago a weakness in that framework appears to have been identified and by late 2006 had been classed as requiring “urgent” action. Between late 2006 and mid-2007, the measures to rectify this weakness appear to have been pursued by the Tripartite authorities with insufficient vigour. We address methods of dealing with this in Chapter 8. (Paragraph 280)
55. While we welcome the Chancellor’s admission that he was ultimately in charge of the decision making process relating to Northern Rock, we are concerned that, to outside observers, the Tripartite authorities did not seem to have a clear leadership structure. We recommend that the creation of such an authoritative structure must be part of the reforms for handling future financial crises and this informs the recommendations we make in the next Chapter. (Paragraph 284)
56. There was no sign of a communications strategy of the Tripartite authorities during the crisis of September 2007. We believe that this was a contributory cause of the run on the bank. The Tripartite authorities must learn the lessons of the failure or absence of a communications strategy between 10 and 17 September. We recommend that the Tripartite authorities revise their communications arrangements for future crises, to ensure a single, coherent and coordinated message, which was absent in the crisis in September 2007. This message needs to take into account the public’s likely reaction, and be in language people can readily understand. (Paragraph 289)
57. The events surrounding the crisis at Northern Rock have been damaging to the financial services industry in the United Kingdom, and for the Tripartite authorities.

It is important that the lessons are learnt from this crisis, and that the changes that result from this process are implemented swiftly, given the continuing problems in the world's financial markets and the desirability of ensuring that the damage to the United Kingdom's reputation as a financial centre is minimised. (Paragraph 292)

58. Where Government money is advanced to a financial institution, the Government, should take appropriate management control or should ensure that it has sufficient control over the activities of the company to ensure that taxpayers' interests are not prejudiced. (Paragraph 294)
59. A lesson to be learnt from this crisis is that the auditor can only provide an assurance of a snapshot of the past state of the company. We recommend that the accounting bodies consider what further assurance auditors should give to shareholders in respect of the risk management processes of a company, particularly where a company is regarded as an outlier. We are also concerned that there appears to be a particular conflict of interest between the statutory role of the auditor, and the other work it may undertake for a financial institution. For example, PricewaterhouseCoopers received £700,000 in non-audit fees largely comprised of fees relating to assurance services in connection with Northern Rock's actions in raising finance". We note the work being undertaken by the accounting boards in respect of this issue and recommend that both they and the FSA give swift consideration to such particular conflicts in financial institutions. (Paragraph 299)
60. The Financial Services Compensation Scheme model works well for all institutions other than large deposit-taking institutions, where systemic risk is more prevalent. We therefore recommend that the Financial Services Compensation Scheme continue to operate under its current regime for all institutions other than large deposit-taking institutions. We also recommend that the authority in charge of the Deposit Protection Fund decide on how such large institutions should be selected. However, in order to prevent discrepancy in the market, we recommend that the insured deposit limit for individuals under the continuing Financial Services Compensation Scheme be equal to that under the Deposit Protection Fund. (Paragraph 302)
61. We therefore recommend that the new regulatory powers relating to banks set out in Chapter 5 of this Report reside with the institution that also controls the Deposit Protection Fund. (Paragraph 304)
62. We have already concluded that we do not wish to dismantle the current structure of the Tripartite system. We therefore do not support the creation of a new institution similar to the US Federal Deposit Insurance Corporation. (Paragraph 305)
63. We consider the need for 'creative tension' within the regulatory system as of sufficient importance to justify overlooking any possible synergies of co-locating the new powers recommended in this Report alongside the existing powers of the Financial Services Authority. We have concluded it would be inappropriate for the Financial Service Authority to receive the Deposit Protection Fund, or the associated additional powers. (Paragraph 308)

64. It is right that where taxpayers' money is being used in a support operation, there should be political responsibility, and that the Chancellor of the Exchequer should make the final decision on whether such operations should be conducted. However, in most instances, regulatory action should and will be taken before such "last resort" support is required. This would be the benefit of a "prompt corrective action" approach. As such, we see no reason for the Chancellor of the Exchequer to be primarily responsible in the decisions that do not require taxpayer support. We have therefore concluded that it would be inappropriate for that the Treasury be the location for the Deposit Protection Fund. (Paragraph 310)
65. We do not consider that it would be appropriate for the Governor of the Bank of England to assume direct responsibility for the exercise of the new powers that we have proposed in chapters 5 and 6 relating to handling failing banks and the new Deposit Protection Fund. We envisage that the exercise of the new powers should rest first and foremost with a person who should have full-time responsibility for that exercise. We are also not convinced that direct responsibility for the new powers by the Governor of the Bank of England is appropriate in view of the Governor of the Bank of England's duties as Chairman of the Monetary Policy Committee. (Paragraph 314)
66. We recommend the establishment of a new post of "Deputy Governor of the Bank of England and Head of Financial Stability". He or she will have direct responsibility for the exercise of the new powers we have proposed in Chapter 5 and for the Deposit Protection Fund. The holder of the new post should have full authority within the Financial Services Authority to meet the requirements of his or her post. We recommend that paragraph 1(2) of Schedule 1 to the Bank of England Act 1998 be amended so that the Deputy Governor and Head of Financial Stability would not be required to work exclusively for the Bank of England. The holder of this new post will have a key role in ensuring that a Chancellor of the Exchequer receives authoritative and co-ordinated advice in any future case where financial stability is threatened by difficulties in the banking sector, and that post-holder would be one of the principal channels of advice to the Chancellor of the Exchequer. (Paragraph 315)
67. An extension of the responsibilities of the Bank of England in the manner we have recommended and the creation of the post of Deputy Governor and Head of Financial Stability must be accompanied by a review of the management structure and lines of responsibility within the Bank of England to ensure that:
- the Governor of the Bank of England's authority and leadership within the new structure of the Bank of England remains clear; and
 - there is an appropriate division of management and other responsibilities between the holder of the new post and the other Deputy Governor of the Bank of England.

We recommend that, as part of this review, consideration be given as to whether it would be appropriate for the holder of the post of Deputy Governor and Head of Financial Stability to be a member of the Monetary Policy Committee or whether that position should be assumed by a senior member of Bank of England staff specifically charged with responsibility for the interface between financial stability

and monetary policy. We recommend that the Deputy Governor and Head of Financial Stability have an important role in the Bank of England's money market operations, but work will be needed to clarify the distinction between that role, and the role needed to ensure money market operations to enact monetary policy. (Paragraph 316)

68. We recommend that an Office of the Deputy Governor and Head of Financial Stability be created within the Bank of England, including staff seconded from the Financial Services Authority, HM Treasury and other organisations. (Paragraph 317)
69. The Office must develop a forward-looking analysis, attempting to identify trends and potential risks to the financial system, and provide a regular update on those risks for the financial community. This role would also include adapting and improving stress-testing techniques, both at the system and individual institution level. (Paragraph 318)
70. One aspect of the recent crisis is the apparent lack of attention paid by financial institutions to the warnings of the Financial Services Authority and the Bank of England. The Office of the Deputy Governor and Head of Financial Stability should be charged with ensuring a feedback system is incorporated between financial institutions and the regulatory authorities for issues relating to financial stability. This feedback system will not just be limited to the financial institutions that have absorbed the message, but also whether the Financial Services Authority has taken these messages onboard. This would of course be linked to the horizon scanning function we outline above. We will discuss this further in our Report on Financial Stability and Transparency. (Paragraph 319)
71. To protect the Deposit Protection Fund for which it would be responsible, the Office of the Deputy Governor and Head of Financial Stability would identify outlying, weakened or potentially systemic financial institutions, and ensure that 'prompt corrective action', if needed, is undertaken. In more extreme circumstances, the Office would have the power to place an institution in the special resolution regime. Such a role would, of course, see this Office working closely with the Financial Services Authority, and we would expect full information disclosure between the Office and the Financial Services Authority. The expectation would be that, while the Office of the Deputy Governor and Head of Financial Stability would have the power to send inspectors into financial institutions covered by the Deposit Protection Fund and to those to which it is considering extending its protection, it would in the main rely on information provided by the Financial Services Authority, marrying this information with the information the Bank of England also receives via its operations in money markets, and liaison work conducted by the Office. (Paragraph 320)
72. We have already concluded that the communications strategy for handling the September 2007 crisis was weak. We therefore recommend that the Office of the Deputy Governor and Head of Financial Stability be given lead responsibility within the Tripartite authorities on ways to ensure that there is clear, coherent and effective communications with the public and the markets in any future financial stability crisis. (Paragraph 321)

73. We recommend, given the potential for a conflict of interest between different functions of the Financial Services Authority, that the Deputy Governor and Office of the Head of Financial Stability be given the role of leading for the Tripartite authorities in relation to the identification of third-party buyers for stricken firms. (Paragraph 322)
74. We recommend that the Office of the Deputy Governor and Head of Financial Stability be given the role of identifying and managing the relationship of the Tripartite authorities with third-party private sector assistance. (Paragraph 323)
75. One of the lessons learnt from this crisis is that legislation had been in preparation before the crisis hit; but that preparation process was not well-advanced. We recommend that the Office be responsible for identifying weaknesses in the legislative framework for financial stability and crisis management and liaising with the Treasury on the formulation of appropriate legislative responses. (Paragraph 324)
76. To prevent an overburdening of the Deputy Governor and Head of Financial Stability, we recommend consideration be given to the case for each of the tasks outlined above to be assigned to a separate Director within the Office of the Deputy Governor and Head of Financial Stability to be charged with overseeing each task. (Paragraph 325)
77. We recommend that, in addition to being responsible for the Bank of England's Financial Stability Report, the Office of the Deputy Governor and Head of Financial Stability produce an annual report on its activities and the work of the Tripartite Standing Committee. (Paragraph 326)
78. We recommend that there should be at least one meeting of the Tripartite standing committee at the Principal level every six months. We would expect a Chancellor of the Exchequer to ensure that, in any case where financial stability is threatened, he or she would be able to draw directly upon the experience and advice of the Deputy Governor and Head of Financial Stability as well upon that of the Governor of the Bank of England and the Chairman of the FSA. (Paragraph 328)
79. We recommend that formal advice given to the Chancellor of the Exchequer by the other Tripartite authorities in any future circumstances where financial stability is threatened be published as soon as reasonable after the immediate threat has passed, excluding any commercially sensitive information. (Paragraph 329)
80. We recommend that the Government clarify as a matter of urgency whether, in the event of the retail deposit guarantee for Northern Rock being invoked, any payments due to depositors would be off-set against depositors' mortgages with Northern Rock. (Paragraph 338)
81. The guarantee on Northern Rock's retail deposits was necessary to stop the run on those deposits. The guarantees issued in September and October to categories of wholesale deposits with Northern Rock assisted with the stability of the company during that period and since. One effect of the various Government guarantees issued in September and October has been to reinforce the incentive for the

Government to help to ensure that Northern Rock remains a going concern that honours its commitments to depositors. (Paragraph 340)

82. State support for Northern Rock has involved the Government entering into contingent liabilities on a very large scale. It is important that the Treasury discharges its obligations to the House of Commons—and through the House of Commons to the taxpayer—promptly and fully to report on the extent of such liabilities. The actual level of Bank of England support underwritten by the taxpayer is not specified within the Bank of England return. The Government itself should not have relied upon either the Bank of England or the Northern Rock to be the sole sources on the scale of the State commitment. The House of Commons should be updated about the scale of the commitment on a quarterly basis. (Paragraph 362)
83. We expect to explore the implications for fiscal policy of the Government's decisions relating to Northern Rock in due course. (Paragraph 380)

Annex 1: Relevant meetings during visit to Stockholm, 26–28 November 2007

The Riksbank

The Swedish Financial Supervisory Authority

The Swedish Finance Ministry

The Finance Committee of the Riksdag

Annex 2: Meetings during visit to Washington DC, 11–13 December 2007

The Institute for International Finance

The Federal Reserve Board

The Federal Deposit Insurance Corporation

The International Monetary Fund

Working dinner hosted by the Deputy Head of Mission, British Embassy

The Department of the Treasury

The American Bankers Association

The Office of the Comptroller of the Currency

Formal minutes

Thursday 24 January 2008

Members present:

John McFall, in the Chair

Nick Ainger	Mr Andrew Love
Mr Graham Brady	Mr George Mudie
Mr Colin Breed	Mr Si�on Simon
Jim Cousins	John Thurso
Mr Philip Dunne	Mark Todd
Mr Michael Fallon	Peter Viggers
Ms Sally Keeble	

The run on the Rock

Draft Report (*The run on the Rock*), proposed by the Chairman, brought up and read.

Ordered, That the Chairman's draft Report be read a second time, paragraph by paragraph.

Ordered, That the Chairman's draft Report be considered in the following order: paragraphs 1 to 5, paragraphs 7 to 369, and paragraph 6.—(*The Chairman.*)

Paragraphs 1 to 5 read and agreed to.

Paragraph 7 read, amended and agreed to.

A paragraph—(*Jim Cousins*)—brought up, read the first and second time, and inserted (now paragraph 8).

Another paragraph—(*Jim Cousins*)—brought up, read the first and second time, and inserted (now paragraph 9).

Another paragraph—(*Jim Cousins*)—brought up, read the first and second time, and inserted (now paragraph 10).

Another paragraph—(*Jim Cousins*)—brought up, read the first and second time, and inserted (now paragraph 11).

Paragraphs 8 and 9 (now paragraphs 12 and 13) read, amended and agreed to.

Paragraph 10 (now paragraph 14) read and agreed to.

Paragraph 11 (now paragraph 15) read, amended and agreed to.

Paragraph 12 (now paragraph 16) read and agreed to.

Paragraph 13 (now paragraph 17) read, amended and agreed to.

Paragraph 14 (now paragraph 18) read and agreed to.

Paragraph 15 (now paragraph 19) read, amended and agreed to.

Paragraphs 16 to 21 (now paragraphs 20 to 25) read and agreed to.

Paragraphs 22 to 24 (now paragraphs 26 to 28) read, amended and agreed to.

Paragraph 25 (now paragraph 29) read and agreed to.

Paragraph 26 (now paragraph 30) read, amended and agreed to.

Paragraph 27 (now paragraph 31) read, as follows:

“It is right that members of the Board of Northern Rock have been replaced, though haphazardly, since the lender of last resort operation began. The high-risk, reckless business strategy of Northern Rock, with its reliance on wholesale funding and a failure to acquire sufficient insurance to cover that risk, meant that it was unable to cope with the liquidity pressures placed upon it by the freezing of international capital markets in August 2007. Given that the formulation of that strategy was a fundamental role of the Board of Northern Rock, overseen by some directors who had been there since its demutualisation, the failure of that strategy must also be attributed to the Board. The non-executive members of the Board, and in particular the Chairman of the Risk Committee and the senior non-executive director, failed in the case of Northern Rock to act as an effective restraining force on the strategy of the executive members.”

Amendments made.

Another Amendment proposed, in line 8, to leave out from “Board” to the end of the paragraph.—(*Jim Cousins.*)

Question put, That the Amendment be made.

The Committee divided.

Ayes, 1

Jim Cousins

Noes, 10

Nick Ainger

Mr Graham Brady

Mr Colin Breed

Mr Philip Dunne

Mr Michael Fallon

Ms Sally Keeble

Mr Andrew Love

Mr George Mudie

John Thurso

Mr Mark Todd

Other Amendments made.

Paragraph, as amended, agreed to.

Paragraphs 28 and 29 (now paragraphs 32 and 33) read and agreed to.
Paragraph 30 (now paragraph 34) read, amended and agreed to.

Paragraphs 31 and 32 (now paragraphs 35 and 36) read and agreed to.

Paragraph 33 (now paragraph 37) read, amended and agreed to.

Paragraph 34 (now paragraph 38) read and agreed to.

Paragraph 35 (now paragraph 39) read, amended and agreed to.

Paragraphs 36 and 37 (now paragraphs 40 and 41) read and agreed to.

Paragraphs 38 to 41 (now paragraphs 42 to 45) read, amended and agreed to.

Paragraphs 42 and 43 (now paragraphs 46 and 47) read and agreed to.

Paragraph 44 (now paragraph 48) read, amended and agreed to.

Paragraph 45 (now paragraph 49) read and agreed to.

Paragraph 46 (now paragraph 50) read, amended and agreed to.

Paragraph 47 (now paragraph 51) read and agreed to.

Paragraph 48 (now paragraph 52) read, amended and agreed to.

Paragraph 49 (now paragraph 53) read and agreed to.

Paragraphs 50 to 52 (now paragraphs 54 to 56) read, amended and agreed to.

Paragraph 53 (now paragraph 57) read and agreed to.

Paragraphs 54 and 55 (now paragraphs 58 and 59) read, amended and agreed to.

Paragraphs 56 to 58 (now paragraphs 60 to 62) read and agreed to.

Paragraph 59 (now paragraph 63) read, amended and agreed to.

Paragraph 60 (now paragraph 64) read and agreed to.

Paragraph 61 read, as follows:

“Professor Wood told us that ‘the FSA does not seem to have carried out its job with the skill and diligence that one might have expected’. Professor Buitter argued that:

The FSA did not properly supervise Northern Rock. It failed to recognise the risk attached to Northern Rock’s funding model. Stress testing was inadequate.

Sir Callum McCarthy told us that ‘I think there are things which the FSA had responsibility for which, as we have both [Mr Sants and Sir Callum McCarthy] made clear, were not done well enough’. The Chancellor of the Exchequer also noted that ‘the FSA have said, and it is right, that they do need to look at their procedures and how they regulate things’. We note that the Financial Services Authority have acknowledged that the time periods between comprehensive regulatory review of Northern Rock were ‘inadequate’. **We are also**

concerned about the lack of resources solely charged to the direct supervision of Northern Rock. The failure of Northern Rock, while a failure of its own Board, was also a failure of its regulator. As the Chancellor notes, the Financial Services Authority exercises a judgement as to which ‘concerns’ about financial institutions should be regarded as systemic and thus require action by the regulator. In the case of Northern Rock, the FSA appears to have been systematically blind to its duty as a regulator to ensure Northern Rock would not pose such a systemic risk, and this failure contributed significantly to the difficulties, and risks to the public purse, that have followed.”

An Amendment made.

Another Amendment proposed, in line 10, after “inadequate”, to insert:

“the FSA did not supervise Northern Rock properly. It did not allocate sufficient resources or time to monitoring a bank whose business model was so clearly an outlier; its procedures were inadequate to supervise a bank whose business grew so rapidly.”—
(*Mr Michael Fallon.*)

Question put, That the Amendment be made.

The Committee divided.

Ayes, 11	Noes, 1
Nick Ainger	Jim Cousins
Mr Graham Brady	
Mr Colin Breed	
Mr Philip Dunne	
Mr Michael Fallon	
Ms Sally Keeble	
Mr Andrew Love	
Mr George Mudie	
John Thurso	
Mr Mark Todd	
Peter Viggers	

Other Amendments made.

Paragraph, as amended, divided and agreed to (now paragraphs 65 and 66).

Paragraphs 62 and 63 (now paragraphs 67 and 68) read and agreed to.

Paragraph 64 (now paragraph 69) read, amended and agreed to.

Paragraphs 65 to 68 (now paragraphs 70 to 73) read and agreed to.

Paragraph 69 (now paragraph 74) read, amended and agreed to.

Paragraphs 70 to 73 (now paragraphs 75 to 78) read and agreed to.

Paragraph 74 (now paragraph 79) read, amended and agreed to.

Paragraph 75 (now paragraph 80) read and agreed to.

Paragraph 76 (now paragraph 81) read, amended and agreed to.

Paragraphs 77 to 83 (now paragraphs 82 to 88) read and agreed to.

Paragraph 84 (now paragraph 89) read, amended and agreed to.

Paragraph 85 (now paragraph 90) read and agreed to.

Paragraphs 86 and 87 (now paragraphs 91 and 92) read, amended and agreed to.

Paragraphs 88 and 89 (now paragraphs 93 and 94) read and agreed to.

Paragraphs 90 and 91 (now paragraphs 95 and 96) read, amended and agreed to.

Paragraph 92 (now paragraph 97) read and agreed to.

Paragraphs 93 and 94 (now paragraphs 98 and 99) read, amended and agreed to.

Paragraph 95 (now paragraph 100) read and agreed to.

Paragraph 96 (now paragraph 101) read, amended and agreed to.

Paragraphs 97 to 105 (now paragraphs 102 to 110) read and agreed to.

Paragraphs 106 and 107 (now paragraphs 111 and 112) read, amended and agreed to.

Paragraphs 108 to 110 (now paragraphs 113 to 115) read and agreed to.

Paragraph 111 (now paragraph 116) read, amended and agreed to.

Paragraph 112 (now paragraph 117) read and agreed to.

Paragraph 113 (now paragraph 118) read and postponed.

Paragraph 114 (now paragraph 119) read, amended and agreed to.

Paragraphs 115 and 116 (now paragraphs 120 and 121) read and agreed to.

Paragraphs 117 and 118 (now paragraphs 122 and 123) read, amended and agreed to.

Paragraph 119 (now paragraph 124) read and agreed to.

Paragraph 120 (now paragraph 125) read, amended and agreed to.

Paragraphs 121 to 130 (now paragraphs 126 to 135) read and agreed to.

Paragraphs 131 and 132 (now paragraphs 136 and 137) read, amended and agreed to.

Paragraph 133 (now paragraph 138) read and agreed to.

Paragraph 134 (now paragraph 139) read, amended and agreed to.

Paragraph 135 (now paragraph 140) read and agreed to.

Paragraph 136 (now paragraph 141) read, amended and agreed to.

Another paragraph—(*John Thurso*)—brought up, read the first and second time, and inserted (now paragraph 142).

Paragraphs 137 to 139 (now paragraphs 143 to 145) read and agreed to.

Paragraph 140 (now paragraph 146) read, amended and agreed to.

Paragraph 141 (now paragraph 147) read and agreed to.

Paragraph 142 (now paragraph 148) read, amended and agreed to.

Paragraphs 143 to 155 (now paragraphs 149 to 161) read and agreed to.

Paragraph 156 (now paragraph 162) read, as follows:

“Although, according to Sir John Gieve, a unanimous ‘decision’ had been reached by the Tripartite authorities not to announce a Government guarantee at the same time as the lending facility, the Governor of the Bank of England and the Chancellor of the Exchequer both told us that they did not discuss the Government guarantee prior to Sunday 16 September, when discussions took place between those two and the Chairman of the FSA. A decision was taken on that day by the Chancellor of the Exchequer to give the Government guarantee. He told us that consideration of the precise terms of the guarantee meant that an announcement was not possible before the markets opened on Monday 17 September, and so the final announcement was made after markets closed on that day.”

Amendment proposed, in line 6, to leave out “A decision was taken on that day” and insert:

“In that context, it was unfortunate that the Chancellor of the Exchequer kept commitments abroad on Friday 14 September. A decision was taken on Sunday 16 September.”—(*Mr Philip Dunne*.)

Question put, That the Amendment be made.

The Committee divided.

Ayes, 3

Mr Graham Brady

Mr Philip Dunne

Mr Michael Fallon

Noes, 8

Nick Ainger

Mr Colin Breed

Ms Sally Keeble

Mr George Mudie

Mr Siôn Simon

John Thurso

Mr Mark Todd

Peter Viggers

Paragraph agreed to.

Paragraphs 157 and 158 (now paragraphs 163 and 164) read and agreed to.

Paragraphs 159 and 160 (now paragraphs 165 and 166) read, amended and agreed to.

Paragraphs 161 to 163 (now paragraphs 167 to 169) read and agreed to.

Paragraph 164 (now paragraph 170) read and postponed.

Paragraph 165 (now paragraph 171) read and agreed to.

Paragraph 166 (now paragraph 172) read, amended and agreed to.

Paragraphs 167 to 169 (now paragraphs 173 to 175) read and agreed to.

Paragraph 170 (now paragraph 176) read, amended and agreed to.

Paragraphs 171 to 175 (now paragraphs 177 to 181) read and agreed to.

Paragraphs 176 and 177 (now paragraphs 182 and 183) read, amended and agreed to.

Paragraphs 178 to 185 (now paragraphs 184 to 191) read and agreed to.

Paragraph 186 read, amended, divided and agreed to (now paragraphs 192 and 193).

Paragraphs 187 to 193 (now paragraphs 194 to 200) read and agreed to.

Paragraph 194 (now paragraph 201) read and postponed.

Paragraph 195 and 196 (now paragraphs 202 and 203) read and agreed to.

Another paragraph—(*Peter Viggers*)—brought up, read the first and second time, amended and inserted (now paragraph 204).

Paragraphs 197 to 207 (now paragraphs 205 to 215) read and agreed to.

Another paragraph—(*Mr Graham Brady*) brought up, read the first and second time, and inserted (now paragraph 216).

Paragraphs 208 to 223 (now paragraphs 217 to 232) read and agreed to.

Postponed paragraph 113 (now paragraph 118) again read, amended and agreed to.

Postponed paragraph 164 (now paragraph 170) again read, amended and agreed to.

Paragraph 224 (now paragraph 233) read, amended and agreed to.

Paragraphs 225 to 241 (now paragraphs 234 to 250) read and agreed to.

Paragraphs 242 and 243 (now paragraphs 251 and 252) read, amended and agreed to.

Paragraphs 244 to 246 (now paragraphs 253 to 255) read and agreed to.

Paragraph 247 (now paragraph 256) read, amended and agreed to.

Paragraphs 248 to 253 (now paragraphs 257 to 262) read and agreed to.

Paragraph 254 (now paragraph 263) read, amended and agreed to.

Paragraphs 255 and 256 (now paragraphs 264 and 265) read and agreed to.

Paragraph 257 (now paragraph 266) read, amended and agreed to.

Paragraph 258 (now paragraph 267) read and agreed to.

Paragraph 259 (now paragraph 268) read, amended and agreed to.

Paragraphs 260 to 264 (now paragraphs 269 to 273) read and agreed to.

Paragraph 265 (now paragraph 274) read, amended and agreed to.

Paragraph 266 (now paragraph 275) read and agreed to.

Paragraphs 267 and 268 (now paragraphs 276 and 277) read, amended and agreed to.

Paragraphs 269 and 270 (now paragraphs 278 and 279) read and agreed to.

Paragraph 271 (now paragraph 280) read, amended and agreed to.

Paragraphs 272 to 274 (now paragraphs 281 to 283) read and agreed to.

Paragraph 275 (now paragraph 284) read, amended and agreed to.

Paragraphs 276 to 279 (now paragraphs 285 to 288) read and agreed to.

Paragraph 280 (now paragraph 289) read, amended and agreed to.

Paragraphs 281 to 284 (now paragraphs 290 to 293) read and agreed to.

Paragraph 285 (now paragraph 294) read, amended and agreed to.

Paragraphs 286 to 289 (now paragraphs 295 to 298) read and agreed to.

Paragraph 290 (now paragraph 299) read, amended and agreed to.

Paragraphs 291 to 301 (now paragraphs 300 to 310) read and agreed to.

Paragraph 302 (now paragraph 311) read, as follows:

“The Bank of England is therefore a potential recipient of the Depositor Protection Fund. On a purely technical level, the Bank of England is used to dealing with such pools of assets as would be built up by the Fund. Moreover the Bank of England’s role in financial stability could be strengthened by this move, countering the fear of the BBA that downplaying the role of the Bank of England would not be regarded well by the international community.”

Amendment proposed, in line 1, to leave out from “of” to “of” in line 4 and insert:

“responsibility for the additional powers in relation to banks in distress that we proposed in chapter 5 and for the Deposit Protection Fund that we proposed in chapter 6. In relation to the powers under chapter 5, allocation of these responsibilities to the Bank of England would complement the Bank’s existing oversight of liquidity and its money market operations, and would strengthen the involvement of the Bank with the liquidity of individual banks. In relation to the powers under chapter 6, attribution to the Bank of England would make sense given that the Bank of England has experience in handling pools of assets of the kind that would be built up by the Deposit Protection Fund. Overall, the new powers would dovetail with the existing responsibilities of the Bank of England in relation to financial stability, while at the same time ensuring the ‘creative tension’ that we

earlier said that we wished to see in the regulatory system. Such a change would also respond to the concern”.—(*Mr Michael Fallon.*)

Question proposed, That the Amendment be made.

Proposed Amendment amended, in line 8, after “Fund”, by inserting “such as the Cash Ratio Deposit Scheme”.—(*Mr Philip Dunne.*)

Question put, That the proposed Amendment, as amended, be made.

The Committee divided.

Ayes, 11

Nick Ainger

Mr Graham Brady

Mr Colin Breed

Mr Philip Dunne

Mr Michael Fallon

Ms Sally Keeble

Mr Andrew Love

Mr George Mudie

John Thurso

Mr Mark Todd

Peter Viggers

Noes, 1

Jim Cousins

Paragraph, as amended, agreed to.

Paragraphs 303 to 308 (now paragraphs 312 to 317) read, amended and agreed to.

Paragraph 309 (now paragraph 318) read and agreed to.

Paragraphs 310 to 314 (now paragraphs 319 to 323) read, amended and agreed to.

Paragraph 315 (now paragraph 324) read and agreed to.

Paragraphs 316 to 319 (now paragraphs 325 to 328) read, amended and agreed to.

Another paragraph—(*Mr Michael Fallon*)—brought up and read, as follows:

“We recommend that formal advice given to the Chancellor of the Exchequer by the other Tripartite authorities in any future circumstances where financial stability is threatened be published as soon as reasonable after the immediate threat has passed, excluding any commercially sensitive information.”

Question put, That the paragraph be read a second time.

The Committee divided.

Ayes, 8
Mr Graham Brady
Jim Cousins
Mr Philip Dunne
Mr Michael Fallon
Ms Sally Keeble
John Thurso
Mr Mark Todd
Peter Viggers

Noes, 3
Nick Ainger
Mr George Mudie
Mr Siôn Simon

Paragraph inserted (now paragraph 329).

Paragraphs 320 to 349 (now paragraphs 330 to 359) read and agreed to.

Paragraph 350 (now paragraph 360) read, amended and agreed to.

Paragraph 351 (now paragraph 361) read and agreed to.

Paragraph 352 (now paragraph 362) read, amended and agreed to.

Paragraphs 353 and 354 (now paragraphs 363 and 364) read and agreed to.

Paragraph 355 (now paragraph 365) read, amended and agreed to.

Paragraphs 356 to 360 (now paragraphs 366 to 370) read and agreed to.

Another paragraph—(*Jim Cousins*)—brought up, read the first and second time, amended and inserted (now paragraph 371).

Paragraph 361 (now paragraph 372) read and agreed to.

Paragraph 362 (now paragraph 373) read, amended and agreed to.

Paragraphs 363 and 364 (now paragraphs 374 and 375) read and agreed to.

Postponed paragraph 194 (now paragraph 201) again read, amended and agreed to.

Paragraphs 365 to 369 (now paragraphs 376 to 380) read and agreed to.

Paragraph 6 read, amended and agreed to.

Annexes agreed to.

Summary amended and agreed to.

Resolved, That the Report, as amended, be the Fifth Report of the Committee to the House.

Ordered, That the Chairman make the Report to the House.

Written evidence was ordered to be reported to the House for printing with the Report.

Ordered, That embargoed copies of the Report be made available, in accordance with the provisions of Standing Order No. 134.

[Adjourned till Tuesday 5 February at 9.30 am.]

Witnesses

Thursday 20 September 2007

Page

Mr Mervyn King, Governor of the Bank of England, **Sir John Gieve**, Deputy Governor responsible for Financial Stability, **Mr Paul Tucker**, Executive Director for Markets, **Ms Kate Barker**, External Member of the Monetary Policy Committee, and **Dr Andrew Sentance**, External Member of the Monetary Policy Committee, Bank of England

Ev 1

Tuesday 9 October 2007

Sir Callum McCarthy, Chairman, and **Mr Hector Sants**, Chief Executive, Financial Services Authority

Ev 21

Tuesday 16 October 2007

Dr Matt Ridley, Chairman, **Mr Adam Applegarth**, Chief Executive, **Sir Ian Gibson**, Senior Non-Executive Director, and **Sir Derek Wanless**, Non-Executive Director, Northern Rock

Ev 47

Thursday 25 October 2007

Rt Hon 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, and **Mr Clive Maxwell**, Director, Financial Services, HM Treasury

Ev 78

Tuesday 13 November 2007

Professor Willem Buiter, London School of Economics; and **Professor Geoffrey Wood**, CASS Business School, City University

Ev 93

Mr Paul Taylor, Group Managing Director and Global Head of Sovereign, Public Finance, Corporate and Financial Institution Ratings, and **Mr Charles Prescott**, Group Managing Director, Financial Institutions, Fitch, **Mr Michel Madelain**, Executive Vice President, and **Mr Frédéric Drevon**, Senior Managing Director, Moody's, and **Mr Ian Bell**, Managing Director and Head of European Structured Finance, and **Mr Barry Hancock**, Managing Director and Head of European Corporate and Government Services, Standard and Poor's

Ev 105

Tuesday 4 December 2007

Mr E Gerald Corrigan, Managing Director and co-Chair of the Firmwide Risk Management Committee, Goldman Sachs, **Lord Charles Aldington**, Chairman, Deutsche Bank, London Branch, **Mr Jeremy Palmer**, Chairman and Chief Executive, Europe, Middle East and Africa, UBS, and **Mr William Mills**, Chairman and Chief Executive of City Markets and Banking, Europe, Middle East and Africa, Citigroup Ev 123

Mr Richard Sexton, UK Head of Assurance, and **Mr John Hitchins**, UK Banking and Capital Markets Leader, PricewaterhouseCoopers Ev 135

Mr Chris Hitchin, Chairman, National Association of Pension Funds and Executive Chairman, Railways Pension Trustees Company, **Mr Peter Montagnon**, Director of Investment Affairs, Association of British Insurers, **Mr Guy Sears**, Director, Wholesale, Investment Management Association, and **Mr David Pitt-Watson**, Chairman, Hermes Equity Ownership Service Ev 144

Tuesday 11 December 2007

Sir Callum McCarthy, Chairman, and **Mr Hector Sants**, Chief Executive, Financial Services Authority, and **Ms Loretta Minghella**, Chief Executive, Financial Services Compensation Scheme Ev 153

Tuesday 18 December 2007

Ms Angela Knight CBE, Chief Executive, British Bankers' Association, and **Mr Adrian Coles**, Director General, Building Societies Association Ev 169

Mr Mervyn King, Governor, and **Sir John Gieve**, Deputy Governor responsible for Financial Stability, Bank of England Ev 177

Thursday 10 January 2008

Rt Hon Alistair Darling MP, Chancellor of the Exchequer, **Mr John Kingman**, Second Permanent Secretary, and **Mr Clive Maxwell**, Director, Financial Services, HM Treasury Ev 197

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2	Tripartite Authorities	Ev 217
3	Financial Services Consumer Panel	Ev 219
4	Financial Services Authority	Ev 220
	Follow-up to evidence session 9 October 2007	Ev 223
	Follow-up to evidence session 11 December 2007	Ev 223
	Letter from the Chairman of the FSA	Ev 227
5	Financial Services Authority and Financial Services Compensation Scheme	Ev 227
6	Northern Rock, follow-up to evidence session on 16 October 2007	Ev 231
	Letter from Chairman of Northern Rock	Ev 240
7	HM Treasury, letter from the Chancellor	Ev 240
	Follow-up to evidence session on 25 October 2007	Ev 242
	Letter from the Chancellor	Ev 243
8	Julian D. A. Wiseman	Ev 244
9	London Investment Banking Association	Ev 247
10	Dr Paul Hamalainen, Loughborough University	Ev 253
11	The Alternative Investment Management Association Limited	Ev 257
12	Fitch Ratings	Ev 258
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13	The Association of British Insurers	Ev 266
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17	Investment Management Association	Ev 288
18	British Bankers' Association	Ev 294
19	The Building Societies Association	Ev 303
20	Council of Mortgage Lenders	Ev 308
21	Professor Willem Buiter, London School of Economics and Political Science	Ev 310
22	National Association of Pension Funds (NAPF)	Ev 330
23	E Gerald Corrigan, Goldman Sachs International	Ev 332
24	David Pitt-Watson, Hermes Equity Ownership Service	Ev 335
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Second Report	The 2007 Pre-Budget Report	HC 54
Third Report	The Work of the Committee in 2007	HC 230
Session 2006–07		Report
First Report	Financial inclusion: the roles of the Government and the FSA, and financial capability	HC 53
Second Report	The 2006 Pre-Budget Report	HC 115
Third Report	Work of the Committee in 2005–06	HC 191
Fourth Report	Are you covered? Travel insurance and its regulation	HC 50
Fifth Report	The 2007 Budget	HC 389
Sixth Report	The 2007 Comprehensive Spending Review: prospects and processes	HC 279
Seventh Report	The Monetary Policy of the Bank of England: re-appointment hearing for Ms Kate Barker and Mr Charlie Bean	HC 569
Eighth Report	Progress on the efficiency programme in the Chancellor's department	HC 483
Ninth Report	Appointment of the Chair of the Statistics Board	HC 934
Tenth Report	Private equity	HC 567
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Third Report	The Monetary Policy Committee of the Bank of England: appointment hearing for Sir John Gieve	HC 861
Fourth Report	The 2006 Budget	HC 994
Fifth Report	The design of a National Pension Savings Scheme and the role of financial services regulation	HC 1074
Sixth Report	The administration of tax credits	HC 811
Seventh Report	European financial services regulation	HC 778
Eighth Report	Bank of England Monetary Policy Committee: appointment hearing for Professor David Blanchflower	HC 1121
Ninth Report	Globalisation: the role of the IMF	HC 875
Tenth Report	Independence for statistics	HC 1111
Eleventh Report	The Monetary Policy Committee of the Bank of England: appointment hearings for Professor Tim Besley and Dr Andrew Sentance	HC 1595
Twelfth Report	Financial inclusion: credit, savings, advice and insurance	HC 848
Thirteenth Report	“Banking the unbanked”: banking services, the Post Office Card Account, and financial inclusion	HC 1717