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THE SUB-PRIME CRISIS, THE CREDIT CRUNCH AND BANK "FAILURE" : AN ASSESSMENT OF THE UK AUTHORITIES' RESPONSE

by

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ABSTRACT

On 8 October 2008 the UK Government announced a far-reaching plan to restore financial stability, protect depositors and re-invigorate the flow of credit to businesses and individuals in the UK. The £400 billion bailout plan embraced three elements: a massive expansion in emergency liquidity support from the Bank of England; recapitalisation of UK banks and building societies using taxpayers' money; and the provision of a Government guarantee of new short- and medium-term debt issuance made by UK-incorporated banks and building societies. This action proved necessary in the wake of continuing and substantial weaknesses in many banks' share prices despite the temporary ban on short-selling imposed by the Financial Services Authority. It followed two revisions to domestic deposit protection arrangements, and the adoption of a piecemeal approach to failure resolution which saw the eventual nationalisation of Northern Rock in February 2008, the nationalisation of Bradford and Bingley in September 2008 and the brokering of takeover rescues of Alliance and Leicester and HBOS by Banco Santander and Lloyds TSB respectively in July and September 2008, and of the Cheshire and Derbyshire Building Societies by the Nationwide Building Society in September 2008. This metamorphosis in approach to failure resolution by the UK authorities in response to the sub-prime crisis and the credit crunch – nationalisation by default to (part) nationalisation as the preferred course of action - is duly analysed in this article, as well as their proposals for banking reforms which still have to be agreed by Parliament.

JEL Classification: E53; E58; G21; G28.

Key words: UK banks; banking regulation and supervision; failure resolution; central banking; deposit protection.

1. INTRODUCTION

Following the provision of a 100 per cent guarantee to depositors and other creditors of Northern Rock in September 2007, a revision of deposit protection arrangements in October 2007 and a belated acceptance by the Bank of England of the need to dramatically expand the scale of its emergency liquidity support operations in the Autumn of 2007 for both the market in general and Northern Rock in particular, domestic financial stability appeared to be restored. But, and not withstanding the eventual nationalisation of Northern Rock in February 2008, the worsening of the credit crunch through 2008 and its impact on British banks' balance sheets served only to heighten investors' concerns about the health of the UK financial system. Stung by criticism from the House of Commons' Treasury Committee and others, the UK authorities duly drafted wide-ranging proposals to restore financial stability and prevent a recurrence of a Northern Rock-style fiasco but, before they could enact the necessary legislative provisions, the UK banking industry's fortunes took a distinct turn for the worse. Unsurprisingly, the Alliance and Leicester, given its exposure to the UK housing market which was now in "meltdown" mode, as lenders both withdrew loan products and raised the price of those remaining, was the first to suffer speculative attack. With the authorities' blessing, it was acquired by the Spanish bank Santander in July 2008 prior to reporting a 99 per cent crash in pre-tax profits to just £2 million for the first half of 2008 in the light of a £143 million sub-prime writedown and £209 million of losses on toxic securities. The next to cause concern was HBOS, the UK's largest mortgage lender, which announced, in July 2008, a 72 per cent fall in pre-tax profits to £848 million for the first half of 2008 after making a £1.09 billion sub-prime-related writedown. Following further sharp falls in its share price in the wake of a ratings downgrade, the bank was shepherded into the arms of Lloyds TSB under the terms of a

£12.2 billion all-share takeover announced on 18 September 2008. And finally, Bradford and Bingley, the only surviving converted building society, also lost its independence following the nationalisation of its loan book and the industry–financed sale of its deposits and branch network to Banco Santander on 29th September 2008. Such drastic action proved necessary in the wake of the bank's announcement of a pre-tax loss of £26.7 million for the first half of 2008, its subsequent downgrading by Moody's to just one notch above junk status, and failure to find a 'White Knight' amongst the UK's five largest banks.

Whilst such *ad hoc* action temporarily calmed nerves, events surrounding the US administration's attempt to enact the so-called ($700 billion) Paulson plan (i.e. the "Troubled Asset Relief Programme", or "TARP"), further spooked markets on both sides of the Atlantic. Indeed, despite both the Upper and Lower houses of Congress voting in favour by the week ending 5 October 2008, stock markets went into free fall, with knock-on effects for a number of banks in Europe. This duly led to 'beggar thy neighbour' blanket deposit guarantees being given to all or part of their national banking systems by the likes of Greece, Germany and others following the lead taken by the Irish government, the British government content, at least for the time being, to increase the level of deposit protection from £35,000 to £50,000 on a *per capita* per bank basis. By now, however, it had become clear that a pan-European solution to financial/banking instability was needed, and that a more comprehensive solution, additional to the massive infusion of liquidity by central banks, was in order. Taxpayer-funded, recapitalisation of sound but ailing banks, as practised by Scandinavian countries and Japan in the 1990s, seemed the only answer, in preference to a backdoor recapitalisation through purchases of impaired assets at above market prices (as feared under TARP in the US). The evolution of official thinking, which ended up with the adoption of this approach, is duly examined in this

article, along with the UK authorities' more detailed proposals for restoring financial stability.

The paper is structured as follows. In Section 2 I set out the background to the collapse of Northern Rock, the events leading up to its eventual nationalisation and the regulatory (and supervisory) response to the bank's demise as a private entity. A review and assessment of the House of Commons Treasury Committee's report on Northern Rock is also provided at this juncture. In Section 3 I provide a personal assessment of the tripartite authorities' proposals for reform. In Section 4 I chart the authorities' handling of the troubled organisations Alliance and Leicester, HBOS and Bradford and Bingley before explaining the nature of, and necessity for, the October bailout plan. Section 5 summarises and concludes.

2. THE NORTHERN ROCK CRISIS[i]

2.1 Background : The US Sub-prime Crisis and its Spillover Effects for the UK

The downturn in the US housing market, the connecting collapse in security prices associated with the sub-prime sector of the market [i.e. those securities, such as residential asset-backed mortgages (RABM) and collateralised debt obligations (CDOs), contaminated by defaults arising from "self-certificated" mortgages or mortgages otherwise granted on the basis of a high multiple of earnings or as a generous proportion (often 100 per cent plus) of the market valuation] and the subsequent global loss of confidence in asset-backed securities (ABS) and other markets[ii] have had ripple effects in the UK. The direct exposure of UK banks and other financial institutions, however, has been fairly limited.[iii] But this has not allowed the UK financial system to emerge unscathed. The prime source of contagion has come through the international interbank market where banks have proved very reluctant to lend to each other, even at penal rates. This situation has arisen because of the banks' need to hoard cash to meet the contingent liquidity claims of their off-balance-sheet vehicles which now find they are unable to fund themselves in the traditional wholesale markets (e.g. the asset-backed commercial paper (ABCP) market) because of the uncertainty about their solvency given their exposure to sub-prime securities. Additionally, given the lack of transparency in the market place about where the sub-prime risks actually lie, and concerns about the likely scale of losses being nursed by prospective counterparties, mutual distrust has set in, causing the market to seize up. These severe liquidity shortages are reflected in abnormally high spreads between three months money and official Bank Rates, and have led to central banks around the globe providing additional liquidity to the markets through a variety of special funding initiatives (*see* Hall, 2008b, Table 1). Their intention is to limit the potentially-

wider damage that could be wrought upon the real economy as liquidity shortages give way to a credit squeeze and lending rates edge up and lending volumes fall, and not just in mortgage markets. Tighter liquidity can also threaten insolvency for institutions over-exposed to the wholesale markets as a source of funds; and individual insolvency[iv] can soon spread to a wider community if depositor/investor panic sets in. Such then were the forces which were to wreak so much damage on the UK financial system and expose its inherent fragility.

2.2 The Events Leading Up to Nationalisation

The events leading up to and encapsulating the Northern Rock crisis, which ended with the bank's nationalisation, are chronicled in Hall, 2008b, Table 2. According to its mid-term balance sheet for 2007, the assets of the UK's eighth largest bank and fifth largest mortgage lender stood at £113.5 billion at the end of June, with mortgages comprising £87.9 billion. Revealingly, only £30.1 billion of liabilities was represented by customer deposits; and shareholders equity amounted to £1.95 billion. The balance sheet starkly reveals the strategy of the bank which distinguished it from the other UK mortgage lenders. With only 72 branches to its name, its retail customer base was limited, causing it to rely heavily on wholesale markets for its funding.[v] As an arch exponent of the "originate and distribute" school, Northern Rock's business model was to expand[vi] through the use of securitisation (of its mortgage pool) and other secured borrowing. Whilst such a strategy delivered an industry-beating cost-to-income ratio of around 30 per cent, it always represented "an accident waiting to happen".

Investor concerns over Northern Rock soon came to the surface once the sub-prime turmoil hit the US financial system, with astute investors correctly predicting the

subsequent trading woes that were to hit Northern Rock as the interbank and covered bond markets ground to a halt. Massive short-selling of Northern Rock's stock – at one stage there was no physical stock left to borrow to facilitate such transactions – and an end-June profits warning saw the share price halve from its February 2007 peak. By August the bank knew the game was up, with no immediate prospect of the credit squeeze ending. As noted above, banks hoarded cash in the expectation that they would be called upon to honour the contingent lines of liquidity previously agreed with their off-balance-sheet conduits which were now denied funding,[vii] and due to uncertainty about where the sub-prime losses lie.[viii] Accordingly, it entered into negotiations with a number of potential buyers, duly keeping the Bank of England and the FSA fully informed. Failure to secure a firm bid,[ix] however, drove it into the arms of the Bank of England, with the latter announcing, on 14 September 2007 (the original intention was to make the announcement on 17 September but leaks on the impending announcement necessitated bringing the date forward), that it was providing an emergency line of credit to Northern Rock to allow it to continue operating. Following confirmation from the FSA that the bank was solvent, the decision to offer official assistance was taken to reassure the bank's depositors and prevent a wider systemic crisis. Under the open-ended facility (the original facility agreed on 14 September was replaced by a wider facility on 11 October), the bank is charged a (undisclosed) penal rate and is able to use mortgages and mortgage-backed securities and other assets as collateral to access the loan. The Bank, in turn, is indemnified against any losses and other liabilities arising from its support by the Treasury.

In the event, however, such action proved insufficient to reassure depositors – the mentioning of "last resort" funding appeared to induce just the opposite response – thereby threatening wider contagion. As a result, on 17 September 2007, the Treasury announced a

full guarantee of all existing Northern Rock deposits in an attempt to stem the nationwide run on the bank which had seen over £2 billion (later increased to over £12 billion) withdrawn in a matter of days, and restore financial confidence. The guarantee (which was extended to include existing and renewed unsecured wholesale funding on 20/21 September and covered bonds and derivatives not backed by mortgage collateral on 18 December – *see* House of Commons, 2008a, p.131-132, para.350 for further details) is due to last for as long as the current financial turmoil persists, and will be extended to other depositors if any further UK banks encounter similar difficulties. Thus, not only was Northern Rock continuing to operate as a commercial entity with a state guarantee, but the whole of the UK banking system's deposit base had now been effectively underwritten by UK taxpayers. The belated provision of the blanket guarantee duly caused the queues to disappear[x] with the Chancellor subsequently announcing, on 1 October 2007, an increase in the level of depositor protection to £35,000[xi] and a review of deposit protection arrangements (HM Treasury, FSA and Bank of England, 2007).

Whilst all this was happening, the House of Commons' Treasury Select Committee held hearings into the affair, interrogating, in turn, the major protagonists. The first to endure their wrath and ire were senior officials from the Bank of England, including the Governor Mervyn King. The Governor was asked, *inter alia*, to explain his *volte face* on the provision of liquidity to the market – *see* below – and the background to the Northern Rock fiasco, and to give his views on the workings of the tripartite arrangements. Subsequently to this, senior FSA officials received a similar grilling but, whilst accepting that their monitoring of Northern Rock was, in some ways, "inadequate" (*see* below), they too refused to criticise the workings of the tripartite arrangements. Finally – the interrogation of the Treasury is considered below - senior Northern Rock officials

themselves were hauled, and mauled, before the Committee but they offered few apologies for their actions arguing that their business model was a "good one", their stress testing was "sufficient" and that they were the victims of "wholly unexpected events".[xii] They also suggested that, had the Bank been willing to extend the liquidity lifeline subsequently agreed for Northern Rock to a potential suitor (i.e. Lloyds TSB), the bank would not be in the position it finds itself in today. The Bank subsequently (on 17 October 2007) released a statement claiming that the suitor had demanded a penalty-free loan of up to £30 billion for a period of up to two years, something which the Bank argued could not be provided, even if it wanted to, given current EU rules on State aid.

The demise of the bank as a private entity duly arrived with its nationalisation on 21 February 2008 (*see* note 9). It is hoped to sell the bank back to the private sector at some future point but, given recent events in the markets and the continuing slowdown in the UK housing market, this is unlikely to happen in the short- to medium-term. Of the Bank of England's loan, which peaked at around £28 billion in January 2008, some £10.5 billion had been repaid by July 2008 notwithstanding Northern Rock's half-year losses for 2008 of £585 million due to rising arrears and repossessions.

2.3 The Regulatory Response to the Financial Crisis and the Northern Rock Fiasco

Actions Taken by the Bank of England

Despite the intensifying liquidity crisis, the Bank, initially, refused to offer additional liquidity to the market other than through the "standing facility" under which banks can borrow (against eligible collateral), without limit, beyond their "target reserve balance" at a penalty of 100 basis points above the official Bank Rate, under the modifications to official money market operations introduced in 2006.[xiii] The Bank's stance was eloquently

explained in a letter the Governor sent to the House of Commons' Treasury Select Committee on the 12 September 2007. Whilst emphasising the Bank's difficulty in balancing the needs of (short run) financial stability against the fear that a wider provision of liquidity would 'undermine the efficient pricing of risk' and hence long run stability, the Governor went on assert that proper management of "the current turmoil, which has at its heart the earlier under-pricing of risk … should not threaten our long-run economic stability." Hence the reason for the Bank's relatively sanguine approach. Additionally, the Governor argued that to go further would only increase moral hazard and raise the likelihood and intensity of a future financial crisis. As he put it:

> "The provision of large liquidity facilities penalises those financial institutions that sat out the dance, increases herd behaviour and increases the intensity of future crises." And,
>
> "The provision of greater short-term liquidity … would undermine the efficient pricing of risk by providing ex-post insurance for risky behaviour … encourages excessive risk-taking and sows the seeds of a future financial crisis."

In other words, a tough line is needed *pour encourager les autres*.

The first sign of the Bank retracting from this principled approach came on the 5 September when, in addition to accommodating the UK commercial banks' increased demand for target reserve balances – they increased by around six per cent, to £17.6 billion, compared with the previous month's figure – it announced that it would allow the banks to bid for an additional £4.4 billion of cash the following week, *without payment of a penalty*, if overnight rates remained high. The move was designed to narrow the gap between secured overnight rates and the official Bank Rate (5.75 per cent), which had peaked at around 75 basis points, and to stimulate interbank lending by increasing the

banks' liquidity cushion. Unlike the ECB's earlier move on 22 August – *see* Hall, 2008a, Table 1 - it was not intended to influence the three months' rate which, the Bank argued, was beyond their control, comprising both liquidity and credit risk premia. In the event, the full £4.4 billion was taken up by the market on 13 September.

Having initially stood out from the crowd, the Bank was always on a 'hiding to nothing' if unfolding events necessitated a change of tack. And, unfortunately for the Bank, just such a change was deemed necessary only two days after publication of the Governor's letter to the Treasury Select Committee. For, on the 14 September, following assurances given by the Financial Services Authority (FSA) that the bank remained solvent, the Bank provided emergency funding to Northern Rock. [Additional lending facilities were also made available on 9 October – *see* House of Commons, 2008a, p.127, para.341.] The move was taken to allow the bank to continue operating, to reassure depositors of the bank and to prevent wider contagion should a bank run spread. Under the arrangements, the bank has access to an unlimited amount of funding (subject to the provision of "suitable" collateral, which can now include mortgages and mortgage-backed securities) for as long as the turmoil persists,[xiv] although a (unrevealed)[xv] penalty rate is imposed. By the end of December the scale of the Northern Rock's indebtedness to the Bank had risen to over £25 billion, the UK taxpayers' total exposure had risen to over £55 billion (because of the extension in the Treasury's guarantee) and there was no end to the bank's plight nor the credit crunch (*see* Hall, 2008b, Table 1) in sight.

Subsequent to this, on 19 September, the Bank announced that it would, after all, lend to banks for periods of up to three months and against a wider range of collateral than hitherto (to include, as in the Northern Rock case, mortgages for example) under a new

emergency facility. An initial £10 billion injection of cash, via public auction, was to be made the following week, with weekly auctions to follow thereafter until the market turmoil subsides. Unlike the Fed however – *see* entries in Hall, 2008a, Table 1, for the 18 September and 31 October - the Bank (i.e. the Monetary Policy Committee) resisted the temptation to cut interest rates early, preferring to wait until the likely impact of the credit crunch upon the real economy, and hence future inflation, became clearer. As noted in Hall, 2008a, Table 2, this was not deemed necessary until 6 December, when Bank Rate was cut by 25 basis points to 5.5 per cent. And, following a further 25 basis points cut on 7 February 2008, the Committee declined to cut rates again at its March 2008 meeting, citing concerns about the possibility of above-target inflation rates in the medium term, which duly materialised with the publication of a CPI figure of 3 per cent for April 2008 on 13 May 2008. On 10 April 2008, however, the Committee cut Bank Rate again, by 25 basis points to 5 per cent, against a background of tightening credit conditions and reduced availability of credit. On 8 October 2008, a further 50 basis points cut was sanctioned as part of the worldwide central bank response to the market turmoil and in response to an improved medium-term outlook for inflation. And finally, on 6 November 2008, in a belated attempt to "get ahead of the curve", the Committee cut Bank Rate by an unprecedented 150 basis points to 3 per cent, the lowest level seen for 54 years. The move was taken in response to evidence suggesting the UK economy faced a "severe contraction" with a high risk that, in the medium term, the inflation target might be seriously undershot if less decisive action was not taken.

Given this remarkable *volte face* on funding in such a short space of time it was inevitable that questions would be raised about the Governor's judgment, thereby threatening to damage the credibility of the central bank.[xvi] The first opportunity to cross-

examine the Governor in public came with his appearance before the Treasury Select Committee on the 20 September, just a day after the announcement of the latest initiative. Lacking his usual self assurance, the Governor argued that changing circumstances necessitated a new approach. As outlined in a letter released the previous day by the Bank, the new policy stance arose "because the situation has changed – there has been a run on a bank … which threatened the reputation of the British banking system" and there is a need "to alleviate the strains on the longer-maturity money markets". He went on to argue that the *volte face* was his decision (i.e. not taken under Treasury duress) and that the moral hazard created by the second initiative would be limited by the provision of a cap on the scale of funding the Bank proposed to supply, both in aggregate and to individual banks, and by the charging of a penalty rate of interest (of at least 100 basis points above Bank Rate).

With respect to the Northern Rock liquidity lifeline, the Governor argued that his preferred course of action [not universally shared, and deemed impractical by the FSA (House of Commons, 2008a, p.56, para.123), although the Chancellor has since announced he will consider revising the regulatory framework to allow for such a possibility and the Treasury Committee has endorsed its use in specified circumstances (House of Commons, 2008a, p.86, para.215)] was a covert rescue operation by another bank but this had been stymied by a serious of legislative obstacles. Specifically, the Takeover Code, given a legislative footing in the Companies Act 2006, and the EU's 'Market Abuse' Directive (2005) prevented a secret takeover; whilst the insolvency regime enshrined in the Enterprise Act 2002 (which requires the freezing of bank accounts in the face of insolvency, thereby delaying compensation to depositors) and the Financial Services

Compensation Scheme of 2001 (which only provided full protection on the first £2,000 of a depositor's funds) conspired to make a nationwide run on Northern Rock rational.

Whatever the respective merits of the Governor's arguments,[xvii] in the event, there were no takers for the newly-proffered funds at either the auction held on 26 September or in subsequent weeks. Whether this reflected an underlying improvement in banks' liquidity positions, the costly nature of the funding or a reluctance by borrowers to be stigmatised by taking advantage of it, nobody is too sure. But it is clear some small banks still faced funding problems in the wholesale markets at the time; and the market's appetite for the auction of three-month money announced on 12 December suggested that funds, at the right price, were still widely needed and that borrowers' fears of being stigmatised if they avail themselves of the special funding facilities may be waning. Indeed, this appears to be one of the positive outcomes of the co-ordinated central bank action announced on 12 December (*see* Hall, 2008a, Tables 1 and 2), together with a narrowing of the spreads between three-month inter-bank rates and official rates.

Since the turn of the year, the Bank has been more receptive to the idea of expanding emergency liquidity support in the face of a worsening financial and economic outlook, both at home and abroad. Apart from a willingness to rollover and increase the size of auctions of three-months, sterling-denominated money, it provided £5 billion of three-day money in the wake of the uncertainty generated by the Fed-sanctioned rescue of Bear Stearns (17 March 2008) and, on 21 April 2008, unveiled a new £50 billion – later extended to £200 billion – 'Special Liquidity Scheme' under which it will swap Treasury bills for securities backed by mortgages made before 1 January 2008 or credit card debts for a period of up to 364 days. And, since then, the Bank has offered substantial dollar-

denominated funds to the market, both on an overnight basis and for longer periods, following currency swaps with the Fed, and has extended the range of collateral it is willing to accept in all of its deals. Finally, on 16 October 2008, the Bank unveiled a revised set of "rules" for its money market operations, designed to operate in normal and crisis times. A new "operational standing facility" will allow banks to borrow against top-quality collateral, without the risk of being identified, for up to a month. A permanent "discount window facility" will also allow banks to swap illiquid assets for government securities, again without the risk of being identified, on this occasion for at least three months. The fees charged will depend on the size of the loan and quality of collateral offered. And, finally, a wider range of collateral will now be accepted at regular monthly auctions.

Actions Taken by the FSA

Apart from endorsing the moves to reform the deposit protection, failure resolution and tripartite arrangements – *see* below – the FSA has also published a discussion paper reviewing liquidity requirements for banks and building societies (FSA, 2007c), in the light of its earlier acknowledgement of flaws in its assessment regime. A consultative paper on the subject, with firm proposals, was promised for mid-2008 (although it has yet to be delivered!). It intends to develop UK policy in line with the international work being undertaken by the Basel Committee and the Committee of European Bank Supervisors but currently envisages the continued use of some form of quantitative liquidity requirement and an intensification in the supervision of individual firms' stress testing and contingency funding plans as well as their off-balance-sheet vehicles. [Further insights into the need for reform are contained in Goodhart, 2007b.]

Further to this work, the FSA is currently monitoring all wholesale and retail banks and deposit-taking institutions more closely under a continuing, principles-based philosophy, whilst reviewing its risk-assessment and risk-mitigation practices. Its internal audit division also delivered a report on the lessons to be learnt from the Northern Rock affair, as promised in December 2007 (FSA, 2007d), although the Treasury Committee much preferred an independent inquiry (House of Commons, 2008a, p.104, para.268). The conclusions were subsequently made public in March 2008 (FSA, 2008), precipitating the adoption of a 'supervisory enhancement programme' by the FSA.[xviii] And, finally, the FSA has already revealed a shake-up on its operating model (*FT*, 11 January 2008), partly in anticipation of the Chancellor's demand for an enhanced role for the regulator in bank failure resolution policy and banking supervision more generally.

Actions Taken by HM Treasury

As discussed earlier, the Treasury has already taken action to amend the deposit protection arrangements and to put in train, with the other tripartite authorities, a wider review of such arrangements.[xix] [Under the proposals announced by the FSA in November 2007 for adoption in April 2008, the Financial Services Compensation Scheme's annual capacity to pay out depositors was increased from £2.7 billion to £4.03 billion, to be funded through *ex-ante* contributions from financial intermediaries.] And, in response to instability in world banking markets, the *de jure* limit of protection afforded UK depositors was raised, yet again, in October 2008 from £35,000 to £50,000.]

Secondly, the Treasury was keen to reform the so-called 'tripartite arrangements' (Bank of England, 1998) which relate to the arrangements put in place in October 1997 to deliver financial stability by ensuring close co-operation and co-ordination between the interested

parties (the Bank, the Treasury and the FSA), especially in the event of a financial crisis, following the Labour government's decision to strip the Bank of responsibility for banking supervision (Hall,1997). The involvement of the Bank is necessary because of its continuing lender of last resort function and its responsibility for "maintaining overall financial stability",[xx] whilst the FSA's presence is obviously required as the main regulatory/supervisory authority and the first port of call for any financial firm which gets into difficulties. Finally, the Treasury is primarily responsible for the international structure of regulation and the regulation which governs it, and has to be consulted if there is a perceived need for an official "support operation". Basically then, in the case of the liquidity lifeline thrown to Northern Rock, the FSA's role was to determine whether or not the bank was solvent, following an appeal for help from the bank; the Bank, as well as the FSA, had to determine whether its failure posed a systemic threat; and the Treasury, as keeper of the nation's purse strings, had to decide, following the receipt of advice from the former bodies, whether to authorise a support operation.

Although both the FSA and the Bank[xxi] were at pains not to criticise the working of the arrangements during their interrogations at the hands of the Treasury Select Committee, outside commentators took a different view. Moreover, the Treasury, in its evidence before the Committee (given on 25 October 2007), indicated that it would seek clarification, in a future draft, of its power to ultimately determine the outcome of tripartite talks in a wider set of circumstances than it believes is currently covered by the agreements. (Should the Bank have bowed to FSA/Treasury pressure to provide additional liquidity earlier?) Additionally, like the Bank, it is keen that the central bank is involved more directly in the monitoring of individual banks' financial health, notwithstanding the FSA's broader remit in this area. Finally, the Treasury was also determined to reform bank

failure resolution policies to reduce the impact of bank failure, should it happen. The formal tripartite proposals for reform were revealed on 30 January 2008 in the shape of a consultation paper (*see* below); and two further consultation papers were subsequently issued in July 2008 (*see* HM Treasury, FSA and Bank of England, 2008b and 2008c). The new Banking Bill was, in turn, introduced to Parliament on 7 October 2008.

2.4 A Review and Assessment of the House of Commons Treasury Committee's Report

The Treasury Committee's report on Northern Rock (House of Commons, 2008a) was published on 24 January 2008. Its main findings (*see* pp.3-4 of the Report) can be summarised as follows:

- the directors of Northern Rock were the principal authors of the bank's difficulties because of the 'reckless business model' which they pursued;
- the FSA 'systematically failed in its regulatory duty to ensure Northern Rock would not pose a systemic risk';
- the Chancellor 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 but the Tripartite authorities failed to prepare adequately for that support operation and to plan in advance for the deposit guarantee eventually introduced;
- new bank failure resolution policies are needed to insulate taxpayers and small depositors from the risks of bank failure;
- new deposit protection arrangements are needed to ensure, *inter alia*, prompt release of depositors' funds protected under the scheme;
- reform of the UK's system of bank liquidity regulation is urgently required and cannot wait for international agreement;

- the Tripartite arrangements need reforming to provide clearer leadership and stronger powers to the authorities; and
- a single authority, other than the FSA (because of a need for 'creative tension' within the regulatory system), should be given the new powers for handling banks together with responsibility for arranging the new Deposit Protection Fund (the Committee's preference is for these duties to be performed by a new Deputy Governor of the Bank of England responsible for Financial Stability).

As regards the *supervisory performance of the FSA*, the Committee was scathing in its criticisms:

- the FSA was guilty of systematic failure in its regulatory duties (p.3);
- it failed to act on warning signs (i.e. rapid growth and share price falls from February 2007 onwards), failed to tackle fundamental weaknesses in Northern Rock's funding model and did nothing to prevent the problems that came to the fore from August 2007 onwards (p.24, para.42);
- it was wrong to allow Northern Rock to weaken its balance sheet [via a 'waiver' allowing the bank to adopt the 'advanced approach' to assessing capital adequacy under Basel II, which subsequently led the bank to increase its dividend payments to shareholders] at a time when it itself was concerned about problems of liquidity that could affect the financial sector (pp.25/6, para.45);
- it failed in its duty to ensure that the Board of Northern Rock undertook adequate stress-testing (p.29, para.52); and
- it 'should not have allowed nor ever again allow the two appointments of a Chairman and Chief Executive to a "high-impact" institution where both candidates lack relevant financial qualifications' (p.33, para.63).

In summary, the Committee concluded that:

> '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 … The failure of Northern Rock, while a failure of its own Board, was also a failure of its 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.' (p.34, para.66).

With respect to the *actions taken by the Bank of England* during the crisis, the criticism was more muted. The Bank, nevertheless, was censured for:

- its pre-occupation with moral hazard concerns during August 2007 (p.44, para.90);
- its failure to broaden the range of acceptable collateral at an earlier stage in the turmoil (p.47, para.97);
- its failure to properly consider the possibilities for covert support action much earlier (p.63, para.42); and
- its failure to hold high level discussions with Northern Rock about the support facility prior to 10 September.

Moreover, along with the other Tripartite authorities, it was condemned for not:

- preparing adequately for the support operation (p.3);
- planning in advance for the announcement of the deposit guarantee (p.3 and p.71, para.165);

- preparing the groundwork to allow for the announcement (that a deposit guarantee would be introduced) to be made the morning following the day the decision was taken (Sunday, 16 September) before the markets opened (p.72, para.166);

- acting with sufficient rigour to address weaknesses (i.e. in relation to the handling of failing banks) in the legislative framework (ultimately the responsibility of HM Treasury) first identified in 2005 and deemed significant enough to require "urgent action" by late 2006 (p.109, para.280).

The Bank, however, was cleared of the charge of unnecessarily blocking a proposed takeover of Northern Rock by Lloyds TSB (p.52, para.112); and the Committee was non-committal on whether the Bank's wider provision of market liquidity earlier in the day (i.e. in August) would have obviated Northern Rock's need for emergency support in September (p.45, para.95), and on whether more might have been done prior to 10 September to facilitate a private sector takeover (p.54, para.118).

In relation to the establishment of a *new bank failure resolution regime*, the Committee endorsed the Bank's earlier call for a new bank insolvency regime but also recommended the introduction of "prompt corrective action" (PCA)-type measures – *see* above. The former is necessary to overcome the obstacles to a speedy payout of depositors' funds in the event of bank insolvency which currently apply under corporate insolvency law; and the latter is required to ensure intervention is more pro-active, thereby reducing the likelihood of a distressed bank moving towards insolvency and triggering a call on the deposit protection scheme and facilitating the orderly resolution of banks which do fail. As regards the former, the Committee favours the introduction of the US-style "Bridge Bank"

scheme, involving the ring-fencing of insured deposits at a failing bank and "least cost" (to the taxpayer!) resolution (*see* Hall, 1993, ch.5) [House of Commons, 2008a, p.83, para.201]. And, with respect to PCA arrangements (*ibid.*, p.80, para.193), the Committee calls for the relevant authority to supplement its judgement with a set of quantitative triggers (or tripwires) when deciding how and when to intervene in a failing bank. Possible contenders for tripwires, as outlined by the British Bankers Association (*ibid.*, p78, para.186), are deterioration in financial condition with respect to liquidity, capital, earnings and asset quality, suspected or actual fraud, and significant growth in business or shift in strategic business planning. The Committee explicitly ruled out a request for official support from a bank as a useful trigger, as suggested by the Chancellor, as this would occur too late in the day to allow for effective remedial action to be taken. Moreover, the Committee recognised that the successful operation of PCA in the UK would require improved information-sharing amongst the tripartite authorities (*ibid.*, p.79, para.189) as well as the provision of significant additional powers to the relevant authority to allow for the prompt collection of all relevant information (*ibid.*, p.80, para.192).

As for its views on how to reform *deposit protection arrangements*, the Committee argued for the following:

- the creation of a new Deposit Protection Fund, to cover deposits held with "large" deposit-taking institutions, to be funded on an *ex-ante* basis by contributions from such institutions (initially, the Government would set up the Fund, to be re-imbursed by the institutions in subsequent years) [*ibid.*, pp.101-102, para.263];
- the size of the new Fund should be sufficient to deal with failures of medium-sized and even larger banks (from April 2008, the reformed FSCS will still only cover losses of up to £4 billion) [*ibid.*, p.77, para.183];

- as currently, the non-application of coinsurance on depositors below the *de jure* limit of protection (the moral hazard consequences can be mitigated by the adoption of PCA and a new bank insolvency regime and by the application of a modest compensation limit) [*ibid.*, p.91, para.227];
- continuation, albeit subject to indexation for inflation, of the current *de jure* limit to protection of £35,000 [*ibid.*, p.93, para.233], as should remain the case for the FSCS which would continue to deal with all other deposit-taking intermediaries;
- repayment of insured deposits within a matter of days of the deposit protection scheme being called upon [*ibid.*, p.93, para.240];
- the introduction of risk-related premia for participating institutions once the Fund has been established at the requisite level [*ibid.*, p.103, para.266];
- enhanced advertising of the new Scheme, at both the national and regional level, and through the display of posters in individual bank branches [*ibid.*, p.96, para.242]; and
- a re-design of the Scheme to prohibit the offsetting of deposits against customers' illiquid liabilities [*ibid.*, p.97, para.251].

Finally, with respect to the *operation of the Tripartite arrangements*, the Committee refused to accept that the system worked well, as argued by the FSA, the Chancellor and the Governor of the Bank of England. It duly reasoned that a run on a UK bank is not only unacceptable but clearly represents 'a significant failure of the Tripartite system' [*ibid.*, p.107, para.276]. Notwithstanding this, however, it went on to argue that despite current arrangements lacking both a clear leadership structure [*ibid.*, p.110, para.284] and a strategy for effective communication with the general public [*ibid.*, pp.111-112, para.289], the financial system in the UK would not be well-served by a dismantling of the Tripartite

arrangements [*ibid.*, p.107, para.277]. Rather it wants to see it reformed, with clearer leadership and stronger powers being provided.

An Assessment

Whilst in agreement with most of the Committee's findings and recommendations – *see* earlier sections to this paper – especially on the reform of failure resolution policies where I have long championed the introduction of PCA and changes to the deposit protection arrangements similar to those suggested by the Committee (*see*, for example, Hall, 2002), I cannot agree with the allied structural changes proposed [elaborated at length in Chapter 8 of the Committee's Report]. To my mind, to create a new post at the Bank of England where the incumbent is responsible for both deposit protection and the handling of bank failure is a retrograde step. I firmly believe the decision to remove banking supervision from the Bank of England was a sound move (*see* Hall, 2001a), and the failure of the Tripartite authorities to come up to scratch with respect to the operation of the Memorandum of Understanding in the Northern Rock case is not an indictment of the new arrangements themselves but rather of the people involved [as accepted as a possibility by the Committee (p.107, para.276). Rather, I favour the introduction of a new agency to function as an independent Deposit Protection Agency to be responsible for insuring the depositors of *all* deposit-taking intermediaries – the deposit sub-scheme of the FSCS would go or alternatively be used to cover just credit unions – and the resolution of failed banks, as in the US. The FSA would receive the new PCA mandate. Appropriate mechanisms would, of course, have to be put in place to deal with the potential principal/agent conflict and communication problems thereby created (*see* Hall, 2002) within a four-agency structure.

3. A REVIEW AND ASSESSMENT OF THE TRIPARTITE AUTHORITIES' PROPOSALS FOR REFORM MADE IN THE WAKE OF THE NORTHERN ROCK FIASCO

The Tripartite Authorities' consultation document of January 2008 (HM Treasury, FSA and Bank of England, 2008a) sets out their reform proposals within the confines of five key objectives:

- to strengthen the financial system (both at home and abroad);
- to reduce the likelihood of banks failing;
- to reduce the impact of bank failure should it happen;
- to improve the effectiveness of compensation arrangements; and
- to strengthen the Bank of England and improve co-ordination between the relevant authorities.

The main reforms proposed under each heading will now be addressed in turn.

To Strengthen the Financial System

To secure this objective, the Authorities' focus is on strengthening banks' risk management (e.g. through better stress testing and improved management of liquidity) and improving the functioning of securitisation markets (including measures to improve valuation techniques and to address the problems – e.g. conflicts of interest, the information content of ratings and over-reliance on ratings by investors – arising from the operation of credit rating agencies). The prudential regulation of banks' off-balance-sheet vehicles is also addressed under this heading. The Authorities' formal proposals in this area embrace the following (Chapter 2, pp.35-36):

1. In relation to stress testing:
    - the FSA will intensify its work with banks to improve stress testing in light of recent events;
    - the Authorities will work with international partners to encourage a stronger consensus on the importance of stress testing, in particular at group level and by multinational banks; and
    - the Authorities will work to consider whether the stress-testing standards under Basel II are sufficiently robust.
2. In relation to liquidity regulation:
    - the Authorities will work with international partners to ensure that liquidity regulation standards are consistently high across banking groups, and encourage more consistent approaches to liquidity regulation.
3. In relation to accounting and valuation of structured products:
    - the Authorities will work with their international counterparts to ensure that firms' valuation approaches are consistent with the relevant accounting standards and the Capital Requirements Directive (CRD)/Basel II prudent valuation guidance; and
    - the Authorities will work with their international counterparts to ensure that firms' valuation approaches are consistent with the relevant accounting standards and the Capital Requirements Directive (CRD)/Basel II prudent valuation guidance;
    - the Authorities will work with their international counterparts to ensure accounting standards require adequate disclosure about the uncertainties around valuations, their significance for the entity and how these risks are being managed; and

- the Authorities will encourage markets to find ways to increase transparency of valuation methodologies and, to the extent appropriate, move towards greater standardisation of methodologies for valuation.

4. In relation to credit rating agencies (CRAs):

   - the Authorities will work with international counterparts in the Financial Stability Forum (FSF) and the EU to look at the role of CRAs in structured finance. The Authorities will also support the work of the International Organisation of Securities Commissions' (IOSCO) taskforce on CRAs, which has recently been reviewing the applicability of its Code of Conduct for CRAs to structured finance business;
   - the Authorities will keep the development of investor practice in relation to structured products under review to determine if further measures are needed to assist markets to achieve an appropriate outcome; and
   - the Authorities will consider the implication for investors in structured products of the recommendations of the advisory groups established in September 2007 by the US President's Working Group on Financial Markets to improve best practice in the operation of hedge funds and the hedge fund working group in the UK chaired by Sir Andrew Large.

5. In relation to transparency of banks and exposure to off-balance-sheet vehicles:

   - the Authorities will work with their international partners in the FSF and the EU to identify whether there remain incentives under the CRD/Basel II framework for banks to minimise their regulatory capital requirements by holding assets in SIVs and other funding vehicles, and if so whether this might reduce the total amount of regulatory capital in the financial system below the level that the Authorities consider desirable; and

- the Authorities recommend that the International Accounting Standards Board (IASB) consider in particular whether reputational risks are properly taken into account in decisions about consolidation.

To Reduce the Likelihood of Banks Failing

Here, the focus is on strengthening the regulatory and supervisory framework in the UK and improving the framework governing the provision and disclosure of liquidity assistance provided by the Bank of England. The former is deemed to require the imposition of new information disclosure requirements on banks to allow the FSA to collect the information necessary to allow it, and the other Tripartite authorities, to adequately discharge their supervisory/stability obligations. Additional powers of intervention are also being sought for the FSA, as well as improved oversight of the payment systems. As far as the Bank's provision of emergency liquidity assistance is concerned, the authorities are seeking powers to allow the Bank to delay disclosure of such action in certain circumstances. Moreover, to facilitate the Bank's operations in the financial stability area, the Authorities are seeking statutory immunity for the Bank in carrying out such responsibilities as well as the effective realisation of any collateral arising from such operations.

The Authorities' formal proposals in this area comprise the following (Chapter 3, pp.46-47):

1. To improve the regulatory and supervisory framework:
    - the FSA intends to consult on new rules to require banks to be in a position to provide additional evidence to the FSA at short notice that they are meeting the

"threshold conditions" (as set out in Schedule 6 to the Financial Services and Markets Act, 2000) on an ongoing and forward-looking basis;

- the Government proposes legislation to ensure that there is no statutory impediment to the FSA obtaining information that the Bank of England and HM Treasury require for purposes related to financial stability; and
- the Government proposes legislation to provide for a flexible framework for oversight of payment systems. The Authorities intend to consult further on the detail of the regime to be implemented under this framework.

2. To ensure the Bank of England is able to lend in an effective manner:

- the FSA will come forward with a proposal to make a limited clarification to the guidance in the Disclosure and Transparency rules;
- the Government is seeking views on whether the requirements for a company to put charges over its assets on to a register of its own and to register them at Companies House should be dis-applied for banks in receipt of liquidity assistance;
- the Government proposes legislation to remove the requirement for the Bank of England to release weekly returns and will consider other statutory reporting requirements related to the Bank of England that have the effect of disclosing operations;
- the Government proposes legislation granting the Bank of England statutory immunity from liabilities in damages arising from acts or omissions in carrying out its responsibilities in relation to financial stability and central bank functions; and, to the extent necessary, to extend the immunities currently available to the FSA and the FSCS in line with their additional powers proposed in this reform;
- the Government proposes legislation to ensure that realisation of any collateral provided to the Bank of England in connection with carrying out its responsibilities

in relation to financial stability and central bank functions, is fully effective whenever carried out;

- the Government proposes legislation so that funds provided by the Bank of England are exempted from the calculation of the proportion of building societies' funding which arises from wholesale funding; and
- the Government proposes legislation to allow building societies to grant floating charges to the Bank of England as security. [Statutory barriers to the Bank of England lending to building societies, where financial stability is threatened, were removed in June 2008 with the approval by Parliament of the Building Societies (Financial Assistance) Order 2008 under the Banking (Special Provisions) Act 2008.]

To Reduce the Impact of Bank Failure

To enable failing banks to be dealt with in a way which minimises the potential impact on financial stability, the Authorities propose fundamental changes to the institutional, legal and insolvency arrangements currently applying in the UK. Mirroring the recommendations of the Treasury Committee, they duly propose the introduction of a 'special resolution regime' including, *inter alia*, a 'bridge bank' scheme and a bespoke 'bank insolvency procedure'. [They also focus on the practical measures that the banks themselves can take to lessen the impact of their failure.] Their detailed proposals are as follows (Chapter 4, pp.64-65):

1. In relation to a special resolution regime, the Government:
    - proposes legislation to introduce a special resolution regime for banks;

- proposes legislation to give the Authorities the power to direct and accelerate transfers of banking business to a third party, in order to facilitate a private sector solution;
- proposes legislation to allow the Authorities to take control of all or part of a bank (or its assets and liabilities) through a 'bridge bank', as is possible in the United States and Canada;
- is also seeking views on whether, building on the FSA's existing power to appoint an expert, the Authorities should have the power to appoint a suitable person or 'restructuring officer' to carry out the resolution;
- would welcome views as to whether the tools above achieve sufficient control of a failing bank, or whether legislation to allow the Authorities to take a bank into temporary public sector ownership as a last resort should be introduced;
- proposes legislation, should it become apparent that pre-insolvency resolution is not feasible, or that immediate closure of the bank was appropriate, to introduce a 'bank insolvency procedure' to facilitate fast and orderly payment of depositors' claims under the FSCS;
- would welcome views on how best to control a bank's entry into insolvency proceedings (the latest ideas on a modified bank insolvency process are set out in HM Treasury, FSA and Bank of England, 2008c, Chapter 4); and
- is consulting on whether all the tools within the special resolution regime should be available to building societies as well as banks (HM Treasury, FSA and Bank of England, 2008c, Chapter 5, sets out the modified proposals for building societies).

[More details on the Authorities' proposals, especially those relating to the treatment of creditors and the protection of shareholders' rights in the event the regime is activated, are

contained in HM Treasury, FSA and Bank of England, 2008c. High-level statutory objectives for the regime are also set out therein – *see* paras 2.2 to 2.4.]

2. Setting out requirements on banks:
    - the Government is seeking views on whether banks should contribute to funding the special resolution regime. As part of this, it is considering whether to amend the FSMA to allow the FSCS to contribute to the funding of the special resolution regime;
    - the FSA intends to work with banks to ensure that agency banks have contingency plans in place in the event that their sponsor banks fails; and
    - the Government proposes to introduce a power enabling it to make secondary legislation in relation to financial collateral arrangements.

To Improve the Effectiveness of Compensation Arrangements

The focus of attention under this heading is a desire to improve consumers' confidence in and understanding of the compensation arrangements as well as to increase their cost-effectiveness. The search for remedies duly addresses, *inter alia*, the issues surrounding compensation limits, coverage, and speed of repayment of depositors' funds as well as measures designed to increase consumer awareness, as set out immediately below (Chapter 5, pp.83-84):

1. In relation to compensation limits and coverage:
    - the FSA intends to consult on changes to the FSCS compensation limit and other factors used in the compensation calculation;
    - the FSA will consider the appropriate FSCS coverage for client accounts and similar arrangements; and

- the FSA plans to explore with the financial sector ways for customers to cover amounts above the compensation limits.

2. In relation to faster compensation payment:
   - the Government proposes legislation to enable the FSA to collect the information the FSCS requires, and share it with the FSCS at the first sign of difficulties in a bank, and to enable the FSCS to obtain information from firms at the earlier of when a firm is declared in default or the date a claim is made;
   - the FSA intends to consult on new rules to simplify the eligibility criteria for FSCS payments;
   - the FSA intends to consult on a move to gross payments and for compatible provisions on set-off to be included in the new bank insolvency procedure;
   - the Government proposes legislation and the FSA intends to consult on new rules to remove the need for consumers to make formal claims for compensation and to remove the need for claimants to make a formal assignment of their rights to the FSCS in all cases when they receive compensation;
   - the Government is seeking views on ways to ensure that the FSCS has access to immediate liquidity, including pre-funding; and
   - the Authorities to work with banks and appropriate trade bodies to ensure that consumers can open a new account quickly enough to facilitate FSCS payments.
3. In relation to consumer awareness, the FSA intends to consult on how consumers can be better informed about the FSCS.
4. In relation to other protection for consumers:
   - the Department of Work and Pensions (DWP) and HM Revenue and Customs (HMRC) will introduce contingency plans to ensure that consumers can receive benefits and tax credits in the event of bank failure; and

- the Government proposes legislation to strengthen the arrangements underpinning banknote issuance by commercial banks in Scotland and Northern Ireland and to bring the law in Scotland relating to the treatment of cheques into line with that in the rest of the UK.

5. In relation to other changes to compensation arrangements:

   - the Government proposes legislation to ensure that the FSCS has the management flexibility it needs to manage a wide range of claim volumes (this proposal was subsequently dropped – *see* HM Treasury, FSA and Bank of England, 2008b, para. 1.64); and
   - the FSA is seeking views on the advantages and disadvantages of introducing risk-based levies or other ways of bringing behavioural factors into levy calculations.

To Strengthen the Bank of England and Improve Co-ordination between the Relevant Authorities

Under this final heading, the authorities analyse the workings of the current Tripartite arrangements and cross-border co-operation. Whilst concurring with the Treasury Committee's view that the former set of arrangements are appropriate for the UK they, nevertheless, argue that they could be improved through, for example, providing a statutory basis for the Bank of England's financial stability role and improving governance arrangements within the Bank to support the new statutory obligations. Moreover, they go on to argue for a strengthening of the Memorandum of Understanding, applying lessons from the application of COBR during 'crisis' situations, and for improvements in external communications. And, with respect to cross-border co-operation, there is a perceived need to improve the co-ordination of approaches adopted towards international financial stability issues, to introduce an early warning scheme on global financial risks, and to improve cross-border crisis management.

Specifically, in relation to the objectives and governance of the Bank of England, the Authorities propose (Chapter 6, p.87):

- legislation to formalise the Bank of England's role in the area of financial stability – it will also be given statutory responsibility for "contributing to the maintenance of financial stability within the UK" - and to give its Court a formal role in overseeing the Bank of England's performance in this area;
- to support the Bank of England's enhanced statutory role in financial stability, legislation to amend the provisions governing the size and composition of the Court; and
- that the Bank of England modernises the arrangements for meetings of the Court.

[Additional legislation for the creation of a "Financial Stability Committee", which would be a sub-committee of Court, to support the Governor has since been announced (HM Treasury, FSA and Bank of England, 2008b, para. 1.72.]

And, with respect to the desire to improve co-ordination between the Authorities, the following proposals were made (Chapter 7, pp.97-98):

1. In relation to the Tripartite arrangements:
    - the Authorities intend to apply some of the lessons from the operation of COBR to the working of the tripartite arrangements:
    - the FSA and the Bank of England will consider the scope for greater combined initiatives to develop common understanding; and
    - the Authorities propose to clarify responsibilities within the Memorandum of Understanding, setting out the roles and responsibilities of the Treasury, the FSA and the Bank with regard to financial stability, including the relevant roles and

responsibilities in relation to the special resolution regime (*see* HM Treasury, FSA and Bank of England, 2008c, paras 2.7 to 2.24).

2. In relation to international co-ordination:
    - the Authorities will work with international counterparts to pursue changes to improve the effectiveness of the Financial Stability Forum (FSF);
    - the Authorities propose that the IMF considers how to improve further the focus of its financial sector surveillance;
    - the Authorities propose that the FSF and IMF enhance their co-operation to bring together the intelligence gathered from IMF surveillance and from FSF members; and
    - the Authorities will continue to work with international counterparts to improve international crisis management arrangements and ensure the UK authorities are well prepared to respond to international financial crises, building on on-going initiatives in the EU and FSF, and working bilaterally with key partners who share exposures to specific risks.

The Authorities also fully support the FSF recommendation that international colleges of supervisors for each of the largest global financial groups be established by the end of 2008 (HM Treasury, FSA and Bank of England, 2008b).

An Assessment[xxii]

Whilst I have no quarrel with the eminently sensible set of proposals set out to deliver the first two key objectives, once again, I disagree with the suggested structural solution to the problems posed by the introduction of a 'special resolution regime' under attempts to reduce the impact of bank failure. The Authorities favour the FSA triggering activation of the new regime, despite the risk of 'regulatory forbearance', following consultation with

HM Treasury and the Bank, although they are still consulting on which body should oversee the scheme's operation once triggered – the Treasury, the Bank, the FSA or the FSCS. [It has since been confirmed – HM Treasury, FSA and Bank of England, 2008b – that the Bank will be given operational responsibility for the special resolution regime, although the Chancellor has to authorise any action which has implications for the public finances or involves the public ownership of an institution.] Moreover, the Authorities argue credit unions should not be subject to the new regime. My own view, as outlined earlier, is that a new Deposit Protection Agency should be established to conduct both insurance operations (all deposits other than, maybe, those of credit union customers should be protected) and to implement the new failure resolution measures. In this way, monetary policy (the primary function of the Bank, although it cannot avoid some responsibility for financial stability given its control of the money supply and its lender of last resort responsibilities) would be separated from supervision (the preserve of the FSA, with added responsibilities under a PCA-type regime – which the Authorities do not explicitly mention, unlike the Treasury Committee) which, in turn, would be separated from the deposit insurance and failure resolution functions.

With respect to the Authorities' proposals for depositor protection arrangements, much remains to be confirmed. [Although, as noted above, the compensation limit was raised to £50,000 in October, 2008.] The Authorities are firmly of the opinion that the maximum period for compensation, providing depositors with access to at least a proportion of their funds, should be reduced to seven days from the date of a bank failing (this would still be well in excess of the one day norm in the US, however), that co-insurance for depositors should not be re-introduced and that the deposit protection body's resources should be augmented, in the event of a crisis, through access to Government/Bank of England

funding (necessary to enhance the credibility of the scheme given its limited resources).[xxiii] The FSA will continue to consult on a possible extension of coverage (e.g. to corporate customers, collective investment schemes, governmental bodies and pension and retirement funds), on the merits of switching from a net (where customers must net off outstanding debts against their deposits to determine the size of their claims) to a gross payments basis, and on the best ways to enhance customer awareness of the existence and nature of the scheme.

Whilst I have no disagreement with the decisions already announced – apart from the postponement of the introduction of pre-funding, which even the Governor of the Bank of England is on record as supporting - I again return to the optimal structural arrangements necessary to allow for the delivery of a cost-effectiveness deposit protection framework. I simply reiterate my preference here for the establishment of a new deposit protection agency to cover the deposits held in all deposit-taking institutions other than, maybe, credit unions (where the current deposit sub-scheme of the FSCS would apply). As recommended, the FSA would then have to collect and share with this body the information necessary to allow the latter to carry out its allotted tasks.

Finally, in connection with the Authorities' desires to strengthen the Bank of England and improve co-ordination between the Authorities themselves and with their overseas counterparts, there is little which is contentious. The proposed legislation to formalise the Bank's role in the area of financial stability and to give its Court a formal role in overseeing the Bank's performance in this area, for example, seem eminently sensible – although the decision to make the Financial Stability Committee a sub-committee of Court, chaired by the Governor himself, dilutes the degree of external oversight secured

(*see* House of Commons, 2008c, pp.83-89 for the Treasury Committee's latest proposals in this area) - as are the proposed changes to the size and composition of the Court and to the arrangements governing the Court's meetings. Similarly, the determination to improve the workings of the Tripartite arrangements through measures designed to increase common understanding and to clarify responsibilities under the Memorandum of Understanding for decisions surrounding the provision of support to firms, particularly in the form of emergency liquidity assistance, are to be welcomed (although the benefit of importing insights from the operation of the UK's COBR remains to be seen). Indeed, the recommended changes imply a recognition that the Tripartite arrangements did not work particularly well in the case of Northern Rock, the strong belief of the Treasury Committee, but something denied by the Authorities in their testimony to the Committee yet reinforced by the recent spats over the filling of senior positions at the Bank and the precise role to be played by the Bank in reformed financial stability arrangements which betrayed a worrying degree of disharmony between the Bank and the Treasury. Such public disagreements do little to re-assure nervous investors and nothing to enhance the credibility of the monetary authority. And finally, the measures aimed at increasing international co-operation in the area of financial economic stability, particularly with respect to cross-border crisis management, also deserve unequivocal support.

4. 'FAILURE' RESOLUTION POLICY POST NORTHERN ROCK

4.1 Brokered Takeover Rescues

As a former building society, and hence an institution whose fortunes are inextricably linked to the state of the UK housing and property markets, with a funding model – roughly 50 per cent wholesale and 50 per cent retail – lying closest to that of Northern Rock, the *Alliance and Leicester* was always going to attract the attention of speculators and struggle to survive as an independent entity during the credit crunch. Along with Bradford and Bingley, its shares suffered most in the wake of the near-collapse of Northern Rock, taking further hits following the announcement in February 2008 of £185 million of writedowns on Treasury investments for 2007. And then, in May 2008, a further £192 million was revealed. Within two months, the bank, with the blessing of the FSA, had found a willing partner, the Spanish bank Banco Santander, which duly made a bid for the bank on 11 July 2008. Three days later, the Board formally accepted the offer, not surprising given that figures released at the end of the month revealed a 99 per cent crash in pre-tax profits to just £2 million for the first half of 2008 following yet another £143 million of writedowns and £209 million of losses on toxic securities.

The next takeover-rescue brokered by the UK authorities was that of *HBOS*, the UK's biggest mortgage lender, by Lloyds TSB. The first signs of trouble at the bank emerged in February 2008 when it announced sub-prime-related losses for 2007 of £227 million. These losses, however, were dwarfed by the £2.84 billion of first-quarter writedowns on complex debt securities announced at the end of April, which necessitated the instigation of a £4 billion rights issue to repair damage to the bank's capital base. In the event, however, only 8.3 per cent of its investors had taken up their allocations in the rights issue

by 21 July, leaving the underwriters and sub-underwriters nursing hefty paper losses. And then, to make matters worse, a 72 per cent fall in pre-tax profits to £848 million for the first half of 2008, following a £1.09 billion sub-prime-related writedown, was announced at the end of July. Desperate to avoid further carnage on the banking high street, the Government duly waived, on national interest (i.e. financial stability) grounds, the competition rules to allow Lloyds TSB's £12.2 billion all-share takeover bid to proceed. The bid, announced on the 18 September, was made in the light of a collapse in the bank's share price over the previous few days owing to ratings downgrades and investor concerns about the bank's excessive reliance on wholesale markets for its funding and on the UK property market for its profits, neither of which was desirable at that particular juncture. Despite the subsequent fall in share price, which led to the re-negotiation of the takeover terms – 0.605 of one Lloyds TSB share will now be offered for one HBOS share rather than the original 0.833 agreed – the takeover is still on track, with the state taking a maximum 43.5 per cent stake in the combined entity under the industry bailout plan announced in October – *see* below.

The third takeover-rescue brokered by the authorities took place within the building society sector of the UK's deposit-taking industry when the largest building society, the Nationwide, was cajoled into rescuing the struggling societies, the *Derbyshire* and the *Cheshire*. The announcement of takeover talks was made on 7 September 2008 and, with the blessing of the authorities, the deal will be finalised before the end of the year. In this way it is hoped to preserve investor confidence in the building society movement – both societies were expected to report pre-tax losses for the first half of 2008 - although further consolidation is inevitable.[xxiv]

4.2 Nationalisation of Bradford and Bingley

As noted above, the Bradford and Bingley was the other converted building society to suffer from speculative attack on its share price in the wake of the near-collapse of Northern Rock although, in this case, the eventual outcome was less favourable than for the Alliance and Leicester. Apart from its funding model, the other aspect of the bank's operations which particularly concerned investors was its over-dependence – they comprised over 85 per cent of the mortgage book – on buy-to-let and "self-certified" mortgage, both of which contributed to rising arrears and repossessions as the UK housing market progressively deteriorated. Evidence of this first appeared with the announcement, in February 2008, of sub-prime-related losses of £226 million for 2007. Then, in June 2008, the bank announced that it would make losses of £8 million in the first four months of 2008 because of rising arrears on its mortgage book and a squeeze on its net interest margins. Accompanying this announcement was a statement that, because of dramatic changes in recent trading conditions, it had proved necessary to lower the rights issue price – from 82p. to 55p. – and to raise the amount of external funding sought from £300 million to £400 million, 23 per cent to be provided by the US private equity investor TPG Capital. Having destabilised the rights issue process, the bank's collapsing share price took a further hammering when, on 27 June 2008, the Board announced its rebuffal of entrepreneur Clive Cowdery's proposed rescue deal by his Resolution vehicle. A second downgrading of the bank's credit rating – from A2 to Baa1, the lowest rating of any UK bank – a few days later by Moody's led to TPG's withdrawal from the deal to inject £179 million into the ailing bank. This led the bank to revamp, for the third time in three weeks, its fund-raising efforts, duly raising the amount sought from the rights issue to £400 million to cover the £179 million shortfall. Under FSA pressure, the regulator being desperate to avoid another banking casualty, the bank's largest shareholders – Legal and

General, M&G, Standard Life and Insight Investments – reluctantly agreed to ride to the rescue, despite the bank's share price collapsing to 50p., 5p. below the rights issue price. In the next few days the share price continued to fall – to a low of 33p. on 8 July – as investors questioned the bank's long-term value, threatening heavy losses for the underwriters and sub-underwriters. The following month, the bank then revealed a first half loss of £26.7 million following writedowns on its structured credit portfolio and a £74.6 million credit impairment charge relating to rising arrears. A further downgrade, to just one notch above junk status, by Moody's at the end of September and a statement by the bank, just two days later, that it was to make further writedowns of up to £133.8 million, duly sealed the bank's fate. On the 29 September 2008 the Government announced that the bank was to be nationalised following the FSA's decision that the bank was no longer a viable deposit-taking institution and a failure to find a 'White Knight' from the banking community.

Having learnt lessons from the earlier nationalisation of Northern Rock and given a determination to protect taxpayers' interests at all costs, the nationalisation process was structured in such a way as to minimise potential costs for the public purse. The bank's £42 billion mortgage book was duly taken over by the state, to be wound down in due course, whilst the bank's £20 billion of deposits and 197 branches were sold to Banco Santander for £162 million. Intriguingly, however, the Chancellor secured the maximum protection for taxpayers from the unwinding of the mortgage book by forcing the UK banking sector to shoulder much of the risk. He did this by making the Treasury a more senior creditor than the Financial Services Compensation Scheme (FSCS), which is being asked, on behalf of the banks, to pay £14 billion – funded by a short-term Bank of England loan shortly to be converted into a three-year government loan on which the bank

must pay interest at one-year LIBOR plus 30 basis points – to Banco Santander to enable the £14 billion of insured deposits to be transferred to the Spanish bank. This means that any losses exceeding £3 billion or so, which are shouldered by equity investors and subordinated debt holders, will fall first upon the banks who will have to reimburse the FSCS via levies for any losses it incurs. Taxpayers will thus not take a hit unless losses exceed £17 billion or so, an unlikely scenario given that this would require arrears at the defunct bank to increase from the current 3 per cent to something close to 10 per cent.

4.3 Part-Nationalisation Under the October Bailout Plan

The October bailout plan, which reflected the Government's attempt to move from a piecemeal approach to failure resolution (akin to "firefighting") to a broadly-based solution to a systemic crisis, embraced three elements (HM Treasury, 2008). The first of these was a massive extension in the provision of emergency *liquidity* from the Bank of England.[xxv] At least £200 billion (double the then current usage) is now to be made available under the 'Special Liquidity Scheme' and, until markets stabilise, the Bank will continue to conduct regular auctions of three-months sterling-denominated funds and one-week dollar-denominated funds against a wider range of collateral.[xxvi] The second element of the plan relates to the *recapitalisation* of the banking industry. "Eligible institutions" (to include UK-incorporated banks and UK bank subsidiaries of foreign institutions which have a substantial business in the UK plus all building societies)[xxvii] can approach the Government for up to £25 billion of funding in aggregate[xxviii] in the form of preference shares, PIBS, or as assistance (e.g. through underwriting) to an ordinary equity fund-raising (at the institution's request). In return for such assistance, recipient institutions will be bound by restrictions on dividend payouts and executive compensation and will be required to commit to lending to small businesses and home buyers. Finally, in order to try

and re-open the market for medium-term funding for eligible institutions that agree to raise appropriate amounts of Tier 1 capital, the Government will make available, for an interim period as agreed and on appropriate commercial terms,[xxix] a Government guarantee of such institutions' new short- and medium-term debt issuance – in the form of senior unsecured debt instruments of varying terms of up to 36 months denominated in sterling, euros or US dollars – to assist in refinancing maturing, wholesale funding obligations as they fall due. The Government envisages a take-up[xxx] of up to £250 billion under this guarantee scheme, the guarantees to be issued by a specifically designated, Government-backed English- incorporated company.

With respect to re-capitalisation, the initial government injections were announced on 13 October 2008. A total of £37 billion (£12 billion more than initially envisaged) is to be injected into three of the largest banks, RBS, HBOS and Lloyds TSB. The capital injections are to take the following forms: for RBS, a total of £20 billion will be injected, comprising £15 billion of new equity and £5 billion of five-year preference shares, paying 12 per cent per annum (this is better for taxpayers than the earlier proposal, envisaging investment in non-voting preference shares only, as it allows them to benefit from any recovery in the banks' share prices); for HBOS, a total of £11.5 billion will be injected, £8.5 billion in new equity and £3.0 billion in preference shares; and, for Lloyds TSB, a total of £5.5 billion is to be injected, comprising £1 billion of preference shares and £4.5 billion of new equity. Assuming no "clawback" by existing shareholders – the most likely scenario unless the restrictions on the payment of dividends are eased – this would give taxpayers a 57 per cent controlling stake in RBS and 43.5 per cent of the combined entity Lloyds TBS-HBOS (with HBOS shareholders holding a 20 per cent stake and Lloyds TSB shareholders a 36.5 per cent stake).

In return for accepting public sector funds, the banks have to abide by a number of restrictions. Firstly, they cannot pay any dividends to ordinary shareholders until the preference shares have been fully redeemed. Secondly, there will be restrictions placed on bonuses and executive remuneration. Thirdly, lending to small businesses and home-owners must be maintained, at competitive prices, at 2007 levels (both the desirability and feasibility of this have been challenged in a number of quarters). Fourthly, the Government will have a say in the appointment of new Board members (up to three at RBS and up to two at Lloyds TBS-HBOS, on completion of the merger). And, finally, the Chief Executive and Chairman at both RBS and HBOS, have been asked to "fall on their swords" and depart without payoffs. The Government, in turn, has promised to manage its investments at "arms length".[xxxi]

Overall, the market's initial reaction to the announcement was positive – with the FTSE 100 rising by 8.3 per cent on the day and CDS spreads on the large banks falling – but the share prices of the three banks affected fell further (by 14 percent in the case of Lloyds TSB, 27 per cent in the case of HBOS, and 8 per cent in the case of RBS) as investors pondered the likely impact of the restrictions imposed – not least that on the payment of dividends – leaving the Government sitting on a paper loss of over £2 billion on its acquisitions! Moreover, medium-term sterling interbank rates barely moved. Longer term, external holders of sterling are likely to determine the extent to which the Government can borrow to finance the bailout package, the preferred domestic solution in the face of an imminent recession.[xxxii]

5. SUMMARY AND CONCLUSIONS

The metamorphosis in bailout philosophy, from nationalisation by default to nationalisation by choice, within a period of just eight months is truly remarkable, even for a Labour government. That this has then spread around the globe, even into the heart of capitalism in the US, is equally remarkable. Whilst systemic problems undoubtedly demanded comprehensive and systematic solutions, the scale of the global "socialisation" of banking still comes as a shock to most. The necessity for it, within a domestic context, has duly been analysed in this article, as well as the various stages of the transformation process. It remains to be seen if enough has been done to stabilise the domestic banking system or if further public handouts will prove necessary, heralding yet further state inroads into the hitherto bastions of laissez faire capitalism.

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Endnotes

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[i] This section rests heavily on Hall (2008a).

[ii] The unfolding of these developments is well documented in Bank of England (2007a), at pp.6-9, and explored in more detail in Goodhart (2007a).

[iii] This is reflected in the scale of UK bank writedowns on sub-prime-related business relative to those of their overseas counterparts. For example, Barclays' writedown of £1.3 billion (announced on 15 November 2007), and Alliance and Leicester's £55 million (announced on 29 November 2007 but followed, with an announcement made on 29 January 2008, by another £135 million writedown), Royal Bank of Scotland's £1.5 billion (announced on 6 December 2007) and Lloyds TSB's £200 million (announced on 10 December 2007) writedowns contrast sharply with those made for the third quarter of 2007 by the likes of Merrill Lynch ($8 billion, followed by a fourth quarter writedown of $14.6 billion), Citigroup ($3.3 billion, followed by a further $18.1 billion in January 2008) and Morgan Stanley ($9.4 billion). And, elsewhere in Europe, UBS headed the list of sufferers with writedowns of $3.4 billion and $10 billion announced in November and December 2007 respectively, followed by a further $4 billion in January 2008 (full-year losses of $18.4 billion were subsequently revealed). Unsurprisingly, as at Merrill Lynch and Citigroup, the CEO at UBS was also forced out of office.

More recently, end-of-year reporting has revealed the full scale of related writedowns for 2007: Bradford and Bingley, £226 million; Barclays, £1.635 billion; Alliance and Leicester, £185 million; Lloyds TSB, £280 million; Standard and Chartered, $300 million; HBOS, £227 million; RBS, £2.9 billion; and HSBC, $17.2 billion. [For 2008-related writedowns *see* Tables 1 and 2 of Hall, 2008b.]

[iv] The solvency of individual institutions is also adversely affected by the conservative writedowns called for by auditors wary of litigation post-Enron, further deterioration in structured finance markets, accelerating credit downgrades of CDOs, SIVs and "monoline" guarantors and re-intermediation following the consolidation of SIV balance sheets. The last-mentioned refers to the action taken by banks (e.g. HSBC, $45 billion; Standard Chartered, $3 billion; Rabobank, €5.2 billion; Société Générale, €4.3 billion; and Citigroup, $49 billion) to rescue their SIVs in this way in order to reduce reputational risk. The subsequent scramble for new equity led a growing number of banks to tap sovereign wealth funds for the necessary finance. For example, UBS raised SFr13 billion from the Government of Singapore Investment Corporation and an un-named Middle Eastern investor; Citigroup raised $7.5 billion from the Abu Dhabi Investment Authority, $9 billion from the China Investment Corporation, £4 billion from the Kuwait Investment Authority and $6.86 billion from the Singapore Investment Corporation; Morgan Stanley raised $5 billion from the China Investment Corporation; and Merrill Lynch raised $4.4 billion from Temasek Holdings (the Singapore state investment company), $2 billion from the Kuwait Investment Authority and $3.4 billion from the Korean Investment Corporation.

[v] No other UK mortgage provider came near to operating a 75 per cent / 25 per cent wholesale/retail funding mix, with the Alliance and Leicester and Bradford and Bingley, the next most heavily dependent on wholesale funding, running ratios of nearer 50 per cent / 50 per cent. Ironically, this didn't protect them from speculators on the hunt for further victims, causing extreme volatility in their respective share prices.

[vi] Its residential lending in the UK rose by 55 per cent in the first eight months of 2007 at a time of slowing house price rises. And its share of net new lending in the UK housing market rose to 19 per cent by mid-2007.

[vii] The world's banking system is estimated to have around $1.4 trillion of exposures to such conduits. Two of the worst affected – Germany's IKB and Sachsen LB – have already become casualties (*see* Hall, 2008a, Table 1) as their conduits' funding dried up.

[viii] Banks have been hit directly as a result of their own investments and indirectly because of failed syndications, the downward pressure on asset prices arising from investment vehicles' firesale of assets and exposure to the leveraged buyout industry.

[ix] The preferred solution of all concerned was an outright sale, preferably to a larger bank. Despite its relative attractions – low cost operator, better than average quality loan book, continuing access (but at penal rates) to the Bank's liquidity lifeline for as long as EU rules allow – however, formidable problems remained for potential bidders. The business was running at a loss (i.e. the yield on the mortgage book was lower than the funding cost). The bank's franchise value had been greatly reduced by the reputational damage caused. The scale of the funding burden (the Bank, which had already lent over £25 billion, would also have to be repaid) was enormous. And no one was sure how long the liquidity crunch would last for.

In the event, only two "approved" private sector bidders were left in the race following the withdrawal of the US private equity group J.C. Flowers and Co. on the 6 December 2007. This comprised the Virgin-

led consortium, which had earlier acquired "preferred bidder" status, and the private equity firm, Olivant. The former group, which included AIG and hoped to secure funding from Deutsche Bank, RBS and Citigroup amongst others, planned to take a majority stake (55 per cent) in the bank, which it would merge with Virgin Money, the latter name usurping the Northern Rock brand. The proposed takeover involved the injection of £1.3 billion in cash, £650 million coming from a rights issue (which would secure 45 per cent of the new company for existing shareholders) and £650 million from the consortium. Virgin Money, valued at around £250 million, would also be merged with the new entity. The consortium also planned to repay £11 billion of the Bank of England's loan immediately, with the rest being repaid by the end of 2010. It hoped to retain the Treasury's guarantee during this period, and would rank the Bank of England's claims equally with private sector creditors.

Olivant, however, was offering to install new management to manage the bank in return for a minority stake (15 per cent). Under the terms of its revised offer (revealed on 7 December 2007), it would repay between £10 billion and £15 billion of the Bank of England's loan immediately with the balance being repaid by end-2009. The provision of warrants would also give the Bank a 5 per cent equity stake if Northern Rock's share price recovered sufficiently. A cash injection of £150 million was also promised with the expectation that existing shareholders would stump up between £450 million and £650 million collectively. It also expected to enjoy the Treasury's guarantee until the Bank is fully repaid.

In the face of doubts about either party's ability to raise the necessary funding – they also have to gain shareholders' approval – the Treasury secured the services of Ron Sadler to act as Executive Chairman in waiting in case the (temporary) nationalisation route was chosen by the Government. The necessary legislation was also prepared in case this was the outcome. In the event, however, the Government decided to try one last time to facilitate a private sector solution, duly backing Goldman Sachs' plan (*see* the entry for 21.1.08 on Table 2) to convert Northern Rock's loan from the Bank of England into government-guaranteed bonds, to be fed to the market as circumstances allow. Although avoiding the political embarrassment associated with nationalisation, the decision meant that UK taxpayers could be burdened with a £58 billion plus exposure to Northern Rock for the foreseeable future with no guarantee that all the funds would ever be repaid to the Bank, which remains heavily exposed, on our behalf, to a rapidly-deteriorating domestic mortgage market.

As it transpired, only two bids were received on 4 February – Olivant having dropped out – leaving the Government to decide between the bids submitted by the Virgin-led consortium and Northern Rock's existing management and the option of temporary nationalisation. The latter option was subsequently chosen in February 2008 as it was deemed to offer better value for money for the taxpayer, although shrinkage of the bank – a necessity if EU Commission rules on State-aid are to be satisfied – may jeopardise taxpayer returns, especially if its securitisation vehicle, Granite, is adversely affected.

[x] Ironically, some melted away faster than others, the laggards maybe doubting the word of ministers – not totally unsurprising given the previous Chancellor's well-documented raids on pension funds and the limited restitution on offer to policyholders in the aftermath of the collapse of Equitable Life – or otherwise questioning the credibility of such a mammoth undertaking.

[xi] Under the UK Financial Services Compensation Fund protection was previously limited to 100 per cent of the first £2,000 and 90 per cent of the next £33,000, on a per customer per bank basis. Maximum protection had thus been increased to £35,000 from £31,700, and "co-insurance" (*see* text) no longer applies.

[xii] Notwithstanding the fact that both the Bank and the Treasury had prophesied just such an eventuality (i.e. of market liquidity squeezes and a tightening of lending terms) in their April 2007 'Financial Stability Report' (p.47) (Bank of England, 2007b) and January 'Financial Risk Outlook' (FSA, 2007a) respectively.

[xiii] As noted in Hall, 2008a, Table 2, Barclays Bank twice accessed such funding in the Summer of 2007. Although borrowers in such situations are supposed to remain anonymous, its identity leaked out to the market causing Barclays furiously to deny that it was in need of an infusion of liquidity other than for technical reasons. Barclays' experience is likely to cause other banks to think twice before taking advantage of the facility, even if it were profitable to do so.

[xiv] Although some argued a six month limit may be operable under EU law on state aid (the Treasury was looking towards a solution being reached by February 2008), a further six months of "restructuring" (as opposed to "rescue") aid might have been possible.

[xv] The presumption is that a rate of at least 7 per cent was initially charged as this would have been in excess of the penalty rate (6.75 per cent) charged on drawings under the standing facility discussed earlier in the text. The size of 'haircuts' being applied to the non-standard collateral is unknown also.

[xvi] To avoid such a situation recurring some suggest that the Governor should, in future, be restricted to serving one term of office.

[xvii] Some dispute the advice (House of Commons, 2008a, pp.59-62, paras.129-137), whilst others, rightly, ask why it took a crisis for the hamstrung nature of the surrounding legal framework to be revealed. Couldn't this have been ascertained earlier?

[xviii] The FSA's bout of "navel gazing", reminiscent of the Board of Banking Supervision's review of the Bank of England's supervision of Barings plc (*see* Hall, 1999, Chapter 12), makes for painful reading. The Internal Audit review identifies four key failings in the supervision of Northern Rock (FSA Press Release, 2008):

1. A lack of sufficient supervisory engagement with the firm, in particular the failure of the supervisory team to follow up rigorously with the management of the firm on the business model's vulnerability arising from changing market conditions.
2. A lack of adequate oversight and review by FSA line management of the quality, intensity and rigour of the firm's supervision.
3. Inadequate specific resource directly supervising the firm.
4. A lack of intensity by the FSA in ensuring that all available risk information was properly utilised to inform its supervisory actions.

The Review Team's 'Executive Summary' provides further detail on these failings, which meant the supervision of the bank, classified as a "high impact" firm under the FSA's own 'ARROW' risk framework, proved deficient. A theme running throughout the Review was the difficulties posed by high staff turnover which, for example, hindered effective engagement with the firm by Heads of Department, created shortages in expertise in crucial areas (e.g. prudential banking and financial data analysis) and militated against effective FSA management oversight. Moreover, given the bank was supervised for part of the time under review by a Department whose primary responsibility was for insurance groups, one has to question the level of expertise brought to bear against Northern Rock's operations. In terms of supervisory performance, a number of instances of "bad practice" were identified. For example, contrary to ARROW standard practices, formal records of key meetings were not prepared. Moreover, although not formally required under ARROW I procedures, it would have been most useful if formal peer group financial analysis (e.g. on asset growth, profitability, net interest margins, cost to income ratios, reliance on wholesale funding and securitisation, etc.) had been presented by the supervisory team at ARROW Panel meetings. Instances of poor judgement are also paraded for our attention, not least the ARROW Panel's decision to endorse the supervisory team's proposal not to issue a 'Risk Mitigation Programme', a mechanism, shared with the firm, designed to highlight, pursue and track contentious issues using a common framework. [Northern Rock was the only high impact firm not to have one.] Similarly, it is difficult to comprehend, even if one accepts that some of the bank's most acute risks were "low-probability" events, the ARROW Panel's decision to lengthen the period between formal ARROW risk assessments of Northern Rock to 36 months, the maximum allowed under internal procedures and 12 months longer than that proposed by the supervisory team. This meant that interim supervision, post 20 February 2006, would be carried out under the less rigorous arrangements for "Close and Continuous" supervision. In the event, only seven such meetings were ever held, five of which were held on one day (30 April 2007), a typed record of which was not even produced! Moreover, supervisors did not appear to fully understand their responsibilities under this framework.

These observations duly led the Review Team to conclude that "overall, the supervision of Northern Rock was at the extreme end of the spectrum within the firms reviewed in respect of these failings and that its supervision did not reflect the general practice of supervision of high-impact firms at the FSA". In other words, people rather than systems/procedures, were primarily to blame. Nevertheless, with an eye on the future, the Review Team makes seven high level recommendations (for further details *see* Appendix 2 of the FSA's document entitled 'Recommendations and Actions'):

- FSA senior management to have increased engagement with high-impact firms (to include an annual review of the firm's business/strategic plans);
- FSA to increase the rigour of its day-to-day supervision;
- FSA to increase its focus on prudential supervision, including liquidity and stress testing;
- FSA to improve its use of information and intelligence in its supervision;
- FSA to improve the quality and resourcing of its financial and sectoral analysis;
- FSA to strengthen supervisory resources; and
- FSA senior management to increase the level of oversight of firms' supervision.

In response to the Internal Audit Report and to the earlier (January 2008) Tripartite Authorities' proposals for enhancing the general framework for dealing with a bank failure, the FSA duly proposed a 'Supervisory Enhancement Programme' designed to strengthen its overall supervisory process. The programme will also incorporate the improvements already under way, as agreed in 2007, and will be a key component of the current three-year plan (running from 2007 to 2010) which, in terms of internal

change, has as its primary objective the creation of an effective management, operational and cultural framework to deliver more principles-based regulation. The main features of the programme, which is due to be completed by December 2008, are (FSA Press Release, 2008):

- A new group of supervisory specialists will regularly review the supervision of all high-impact firms to ensure procedures are being rigorously adhered to.
- The number of supervisory staff engaged with high-impact firms will be increased, with a mandated minimum level of staffing for each firm.
- The existing specialist prudential risk department of the FSA will be expanded following its upgrading to divisional status, as will the resource of the relevant sector teams.
- The current supervisory training and competence framework for FSA staff will be upgraded.
- The degree of FSA senior management involvement in direct supervision and contact with high-impact firms will be increased.
- There will be more focus on liquidity, particularly in the supervision of high-impact retail firms.
- There will be raised emphasis on assessing the competence of firms' senior management.

[xix] For a critique of current arrangements under the FSCS *see* Hall, 2001b and 2002.

[xx] The allocation of respective responsibilities under the 'Memorandum of Understanding' was modified in March 2006, changing the Bank's remit to one of "contributing to the maintenance of stability of the financial system as a whole".

[xxi] The Bank has since acknowledged that improvements in the tripartite arrangements are required along with the other components of the crisis management arrangements (i.e. bank insolvency arrangements and deposit insurance arrangements) (Bank of England, 2007a, p.2). And the need for a review was acknowledged by the Chancellor in his statement to the House of Commons on financial market instability on 11 October 2007.

[xxii] The Treasury Committee's views are set out in House of Commons, 2008c.

[xxiii] Their original support for an element of pre-funding has since waned, given the banking industry's opposition in the face of mounting pressure on their balance sheets. The Government now only intends to give itself powers that would allow it to introduce pre-funding of the FSCS "if it was considered appropriate to do so in the future" (HM Treasury, FSA and Bank of England, 2008b, para.1.67).

[xxiv] On 22 October 2008 another takeover within the building society movement was announced. It concerned the Yorkshire Building Society's takeover merger of the Barnsley Building Society – to be concluded by end-2008 – to end the uncertainty surrounding the impact of the latter's possible loss of £10 million held in Icelandic banks. As in the earlier takeover, members of the Barnsley society will not get a vote on the issue nor receive windfall gains. And then, on 3 November 2008, the planned merger of the Skipton and Scarborough Building Societies was announced. As in the earlier cases (including the proposed merger between the Catholic and Chelsea Building Societies announced on 7 June 2008), the merger is expected to be completed by end-2008.

[xxv] The Bank's new permanent emergency liquidity regime was unveiled a week later (*see* p.14).

[xxvi] To include bank debt guaranteed under the new Government guarantee scheme – *see* below.

[xxvii] By the 8 October 2008, the following institutions had already agreed to participate in the Government-supported recapitalisation scheme: Abbey; Barclays; HBOS; HSBC Bank plc; Lloyds TSB; RBS; Standard Chartered; and the Nationwide Building Society.

[xxviii] Those already committed to the scheme and which had promised to raise their aggregate Tier 1 capital by £25 billion by end-2008 have access to a further £25 billion, if they want it, in the form of preference share capital, PIBS, or as assistance to an ordinary equity fund-raising.

[xxix] A fee is charged based on the bank's median cost of protecting its bonds against default in the credit derivatives market over the 12 months to 7 October 2008 plus 50 basis points plus an extra fee if the debt is not denominated in sterling.

[xxx] By the 12 November 2008, Barclays Bank (€3 billion), HBOS (nearly £3 billion), RBS (£3 billion), Lloyds TSB (£1.4 billion plus €2 billion), and the Nationwide Building Society (£1.5 billion) had all taken advantage of the government guarantee scheme.

[xxxi] A new company, UK Financial Investments Limited, was set up for this purpose on 3 November 2008.

[xxxii] The Pre-Budget Report, unveiled on 24 November 2008, revealed the Government's intentions. A £20 billion fiscal stimulus, amounting to around 1 per cent of GDP, would be delivered for just over a year to try and dampen the severity of the downturn (by around 0.5 per cent of GDP). The main expansionary forces derive from an immediate cut in VAT – from 17½ per cent to 15 per cent – programmed to last until end-2009, and the bringing forward of capital expenditure from future years. To convince the markets of the Government's commitment to returning to fiscal "responsibility" as soon as circumstances allow – 2015/16 is the suggested date – the Government simultaneously announced a series of deferred tax rises and planned expenditure cuts. On its own reckoning, however, the implications of its policies

for the public finances are profound. Public borrowing is forecast to hit a record level of £118 billion (equivalent to 8 per cent of GDP) in 2009/10 falling to a "prudent" level only by 2015/16. And government net debt is forecast to reach 57 per cent of GDP by 2014/15, well above the current preferred limit of 40 per cent of GDP, exceeding £1 trillion for the first time in 2012. And these projections are based on what are likely to prove over-optimistic assumptions concerning growth forecasts – the economy is expected to contract by between 0.75 per cent and 1.25 per cent in 2009, with growth resuming in the second half of 2009 to deliver growth of between 1.5 per cent and 2 per cent in 2010 and 3.25 per cent in 2011/12 and thereafter – and the scale of additional "efficiency savings" that can be squeezed from the public sector. The scale of additional gilt funding that these projections imply may yet prove unsustainable; and foreign investors may balk at maintaining their investments at current levels even if yields are substantially raised to compensate them.