Appendix 1

The Nationalisation of Northern Rock PLC and the Banking Act 2009 "Bank Special Resolution Scheme"

1. The factors leading to the Nationalisation of Northern Rock (NR), and those relevant to post-nationalisation are related in detail in our Main Report and Appendix 2 and are not related here.

2. Our concern is with the "taking of NR into Temporary Public Ownership" through Nationalisation and thereby acquiring the interests of Ordinary Shareholders in NR without payment of compensation.

3. In 2007/8 the only UK Law that could be applied in the circumstances was the Insolvency Law 1986. This was because, despite the fact that one was available in other G20 countries, the UK had no Special Resolution Regime Law (SRR) that could be applied to banks that were failing or likely to fail.

4. The absence of an SRR was recognised in 2007 but none was available. The Triumvirate Regulatory Authorities had worked on how to deal with major financial sector problems in 2004 but regarded it as a low priority that was not completed.

5. When NR required Emergency Assistance in 2007, it was granted by the B of E with the approval of The Chancellor. This assistance enabled NR to carry on its business activities. The Government intention was that it should do so until a "takeover" by another bank could be arranged and the B of E loans repaid, something that was only partly achieved in 2012.

6. The difficulties and uncertain future in the financial markets in 2007/8 made it impossible to achieve those objectives, therefore The Chancellor was advised that the only other option was to temporarily nationalise the bank.

7. The subsequent events were a direct result of the unavailability of a Special Resolution Scheme for banks. Such schemes are structured to address the special problems that make it unsuitable to treat failing banks in the same way as other commercial companies by means of a universal Insolvency Law.

Special Resolution Regimes for banks

1. The liquidity problems facing Northern Rock in 2007 caused the government to issue a Consultancy Paper that preceded preparation of a Bank Special Resolution Scheme. It is important to recognise that much of the administration of NR after nationalisation utilized principles that were under consideration in early 2008 and which were later incorporated in The Banking Act 2009 (passed into law on 21st February 2009). That Act included a Special Resolution Regime for failing banks or for banks that it was considered likely to fail. It also applied to certain other financial undertakings but that aspect has no present relevance.

2. Bank Special Resolution Regimes are designed to address systemic risks resulting from a bank failure while freeing the public authorities from the dilemma of having to use public funds to bail out all of a bank's creditors.

3. A bank SRR is different in that it provides alternative methods of preventing the failure of a bank without resorting to nationalisation which is regarded as a "last resort solution".

4. Because in 2007/8 the UK had no SRR in law, the EC Court of Human Rights declared that it was within the powers of a national government to set the terms on which compensation should

be assessed, enabling the Government to stipulate three assumptions that had to be made and that resulted in the "no value" conclusion by the appointed valuer, this was despite the fact that HMT's adviser, Goldman Sachs had recently placed a valuation of £2.8Bn on NR.

5. The 2009 Bank Act in its provisions relating to the SRR states one of the objectives that have to be observed as "Objective 7 is to avoid interfering with property rights in contravention of a Convention Right (within the meaning of the Human Rights Act 1998)". The primary Convention right at issue is Article 1 of Protocol 1 to the Convention on Human Rights (right to property). In other words, now that the SRR is in place the government can no longer exercise its discretion regarding the terms on which compensation may be payable.

6. The term "avoiding interfering with property rights in contravention of a Convention right" (objective 7) refers to holders of property rights in a failed or failing banking institution. These holders can include the institution itself, its shareholders and other creditors, etc.

7. The inclusion of this objective acknowledges the importance of ensuring that any interference with Convention rights is lawful, in the public interest and proportionate.

8. Section 6 of the Bank Act 2009 sets out five stabilization options for resolution of a failing banking institution provided that the conditions for exercising the SRR tools, as set out in that section are satisfied including transfer of the institution by the Treasury into temporary public ownership.

9. A banking institution is considered to be failing or likely to fail in one or more of the following circumstances:

   - if the banking institution is failing, or is likely to fail to satisfy the threshold conditions in circumstances where that failure would justify the variation or cancellation by the PRA or FCA of the banking institution's permission to carry on one or more regulated activities;

   - the value of the assets of the banking institution are or are likely soon to be less than the value of its liabilities;

   - the banking institution is unable or likely to become unable to pay its debts as they fall due; or

   - extraordinary public financial support is required except when, in order to remedy a serious disturbance to the economy and preserve financial stability, it takes the form of either a State guarantee to back liquidity facilities provided by the central bank according to the central bank's conditions. (There are other circumstances, but this is the one that would have been relevant to NR's situation).

   - It should be noted that the BofE intervention in the case of NR was not made to rescue NR, it was made in respect of the underlined sentence above which relates to Objectives 1, 2 and 4.

10. If NR had been subject to the SRR prior to nationalisation in 2008, one of the other stabilization options could have been applied and instead of nationalisation, a "bridge bank" may have been set up by the B of E and the resolution options that became law in 2009 would have been invoked. Because the SRR was not available, NR continued to operate more or less normally until, 2010, but in Government ownership.

11. When NR was split into two in 2010, a new NR which kept the public deposit liabilities, a quantity of mortgages and cash injected by means of a further government loan. This loan was not required to stabilise the bank but to enable it to grant a larger volume of mortgage loans to facilitate a government objective. The remaining assets, including those subject to securitisation were transferred to NRAM for administration and disposal as opportunities were presented. The foregoing is effectively the same as the "bank administration procedure", one of the SRR "tools" for use where there has been a partial transfer of business from a failing institution

12. Although the SRR had not been finalised and had not become law, the continuation in business by NR from 2008-12 was effectively a substitute for a "bridge bank", as described in the 2009 Bank Act. The splitting of NR into two separate parts also mirrored two of the SRR stabilising options. During the period from September 2007, NR reduced the amount of mortgage assets held by it and used the proceeds to reduce the B of E, later HMT, loans. By 2016 all the original loans that were said to be "taxpayer bailout loans" had been repaid

13. Under SRR, the temporary public ownership tool is a "last resort" option and will only be used once the other stabilisation options have been exploited to the extent practicable while maintaining financial stability. The Treasury will make this determination after consulting the Bank of England.

14. Under SRR rules, The Treasury may only use the temporary public ownership option where shareholders and creditors of the banking institution have made a contribution to loss absorption and recapitalisation that is equivalent to at least 8% of the liabilities of the institution, measured at the point when the action is taken. NR did not make such losses, therefore this condition would have had no application and a period of "temporary public ownership" would not have been an eligible option.

15. In the case of NR, whilst it would be regarded as a "failing bank" under the SRR legislation because "it was unable to pay its debts" (inter-bank loans coming up for repayment), it was not insolvent, a fact that was stressed by various government or government related bodies. Its problem in 2007/8 was one of illiquidity at the time it sought emergency assistance.

16. It is apparent that had SRR been available in law, NR had more than sufficient assets to enable a recovery over time from its illiquidity problems if the options made within the SRR legislation had been available to its management.

17. The amount and value of NR assets that were "temporarily taken into public ownership" was excessive when compared with the amount of the State Loan outstanding in August 2008. That would have meant the contravention of the EU SRR requirement that such action should be "proportionate".

18. As it is apparent that the post-nationalisation actions taken on NR mirrored the subsequent SRR legislation in nearly every aspect, it raises the question, why do later Conservative Governments insist that the lack of compensation for shareholders should continue to be based on the financial uncertainty and unsatisfactory legal system available in 2008 and not, (particularly in view of the substantial profits that are now expected), in accordance with the Code of Practice for the present SRR that was first put in place on 21st February 2009.

19. The claim for compensation is being presented now because it is known that there will be a substantial surplus of NR assets out of which compensation could be paid. It will not be a charge on Government Revenues or the taxpayers. In all the circumstances it is only fair and reasonably that the former uncompensated shareholders participate in the positive outcome of the nationalisation of NR.

20. Although the SRR provisions were not formalised in Law until 21st February 2009, it is apparent that the provisions later to be incorporated in the 2009 law were being developed during 2008

and were adopted to resolve the problems of several other banks that failed during 2008 in order to avoid further nationalisations (which the Government of the time is on record as saying that it wished to avoid).

Conclusions

The uncertain and deteriorating situation within UK banking, accompanied by an unexpected run on NR deposits meant that the Authorities had to take immediate remedial steps within the existing legal framework to prevent panic from spreading to other banks. Although the B of E had resolved NR's illiquidity problems by extending Emergency Assistance, the Government in the very difficult financial circumstances at the time had no option but to nationalise NR.

Nationalisation did not solve the illiquidity problems but it enabled the Government to acquire ownership of NR from the shareholders. At the same time, in a Compensation Order it described how compensation for shareholders would be assessed. The Order included assumptions that had to be made which meant that the only conclusion an assessor could reach was that the shares were valueless.

It is important that one recognizes that at the date of nationalisation NR owned illiquid mortgage assets worth around £90 Billion and had total liabilities that were much less than that sum. Later in August 2008 when the Government had the B of E loans novated to it, the outstanding loans to government amounted to £15 Billion and three months later that sum had remained the same, 15Bn pounds.

The problems at NR spurred the Authorities to resume work on a Bank Special Resolution Regime (SRR) and in the Bank Act 2009 an SRR passed into law on 21st February.

The new SRR provided options for the treatment of banks requiring assistance, whether solvent or not. The last option, and one which it was stated had to be regarded as a last resort, was nationalisation.

Seven objectives were included in the Act, the last of which required observance of the EC Human Rights legislation, principally the avoidance of interference with property rights, in this case, the rights of the NR shareholders.

The treatment of other banks that required and received assistance during 2008 appears to have taken into account the work that led to the Bank Act 2009. None were nationalised and no shareholders had their shareholding rights removed.

It is apparent that had the SRR provisions of the Bank Act 2009 been available in 2007/8, as with hindsight one can reasonable suggest should have been the case, NR and its shareholders would have been treated very differently. A claim is being made now on behalf of shareholders because it has been officially acknowledged that the government (taxpayer) will benefit substantially from the final realisation of NR assets and therefore it is only fair and reasonable that former shareholders share in the profits derived from assets of which they were the legal owners in 2007.

NR shareholders will not be compensated out of H M Treasury or "taxpayers" funds.

UKSA Northern Rock Sub-committee

June 2017