

## Summary Assessment of Northern Rock situation 2007 - 2017

- 1) NR was a solvent bank with a severe liquidity shortage brought about in 2007 by extreme financial problems facing banks and investment institutions globally.
- 2) Media and government comment at the time placed the blame firmly on NR's own management policies but those had been followed successfully for up to ten years without, at any time, criticism or regulatory advice from the FSA.
- 3) Some of the criticisms described a "rogue bank" pursuing "reckless" policies. Subsequent events demonstrated that the policies were similar to those followed by many banks, in the UK and elsewhere. Far from being a "rogue bank" it became evident that NR did not suffer huge credit related losses such as caused other banks to seek government bail-outs in 2008/9.
- 4) There were two matters in respect of NR that Government had to take into account in 2007. The first was that in the circumstances affecting the global financial system at the time NR was unable to generate new working funds from its customary sources. That situation could have been dealt with by a "covert" loan from the Bank of England, as would have been the case in normal circumstances.
- 5) However, the "run" by NR depositors, started by premature "leaking" of information to a BBC reporter anxious for a "scoop" which was then subjected to immediate concentrated media attention meant that a "covert" solution could not be achieved.
- 6) Unlike most commercial companies a bank takes in money from depositors and other sources and uses it to finance loans to customers. A bank can have money lent out and therefore owed to it as assets but if it cannot source new funds, its ability to operate is limited. It may become illiquid but not insolvent. That was the situation NR faced in 2007.
- 7) Why not a voluntary (or forced) administration process?
- 8) The government wished to avoid that process because until the administration is completed the ability to repay depositors' monies would be unascertained. That might have caused depositors in other banks to start "runs" on UK banks that would have created financial instability and would have been contrary to the "public interest".
- 9) The alternative options were: a) to find a private sector bidder to acquire the bank or b) to take the bank into temporary public ownership through nationalization. Nationalisation became necessary because the Government wished a prospective bidder to "take over" the whole of NR, not a part as was later allowed for Bradford and Bingley (*in anticipation of the Banking Act 2009 provisions*).
- 10) From the Treasury 7th Report issued on 21<sup>st</sup> April 2009, "*Northern Rock was paying a 'penalty' or 'higher rate' of interest on Government loans. Mr. Sandler, the non-executive chairman, was not in a position to disclose (to the Committee) the details of the rate paid.*"
- 11) Because a bank Special Resolution Regime did not exist in English law, no consideration was given in 2007 to separating the bank into two parts, one of which could have been structured to make it an attractive "takeover" proposition, the other could administer and realize the remaining assets but would be closed to new business. That was in fact what transpired in 2010, after the passing of The Banking Act 2009.
- 12) The only English Law that could be applied to the NR situation in 2007 was the Insolvency Act 1986 but application of that Act required NR to be insolvent.
- 13) The Banking (Special Provisions) Act 2008 enabled a Government Minister to declare NR to be "effectively insolvent" allowing the Insolvency Act to be applied. This was notwithstanding that the Bank of England and several government bodies had accepted that NR was solvent.
- 14) The government was faced with the problem that UK law did not contain a Bank Special Resolution Regime whereas other G8 countries had one. Mervyn King, Governor of the BoE drew attention to that fact in evidence to the TSC in 2007. Later, in a TV interview in October 2017, he said that his preference would have been to offer "covert" LOLR assistance. He also expressed the opinion that if that had been done, NR's liquidity problem could have been resolved over a weekend. He added that his legal advice was that "covert" assistance would have been contrary to EU regulation. He also added that his expectation was that former shareholders would share any excess assets after the government loans had been repaid.

- 15) 'The Banking (Special Provisions) Act 2008 provided for a scheme to be set out subsequently by Ministerial Order for the assessment of compensation to shareholders. This was achieved by means of a Compensation Order that included three assumptions that the appointed "*independent*" valuer had to take into account. The effect of those was that the valuer could only determine a "*nil valuation*". In other words, shareholders received no compensation for the loss of their shares.
- 16) It is not known why those three assumptions were adopted by HMT but they had already been considered as part of the preparation for what became The Banking Act 2009.
- 17) Nationalisation by government was adopted because HMT was unable to attract bids for the takeover of NR except on terms that were considered unsatisfactory.
- 18) The basis of "*unsatisfactory*" was that the government (*taxpayer – public purse*) would bear all the risks associated with the administration of NR whilst all the benefits (or potential profits) would accrue to private sector interests (a successful bidder).
- 19) Quite rightly that was seen as an unacceptable situation.
- 20) It took five months for the one and only application for an appointment as "*valuer*" to be received by Government. Was this because the "big four" accounting firms did not apply because they considered the terms of appointment to be at variance with established practice and generally accepted facts? This could have been a well remunerated appointment, HMT later paid £4.5Million in fees to the appointed '*valuer*'.
- 21) "LOLR" loans are not normally regarded as "*State Aid*". Banks judged on normal criteria to be "*solvent*" had a well-established expectation that Central Banks, in their role as "*Lender of last resort*" would resolve their temporary liquidity shortages.
- 22) The BofE LOLR loans in 2007/08 resolved the lack of liquidity that was NR's problem. Later Nationalisation, described as "*taking NR into TEMPORARY public ownership*", was effected in order to ensure that as well as assuming "*risks*", government would reap all the "*benefits*". Nationalisation was described in BofE Minutes (not published until 2013) as a "*method of dealing with the shareholders*".
- 23) Why? Because shareholders owned and ultimately controlled the bank under Company Law
- 24) "*Taking NR into TEMPORARY Public ownership*". Ten years later, after the original loans had all been repaid by 2015, the residue of NRAM (the renamed Northern Rock) is still in "*Public Ownership*" with no government plans to terminate that status or to return any part of it to the former shareholders and owners.
- 25) Notwithstanding the Chancellor's statement in 2008 that nationalisation would ensure that all the benefits would accrue to the government, the Banking Act 2009 includes a statement that "*government did not intend to profit from failing banks*"
- 26) In the present case, NR was nationalised "*for the public good*" in order to minimize the risk foreseen by some, that this initial liquidity problem could spread rapidly to other UK banks.
- 27) Nationalisation may have been the only option available (because a "*take-over*" of the whole of NR by another bank proved impossible to achieve on satisfactory terms), and because the government did not wish to commit to compensation if it had to be paid out of "*taxpayer*" funds (a government loan).
- 28) However it is not accepted that the government was entitled to acquire a disproportionately excessive amount of assets as security for the "*risks*" that it undertook in 2008. By 31<sup>st</sup> December 2008 the amount owing to the Government (or to the BofE) had been reduced from £29.8 Bn to £8.9Bn. Surely that was evidence of NR's ability to clear the total debt within a reasonable time scale?
- 29) The ECHR Convention Art 6, applies to this situation.
- 30) Art 6 acknowledges the importance of ensuring that any interference with Convention rights is lawful, in the public interest and proportionate.
- 31) The nationalisation of NR was validly carried out in the public interest but was it "*proportionate*"? It is difficult to accept that having possession on 31<sup>st</sup> December 2008 of £72.893 Bn of customer loans (including £28.679 Bn of advances secured on property not subject to securitisation) as security for a state loan of £8.9Bn can be considered to be "*proportionate*".

- 32) It is questionable to maintain that the law governing the administration of NRAM (formerly known as NR) should continue to be The Insolvency Act 1986 when all other banks that may now find themselves in similar circumstances would be subject to the SRR provisions of The Banking Act 2009.
- 33) Other Banks such as Bradford and Bingley, HBOS/LloydsTSB and RBS were treated very differently in 2008 although the Banking Act 2009 was still not available.
- 34) Consideration needs to be given now to the provisions of the Banking Act 2009
- 35) Because reliance had to be placed in 2007 on the application of The Insolvency Act 1986 and on The Banking (Special Provisions) Act 2008 (that had a declared life of twelve months only) it is appropriate to consider the relevance of The Banking Act 2009 to the administration since 2010 of Northern Rock (renamed Northern Rock Asset Management in 2010).
- 36) It is accepted that the 2009 Act provisions were not available in 2008 when NR required assistance, but what is maintained now is that compensation needs to be awarded on the present facts of the case and with due regard to the laws of equity.
- 37) Realisation of NR assets enabled all the original Emergency Aid loans to be repaid by 2015 (at the latest) and there will still be a surplus of assets remaining, currently amounting to £4.6BN even after the balance of subsequent government loans amounting to £9.9Bn are repaid.
- 38) **It has to be noted that in 2012 the benefit of those subsequent loans from HMT formed part of the assets transferred to Virgin but remained liabilities of NRAM – an example of what the government in 2007/8 was anxious to avoid by nationalizing NR. (see note 19 above)**
- 39) It has to be acknowledged that The Insolvency Act 1986 was intended to provide legal insolvency procedures to deal with the insolvency of commercial companies. Although “banks” are also commercial companies the LOLR arrangements put in place by the BoE as Central Bank meant that a cause of corporate insolvency, inability to pay due debts, had no application.
- 40) It is important to establish which Banking Act applied to NRAM after February 2009. The 2009 Act introduced new provisions that had never been included in earlier Acts. The Banking (Special Provisions) Act 2009 replaced the 2008 Banking Act that had a life of only one year.
- 41) The Banking Act 2009 included the statement - *“it was not the government’s intention to profit from failing banks”*.
- 42) Why then did government continue to administer NR, or NRAM under the changed name after 2010, in the terms of the Insolvency Act that it used in 2008 only because an applicable SRR law did not exist in 2008?
- 43) Provisions of the Insolvency Act 1986 that are relevant to banks have since been incorporated in The Banking Act 2009. It is therefore reasonable and equitable that the bank (NRAM) that exists now should be administered in accordance with the provisions of the first Part of The Bank Act 2009, because NR has never been insolvent **in accordance with the accepted conditions for banks**. “Assumptions” were required to create a state of “*effective insolvency*” that did not normally play any part when Emergency Liquidity Assistance was lent to “*solvent*” banks by the Bank of England acting as a Central Bank.
- 44) Three different situations are identified in The Banking Act 2009.
- 45) They are: Part 1). A Special Resolution Scheme. Part 2). Bank Insolvency. Part 3). Bank Administration.
- 46) Had this Law been in place in 2008, a stabilization power contained in Part 1) would have applied to NR. It would neither have been appropriate nor necessary for NR to have been dealt with in accordance with the provisions of Parts (2) or (3).
- 47) Compensation (including of shareholders) is provided for in Sections 49-62 of the Special Resolution Regime in The Banking Act 2009.
- 48) The Banking (Special Provisions) Act Compensation Order 2008 only made provision for compensation according to the requirements included in the 2008 Act in order to satisfy the provisions of the Insolvency Act 1986. The Banking Act 2009 Part (1) - Special Resolution Regime provided an alternative solution.

- 49) **The bank that exists now is the original Northern Rock renamed in 2010 as Northern Rock Asset Management.**
- 50) Section 2 (4) of Part 1) of the 2009 Act states: *“Where a stabilisation power is exercised in respect of a bank, it does not cease to be a bank for the purposes of this Part if it later loses the permission referred to in subsection (1)”*.
- 51) (That permission reads: *In this Part “bank” means a UK institution which has permission under Part 4 of the Financial Services and Markets Act 2000 to carry on the regulated activity of accepting deposits (within the meaning of section 22 of that Act, taken with Schedule 2 and any order under the section).*
- 52) he FSA stated in 2007 that NR could continue to operate as a bank, but would be closed to new deposits.
- 53) The Banking Act 2009, inter alia, makes the following provisions:
- 54) *“The property transfer powers (sections 33-48) provide the flexibility to transfer just some, **but not necessarily all, of the property of a failing institution**”. The most likely use for this power is to transfer the ‘good’ part of an institution’s business to a new entity – either a private sector purchaser or a bridge bank – with a ‘residual bank’ left behind, containing any assets and liabilities that are not transferred.*
- 55) If that provision is related to NR, it was split between two companies in 2010 that created a new operational bank that was of a suitable size and liquidity to encourage a “takeover” by a third party. The residual bank, renamed NRAM, contained assets not transferred but to be realised in other ways. Although referred to in some quarters as “*the bad bank*” it has been administered independently since 2010 and there has been no indication that its assets (mortgage and other loans) were not of good quality and realisable over time.
- 56) A reverse share transfer order is a share transfer order which -  
*“Provides for transfer to the transferor under the original order (where subsection (2) applies); Sub-section 2 reads: The Treasury may make one or more reverse share transfer orders in respect of securities issued by the bank and held by the original transferee (whether or not they were transferred by the original order)”*.  
This last provides that it is possible within the law for “confiscated” shares to be returned to the original owners in certain circumstances. Alternatively, compensation can be paid to former shareholders.
- 57) Northern Rock may have been “*deemed to be insolvent*” but only because of the “*assumptions*” that government imposed. It is not suggested that the “*assumptions*” should not have been included in the Banking (Special Provisions) Act 2008, but they do not feature in the 2009 Special Resolution Regime for solvent banks.
- 58) The fact that after ten years there will still be assets remaining after all government loans have been repaid, many other expenses directly related to the nationalisation settled and after fees and a penal rate of interest have been paid to HMT for the last ten years indicates that NR was never insolvent in the accepted sense and that its shareholders should be compensated.
- 59) If NR was never insolvent in the accepted sense for a bank, then any surplus of assets would have belonged to the shareholders had nationalisation not taken place.
- 60) It is accepted that the financial markets in 2007/8 were subject to extreme uncertainties and that government action needed to be taken decisively and quickly. It is also acknowledged that administration of the two Northern Rock companies over the past ten years has been difficult and complex.
- 61) Those facts are not subject to question. Although possibly not anticipated in 2007/8, the situation now is that there will be a considerable surplus of funds accruing to the government.
- 62) This is a matter to be resolved through the application of **the law of Equity**, not by an application of a superseded piece of emergency legislation and a subsequent related Ministerial Order.
- 63) The question is whether NR, or NRAM as it is now, should remain subject to the unsatisfactory legal situation that existed in 2007/8 when there was no alternative to a contrived application of the Insolvency Act 1986 or whether the remaining “*bank*” (NRAM) should actually be administered in accordance with the Banking Act 2009, Part 1 that provides an SRR.
- 64) **Compensation will be payable out of excess NR funds and will not be a charge on taxpayers or upon the Public Purse.**