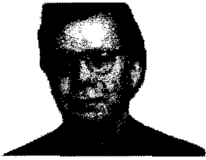
The Northern Rock fiasco: how the EU has damaged Britain's ability to govern itself



One of Britain's leading economic commentators, **Professor Tim Congdon**, looks into the Northern Rock fiasco and asks if the EU played any part in the way in which Britain governed itself. Fundamental to the crisis was the way in which the FSA, the Bank and the Treasury were crippled by limitations on their power, and uncertainties about exactly what their powers were, which arose from the UK's membership of the EU. The Northern Rock fiasco illustrated, with remarkable clarity, the damage that EU membership has done to Britain's ability to govern itself.

Shocking though it may seem – Parliament is no longer supreme in our own nation. Instead, because of the UK's membership of the European Union, 'competences' over large areas of national life have been ceded to EU institutions, particularly the European Commission. Government and Parliament cannot always respond – sensibly, pragmatically and successfully – to new policy challenges because the EU has issued directives or regulations which are binding in this country. Powers and responsibilities that were once exercised freely and effectively by agencies of the British state have been taken away, and instead belong to the EU.

The transfer of competences has been gradual and, relative to the fundamental nature of the power realignment under way, it has also received surprisingly little comment in the British media. Of course the so-called *acquis communitaire* has encroached on British law-making since the UK joined the European Economic Community (as it then was) in 1973. But at first its impact was marginal, and largely confined to farming, fisheries and matters very narrowly related to trade policy. It is only since the Single European Act of 1986 that the acquis has come to influence virtually all areas of national economic life.

Nowadays, when there is a clash between national interest and legal principle, it takes a form very different from that before the late 1980s. Policy-makers have to check the answer to the question 'is the proposed policy compatible with European law (and not just the law of England/Scotland)?' before they consider the question 'what policy is most in the interests of the British nation?'. The insidious effect is that policy-makers put the requirements of European law ahead of our own national interest. Although they believe themselves to be 'doing the right thing' because they have taken legal advice and behaved accordingly, they end up supporting actions which are against their fellow citizens' best interests.

By common consent the British state's handling of the Northern Rock affair in late 2007 and early 2008 was a fiasco. Part of the trouble was that banking regulation was split between three bodies, the Financial Services Authority, the Bank of England and the Treasury which together formed 'the Tripartite Authorities', leading to much confusion. The contrast between the Bank of England's skilful handling of previous financial crises and the Tripartite Authorities' bungling of the Northern Rock problem could hardly have been more extreme. But also fundamental was that the FSA, the Bank and the Treasury were crippled by limitations on their power, and uncertainties about exactly what their powers were, which arose from the UK's membership of the EU. The Northern Rock fiasco illustrated, with remarkable clarity, the damage that EU membership has done to Britain's ability to govern itself.

The crisis began in mid-August, when Northern Rock found that its usual source of funding – the international market in so-called 'structure finance products' – was closed as a by-product of rising defaults on American home mortgages. It told its regulator, the FSA, about its problems, and the FSA and the Bank of England tried to coordinate a response. Perhaps the simplest answer would have been for the Bank to open discussions about Northern Rock's travails with larger, better-funded banks, and to persuade them to lend to Northern Rock for, say, six months or longer until a more permanent solution could be found. A low-key and small-scale rescue effort – conducted quietly between the Bank of England and banks in the private sector – ought to have been sufficient to deal with the immediate problem. Northern Rock's funding shortfall was modest compared with the UK's inter-bank market and the capital of the British banking system.

Unhappily, the Bank – or the Bank, the FSA and the Treasury acting in concert (if that is the right expression) – fluffed the negotiations. They failed to organize inter-bank support operation for Northern Rock, let alone the injection of more permanent capital or a take-over. Even worse, when the announcement of a Bank of England loan facility for Northern Rock was made in mid-September, it did not reduce

nervousness about the bank's funding difficulties. A BBC financial journalist, Robert Peston, somehow came into possession of a leak about Northern Rock's troubles and put out an alarmist story which gave the impression that the bank was bust. A run on Northern Rock's deposits developed, with television pictures of long queues outside its branches adding to the momentum of the withdrawals. The run – the first on a British bank since the late 19th century – was halted only by the further announcement, on 17 September, that the government would guarantee all of Northern Rock's deposits.

When asked by the Treasury Committee of the House of Commons on 20 September for his views on the crisis, Mervyn King, the Bank's Governor, said that the Bank would have liked to act as lender of last resort as it had done in the 1990s. He then identified the interaction between 'four pieces of legislation' as hindering the exercise of the lender-of-last-resort function:

- the Takeover Code
- the Market Abuse Directive
- the UK's system of deposit insurance, and
- the lack of special legislation in the UK for failing banks.

The next few paragraphs will show that, for the first two of these four alleged culprits, the European dimension was critical.

First, the Takeover Code was introduced in 1968 to set out a framework for the orderly and honest conduct of takeover activity in the City of London. For most of the subsequent period it has been a voluntary code respected by participants in financial markets, rather like the rules of chivalry in medieval warfare. Until recently it had no legislative force, and was readily set aside in both the secondary banking crisis of the mid-1970s and the mini-crisis of the early 1990s. It became statutory only in 2006, as a by-product of EU legislation as the member states tried to reach an accord on the conduct of takeover activity across the whole of the Union. Whether the Takeover Code was in fact an obstacle to an inter-bank rescue operation in the summer of 2007 seems moot, to say the least. The important point for present purposes is that King thought that it was a valid justification for the Bank's reluctance to organize such an operation. Before 2006 he could have acted pragmatically and sensibly, as had his predecessors in similar circumstances, because the Takeover Code was not law.

Secondly, King believed that the appropriate method of dealing with Northern Rock's funding problem was 'covert' lending, but – in his opinion, after taking legal advice – 'covert support is ruled out because of [the EU's] Market Abuse Directive'. The Market Abuse Directive describes how publicly-quoted companies must reveal inside information that may affect the stock market's valuation of their businesses. The obvious counter-argument is that the Bank of England had been involved in commercially sensitive negotiations, of one sort or another, with publicly-quoted companies for many decades before 2007. No one had thought that a EU directive on insider trading should intrude into such negotiations or somehow stop them taking place.

King's reference to the Market Abuse Directive may have been misjudged. According to Professor Willem Buiter of the London School of Economics in a report in Financial News on 4 February 2008, 'There is nothing in the Market Abuses Directive to prevent covert support to banks in trouble. On the day the Governor of the Bank of England said it, the statement was contradicted by a spokesman for the European Commission.' Three months after King's initial evidence to the Treasury Committee, the Tripartite Authorities submitted a further memorandum on the meaning of the directive. This included a lengthy but inconclusive disquisition on whether an announcement about certain types of commercial negotiations might be delayed and still comply with the Market Abuse Directive, because the announcement would itself materially affect the outcome of the negotiations! As King himself noted, the wording of the directive was 'ambiguous'.

Arguably, the important point here is not whether King was right or wrong in his original interpretation of the Market Abuse Directive. Rather the point is that the uncertainties of the legal context did affect his perception of the Bank's own responsibilities. Further, these uncertainties arose – above all – from the difficulty of understanding a law made by the EU. In earlier financial crises the Bank of England had not had to bother about the perplexities and confusions of European law, because there was no European law to bother about. In the summer of 2007 the time and energy absorbed by legal

" Secondly, King believed that the appropriate method of dealing with Northern Rock's funding problem was 'covert' lending, but – in his opinion, after taking legal advice – 'covert support is ruled out because of [the EU's] Market Abuse Directive'. . . . . "

niceties hampered the Northern Rock rescue.

Third, deposit insurance is relatively new in the UK. Until 1979 bank deposits were not insured at all and, in principle, a bank failure would cause depositors to lose at least part of their money. Academic studies have shown that bank failures are more common in nations with deposit insurance than in those without. Nevertheless, as with takeovers and insider trading, the EU has made attempts to regularise different member state's arrangements. In 1994 a directive was produced requiring all member states to have a deposit insurance scheme, even though the minimum level of the insured deposit was very low at 20,000 euros. This directive cannot be blamed in any way for the Northern Rock fiasco, but the message seems to be that the UK will in future have to retain a system of deposit insurance whether it likes the idea or not.

In short, King's remarks on 20 September reflected the Bank of England's difficulties both in interpreting European law and in responding to Northern Rock's funding problems given what it took the legal framework to be. Whatever the rights and wrongs of the matter, King and the Bank have subsequently been heavily criticised for their initial handling of the crisis. From the extension of the government guarantee to all of Northern Rock's deposits on 17 September, the Bank was sidelined and the Treasury increasingly took control. But the Treasury's response was also conditioned by a perceived need to respect EU law. Like the Bank, it made a complete hash of the situation.

A central objective of public policy in lender-of-last-resort lending must be to obtain the maximum value from the borrowing banks' loan assets. But the extraction of the maximum value from a portfolio of bank loans and securities takes time. A commonplace of business life is that, if assets are sold off in a rush under pressure (in a so-called 'fire sale'), they are worth less than if the seller can choose the time of the transactions and take advantage of favourable market conditions. It follows that – when a central bank extends a lender-of-last-resort loan to a bank with funding problems – the imposition of a deadline for early repayment is, almost invariably, misguided. The correct attitude is flexibility over the timing of repayment, plus the enforcement of a penalty rate of interest.

So, once Northern Rock had received its lender-of-last-resort loan and deposit guarantee in September 2007, the Tripartite Authorities should have been in no rush for the loan to be repaid. Unfortunately, the Treasury was anxious that the assistance to Northern Rock constituted state aid under EU law. If the assistance were state aid, it was subject to a specific set of rules, including – crucially – rules about the length of time the aid could continue before it became illegal. Indeed, unless a number of conditions were met and an exemption obtained from the European Commission, state aid had to be repaid within six months. The logic of the situation and a large body of precedents argued that a deadline for early repayment of Northern Rock's loan should not be imposed; the obligations of EU membership, as understood by the Treasury, implied that a deadline for early repayment was mandatory.

From an early stage the Treasury's lawyers were busy in enunciating their interpretation of EU law and taking the steps necessary for its enforcement. On 28 September the UK authorities made a submission to the European Commission, in which they sought clarification of the legal status of the Northern Rock rescue package. Since they believed that parts of the package were state aid, they expected 17 March 2008 (i.e., six months from 17 September 2007) to be the effective cut-off point. In late 2007 a number of private sector parties were interested in investing in or even acquiring Northern Rock, despite its well-publicised difficulties. In line with the final cut-off date of 17 March, these parties were told that they must put together their proposals by 4 February. The Treasury insisted that, to be considered valid at all, bidders must include clear and definite plans for full repayment of the lender-of-last-resort loan.

The evident tensions between the Bank of England and Britain's leading commercial banks and the high-handed attitude of the Tripartite Authorities did not encourage potential investors. But the rigidity of the deadline for the repayment of the lender-of-last-resort loan was the more fundamental deterrent. One of the front-runners, the Olivant private equity group, withdrew in early February, citing the Treasury's insistence on a three-year deadline for the loan

“ So, once Northern Rock had received its lender-of-last-resort loan and deposit guarantee in September 2007, the Tripartite Authorities should have been in no rush for the loan to be repaid. Unfortunately, the Treasury was anxious that the assistance to Northern Rock constituted state aid under EU law. . . . . ”

repayment as the main stumbling-block. The government's preferred bidder turned out to be Sir Richard Branson's Virgin Group. But several newspapers carried stories that Virgin had been unable to line up the inter-bank funds needed to repay the lender-of-last-resort loan. So for Virgin also the Treasury's inflexibility on the timing of the loan repayment was a basic problem. This inflexibility may have been partly the result of Treasury ministers' and officials' own attitudes, but it must also have owed something to their apparent fear of being reprimanded by the European Commission for breaching state aid rules.

Finally, on 18 February the Chancellor of the Exchequer, Alistair Darling, announced that the two remaining private sector options – the Virgin bid and another from an in-house management team – were unacceptable to the government. Northern Rock would be nationalised. Over the next week a bill for that purpose was passed by both Houses of Parliament. The resulting legislation – the Banking (Special Provisions) Act 2008 – included criteria for the compensation of shareholders that would, if interpreted at face value, leave them with only a fraction of the book value of Northern Rock's equity.

What did the European Commission think of all the shenanigans between Northern Rock and the Tripartite Authorities in late 2007 and early 2008? On 5 December it produced a decision on the various measures of state assistance to Northern Rock. The Commission's main finding was that the lender-of-last-resort loan from the Bank of England was not, by itself, a form of state aid, but that the subsequent guarantees on Northern Rock's deposits were state aid. On the face of it, the Tripartite Authorities would have been justified in making every effort to present their approach as – in all the key essentials – a lender-of-last-resort operation. After all, Northern Rock had to pay for the government's guarantee and the guarantee fee was analogous to the penalty element in the interest cost on a last-resort loan. However, that was not the line taken by the UK's Tripartite Authorities who, by this stage, were clearly being led by the Treasury. Instead the Treasury and its ministers, who ultimately pulled the strings, showed a remarkable willingness to kowtow to the Commission's verdict.

Under the state aid rules the European Commission allows the governments of member states to keep rescue packages in place for longer than six months as long as clear efforts are being made to restructure the business involved. Large redundancies are regarded as evidence of such restructuring. So on 18 March, a day after the Treasury's six-month's deadline, the newly-nationalised Northern Rock announced that 2,000 jobs would be lost from a total payroll of 6,500.

Public comment was muted, but here surely was the ultimate dottiness. The British state had given financial support to a cash-strapped bank in order to keep it in business, but – in order not to be reprimanded by the European Union for its action – the Treasury had to instruct the same bank's management to sack a third of their staff. A spokesman for Neelie Kroes, the Competition Commissioner, advised The Guardian that Northern Rock had 'to be restored to viability so that it can survive in future without any further injections of public money. There must be compensatory measures to offset the distortion of competition caused by the subsidy and normally that's a reduction of capacity'. As will be discussed, these remarks from the Commission's spokesman were a grotesque misrepresentation of the facts of the Northern Rock situation, even if they parroted numerous reports in the British press. At any rate, the redundancies of 2,000 people in one of the UK's poorest regions constituted the necessary 'compensatory measures'.

But that was not the end of the EU's involvements in the Northern Rock affair. Three more need to be mentioned. First, the nationalisation of Northern Rock opened up the possibility of unfair competition. Since it was in public ownership and its deposits enjoyed a government guarantee, the terms on its deposits would – at the same interest rate – be more attractive than those of other banks. To anticipate possible criticisms the European Commission had to lay down the business framework within which Northern Rock was allowed to compete. As Ron Sandler, the executive chairman appointed to the newly-nationalised bank, himself noted on 18 February, 'the bank will have to operate according to a set of rules set in Brussels'.

Secondly, the evident intention of the Banking (Special Provisions) Act 2008 was to take Northern Rock into public ownership regardless of shareholders' wishes and to pay negligible compensation to those shareholders. But only a few weeks after nationalisation Northern Rock published its results for 2007, showing positive shareholders' funds at end-year of about £1.7b. No one knew for certain in early 2008 whether Northern Rock would be able the repay the Bank of England loan and still have most or all of this £1.7b. intact. But Sandler – again in his statement on 18 February – said that the bank was 'a very sound and well-managed institution'.

Given the large sums of money at stake and the important matters of principle raised, it is hardly surprising that the shareholders decided to seek judicial review of the government's actions. The most important legislation to help them in their claim was the 1998 Human Rights Act, which included a right to private property. According to Lord Woolf, Lord Chief Justice from 2000 to 2005, in his collection of papers on The Pursuit of Justice, the passage of the Human Rights Act 'incorporated the European Convention [on Human Rights] into our domestic law'. In his view this 'had proved a catalyst, transforming the availability of protection for breaches of human rights' in the UK. Again, in his words, before the Human Rights Act became effective in 2000, 'All too often our citizens would have to appeal to the Court of Human Rights at Strasbourg for remedies they could not obtain from their own English courts'.

Thirdly, in early June the European Commission wrote to the Treasury expressing concern that – despite the steps

already taken by the British government – some elements of the Northern Rock package remained illegal under state aid rules. Despite the 2,000 redundancies, the EU's officials felt that more needed to be done. As explained below, the economic basis of the Commission's attitude, that Northern Rock was in receipt of state aid, was almost certainly wrong. Nevertheless, it demanded more job losses in a part of England already suffering from high unemployment, purely in order to comply with the rules.

Most British people continue to believe that they live in an independent nation. A British army, a Royal Navy and a Royal Air Force are still in being, a British team appears in the Olympics, a British entry is made for the Eurovision song contest, every year the Queen makes a speech about the government of her realm at the state opening of Parliament, thousands of young people sing 'Rule Britannia' with gusto at the Last Night of the Proms, and so on. The account of the Northern Rock affair in this paper has shown that in reality key institutions of the British state now take their orders, to a large extent, from the European Commission or other EU agencies.

Most conspicuously, the Treasury may purport to be the premier department in the British state, but on important matters it regards itself as subordinate to the European Commission. That is the only interpretation allowed by its determination to seek out the Commission's opinion of the applicability of the EU's state aid rules to the Northern Rock package. Moreover, Treasury ministers took decisions with the deliberate and explicit purpose of complying with these rules. Britain's own national interest appeared not to figure in their thinking. Again, after its nationalisation Northern Rock's new management acknowledged that it had to respect a mass of rules for state-owned banks formulated in Brussels, not in London. Even worse, within a few weeks of the nationalisation announcement the management had to sack almost a third of the staff for no reason other than that the European Commission demanded that they be sacked.

While direct contacts between the Bank of England and EU institutions are unimportant and infrequent because the UK has retained its own currency, the Governor of the Bank of England's concern to obey European law was at least partly to blame for the Bank's unimpressive performance in the Northern Rock affair. The imprecise wording of allegedly relevant directives, especially on insider trading, delayed and hampered decision-taking in the critical weeks in August and September when Northern Rock sought help from its regulator, the FSA, and the Bank. Depressingly, the first question in the minds of senior Bank of England officials seems to have been 'are we acting in accordance with European law?', not 'what is the right course of action for Britain and its financial system?'

In some respects the EU contribution to decision-taking was downright wrong. Neelie Kroes' spokesman referred to 'the injection of public money' into Northern Rock, echoing numerous statements in British newspaper about how 'government money' was supposedly being wasted on 'a bank bail-out'. In fact, no government money had been injected. Instead Northern Rock had received a loan and a government guarantee on its deposits. A loan is a loan and must be repaid; it is not a gift. Further, the loan was at a penalty rate and a fee was charged for the guarantee, so that significant sums – running into tens of millions of pounds – have been paid by Northern Rock to the state. The effect of Northern Rock's payment of these items has so far been positive for the public sector's finances. It is possible that Northern Rock may ultimately not be able to repay the Bank of England's loan in full, and that the intervention may have a net cost to the taxpayer. But – as noted earlier – that was not Sandler's assessment in February this year.

A case can be made that the Bank of England's loan to the solvent but illiquid Northern Rock in the autumn of 2007 amounted to nothing more than a particularly large-scale lender-of-last-resort operation and was not 'state aid' at all. If it had been deemed not to be state aid, the deadlines and 2,000 redundancies in March 2008 would not have been necessary. The British government should have been arguing with the European Commission, as every other European government does, instead of meekly accepting its diktat.

As far as Britain and the EU are concerned, the implications of the Northern Rock fiasco are at least twofold. First, if its agencies are to function freely and effectively (as they did in the past), the British state must repatriate powers from the EU. At present bodies such as the Treasury and the Bank of England are unsure how their responsibilities are to be defined, and the uncertainties affect the quality of their decision-taking. Secondly, Parliament must either pin down the meaning of EU directives or replace such directives with clearly-expressed English law which is superior to the directives. Of course, the deliberate replacement of loosely and ambiguously stated European 'law' (i.e., the so-called 'law' contained in directives and regulations) by better home-made law conflicts with commitments made by the British government in a succession of treaties.

A basic question raised by the shambles of the Northern Rock affair is therefore whether it would be sensible for Britain to renegotiate its membership of the European Union. In the view of a large and growing number of people in this country, the UK's membership of the EU on the present terms is becoming increasingly difficult to reconcile with the efficient and sensible conduct of British public policy. The European aspects of the Northern Rock fiasco therefore illustrate a wider and more important theme.

Professor Tim Congdon is one of Britain's leading economic commentators and the founder of Lombard Street Research.

This article draws heavily on a pamphlet Northern Rock and the European Union *recently published by Global Vision.*