



House of Commons
Treasury Committee

**The run on the Rock:
Government Response
to the Committee's
Fifth Report of Session
2007–08**

**Eleventh Special Report of Session
2007–08**

*Ordered by the House of Commons
to be printed 2 July 2008*

The Treasury Committee

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

Current membership

Rt Hon John McFall MP (*Labour, West Dunbartonshire*) (Chairman)
Nick Ainger MP (*Labour, Carmarthen West & South Pembrokeshire*)
Mr Graham Brady MP (*Conservative, Altrincham and Sale West*)
Mr Colin Breed MP (*Liberal Democrat, South East Cornwall*)
Jim Cousins MP (*Labour, Newcastle upon Tyne Central*)
Mr Philip Dunne MP (*Conservative, Ludlow*)
Mr Michael Fallon MP (*Conservative, Sevenoaks*) (Chairman, Sub-Committee)
Ms Sally Keeble MP (*Labour, Northampton North*)
Mr Andrew Love MP (*Labour, Edmonton*)
Mr George Mudie MP (*Labour, Leeds East*)
Mr Siôn Simon MP, (*Labour, Birmingham, Erdington*)
John Thurso MP (*Liberal Democrat, Caithness, Sutherland and Easter Ross*)
Mr Mark Todd MP (*Labour, South Derbyshire*)
Sir Peter Viggers MP (*Conservative, Gosport*).

Powers

The Committee is one of the departmental select committees, the powers of which are set out in House of Commons Standing Orders, principally in SO No. 152. These are available on the Internet via www.parliament.uk.

Publications

The Reports and evidence of the Committee are published by The Stationery Office by Order of the House. All publications of the Committee (including press notices) are on the Internet at www.parliament.uk/treascom.

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

Committee staff

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

Contacts

All correspondence should be addressed to the Clerks of the Treasury Committee, House of Commons, 7 Millbank, London SW1P 3JA. The telephone number for general enquiries is 020 7219 5769; the Committee's email address is treascom@parliament.uk.

Eleventh Special Report

The Treasury Committee published its Fifth Report of Session 2007–08, *The run on the Rock*, on 26 January 2008, as House of Commons Paper No. 56. The Government Response to this Report was received on 1 July 2008, and is appended below.

Appendix: Government Response

Introduction

1. We welcome the Government’s commitment to taking full account of our Report before making its legislative proposals in response to the run on Northern Rock. We consider it crucial that, insofar as possible, measures in this area are taken forward on a cross-party basis. This Report is being agreed unanimously and we believe that it forms the basis for cross-party agreement on such legislative proposals. (Paragraph 6)

The Government welcomes the unanimous report of the Committee. The report informed the consultation document *Financial stability and depositor protection: strengthening the framework* published on 30 January 2008 and the follow-up consultation published on 1 July 2008 *Financial stability and depositor protection: further consultation*. The contents of the report were debated in the Commons during the Estimates Day Debate of 10 March 2008. The Government is grateful for the Committee’s contribution and will continue to work constructively with the Committee in developing its proposals.

Northern Rock’s business model

2. The directors of Northern Rock were the principal authors of the difficulties that the company has faced since August 2007. It is right that members of the Board of Northern Rock have been replaced, though haphazardly, since the company became dependent on liquidity support from the Bank of England. The high-risk, reckless business strategy of Northern Rock, with its reliance on short- and medium-term wholesale funding and an absence of sufficient insurance and a failure to arrange standby facility or cover that risk, meant that it was unable to cope with the liquidity pressures placed upon it by the freezing of international capital markets in August 2007. Given that the formulation of that strategy was a fundamental role of the Board of Northern Rock, overseen by some directors who had been there since its demutualisation, the failure of that strategy must also be attributed to the Board. The non-executive members of the Board, and in particular the Chairman of the Board, the Chairman of the Risk Committee and the senior non-executive director, failed in the case of Northern Rock to ensure that it remained liquid as well as solvent, to provide against the risks that it was taking and to act as an effective restraining force on the strategy of the executive members. (Paragraph 31)

The Government agrees with the Committee that the responsibility to minimise risks and prevent problems from happening in a particular bank lies first and foremost with the directors.

3. The business model of the Board of Northern Rock was clearly stated. It is unfortunate that the shareholders who acquired their shares as part of demutualisation and the staff of Northern Rock have suffered significantly from the fall in the value of Northern Rock shares. However, it is not possible to make a distinction between types of shareholders in the circumstances of Northern Rock. In a market environment shareholders as a whole must be viewed as taking a risk from which they sought a reward and for which they are now paying a price (Paragraph 34)

The Government notes the Committee's comments and agrees with the principle that there should be no discrimination between the interests' of different holders of the same class of shares.

The regulation of Northern Rock

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

5. The Basel II waiver, and the dividend increase this allowed to Northern Rock, came at exactly the wrong moment. While we accept that Basel II is a capital accord and the problems at Northern Rock that soon became all too evident were ones of liquidity, it was wrong of the FSA to allow Northern Rock to weaken its balance sheet at a time when the FSA was itself concerned about problems of liquidity that could affect the financial sector. (Paragraph 45)

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

7. If the Financial Services Authority was "very unhappy" with the stress testing conducted by Northern Rock, it appears to have failed to convey the strength of its concerns to the Board of Northern Rock, and to secure remedial action. Although the Board of Northern Rock undertook some stress testing of its own business model, it proved to have been thoroughly inadequate. It was the responsibility of the Financial Services Authority to ensure that the work of the Board of Northern Rock was sufficient to the task. The Financial Services Authority failed in its duty to do this. (Paragraph 59)

8. We are concerned that the Chief Executive of Northern Rock was not a qualified banker, although of course he has significant experience. The Financial Services Authority should not have allowed nor ever again allow the two appointments of a Chairman and a Chief Executive to a "high-impact" financial institution where both

candidates lack relevant financial qualifications; one indication that an individual has been exposed to the relevant training is an appropriate professional qualification. Absence of such a qualification should be a cause of concern. We therefore recommend that the FSA undertake an urgent review of the current qualifications of senior directors in financial firms (especially of those firms deemed to be “high-impact”) and ensure that the current approved person regime requirements are adequate, and respond to us on this by June 2008. (Paragraph 63)

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

51. We think it wrong in principle that the Financial Services Authority should be investigating its own failure. We recommend that the FSA ensure that there is an independent component in the analysis of the decision-making of the FSA in relation to Northern Rock. (Paragraph 268)

These recommendations are a matter for the Financial Services Authority (FSA). Since the Committee’s report was published, the FSA has published an internal audit report into its supervision of Northern Rock. This report identified specific weaknesses in the supervision of Northern Rock,¹ but endorsed the suitability of the overall principles and risk-based regulatory approach. In response to this report, the FSA announced details of a supervisory enhancement programme, including the following elements:

- increased senior management engagement with high-impact firms;
- increased focus on prudential supervision, including liquidity and stress testing;
- increased numbers of supervisory staff engaged with high impact firms and the creation of a new group of supervisory specialists;
- raised emphasis on assessing the competence of firms’ senior management; and
- improved use of information and intelligence.

The Consultation document *Financial stability and depositor protection: further consultation* sets out in detail the FSA’s response to the internal audit report and its relationship with the wider proposals to reduce the likelihood of future bank failure.

¹ http://www.fsa.gov.uk/pages/Library/Other_publications/Miscellaneous/2008/nr.shtml

The FSA is currently conducting a review of its liquidity requirements for banks and building societies with a view to addressing practical shortcomings and improving standards of liquidity risk management. An update on the review is given in the consultation follow-up document. The FSA aims to publish a consultation paper in the autumn to set out proposals on sound practices for managing liquidity risk with a strong focus on stress-testing. These enhanced requirements will reflect the work currently underway in the Basel Committee, due to be consulted on in July 2008.

The events of August and September

10. **The Bank of England, the European Central Bank and the Federal Reserve each pursued a different course of action in response to the money market turmoil in August 2007. Only the Bank of England took no contingency measures at all during August, in order to protect against moral hazard, that is, the fear that an injection of liquidity would offer incentives for banks to take on more liquidity risk, secure in the knowledge that the Bank of England would step in to resolve future liquidity crises. The European Central Bank appeared to attach far less weight to the moral hazard argument than the Bank of England. Instead, it adopted a proactive approach in resolving what it saw as a practical problem of a faltering market resulting from banks losing confidence in each other. Although the European Central Bank injected no net additional liquidity in August, it did alter the timing and term profile of its regular operations, front-loading its credit supply towards the start of August, and draining this liquidity before the end of the maintenance period. In doing so, the European Central Bank appeared to satisfy the immediate liquidity demands of the Eurozone banking sector, whilst UK banks' sterling demands went unmet. We are unconvinced that the Bank of England's focus on moral hazard was appropriate for the circumstances in August. In our view, the lack of confidence in the money markets was a practical problem and the Bank of England should have adopted a more proactive response. (Paragraph 89)**

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

12. **We cannot know whether an open market liquidity operation of the kind asked for by a number of banks in August would have prevented Northern Rock's need for emergency support from the Bank of England in September. It is most unlikely that any such lending operation in September, following the stigmatisation of Barclays which we deal with later, could have been of a sufficient scale to ensure that Northern Rock could have received the liquidity it then required. Such an operation would also have raised severe 'moral hazard' concerns, signalling to the banking sector as a whole that public sector support would be made available in the event of any bank facing distress. (Paragraph 95)**

13. The fact that the European Central Bank accepted a wide range of collateral, including relatively illiquid assets, certainly assisted European banks, throughout the period of turmoil. The broadening of acceptable collateral by the Bank of England in September similarly assisted UK banks. The Governor depicted the Bank's decision as being finely balanced between giving the banks the liquidity they wanted and moral hazard. If the Bank were always to accept a wider range of collateral, banks would have an incentive to alter their asset portfolios away from the safest classes and towards higher-risk classes, and we consider this moral hazard argument to be important. Nevertheless, with the benefit of hindsight, we have concluded that the Bank of England should have broadened the range of acceptable collateral at an earlier stage in the turmoil. (Paragraph 97)

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

15. We recommend that the Bank of England, in its response to this Report, set out the rationale behind the design of its standing facilities, and any changes to them that it is considering making. (Paragraph 100)

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

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

These recommendations are a matter for the Bank of England (Bank). The Bank is undertaking a review of its money market operations that encompasses the issues raised in the Committee's Report and it will announce its conclusions later in the year.

18. With the benefit of hindsight, the financial support enquired about by a potential buyer of Northern Rock prior to 10 September may conceivably have represented a better deal for the taxpayer than the financial support that has been provided since 14 September. Unfortunately we received conflicting evidence from Northern Rock and the Tripartite authorities over the details of the support facility requested by the

potential bidder for Northern Rock. This unresolved conflict prevents us from drawing any firm conclusion on whether a safe haven was possible. What also remains unclear is how proactive the Tripartite authorities were in pursuing this option. Clearly the amount and type of State aid was a major factor but equally so was the question of whether the Takeover Code inhibited Tripartite attempts to facilitate a private sector solution for the troubled bank. In any event, it needs to be borne in mind that the consequences of any announcement that might have been made relating to a potential takeover would have been unpredictable. Furthermore, it is not evident that the State could, or should, underwrite a safe haven option, where a single, presumably profitable, bank received State support (in the form of a lending facility) to undertake, or at least announce the takeover of Northern Rock. (Paragraph 118)

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

The Government agrees with the Committee's conclusions on the support facility made available to Northern Rock in September 2007 and, as the Committee notes, the provision of public finances to support a commercial takeover of one institution by another raises important public policy and legal questions. It is right that such decisions would be considered carefully and in the specific circumstances and legal frameworks in place. If such support could have been offered it could have been necessary to give other banks an opportunity to consider using it too and any provision of support would have had to be consistent with State aid rules.

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

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

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

23. In view of the role that fears of a leak of a support operation had played in the decision on Tuesday 11 September that a covert operation was not possible, the Tripartite authorities were unwise initially to accede to Northern Rock’s request for the announcement of the support operation to be delayed until Monday 17 September. In the light of subsequent events, it seems evident that the Tripartite authorities and Northern Rock ought to have strained every sinew to finalise the support operation and announce it within hours rather than days of the decision to proceed with the operation. A swift announcement would have been assisted by early preparation of such an announcement. In that context, we find it surprising that high level discussions between the Bank of England and Northern Rock about the support facility did not take place prior to 10 September. (Paragraph 145)

24. In failing either to make an announcement earlier in the week or to put in place adequate plans for handling press and public interest in the support operation, the Tripartite authorities and the Board of Northern Rock ended up with the worst of both worlds. (Paragraph 148)

38. We recommend that the Government seek to work with the European Commission, European Central Bank and national central banks within the European Union to establish whether the Market Abuse Directive ought to be amended, so as to ensure that covert support operations by a central bank are permitted in specified circumstances. (Paragraph 215)

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

It was for the company to request emergency liquidity support from the Bank of England and to decide whether it was necessary to make an announcement to the markets.

Separately, the Authorities were actively engaged in seeking a resolution for the situation at Northern Rock from August 2007 and had contingency plans for a variety of scenarios.

The company was making the practical preparations for an orderly handling of public and press interest when news of the application for emergency liquidity support leaked. The company made its announcement to the markets at the earliest opportunity after news leaked. The announcement made by the Chancellor, on behalf of the Tripartite, had been worked up as one of the contingency measures.

As the Committee acknowledges and as set out in the January 2008 consultation document, the issues around disclosure are complex and relate to numerous factors. The January 2008 banking reform consultation indicated that the Government intends to legislate to remove the requirement for the Bank of England to release weekly returns. The further consultation notes the Government intention to legislate so that any charges granted to a central bank in connection with its functions as a central bank will be exempt from registration at Companies House.

As part of its July 2008 quarterly consultation paper, the FSA will consult on a proposal to make a limited clarification on the guidance to the Disclosure and Transparency Rules. Within the European Commission's planned review of the implementation of the Market Abuse Directive we will consider the practical operation of the rules on issuers' ability to delay disclosure.

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

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

The response of the Authorities to the problems at Northern Rock needed to be proportionate to the situation faced, recognising, for example, the potential impact on the public finances as well as financial stability and consumer protection. The provision of a

guarantee was always an option. Over the weekend of 15-16 September 2007 the full range of options for possible action to avert the problems at Northern Rock spreading were under consideration, including the possibility of issuing some form of guarantee. There were a number of issues to be resolved before any final decisions were to be taken on the announcement of any form of guarantee. The announcement made at 5pm on Monday 17 September 2007 was made on the basis of consideration of a range of available options and developments in the markets.

Dealing with failing banks

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

The Government agrees with the Committee on the important role that banks and building societies have in the economy. The Government also recognises that it is neither possible nor desirable to maintain a regulatory system that removes entirely the possibility of a bank failing. The consultation document *Financial stability and protecting depositors: strengthening the framework* sets out the Government’s proposals for managing and reducing the impact of a failed bank. This is further discussed in the latest consultation document.

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

The Government agrees with the Committee that the responsibility to minimise risks and prevent problems from happening in a particular bank lies first and foremost with the directors. The Government further agrees that bank shareholders should, to the extent possible, bear the costs of a bank failing. It should be noted that it is estimated that the vast majority of deposits² are fully covered by the Financial Services Compensation Scheme. Most depositors would not, therefore, suffer any financial loss in the event of a bank failing. However in some circumstances, for example to protect against risks to financial stability, public finances may need to be used to deal with a situation involving a failed bank.

29. Although the Financial Services Compensation Scheme is portrayed as offering protection to the depositors of all financial institutions, examination of its funding indicates that it would not be able to cope with the failure of a medium-sized, let alone a major, financial institution. If such an event were to occur under present arrangements, only the Government, using taxpayers funds, would be in a position to protect depositors, as it did with Northern Rock. We are concerned that banks and building societies appear to be viewing the Government’s support to Northern Rock as an acknowledgement that no bank would be allowed to fail. The Government must take

² See chart 5.2 of *Financial stability and depositor protection: strengthening the framework*

steps to ensure that its framework for maintaining financial stability does not provide free insurance to banks. We do not believe that a deposit protection scheme should apply solely to the very smallest institutions. All banks and building societies should be covered by a deposit insurance scheme, such that, in cases such as Northern Rock, or an even larger bank, the Government would not be required to step in to protect depositors. (Paragraph 183)

The Government agrees that the taxpayer should not be expected to provide free insurance to banks or building societies of whatever size. The costs of the FSCS are borne by the financial sector and the Government does not propose to change this. The Government has set out its views on the FSCS future funding in the recent consultation published on 1 July 2008. These reforms include provision for the possible future introduction of an element of pre-funding in the FSCS funding arrangements and explicit provision for the FSCS to borrow from the Government (the National Loans Fund (NLF)). Loans from the NLF will have to be repaid in full with interest by the FSCS and the costs of doing that will be recoverable by the FSCS from the industry in levy payments.

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

The Government agrees with the recommendation, and in particular on the importance of early action to deal with emerging problems, and early access to information and appropriate sharing of such information among the relevant authorities being likely to improve the chances of a successful resolution of a failing bank. The consultation documents recently published by the Authorities set out the Government’s proposals in relation to information provision to the Authorities. These proposals would also facilitate information sharing between the Authorities and enable the Financial Services Compensation Scheme to obtain earlier access to information through the Financial Services Authority.

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

The Government agrees with these recommendations. The January consultation outlined the existing, wide-ranging regulatory interventions already available to the FSA and

concluded that only a small number of additional regulatory powers were required. The Government agrees that a further set of tools is required to help resolve failing banks in a manner that supports continued access to banking functions or rapid and orderly payments to depositors. The consultation document published on 1 July 2008 sets out the Government's proposal to create a special resolution regime (SRR) for banks. The SRR is designed to ensure that the Authorities have a range of tools available to resolve a failing bank. The Government intends to publish draft clauses and further information on how the SRR will operate, before summer parliamentary recess.

The Government believes that a decision to subject a failing bank to the application of the tools in the SRR should be based primarily on regulatory triggers. Such a trigger would be linked to regulatory guidance material, including quantitative and qualitative criteria and would be made by the FSA following consultation with the Bank and Treasury.

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

The Government agrees, and does not propose to use the provision of emergency liquidity support from the Bank of England as the trigger for the application of any of the tools in the special resolution regime (SRR). While it almost certainly indicates problems with a bank, it should be stressed that requesting access to emergency liquidity support is not, in itself, evidence that a bank is failing. Such a request does not in itself mean that the tests for the insolvency triggers are met. It remains important that a bank can access emergency liquidity support without triggering its failure. The recent consultation document *Financial Stability and Depositor Protection: strengthening the framework* and *Financial Stability and Depositor Protection: further consultation* set out the Government's proposals for triggering the SRR. The Government intends to publish draft clauses and further information on how the SRR will operate, before the summer parliamentary recess.

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

In line with the Committee's recommendation, the Government consulted on introducing a special resolution regime (SRR) for banks, with a range of tools designed to help resolve failing banks in a manner that supports continued access to banking functions or rapid and orderly payments to depositors. These tools include the possibility of transferring the property to a bridge bank. The Government confirmed its intentions in the consultation document published on 1 July 2008, and will provide more detail, including draft clauses, in a further document before summer parliamentary recess.

Any resolution tool involving public money would require approval by HM Treasury and a key objective of the SRR would be to protect public finances.

34. We recognise that the ring-fencing of insured deposits, and transfer of them to a third party, would be to the detriment of other creditors of banks, and that this might serve to increase banks' funding costs. However, we believe that this is a cost that the banking industry must bear, because we view a special resolution regime "to be" an essential pillar of an effective system for ensuring financial stability. (Paragraph 202)

The Government agrees with the Committee that a special resolution regime (SRR) is required to provide sufficient tools to help resolve failing banks in a manner that supports continued access to banking functions or rapid and orderly payments to depositors. The Government believes that giving depositors priority over other funders is likely to hasten funding issues for banks in difficulty. It believes that the FSCS should be used to ensure that deposits covered by the FSCS are available.

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

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

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

The Government agrees that the Authorities require tools to take greater control of a failing bank than is possible at present. The proposed special resolution regime (SRR) provides such tools, as set out in the consultation document, *Financial stability and protecting depositors: strengthening the framework* published in January 2008, and the

follow-up consultation published on 1 July 2008. Further details and draft clauses will be published before summer parliamentary recess.

The Government agrees that tools which may transfer all or part of a bank's business outside normal consent regimes must be justified on the basis of legitimate public policy interests; such as maintenance of financial stability; protection of taxpayers; continuity of banking arrangements with minimum disruption for a failing bank's customers; and protection of the interests of depositors.

The Government consulted on whether all the tools within the SRR should be available to building societies as well as banks and, in line with respondent's views will be bringing forward tools for building societies too.

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

The Government agrees that new tools are required to support continued access to banking functions in the event of a bank failing. The tools of the proposed special resolution regime (SRR) include an accelerated and directed transfer to a third party, and a bridge bank mechanism, as well as temporary public ownership. All of these tools provide the means for customers to have continued access to banking services.

Depositor protection

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

The Government agrees that an element of co-insurance below the compensation limit can create incentives for depositors to withdraw their funds at the first sign that a bank is in difficulties. The Financial Services Authority removed the co-insurance element from the

deposit protection rules of the Financial Services Compensation Scheme on 1 October 2007.

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

The Government agrees that the setting of an appropriate compensation limit requires a balance of a number of different objectives, including those identified by the Committee. The Financial Services Authority is responsible under the Financial Services and Markets Act 2000 for setting the compensation limits and other parameters of the Financial Services Compensation Scheme in its rules. The consultation document published on 1 July 2008 confirmed that the FSA intends to consult on changes to the FSCS compensation limits for deposits and other sectors later this year. They expect their consultation paper will propose as one option an increase in the compensation limit for protected deposits to £50,000.

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

The Government agrees with the Committee that it is impractical for the FSCS to protect very large deposits held for short periods. The Financial Services Authority will explore with the financial sector ways for customers to cover amounts above the compensation limit.

43. The current arrangements, under which the Financial Services Compensation Scheme could take months, maybe years, to reimburse the depositors of a large failed institution, are completely inadequate. The speed of release of funds is of critical importance. However generous a compensation scheme may be, and however much confidence consumers may have in eventually getting back their deposits, it would still be rational for a depositor to withdraw their funds from a failing bank if there were a prospect of them losing access for more than a few days. There should be a requirement in law that all insured deposits should have to be paid within a few days of a bank failing and calling on the deposit protection scheme. The relevant authority must ensure that banks' information systems and procedures are capable of such a speedy release of funds. (Paragraph 240)

The Government agrees with the Committee that the speed of release of funds is of critical importance. The consultation document *Financial stability and depositor protection: strengthening the framework* published in January 2008 therefore proposed that the Financial Services Compensation Scheme (FSCS) should aim to make compensation payments within one week of a bank closing. It was always recognised that this would be an ambitious goal and respondents to that consultation document were in no doubt that one week would be an extremely challenging target in almost all circumstances. The Government fully accepts that a number of reforms would be needed before a realistic target could be achieved including changes in a number of areas identified by the Committee in its report. The consultation document *Financial stability and depositor protection: further consultation* published on 1 July 2008 confirms that the Government will continue to pursue such reforms and, as part of work on developing options, the question of establishing an appropriate and realistic target for payout will continue to be considered.

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

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

The Government agrees with the Committee on the importance of consumer awareness of the Financial Services Compensation Scheme (FSCS), the compensation limits and other relevant scheme parameters and recognises the role of effective communication with consumers in securing this. Plans on this were set out in *Financial Stability and Depositor Protection: strengthening the framework* published in January 2008 and are confirmed in the follow-up consultation document published on 1 July 2008. The Financial Services Authority (FSA) and the FSCS will continue to discuss with relevant industry stakeholders and consumer bodies the best methods by which consumers' awareness and understanding of the FSCS can be raised.

45. It is important for the relevant authority operating a deposit protection scheme to understand the size and profile of the depositors it is insuring, not least so that that authority can calculate an appropriate funding requirement. Furthermore, an essential prerequisite of the speedy reimbursement of funds to the depositors of a failed

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

The Government agrees that it is important for the Financial Services Compensation Scheme (FSCS) to have adequate information about the consumers which it is protecting and the size of its potential exposure if compensation has to be paid. The consultation document published on 1 July 2008 contains a number of proposals to ensure that the FSCS has early access to the information it needs and that the FSA intends to consult on new rules requiring banks to have readily available information on the accounts held by depositors eligible for compensation from the FSCS.

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

The Government agrees that the netting off of loans owed by depositors against the deposits which they have is an important issue. The FSA intends to consult on a move to gross payments. This may require amendments to the Insolvency Rules in the proposed bank insolvency procedure to ensure that a system of gross payments to eligible depositors will give a fair result for different customers and the financial services firms (who fund the Financial Services Compensation Scheme through their contributions as levy payers).

48. We regret the FSA's decision to press ahead in November 2007 with changes to the funding of the Financial Services Compensation Scheme, in view of the FSA's knowledge that substantial changes to the Scheme were highly likely in 2008. The FSA's decision to do so pre-empts the Tripartite review of funding issues in relation to deposit protection in which the FSA itself is involved. (Paragraph 256)

The Government notes the Committee's comments. The FSA's announcement followed the completion of considerable work on reforming FSCS funding arrangements.

49. We believe that the 'pay as you go' approach to funding depositor protection, as currently used by the Financial Services Compensation Scheme, has two fundamental disadvantages. First, it does not create the requisite depositor confidence in the availability of a source of prompt funding, so fails to contribute towards financial stability. Second, a 'pay as you go' approach could cause significant pro-cyclicality problems. Such an approach could mean obtaining funding from banks at the worst possible time, whereas a pre-funded model could obtain most of its funding at times of plenty. We have noted the arguments of the British Bankers' Association that ex-ante funding is not appropriate in the United Kingdom due to the concentrated nature of the United Kingdom's banking sector. We do not believe that the nature of the banking sector is itself a barrier to the adoption of such a funding arrangement. Objections to an ex-ante scheme appear to be based on the notion that certain United Kingdom banks are 'too big to fail'. We reject this notion. The principle that must underpin a future scheme is that it should be capable of coping with any foreseeable bank failure. We recommend accordingly the establishment of a Deposit Protection Fund, with ex-ante funding. The Fund would receive contributions from banks and building societies on a regular basis, and be of sufficient size to obviate the need for the Government to step in to rescue a major bank. The establishment of a pre-funded scheme would be a significant cost to the institutions involved, but it seems only right to us that the costs of bank failure should be borne by the industry rather than the taxpayer, as would currently be the case. To ensure that the Fund is adequately resourced from the outset, we recommend that it be financed initially by a Government loan, which would then be repaid over time as banks' contributions accumulated (Paragraph 263)

The Government recognises these arguments. It is important to distinguish between the question of funding and the question of how the FSCS has access to the liquidity it needs at the time payment has to be made. Both issues were discussed in the consultation document *Financial stability and depositor protection: strengthening the framework*. The consultation document published on 1 July proposes that the FSCS should be able to borrow from the National Loans Fund (NLF) and that the Treasury should have the power to introduce and regulate pre-funding in the FSCS in secondary legislation and to set limits on FSCS borrowing from the NLF.

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

The consultation documents *Financial stability and depositor protection: strengthening the framework* and *Financial stability and depositor protection: further consultation* discuss the

issue of risk-based levies. The Financial Services Authority is planning further consideration of risk-based levies and to consult on any changes to the criteria for calculating deposit contributions if appropriate in due course.

Lessons learned

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

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

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

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

56. There was no sign of a communications strategy of the Tripartite authorities during the crisis of September 2007. We believe that this was a contributory cause of the run on the bank. The Tripartite authorities must learn the lessons of the failure or absence of a communications strategy between 10 and 17 September. We recommend that the Tripartite authorities revise their communications arrangements for future crises, to ensure a single, coherent and coordinated message, which was absent in the crisis in September 2007. This message needs to take into account the public’s likely reaction, and be in language people can readily understand. (Paragraph 289)

The Government continues to believe that the Tripartite structure, based on co-ordination between the three organisations, each with their own responsibilities, remains the right structure. The Authorities will learn lessons about improving external communications, as recommended by the Committee, including the involvement of the Financial Services Compensation Scheme. The follow-up consultation *Financial stability and depositor protection: further consultation* published on 1 July 2008 sets out changes to the Tripartite arrangements the Government is proposing to make as part of the reforms to introduce a

Special Resolution Regime (SRR). These include clarification of the information exchange between the members of the Tripartite.

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

The Government is fully committed to the principles- and risk-based approach to regulation that has played such an important part in maintaining the City's competitiveness. The reforms proposed by the Authorities build on this approach. The Government has worked with the FSA and Bank of England in formulating the proposals and collectively the Authorities (Treasury, FSA and Bank of England) have undertaken extensive consultation with a wide range of stakeholders. The proposed reforms set out in the recent consultation documents will strengthen the United Kingdom's reputation as the world's leading international financial centre, and are founded on the Government's commitment to maintain a strong and stable economy. Following consultation over the Summer, the Government intends to introduce legislation in the Autumn.

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

Directors are obliged under the Financial Reporting Council's Combined Code to assess annually whether their system of controls over risk are effective, and to describe in the Annual Report the steps they have taken to improve effectiveness. This is reviewed by the auditors.

The limits on auditors to undertake other work on behalf of their audit clients are set out in the Auditing Practices Board's Ethical standards.³ These standards are currently under review.

Reforms

60. The Financial Services Compensation Scheme model works well for all institutions other than large deposit-taking institutions, where systemic risk is more prevalent. We therefore recommend that the Financial Services Compensation Scheme continue to

³ www.frc.org.uk/apb/publications/ethical.cfm

operate under its current regime for all institutions other than large deposit-taking institutions. We also recommend that the authority in charge of the Deposit Protection Fund decide on how such large institutions should be selected. However, in order to prevent discrepancy in the market, we recommend that the insured deposit limit for individuals under the continuing Financial Services Compensation Scheme be equal to that under the Deposit Protection Fund. (Paragraph 302)

The Government sees considerable difficulty in establishing two schemes covering different financial institutions. There is already sufficient flexibility within the existing arrangements for establishing different funds for different kinds of claim.

61. We therefore recommend that the new regulatory powers relating to banks set out in Chapter 5 of this Report reside with the institution that also controls the Deposit Protection Fund. (Paragraph 304)

The Government notes the Committee's proposal for the allocation of proposed regulatory powers for dealing with failing banks. As set out in the consultation document *Financial Stability and Depositor Protection: further consultation* the Government has proposed a model on which it is seeking views, on the governance arrangements that would be most suited to implementing the proposed special resolution regime for failing banks.

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

The Government welcomes the Committee's conclusion.

63. We consider the need for 'creative tension' within the regulatory system as of sufficient importance to justify overlooking any possible synergies of co-locating the new powers recommended in this Report alongside the existing powers of the Financial Services Authority. We have concluded it would be inappropriate for the Financial Service Authority to receive the Deposit Protection Fund, or the associated additional powers. (Paragraph 308)

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

The Government agrees with the Committee's conclusions. Under the existing arrangements, established under the Financial Services and Markets Act 2000, the Financial Services Compensation Scheme is operationally independent of the Financial Services Authority. Apart from the Treasury taking powers to regulate pre-funding and FSCS borrowing from the National Loans Fund (see response to conclusion and

recommendation 49 above), the Government proposes no changes to the arrangements for making the rules under which the FSCS operates.

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

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

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

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

We recommend that, as part of this review, consideration be given as to whether it would be appropriate for the holder of the post of Deputy Governor and Head of Financial Stability to be a member of the Monetary Policy Committee or whether that position should be assumed by a senior member of Bank of England staff specifically charged with responsibility for the interface between financial stability and monetary policy. We recommend that the Deputy Governor and Head of Financial Stability have an important role in the Bank of England's money market operations, but work will be needed to clarify the distinction between that role, and the role needed to ensure money market operations to enact monetary policy. (Paragraph 316)

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

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

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

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

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

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

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

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

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

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

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

As set out in the *Financial stability and depositor protection: further consultation* of 1 July 2008, the Government proposes that the roles of the Authorities in the special resolution regime should be:

- the FSA for supervisory decisions and regulatory actions, including the ongoing supervision of any firm while it continues to operate in the SRR;
- the Bank of England for liquidity support and operation of the special resolution regime; and
- the Treasury for public finances and the overall public interest.

The Government has informed the Committee of its proposals to strengthen the governance arrangements within the Bank of England in respect of financial stability.⁴ The Government accepts two of the main propositions that the Committee set out in this report, namely that new powers in relation to financial stability should be conferred upon the Bank of England and that the governance framework should reflect this change.

The Government would see complications with an organisational structure where the Deputy Governor for financial stability reported to someone other than the Governor. The proposals that have been put forward, including the creation of a Financial Stability Committee to include experts from outside the Bank of England will, in the Government's view, provide credibility and ensure that the Bank's decision-makers have access to all the information they need and provide protection against any possible tension between the

⁴ See letter from the Chancellor of the Exchequer to the Committee Chairman, dated 19 June 2008.

Bank of England's objectives. The Government agrees with the need for regular meetings of the Standing Committee at the level of Principals.

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

The Government is considering when and how it is appropriate to put such information into the public domain. There may be clear and overriding commercial and financial stability reasons for delaying any public disclosure of such information.

Northern Rock since September

80. We recommend that the Government clarify as a matter of urgency whether, in the event of the retail deposit guarantee for Northern Rock being invoked, any payments due to depositors would be off-set against depositors' mortgages with Northern Rock. (Paragraph 338)

The Government will provide details on the operation of the guarantee arrangements in the event that they are ever invoked.

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

The Government welcomes the Committee's conclusion that the announcement of the guarantee arrangements was necessary in the circumstances. The objectives of the Government throughout have been to maintain financial stability, whilst protecting consumers and the interests of the taxpayer.

82. State support for Northern Rock has involved the Government entering into contingent liabilities on a very large scale. It is important that the Treasury discharges its obligations to the House of Commons—and through the House of Commons to the taxpayer—promptly and fully to report on the extent of such liabilities. The actual level of Bank of England support underwritten by the taxpayer is not specified within the Bank of England return. The Government itself should not have relied upon either the Bank of England or the Northern Rock to be the sole sources on the scale of the State commitment. The House of Commons should be updated about the scale of the commitment on a quarterly basis. (Paragraph 362)

The Government has kept Parliament informed of events surrounding Northern Rock. Parliament has been notified of all liabilities assumed by the Treasury in the proper way.

The Government does not normally comment on the Bank of England lending to individual institutions. Proposals for the disclosure of liquidity support and Bank of

England reporting of such support are set out in Chapter 3 of the further consultation document.

In Budget 2008 the Treasury stated the intention to transfer the Bank of England's loan to Northern Rock to HM Treasury during the financial year 2008-2009. The Main Estimate and the Summer Supplementary Estimate provided to Parliament contained an initial and then revised assessment of the amount of the loan that would be novated. The Government will continue to report to Parliament in the normal way any contingent liabilities and the size of the loan once transferred to the Treasury.

83. We expect to explore the implications for fiscal policy of the Government's decisions relating to Northern Rock in due course. (Paragraph 380).

The Government notes the Committee's intention.