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Northern Rock and the European Union:
How far was the EU to blame for the Northern Rock fiasco?

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Executive summary

This pamphlet shows that the effectiveness of the three official UK institutions most involved in the Northern Rock rescue – the Treasury, the Bank of England and the Financial Services Authority – was undermined by commitments made by the British state to the European Union. It highlights:

1. the Bank of England's reluctance in August and September 2007 to act as an 'honest broker' to Northern Rock because of worries about breaking the Takeover Code (which became statutory only in 2006 as a by-product of EU legislation),

2. the Bank of England's and the FSA's uncertainties in mid-September 2007 about the meaning of the EU's Market Abuse Directive,

3. the contrasts (from the start of the crisis until now) between the Bank of Spain's attitude to its banks' liquidity problems and the attitude of the UK authorities towards such problems at British banks, implying the lack of a 'level playing field' in lender-of-last-resort arrangements across the EU's supposedly 'common market',

4. the Treasury's concern (from mid-September 2007 onwards) to comply with the EU's rules on state aid, which led to the inappropriate imposition of a deadline for a private sector rescue and the repayment of the Bank of England's loan,

5. the acceptance by the Treasury and Northern Rock's management (from February 2008) of EU rules on the conduct of business by state-owned banks, and

6. the heavy redundancies at Northern Rock (from March 2008), imposed by the European Commission in applying the EU's state aid rules, even though – in fact – Northern Rock's cost of funds from mid-September 2007 was well above market rates and arguably the bank had not received any aid at all.

The common theme here is that agencies of the British state have less freedom and ability to act, and so are less powerful, because of the UK's membership of the European Union. A further feature is that the transfer of powers to EU institutions, while very real, has taken place by stealth. Many details have been left unclear. As a result, the Treasury, the Bank and the FSA are uncertain about the extent of the powers and responsibilities that they retain. The conclusions are twofold:

1. if the British people and government want key agencies of their state to function freely and effectively, as they did in the past, the UK must repatriate powers from the EU, and

2. if the uncertainties created by the encroachment of European law on the law of England are to be eliminated, Parliament must replace ambiguous EU directives and regulations with clearly-expressed English law.

The repatriation of powers and the replacement of European law by English law will, inescapably, necessitate a renegotiation of the UK's relationship with the European Union.

Northern Rock and the European Union

How far was the EU to blame for the Northern Rock fiasco?

Are the Bank of England and the Treasury able to regulate the British financial system, and to support banking institutions if they run into difficulties? 40 years ago the answer would have been 'yes, of course'. The answer nowadays is 'no, not really, because the Bank and Treasury no longer have the same powers and freedom to act'. The argument here is that the UK's membership of the European Union has reduced the scope of key agencies of the British state to respond to financial crises, as well as increasing uncertainties about the extent of the responsibilities they retain. By common consent the Northern Rock affair was badly handled. The claim to be made in this paper is that officialdom's blunders and misunderstandings can be largely blamed on commitments arising from the UK's membership of the EU.

The Bank of England's past success

When the UK decided in the late 1990s to reject the single European currency and instead to keep the pound, the Bank of England became in one respect the most important *national* central bank in Europe. Whereas the national central banks in the single currency area handed over the levers of monetary policy-making to the European Central Bank, the Bank of England was given extra powers by being granted operational independence to set interest rates in 1997. Over the following decade it did a magnificent job in delivering on-target inflation and steady economic growth or, in a phrase, preserving 'monetary stability'. However, such was its success in this task that many people forgot that it had another vitally important objective, that of maintaining 'financial stability'. This objective can be defined, roughly speaking, as ensuring the convertibility of bank deposits into notes at 100p. in the £ and preventing runs on banks.

The amnesia on financial stability was a contributory influence on the Northern Rock crisis in autumn 2007. But an argument can be made that wider developments in the European policy context were more significant. Although the UK has kept the pound, it has handed power over to the European Union in numerous other areas of state action. Moreover, the concept of 'the law of England' has been heavily diluted because of the accretion of 'laws', designated as 'directives' and 'regulations', which emanate from the EU's Council of Ministers and, at a further remove, from the European Commission. The erosion of sovereignty and dilution of national law have occurred because so-called 'competences' have passed from the member states to EU authorities of various kinds. Unfortunately, the transfer of competences has been done with insufficient care and precision, leading to uncertainties about the demarcation of functions and responsibilities of the agencies (central banks, financial ministries and so on) which remain at the member state level.

Central banks are very special institutions. The state has given them the unique prerogative of issuing legal-tender banknotes, with the result that the definition of their role is necessarily a matter for the government. On the other hand, profit-seeking commercial banks leave deposits with them and sometimes borrow from them. They are therefore banker both to the government and to the banking system, and they straddle rather awkwardly the public and private sectors. Given this ambivalence, it is unsurprising that one recognised central bank task – that of making so-called 'lender of last resort' loans to banks when they are short of cash – can become a subject of political controversy.

Historically, the British record in this area of public policy was magnificent. The Bank of England, set up in 1694 to help William III in his long military struggle to stop the French dominating Europe, is one of Britain's most distinguished institutions. In the 19th century it pioneered the modern conception of central banking and in the 20th century its adroit handling of financial crises contributed to the high international regard for the City of London. Whereas in the Great Depression of the 1930s thousands of banks 'closed their doors' in the United States of America, no one lost money on a deposit with a bank in the British Empire. But in the summer of 2007 the Bank of England faced a new challenge. It had to confront a financial crisis when its own freedom of manoeuvre, like that of other agencies in the British state, was constrained by the UK's membership of the European Union. The next section discusses how it dealt with – or rather failed to deal with – the resulting problems.

Northern Rock's funding problem

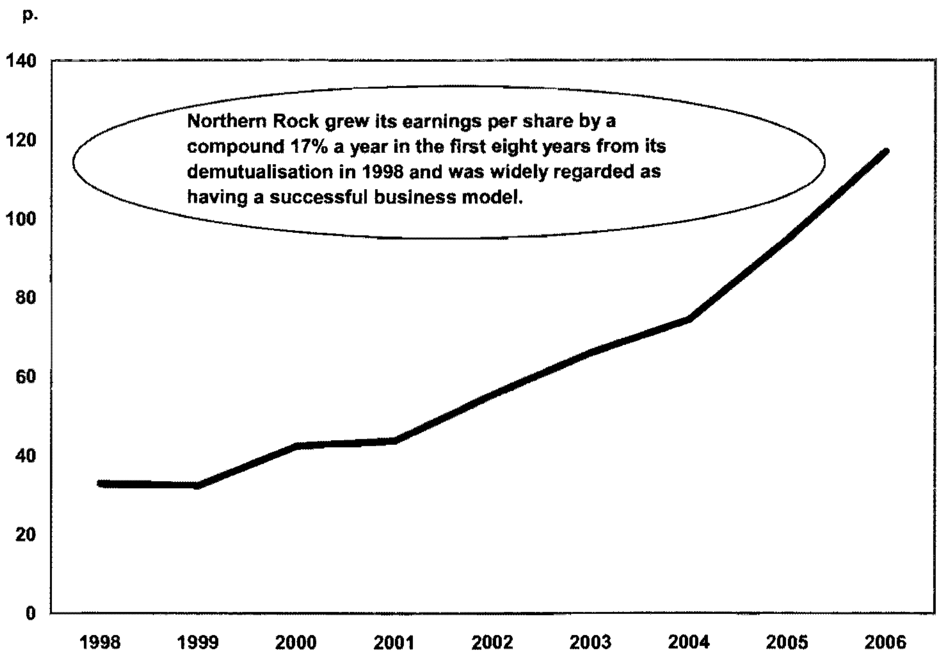
Banks can fund their lending in two ways, either by taking retail deposits over the counter or by borrowing from other banks (and to some extent large companies and financial institutions) in so-called 'wholesale markets' around the world. In early 2007 this second type of funding became increasingly difficult as a by-product of unwise business practices in the American mortgage industry. On 9 August 2007 some French money market funds, supposedly with an asset backing at least as safe as that of bank deposits, announced large losses on American mortgage-backed securities. Financial markets realised that these securities, many of which had been granted triple-A status by the credit rating agencies, could be risky and illiquid (i.e., difficult to sell). Tried-and-tested models for valuing mortgage-backed securities and related instruments became unreliable. In 2006 tens of billions of dollars of new securities were being issued every week in the international wholesale banking markets; by mid-August 2007 these markets were paralysed.

One category of British bank – three former building societies (Northern Rock, Alliance & Leicester, and Bradford & Bingley) specialising in mortgage lending – were particularly threatened by these developments. They had never had the extensive branch networks that had provided the large clearing banks with their retail deposits, and so had financed their expansion since the mid-1990s predominantly by wholesale funding. Northern Rock had been the most aggressive and successful of the three specialist mortgage banks, and was most dependent on continued wholesale borrowing. When it realized in mid-August 2007 that it could not roll over a significant proportion of its liabilities, amounting to over £5b. out of a total balance sheet of more than £100b., it informed its regulator, the Financial Services Authority. The message was that within a few weeks it would need a large loan to prevent a fire-sale liquidation of its assets.

The need to approach to the FSA was itself a

Northern Rock's growth as a mortgage bank

Chart shows earnings per share, on FRS3 basis



departure from precedent. The 1998 Bank of England Act and the 2000 Financial Services and Markets Act had taken the job of banking supervision away from the Bank of England and shared it out, in rather ill-defined proportions, between the FSA, the Bank and the Treasury (the so-called 'Tripartite Authorities'). Until 1998 a bank with funding difficulties would have gone directly to the Bank of England. Indeed, within the memory of many people working in the City of London, numerous banks had done exactly that in the 'secondary banking crisis' of the mid-1970s and a smaller, less well-known crisis in the early 1990s. The secondary banking crisis had affected dozens of institutions and endangered billions of pounds of bank lending. It had arisen from an explosion of credit after the removal of artificial official restrictions on the banks in September 1971, and a subsequent boom and bust in property values. The Bank's handling of the secondary banking crisis was expensive (in terms of the losses the Bank itself took), but by common consent its negotiations with a wide range of financial system counter-parties were well-judged and skilful. Throughout the crisis the understanding in the world's financial markets remained that a British bank deposit would always be repaid at par. Although several institutions lost all the investment made by their shareholders, there was no run on a British bank.

The FSA in 2007 – unlike the Bank of England in 1974 – had no capital, no balance sheet and no ability to lend. So the FSA had to report Northern Rock's problem to the Bank and together they had to coordinate a response. Despite its diminished status, the Bank of England still did have capital, a balance sheet and the ability to lend. But, in contrast to the historical pattern, its response to the looming crisis was dilatory and clumsy.

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. This would have been similar to the Bank's behaviour in the mini-crisis of the early 1990s, in the secondary banking crisis and in earlier episodes. (In the early 1930s the Bank had organized finance for Williams Deacon's Bank, a minor but well-known clearing bank, as a prelude to its takeover by the Royal Bank of Scotland.) In August 2007 Northern Rock was not only solvent with capital of almost £2b., but in the first half of the year it had enjoyed profitable trading and received the usual regulatory endorsements from the FSA. It ought to have been an attractive take-over target to a bank with good access to retail funding. 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 an 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. Instead 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. The cash run was the dominant 'balance sheet counterpart', in accounting terms, of the Bank of England's loan.

The hole in Northern Rock's balance sheet

At 31st December 2007 Northern Rock owed £28.5b. to the Bank of England, whereas a year earlier it had owed the Bank nothing. In terms of counterparts, the loan had been necessitated by three developments.

	£b.
- Increase in Northern Rock's assets	**8.8**
- Decrease in 'customer accounts' (i.e., cash)	**15.3**
- Decrease in other liabilities, mostly wholesale	**4.4**
Total of three developments	**28.5**

The Bank of England and the uncertainties of European law

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, certainly for the first two of these four alleged culprits and arguably for all four, the European dimension was fundamental.

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'. (In early 2008 the French bank, Société Générale, failed to make an immediate announcement about losses, due to the activity of just one trader, that were much larger than Northern Rock's entire capital. Lawyers debated whether this was a breach of the directive. If it was, a conspicuous fact is the French regulatory authorities did not take the trouble to prosecute Société Générale.)

Again, 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 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.

What, finally, is to be said about the lack of specific legislation to deal with failing banks? King seems here to have been thinking of the situation in the USA, where in the past vast numbers of banking institutions have lost all their shareholders' money and, in far too many cases, a chunk of their depositors' money too. The USA does have special legislation related to failing banks and, as a result, a bankruptcy regime that differentiates between banks and non-banks. The record of the UK's banking industry in repaying deposits has been much better than that of the USA's, perhaps in part because the UK is a unitary state with a compact, closely-knit financial elite whereas the USA is large, federal and de-centralised. At any rate, if the EU evolves further into a federal United States of Europe (as many of its admirers want), the American experience argues that the incidence of bank failure may become a livelier topic in public debate. The course of any such debate will be influenced by the EU's long-standing rules on state aid, to which the discussion will now turn.

The Treasury and the EU's rules on state aid

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. The higher is the value of the loan assets because of a successful resolution process, the higher also is the likelihood that this value will exceed the bank's liabilities apart from the central bank's loan. Of course if the loan assets are worth more than the bank's liabilities apart from the central bank's loan, the loan can be repaid and still leave something for shareholders. From a public policy standpoint, that is the end of the matter. Everyone – certainly the borrowing bank's customers, the central bank and the central bank's owner (i.e., the government), and probably the bank's shareholders – ought to be happy.

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. Accountants differentiate between the valuation of a business on a 'going concern' basis and on a liquidation, fire-sale basis. 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. The high cost of the money gives the management an incentive to seek alternative finance and so to repay the lender-of-last-resort loan. There is no need to be precise over a repayment date.

In practice, the eventual resolution of banking crises can take many years. The definitive account of the secondary banking crisis was written by Margaret Reid and published in 1982, but at that point the affairs of one of the most prominent secondary banks, the First National Finance Corporation, were still not settled. The Bank of England intervened in

Johnson Matthey Bank in 1984, after it had lost tens of millions of pounds on foolish loans to Asian businessmen. The Bank's officials were still tidying up the some of the Johnson Matthey's deals over a decade later. The winding-down of the balance sheet of a failed bank, even in a mostly healthy banking system, can therefore be protracted and complex.

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. (That would leave some leeway for tidying-up details and paperwork.) 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. At first this requirement seemed to mean repayment by 17 March 2008, but in the event the acceptable repayment date moved out rather fuzzily, perhaps to as long as five years.

In short, the fixed six-month deadline for the ending of state aid under the EU rules was sharply at variance with the flexible and multi-year duration of most lender-of-last-resort episodes, while the true deadline for the making of a deal was much shorter than six months. The period available for 'due diligence' (i.e., examination of Northern Rock's books by possible investors), negotiations with the authorities, and discussions with staff, suppliers and all the other stakeholders was actually little more than four months (i.e., late September to early February).

The evident tensions between the Bank of England and Britain's leading commercial banks, and the high-handed attitude of the Tripartite Authorities towards the various potential investors, did not encourage investor interest. 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 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.

When the Spanish government and banking authorities faced a similar challenge at about the same time, the outcome was very different. In recent years the leading Spanish banks have pursued a business model similar to that of the UK's specialist mortgage banks, with a heavy reliance on wholesale funding. In the summer of 2007 they faced the same dilemma as Northern Rock, namely that their main source of funds had dried up and the only institution that could readily replace the wholesale markets was the central bank. Despite European monetary union, this still meant in practice the Bank of Spain rather than the European Central Bank. Last autumn the Bank of Spain made available to Spain's mortgage banks three-month loans which, in some cases, have now been renewed twice. In other words, they have received special financing for a period of nine months, longer than the six-month EU limit on state aid. But –

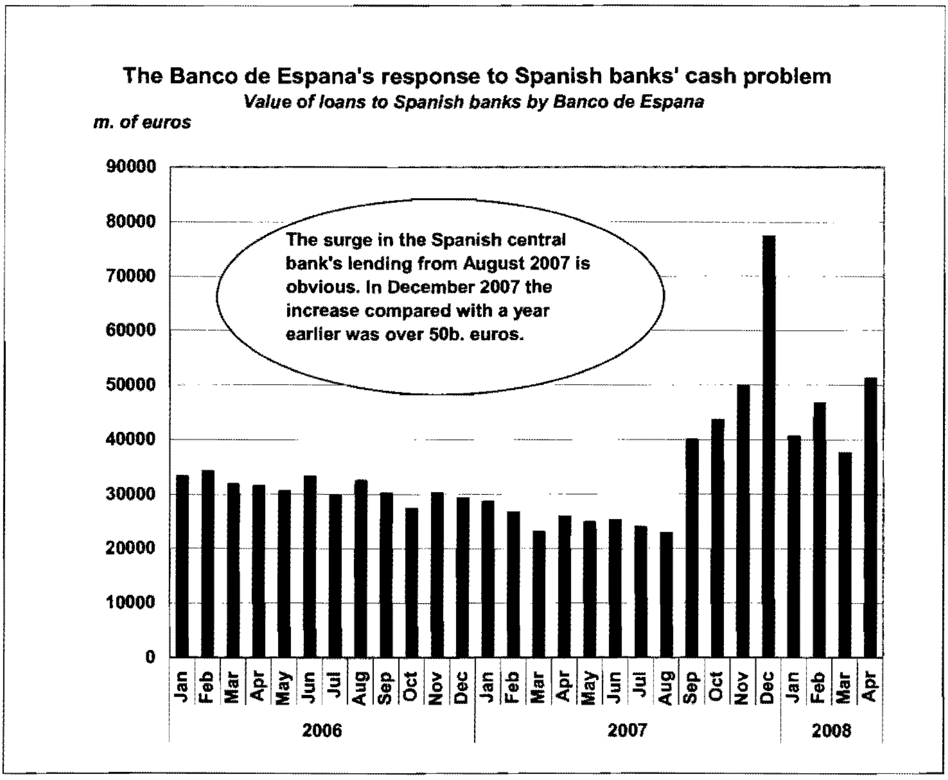
because the financing was a loan from the central bank and no government guarantee was announced – the European Commission has not interfered. No public row has occurred between the Spanish banks and their regulatory authorities, no run on bank deposits has occurred in Spain, and not one of Spain's banks has been nationalised. In May 2008 Leslie Crawford, the *Financial Times*' Madrid bureau chief, remarked in the magazine *Financial World*, "[W]hen the capital markets seized up last August, some economists predicted the Spanish edifice would collapse like a pack of cards. It has not done so." (He was nevertheless sceptical that Spain's banks could remain unscathed indefinitely.)

European law and Northern Rock after nationalisation

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 in the final section, 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. According to a report in *The Times* on 16 March, Danish banks had written to the European Commission objecting to 'the extraordinary protection' given to Northern Rock by the British government and described the situation as a 'distortion of competition'. To anticipate these 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". The obvious questions were, 'if Northern Rock does repay the Bank of England loan, to whom does the capital then remaining in the business belong?' and 'would the government be justified in making a very low level of compensation (say, only £100m. - £200m.) and, in effect, appropriating the remaining equity, which might be worth several hundred million pounds or even more than a billion pounds?'.

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 poor part of England, purely in order to comply with the rules.

Conclusion: confusion and muddle are inherent in European integration

In 2005 the introduction of the European Constitution was opposed by referenda in France and the Netherlands. Further, a large body of European public opinion is opposed to the further handover of competences, along with other redefinitions of powers, contained in the Lisbon Treaty. British public opinion in particular is mostly hostile to the transfers of sovereignty, from Westminster to Brussels, both in prospect and that have already taken place. Given this background, who can be surprised that the processes of European integration have not been announced with openness and enthusiasm in the UK? Instead these processes have occurred by stealth, and much of the nitty-gritty has been left loosely defined, vague, untested and uncertain.

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 analysis 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. Indeed, 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 the lay-offs.

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 lack of clarity in the definition of responsibilities, and therefore the failure of British policy-makers to act quickly and efficiently in the financial crisis of autumn 2007, was partly self-inflicted. In particular, the creation of the Tripartite Authorities' regime in the 2000 Financial Services and Markets Act was a recipe for confusion. Even so a large part of the blame must lie with the ambiguities of European legislation. There is an embarrassing contrast between the Bank of England's 'light touch' and effectiveness in the secondary banking crisis of 1974, and its heavy-handedness and ineffectiveness in the Northern Rock fiasco of late 2007.

The intrusion of European laws and institutions into the British policy-making arena might be welcome if it had led to better decisions. But in the Northern Rock case the EU's interventions made matters worse. The state aid rules led to the imposition of deadlines for the lender-of-last-resort loan and the private sector deal. But virtually all past experience showed that flexibility in timing was likely to improve the financial outcomes and, crucially, the likelihood of the loan being repaid. The 2,000 redundancies were justified in terms of compliance with the state aid rules, not in terms of their costs and benefits to the British nation. 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 newspapers 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.

The Commission also appears to endorse the Danish banks' worries about the 'distortion of competition', with Northern Rock theoretically being advantaged because of its public sector status. But theory and practice are quite different. The Commission has overlooked an obvious feature of the situation. There is indeed a distortion of competition, in that the penalty interest rate and guarantee fee cause Northern Rock to pay a cost of funds *above* the market. The distortion is to the detriment of Northern Rock, not of its competitors! Northern Rock has been shrinking, not expanding, its balance sheet in the last few months. How can its competitors assert that they have been undercut by a low-cost competitor which has stolen market share from them? The proposition is obvious bunkum.

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 the redundancies 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. Anyhow virtually every decision taken by the FSA, the Bank of England and the Treasury was misguided, to a greater or lesser extent. The comments of such individuals as Neelie Kroes' spokesman did not help matters.

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 larger 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.

About the Author

Tim Congdon CBE is an economist and businessman, who has for over 30 years been a strong advocate of sound money and free markets in the UK's public policy debates. He was a member of the Treasury Panel of Independent Forecasters (the so-called "Wise Men") between 1992 and 1997, which advised the Chancellor of the Exchequer on economic policy. He founded Lombard Street Research, one of the City of London's leading economic research consultancies, in 1989. Tim was Lombard Street's Managing Director from 1989 to 2001 and its Chief Economist from 2001 to 2005. He has been a visiting professor at the Cardiff Business School and the City University Business School (now the Cass Business School), and is currently a Visiting Research Fellow at the London School of Economics. Tim was awarded the CBE for services to economic debate in 1997. His most recent book, on *Keynes, the Keynesians and Monetarism,* was published last year by Edward Elgar Publishing. He is currently writing a short book for the Institute of Economic Affairs on *Central Banking in a Free Society.* He is also a member of Global Vision's Economic Advisory Panel.