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Managing the Financial Crisis – The Constitutional Dimension

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Abstract: The financial crisis has required the state, not just in the UK, to intervene in the financial markets to an extent that is unprecedented. This paper focuses on the management of the crisis and its aftermath in the UK, focusing on the constitutional dimension. The financial crisis did not cause a constitutional crisis, but it did reveal the practical operation of the constitution at times of crisis, demonstrating that we do indeed have a 'flexible constitution'. In contrast to the US, where Congress was deeply involved in the terms of the bail-outs, in the UK executive decision-making most often took the form of 'decide now, act immediately, explain quickly, and validate later'. However the crisis demonstrated that legal constraints on government action can come from a number of unexpected sources. The EU rules on state aid gave the EU Commission a far greater role in determining how UK taxpayers' money was spent than the Westminster Parliament. The government is constrained in its ongoing management of its investments in the banks by corporate and financial regulation. The crisis has led to the creation of novel and challenging roles for the state, and the creation of a bespoke administrative apparatus to manage them. In many respects, formalisation, juridification, and greater transparency are replacing informality and opacity in some aspects of the management of financial stability and any future financial crisis. However the bodies managing the bail-out investments sit in an uneasy position in the structures of accountability and their experience to date demonstrates that trying to reconcile the pursuit of public interest objectives in the face of conflicting political and regulatory demands and within the twin confines of corporate law and constitutional structures is a difficult task. Finally, whatever the constitutional situation, the crisis has made it clear that the state ultimately

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underwrites the financial system. The markets may fear 'big government' but governments are now beginning to fear 'big markets'. For as the current turmoil in the sovereign debt markets illustrates, financial markets can pose a greater risk to the state and its taxpayers than the state can ever pose to the markets.

INTRODUCTION

Between September 2007 and February 2010, the UK government nationalised, in whole or in part, four banks, arranged for the transfer of assets of two building societies and two subsidiaries of Icelandic banks; injected £37bn into Royal Bank of Scotland (RBS) and Lloyds Group through recapitalisation, and in November 2009 agreed to purchase a further £39bn in shares (mainly in RBS); extended over £280m in liquidity support; created £200bn of new money through 'quantitative easing' to support banks by buying their UK gilts, leading to the Bank of England owning 20 per cent of the gilt market; and agreed to guarantee up to £250bn of wholesale borrowing by banks and to underwrite £281bn of RBS's assets. It provided approximately £40bn of loans and other funding to Bradford & Bingley and the Financial Services Compensation Scheme. At December 2009 its net cash outlay for lending to banks and purchase of shares stood at £117bn.[1] The UK was not alone. Governments in the US, the UK, and the rest of the EU were forced to inject US$ 4.89 trillion directly into banks and other financial institutions, equivalent to 6 per cent GDP in each country / region and to issue guarantees on bank borrowing and bank assets which, if called upon, would equate to US$14 trillion gross: the equivalent of 50 per cent of the GDP in each country/region. [2]

In the midst of the crisis, on a visit to the London School of Economics in November 2008, the Queen asked: 'Why did no one see this coming?'[3] The causes of the crisis were several, and did not lie solely in financial regulation. However, the crisis has caused a significant reassessment of financial regulation at all governance levels: the global, regional (EU), and national. For many observers it has also called into question the model of financial capitalism that financial institutions, governments, and regulators have created. More immediately, it has required a reconfiguration of the relationship between the markets and the state. Governments have been used to hearing the dictum that they should move from

[1] Details can be found in NAO, *Maintaining Financial Stability Across the UK Banking System,* Report of the Comptroller and Attorney General, HC 91 Session 2009-10, and in the Bank of England, *Financial Stability Reports* of October 2008, June 2009, and December 2009.
[2] Bank of England, ibid, October 2008, June 2009.
[3] The British Academy forum of economists convened to answer the Queen's question wrote to her concluding that 'the failure to foresee the timing, extent and severity of the crisis and to head it off, while it had many causes, was principally a failure of the collective imagination of many bright people, both in this country and internationally, to understand the risks to the system as a whole'. Letter dated 22 July 2009.

'rowing to steering'.[4] The financial crisis saw governments move from steering, to throwing lifelines, bailing out, rowing, and ultimately re-building the boat. But most governments have made it clear that they are reluctant shipbuilders and rowers and would prefer to return to steering as soon as possible, though with a firmer grip on the tiller. The philosophy that determines the relationship of the state and the market may have been temporarily adjusted, but it has not, yet, been fundamentally rejected.

However, the political balance has shifted even if only temporarily. The phrase the 'privatisation of gains and the socialisation of losses' has come to epitomise the crisis. Markets are no longer trusted to be able to deliver optimal outcomes, and firms are no longer trusted to be able to manage themselves in such a way as to ensure their own financial soundness, let alone produce stability across the financial system. Financial institutions which have long enjoyed significant lobbying influence, regardless of the colour of government in power, are now described as 'socially useless' by the chairman of the body that regulates them, the Financial Services Authority (FSA).[5] The large banks are also told, by central bankers no less, that the risks they want to take are too great for our economy to support them. As Andrew Haldane, a Deputy Governor of the Bank of England, has argued, in the past 'the greatest threat to the banks was the sovereign. Today, perhaps the biggest risk to the sovereign comes from the banks'.[6] The UK's response to the crisis has led to changes in the institutional structures of financial regulation, and there may be more to come.[7] The crisis also has a number of very significant implications for the philosophy and techniques of financial regulation used to date.

So where in all this 'mess', lies the constitution? The fact that this question has attracted little attention is not surprising: the government did not fall; Parliament did not revolt; no barricades were manned; and much to the chagrin of many observers, no senior bankers were arrested, let alone beheaded.[8] And after all, there were one or two other issues which snatched the headlines, such as the continued survival of our economic and financial system, and the banks' success in plunging most Western economies into their worst recession in post-war history.

Nonetheless, questions have been raised about the transparency of the crisis-resolution process; and legal challenges have been brought with respect to some of the actions taken, though none has yet succeeded. The government has

[4] D. Osborne and T. Gaebler, *Reinventing Government* (New York: Longman, 2001).

[5] P. Jenkins, 'Solid Support for Tough Action Against Bankers' (24 January 2010), reporting results of a Financial Times/Harris poll in which 80 per cent of respondents thought there should be a cap on bankers' salaries and bonuses.

[6] P. Alessandri and A. Haldane, 'Banking on the State' (speech delivered 9 November 2009).

[7] The coalition government announced that there will be an independent commission to consider reform of banking regulation and that the Bank of England will have oversight over micro-prudential regulation (ie of individual banks). Conservative party proposals to demolish the Financial Services Authority, published in July 2009, appear to have been abandoned: Cabinet Office, *The Coalition: Our Programme for Government* (May 2010).

[8] Though the New York prosecutors have filed charges against executives in Bank of America concerning its takeover of Morgan Stanley.

introduced legislation which contains sweeping Henry VIII clauses which will allow it to do anything necessary, in practice, to respond to bank failures in the future. It has brushed aside competition law to enable the merger of Lloyds and HBOS, much to the opposition of the Office of Fair Trading, the UK competition regulator. It is proposing to give the FSA wide powers to impose collective compensation orders on financial institutions without court intervention or approval.[9] Whilst the Treasury Select Committee (TSC) has done a competent job, we have no equivalent to the US Financial Crisis Inquiry Commission, a bipartisan and bicameral commission with powers to subpoena witnesses from the US and overseas and hear evidence under oath.[10]

The crisis and the subsequent inquiries into its handling have also given us a fascinating glimpse of how the political system works in times of crisis. It has demonstrated that the UK does indeed have a flexible constitution but that there are limits to that flexibility, some of which have come from unexpected sources. The management of the crisis has required the government to take on new roles of asset manager, insurer, and bank manager. As a result it has led to the adoption of new institutional structures and new configurations of relationships between bodies within the 'extended executive' – a term I use to refer to the core executive (departments, Cabinet, and the Prime Minister), plus the diaspora of executive agencies, non-departmental bodies, other independent regulatory bodies (including the Bank of England), and associated appeal tribunals which fan out from it.

After briefly outlining the pre-existing structure of UK financial regulation, the paper focuses on the UK's response to the crisis as it unfolded and on some of the innovations, formalisations, and realignments in the regulatory landscape prompted by the crisis. It draws attention to the importance of understanding the dynamics of the interrelationships between bodies operating within 'extended executive'. It assesses the scrutinising and validating role played by Parliament. Finally it examines some of the implications of the tensions between globalising financial markets, international regulatory harmonisation, and national bank rescues.

STRUCTURE OF UK FINANCIAL REGULATION PRE-CRISIS

Prior to and during the crisis, there were three main organisations involved in the management and regulation of the financial system in the UK: the Treasury, the Bank of England, and the Financial Services Authority (FSA). The Treasury

[9] Financial Services Act 2010, s 14: this has proved to be highly controversial provision and was amended in the 'wash up' process just prior to the election. The power will now only come into force by Treasury order to allow for further amendments to be made in the secondary legislation.

[10] The Commission was created by s 5 of the Fraud Enforcement and Recovery Act of 2009 (Public Law 111-21).

oversaw regulatory developments and produced various statutory instruments under the principal legislation, the Financial Services and Markets Act 2000. It held the FSA to account through, for example, commissioning the National Audit Office's review of aspects of the FSA's work, and commissioned its own periodic reviews of aspects of regulatory policy.[11] Finally, of course, it represented the government's interests in the EU Council of Ministers and the European Committees which advise the Commission on financial regulation. Much of the UK's financial regulation is derived from EU legislation.

The Bank of England was divested of its powers and responsibilities to supervise the financial stability of banks shortly after the New Labour Government came to power. After the Bank of England Act 1998, its main role was to manage monetary policy.[12] It retained a statutory objective to ensure stability of the financial system, however, and employed a large staff to that end (around 100 over the period). It mainly fulfilled this role by producing periodic reports on macro-economic developments and on the activities of financial institutions that might have implications for financial stability. Its other functions include overseeing the payment systems, which are the 'plumbing' of the financial markets: the pipes through which money (over £200 trillion in the UK in 2008)[13] flows between banks on a daily basis as people and companies buy and sell things in the normal course of market economic activity.

Critically, the Bank, like all central banks, provides liquidity to the deposit-taking banks. In particular, it can provide exceptional funding, known as 'lender of last resort' facilities (LOLR), when a bank cannot get that funding through the markets. The liquidity it provides can come from the Bank itself, from its own balance sheet. When that is exhausted, it has to apply to the Government for further funding to go either to the Bank or directly to the bank which is in difficulty. There are no written or legal rules as to when and how the Bank will act as LOLR. Rather the Bank follows the principles set out by Thornton and Bagehot two centuries ago. These are, first, to provide LOLR facilities only when a bank failure will have systemic consequences for the financial system as a whole either because of its size, its interconnectedness to other financial institutions, or because its failure may lead to a lack of confidence by depositors in other banks, prompting a series of bank runs; second, only to provide liquidity if the bank is illiquid but not insolvent; third, to advance as much money as is needed; but, fourth, against collateral and at a penal rate.[14]

Providing LOLR facilities is not a straightforward operation. First, the issue of transparency is complicated, as disclosure that the facility is being provided

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[11] A recent example is the Walker Review into corporate governance in UK banks, which reported in November 2009: *A Review of Corporate Governance in UK Banks and other Financial Industry Entities: Final Recommendations* (London: November 2009).
[12] The Treasury's power to give directions to the Bank was amended in the Banking Act 1998 to specifically exclude the power to give directions with respect to monetary policy.
[13] Bank of England, *Payment Systems Oversight Report* (April 2009).
[14] For discussion, see R. Lastra and A. Campbell, 'Revisiting the Lender of Last Resort' (2009) 24 *Banking and Finance Law Review* 453.

could of itself cause a run on the bank, precipitating the very event that the LOLR provision is attempting to prevent. The stability of banks depends on confidence. Paradoxically perhaps, transparency, or at least 'real time' transparency, can cause loss of confidence. This proved to be a key issue in the management of the crisis. Secondly, the mere possibility that LOLR assistance might be available creates the danger of moral hazard: that banks will undertake more risky activities knowing that they will benefit if the gamble pays off, but will not have to bear the losses if it does not. Central banks are therefore reluctant to state categorically in advance when they will bail out a bank, and make an art of using 'constructive ambiguity' as an instrument of financial supervision. They will also let a bank fail if it assesses there are no systemic consequences, as with BCCI in 1991 or Barings in 1995. Banks nonetheless operate with certain implicit privileges: that they are commercial businesses, but contrary to the normal operations of a capitalist economy, some of them will not be allowed to fail because of the impacts that will have on the financial system as a whole.

In the UK, from 1997 to the time of writing, the role of prudential supervisor has been given to a separate body, the FSA, which is responsible for the day-to-day regulation of financial institutions. The FSA is a private limited company, but it has statutory powers, duties, and objectives under the Financial Services and Markets Act 2000. The Chairman and governing body must be appointed, and are liable to removal from office by the Treasury. [15] There is some cross-membership at Board level between the FSA and the Bank: The Deputy Governor of the Bank responsible for Financial Stability is a member of the FSA board, and the FSA chairman is a member of the Bank's Court of Directors.

The FSA is an 'integrated regulator': it regulates all financial institutions carrying on a wide range of investment business, including banking, dealing and managing financial instruments, and giving financial advice, and it regulates both the manner in which they conduct their business and their financial soundness. No person can engage in investment business without authorisation from the FSA, unless it is already authorised by another member state in the European Economic Area in which case it can benefit from the passporting provisions in EU directives. This provision proved to have significant consequences for UK depositors with Icelandic banks when these collapsed during the crisis, leaving UK depositors largely unprotected. The FSA has wide powers to make rules and impose sanctions on those it authorises, and is funded entirely by the industry. It has a statutory obligation to establish the Financial Services Compensation Scheme, which provides compensation to depositors of failed banks, amongst others, but the Scheme is run independently from the FSA.

The FSA is nested within a multi-level network of financial regulators that together comprise the global financial regulatory regime. The FSA sits on the European 'level three' committees which advise the governmental committees

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[15] FSMA, Sched 1, paras 2, 3.

which advise the Commission on financial regulation, and which issue guidance on the interpretation of EU financial legislation. Following a report on European financial regulation initiated as a result of the crisis, these regulatory committees are due to become statutory bodies with powers to give directions to national regulators under legislation currently under consideration at the EU level.[16] National regulators will be members of these committees. Further, in a notable reminder to constitutional scholars of the significance of transnational, non-state regulation, it is the FSA, not the Treasury, which sits on many of the international committees which set the international norms of financial regulation, including the influential Basle Committee on Banking Supervision which sets the capital adequacy rules for banks. In a further reminder, in this time of the hybrid and polycentric nature of regulation at all levels, those rules were subsequently adopted by the EU and enacted in the UK by the FSA through its Handbook.

The distribution of powers and responsibilities between the Treasury, Bank, and FSA is set out in the Tripartite Agreement, a Memorandum of Understanding (MOU) agreed in 1997 and subsequently revised in 2002.[17] The operation of the Tripartite Arrangement came under close scrutiny during the financial crisis, and was subject to a significant amount of criticism from the TSC. The MOU sets out the respective roles of the Treasury, Bank, and FSA in terms close to those previously described. The institutional structure for coordination, aside from cross-Board memberships, is the Standing Committee on Financial Stability (SCFS), chaired by the Treasury and comprising representatives of the three members. The MOU provides that SCFS is the 'principal forum for agreeing policy and, where appropriate, coordinating or agreeing action between the three authorities. It is also an important channel for exchanging information on threats to UK financial stability'.[18] It meets monthly at the level of deputies, and a sub-group of the Standing Committee 'co-ordinates the authorities' joint work on financial sector resilience to operational disruption and maintains and tests tripartite arrangements for effective crisis management in an operational disruption'.[19]

The MOU in fact defined the respective roles of the three bodies in terms which reinforced the separateness of their operation. The Treasury would communicate with Ministers and the Debt Management Office (DMO). The Bank would be responsible for ensuring the orderly functioning of the markets, communicate with market participants, and provide liquidity and other support. The FSA would monitor the financial health of its regulated firms.[20] Despite the lack of clear coordination between the three bodies in the handling of Northern Rock in the summer of 2007, the TSC has heard evidence that the sub-group

[16] *Report of the High Level Group on Financial Supervision in the EU* (Larosiere Report) (Brussels: April 2009).
[17] Memorandum of Understanding between HM Treasury, the Bank of England and the Financial Services Authority (London: 2002).
[18] ibid, para 10.
[19] ibid, para 12.
[20] ibid, para 17.

conducted a series of 'war games' in which they considered how the three bodies would interact in the event of a financial crisis. Ironically, one of these exercises involved the failure of Northern Rock and HBOS, and the other the failure of Lehman Brothers and Goldman Sachs.[21] One result of those scenario exercises was the conclusion in 2005-6 that the authorities lacked significant legal powers to manage the orderly collapse of a bank, and that legislation was urgently needed.[22] The Treasury had started a project in early 2007 on how the resolution of a failing bank with systemic repercussions would take place, with plans to produce a consultation paper that autumn.[23] Scoping work had been done, but it had not been regarded as particularly pressing in the benign economic environment which then prevailed. In short, the matter was not considered urgent as no one thought the scenarios envisaged in the war games would actually happen. As a result, the authorities had very few legal options open to them and had to be creative in the solutions that they could find.

THE DEVELOPMENT OF THE CRISIS IN THE UK AND THE AUTHORITIES' RESPONSE

The crisis had deep roots, but its precipitating moment in the UK was the run on Northern Rock in September 2007. The crisis deepened, reaching a critical point in September-October 2008. Its aftermath is still continuing.

Table 1 sets out a more detailed timeline of events:

Table 1: Timeline of key events in UK

Date	Event
14 September 2007	Bank of England extends emergency liquidity to Northern Rock (NR); news leaks precipitating a run on the bank
17 September 2007	Government guarantees all existing deposits in NR
7 October 2007	Government extends guarantees and provides £3bn capital; Bank provides further liquidity
October-December 2007	Continued support provided to NR
18-22 February 2007	Banking (Special Provisions) Act 2008 (BSPA) passed; to lapse after one year
23 February	Northern Rock nationalised under BSPA

[21] FSA official, communication with author; note on file with author.
[22] Treasury Select Committee, *The Run on the Rock* 5th Report of Session 2007-8 HC 56-1, paras 278-280.
[23] NAO, *Nationalisation of Northern Rock*, Report of the Comptroller and Auditor General, HC 298 Session 2008-9, para 31.

16 March 2008	US securities house, Bear Stearns collapses; US government provides $30bn to fund Bear Stearns assets to facilitate a takeover by JP Morgan Chase
21 April 2008	Bank of England Special Liquidity Scheme introduced (SLS); anticipated to require £50bn
14 July 2008	Authorities arrange the take over of Alliance and Leicester by Santander, completed on 10 October 2008
15 September 2008	Lehman Brothers collapses
17 September 2008	Merger of Lloyds TSB with HBOS agreed; Government suspends competition law to permit merger 'in national interest'
28 September 2008	Bradford and Bingley nationalised under BSPA; deposits and branches transferred to Abbey National, a wholly owned subsidiary of Santander
3 October 2008	US Congress approves US Governments Troubled Assets Relief Programme (TARP) to buy up $700bn of US banks' 'toxic assets'
8 October 2008	Government imposes a freezing order on the assets of the Icelandic bank, Landsbanki. Most of the deposit business of subsidiaries of two Icelandic banks (Heritable, a UK subsidiary of Landsbanki and Kaupthing Singer & Friedlander, a UK-based banking subsidiary of Kaupthing Bank) transferred to ING Direct, a wholly-owned subsidiary of ING Group. The remainder of the two businesses put into administration. UK local authorities had over £900m deposited in failed Icelandic banks, of which c £24.6m belonged to fire and police authorities
8 October 2008	UK Government announces bank recapitalisation plan comprising (i) recapitalisation; (ii) guarantees; (iii) extension of SLS to £200bn. £20bn invested in RBS, £5.5bn in Lloyds TSB; and £11.5bn in HBOS; through October 2008 Bank of England provides emergency lending to RBS and HBOS peaking at £60bn; Treasury provides indemnity to Bank for the loans, peaking at £18bn, which is not disclosed to Parliament until December 2009 following NAO report
3 November 2008	UK Financial Investments Ltd established to manage the government's investments in Northern Rock, Bradford and Bingley, Lloyds Group, and RBS; responsibilities gradually moved from Treasury and Shareholder Executive from November 08-January 2010
12 February 2009	Banking Act 2009 enacted days before BSPA lapses, introducing the Special Resolution Regime

26 February 2009	Asset Protection Scheme (APS) introduced; RBS announces its intention to protect £325bn of assets; Government to inject up to £16bn in capital bringing shareholding to 84 per cent (70 per cent voting). Participating banks to agree to legally binding commitments on lending, bank charges, remuneration, and bonus caps
3 March 2009	Bank of England introduces Quantitative Easing, making £75bn available
7 March 2009	Lloyds announces its intention to participate in the APS. Lloyds intends to protect £260bn of assets; Government to inject £15.3bn in capital bringing shareholding to 62 per cent (43 per cent voting)
28 March 2009	Special Resolution Regime deployed to manage the failure of Dumferline Building Society: deposits, good assets, and branches transferred to Nationwide; social housing loan book and some associated deposits transferred to bridge bank; remainder put into special administration
10 June 2009	Landsbanki freezing order lifted
28 October 2009	EU Commission approves state aid to and restructuring of Northern Rock into a 'good bank' and 'bad bank'
3 November 2009	Lloyds announces intention to withdraw from APS through rights issue of £21bn; Government injects £5.7bn to maintain share holding at 43 per cent; conditions on lending, remuneration, and charges remain in place; restructuring plans for RBS and Lloyds Group announced
7 November 2009	Quantitative easing increased to £200bn
7 December 2009	Asset Protection Agency established to supervise APS for RBS
14 December 2009	EU Commission approves state aid for RBS and specifies detailed restructuring plan
3 January 2010	Northern Rock restructured into Northern Rock (good bank) and Northern Rock Asset Management (bad bank); buyers sought for Northern Rock
25 January 2010	EU Commission approves liquidation of Bradford and Bingley & resolution of Dunfermline Building Society
4 February 2010	Bank of England announces suspension of quantitative easing
6 March 2010	Icelandic referendum rejects proposals to compensate British and Dutch governments for money paid to depositors in Icesave

In September 2007 the Bank of England extended emergency liquidity to Northern Rock, a medium-sized bank based in the North East of England. The Bank had in fact delayed offering covert support for some weeks following legal advice that such covert support would be in contravention of the disclosure provisions in the Market Abuse Directive.[24] The authorities finally determined that support had to be provided and intended to announce their actions on 17 September. The news was famously leaked by Robert Peston of the BBC four days earlier on Thursday, 13 September. In the absence of any reassurance or clear communication from any of the authorities involved, the news precipitated a bank-run. The run was exacerbated by Northern Rock's own service infrastructure. It had relatively few branches, and its internet banking service had insufficient bandwidth to meet demand. Queues quickly formed as people rushed to withdraw their money. The government was forced to announce guarantee arrangements for all existing Northern Rock account holders as soon as markets opened on the following Monday, 17[t] September, along with the support being provided, but this did not stem the outflow of deposits or increase the availability of funding from the wholesale markets. So the Treasury extended the guarantee to cover new deposits and unsecured wholesale borrowing three days later. On 9 October 2007, it extended the guarantee to new retail deposits and, together with the Bank of England, modified the terms and conditions of the emergency liquidity assistance, losses from which were from that date also covered by a Treasury indemnity. It also imposed conditions on Northern Rock's lending, and required it to seek the Bank's approval for all decisions relating to restructuring, making substantial changes to the nature of its business, and paying dividends. By the end of December 2007 the Bank of England had lent Northern Rock £27bn; in addition, the Treasury had assumed contingent liability under guarantees of some £29bn, and had provided support through recapitalisation of nearly £3bn.[25]

It was clear that the level of support being provided could not continue indefinitely. Moreover, the EU commission ruled in December 2008 that although the initial liquidity provided was not state aid, the guarantees put in place in October 2007 onwards were. The government started casting around for options but was hampered by the lack of specific legal powers to resolve the bank's failure. The bank could have been put into administration, but the position of depositors in English banking and insolvency law is that they are unsecured creditors and the last to be paid on any insolvency, coming prior only to shareholders in their ranking. Depositors would have been left subject to a deposit protection scheme which was not pre-funded, and which would have taken several months to pay out, leaving depositors without access to their money and possibly precipitating a run on other banks.[26] The government could have purchased Northern Rock shares, injecting capital, but in order to provide

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[24] This was a controversial interpretation: see TSC, n 22 above, paras 123-142.

[25] NAO, n 23 above, provides details, as does the TSC report, n 22 above.

[26] The Treasury was also concerned that administration would lead to a 'firesale' of the banks' assets, leaving it with insufficient funds to repay the money already injected by the Government.

sufficient capital it would quickly have reached the point at which it would have been subject to takeover rules and so would then only be able to take over the bank if shareholders agreed. Shareholders were unlikely to agree to the purchase price that the government would offer (and in fact subsequently sought judicial review of the amount they were paid)[27] and so could refuse to sell. As a result, in the absence of any powers to take over the bank, as Mervyn King explained to the TSC, 'shareholders can block discussion of those financing the vast bulk of the balance sheet.'[28] A preferred option was for Northern Rock to be bought, and for the new purchaser to repay the loans owing to the Government and the Bank. However, both the Treasury and the Bank feared that if they played an active role in the process to find a buyer and sought to influence the board of Northern Rock they would become 'shadow directors' under company law, and thus liable for their actions should the company go into administration. This put the authorities in the position of providing continued funding to the bank but with no means of controlling how that funding was used, or as Wilhelm Buiter colourfully expressed it, of 'open-ended breastfeeding'.[29]

The Treasury therefore left the process of finding buyers to the board of Northern Rock, despite the amount of public money at risk, but they did play a close role in determining the conditions on which offers should be made. They also appointed Goldman Sachs to advise potential purchasers to structure their bids. However, the lack of clarity as to who was making the decisions as to Northern Rock's future direction clearly did not help and was found by the NAO to have added to the difficulties in finding a private sector bidder.[30] By February 2008 it was clear that no purchasers could be found who would satisfy the Government's conditions. The decision was finally taken to nationalise the bank. The Banking (Special Provisions) Bill 2008 Act moved from draft bill to full legislation in just three days. Northern Rock was taken into public ownership under the newly minted powers on 23 February 2008,[31] formalising what was already the de facto situation.

The credit crisis intensified over the next few months across the US, UK, and the rest of the EU in particular. In April 2008 the Bank of England introduced the Special Liquidity Scheme to improve liquidity and increase confidence in the markets. At that point, the Bank had already extended £25bn in loans to the UK banks. Under the scheme, the Bank would lend gilts to the banks in return for collateral. The Bank initially anticipated that use of the scheme would be in the

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[27] *R (on the application of SRM Global Master Fund LP and others)* v *Treasury Commissioners* [2009] EWCA Civ 788; [2009] U.K.H.R.R. 1219 (CA).
[28] ROR, para 197.
[29] TSC, n 22 above, para 198.
[30] NAO, n 23 above.
[31] The Tripartite Authorities' stated objectives for Northern Rock under temporary public ownership are to protect taxpayers, maintain wider financial stability, and protect consumers. Responsibility for managing the government's relationship with Northern Rock has lain with the Treasury and the Shareholder Executive, discussed below.

region of £50bn and last for six months; in fact, under the scheme, the Bank has lent a total of £185bn in gilts to the banks, in return for £573m in fees. As the asset swaps expire, the banks will return the gilts to the Bank and take back their assets.

The crisis intensified further. In the US, on 7 September the US mortgage finance agencies, Fannie Mae and Freddie Mac, were taken into government conservatorship. On 15 September 2008 Lehman Brothers collapsed after it had failed to find a buyer and the US government refused to bail it out. One potential buyer, Barclays, was blocked after the US Secretary of State, Hank Paulson, asked the Chancellor of the Exchequer, Alastair Darling, to waive the UK company law requirement for shareholder approval, which the Chancellor refused to do.[32] The failure of Lehman's precipitated a full-scale financial crisis. The US government agreed to rescue AIG two days later, agreeing to lend US$85bn in return for a 79.9 per cent stake. In the following few days, Merrill Lynch was bought by Bank of America, Washington Mutual collapsed in the largest bank failure in US history, and Goldman Sachs and Morgan Stanley agreed to become bank holding companies in order to access additional Federal Reserve Board liquidity funding.

It is no exaggeration to say that the markets were in turmoil, and the financial system in the US, UK, and EU was on the verge of collapse. On 18 September, Lloyds and HBOS agreed to merge, with rumours of direct intervention from the Prime Minister prompting the merger. The government agreed to amend competition law restrictions to allow the merger to go through 'in the national interest'.[33] On 28 September, Bradford and Bingley was nationalised. Its deposit business, branch network, and shares in its Isle of Man subsidiary were transferred to Abbey National (itself owned by Santander, a large Spanish bank), with the rest of its business to be wound down.[34]

Conditions continued to worsen in the markets, and after intense negotiations, on 8 October 2008 the Government announced a major bank recapitalisation plan, described by the Bank of England as 'the largest UK government intervention in financial markets since the outbreak of the First World War'.[35] The plan, which was followed in several key respects by a number of other EU governments, had three elements: recapitalisation of the banks, the Credit Guarantee Scheme, which guaranteed banks' borrowing on the wholesale

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[32] H. Paulson, *On the Brink: Inside the Race to Stop the Collapse of the Global Financial System* (NY: Hachette Book Group, 2010). After its collapse Barclays quickly acquired key assets of Lehmans, including its headquarters at firesale prices.

[33] One of the knock-on consequences of these events was that they triggered default clauses in the credit derivative instruments, requiring holders to pay out. That meant banks had to hold cash to be ready to settle outstanding CDS linked to the debt of Fannie Mae, Freddie Mac, and Lehman Brothers, which then temporarily intensified funding pressures and increased uncertainties in funding markets: Bank of England, October 2008, n 1 above.

[34] The businesses were transferred for a consideration of £612m. The Treasury and Financial Services Compensation Scheme also paid Abbey a total of £18bn (less the consideration of £612m). The retail deposits which were transferred from Abbey were replaced by a statutory debt to repay the Treasury and the FSCS the sum of £18.4bn owing: Details can be found in NAO, n 1 above.

[35] Bank of England, October 2008, n 1 above, 32.

market (ultimately extended to £250bn),[36] and an extension of the Special Liquidity Scheme to £200bn. In order to ensure confidence, and not single out any particular bank as requiring assistance, the Bank and the Government insisted that all the major UK banks join the scheme, even if they were not in particular need of capital.

On the same day, and reflecting the intensity of the crisis and its international nature, the government used terrorism legislation to impose a freezing order on the assets of the Icelandic bank Landsbanki following reports that several Icelandic banks were about to fail.[37] UK depositors had significant sums at risk in Landsbanki's internet-based branch, Icesave, as indeed (it transpired) did local authorities. On 7-8 October 2008 the FSA determined that the subsidiaries of two other Icelandic banks no longer met their conditions for authorisation. The government therefore transferred most of their deposit businesses to ING Direct, part of the ING Group, putting the rest into administration. The Bank of England agreed to extend a loan to the Financial Services Compensation Scheme in order to pay compensation to deposit holders in both the subsidiaries and in Icesave.[38]

In addition, but unknown to the markets at the time, or indeed to anyone apart from the authorities most closely involved, through October 2008 onwards the Bank of England provided emergency loans to RBS, Lloyds, and HBOS of up to £60bn. It lent from its own balance sheet and had obtained £100bn in collateral against the loans. However, it also sought an indemnity from the Treasury on the basis that it could not lend at such a level without one. The indemnity reached at its maximum £18bn. Critically, this indemnity was not reported to Parliament at the time as 'normal conventions' would require. Rather it was only revealed following an NAO review of the financial stability measures, published in December 2009.[39] As we shall see, the revelation of the non-disclosure drew the wrath of the Public Accounts Committee.

The recapitalisation plan stabilised the banking system, but it became clear that further action was needed to stabilise RBS, Lloyds, and HBOS. In February 2009 the Government agreed to restructure the recapitalisation investment by redeeming the preference shares financed by the issue of ordinary shares, raising its shareholding to 70 per cent in RBS and 43 per cent in Lloyds. It also introduced the Asset Protection Scheme (APS), designed to provide protection against future credit losses on certain assets in return for a fee to the taxpayer, and entry into legally binding commitments on lending and remuneration. RBS and Lloyds were required by the Financial Services Authority to participate. However,

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[36] The scheme was due to close in December 2009, but was extended to 28 February 2010: Debt Management Office, *Market Notice: Extension of Drawdown Window for Government's Credit Guarantee Scheme* (9 December 2009).
[37] Landsbanki Freezing Order 2008, SI 2228.
[38] Details can be found in NAO, n 1 above.
[39] ibid.

in November 2009, the FSA agreed to allow Lloyds not to go ahead but to raise £21bn in a rights issue.[40] RBS did enter the scheme, but agreed to protect a lower value of assets. Both banks were held to commitments on lending and on remuneration, although the only formal sanction available to the Government is to refuse to extend guarantees for the banks' borrowing under the Credit Guarantee Scheme.[41]

RBS had to stay in the scheme, but after intense negotiations again, the terms were altered and the amount of assets protected was reduced to £281bn, with the first loss increased to £60bn.[42] The Treasury continued to bear 90 per cent of all further losses. The Government agreed to a second recapitalisation of £25.5bn, equal to that previously announced. As a result the Government's economic interest in RBS rose to 84 per cent, but the Government's ordinary shareholding is limited to 75 per cent. RBS can only leave the scheme with FSA approval.

The Bank of England also embarked on an innovative strategy of 'quantitative easing' (QE). In simple terms, this involved increasing the amount of money on its balance sheet simply by changing the number – creating money literally at a keystroke. It then used this money to purchase government bonds (gilts) from the banks, providing the banks with cash. The idea was that banks would lend this money into the 'real economy' and so stimulate economic growth and mitigate the recession. The second part has not worked quite as intended, but the first part has been extensive. Through quantitative easing the Bank has created £200bn from its launch in February 2009 to its withdrawal in February 2010.[43] As a consequence of QE and the Special Liquidity Scheme, the Bank owns or has interests in a significant proportion of the gilts market, making it probably the government's largest single lender.

CHANGES TO REGULATORY STRUCTURES AND POWERS AS A RESULT OF THE CRISIS: INNOVATIONS, FORMALISATIONS, AND REALIGNMENTS

The crisis and the scale of government intervention in the markets to address it were both unprecedented. The following discussion first explores the new roles for the state in managing 'UK plc': as banker, insurer, and asset manager, and the institutions put in place to conduct these roles. Secondly, it looks at the role played by, and given to, various bodies within the 'extended executive' in responding to the crisis and managing its aftermath, and at the relationships

[40] After intense negotiations, it agreed to pay the Government a fee of£2.5bn in return for the implicit protection already provided by the taxpayer since the announcement earlier in the year.
[41] This limited range of sanctions was criticised by the Public Accounts Committee (PAC), *Maintaining Financial Stability Across the UK Banking System* 12th Report Session 2009-10, HC 190, para 11.
[42] Full details are set out in HM Treasury, *Royal Bank of Scotland: Details of Asset Protection Scheme and Launch of the Asset Protection Agency* (November, 2009).
[43] See Bank of England, June 2009 and December 2009, n 1 above, for details.

between them. Thirdly, it examines the role played by the bodies that constitutional and administrative lawyers traditionally turn to for accountability, in particular Parliament. Fourthly, it examines the role of the EU in the crisis and in managing its aftermath. Finally, it highlights the tensions that exist between the drive for international harmonisation of rules and globalisation of markets, and the decidedly national implications of bank failures and any associated rescue.

MANAGING UK PLC

The measures put in place to resolve the crisis have involved significant Government investment in the UK banking sector, much of which is still in place at the time of writing. Although the Government has repeatedly stressed that it sees these investments as temporary, they are of such a size that they will take some years to dispose of. The Bank of England, for example, currently owns 20 per cent of the UK gilt market;[44] it cannot simply off load that onto the markets in one sale. Again, the sale of the 'good bank' of Northern Rock has commenced, but restructuring its 'bad bank' and winding down Bradford and Bingley's mortgage book will take several years. As the various support schemes are wound down, those banks using them will have to refinance over £1 trillion in the next five years.[45]

As a result of its actions to manage the crisis, the Treasury now has to manage the divergent roles of owner or part-owner, asset manager, insurer, and guarantor of banks' wholesale borrowing. It has increasingly performed these roles through allocating them to new or existing executive agencies or other bodies. There are or have been three main organisations involved in managing or overseeing the Government's investments addition to the central Treasury, Bank of England, and the FSA. These are the Shareholder Executive, UKFI and the Debt Management Office (DMO), and a fourth established but not yet fully operational: the Asset Protection Agency (APA).

Shareholder Executive

The role of government as shareholder and business owner is not new. It owns a diverse set of companies ranging from Royal Mail to the Covent Garden Market Authority. Some of these are limited companies which are wholly or partly owned by the government; others are public corporations (established under statute), limited liability partnerships, or particular executive agencies. The main organisation responsible for managing these investments and advising their boards is the Shareholder Executive, an executive agency established in 2003 to improve the government's performance as a shareholder in government-owned businesses and to provide a source of corporate finance expertise within government.

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[44] *FT* (28 January 2010).
[45] Council for Financial Stability, Minutes of Meeting of 14 January 2010.

In the early stages of government intervention, the Shareholder Executive played an increasingly significant role in advising the Government and in managing the assets of Northern Rock, Bradford and Bingley, RBS, and Lloyds as they were acquired. In each case, terms of agreement were concluded with each bank. These imposed conditions on their business activities and, in relation to the part-owned banks, RBS and Lloyds, gave the Government the right to appoint three and two non-executive directors to the Board respectively. Over time, responsibility for managing the government's relationship with each of these banks has been transferred to UK Financial Investments Ltd (UKFI) on a bank-by-bank basis, culminating in the transfer of responsibility for Northern Rock to UKFI in January 2010.

UK Financial Investments Ltd

UKFI was set up in November 2008 to manage the Government's newly acquired investments in UK financial institutions. It is an executive agency, and a limited company in which the Treasury is the sole shareholder. The company's activities are governed by its Board, which is accountable to the Chancellor of the Exchequer and – through the Chancellor – to Parliament. Membership of the UKFI Board comprises a private sector Chair, non-executive private sector members, a Chief Executive, and senior Government officials. The Treasury appoints the chair and two directors, and approves nominations of the other directors. It is a small agency, operating with only 12-16 staff.[46]

There have been two distinct phases in UKFI activities. Initially, its main role was to assist in the development and implementation of the bank recapitalisation plans and the Asset Protection Scheme.[47] As part of this first phase, UKFI was involved in intensive discussions with Sir Philip Hampton, the new Chairman of RBS, about reshaping the Board, and, with Stephen Hester, the new Chief Executive, about realigning the company's strategy.

The second phase was to manage the government's investments, initially in RBS and Lloyds, and then successively in Bradford and Bingley (from July 2009) and Northern Rock (from January 2010). Its mandate is to develop and execute a strategy for disposing of the Government's investments in the banks in an orderly way, while protecting and creating value for the taxpayer and ensuring that the banks deliver on the commitments made as part of their re-capitalisation.[48] Initially it was given the responsibility for ensuring that RBS and Lloyds complied with all the terms of their recapitalisation agreements, including those on lending, but the political sensitivity of these commitments led to the Treasury resuming responsibility with respect to the lending conditions.

Its relationship with the Treasury is set out in a Framework Agreement, which has been successively revised as the UKFI takes on responsibility for

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[46] UKFI, *Annual Report* (2008/2009).

[47] Evidence of the First Chair, Glen Moreno, to Treasury Select Committee: TSC, *Banking Crisis: Dealing with the Failure of UK Banks* HC 416 Session 2008-9, paras 203-229.

[48] UKFI *Framework Agreement*, para 3 (the 'overarching objective').

managing an additional wholly or partly owned bank. The Framework Document sets the key parameters for how UKFI will conduct its business. The intention is for UKFI to operate at arm's length from the Treasury. To this end, a 'heavyweight' board has been created to manage UKFI. The organisation initially shared a premises with the Treasury, but in January 2010 it moved to new premises following criticism from TSC that this did not give sufficient signals that the body was indeed operating at arm's length.[49] The framework agreement seeks to make a clear distinction between commercial decisions, which are for UKFI to take within the context of a high-level Investment Mandate; and policy decisions, which are for Ministers. UKFI is given a clear mandate to manage the investments commercially, and with a view to achieving an exit. The latest framework document, agreed in January 2010, gives greater authority to UKFI to take decisions as to value realisation transactions, and disposal or restructuring decisions, without prior HMT approval. In addition, UKFI has power to manage the investments, loan arrangements, and guarantee arrangements and effect investment strategies at its discretion in accordance with the various framework documents. Its responsibilities are detailed further in its Investment Mandate, agreed with the Treasury, which also provides greater details on which decisions require HMT approval.[50] The mandate was not published initially, the reason given by the Treasury being that of 'commercial confidentiality'. However, following criticism by the TSC of UKFI's 'enigmatic' character,[51] the mandate was published in January 2010.

The relationship between the Treasury and UKFI is framed as one of a shareholder to a company, and quarterly meetings are referred to as shareholder meetings. The funding of UKFI is framed as a performance fee paid to the company by the Treasury for services rendered. The Framework document recognises that formal documents can only partly determine the nature of a continual relationship, however, and so provides that 'interactions between the Company and HM Treasury need to be underpinned by resolve on both sides to conduct affairs on the basis of a professional, efficient, trustbased dialogue'.[52] As ever, there is a tension between maintaining 'arm's length' and ensuring adequate political control, in this case over the management of several hundred billion pounds of taxpayer money. Thus although UKFI is to have day-to-day control, the Treasury retains the power to issue it with directions, with which the Board is required to 'comply or resign'.[53]

UKFI's relationship with the investee companies (the wholly or partly owned banks) is detailed in the Framework Agreement and the agreements concluded with each bank at the time of its rescue. Overall, the framework document

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[49] TSC, n 47 above, para 222.
[50] UKFI, *Investment Mandate.*
[51] TSC, n 47 above, para 212. .
[52] Framework Document 2010, para 9.
[53] ibid, para 9.24.

provides that UKFI will manage the investments 'on a commercial basis and will not intervene in day-to-day management decisions of the Investee companies'.[54] The exact terms of its relationship however varies depending on whether the bank is a wholly owned investee company (WOIC) (Northern Rock or Bradford and Bingley) or a listed investee company (LIC) (RBS and Lloyds). With respect to WOICs, UKFI has more executive responsibilities consistent with the framework documents for those companies.[55] The boards will report to UKFI, which will actively engage with them 'in a manner similar to that in which a financial sponsor would engage with a wholly-owned portfolio company'.[56] In addition, UKFI is to design an investment strategy with respect to the investments, loan arrangements and guarantee arrangements which ensures implementation of their business plans and delivers the objectives set out in the framework documents applying to those companies.

With respect to the partly owned banks, the presence of other private shareholders and the company's listing on the Stock Exchange has a significant impact on the formal structure and dynamics of the UKFI's relationship with the bank. RBS and Lloyds are subject to company law provisions on the relationship between directors and shareholders, to overall supervision by the FSA relating to market abuse and insider dealing, and to the listing rules and corporate governance provisions, also overseen by the FSA. The first chief executive of UKFI, John Kingman, described UKFI's role as one of a 'very engaged institutional shareholder',[57] and UKFI has stated it will 'engage actively with the Investee Company in accordance with best institutional shareholder practice'.[58] However, as Kingman recognised, UKFI also has a more political mandate, in particular with respect to remuneration and the boards of the LICs. The Investment Mandate requires UKFI to ensure LICS comply with the remuneration principles and to strengthen boards of directors of LICs, but its only means of doing so (other than suasion) is through its voting rights, and these are not fine-tuned instruments for controlling managers.

In practice, UKFI is trying to steer an impossible course between the political expectations of the public and Parliament that the Government or UKFI can and should be dictating the policy of the boards of RBS and Lloyds, and the constraints of company law and market expectations. In regulatory jargon, the creation of UKFI could be seen as demonstrating the government's 'credible commitment' to the commercial re-building of the LICs with a view to future divestment.[59] To this end, the UKFI and the Treasury may maintain the stance

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[54] ibid, para 7.1.
[55] The transfer orders of both banks provide that it is not a shadow director: Northern Rock plc Transfer Order 2007 SI 438, s 17; Bradford and Bingley Transfer Order 2008 SI 2546, s 13.
[56] Framework Document, n 52 above, para 7.2A.
[57] TSC, n 47 above*,* para 214.
[58] Framework Document, n 52 above, para 7.2B.
[59] Reflecting Levy and Spiller's influential argument that independent regulatory agencies are established to indicate the government's credible commitment to investors that the newly liberalised sector will not

that UKFI is just another institutional investor, but this claim is disingenuous for two reasons: First, it has a far higher proportion of shares than any institutional investor would ever have in each company. Secondly, unlike other institutional investors, it cannot divest itself of its investments easily or at will. Both factors give it an interest in the management of the LICs than the other shareholders. However, given that the LICs are public limited companies still partly owned by private sector investors, the government could not amend the normal company law provisions prohibiting directors from acting in the interest of particular shareholders without precipitating a sale of those investments and prompting the need for further capitalisation from the Government. Nor can it receive information from the LICs which is not also made available to other shareholders and the market as it is bound by the listing rules and provisions on market abuse.

UKFI therefore has to manage its relationship with the boards of the LICs in the framework of both of corporate and financial regulation. However, trying to manage this unique relationship within a company law framework is far from satisfactory and its rights as a shareholder does not give UKFI particularly refined regulatory tools at its disposal. UKFI is required to use a corporate governance relationship to achieve conflicting commercial, regulatory and political ends, and it is not a comfortable fit.

The presence of UKFI does however provide the government with a useful device for deflecting questions relating to the government's relationship with the rescued banks: indeed Robert Peston has described UKFI as the Government's 'human shield', protecting it and the banks from awkward questions on lending and remuneration policies. The attempt to maintain the 'just an investor' line has inevitably come under fire. A report by a coalition of organisations, including the World Development Movement and Friends of the Earth (Scotland), has strongly criticised UKFI's 'hands-off' approach to RBS management decisions regarding the infrastructure projects it finances, for example, arguing that UKFI should be insisting that RBS sign up to the Carbon Disclosure Project and to the Environmental, Social and Governance guidelines.[60] There have been questions in Parliament as to why Lloyds cut charitable funding in Scotland.[61] Most criticism has focused on the banks' remuneration and lending policies, however. UKFI may try to maintain that 'UKFI's role is to manage the Government's investments, not to manage the banks',[62] but this is going to be a difficult line to maintain. It is hard to believe that UKFI does or should maintain a 'normal commercial relationship' with the partly-owned banks when it has the level of influence over them that it has.

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be re-nationalised: B. Levy and P. Spiller, *Regulation, Institutions and Commitment*, (Cambridge: Cambridge University Press, 1996).

[60] N. Silver, *Royal Bank of Sustainability* (London: World Development Movement, 2009).

[61] Lords Hansard 5th January 2010 col WA9.

[62] UKFI, n 46 above, 7.

Further, the UKFI's independence from the Treasury is to be supported, but as the UKFI's role and responsibilities have grown its associated accountability structures have remained orientated firmly inwards to the Treasury, and not outwards to Parliament or other bodies. Following sustained criticism of this position, the UKFI has now said that it will issue six-monthly reports to Parliament if asked.[63] Certainly greater transparency is needed if its accountability structures are to be commensurate with its role and responsibilities.[64]

Asset Protection Agency

In order to oversee the management of the £281bn of RBS assets which are now part of the Asset Protection Scheme (APS) (ie underwritten by the taxpayer), the Treasury in December 2009 established the Asset Protection Agency (APA).[65] The APA is an Executive Agency, which unlike the UKFI, is not a separately incorporated company and does not have legal personality. The creation of the APA was in many respects the formalisation of an existing Treasury team that had been working in the APS, and so the APA had existed in an informal sense with its own chief executive before the Agency itself was formally created. The Chief Executive will be supported by an advisory board to be composed of APA executives, officials from HM Treasury, and external Non-executive Directors. The advisory board will meet at least quarterly. Notably, the costs of establishing and running the agency are to be reimbursed by RBS.

The responsibilities of the APA are detailed in its Framework Agreement with the Treasury. This provides that the objectives of the Scheme are 'to support the stability of the UK financial system, increase confidence and capacity to lend, and thus support the economy by protecting financial institutions participating in the Scheme against exceptional credit losses on certain portfolios of assets'. The assets included in the APS will remain on RBS's balance sheet, and RBS remains the primary manager of the assets. However, RBS is required under the APS rules to manage such assets in accordance with a combination of overarching and detailed requirements. The APA's main function is to monitor RBS's compliance with the terms of the APS. In particular, they are:[66]

- Monitoring the management of assets in the scheme and, where necessary, intervening in the management of those assets
- Reviewing and approving significant decisions, such as disposals and restructurings, in relation to APS assets

[63] N. Smith, 'Sell Off to Taxpayer May Take Five Years' at http://news.bbc.co.uk/1/hi/uk_politics/8616393.stm.
[64] Note that Northern Rock and Bradford and Bingley are excluded from the Freedom of Information Act under their respective transfer orders.
[65] For detail, see HM Treasury, *Royal Bank of Scotland: Details of the Asset Protection Scheme and Asset Protection Agency* (7 December 2009).
[66] ibid, para 5.4.

- Verifying the losses on covered assets to enable the APS to make appropriate payments
- Forecasting future losses under the APS to enable HM Treasury to predict any fiscal impact

It is intended that the APA will operate at arms' length from HM Treasury, and indeed it has started out with its own separate premises. The Agreement provides that where appropriate, ongoing operational decisions relating to the APS are taken on a commercial basis informed by appropriate specialist knowledge and expertise. However, interventions that could have particularly significant implications for the taxpayer or that carry wider sensitivities remain subject to ministerial approval, as are any policy decisions that relate to the APS or the Government's other interventions in financial markets. While it remains in the APS, RBS will refund to HM Treasury the operating costs of the APA.[67]

In terms of its accountability, the Chief Executive Officer is responsible to HM Treasury and is to provide Treasury Ministers with any information they need in the course of Parliamentary business. The APA will prepare and publish an Annual Report and Accounts each year. This will be laid before Parliament in the normal way. The Government will report on the APS to Parliament through the usual Budget process. The APA will also be subject to audit by the National Audit Office (NAO). Further, the Permanent Secretary to HM Treasury has designated the APA Chief Executive as an 'Additional Accounting Officer' for the APA. As such, the APA Chief Executive is personally accountable to Parliament for the APA's use of resources in carrying out its functions, safeguarding the public funds for which he or she has charge, ensuring propriety and regularity in the handling of public funds, and the day-to-day operations and management of the APA. The Chief Executive is liable to be summoned to attend as witnesses to a hearing of the Parliamentary Committee of Public Accounts (PAC) to give evidence on the discharge of his or her responsibilities as Accounting Officer.

The details of the APS and the APA's relationship with RBS are set out in the Asset Protection Agreement (the Agreement). The APS and the Agreement have a more regulatory character than the framework agreements with the banks that the UKFI has to oversee. The APS rules specify certain monitoring and reporting conditions, which are aimed at ensuring that the APA has full visibility over RBS's management of the assets included in the APS at all times. The APS rules also specify a number of governance and oversight conditions which are aimed at ensuring that RBS has an appropriate governance framework in place so that the covered assets are managed in a way that gives the APA sufficient oversight over their management. The APA also has a range of remedies available to it should the RBS breach any of the APS terms or certain other trigger events occur. These

[67] ibid, para 5.2.

include rights to suspend (or terminate) APS payments; rights to require RBS to appoint special advisers to the 'Senior Oversight Committee' (SOC), which APA senior managers attend; rights to take a more active role in the management of an asset, including by requiring the appointment of one or more 'Step-In Managers' to oversee or directly manage APS assets; and an indemnity from RBS in favour of HM Treasury (and the APA), covering all losses and damages suffered by HM Treasury and other government bodies (other than a loss under the APS) with respect to RBS, either in relation to APS assets or otherwise.[68]

The task of the APA is thus in many respects more clear cut than that of the UKFI. It is not trying to walk the tightrope between 'directing owner' and 'engaged shareholder'. Nor is it in the politically contentious position of ensuring that RBS adheres to the additional commitments on remuneration and lending, for example, which form part of the APS 'package'. Nonetheless, the responsibilities of the APA are significant: to ensure that the detailed and potentially complex provisions of the APS Agreement are observed and that the £281bn insurance scheme that is underwritten by the tax payer is not called upon. The Agreement is in effect regulation by contract over a significant swathe of RBS's balance sheet. Nonetheless, there is always scope for RBS to 'creatively' manipulate the portfolio of over assets covered by the Scheme, which covers a million assets,[69] to the disadvantage of the taxpayer. The APA has a significant responsibility therefore, not to act as manager of the assets, but rather as overseer of their management by RBS. The government response to the crisis thus sees the government add not just meta-regulation but meta-fund management to its roles with respect to the rescued banks.

Debt Management Office

The DMO is an Executive Agency of the Treasury. It has been given the task of administering two guarantee schemes. The first is the Credit Guarantee Scheme introduced in October 2008, which guaranteed banks' borrowings. Originally intended to last until April 2009, the drawdown window was extended until December 2009.[70] The Bank of England stated its openness to lend against the guarantee but this facility has not been used.[71] The second is the Asset Guarantee Scheme, which opened in April 2009, with a limit of £50bn. This was aimed at stimulating mortgage lending by guaranteeing the securitisation of mortgages, enabling banks to continue to raise funds through this route. It provides full or partial guarantees for eligible triple-A rated asset-backed securities, including mortgages and corporate and consumer debt, in return for obligations by the participating bank to indemnify the Government for any losses incurred as a result of the guarantee. The conditions imposed under the Scheme posed difficulties for

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[68] HM Treasury, n 65 above, para 4.5 ff Notably, disputes between the RBS and the Government as to the operation of the APS are to go to arbitration, a private process, not to the courts.
[69] PAC, n 41 above.
[70] DMO, *Extension of Drawdown Window for Government's Credit Guarantee Scheme* (January 2009).
[71] Bank of England at http://www.bankofengland.co.uk/markets/apf/cgs/.

banks, and the scheme was modified and extended for a further six months to December 2009.[72]

Its main role now is in trying to sell government gilts. This used to be a straightforward operation. However, with the end of the Bank's policy of quantitative easing the DMO now has a real job on its hands. It has to sell £200bn of government debt, more than it had to sell in total in the first seven years of its operation. When it was established in 1998 it issued £8.9bn of gilts in its first year. It can now issue that amount in a week. Further, in the week Lehman's collapsed it faced its first ever auction failure – in other words there were no buyers for the UK government's debt. Although the situation was extreme, other auction failures cannot be discounted. As a result, it has expanded its staff significantly, recruiting experienced City professionals. It has also had to devise new ways of selling debt, adopting practices such as arranging syndicated purchases and mini-tenders (small-scale auctions).[73]

CHECKS, BALANCES, AND CONFLICTS OF INTEREST WITHIN THE EXTENDED EXECUTIVE

What is particularly striking from a constitutional standpoint is the number of different executive bodies involved in the crisis management, and the nature of their interrelationships and interdependencies. The term 'extended executive', as noted above, refers to the core executive: departments, Cabinet, and the Prime Minister, plus the diaspora of executive agencies, non-departmental bodies, other independent regulatory bodies (including the Bank of England), and associated appeal tribunals which fan out from it. The bodies comprising the diaspora all operate at 'arm's length' from the core executive though have very different degrees of autonomy, both legally and in practice (some arms are longer than others).

Central to the management of the crisis was the role played by the Tripartite Authorities: the Treasury, the Bank, and the FSA. Central to the management of its aftermath have been those three bodies, plus those outlined above. Also relevant were the competition authorities, the Office of Fair Trading, the Competition Commission, and the Competition Appeal Tribunal. Together, these bodies illustrate the strength, depth, and sheer institutional variety that characterises the 'extended executive'. What is also interesting to observe is the relationship between those bodies which are formally independent from government both to each other and to the organs of government which are meant ultimately to be supreme to them, notably the Treasury. The relationship between

[72] For details, see European Commission State Aid N 550/2009 – UK Prolongation of the Asset Backed Securities Guarantee Scheme, Brussels 27.10.09 C2009 8309 final.
[73] D. Oakley, 'Buyers Bought for Public Debt as Bank Bows Out' (5 February 2010) *Financial Times*.

the government and the Bank is particularly interesting for, as noted above, as the Bank's position in the gilt market makes it the government's single largest lender.

Together, the formal and operational autonomy of the bodies within the extended executive has the potential to operate as an internal system of checks and balances which operates not as a system of post hoc accountability structures but as a system of co-decision-making and polycentric regulation. There are significant interdependencies between them, but each has a different remit, and as such each had and has different and potentially conflicting interests which it sought to pursue, and continues to pursue. What is also interesting is the different ways in which this system operated, with powers and decision making roles being formalised or overridden in the course of the crisis, and new ones created.

Overridden: competition law

Two significant casualties of the crisis were competition law and the autonomy of the competition authorities. In the early stages, the role of the OFT was affirmed by an undertaking made by the government in the passage of the Banking (Special Provisions) Act 2008 that the OFT would issue an annual report on the impact of public support for Northern Rock on competition in the financial sector.[74] Further, the OFT's operational independence in merger cases had been bolstered, and it would have hoped, ensured, by the Enterprise Act 2002. One of the aims of the Act was to depoliticise decisions on merger control by taking the power to approve or veto mergers from the Secretary of State and giving it to the revitalised OFT and the newly created Competition Commission. The Act also replaced the previous test for clearance, which referred to whether or not the merger was in the 'public interest', with a more specific test, which is whether the transaction would lead to a 'substantial lessening of competition'. However, the Secretary of State retained the power to issue an Intervention Notice in exceptional cases which involve 'public interest considerations' as specified in the Act or a subsequent order.

At the time, the only public interest considerations specified by legislation were national security and those relating to newspaper and media mergers. However, on 18 September 2008 the Secretary of State for Trade issued an Intervention Notice on the basis that 'the stability of the UK financial system' may be relevant to the review of the Lloyds TSB/HBOS merger. [75] He stated that he was acting on the advice of the UK Tripartite Authorities. Both the Treasury and the FSA issued statements confirming their view that the merger would enhance stability within the financial markets. He instructed the OFT to complete its investigation by 24 October 2008. An order validating the Notice was laid before

[74] OFT, *Northern Rock: The Effect of Public Support on Competition* (March 2009); a further report was issued in January 2010, but an agreement had been reached with the Treasury that annual reports were no longer required.

[75] BERR, Intervention Notice Under s 42 Enterprise Act at http://www.berr.gov.uk/files/file47995.pdf.

Parliament when it returned from recess on 7 October 2008, and came into force the same day that the OFT investigation was completed.[76]

An action group formed of HBOS shareholders and business customers challenged the merger. They appealed the Government's decision to the Competition Appeal Tribunal on the grounds the Secretary of State had been unable to exercise independence in making the decision to create a new 'public interest' ground for intervention. They argued his discretion had been fettered by prior statements made by the Prime Minister and Chancellor that competition law would be waived to allow the merger to proceed. They thus framed the action in constitutional terms: that the constitutional autonomy of one part of the core executive had been trammelled by another part. The CAT dismissed the action on the facts, deciding that the Secretary of State had exercised his independent judgement. However, the principle was not questioned.[77] Even if 'primus inter partes' rarely characterises the de facto political relationship between the Prime Minister and other ministers (and the relationship between ministers themselves), the CAT's decision implicitly confirms that it does characterise their legal relationship.

Formalised: Tripartite Authorities and the Council for Financial Stability

The relationship between the Tripartite Authorities is another example of the complexities of the interactions between legally autonomous and independent bodies. The Financial Services Bill, introduced in November 2009, proposed to formalise the relationship that the authorities should have on an ongoing basis to monitor and manage financial stability. The Bill conferred on the FSA the additional objective of protecting and enhancing financial stability, aligning it with the same objective conferred on the Bank under the Banking Act.[78] It required the FSA to prepare a financial stability strategy, setting out its approach to meeting this objective.

The Bill also put the Tripartite Authority on a partly statutory footing through the creation of the Council on Financial Stability.[79] The Terms of Reference for the Council provide that it is to be a monitoring and coordinating body, responsible for considering emerging risks to the financial stability of the UK and global financial system, and coordinating an appropriate response by the UK's Authorities.[80] The Council is to act as a 'forum for challenge and coordination' of the Bank and FSA's strategies, although the determination of individual strategies will be a matter for each independent Authority in consultation with the

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[76] The Enterprise Act 2002 (Specification of Additional Section 58 Consideration) Order 2008 SI 2645.

[77] 1107/4/10/08 *Merger Action Group* v *Secretary of State for Business Enterprise and Regulatory Reform* [2008] CAT 36.

[78] Financial Services Bill 2009, clause 5. The Bill also removes the objective of promoting financial awareness; instead the FSA is to establish a separate corporate body responsible for financial education: ibid, clause 6.

[79] ibid, clauses 1-4.

[80] HM Treasury, *Council for Financial Stability Terms of Reference* (November 2009).

Treasury.[81] Greater transparency is assured through annual reporting requirements to Parliament and publication of the minutes of the strategic (ie non-firm specific or market sensitive) discussions each meeting. It will consider, on an ongoing basis, emerging evidence from the markets as to the current stability of the system as a whole, and potential mitigating measures including use of the SRR tools. In a crisis it will be the forum where use of the SRR tools is coordinated. The MOU between the Authorities will remain in place, but will be revised to specify in greater detail the role and responsibilities of each Authority with respect to financial stability and arrangements for handling financial and operational crises. The Bill's provisions on the Council were dropped in the 'wash-up' before the general election in May 2010. However, the Council nonetheless is in place. It had already been created in anticipation of the passage of the Bill, and minutes of its first meeting have been published.[82]

The creation of the Council will bring greater clarity to the roles to be played by each, and greater transparency to their decisions. However, the early difficulties in coordination were not just due to poor communication. They were more deeply rooted, and the creation of a new Council will not remove them. Nor, arguably, should it. Each of the Treasury, the Bank, and the FSA had a different job to do, a different remit to pursue, and that gave (and continues to give) rise to different interests. Take the issue of whether a bank should continue to be authorised. The Treasury has to protect the country's fiscal position, which may mean allowing an industry which is generating high tax revenues to expand. The FSA has to ensure that each individual institution meets its threshold conditions for authorisation, including prudential requirements. Failure by an institution to continue to meet these conditions is a ground for withdrawing authorisation. The Bank has to manage the stability of the financial system, which may be affected by the withdrawal of the bank's authorisation to operate. Or take the issue of bank lending. The Bank and the Treasury may want banks to expand their lending in a downturn, but this is the time the prudential regulator is likely to want banks to shore up their capital reserves to weather the downturn.

The relationship between the Tripartite Authorities was in the spotlight with respect to Northern Rock, but what is also interesting is the nature of the ongoing relationship in the course of managing the crisis and its aftermath. Take the interactions with respect to the nationalised banks. The Treasury is owner or part owner, and has delegated many of the associated functions to two executive agencies, as discussed above. The banks, however, continue to be regulated by the FSA. This gives the FSA a key role in decisions relating to their ongoing management. As noted above, the FSA's agreement was needed to finalise the terms of the APS, for Lloyds to withdraw from the APS, and will be necessary for

[81] ibid, para 17.

[82] The 'wash up' is the process in which Bills are finalised under special procedures prior to the cessation of Parliament consequent on a General Election. The Financial Services Act 2010, n 9 above, received Royal Assent on 6 April 2010. The provision conferring a financial stability objective on the FSA did survive, however.

RBS to leave in the future.[83] The FSA has to ensure that the banks meet their disclosure obligations to the market, which for the part-owned banks includes details of their relationship with government which may be price sensitive: the cause of the Bank's (but not necessarily the FSA's) initial concerns about providing covert support to Northern Rock.[84] The FSA also has power to approve the appointment of directors and other senior managers, and under its Remuneration Code, to approve remuneration policies. These are highly sensitive political decisions. The FSA as a regulator thus has far greater powers to influence the corporate governance of the LICS than the government does as a shareholder. The UKFI, FSA, and Treasury appear to be working in concert at present, as illustrated by the joint pressure placed on Stephen Hester, chief executive of RBS, to forgo his bonus for 2009, but it is not impossible for them to be in conflict.

Newly created relationships and organisations in the management of bank failures

In addition to the potential creation of the new Council, new and wide ranging powers have been introduced for the resolution of bank failures under the Banking Act 2009. This formalises the respective roles of the FSA, the Treasury and the Bank, and confers on them wide-ranging powers to manage bank failure. Its predecessor, the Banking (Special Provisions) Act 2008 gave the Treasury wide-ranging powers which could be used 'if it appears to the Treasury to be desirable' for the purposes either of 'maintaining the stability of the UK financial system where it considers there would be a serious threat to stability if the order were not made' or 'protecting the public interest in circumstances where financial assistance had been provided by the Treasury to the deposit taker for the purpose of maintaining the stability of the UK financial system'.[85] The Act also contained wide-ranging Henry VIII clauses giving significant powers to the Treasury to make orders for the purposes of the Act which 'may disapply any statutory provision or rule of law; or modify it; and for imposing a moratorium on commencement of legal proceedings with respect to any body or property of any descriptions'. Many of these orders could have retrospective effect up to 3 months prior to passing of the Act, and again were subject to the affirmative resolution procedure.

The Act was only intended to be temporary, and, unusually, contained a sunset clause which provided that it would cease to have effect one year after its enactment.[86] Although the Act was passed to deal with Northern Rock in particular, it was used seven months later to manage the failure of Bradford and Bingley,[87] and again the following month to transfer deposits from two Icelandic

[83] Or whichever body takes over from the FSA, should this occur.
[84] This was a controversial issue and is discussed in TSC, n 22 above, paras 123-142.
[85] Banking (Special Provisions) Act 2008, s 2.
[86] ibid, s *.
[87] The Bradford and Bingley plc Transfer of Securities and Property etc Order SI 2546/2008 (which came into force three hours before it was laid before Parliament).

banks to ING.[88] In each case, the orders came into force literally minutes after they were made, and were only laid before Parliament several hours later.

The enactment of the BSPA gave the authorities a breathing space in which to develop a more detailed set of provisions on managing the failures of banks and building societies. The Banking Act 2009 establishes a Special Resolution Regime to manage failing banks. The same mechanisms for managing a failing bank are retained, but the powers to act are no longer concentrated on the Treasury alone. Instead there is a more complex and carefully crafted process in which each of the three authorities provides a potential check on the other, and a fourth institution, the Financial Services Compensation Scheme, is awarded a far greater role in any decision-making if a bank is put into administration or insolvency. The Act also provides for the creation of a Banking Liaison Panel, to advise the authorities in the exercise of their powers under the SRR.

The Act is a very complex piece of legislation, but briefly, the SRR has three pillars: stabilisation, administration and insolvency. Stabilisation itself has three elements, which may be deployed alone or in combination with each other. These are transfer to a private sector purchaser, transfer to a 'bridge bank', ie a company owned by the Bank of England, and transfer to temporary public ownership.[89] Each of the three authorities, the Treasury, the Bank, and the FSA, has a different role to play in each of the three stabilisation options. With respect to each, the FSA acts as the trigger, acting in consultation with the other two bodies. The Bank can then decide (in consultation) whether to transfer ownership to a private sector purchaser or to a bridge bank. The Treasury can veto this decision if it will have implications for public funds[90] but otherwise has no power to direct the Bank with respect to the exercise of these powers except to ensure that if the Bank does act, it complies with the UK's international obligations.[91] The decision to pursue the third stabilisation option, taking into temporary ownership, can only be taken by the Treasury.[92]

The combined effect of the complex distribution of trigger and veto powers is thus that no stabilisation procedures can be commenced without the FSA triggering them; and that should the Bank refuse to exercise its powers to pursue the first two stabilisation strategies (transfer to a private sector purchaser or a bridge bank), the Treasury can nonetheless take the bank into temporary public ownership. The Act also assumes in the case of all three stabilisation options that the Treasury has been able to act to provide financial assistance unilaterally and prior to the SRR coming into effect. There are no statutory provisions as to the form this assistance can take, nor as to the transparency of the decision or reporting procedures that pertain to it.

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[88] See the Heritable Bank plc Transfer of Certain Rights and Liabilities Order 2008 SI 2644 and the Kaupthing Singer & Friedlander Limited Transfer of Certain Rights and Liabilities Order 2008 SI 2674.
[89] Banking Act 2009 (hereafter 'BA 2009'), Part I.
[90] ibid, ss 78-79.
[91] ibid, n 89 above, ss76-77.
[92] ibid, s 82.

The Treasury is required under the Act to issue a code of practice on the operation of the SRR, insolvency, and administration procedures.[93] The new Banking Liaison Panel will advise the Treasury on the Code on the terms of certain statutory instruments issued under the Act, and anything else that the Treasury refers to it.[94] The Panel is meant to represent the views of non-governmental stakeholders, although all those appointed are City practitioners.[95]

ACCOUNTABILITY IN THE CRISIS: PARLIAMENT'S ROLE

The crisis revealed what the Banking Act confirms, that in the management of this crisis and any future crisis, Parliament's role is largely confined to post-hoc scrutineer rather than active, 'real time' participant. After all, the logistics of effective crisis management largely preclude the detailed involvement and deliberation of the legislature. The UK response to the crisis could be far swifter than that of the US, where Congress had to approve the US executive's proposals. Nevertheless, the use of Parliament simply to validate decisions already made, even when swift decision by Parliament was possible, is striking.

The Banking Act 2009 further restricts Parliament's involvement in crisis management in two ways. Firstly, the powers given to the Bank of England to make transfer instruments in implementing the first two stabilisation options are not subject to Parliamentary approval.[96] Secondly, the Act contains wide-ranging Henry VIII clauses. Section 74 of the Act gives the Treasury considerable powers to make regulations concerning the fiscal consequences of the exercise of any stabilisation power, which, amongst other things, may modify or disapply an enactment, and which may have retrospective effect for up to three months prior to the date on which the stabilisation power was exercised.[97] These regulations are subject to affirmative resolution procedure. It is section 75, however, which gives possibly one of the widest powers granted in legislation to override existing statute or common law, and moreover to do so with retrospective effect. It provides that 'The Treasury may by order amend the law for the purpose of enabling the powers under this Part to be used effectively, having regard to the special resolution objectives.'[98] Such an order 'may make provision which has retrospective effect in so far as the Treasury consider it *necessary or desirable* for giving effect to the particular exercise of a power under this Act in connection with which the order is made' (emphasis added). An order may be made for general purposes under the Act, or in connection with the exercise of a specific power. Orders made under

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[93] ibid, s 5.
[94] ibid, s 10.
[95] A list of members is available at http://www.hm-treasury.gov.uk/consult_banking_liaison.htm.
[96] BA 2009, n 89 above, s 24. The lack of Parliamentary involvement in the exercise by the Bank of these powers was criticised by the House of Lords Delegated Powers and Regulation Reform Committee, Session 2008-9 HL Paper 12, paras 3-4.
[97] BA 2009, ibid, s 74.
[98] ibid, s 75(1).

section 75 are subject to an affirmative resolution procedure, but the Act also provides that should the Treasury think it necessary to make an order without following the affirmative resolution procedure then it shall be subject to negative resolution procedure, and that anything done during the 28 days when it is lying before Parliament shall remain valid, provided that at the time the action was taken neither House had declined to approve it.[99]

The retrospective powers granted in section 75 were strongly criticised by the House of Lords Constitution Committee.[100] The Committee reluctantly accepted the need for the Treasury to have the wide powers granted under section 75. However, it argued that the provision was nevertheless unconstitutional as it gave the Government power to issue retrospective legislation when Treasury consider it 'desirable'. It argued that retrospective legislation could only be justified where it was necessary and not merely desirable. The Government insisted on retaining the grounds of 'desirability' but attempted to meet these concerns by including in the section the proviso that 'in relying on this subsection the Treasury shall have regard to the fact that it is in the public interest to avoid retrospective legislation'. However, the Committee would not be placated, and unusually (given its role is to scrutinise Bills) continued to engage in correspondence with the Government on the issue after the Bill was enacted. It reiterated the point in a further report stating that '[i]t remains our view that "desirability" should not be a basis on which to allow ministers to change the law retrospectively'.[101]

Westminster has however used its powers of scrutiny extensively throughout the crisis and its ongoing resolution. The TSC has led the way.[102] TSC held 41 evidence sessions and published nine reports related to the crisis between 2007 and end 2009, and in January 2010 commenced an inquiry into the question of 'too important to fail'.[103] In addition it undertook visits to the US and other countries, hosted a meeting of finance committees from other legislatures overseas, and held a number of visits to the Bank of England. Its reports have had impact on the design of the special resolution regime in the Banking Act, and have been referred to in debates on the floor of the House.[104] However, TSC has expressed its frustration that the Government in effect ignores its activities and gives it inadequate time to consider policy proposals. For example, the Treasury published its white paper, 'Reforming Financial Markets', just hours before the Minister was due to give evidence to the Committee.[105] Nonetheless, TSC has been an active participant in the debate on various aspects of reform of financial

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[99] ibid, s 75(8).
[100] House of Lords Select Committee on the Constitution, Banking Bill, Third Report, Session 2008-9 HL Paper 19; Banking Act 2009: Supplementary Report on Retrospective Legislation, 11th Report Session 2008-9 HL Paper 97.
[101] House of Lords Select Committee on the Constitution, 11th Report, para 12.
[102] Although the PAC's involvement has been prompted by the NAO's reports to it concerning Northern Rock and the management of the crisis.
[103] TSC, *Financial Inquiry – Too Important to Fail*.
[104] See TSC, *Report of the Work of the Committee 2007-8* HC 173, 3rd Report, Session 2008-9; and TSC, *Report on the Work of the Committee 2008-9* HC 134, 2nd Report, Session 2009-10.
[105] TSC, *Report on the Work of the Committee 2008-9*, ibid, para 23.

regulation and policy, and its inquiries have brought a wealth of evidence into the public domain.

MPs were however outraged to learn in November 2009 that the Treasury had over a year earlier agreed to indemnify the Bank of England up to £18bn with respect to the £60bn of emergency liquidity assistance (ELA) the Bank was providing to RBS and HBOS. The indemnity ran from October 2008-mid January 2009, by which time the emergency support had been replaced by other funding.[106] The Bank and the Treasury were extremely concerned that details of the ELA should not leak, remembering the consequences that the leak of similar assistance to Northern Rock had had on the bank. Given that at the time the whole financial system was in a far more dangerous state, and the banks involved were together far larger than Northern Rock, the consequences could have been extremely severe. Further, the government had in the previous week announced a £250bn support scheme through the Credit Guarantee Scheme, and it was considered that the contingent liability to the Bank of (at the time) less than 5 per cent of that sum could be considered part of the overall support package which had already been announced.[107] To minimise the risk of a leak, and bearing in mind the overall support package that had been agreed, no disclosure of this particular indemnity was made.

There is a constitutional convention dating from 1977,[108] and restated out in Treasury guidance,[109] that indemnities should be notified to both the Public Accounts Committee (PAC) and the TSC, or where there is a need for confidentiality, the chairs of those committees should be notified. Both TSC and PAC took evidence from senior officials on the reasons why disclosure was not made. Revealing an odd combination of observation for formalities with the decision to ignore them, in deciding not to notify the Committees much store appears to have been set on the understanding that the notifications had to be written.[110] The fear was that details of the letters would inevitably leak, causing a run.[111]

The reactions of the two committees were slightly different in tone, though both recommended that in future the chairs of the committees should be notified orally.[112] PAC's conclusion was vehement: 'There can be no excuse for flouting Parliamentary procedure. It is unacceptable that the Treasury did not notify us of

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[106] Details are set out in PAC, n 69 above; TSC, *Reporting Contingent Liabilities to Parliament* HC 181, Session 2009-10; and the NAO, n 1 above.
[107] Sir Nicolas Macpherson, response to Q4; TSC, ibid.
[108] Treasury Minute on the Reports from the Committee of Public Accounts Session 1976-77 and abstract of Appropriation Accounts, Cmnd 6977, 28, cited in TSC, n 106 above, para 5.
[109] HM Treasury, Managing Public Money, ch 5: Funding, Box 5.2: contingent liabilities: notifying Parliament, cited in TSC, ibid.
[110] TSC, ibid.
[111] Evidence of Sir Nicholas Macpherson to PAC in response to Q 87-88 and 145-155.PAC Report HC 190.
[112] TSC, n 106 above, para 14; PAC, n 69 above.

an £18 billion indemnity.'[113] The TSC was more forgiving: 'Given the events surrounding the failure of Northern Rock, the extreme urgency of the situation, and the Bank of England's view that "secrecy was of the utmost importance", we can understand why the Chancellor decided that absolute secrecy was paramount, and why [the Permanent Secretary] considered that decision proper.'[114] Again, in PAC's view, 'the Treasury accepted that the emergency assistance provided to RBS and HBOS should have been separately notified.'[115] The evidence given to PAC, however, was not so categorical. The TSC's summary is a more accurate reflection, viz that the Treasury's view at the time was that the circumstances were exceptional, and that observing the convention of giving written evidence posed too great a risk to the stability of the financial system.[116]

The TSC, after all, was very familiar with the events of October-December 2008 and of the complicated implications of 'real time' transparency in bank rescue operations. The PAC, however, had not investigated the crisis in any depth (some members were even under the delightfully naive impression that there were still a number of UK-owned investment banks on whom the government could have called for advice).[117] Both Committees were concerned to protect constitutional safeguards on the commitment of public expenditure. However, the PAC adopted a highly formalistic approach, whereas the TSC had a more contextualised understanding of the circumstances in which the decision was taken. It has also to be borne in mind that although the amount of money involved is significant, in the context of the £855bn that the UK government has committed to supporting the banks, £18bn is only a small fraction, just over 2 per cent. It is agreed that once the need for 'real time' confidentiality has passed that the indemnity could have been notified to the chairs of the committees prior to its publication in the NAO report.[118] However, the PAC may have exhibited high dudgeon in not being told, but it has been made aware of far larger commitments of public money. In focusing on the (relative) minnows there is a danger of allowing far bigger fish to swim free.

BANKS – GLOBAL IN LIFE AND NATIONAL IN DEATH: NATIONAL CRISIS MANAGEMENT IN THE CONTEXT OF GLOBAL MARKETS AND MULTI-LEVEL GOVERNANCE STRUCTURES

The focus of the discussion so far has been on the national resolution of the national aspects of a much wider crisis. However financial markets are global, and financial regulation has long been marked by the mismatch between global markets and national rules. In response to the globalisation of markets, a number

[113] PAC, ibid, para 9.
[114] TSC, n 106 above, para 14.
[115] PAC, n 69 above, para 20.
[116] TSC, n 106 above, para 14.
[117] PAC, n 69 above, Minutes of Evidence, Q 102-103.
[118] NAO, n 1 above.

of transnational committees of regulators have formed to devise common global norms which have no legal status, but which are nonetheless adopted by a significant proportion of national financial regulatory bodies. The crisis has reemphasised this trend,[119] and also prompted greater international collaboration in the actual supervision of global financial institutions through the creation of colleges of supervisors.

The crisis also brought into sharp relief an additional problem. As Mervyn King, Governor of the Bank of England, observed: banks may be global in life, but they are national in death. When they founder, it is national governments who have to support them, using national taxpayers' money and creating significant holes in their own budget deficits. This 'mortality mismatch' creates significant tensions between moves to harmonise and globalise financial regulation on the one hand, and moves from national governments and regulators to enhance local supervision in order to protect their own taxpayers and budget deficits on the other. Thus despite calls for harmonised action, we have seen national governments take unilateral action, for example the French and UK governments' tax on bonus pools, and more recently President Obama's dramatic announcement to limit the activities of deposit-taking banks, and to return to a revised version of the mandatory separation between commercial and investment banks introduced in the 1930s and which persisted until its repeal in 1999.[120]

Indeed, in one sense, the UK government was fortunate. If it had not been for the fact that the UK remains outside the Eurozone, and that the largest banks that failed were not foreign-owned, the crisis could not so easily have been managed within national borders. However, the crisis did have to be managed within the context of EU regulatory regimes on banking regulation and state aid. The former arguably was a contributing cause of some of the problems the UK authorities faced in the crisis; the latter was something that had to be navigated in the course of resolving it. Moreover, this was an international (if not quite global) crisis, and the cross-border character of banking services meant that this international dimension had very real and direct implications for the UK's handling of the crisis at the national level. This point can be summed up in one word: Iceland.

EU state aid

Across the EU, governments' actions to rescue their banks triggered the state aid rules, prompting the detailed involvement of the EU Commissioner for Competition in the management of the financial crisis. In the immediate days after the recapitalisation plans were put into effect in October 2008, the

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[119] See, for example, Financial Stability Board, *Framework for Strengthening Adherence to International Standards* (9 January 2010). Notably the US and China have now both agreed to have their compliance assessed.

[120] President Barack Obama, 'Remarks by the President on Financial Reform' (White House press conference, 21 January 2010) at http://www.whitehouse.gov/the-press-office/remarks-president-financial-reform.

Commission had almost no choice but to approve them as rescue aid. Scope for greater engagement in the detail of the rescue plans came as the situation stabilised, and governments had to negotiate their restructuring arrangements as the timeline for the rescue aid expired. In practice, approval came some time after the action had already been put in place.

But the Commission did not simply act as a rubber stamp thereafter. The UK Government has had to engage in detailed negotiations with the Commission concerning the terms of its continued support for the banking system and its plan for eventual divestment. In relation to RBS in particular, negotiations on the precise requirements for its restructuring were subject to long, detailed, and hard fought negotiation. At its conclusion, Competition Commissioner Neelie Kroes said, 'This case has been one of the most complex the Commission has had to deal with during the financial crisis. I am very pleased with the result.' However she warned, 'be aware that in case RBS does not deliver on its balance sheet reduction targets by 2013, the Commission will be able to intervene again and more divestments will be required.'[121] In short, it is the Commission, rather than the UK Parliament, which is the body outside the UK executive which has had the greatest involvement in determining how UK taxpayers' money will be spent.

Iceland

The shenanigans of high finance usually remain opaque to those outside the rarified corridors of financial power. It was events in Iceland, however, which brought the reality of cross-border global finance home to everyday depositors. It also highlighted the risks posed by the EU's passporting system for banks whereby any bank authorised in another state can also establish a subsidiary in an EEA state. That subsidiary requires separate authorisation, but under the rules applying to financial conglomerates, the 'home state' can be the lead regulator for that bank. Further, any bank authorised in an EEA member state can establish a branch in any other member state without the need for authorisation from the host state and without the host state being able to supervise the financial soundness of that bank. The 'host' state thus has some control over the authorised subsidiary, but virtually none over the branch, relying on the supervision of the entity by the 'home' state. Significantly, depositors in a branch of a bank are covered by the 'home' state compensation scheme, which in turn has to comply with EU rules.

Icelandic banks had built a strong presence in the UK retail market in the years immediately preceding the crisis. In particular, a branch of Landsbanki, trading as Icesave, had attracted considerable numbers of deposits through the payment of high interest rates. As discussed above, the Government froze the assets of Landsbanki in the UK on 8 October 2008, following the freezing of its assets by the Icelandic government, using provisions under the Anti Terrorism, Crime and Security Act 2001 on the grounds that the Treasury believed that action

[121] Europa IP/09/1915**,** Brussels, 14 December 2009.

to the detriment of the UK's economy had been or was likely to be taken by certain persons who are the government or resident of a country of territory outside the UK. At the same time the FSA determined that two subsidiaries of other Icelandic banks no longer met their conditions for authorisation. The government transferred most of the deposits of those subsidiaries to ING Direct, part of the ING group.[122] Remaining deposit holders had to be compensated by the UK financial compensation scheme. Only some of those deposit holders were protected by the compensation scheme, however. Local authorities, who are not covered by the scheme, were major depositors. The UK Government called on Iceland to reimburse the compensation it had paid out to depositors in Icesave, as the Icelandic fund had insufficient money to compensate them. The UK government is not alone; the Netherlands was also particularly affected.

The UK is claiming Euro 3.9bn in compensation from Iceland, plus (most controversially) interest at 5 per cent. Although this seems a relatively small number, it is equivalent to 50 per cent of Iceland's GDP.[123] Iceland had also been furious at the Landsbanki freezing order, and claimed it precipitated the collapse of the bank. The dispute has led to complex political negotiations with the Icelandic government to compensate deposit holders and to recover the money deposited by local authorities. The UK and Netherlands governments offered to lend Iceland the money to repay them for the compensation they paid out to depositors, but agreement as to the terms of the repayment of the loan has become embroiled in Iceland's negotiations to join the EU, and the IMF had stated it would withhold further support to Iceland until the issue was resolved.[124] Although a deal was approved by the Icelandic Parliament it was stopped by the Icelandic president in December 2009 triggering a national referendum. The referendum, held on 6 March 2010, resoundedly rejected the proposed terms of repayment, with 93 per cent of voters against. The matter still awaits resolution. The details of the arrangement aside, that taxpayers in one country can be called upon to compensate those in another is a striking reminder of who in the end has to foot the bill for the banks' excesses.

REFLECTIONS

The financial crisis has required the state, not just in the UK, to intervene in the financial markets in ways and to an extent that is unprecedented. Paradoxically, the failures of coordination and communication that characterised the early

[122] See TSC, n 106 above.
[123] A. Ward and J. Boxell, 'Brown Asked to Step in as Voters Reject Bank Deal' (8 March 2010) *Financial Times*.
[124] In April 2010 it agreed to extend further loans.

handling of Northern Rock bore the UK authorities in good stead, as it taught them a number of lessons. It caused the passage of emergency legislation that was then used twice in the succeeding months. In October 2008, as meltdown approached, the Bank, Treasury, and FSA were able to respond more quickly, innovatively, and decisively than they perhaps would have been had they not had the 'dry run' of Northern Rock a year earlier.

In many respects, the UK constitution worked reasonably well during the financial crisis, at least in formal terms. Government acted to nationalise banks only once it had received legislative powers to do so.[125] The Bank of England did not commit taxpayers' money to funding the banks without Treasury authorisation. The Treasury informed Parliament of the amount of public money being committed (at least, it partly informed it). The classic accountability mechanisms have all kicked into place. Parliament, in the form of the Treasury Select Committee, proved very responsive, holding successive hearings in which key figures in the public and private sector were questioned as each wave of the crisis occurred. The National Audit Office has produced two reports assessing whether the billions of pounds of taxpayers' money that was used to prop up the system was in fact well spent,[126] and concluding that it was.[127] Some of the government's actions during the crisis have been called to account legally through appeals and judicial review and have been upheld.[128]

The financial crisis did not cause a constitutional crisis, but it did reveal the practical operation of the constitution at times of crisis. It demonstrated that we do indeed have a 'flexible constitution' but that there are limits to that flexibility, sometimes from unexpected sources. It also gave insights into the often surprising role played by some parts of the government machine, and the notable absence of others. In some instances, parts of the administration which would appear to have nothing to do with the government's handling of the crisis revealed they had previously unsuspected powers which surprised many, including to the government itself. Notable here is the statement by the National Statistics Office on 7 February 2008 that for the purposes of government accounts, Northern Rock was in fact nationalised in September 2007 when the government guaranteed its deposits, prior to its formal nationalisation under the BSPA powers two weeks later.[129] The statement by the NSO was an interesting twist in events, and revealed an unexpected source of authority within the administrative structure, but it is not something to cause the constitution to quiver in its boots. It should send a slight shiver down its spine, however, reminding us that executive action can have significant financial implications regardless of the constitutional niceties which require that the government spend only that which Parliament authorises it

[125] Though that statement does have one significant caveat, noted below.
[126] US$ 690bn in direct support, and US$2.06 trillion in guarantees: Bank of England, 2009, n 1 above.
[127] NAO, n 23 above.
[128] *R* (*on the application of SRM Global Master Fund LP and others)* v *Treasury Commissioners*, n 27 above.
[129] Office for National Statistics, News Release, Statistical Classification of Northern Rock plc (7 February 2009).

to do. Certainly the NSO's announcement gave the Parliamentary debates on the Banking Special Provisions Bill, which would empower the government to nationalise Northern Rock, an air of unreality. Whilst Parliament may have thought it was debating whether or not to add Northern Rock's liabilities to the state's financial liabilities, in accounting terms, the Government had done just that the previous October when it guaranteed its liabilities.

The handling of the crisis also reveals some interesting aspects of how the political system operates, and not only when under stress. Cabinet government appeared, to outsiders at least, to come a poor second to control from numbers 10 and 11 Downing Street.[130] 'Sofa government' perhaps conjures up a more relaxed pace of decision-making than that which the speed of events permitted, but detailed reports of discussions surrounding the critical bail-out package introduced in October 2009 show that the decision to commit nearly 60 per cent of the UK's GDP to supporting the financial institutions was made by a small group consisting of the Chancellor, the Prime Minister, the Treasury Minister, key Treasury civil servants, and external advisors. Whilst it may be argued that the crisis posed exceptional demands on the decision-making capacity of government, and certainly resources were extremely stretched,[131] it did reveal the extent to which decision-making at the heart of government is confined on critical key issues to a relatively small number of individuals. In constitutional terms, decision-making during the crisis most often took the form of decide now, act immediately, explain quickly, and validate later.

The crisis also reveals that parts of the administrative and regulatory structures, in this case the relationship between the Bank of England, the Treasury, and FSA, had relied perhaps for too long on informal arrangements in allocating responsibilities and powers. A complex and wide-ranging set of powers and procedures for managing bank and building society failures has now been put in place, with market practitioners constituting a statutory advisory board on how the powers should be exercised. The roles and responsibilities of each of the Tripartite authorities in managing the failure of a bank or building society are now more clearly delineated, and proposals are in place for formalising the responsibilities of each for maintaining financial stability on an ongoing basis through the statutory Council on Financial Stability. These measures are to be accompanied by enhanced transparency, both real time and post hoc, which is welcome. Formalisation, juridification, and greater transparency are thus replacing informality and opacity in some aspects of the management of financial stability and any future financial crisis.

The crisis also demonstrates that legal constraints on government action can come from sources other than public law. The government was constrained in its

[130] This finding is echoed in the Better Government Initiative, *Good Government: Reforming Parliament and the Executive,* (London: January 2010).
[131] See NAO, n 1 above.

relations with Northern Rock by company law provisions on shadow directors, which it feared could lead to liabilities should Northern Rock go into administration. Its ongoing relationship with the partly-owned banks remains constrained by company law provisions on directors' duties and shareholder rights. The crisis also showed the impact of conservative legal opinions combined with a management averse to taking legal risks on executive action, notably whether covert support for Northern Rock would have been in contravention of the Market Abuse Directive. Later on in the crisis, Government was to demonstrate that it was happy to sail much closer to the legal wind in the protection of depositors and other creditors when it provided covert support for RBS and HBOS and used anti-terrorist legislation to impose a freezing order on the assets of the branches of Icelandic banks in the UK. The crisis has also led to the creation of novel and challenging roles for the state, and the creation of a bespoke administrative apparatus to manage them. The Treasury has become the owner and manager of two banks, the dominant owner of another, and the significant owner of a fourth. It is also an asset manager, and a guarantor of banks' wholesale liabilities. It has created the Asset Protection Agency as a 'meta-asset manager', overseeing the asset management activities of RBS with respect to a defined set of assets, on detailed terms and with a range of remedial powers. In contrast, it has charged the specially created UKFI with the complex task of managing conflicting public and market demands. UKFI has powers which reflect its ambiguous and often conflicted role. It is meant to prime the banks to ensure their share price increases to enable it to sell at a profit, whilst trying to ensure that they behave relatively conservatively and do not gain excessive market share. Whilst it has some specific powers to influence decision-making under the recapitalisation agreements, with respect to its more general task, of enhancing the value of the banks, it has been given only the tools of suasion and shareholder rights under company law with which to accomplish the difficult task of being an 'engaged shareholder' but not a 'directing owner'.

UKFI and the APA sit in an uneasy position in the structures of accountability. The government will not answer for their actions on the basis they are 'arm's length', but at the same time their accountability structures are not those of an independent regulatory body; they are those of a Treasury agency. Whilst it was understandable that in the immediate handling of the crisis the accountability of bodies such as UKFI and the APA was orientated to the Treasury, and indeed they grew out of Treasury divisions, their task has grown and their status has altered. The organisations responsible now for managing 'UK plc' have reached a point at which greater accountability to bodies beyond the extended executive is required. However, their experience to date demonstrates that trying to reconcile the pursuit of public interest objectives in the face of conflicting demands and within the twin confines of corporate law and constitutional structures of accountability is a fraught and near impossible task.

The crisis also illustrates how the EU regulatory structures have conferred a veto power on the Commission with respect to some of the most politically sensitive and critical decisions that member states' governments have had to make in recent years: notably how to deploy billions of taxpayers' money to rescue their financial institutions. Through the administration of the state aid rules, the European Commissioner for Competition played a pivotal role in determining the detailed arrangements that each member state government has put in place for the rescue of their banks. In the UK, this was a far greater role than that played by Parliament. In a further unexpected twist, power shifted within the Commission itself. For as a consequence of governments' interventions to support banks, it is the European Commissioner for Competition rather than the Commissioner for the Internal Market, who has been a critical figure in the detailed decisions as to how the crisis should be managed, and in what commercial activities the rescued banks should be allowed to engage.

Finally, although the crisis has enhanced moves to greater internationalisation and harmonisation of regulation at the global level, there are corresponding centripetal tensions which pull regulation back to the national level. The crisis has made it clear that the state ultimately underwrites the financial system. In the end, it is national taxpayers that pay and national budget deficits which suffer. As Iceland has found, there are limits to how big a financial system a country can afford to have. Yet in turn it is to the markets that national governments have to turn to raise the money necessary to resolve the problems those same markets have caused. As the UK government has experienced, there may be no one who wants to buy its debt, or who will do so only at a very high price. The state and the financial markets are inextricably intertwined, whether they want to be or not. The markets may fear 'big government' but governments are now beginning to fear 'big markets'. For as the current turmoil in the sovereign debt markets illustrates, financial markets can pose a greater risk to the state and its taxpayers than the state can ever pose to the markets.