Central banking, financial regulation and property rights

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Most constitutional formulations of human rights include the right to own property. The first part of Article 17 of the Universal Declaration of Human Rights 1948 states that “everyone” has the right to own property, while the second part elaborates this principle by saying: “No one shall be arbitrarily deprived of his property.” In practice, private property rights are less than absolute in all jurisdictions. Well known are the problems arising from ‘externalities’, where a divergence between private and social costs may justify restrictions over the exercise of property rights. Further, the tax system may sometimes discriminate against particular groups and hence make them worse off, so that the economic effect is the same as if they had lost part of their property. The results of new regulations can be similar in that they encroach on individuals’ freedom to act according to their perceived self-interest and prevent them reaching a desired outcome.

The argument of this chapter is that the recent financial crisis has shown a particular kind of property right - that to the ownership of bank equity - to be highly vulnerable to changes in law and regulations. It will be suggested that government interventions in the banking industry in 2007 and 2008, particularly their recapitalisation packages in late 2008, had major adverse impacts on the value of banks’ equity. Whether these impacts amounted to the arbitrary deprivation of property remains to be established, both in the courts and elsewhere. At any rate, the expectation must be that the new insecurity of property rights in this area will inhibit future investment in the banking industry. The chapter concentrates on the United Kingdom, where government policy towards the banking system has been punitive by international standards.1

1. Illiquidity, insolvency and the central bank’s role

Our initial focus is on problems arising from the breakdown in the international wholesale money markets in Summer 2007. These problems can be better understood if a distinction is drawn between banks’ solvency and liquidity. The meaning of the term ‘solvency’ is somewhat different in banking from that in other industries. Generally, non-banking companies are insolvent when payments cannot be made from bank deposits as they fall due and continued trading would mislead creditors about the ultimate ability to pay. By contrast, banks can create liabilities against themselves by issuing new deposits and promising to convert these deposits into legal tender cash. Indeed, since banks can expand deposits (ie, money) ‘out of thin air’ by adding identical

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1 The clearest illustration of this statement is the pricing of the preference shares which a number of governments forced banks to issue in order to boost their capital. In many countries governments themselves were the only or main subscribers to these shares. In the United Kingdom, the government required banks to pay a 12% interest rate on the preference shares, compared to 5% to 8% in other nations. But in other respects also, such as its preparedness to pass legislation which would nationalise banks with limited or negligible compensation, the United Kingdom was out of line with most other industrial countries, including nations such as the United States and Canada which share its common law traditions. (But see footnote 20 on the passage of German legislation allowing the expropriation of banks.)
amounts to both sides of a balance sheet, the concept of banking solvency is surprisingly elusive.² The viability of a banking business has two aspects:
- liquidity - that is, the ability to convert deposits into cash at the request of its depositors;
- solvency - that is, the excess of assets over all liabilities except those to non-depositors.

In order to keep the discussion manageable, we may assume that banks have only two categories of creditor: depositors and shareholders. 'Solvency' can then be defined as a condition in which the value of shareholders' claims on a bank is positive because the value of assets is greater than that of deposits. The distinction between liquidity and solvency can easily be represented graphically (see the diagram below). A bank is liquid if it has a sufficiency of cash on the assets side of the balance sheet and it is illiquid, at least in one rather crude sense, if it has no cash whatsoever. On the other hand, a bank may be understood as being solvent if it has positive obligations to shareholders on the liabilities side of the balance sheet. It is immediately evident that a bank can be illiquid but solvent, or liquid but insolvent, as is illustrated by the two cases in the diagram.³

![Insolvency and illiquidity in banking](image)

For any given profit margin on their loan portfolios, the rate of return on banks' capital is inversely related to the ratios of their cash and capital to assets.⁴ It follows that profit-seeking commercial banks are constantly trying to find ways to reduce these two ratios while preserving the convertibility of deposits into cash. In the words of Phillips in his 1921 classic Bank Credit,

² The ability of banks to create new deposits (ie, money) from nothing has been compared to counterfeiting by Nobel-prize-winning economist Maurice Allais.
³ A bank can be solvent in the minimal sense that it has positive equity capital and yet not be solvent in a regulatory sense. Regulations usually specify a capital/asset ratio well above zero.
⁴ The point was developed by the author in a simple algebraic argument on pp 41-43 of Timothy Congdon, Central Banking in a Free Society (London: Institute of Economic Affairs, 2009).
"the essence" of banking "consists in the practice of extending loans far in excess of either the capital or the cash holding of the bank in question". By the start of the 21st century, banks’ ratio of equity capital to assets was typically under 5% across the industrial world, while in many countries cash was minute, amounting to 1% or less of deposit liabilities.

Nowadays central banks have a special constitutional position, since in most nations they are the only issuers of legal tender banknotes. Arguably, commercial banks’ dominant motive in establishing a relationship with the central bank is to lower their cash requirement and, at least in the first instance, to increase their rate of return on capital. A reduction in the cash requirement becomes possible because of the central bank’s ability to create new legal tender notes at negligible resource cost. If a commercial bank has a cash shortfall, the central bank can lend to it, usually by adding a sum to its cash reserve deposit. The cash reserve deposit is then available to meet deposit withdrawals or adverse balances in inter-bank settlement. The loan can be repaid when cash inflows to the commercial bank resume on a sufficient scale. By these means, access to central bank credit enables commercial banks to operate with lower cash/deposit ratios than would otherwise be the case.

For the most part, central bank credit is granted on a temporary and more or less technical basis, with the central bank having no doubt about the borrowing bank’s solvency and its capacity to repay the cash in a few working days or weeks. However, from time to time banks have more serious strains in their balance-sheet management, and a particular bank (or banks) may have trouble financing its assets over an extended period of uncertain length. This financing difficulty does not necessarily imply that the assets are of low quality or that the bank is insolvent. Indeed, it may be a valid assumption that, if the assets were realised over an interval of time 'normal' for the type of banking business in question, the bank would be fully solvent. (The normal realisation period for most mortgage assets is several years.) However, the bank’s inability to finance its assets may force it to dispose of them in a hurry, as in a so-called 'fire sale', perhaps at a discount of 10% or more on their true value. Whereas a bank (with a capital/asset ratio of 5%) is solvent if the realisation of its assets proceeds normally, it is insolvent if assets have to be relinquished in fire-sale conditions.

It follows that banks’ solvency at any particular balance-sheet date is not a simple and immutable given, but depends on the realisation period of assets in future. This characteristic of banking business goes a long way to explain both the potential awkwardness of the solvency notion and commercial banks’ keenness to have access to central bank credit when suffering from cash withdrawals. The often problematic context in which such credit is sought is captured by the description of the central bank as “lender of last resort". As noted in Perspectives on Safe & Sound Banking (1986), commissioned by the American Bankers’ Association:

> The lender of last resort should provide direct assistance to institutions that are economically solvent, but are experiencing deposit runs of sufficient magnitude that... rapid asset sales at fire-sale prices could render them fire-sale insolvent. Little cost attaches to assisting such

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6 Bagehot noted the connection between access to central bank credit and banks’ economisation on cash in "What the money market is, and why it is so changeable", The Economist, September 3 1864. See Norman St John-Stevas [ed], The Collected Works of Walter Bagehot (London: The Economist, 1978), Vol 9, pp 421-426.
7 Banks’ cash ratios fell in the 15 years following the founding of the Federal Reserve in 1914, but rose sharply in the early 1930s because of the collapse of confidence in the banking system. For the long-run behaviour of banks’ cash ratios, see Chapter 3 of Timothy Congdon, Central Banking in a Free Society, op cit.
institutions, and substantial economic and social benefits accrue from maintaining them as going concerns. The major form of assistance involved is a grant of time that allows the bank to restructure its affairs less expensively.\(^8\)

2. The breakdown of the international wholesale money markets

Over the 40 years to mid-2007, banks and other large financial players had built up large claims on each other in the international wholesale money markets. Whereas in the 1950s and earlier decades banks’ assets consisted largely of government securities and loans to domestic residents in the local currency, by mid-2007 they included substantial claims on other banks. These claims included banks in other countries and were often denominated in a foreign currency. Some banks were large net creditors in the wholesale money markets, but a significant proportion were also net debtors and could not sustainably maintain their loan portfolios without continued financing (much of it in the form of securities) from the wholesale markets.

The opening and middle years of the current decade saw a boom in structured finance. Banks in the United States and Europe arranged the issue of securities which were backed by assets such as houses and credit card receivables, and sliced into tranches of different creditworthiness. In early 2007 falls in US house prices undermined the credit standing and market price of these securities. On August 9 2007 three French money market funds, which held them in large quantities, announced heavy losses. Since banks knew that virtually all their wholesale counterparts (including other banks) held asset-backed securities to a greater or lesser extent, market participants cut back on transactions between each other. By mid-August the international wholesale money markets were paralysed. Banks that were net debtors to these markets would be obliged to shrink their assets, perhaps in fire-sale circumstances, if they were unable to find new sources of finance. The case of Northern Rock, a leading UK mortgage bank, illustrated the larger dilemma. Although in May 2007 it had raised £4.7 billion in a securitisation issue which had been oversubscribed 2.2 times and was Northern Rock’s “third cheapest deal ever”, it realised that another securitisation issue of similar size due in September could not proceed.\(^9\) It informed the Financial Services Authority (FSA), its regulator, of this on August 10.

On the face of it the crisis – both as it affected Northern Rock and more generally – was a classic opportunity for last-resort lending. In early 2007 most banks in the United Kingdom and across the industrial world were profitable, solvent and well regulated, while virtually no one had forecast the sudden closure of the vast markets in international wholesale finance. An important virtue of a last-resort loan is that, when made to a solvent bank, the interests of shareholders are respected. Since the repayment of a loan ends the lender’s claim on the borrower, a last-resort loan ought to enable a profitable bank with the appropriate amount of regulatory capital to remain in business. The advantages of last-resort arrangements have long been widely understood in the banking industry, as shown by the above quotation from the American Bankers Association volume. Critically, by avoiding the fire-sale liquidation of bank assets, last-resort lending steadies asset values and contributes to macroeconomic stability.

The United Kingdom had enjoyed the benefits of skilful central bank operations in the secondary banking crisis of 1973 to 1976, when the disintegration of the banking system had been averted.

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by a 'lifeboat' operation of inter-bank lending coordinated by the Bank of England. In short, when a solvent bank that has complied with regulations has difficulty in financing its assets (i.e., it is illiquid), the right public policy response is last-resort assistance from the central bank. A loan at a penalty rate is the most common form of such assistance, but the orchestration of inter-bank lending, perhaps backed by guarantees, should also be mentioned. To be effective, the loan must be extended for as long as necessary and on a sufficiently large scale, subject only to the conditions that the borrowing bank should remain solvent and provide good-quality collateral.\(^{11}\)

3. The nationalisation of Northern Rock

This was not the view taken by influential UK commentators in the Northern Rock case. Martin Wolf of the Financial Times and Anatole Kaletsky of The Times, along with a large number of other financial journalists, advocated nationalisation. After a run on its retail deposits over the weekend of September 15-16, Northern Rock did indeed receive a last-resort loan. But the loan was given grudgingly on punitive terms and UK officials did not make clear that it wanted the loan repaid quickly.\(^{12}\) Insofar as the commentators provided any serious reasoning to support nationalisation, it had two main elements. The first was that the last-resort loan was 'government money' and represented an improper subsidy to an unworthy private sector activity. The second was that Northern Rock was 'bust', with the apparent interpretation being that Northern Rock's funding difficulties amounted to full-scale insolvency. Perhaps because of the confusion between illiquidity and insolvency, the media proponents of nationalisation invariably made no mention of compensation. They implied that shareholders should receive nothing, even though the book value of Northern Rock's shareholder funds at the end of 2007 was over £1.6 billion.

The demands for the early repayment of the loan and the nationalisation of Northern Rock were part of a media hubbub which undoubtedly reduced the bank's market value. Although several private parties expressed interest in purchasing it and preserving it as a going concern, on February 18 2008 Chancellor of the Exchequer Alistair Darling announced that Northern Rock would be nationalised. Over the next week a bill for that purpose was passed by both Houses of Parliament. The resulting legislation, the Banking (Special Provisions) Act 2008, included clauses on shareholders' compensation which, if interpreted at face value, would leave them with only a fraction of Northern Rock's book value or even with nothing at all. Meanwhile, the government made no secret of its intention to run Northern Rock on commercial lines and eventually to privatise it. Prime Minister Gordon Brown said openly that the state might make a profit on the transaction. Clearly, if Northern Rock's assets proved to be of good quality (as was generally

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\(^{10}\) A full account of these events is in Margaret Reid, The Secondary Banking Crisis 1973 – 5 (London and Basingstoke: Macmillan, 1982).


\(^{12}\) Fear of breaching the European Union's state aid rules, which limit aid to only six months, was apparently a key motive behind the pressure for early repayment - see Tim Congdon, Northern Rock and the European Union (London: Global Vision, 2008), pp 9-10.
believed), and if the proceeds of the privatisation issue were a multiple of book value at the time, the state would indeed make a handsome profit from its involvement in the Northern Rock affair.\(^1\) (In the long run, banks have typically traded at two or more times their book value in public markets.)

Not surprisingly, the shareholders of Northern Rock were dismayed by this outcome. In Spring 2008 two of the principal shareholders, SRM Global Masters Fund and RAB Special Situations Fund, decided to seek judicial review of the compensation procedure. They appealed in particular to the property rights provisions of the Human Rights Act 1998, a piece of legislation which has undoubtedly given impetus to numerous cases of judicial review over the last decade.\(^2\) Judicial review was granted, with the case coming to court in January 2009. By this stage SRM and RAB had been joined by Legal & General and the Shareholder Action Group. The judges dismissed the shareholders’ case, although the claimants were given leave to appeal.

4. The generalisation of the crisis

During 2008 the crisis intensified and became more general. Until late in the year, central banks were anxious about rising inflation, with oil prices reaching over $140 a barrel in the summer. Although inter-bank rates were well above the policy rates indicated by the central banks (ie, the base rate in the United Kingdom, the federal funds rate in the United States and the repo rate in the Eurozone), and the wholesale money markets remained closed, significant reductions in policy rates were postponed until the final quarter of the year. The result was that by Autumn 2008 a large number of banks across the industrial world were suffering from funding problems similar in character and severity to those faced by Northern Rock in August and September 2007. Further, the banking crisis had started to impinge seriously on the macroeconomic situation. Because they were unable to tap the inter-bank market for funds, banks were cautious in the management of their own cash and restricted their lending. Particularly in the United Kingdom, this restriction led to slower growth of bank balance sheets and so of the quantity of money. Whereas corporate bank deposits were growing at an annual rate of 15% in early 2007, in the second half of 2008 they contracted by almost 5% (ie, at an annualised rate of 10%).

In September another mortgage bank, Bradford & Bingley, suffered a downgrading by a credit rating agency and found it increasingly difficult to raise finance in the inter-bank market. In contrast with the slow response to Northern Rock’s problems, the tripartite authorities (the Treasury, the Bank of England and the FSA) decided to nationalise Bradford & Bingley without further ado. The nationalisation took advantage of the terms of the Banking (Special Provisions) Act 2008 and again implied that shareholders might receive nothing. Since Bradford & Bingley had raised £400 million in a rights issue only a few weeks before it came into the state’s hands, either Bradford & Bingley’s guidance to investors in the rights issue prospectus had been misleading or the official action was a startling violation of property rights. Shareholders have taken the management and underwriters to court to seek damages over the wording of the rights issue prospectus. At the time of nationalisation, Bradford & Bingley’s mortgage book was widely

\(^1\) At the time of writing (late April 2009), newspaper stories have appeared that the government plans to split Northern Rock into two entities: a ‘good bank’ with the best-quality mortgage loans and a ‘bad bank’ with the low-quality assets. The Virgin Group, interested in acquiring Northern Rock in late 2007, is said again to be a possible buyer of the good entity.

deemed to be of poor quality, but 97% of its loans were current (ie, with all interest and capital payments on time), its capital/asset ratio was well above the regulatory minimum and the average loan-to-value ratio of its mortgage portfolio was under 55%. Indeed, the Bank of England and the FSA had been closely involved in overseeing and endorsing the terms of the rights issue so that Bradford & Bingley’s enhanced capital would comply with regulations.

Northern Rock and Bradford & Bingley were relatively small institutions, but in early October concern had emerged that the core UK high-street banks might also experience strain in financing their assets. The UK government understood these banks’ problems to reflect lack of market confidence in their creditworthiness, which it attributed to inadequate capital. In two separate announcements on October 8 and 13 the tripartite authorities took steps to recapitalise the banks. In the first of these the authorities indicated their preparedness to guarantee inter-bank borrowings (for a fee) and to inject capital into privately owned banks. But the message appeared to be that any injections would take the form of preference capital, leaving shareholders’ interests unaffected. The second announcement was very different and was described in several reports, including those from the BBC’s Robert Peston, as amounting to the nationalisation of the UK banking system.

From the banks’ own point of view, the surprise feature of the announcements was that – very suddenly – officialdom mandated them to hold far more capital than had previously been the case. The justification for the change was that the Treasury and the Bank of England had decided that the United Kingdom faced a few years of deep recession, so the banks needed a cushion of excess capital in advance of possible heavy loan losses.15 The Treasury said that it would underwrite issues of new equity by the Royal Bank of Scotland (RBS) and HBOS. Both Barclays and RBS put out press releases saying that they had not sought additional capital from the government or any other source. Nevertheless, they had to raise such capital or to alienate their regulators and forfeit access to the credit guarantee scheme. At the same time the UK Debt Management Office embarked on heavy issues of medium and long-dated government securities, which lowered financial institutions’ money holdings and limited their ability to subscribe for new issues of bank shares.16 Given the squeeze on the quantity of money and hostile media coverage of the banking industry, private investors were unwilling to apply for the newly issued shares in RBS and HBOS. By this means the government came into possession of 57% of RBS’s equity at a cost of £15 billion. The stake in HBOS was more complicated, because HBOS was being merged with Lloyds TSB.

Little more than a month earlier RBS had issued its interim report for 2008, indicating shareholders’ funds at the end of June of just over £59 billion, which had been bolstered by a recent rights issue of £12 billion. Even if this figure were written down to £40 billion to allow for the goodwill element in RBS’s takeover of part of ABN Amro in 2007, the government’s investment appeared to be on highly favourable terms. It was acquiring assets that, according to the latest RBS balance sheet, were worth at least £31 billion for less than half that sum. As with Northern Rock, the prime minister insisted that the investments were assets, “not just money

15 For the rationalisation of official actions, see the October 2008 issue of the Bank of England’s Financial Stability Review (London: Bank of England). The banks were subjected to a sudden step-change in capital requirements, a development which hit the market values of their business and was unprecedented.

16 Net official sales of gilts (ie, net of redemptions) were £46.42 billion in the fourth quarter of 2008, exceeding those in any previous quarter by a multiple of more than two. Gross official sales of medium and long-dated gilts totalled £18 billion, also an all-time record for one quarter. See relevant issues of Financial Statistics (London: The Stationery Office), Table 1.2C, p 26.
being pumped in", and that the government would sell its RBS stake at some point. Needless to say, the government’s intervention led to a further flight of investor confidence and a slump in the stock market’s valuation of the UK banking industry. In January the government had to put out an announcement that it did not wish to nationalise the entire sector. At that point the market capitalisation of the United Kingdom’s leading banks was a fraction of their book value. A case could be argued that, even if it took place at market prices, nationalisation would have amounted to expropriation.

5. Further ambiguities in banking solvency

Banking is always and inevitably exposed to risks of macroeconomic upheaval. The ability of borrowers to repay bank loans depends on the level of asset prices, which is influenced by the general monetary environment. Further, because asset prices are volatile and loan loss incidence impacts on banks’ profitability and capital positions, the solvency of the banking industry is to some extent 'in the eye of the beholder'. At end of 2008 someone who expects house prices to fall by 40% in the next two years may deem the banking industry of his or her country to be bust, whereas someone who expects house prices to fall by 20% over the next three years may view the same banking industry as solvent. This type of ambiguity in the notion of bank solvency is distinct and separate from the confusion between illiquidity and insolvency discussed above. Evidently, if a commentator wants to cast aspersions on banks’ solvency and more broadly on their management competence, they are a soft target.

The counter-argument is that problems in assessing banks’ loan loss incidence, profitability and capital are not new, and auditors have had decades to build up a body of relevant rules and practice. Much of the trouble in 2007 and 2008 arose because banks had unusually large holdings of so-called 'available for sale’ securities which were esoteric products created during the structured finance boom. For the most part, the leading UK banks held only AAA-rated tranches of these issues and these tranches continued to pay interest and were unimpaired. However, their market value had collapsed in the turmoil after August 2007 and accountants and managements were required under new ‘mark to market’ rules to regard the fall in the securities’ value as eroding banks’ equity capital.

At any rate, the media witch-hunt against the financial sector in this period licensed politicians and journalists to make numerous allegations that banks were bust or insolvent, when banks’ annual reports indicated positive capital running into tens of billions of pounds. Undoubtedly crucial in the government’s assault on the banking industry was a widespread failure to understand that a bank may be illiquid and in need of last-resort market funding, but still fully solvent. In his 1873 text on Lombard Street Walter Bagehot advocated that the central bank organise large-scale and pre-emptive last-resort lending to handle an illiquidity crisis. But in Summer 2007 Mervyn King, governor of the Bank of England, repudiated the Bagehot doctrine and said that it was not his institution’s job to make large loans on an extended basis to privately owned commercial banks.17 King believed that this was a job for the government. Therefore, from an early stage the Treasury was involved in the crisis, which became heavily politicised.

6. Are property rights in the banking sector inherently insecure?

17 See King’s evidence to the Treasury Committee of the House of Commons on September 11 2008, discussed on p 142 of the author’s Central Banking in a Free Society.
The UK banking industry did ultimately receive the economic equivalent of last-resort assistance from the UK state, although it came more from the government than the central bank. Preference capital subscribed by the government is more or less the same thing as a long-term last-resort loan at a fixed high rate, while Treasury guarantees on inter-bank lending are indistinguishable from central bank coordination of inter-bank facilities with an indemnity against loss to the creditor banks. However, the government accompanied its assistance by the acquisition of significant stakes in the banking industry at well beneath book value. The banks were so vulnerable to funding risk because of the closure of the wholesale money markets that they could not resist official pressure. Indeed, an argument can be made that the tendency to regard a solvent but illiquid bank as bust gave a pretext to nationalise – or at any rate, to attempt to nationalise – significant assets without compensation. (In the January 2009 trial government counsel Lord Grabiner made the outright statement that “Northern Rock was bust”. In fact, in September 2007 Northern Rock had a level of capital sufficiently positive to comply with FSA regulations.) The public bullying of the UK banking industry and the virtually blatant indifference to shareholder rights had no historical precedent. Until 2007 and 2008 the UK state had never tried deliberately to appropriate equity capital from bank shareholders in a financial crisis.

However, when the passage of events led to extensive speculation that the entire banking system would be nationalised, the government decided to be less confrontational. It insisted that it wanted the UK banking system to remain mostly in private hands. The truth was that public policy had been inconsistent and unpredictable, and contained a large element of intimidation. If the measures announced in October 2008 had been put in place earlier, and in particular if the government guarantee on all inter-bank borrowing had been available from August 2007, it is at least arguable that both Northern Rock and Bradford & Bingley could have remained going concerns in the private sector. At any rate, the government’s behaviour had made shareholder rights in the UK banking industry insecure and inflicted serious damage to the market value of those banks that remained in private ownership. In late 2008 HSBC let it be known that it had conducted an internal review of whether it wished to continue to locate its corporate headquarters in London.

Of course, the United Kingdom is not the only country where policymakers have faced new and unexpected dilemmas in the management of their banking industries. Nevertheless, other jurisdictions have generally been more circumspect in their treatment of shareholder rights. In Germany, mortgage lender Hypo Real Estate, which relied on wholesale funding in much the same way as Northern Rock and the other UK mortgage banks, had become unable to fund its assets from market sources by late 2008. The Finance Ministry was prepared to organise new funding, but only on condition that it could acquire 75% of the equity, and drafted a bill to that

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18 Arguably, preference shares subscribed by the government are similar in economic effect to a last-resort loan from the central bank. In both cases a privately owned bank receives finance from the state at a penal rate. As long as the money is repaid, the state makes a profit because its own cost of finance is much lower than the rate it charges the troubled bank.

19 In evidence to the Treasury Committee of the House of Commons on November 25 2008 Mervyn King said that total nationalisation of the banking system might become necessary if banks were not prepared to resume lending “to families and firms”. The implicit threat was that the Banking (Special Provisions) Act 2008 would be used to nationalise the recalcitrant banks and that management would be removed and shareholders left without compensation. The theme continued in public comment for several more months. According to a leader in The Mail on Sunday (January 18 2009): “The British taxpayer is entitled to be utterly exasperated by the apparent ingratitude of the banks... too nervous to restart the lending that alone can revive a rapidly weakening economy.”
effect. But the ruling coalition, led by the conservative Christian Democrats, decided that the bill amounted to expropriation and was in conflict with Articles 14 and 15 of the Constitution. In Belgium, small shareholders were able to secure a court ruling against government plans to break up Fortis bank, although the eventual outcome of their intervention is uncertain at the time of writing.

Were the UK government’s acquisition of a major part of the UK banking industry and the collapse of the market value of the remaining privately owned banks inevitable sequels to the closure of the international wholesale money markets in 2007? And could the wider macroeconomic trauma have been avoided? The thesis here has been that the trouble, at least in the United Kingdom, stemmed largely from the reluctance of the Bank of England to act as lender of last resort in the traditional manner. Because the central bank was unwilling to extend large-scale loans for an extended duration to solvent but illiquid banking companies, these companies were forced to deal with an unsympathetic government. The government, egged on by both influential commentators and the popular press, misinterpreted illiquidity as insolvency, and then rode roughshod over the property rights of banks’ shareholders. A different relationship between banks and the UK state, and more specifically between banks and the Bank of England, may be needed to restore confidence in the security of property rights in the UK banking sector.

The recent financial crisis confirms the familiar theme that all property rights are defined relative to a particular social and political context. The value of equity in any country’s banking industry depends, in particular, on financial regulation and the quality of the services that the central bank provides to commercial banks. Investors in the banking sector of any country cannot be surprised that the value of their holdings can be slashed, by large amounts in a very short period of time, by changes in regulation. But shareholders in the UK banks may feel that, in its behaviour towards them in 2007 and 2008, the British state breached a longstanding implicit contract. This contract had long benefitted not only their private interests, but also the economy and society in which their industry had developed.

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30 Bertrand Benoit and James Wilson, "Berlin shies away from bank law", *Financial Times*, February 3 2009. See also an article by James Wilson on "Hypo reality" in the *Financial Times* of March 20 2009. US private equity firm JC Flowers had a stake in Hypo Real Estate and argued that the German authorities’ actions amounted to expropriation, as well as unfair treatment of a foreign investor. In the end, legislation to allow expropriation of failing banks was passed by the *Bundestag*.

21 In their action against the government the Northern Rock claimants decided not to emphasise the doctrine of legitimate expectation to justify the argument that Northern Rock was entitled to a lender-of-last-resort loan. Nevertheless, most bankers have traditionally believed that the central bank ought to help them in a funding crisis (see footnote (8)).

22 On April 2 2008 Paul Tucker, the Bank of England’s executive director for markets, gave a speech on "Monetary policy and the financial system", in which he said "a social contract between the banking system and the authorities", in which banks could borrow on last-resort terms if they had a cash problem, had been in place "for well over a century". But he judged that since Summer 2007 it had been toxic for banks to borrow from the central bank in the way suggested by the contract (article in *Bank of England Quarterly Bulletin*, 2008 Q2 issue, Vol 48, 2, quotation from p 205). However, he did not specify whether a legally binding contract and a social contract came to the same thing.