



the run on the rock

The Treasury Select Committee's recent report on the fall of Northern Rock is a searing indictment of the bank's directors and the FSA's failure to regulate for unforeseen risks. Mick James examines the lessons learned.

■ The 'failure' of Northern Rock can be attributed to the interaction of three factors.

The initial impetus was, of course, the credit crunch precipitated by the crisis in the American sub-prime mortgage market. However, this has not yet caused serious problems for other mortgage lenders in the UK, so the unique business strategy pursued by the directors of Northern Rock must have played a part. Finally there are the perceived inadequacies of the regulatory regime, the so-called 'Tripartite Authorities' of the FSA, the Bank of England and the Treasury, both in the supervision of the Rock in the run-up to the crisis and in the immediate aftermath.

In its recent report, 'The Run on the Rock', the Treasury Committee is clear in its assignation of blame:

"The directors of the Northern Rock...were the principal authors of the difficulties...(they) pursued a reckless business model which was excessively reliant on business funding. The Financial Services Authority systematically failed in its regulatory duty to ensure that Northern Rock would not pose a systemic risk."

The Bank of England, and the Treasury, get off more lightly: "The Chancellor...was right to view Northern Rock as...a systemic risk and to authorise the Bank of England's support facility. However, the Tripartite Authorities did not prepare adequately for that support operation."

the first run on a British bank...

The report gives surprisingly little weight to the exceptional nature of the 2007 'credit crunch', even while acknowledging that it has had a worse and more prolonged effect on international liquidity than 9/11 (a subsequent report will examine liquidity in more detail).

Is the extreme criticism of both the Rock and the FSA justified? The report makes much of this being "the first bank run in the United Kingdom since Victorian times", but this crisis is starkly different. Queues outside branches – caused by a combination of limited counter-space and the need to comply with money-laundering regulations – made good television. But at no time did the Rock suspend payments, nor was the rush to secure deposits mirrored by a

similar run on other institutions. The contrasts with the Victorian runs are striking, being initiated either by the suspension of payments in the face of investment losses or the collapse of a bank due to fraud. These runs quickly spread to other banks until the Bank of England stepped in.

The irony of the Northern Rock crisis is that the rush to withdraw deposits only began *after* it was revealed that it had sought – and secured – emergency funding from the Bank of England. Subsequent media coverage reminded depositors of their limited deposit protection scheme, and closing one's account at the Rock became a matter of simple prudence rather than panic, only stopping once the Bank of England fully guaranteed all deposits. Most of the cash seems to have been immediately redeposited elsewhere, so was this really a run in the sense of a general collapse in confidence in the banking system? Even determined 'who's next?' speculation by the media, focusing on smaller institutions such as the Alliance & Leicester and Bradford & Bingley, failed to spread the panic.

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Treasury Committee report, 'The Run on the Rock'

Recognising the root of the run, Chancellor Alistair Darling expressed the wish that Bank of England (BoE) interventions could be made 'covertly'. The Treasury Committee now says the principle of co-insurance of deposits is discredited, presumably looking forward to a future in which the principle of 'caveat emptor' or 'buyer beware' is completely removed from the retail savings market.

While the Bank of England believed it was legally barred from a covert operation, it did not follow the lead of either the ECB or the US Federal Reserve in taking action to support liquidity in the market generally.

As Chas Roy-Choudhary, head of taxation at ACCA, points out: "The Fed is a very hard-nosed organisation, the ECB much less so – yet they did exactly the same thing. The Bank of England has an inflation remit but so does the ECB – yet the ECB was able to see outside its remit."

a 'reckless' strategy

Rather than criticise the Bank of England, however, the report prefers to focus on the 'recklessness' of Northern Rock's strategy. Northern Rock's rapid growth since demutualisation in 1997 came in large part from the adoption of novel (at least to the UK market) ways of financing mortgages through wholesale finance. Rather than supporting mortgages with UK deposits, the Rock securitised its mortgages through an offshore vehicle known as Granite. In this way the risk from 50% of the Rock's loans was transferred from the Northern Rock's balance sheet to other lenders, in periods averaging three and a half years. Only 25% of the borrowings were from the wholesale market, of which half had a life of more than a year. Northern Rock's mortgage arrears are roughly half the UK average. The Committee notes as significant the fact that "there was no correspondingly rapid

growth" in the Rock's retail funding, i.e. deposits, although this is an obvious consequence of the securitisation of the loan base which allowed its rapid growth. The expansion was not, as some believe, achieved by a move into sub-prime lending – the Rock's arrears are half the UK average. Despite this the report quotes with approval criticism of the Rock's expansion from Dr Willem Butler of the LSE: "It is hard to believe that the quality of the asset portfolio and the ability to vet the credit-worthiness of your customers does not suffer...they were an organisation that was clearly engaged in high-risk behaviour."

In fact it was the very quality of the Rock's asset base that led the directors into a false sense of security. The Bank of England's Financial Stability report identified, in April 2007, that increased wholesale funding of banks was a potential risk "if markets became less liquid". In the light of this the Rock had already issued a profit warning, and was seeking to diversify the geographical spread of its funding to avoid a tightening of credit in the US. It also believed that, in a credit crunch, it would benefit from a 'flight to quality' on the basis of the quality of its asset book. What it did not foresee was the simultaneous closure of all global markets, to any business, based on the 'global shock' of the US sub-prime crisis in August 2007 – and nor did its regulators.

This leads into the question of the stress-testing carried out by the Board under the supervision of the FSA, whose chief executive, Hector Sants, now suggests was inadequate: "relying on historical statistical analysis as a method of predicting the future...is not a sufficient way to discharge your responsibilities as a board...firms need to seek to run full scenario tests...regardless of whether that type of modeling looks particularly probable."

lessons learned

Mr Sants agreed that the FSA should have gone further: "I do not think any reasonable professional would have anticipated that set of circumstances but I think as a regulator we should have engaged with that in an extreme stress test". Since, logically, any business model whatsoever will inevitably fail such a stress-test, it will be interesting to see what kind of regulatory regime will arise from the adoption of this principle. Indeed the report recommends a slew of new measures: a new regime for dealing with 'failing banks', a new depositor protection scheme, and a new authority (not the FSA) to handle it.

In hindsight – a phrase which crops up frequently in the report – Northern Rock was trading in markets whose inherent fragility was made apparent in the starkest way. Many like George Soros believe that this is a crisis in liquidity which has been building for years and has only been exacerbated by regulators. But whether this represented a crisis for the entire British banking system which warranted such large-scale intervention is debatable. As Michael Mainelli, chairman of risk/reward management firm Z/Yen, says:

"Callum McCarthy has stated repeatedly and loudly that he does not run a 'no fail' regime, and there have been failures. The problem is that the FSA hasn't publicised those failures enough."

Whether or not there was ever a 'systemic risk' to the British banking system in the Autumn of 2007, it was averted by the current system, but despite that the system will now be radically overhauled. However, exceptional and temporary the credit crunch proves to be, its effects will be enshrined in the regulation of British banking for a long time to come. ■

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