Northern Rock - Could It Happen Again ?

The sight of worried depositors waiting in line outside branches of the Northern Rock Bank in England during September 2007 is a spectre which Gordon Brown wishes to banish from the UK high street.

The Northern Rock disaster, and the television images of agitated depositors, was beamed round the world. The long term damage to the reputation of London as the world's leading financial centre is palpable, but difficult to quantify. The confused response of the UK authorities has undermined the reputation of the Government, the Financial Services Authority (FSA) and the Bank of England.

Unfortunately, all the politicians and civil servants remain in office despite their evident lack of ability to deal with the challenge. The only casualty appears to be MrClive Briault, the Director of Retail Operations at the FSA who left his post by mutual consent in April 2008 on the basis of a redundancy deal estimated at around GBP615,000. This looks more like a reward for his ineptitude rather than a punishment for incompetence.

Northern Rock was nationalised by the UK government. This means that funds invested by depositors are safe. However, shareholders who paid up to GBP12 per share at the peak face a very uncertain future. The shares stood at around 90 pence when the bank was nationalised and the UK government is claiming that the bank was effectively worthless when taken into public ownership. This claim is an attempt by the government to justify the little or no compensation they intend to pay to shareholders.

A consultative document 'Financial Stability and Depositor Protection' has been issued by the UK government and dated July 2008. The full document can be found at the HM Treasury website. Several politicians and commentators have stated that the Northern Rock crisis could have been averted if the proposed provisions had been in place 12 months ago.

This raises a number of points -

Firstly, the unimpressive deposit guarantee scheme which currently only guarantees 90 percent of the first GBP35,000 will be improved to cover the first GBP50,000 and there will be a 100 percent guarantee.

The document is vague concerning the question of who will pay for this improved guarantee. It would be appropriate for the banks to fund the insurance scheme themselves, but the government has backed away from an insistence on this.

Providing an insurance scheme for depositors' funds should be a core business feature for a bank, and the lack of such a scheme should disqualify a bank from having a licence to trade. Alternatively, banks should be encouraged to take out insurance and then let retail customers decide whether to place their deposits in insured or uninsured banks.

Secondly, banks will be required to meet new liquidity targets in addition to minimum capital ratios. There are already international regulations in place and these will be reviewed. The emphasis has moved to liquidity, so that banks are in a better position to deal with an unexpected surge in withdrawals.

The crisis at Northern Rock was precipitated by a drying up of short term funds in the wholesale market which the bank had been using to fund mortgage advances for property purchases. The liquidity proposals will also give the Bank of England covert powers to provide funds, albeit at penal rates.

Mervyn King, the Governor of the Bank of England, bemoaned the lack of a covert capability as the enormity of the Northern Rock crisis developed. Most commentators ridiculed his use of this expression and suggested that he was not cut out for a James Bond style operation.

Lloyds TSB was interested in mounting a takeover of Northern Rock in mid 2007, before the crisis broke. There was initially a series of confidential meetings between Lloyds TSB and the Bank of England. However, it is generally thought that Mervyn King refused to provide funds or guarantees to Lloyds TSB, and because of this, no deal was done.

With the benefit of hindsight, this was a lost opportunity. It was precisely such a guarantee offered by the US Fed which allowed J P Morgan to rescue Bear Stearns from disaster in March 2008.

Thirdly, there will be a Special Resolutions Regime whereby the FSA will have increased powers to intervene in the running of a bank. These will include moving control of a bank from its current directors and disposing of parts of the assets. In the extreme, it will have powers to take the bank into public ownership, as per Northern Rock.

These draconian proposals have shocked the banking sector, and there will be a prolonged and acrimonious debate on the details of any new powers for the FSA. One aspect of the proposed new powers is the proposals for the status of bank creditors, namely large investors and shareholders. The disdain with which these parties have been treated by the authorities in respect of Northern Rock has sounded alarm bells throughout the financial sector.

The question remains. Would these increased powers have saved Northern Rock if they had been in place a year ago ?

All public bodies would welcome increased powers, and they are largely and consistently successful in acquiring such powers. It is a most unfortunate trend in western capitalist countries that the state, via politicians, systematically and uncritically grants new powers to public bodies. This is often justified in terms of a response to the 'War on Terror' but also extends into many other areas.

It is generally agreed that the Lloyds TSB takeover of Northern Rock would have averted a crisis. The Bank of England could have provided a guarantee of funds based on its existing powers.

With respect to the desire to act covertly, this point attracted ridicule last year, and the hilarity is rekindled. The problem with all state agencies is that their staff talk among themselves and gossip, rumours and innuendo inevitable filter through to the media. Also, a salient feature of the Blair years was the practice of government to leak news or proposals to the press in order assess media and public reaction.

The ability to act covertly will not be achieved by requiring staff to sign an Official Secrets Act style document, but by ensuring sensitive meetings and conversations are kept confidential. This could be better achieved by meeting banks in neutral premises rather than their London city offices or at the FSA, and by having a small tightly knit team dedicated to such delicate matters.

In conclusion, the debacle at Northern Rock was primarily due to the poor quality of the actors from the UK Government, the FSA and the Bank of England who played their parts in the unfolding drama with smug complacency and incompetence and whose performance on the public stage served only to demonstrate the failure of the much vaunted Tripartite System.

The proposed solution is to grant additional powers to these three bodies. This will inevitably increase the size of these bloated organisations without addressing the need for a skilled and professional approach in dealing with financial emergencies.

A more robust response would be to allocate responsibility to one of these three bodies and to strengthen the banks by promoting the concept of private insurance for depositors' funds.

About the Author

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