Northern Rock

Britain: Government attempts to stem banking crisis

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The Labour government's pledge to guarantee savings at the Northern Rock has been forced on it by a massive public display of no-confidence in Britain's banking sector.

Strenuous government and media attempts to insist that Northern Rock was a liquidity problem due to a bad business model and not a systemic crisis—and that the bank remained solvent—fell on deaf ears, as customers continued to queue up to close their accounts and bank shares took a hammering.

Chancellor Alistair Darling was forced to guarantee savings at the mortgage lender to "promote a stable banking system," amidst fears that the bank faces collapse, with savers withdrawing more than £3 billion. Other major mortgage lenders such as the Bradford & Bingley had begun to register losses, with the Alliance & Leicester worst hit with a fall of 30 percent. The Alliance & Leicester recovered all but 2 percent of its fall with others rising by lesser amounts. But the fact that the government's promise only slowed the demand for cash and raised Northern Rock shares by just 8 percent one day, only to fall back twice as far the next, indicates that the loss of public confidence is just as great in the political sphere, if not worse.

The general recovery in share values has more to do with the cut in interest rates by the US Federal Reserve than any move by the British government.

The *Financial Times* opposed action to rescue Northern Rock by the Bank of England, stating that Mervyn King, the Bank governor, had "played by the book" in initially opposing such a move. It published a comment by Philip Stephens entitled, "Stopping a crisis becoming a catastrophe."

He concludes, "In the end fine economic judgments were swept aside by politics, calm deliberation by panic on the streets.... Signs that the contagion was spreading to other leading banks risked a crisis turning into a catastrophe. Only a blanket guarantee would do.... Gordon Brown's government has built its reputation on economic competence... This week's scenes of anxious voters emptying their bank accounts, redolent of Latin America 20-odd years ago, threatened to sweep it all away."

Under the headline, "A government rocked," the *Guardian* editorialised, "Before he made his announcement, chancellor Alistair Darling must have been given news from the markets. There was carnage among bank shares, with nearly a third knocked off the value of Alliance & Leicester. What had seemed a local problem on Thursday evening, confined to a Newcastle-based bank that had made outlandish business decisions, threatened by Monday night to become a banking crisis.... In the end though, the queues won."

A spokesman for one of Britain's top retailers had warned as much days earlier: "Up until now, the credit crunch has been way up in the clouds—now it is on the street. This is the first consumer-related event. This has massive significance on the high street, it is major. People are worried about money and they won't be spending."

The lack of confidence in the banking system proved to outstrip the actual import of the Northern Bank in the financial markets. But that does not mean that customer reaction was merely panic.

Northern Rock was first of all the UK's eighth-largest bank and fifth-largest mortgage lender, with 1.4 million savings customers, 800,000 mortgage customers and assets totalling £113 billion. If the bank had collapsed, then many of these customers would have faced massive losses. The official Financial Services Compensation Scheme covers only the first £35,000 in savings. In the event of insolvency, an individual saver would get back all of the first £2,000 in the account, but only 90 percent of the next £33,000—a possible loss of £3,300. Any savings above £35,000 are not guaranteed.

Northern Rock looks to be a dead dog, beyond rescue. It will reportedly pay a penalty interest rate of close to 7 percent to borrow funds from the Bank of England, which is too high to sustain profitability on its own mortgages. It is expected to appoint the US bank Merrill Lynch in an attempt to find a buyer. Its shares will probably go for less than £3, down from a high of £12.

Baillie Gifford is the largest institutional shareholder in Northern Rock and is believed to have lost more than £250 million. Other major shareholders include Scottish Widows, Legal & General and Fidelity. Northern Rock staff own 46.7 million shares and have lost hundreds of millions.

Secondly, Northern Rock gets 73 percent of its funding from wholesale markets rather than customer deposits. Its strategy of borrowing money from other banks and then lending to its customers at a higher rate fell foul of the international credit squeeze that followed the sub-prime mortgage collapse in the United States.

As Adam Applegarth, Northern Rock's chief executive declared, "Life changed on August 9, like snapping a finger. Watching the liquidity disappear since then has been astonishing."

The impact of the sub-prime mortgage crisis is still working its way through the system. At least 16 US lenders have been forced into bankruptcy, and the Federal Reserve was forced to cut its discount interest rate to prime the economy.

The European Central Bank has loaned cash to banks seven times since August 9, and Germany's Landesbank Sachsen Girozentrale and IKB Deutsche Industriebank AG are getting emergency bailouts. Bear

Stearns & Co., Goldman Sachs Group Inc. and Barclays Plc have all been forced to prop up investment funds in the past three months.

The failure of the market in risky mortgages in the US has left banks internationally saddled with huge losses and unwilling to lend to one another. And though Northern Rock lends more money from other banks than its rivals, it is not alone in facing a liquidity crisis. For example, Bradford & Bingley's buy-to-let loans account for more than half of its mortgage book. It has the second-highest ratio of loans to deposits after Northern Rock, with loans accounting for 1.8 times its savings and deposits compared with 3.1 times for Northern Rock.

Awareness of the impact of the credit squeeze on millions of working people was also raised by the recent announcements that Britain's house prices are stagnant or falling. Hometrack's August survey found London to be the only part of the UK that showed any rise in prices. The website Rightmove and the Royal Institution of Chartered Surveyors have both reported that property prices fell in the last month for the first time in three years.

UK interest rates have risen five times since the middle of last year. Mortgage repayments already take up more than 50 percent of take-home pay, with interest on loans taking up a whopping 17.4 percent of income. Banks are now expected to raise loan rates still further, hitting tracker mortgages immediately and the 2 million UK borrowers with fixed-rate mortgages when their deals expire. A credit squeeze will also force banks and building societies to clamp down on the amount they are prepared to lend. Some lenders have been offering loans of up to 125 percent of a property's value and six times a customer's annual salary.

An end to Britain's 10-year house price boom will have a massive impact on the entire economy, but it is only one manifestation of a credit-fuelled boom that has left Britons with total debts of £1.3 trillion.

An economic slowdown is already evidenced in rising bankruptcies and mortgage repossessions. The Ernst & Young Item Club has predicted that UK economic growth may be as much as 1 percent lower in 2008 and 2009 as a result of the credit crunch, stating that this "will have a ripple effect on everything from related industries to the top end of the housing market."

A drying up of credit has grave implications. Northern Rock is an extreme example, but its reliance on credit is nevertheless illustrative: During the first half of 2007, it received just £1.7 billion of new money from savers, but lent £10.7 billion to new borrowers financed by borrowing £10.3 billion from the City. As one independent investment banker told the *Telegraph*, "Everyone frets about insolvency, but it's never insolvency that brings a bank down. It's liquidity. If a bank has solvency issues it dies a long painful death.

"A lack of liquidity can be like a bullet that hits you out of the blue. It was liquidity that caused the great Wall Street crash in 1929."

Danny Gabay, director of consultants Fathom, warned, "The UK has a double vulnerability. We are vulnerable because of our hugely over extended consumer sector, and because of our large financial services sector. This is a financial market event; but the longer it goes on, the greater the risk that it becomes a real economy event—and I think we are at a tipping point."

The City of London and the finance sector account for just under a third of Britain's annual income. A generalised economic slowdown in Britain and internationally would render the promise by the government to guarantee savings at Northern Rock worthless and would absolutely exclude any similar promise being made should another bank run occur.

Darling initially promised that people could get their money back "whatever happens." But his pledge could only be made in the hope that restored confidence would mean it never had to be honoured. To do so in face of a collapse would cost around £20 billion. That is why he later told the BBC that savers could get their money back "at the moment."

Northern Rock is not just an economic event, but a political event. It has underlined the degree to which the Labour government has relied on a credit-fuelled spending boom to offset the impact of its pro-big business agenda on working people.

Prime Minister Gordon Brown has yet to rule out a snap general election, but his cabinet ministers are clearly rattled, with some calling for no election to be held until 2009. Darling told the press, "I don't get any sense that people inside government or outside government are anxious for a dash to the polls," while Health Secretary Alan Johnson said, "My instinct is we should get on with the job of governing. There's big issues to tackle."

Whatever happens, Philip Stephens was correct when he wrote in the *Financial Times*, "Now, nothing seems quite so solid. Politics, as they say, has got interesting again."

With the Brown government already deeply unpopular, a sharp change in the economic situation can galvanise an already alienated and hostile population into taking political and industrial action.

Conservative Leader David Cameron has failed once again to benefit significantly from the government's difficulties. But this is because his party is as hated and mistrusted as Labour—and as out of touch. He even chose to pontificate about the dangers facing "every business and family in the country" in a speech to a meeting of international accountancy firm KPMG and in the pages of the *Sunday Telegraph*.

The real danger facing the government is not a transfer of voter allegiance from one right-wing party to another, but a decisive shift to the left in the working class and an eruption of sharp class conflicts.