Northern Rock: the crisis mounts for British government

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The ever increasing financial support for Northern Rock, Britain's eighth largest bank, by the Bank of England is testimony to a growing financial crisis that the government is powerless to contain.

Northern Rock had no involvement in the US sub-prime market and its bad debts on British mortgages were low. It was a victim of the credit squeeze following the sub-prime crisis and needed a bailout. But despite repeated and unprecedented measures, including a £16 billion cash injection from the Bank of England, the government has been unable to resuscitate the bank. Northern Rock is now bleeding cash to the tune of £3 billion a week and its shares are not worth the paper they are written on, as financial commentators have admitted.

The *Sunday Times*, writing in the context of potential take-over bids from private equity groups, including Richard Branson's Virgin Group, JC Flowers and Cerberus, said that "there is a strong possibility that despite the takeover speculation that has pumped up the [share] price to 273p, its real value could be close to zero".

The Bank of England and the government intervened to prevent the institutional lenders from pulling out and Northern Rock collapsing, inflicting massive damage to the financial sector upon which so much of the UK economy depends.

Now, not only is it clear that the bailout has failed, but it also threatens to engulf not just the bank but the British government's financial resources.

It is not just Northern Rock that is a victim of the credit squeeze. The collapse of inter-bank lending threatens many other financial institutions, while the credit squeeze will lead to a slow-down in lending by other mortgage lenders and send house prices spiralling downwards, ruining many families.

The International Monetary Fund has said that the global economy faces a marked slow-down as a result of the crisis in the financial markets. The lack of liquidity in the banking markets "may test the strength of the current expansion" and its effect on the US and UK housing market would be a significant drag on the world economy. The IMF has downgraded its estimate of next year's growth from 5.2 percent to less than 5 percent.

The UK, with the world's most overvalued housing market, would be particularly vulnerable if the credit squeeze continues. Thus the collapse of Northern Rock is not an aberration but portends a much broader economic crisis not just for the UK, but the rest of the world.

Northern Rock's lending was based not so much on deposits but on the loans it could raise in the short-term credit market. Its deposits were worth £22 billion compared with a loan book of £113 billion.

It raised loans by bundling its mortgages together and pledging their future income, a debt instrument known as securitisation, to service the loans. It issued these loans via a series of transactions, off-shore trusts and registered charities, including its Granite companies, so complex that few understand them despite their ubiquity within international finance. More than 50 percent of its mortgage lending was raised in this way.

This enabled the bank to increase its loans to home buyers at a much faster rate than its competitors, enlarge its market share and boost its profits. It compensated for its low margins with high-volume lending.

This strategy, described in the *Observer* newspaper as "one of the most admired business models in the business market", worked only as long as credit was freely available. It began to unravel in August, when the credit squeeze started to bite and inter-bank lending all but came to a halt. As Northern Rock's position became known in the City, its shares plunged and depositors scrambled to withdraw their money.

The Bank of England had at first refused to intervene to increase general liquidity in the interbank lending market, which underpins the credit market as a whole. It also refused, as lender of last resort, to lend to Northern Rock. This was because it contradicted the Bank's practice that financial institutions engaged in high risk activity should not be bailed out: it would only encourage others to follow suit in similar high risk strategies—the so-called "moral hazard" argument.

On September 12, the Governor of the Bank of England, Mervyn King, wrote to the Treasury Select Committee criticising some banks for their lending and borrowing decisions and, by implication, criticising support from other central banks since it would "sow the seeds of a future financial crisis". Rescues would only be organised when there was a threat to the entire financial system.

Just two days later on September 14, as depositors were queuing up to withdraw their money, King reversed his position. He stepped in to provide short-term emergency credit at what are believed to be penal rates of interest, several percentage points above the normal rate.

His U-turn could only mean that the UK's financial system was indeed in peril. So, far from reassuring depositors, the Bank's action only confirmed the public's lack of confidence.

Their distrust was entirely justified. The penal rates of interest, about 7 percent, meant that Northern Rock was unviable. Should it close its doors, its depositors would take second place to the institutional creditors. Under the official Financial Services Compensation Scheme, only the first £35,000 is covered and only up to 90 percent of that.

As the implications sank in, shares in other major mortgage lenders fell precipitously. When the queues of depositors waiting to pull out their money did not abate, the Treasury was forced to guarantee retail (small depositors) *and* wholesale deposits (commercial loans from other banks) in order to reassure the institutional creditors and restore inter-bank lending, which had all but dried up.

None of this was enough. On October 9, the Treasury extended its guarantee to new deposits made after September 13, to attempt to reassure prospective savers. Without new deposits, Northern Rock would become unviable as a "going concern" and thus unsaleable, leaving the Treasury as the *de facto* owner.

That was not enough either. Two days later, the Treasury said it would continue its guarantees until February by which time it hopes to have found a buyer. The February date is crucial as, after six months, the government would have to withdraw its support for Northern Rock or fall foul of the European Union's rules on State Aid. Public support beyond a six month period amounts to "rescue aid" and is outlawed.

The Bank of England has been lending Northern Rock at least £2 billion a week and the amount has been rising. In other words, the bank needs ever more funds each week, not less. With no end in sight, the Bank of England has now lent a massive £16 billion, a sum unprecedented in the history of UK government bailouts.

Furthermore, it has reduced the terms of its emergency lending conditions and is now prepared to accept Northern Rock's high-risk, sub-prime loans as collateral, all the rest of its more secure loan portfolio being already pledged.

The Treasury has said that should Northern Rock fail to repay the Bank, then it—for which read the British taxpayers—will make good the Bank's losses. This comes on top of Chancellor of the Exchequer Alistair Darling's previous announcement that the government would introduce legislation raising the maximum amount of deposit that was fully insured to £100,000 in order to reassure savers.

The Treasury also announced that it would extend its guarantees for Northern Rock's depositors, at a potential cost that is now believed to be *£24 billion*, until next February, by which time it hopes to have found a buyer for the bank, to "promote financial stability" and protect consumers and taxpayers.

Just to put this in context, £24 billion guarantees are more than the government's entire annual transport budget. With small savings believed to be worth £2 billion, this means that the Treasury is guaranteeing £22 billion worth of loans from Northern Rock's senior creditors—the financial institutions.

The Bank of England does not have the reserves to cover its position and the government has itself had to step in as ultimate guarantor to prevent a further run on the bank and a broader banking collapse. But Northern Rock has £14 billion debt due in the second half of next year and £30 billion in the following 12 months.

Taken together, this means that the government has pledged at least £40 billion pounds of taxpayers' money—and this sum is rising daily. It is far higher than the failed £3 billion rescue operation that the Conservative government mounted to prop up the pound when sterling fell out of the Exchange Rate Mechanism in September 1992.

This is both a major financial crisis and a political crisis for the Labour government. It was, after all, the prime minister, Gordon Brown who as chancellor for the last 10 years did more than anyone to promote the City of London as an international financial centre and so enrich the financial elite.

Now the chickens are coming home to roost.

All this time, Northern Rock has continued to trade its shares—now worth one-third of their pre-crisis value—on the London Stock Market. The government has worked to ensure such an outcome, so as not to upset the markets. As a *Financial Times* columnist was moved to ask: is there a case for the Financial Services Authority to investigate the government for creating a false market in Northern Rock's shares?

Northern Rock's directors have received more than £30 million in salaries, bonuses and share options in the last five years, more than a third of which went to Adam Applegarth, Northern Rock's CEO, whose take home pay last year was £1.6 million. They have remained in office throughout the crisis.

When giving evidence last week to the Treasury Select Committee, Applegarth and his co-directors refused to accept any responsibility for the crisis. He insisted that Northern Rock had a good business model, although it had never been tested for "stress conditions". Top management could not be blamed for having failed to have prepared for "unforeseen events" such as that credit crunch and the lack of inter-bank lending. Blame lay with the Bank of England which had refused to provide a two year £30 billion loan without a penalty rate of interest to a potential bidder for Northern Rock before its plight became public knowledge.

While there are apparently several private equity funds, but significantly no banks, interested in taking over Northern Rock, it is far from clear that any takeover will go ahead. Northern Rock can only be a viable concern if there is a cut in interest rates and the cost of its loans falls below the 6 percent yield on its lending, hence the Treasury's guarantees to encourage deposits.

Otherwise, the bank will have to close itself to new business and put its mortgage book into run off, leaving the Treasury to pick up the tab. At the very least, any prospective bidder will seek to take advantage of a desperate government anxious to offload this all-but-nationalised bank. And it will need government help to refinance the bank.

Even if a deal is negotiated, that may not be the end of the matter, as a current US experience demonstrates. One of the potential buyers, J C Flowers is currently trying to claim a material adverse change on its $25 billion acquisition last April of Sallie Mae, the US student loans company, to get the price slashed or it might pull out of the deal.