Britain: Northern Rock crisis deepens

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What began as a crisis of liquidity for one bank has become a major political crisis for the British government. The failure of the attempt to bail out Northern Rock has led to serious political recriminations and conflicts among the political and financial elite as the Labour government of Prime Minister Gordon Brown finds itself pouring money into a bottomless pit.

Northern Rock is the UK's eighth largest bank. It has specialised in mortgage lending based on the availability of cheap credit. The credit crunch that followed the collapse of the US sub-prime mortgage market meant that Northern Rock was unable to raise loans. The Bank of England stepped in to provide loans when depositors scrambled to withdraw their money in the first run on a British bank since Overend and Gurney in 1866. Even Wall Street shuddered at the spectacle. The threat of contagion was felt internationally, and the Bank of England was forced to act.

That was in September. Now, three months later, the Bank's action has not only not failed to resolve the crisis, but it has deepened it as it transformed bank deposits into public debt. The obligation shows no sign of lessening. In October, the Bank was lending £2 billion a week to Northern Rock. Its commitment to guarantee the depositors' savings amounted to an estimated £24 billion—the equivalent of the entire annual transport budget.

Even that huge sum has been dwarfed by the Treasury's announcement on Tuesday, December 18, that it will guarantee all wholesale deposits and borrowing that do not require collateral. It is estimated that the government's exposure will increase to £100 billion, three times the annual defence budget or the equivalent of the National Health Service budget. The sum amounts to more than 16 percent of total public spending—all of which has been committed to one bank.

The Treasury's announcement means that the fate of millions of ordinary working people is being pitted directly against the interests of a few wealthy finance capitalists. For this plutocratic layer, even the present credit crisis offers a means of making money. The immediate response of Northern Rock's largest shareholder, the hedge fund SRM, was to increase its stake in the company. Northern Rock shares rose by 2.2 percent on the announcement of extra government funding.

The Treasury's decision follows the attempt by central banks to stimulate the flow of credit by injecting funds into the international market. But tens of billions of dollars and a coordinated cut in interest rates have failed to restore confidence and have only confirmed the seriousness of the crisis facing the international banking system.

What had manifested itself initially as a crisis of liquidity is proving to be something else—a crisis of solvency. In guaranteeing Northern Rock's wholesale debt, the Treasury has tacitly admitted that.

The problem is not a contingent one of liquidity caused by temporary market conditions, but a systemic one of solvency produced by the creation of massive amounts of fictitious capital. Northern Rock was able to maintain its business model because of the development of what has been termed 'the shadow banking system."

"A plethora of opaque institutions and vehicles have sprung up in American and European markets this decade," according to the *Financial Times*, "and they have come to play an important role in providing credit across the financial system." Their dealings never appear on the balance sheets of the "real" banks that use them. The full extent of this system is only becoming apparent now that it is imploding.

In the United States, the shadow banking system may have accounted for half of all new credit created in the last two years. Northern Rock was entirely dependent on the boom in cheap short-term credit that this market produced. The market in Structured Investment Vehicles (SIVs) and Collaterialised Debt Obligations (CDOs), in which the shadow banking system deals, is closely linked to the hedge funds that provide the equity that underpins the system. Both the hedge funds and the shadow banking vehicles rely on highly geared ratios of debt.

In one case "just $10m of real, unlevered hedge fund money supports an $850m mortgage-backed deal." Satyajit Das, expert in derivatives, told the *Financial Times*, "This means $1 of real money is being used to create $85 of mortgage lending—credit creation far beyond the wildest dreams of high-street bankers."

As investors withdraw their money from this shadow banking sector, something like a super-bank run is taking place. But it is not one that produces television footage like that at Northern Rock. The SIV sector is thought to have seen its value shrink by US$150 billion this year from its peak of US$400 billion with another US$400 billion lost from the CDOs. What has been termed the "Vehicular Finance Sector" is running into a multi-vehicle smash.

The pile-up leads back to the major banks, which are ultimately responsible for lines of credit they never thought they would have to realise. Nor do they have the assets to do so. Banks used to have the capital to cover their liabilities. But regulatory reform has allowed them to package their loans into bonds, which they have sold to other institutions. It is this process that lies behind the ballooning of credit in recent years.

Northern Rock created SIVs through what was supposedly a charity. It raised £71 billion through a trust called Granite, registered on the Channel Island tax-haven of Jersey. The trust's prospectus says that profits "will be paid for the benefit of the Down's Syndrome North East Association (UK) and for other charitable purposes." However, the small charity Down's Syndrome North East knew nothing about the trust and has so far received no donations.

Remarkably, this practice is entirely legal. Investigations by the *Guardian* have revealed that the business model employed by Northern Rock is far from unusual. Other major British banks have adopted the same strategy of bundling mortgages together and then using the package to raise loans through off-balance sheet trusts with charitable status. The trusts are not obliged to (and in practice rarely do) give anything to charity.

Twelve major banks have used the same technique to raise money on £234 billion of home loans. So complex is the structure created by this method that the full liabilities of the banks are unknown. In the case of Northern Rock, the £30 billion lent by the government may not be actually covered by the value of the home mortgages on their books.

Even if £30 billion is an accurate figure, it was based on the inflated house prices of recent years. House prices are now falling, and since Northern Rock often lent 90 percent or more of property value, it will not be long before the asset value no longer covers the Bank of England loan.

The Treasury stressed that its wholesale debt guarantee does not underwrite the liabilities of Granite. But it is difficult to see how the government can protect itself from this largely hidden mountain of debt. Nobody knows just how highly geared Northern Rock's vehicular investment may be.

The government's aim in guaranteeing Northern Rock's wholesale debt was to make the company more attractive to a buyer. Two potential buyers exist—the Virgin group of Richard Branson and Olivant, a private equity company—but neither has been able to raise the finance necessary. No bank is willing to underwrite such a large deal and agree to repay the massive Bank of England loan when the credit markets are frozen. The result is that the government has been forced to make even more money available in an attempt to sugar the pill.

It is increasingly being recognised that the only alternative the government has is to nationalise Northern Rock. The government is said to have already drawn up proposals to do so.

Even so, significant interests remain wary of nationalisation. Robert Parker, head of asset management at Credit Suisse, assured the BBC that the Treasury guarantee does not make nationalisation more likely. The government is gambling that the central banks' injection of funds into the international credit markets will eventually pay off in the New Year and allow a buyer to raise sufficient money. It will then avoid having to make a policy u-turn. But that scenario is looking increasingly unlikely.

Vince Cable, the caretaker leader of the Liberal Democrats, is one of the strongest advocates of nationalisation. He has been highly critical of the government. It "now seems to have got the worst of all possible worlds," he told the BBC on Tuesday. "It's effectively nationalised the liabilities of the bank while at the same time it doesn't control it—it doesn't own it, and if it is sold then all of the upside—all of the capital gains—will accrue to speculative investors and not to the taxpayers."

The only practical option, Cable argues, is for the government to take Northern Rock over in the short term and sell it when market conditions improve. A broad consensus of opinion seems to favour that option. The *Guardian* and the *Financial Times* have both argued for nationalisation. They point to the precedent of the Long Term Credit Bank in Japan, which was nationalised in 1998 and then sold to a US private equity firm. The Bank of England stepped in to rescue the National Mortgage Bank in 1994, and the US government effectively nationalised Continental Illinois before selling it.

Even the shadow Chancellor, George Osborne, has called for "the authorities to intervene and seize control of a financial institution when it is close to failing." He warned in the *Financial Times* that the damage to the City of London continues every week that the future of Northern Rock hangs in the balance.

"We must stop the ugly sight of shareholders who have come in since September holding the taxpayer to ransom, when those shares would be worthless without the Bank's support," he said.

From a potential Tory Chancellor of the Exchequer this is remarkable language. But it reflects the scale of the crisis and the extent to which existing political formations and their economic programmes have been challenged by the collapse of the credit market.

Brown prides himself on having engineered the longest period of sustained economic growth since records began. He has been thrown into a political crisis by the sea-change that is taken place. His whole political perspective is based on the period of credit-fuelled economic growth. The credit crunch has destroyed the illusion of his financial competence and left his government seemingly paralysed.

Powerful figures are concerned at this situation. Rupert Murdoch's economic adviser, Irwin Stelzer, took the unusual step of using the front page of the *Times* to attack Brown's government at the weekend. Stelzer reports a Bank of England senior official saying that Gordon Brown and Chancellor Alistair Darling are now "unable to focus because morale throughout the government is so low."

For a government that has relied on Murdoch's approval since the Blair administration came to power in 1997, Stelzer's very public criticism is devastating. Murdoch wields this kind of power because he speaks, not just for himself and his media empire, but for the financial oligarchy on which the Labour government relies and to which it answers. The plutocratic elite want decisive action, even nationalisation, provided it is envisaged as a temporary measure and the prelude to selling Northern Rock back into the market once conditions allow.

In reality, there is no guarantee of any future recovery in the financial sector, but quite the reverse. Most analysts are predicting a major economic downturn in the New Year, in Britain and internationally. Nationalising Northern Rock under these conditions will have an "upside" only as far as its major investors are concerned, with the state paying them billions for shares that are worthless.

Ever since Labour came to power in 1997, it has set its face against nationalisations and has been committed to privatisation of public assets. For it to be forced to resort to such a measure—and to do so only in order to guarantee the investments of the supposedly superior private sector finance institutions—is more than merely an exposure of its free-market propaganda. It will be a grotesque example of its continued readiness to pick the pockets of working people in order to feather the nests of the major corporations and banks.