

# UK government nationalises Northern Rock

Ann Talbot  
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The nationalisation of Northern Rock, the UK bank that ran into trouble last September as the credit crunch began to bite, was characterised in a *Guardian* lead article as “a shaming moment for a government that has struggled for six months to fend off the inevitable.”

From a newspaper that has been one of the Labour government’s staunchest supporters this is a serious criticism. The article went on: “Labour’s reputation for economic competence, the bedrock of success in three elections, has cracked if not shattered.”

Goldman Sachs, the global investment banking and securities firm the government hired to advise it on Northern Rock, passed an even harsher judgement. The whole affair, Goldman Sachs warned, has tarnished the reputation of the City of London as a centre of international finance capital.

The damage comes not just from the act of nationalisation, but from the prevarication and delay that preceded it and which have created an air of ineptitude and incompetence that the City cannot tolerate in a period of global crisis.

Goldman Sachs is said to have warned the government at an early stage that it would prove very difficult to achieve a private sale of Northern Rock and that nationalisation would be necessary.

This solution was politically unacceptable to Prime Minister Gordon Brown. Labour set its face against nationalisation even before it came to power in 1997. Once in power it has continued the policy of privatisation that the Conservative government of Margaret Thatcher began in the 1980s. When industries failed the Labour government refused to consider nationalisation, even though in the past both Labour and Tory governments have resorted to it.

As the news was announced, the value of the pound fell against the euro and the dollar. The government’s inability to find a private buyer was taken as an indication of the general state of health in the financial sector. It has highlighted fears that the UK economy as a whole is too dependent on the financial services sector and will inevitably suffer heavily from the global financial crisis.

Chancellor Alistair Darling could not bring himself to use the word “nationalisation”, even when he announced the plan. Instead he referred to “a temporary period of public ownership.”

Darling stressed that the intention of the government was to return the bank as quickly as possible to the private sector. This would be done as soon as market conditions allowed, he insisted. In an attempt to avoid a repeat of the scenes of desperate depositors queuing to withdraw their money, he emphasised that it would be business as usual on Monday morning.

But Darling’s anodyne words could not cover up the air of panic in which the decision was taken on a Sunday afternoon, with private bidders still attempting to negotiate a sale. The government was playing what the *Financial Times* referred to as “high stakes poker” with Richard Branson’s Virgin Group up until the last minute. When

Branson proved unable to raise his bid, the government had no option but to nationalise.

The failure followed an extraordinary attempt to raise money by creating special government-backed bonds. Branson even accompanied Brown on his recent trip to China touting for investment, but without success.

A swarm of predators were attracted by the government’s hesitation over Northern Rock. As the government continued to insist that the company was still viable, hedge funds moved in to profiteer from the crisis. RAB Capital and SRM Global seized a controlling interest in Northern Rock as the company foundered. QVT Financial won a smaller share of the company. Now that nationalisation has taken place, they intend to pursue the government through the courts. Northern Rock shares closed at £0.90 on Friday but the hedge funds are demanding compensation at the rate of £4.25 per share.

Other hedge funds, such as Landsdowne Partners, pursued a different strategy. They have already made profits out of the Northern Rock crisis by short selling the company’s shares—that is to say betting that the price of Northern Rock shares would fall. One trader alone is estimated to have made £1 million out of selling Northern Rock shares short.

In a sense, the decision to nationalise was no more than a formalisation of the de facto situation. If the government had not stepped in to support Northern Rock last year it would have collapsed. The bank was already nationalised in all but name. Many financial commentators have recognized this.

Writing in the Lombard column of the *Financial Times*, Andrew Hill attempted to allay fears for the reputation of the City. “Wall Street, Paris and Frankfurt would,” he said, “be unwise to cast stones at the UK ... their own financial glasshouses are looking far more fragile.”

Hill pointed out that the German government has just bailed out IKB, France has its own troubles with Société Générale and the US government is struggling with the subprime crisis.

The *Financial Times* editorial admitted that “Nationalisation was never an attractive option; it was the least bad of the limited options available.” It concluded that “anybody who suggests that the Labour government has gone back to 1970s socialism deserves ridicule. It has made a sensible, hard-headed, non-ideological choice.”

Yet the damage is very real. The government has lost a major plank of its policy. Comparisons can be made with the experience of the Tory government on Black Wednesday when the pound was forced out of the European Exchange Rate Mechanism.

The fact that the government of every major country is struggling with some form of financial crisis does nothing to lessen the significance of the collapse of Northern Rock. It serves to underline the inability of the UK government to deal with the turbulence that has engulfed the world economy.

The government itself tacitly admitted the scale of the crisis in the emergency legislation that it introduced into the House of Commons to allow the nationalisation to take place. By the end of the week the government will have powers to nationalise any deposit taking financial institution which needs assistance from the Bank of England as the lender of last resort.

Faced with what experts have characterised as a breakdown in the world banking system, any bank or building society may find itself in that position in the not too distant future. A number of other mortgage banks like Northern Rock are already being named as likely candidates. Even the major clearing banks are at risk. Barclays recently increased its dividend payout after making only a small write-off to cover its exposure to the US subprime crisis. But its share prices immediately fell. Over the last year, Barclays' share prices have fallen by 40 percent, reducing the value of the company by £20 billion. Hedge funds are actively betting that a black hole will emerge in Barclays' finances.

The clear implication of the government's decision to arm itself with general powers is that they do not expect Northern Rock to be the last financial institution to face collapse.

In such unsettled market conditions, it has become impossible for the Labour government to maintain the relationship that it has previously enjoyed with the financial elite who have made London their home and base of operations. The *Financial Times* had already warned Brown that he must "rekindle Labour's love of the filthy rich."

Darling was jeered when he addressed bankers at a formal dinner in the City recently. When added to the row over Labour's plans to tax wealthy non-domiciled foreigners and to raise capital gains tax—both of which it summarily abandoned—the nationalisation of Northern Rock has strained the government's relationship with what has been its social base over the last decade.

What emerges clearly from the Northern Rock affair is that Brown and Darling were willing to sacrifice the interests of ordinary working people in their attempt to prop up the financial system. They have put at risk billions of pounds of public money. They are committed to Northern Rock through loans and guarantees to the tune of £110 billion. That is a sum equivalent to the annual budget of the National Health Service.

Their commitment to Northern Rock has pushed the government borrowing requirement over its 40 percent target. That money must be clawed back from public spending. Social security, education and health spending will all suffer as a result of the government's desperate bid to preserve its reputation as a business-friendly administration.

Now that Labour has nationalised Northern Rock, moreover, it will be responsible for cutting jobs—3,000 jobs are expected to go immediately—and foreclosing on families who default on their mortgages. Gordon Brown expressed the hope that Northern Rock would become a profitable financial institution. In an environment of falling house prices and tight credit, that can only be achieved by the most ruthless business practices.

Ron Sandler, who has been appointed chief executive to run the nationalised bank, expressed his intention to "return the bank to a more sustainable size." His remark was an indication that branches will close and head office staff will be cut in Newcastle, which is one of the most deprived areas of England.

Government ministers are quick to point out that the loans and guarantees they have extended to Northern Rock are supported by the

assets of the company in the form of its mortgages. But it emerged in the course of the debate on nationalisation that Northern Rock's offshore trust, Granite, is not to be included in the government takeover. There is a suggestion that the best mortgage assets now belong to Granite and that the government is effectively nationalising "rubbish" mortgages.

City experts on securitisation—the process by which mortgages are turned into bonds—admitted that Granite would need to be fed with more mortgages to keep going. Ron Sandler may refuse to do this. Granite should then simply wind down, but the area remains one of uncertainty and may yet expose the government to further liabilities.

Northern Rock was among the most reckless lenders during the housing price bubble. The creation of Granite, which is a charitable trust although it has never given a penny to charity, was one of the ways in which it financed its expansion. The quality of its mortgage book is open to question. Even if all its mortgages were sound when they were issued they may not withstand a recession. If unemployment and interest rates were to rise, the bank, and now the government, would be faced with massive default.

Such a scenario is far from impossible. US banks have been borrowing huge amounts of money over the past few weeks from the US Federal Reserve's Term Auction Facility that was established in December. One analyst suggests that the banks are off loading "garbage collateral" on to the Federal Reserve. Christopher Wood of CLSA told the *Financial Times*, it "suggests a perilous condition for America's banking system."

*Financial Times* columnist Martin Wolf is predicting "the mother of all meltdowns" for the US economy. He cites Nouriel Roubini of New York University's Stern School of Business, founder of RGE monitor. Roubini predicts "a rising probability of a 'catastrophic' financial and economic outcome."

The scale of the recession that Roubini anticipates in the US would make it impossible for the UK economy, or any other, to decouple. It would have a global and inescapable impact. Under those circumstances, just as Northern Rock was brought down by the first wave of the crisis associated with the US subprime market, so the UK government would find itself picking up the pieces left by the second wave.

The scale of the government's commitment to Northern Rock would be dwarfed by its attempts to stem the collapse of other, bigger banks. The £110 billion would look almost insignificant.



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