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NORTHERN ROCK: THE CRISIS OF A UK MORTGAGE LENDER

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Abstract

The global market liquidity squeeze for securities that initiated in 2007 has increased pressure among banks to sell, pushed down prices, and impacted the market for interbank loans, leading to a funding gap at Northern Rock, Britain's fifth largest mortgage bank. This paper presents an analysis of the events that lead to the collapse of Northern Rock in the second half of 2007 and its rescue by the UK Government towards the end of the same year and the beginning of 2008. The paper presents the implications and banking reforms proposed by the UK financial authorities.

Key words: mortgage bank; market liquidity; banking reforms; financial authorities; financial crisis

JEL classification: G14; G21; G33

Introduction

"The period between 14-17 September 2007 experienced the first run on the retail deposits of a UK bank since Victorian times" (UK Treasury Committee). This was related to the funding difficulties faced by Northern Rock plc (NR). Its reliance on wholesale market funding, identified by the Treasury Select Committee as the primary cause of its difficulties, led it to seek emergency liquidity assistance from the Bank of England (BoE) in September 2007, when it became unable to secure sufficient funding from the wholesale markets. Publicity about the position of the firm precipitated a sudden withdrawal of funds by retail customers. Since then, the authorities have put in place funding arrangements to enable the firm to take strategic decisions about its future.

In January 2008 the UK Treasury Committee published a report entitled "The Run on the Rock" examining what caused the run on the bank, the consequences for NR and the wider financial stability, the way the events were handled by public authorities and the lessons to be learned. The report called for large-scale reforms to the way the tripartite regulatory system – the Treasury, the Financial Services Authority (FSA) and the BoE – operates, and argues that complacency, lack of communication and clumsy decision-making between the three bodies made a bad situation worse. The report, following several months of inquiries, is the most comprehensive assessment yet of the lessons to be learnt from the

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near collapse of NR last September. The FSA has also instigated an internal review (due to report in March 2008) into the lessons of the events surrounding NR in 2007, and what changes these suggest for the FSA's risk assessment and risk mitigation practices in general.

Summary of causes

The failure of NR, while a failure of its own Board, was also a failure of its regulators.

Causes related to Northern Rock: The directors of NR were the main creators of the difficulties faced by the company since August 2007. They pursued a reckless business model that was excessively reliant on wholesale funding.

Causes related to the FSA: FSA did not supervise NR properly. It failed in its regulatory duty to avoid a systemic risk. It did not allocate sufficient resources or time to monitoring a bank whose business model was clearly an outlier. Its procedures were inadequate to supervise a bank whose business grew so rapidly.

Causes related to the Tripartite system: the Tripartite authorities did not prepare adequately for the systemic risk support operation. The Tripartite arrangements lack a clear leadership structure or a strategy for effective communication with the public[1].

Background on Northern Rock

Northern Rock plc was - until its collapse - one of twoFinancial Times Stock Exchange (FTSE) 100 headquartered in the North Eastern part of England, creating economic opportunities for the region.

NR was formerly a building society which demutualised on 1 October 1997. Between 1997 and the end of 2006, its consolidated balance sheet had grown more than six-fold, reaching an asset value of £101 billion. The assets were comprised mainly on secured lending on residential properties.

In 1997, at the time of its demutualisation, NR set up the NR Foundation, to which it paid out 5% of its pre-tax profits; according to NR 2006 Annual Report, since 1997 the Foundation received £175 million from NR Plc. The importance of the Foundation is reflected in the fact that, should NR be taken over, it would have 15% of the share capital.

The shareholder base of NR reflects its demutualisation. A significant number of its employees were also represented in the shareholder base (75% according to the company).

NR described itself as a "specialised lender, whose core business is the provision of UK residential mortgages funded in both retail and wholesale markets". As at end of 2006, 89.2% of its assets were residential mortgages.

<u>Northern Rock Assets</u>. According to NR: the analysis taken as part of the Basel II process had shown that NR's lending in the 18 months prior to August 2007 was better quality than the previous two or three years. The Bank of England was also supportive of the

[1] The roles of the Tripartite authorities as set out in the Memorandum of Understanding signed in 1997 and updated in 2006 are based on four principles: 1) clear accountability – each authority must be accountable for its actions, so each must have unambiguous and well-defined responsibilities; 2) transparency – Parliament, markets and public must know who is responsible for what; 3) avoidance and duplication – each authority must have a clearly defined role; 4) regular information exchange – helps each authority to discharge its responsibilities efficiently.

quality of the asset book. While introducing subprime borrowers to a third party, NR did not hold such subprime loans on its balance sheet.

Northern Rock Liabilities. In order to achieve this level of growth in assets, the company changed the structure of its liabilities. NR had adopted an “originate-to-distribute” model[2] of funding and began to borrow money from the wholesale markets, parceling up mortgages and using them as collateral for further funds, a process known as “securitisation”. Thus a new entity was created called Granite, which was their securitisation vehicle. FSA stated that the entity was functioning normally. The overall funding of NR was comprised of: 50% securitisation with an average life of 3 ½ years; 10% was covered bonds with an average life of about 7 years; 25% wholesale borrowings, from which half had a duration no longer than one year and the other half less than one year. While the wholesale funding of NR grew, there was no corresponding growth in its retail funding. Retail deposits and funds fell significantly comparing to other banks that were previously building societies: from 62.7% at end-1997 to 22.4% at end-2006.

The events of 2007: August crisis

NR expanded its mortgage lending facilities in the first half of 2007, with a net increase of £10.7 billion. NR denied that this was a departure from the trend of the preceding decade.

In March the company picked up the warning signs that the US subprime position led to a tightening in pricing and therefore it slowed down its rate of growth.

In April the BoE identified the increasing wholesale funding of banks as a potential risk if markets became less liquid.

In May a review of NR’s stress-testing was undertaken as part of its Basel II waiver programme. This review led to the conclusion in July that the FSA was not comfortable with NR’s test scenarios.

In June the FSA approved NR’s application for a Basel II waiver[3]. This lead to an announcement by NR of an increase in its interim dividend of 30.3%

The company started to obtain retail funding from Denmark besides the UK retail market, and increased its liquidity at half-year stage.

On 9 August NR noted a dislocation in the market for its funding, due to the global financial shock with the US subprime mortgage market at its centre. This surprised the company, which believed that “high-quality assets and transparency was the way to maintain liquidity”; it also did not foresee all its funding markets closing simultaneously, as it happened after 9 August.

[2] Most banks made a transition from the ‘originate-to-hold’ model to ‘originate-to-distribute’ model, where banks no longer hold loans to maturity but instead sell on loans to investors. This shift has been stimulated by the rapid innovation in financial instruments, in particular with regards to the interaction of the credit derivatives markets with the rapid growth of securitisation technology. The originate-to-distribute model has several consequences on the financial market, in particular related to the way financial institutions manage their risk exposures. Risks are more widely distributed outside the banking system, they are more transparent and there are more tools to manage risk concentration. As a result, deteriorating credit exposures can be managed more actively at an earlier stage. The new model also raises new risks for banks.

[3] When adopting the Basel requirements for capital adequacy, a bank may choose to adopt certain “advanced approaches” to their management of credit risk.

NR continued to find some funding. It stated that the company had "two or three months' worth of liquidity"; until it fell into a retail run which reduced its liquidity. This situation led to the necessity to receive funding support from the BoE. NR became reliant on exceptional, state-backed financing.

During these months, several directors announced resignation or retirement.

Throughout the first half of the year, before the financial market crisis hit, NR's share price had been in steep decline.

The rescue of NR (August 2007 – February 2008)

NR and the Tripartite authorities pursued a three-fold strategy to salvage NR from its difficulties. There was considerable overlap between consideration of the several options, which are described below.

- Resolving its liquidity crisis through its own actions in short-term money markets and by securitising its debt; this option was pursued until abandoned on 10 September.
- Obtaining the "safe haven" of a takeover by a major retail bank. The search for a private buyer started on 16 August and continued until 16 September. Two institutions showed interest in acquiring NR: one only showed a slight interest without pursuing it; the other interest was showed by a high street retail bank, however no offer was made. There was conflicting evidence from NR and the Tripartite over the details of the support facility requested by the potential bidder, which inhibited the solution.
- Receiving a support facility from the BoE guaranteed by the Government; this possibility was raised on 16 August.
- Possibility for NR to access European Central Bank (ECB) funding, taking advantage of its collateral requirements, more generous than BoE's, and its willingness to adjust the timing of its credit supply. NR could have made use of this liquidity via its operation in Ireland. NR did not however recur to this solution due to length of time necessary to set up the legal process to provide the collateral through the Irish branch[4].
- A fifth solution was the one preferred by the BoE: a covert support operation; this was abandoned on 11 September. There were two obstacles to such an operation: the requirement for NR to make an announcement to the stock market about their situation (according to the Market Abuse Directive (MAD)) and the practical difficulties associated with the possibility of a leak of a covert operation. [5]

On 13 September rumours in the market started in relation to BoE's proposed support operation. NR hoped to use the facility as a "backstop" and had hopes that the facility would not be drawn down; in reality, because of the loss of retail deposits, NR was forced to use the facility almost as soon as it became available.

[4] Although banks are regulated and supervised at the national level, many banks conduct their business across borders and many have access to the credit supplied by more than one central bank. A bank is able to gain access to central bank funding in any country where they operate. For example, a UK-registered bank with operations in the euro area is able to access ECB funding throughout the crisis, taking advantage of its credit supply. However, such operations would neither be conducted in sterling, nor accept sterling-denominated collateral, which is a significant obstacle to UK banks extending their use of these facilities.

[5] Covert support operations only appear to be permitted under the MAD in instances when the issuer can be assured of confidentiality.

The run on the deposits of NR took place between 14 September and 17 September and was the central element in the problem that NR faced subsequently. This gathered momentum in part because of the difficulties encountered by NR customers in seeking to withdraw their money.

On 17 September the BoE made the announcement that it would guarantee NR's deposits, which halted the momentum of the run. This was the initial Government guarantee and was referred to all the existing deposits in NR; subsequently, this was extended to cover accounts re-opened in the future by those who closed them in the days of crisis; the guarantee was further extended to all deposits made with NR since 19 September.

On 9 October the BoE announced that additional facilities would be available to NR, which were intended to enable NR to pursue its strategy options and were limited to the period needed to pursue such options, by February 2008. These facilities were different from the earlier ones, as being from the Government through the BoE, with the risk born entirely by the Government. These were secured against collateral.

On 18 December the Government granted a further extension of the earlier guarantee arrangements at the request of NR, which covered nearly all the wholesale deposits.

In the period September – November 2007, NR searched for a private sector takeover solution to its difficulties. The proposals already received were of two types: 1) proposals to invest in the company through an injection of assets as well as new capital; 2) proposals to acquire parts of the business or assets of the company. On 12 October Virgin Group submitted a non-binding indication of interest to the NR; on 12 November Olivant Advisors Ltd indicated that it was preparing a bid. Small shareholders' groups, and many individually, were hostile to the first option of the takeover, fearing shareholders will see their stakes diluted for Virgin's gain; the Olivant bid was much more strongly favoured.

Another potential route for saving the bank was its nationalisation, which would pass many of NR activities to other institutions in the public sector and would see a new management team and a new ownership.

NR's nationalisation was announced on 17 February 2008. The Treasury acquired all of the bank's shares in Northern Rock. This represents the first nationalisation of a sizeable British bank in a quarter of a century. It put NR into public ownership, which infuriated shareholders and stopped the two private bidders from taking over the mortgage lender.

At the end of March 2008, NR reported a loss for the last year that reflected the interest payments to the BoE for the emergency loans, as well as writedowns and fees to advisors incurred before the nationalisation. Nevertheless, the FSA stated that the bank had a good mortgage book.

Board's responsibilities

Since the beginning of 2005 banks have been required to undertake stress testing and scenario analysis, to have in place contingency funding plans and to document them adequately. Under Pillar 2 of Basel II banks are required to assess regularly and regulators to review their liquidity funding plan in a stressed situation. Regulators have the right policy tools to quiz banks about their stressed liquidity plans.

The Board has the responsibility to run the company prudently; the stress test scenarios are designed by the Board (not by the FSA).

The Board acknowledged that the company's funding strategy had been looked at and discussed by the Board. Part of the liquidity strategy was conducted by the Risk Committee chaired by a non-executive of the Board.

NR took advice from the FSA, the UK Listing Authority and its own legal advisors, and stated that it was fully satisfied that they followed the best advice.

Central Banks actions

The BoE, the ECB and the US Federal Reserve (FED) each pursued a different course of action in response to the money market turmoil in August 2007.

The BoE was the only one that did not take contingency measures in August in order to protect against moral hazard – the fear that an injection of liquidity would offer incentives for banks to take on more liquidity risk.

The BoE injected additional liquidity into the money markets in September, when the ECB and Fed did not. In December 2007 the BoE started its three-month lending against mortgage-backed securities; in April it introduced a "special liquidity scheme", by offering to swap 'difficult-to-sell' mortgage-backed assets for Treasury bills, making the liquidity scheme twice as big as the existing December scheme.

It cannot be assessed whether an open market liquidity operation of the kind asked for by a number of banks in August would have prevented NR's need for emergency support from the BoE in September. The BoE liquidity support facility for NR was formally announced on 14 September 2007.

The ECB attached less weight to the moral hazard argument. It adopted a proactive approach in resolving the problem of a lack of confidence in the banking system by satisfying the immediate liquidity demands of the Eurozone banking sector. Although it did not inject any additional liquidity in August, it altered the timing and term profile of its regular operations, front-loading its credit supply towards the start of August and draining this liquidity before the end of the maintenance period.

The acceptance by the BoE and the ECB of a wide range of collateral, including relatively illiquid assets, assisted European banks throughout the crisis.

The environment is prone to stigmatisation – whereby financial institutions do not approach the central bank for assistance for fear of being regarded as weak by the public is a problem in money markets across the world, including the UK.

Accusations to Northern Rock

The BoE raised the issue of NR's lack of insurance against the trouble it faced in August. The BoE also stated that it was the business strategy that was fatally flawed as once the markets were closed for mortgage-backed securities, NR was unable to finance its illiquid assets. The company became dependent on liquidity support from the BoE.

According to the FSA, the failure of NR should first and foremost be attributed to the failure of its board and executives to create a durable funding model which could withstand the exceptional set of market circumstances that occurred in summer 2007.

The directors of NR were the main creators of the difficulties faced by the company since August 2007. The failure of the strategy is attributed to the Board. They pursued a high-risk, reckless business strategy, with reliance on short- and medium term wholesale funding, with insufficient insurance and a failure to arrange a standby facility or cover that risk.

The formulation of strategy, which was a fundamental role of the Board, was overseen by some directors, regardless of the fact that they had the NR experience since demutualisation.

The non-executive directors – in particular the Chairman of the Board, the Chairman of the Risk Committee and the senior non-executive director – failed to ensure that the company remained liquid as well as solvent, to provide against the risks that it was taking and to act as an effective restraining force on the strategy of the executive members.

There are concerns that the CEO was not a qualified banker, although he did have experience.

Accusations to supervisory authorities / Failure of regulation

Although the FSA undertook greater "regulatory engagement" after acknowledging the signals about the risks associated with NR's business model, this approach failed to tackle the fundamental weakness in its funding model and did nothing to prevent the problems occurred from August 2007 onwards.

The FSA acknowledged that its supervision of NR in the period leading up to July 2007 was not of sufficient intensity or appropriate rigour to challenge the company's board and executives on their risk management practices and their understanding of the risks posed by their business model.

While the problems affecting NR were those of liquidity and funding rather than solvency, the FSA's concerns were focused on capital adequacy and solvency issues, rather than on liquidity issues. The UK regulatory regime for liquidity of banks is flawed. This regime did not prevent the problems that arose at NR.

Although NR's problems were ones of liquidity, it was wrong of the FSA to allow the company to weaken its balance sheet at a time when the FSA was itself concerned about problems of liquidity that could affect the financial sector.

If the FSA was unsatisfied with the stress testing conducted by NR, it appears to have failed to convey its concerns to the Board of NR and to secure remedial action.

The FSA should not have allowed two appointments of a Chairman and a Chief Executive to a "high-impact" financial institution where both candidates lack relevant financial qualifications.

The BoE took no contingency measures at all during August 2007 in order to protect against moral hazard. The BoE should have adopted a more proactive response to the liquidity crisis and consider injecting liquidity in due time.

Although it was considered that the BoE took a reasonable cautious stance regarding collateral, it should have broadened the range of acceptable collateral at an earlier stage in the turmoil.

The questionable BoE's system of voluntary reserves: banks are able to choose their reserve requirement for each maintenance period[6].

[6] A distinctive feature of the UK system is that, each month, banks choose the level of reserves they wish to target over the 'maintenance period' between meetings of the Monetary Policy Committee. Banks can therefore access more central bank money by, in aggregate, setting themselves higher targets.

The possibilities for a covert support operation should have been properly considered in due time.

The Tripartite authorities and NR should have pushed and announced the support operation within hours rather than days of the decision to proceed with it. A swift announcement would have been assisted by early preparation of such an announcement. The delay prolonged the run on NR deposits and damaged the company.

The Tripartite communication strategy with the public and the markets for handling the 2007 crisis was weak.

Although legislation had been in preparation before the crisis hit, the preparation process was not well-advanced. This refers to the legislative framework for financial stability and crisis management.

Proposals for UK reforms

Although there are concerns over the operation of the Tripartite system, its dismantle is not what is desired, but its reforming with clearer leadership and stronger powers. The Governor of the Bank of England described the UK's system for dealing with bank insolvency (and deposit insurance) as "markedly inferior to other countries" and "inadequate". "We now require a serious reform of deposit insurance, of the administration of banks, of the clash between the wish for transparency of companies to their shareholders, the tension between that and how it applies to banks when in difficulty, and the length of time it takes to deal with transfer of ownership of banks".

Currently, the following reform proposals are being discussed:

- A single authority should be given powers for handling failing banks and this should not be the FSA.
- The BoE is reviewing elements of its money market operations over the following period in consultation with banks, the other Tripartite authorities and other central banks.
- All banks and building societies should be covered by a deposit insurance scheme so that, in cases such as NR or a larger bank, the Government would not be required to step in to protect depositors.
- There should be a requirement in law that all insured deposits should be paid within a few days of a bank failing and calling on the deposit protection scheme.
- Banks should have systems to inform the FSA at "short notice" their liquidity situation.
- The "prompt corrective action" approach adopted in the US and other countries should also be considered by the UK. This enables the relevant authority to rapidly identify banks' situation and immediately take steps to lessen the wider impact of its difficulty.
- Any new legislation must clearly set out any changes to the status of shareholders of banks and members of building societies. In the event of a bank failure, the relevant authority should be endowed with the decision-making powers currently held by the shareholders, whilst protecting those shareholders' financial interest.
- The relevant authority must ensure that information systems and procedures are capable of a speedy release of funds, which is of critical importance.

- FSA should undertake an urgent review of the current qualifications of senior directors in financial firms, especially in those with "high impact" and ensure that the current approved person regime requirements are adequate.
- Reform of the management structure of the BoE[7] is required to ensure that proper weight is given to the increased responsibilities within the management structure, while also maintaining the appropriate priority for the conduct of monetary policy

The FSA will implement a Supervisory Enhancement Programme designed to strengthen its overall supervisory process, due to be completed by December 2008. The programme will be a key component of the authority's three-year plan (2007 – 2010) which, in terms of internal change, has as its primary objective the creation of an effective management, operational and cultural framework to deliver more principles-based regulation.

Further Corporate Governance lessons

Banks should be allowed to fail, to preserve market discipline on financial institutions. However, it is important that such 'failure' is handled in an ordered manner, managed in such a way as to prevent further damage to the economy, the financial system and the interests of small depositors.

A bank's recourse to the Central Bank in its capacity as lender of last resort is not an ideal trigger for prompt corrective action. This option should be approached as a last resort and the relevant authorities must be able to identify a bank as failing prior to this stage.

As the external auditor can only provide an assurance of a snapshot of the past state of the company, accounting bodies should consider what further assurance auditors should give to shareholders in respect of the risk management process of a company. Attention should be given by banking supervisors to the conflicts of interest between the statutory role of the auditor and the other work it undertakes for the financial institution.

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[7] E.g. the creation of a new post of Deputy Governor of the BoE and Head of Financial Stability.