Credit crisis spreads as British bank collapses

By Nick Beams
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The collapse of Northern Rock, Britain's fifth largest mortgage lender, has added a new dimension to the global financial crisis.

The demise of Northern Rock, which had to be rescued on Friday by the Bank of England, was not caused by its overexposure to the US subprime mortgage debt. It was the result of the impact of the credit market freeze on its own financial strategy.

Northern Rock, which was based in Newcastle, was formed out of the amalgamation of two building societies in 1997. It adopted a business model in which its lending for mortgages was not based primarily on the deposits it received, but rather the loans it could raise in the short-term credit market. Three quarters of its funds came from these sources rather than from depositors.

Its strategy was to use funds raised in the money markets to offer cut-rate loans to home-buyers, thereby increasing its market share and boosting profits. Operating on a tight margin between the interest rates at which it borrowed and those at which it lent, it sought to compensate for the narrow spread by a large turnover.

So long as credit was freely available, this strategy brought a measure of success—in the first eight months of this year its lending was 55 percent higher than a year ago. But with the development of a credit market crunch from the beginning of August, its operations began to unravel, forcing the bank to seek a bail-out from the Bank of England.

The move sent shares in the company tumbling and led to a scramble by depositors to withdraw their money as long queues formed outside branch offices around the country. Latest reports indicate that as much as £2 billion may have already been withdrawn with the outflow set to increase this week.

Northern Rock is expected to try to find a buyer this week and attempts will be made to maintain it as a "going concern" under new ownership. But these efforts are being hampered by the continuing turmoil in credit markets. According to a report in today's *Financial Times*, Northern Rock was in discussions with Lloyds TSB last Monday. Negotiations broke down because of concerns about the state of credit markets and the reluctance of the Bank of England to offer financial support for a deal.

The decision by the Bank of England to finance the deal has come under criticism in the financial press because it is seen to be in a direct contradiction to the prescription for sound central bank practice as set out by its governor, Mervyn King. In a message to parliament last Wednesday, King said that financial institutions that engaged in high risk activity should not be bailed out as this penalised those which "sat out the dance". Such actions encouraged "herd behaviour" and only sowed the seeds of future crises. Bailouts should only be organised when there was a threat to the entire financial system.

Critics of the Bank of England's move have argued that this was not the case with the demise of Northern Rock. In their view the company should have been allowed to fail while the interests of depositors would have been covered by the Financial Services Authority (FSA) and the Financial Services Compensation Scheme.

Writing in today's *Financial Times*, two leading academic economists, Professors William Buiter and Anne Sibert, warned that the bailout had damaged the Bank of England's credibility. It should concentrate on providing overall market stability leaving the bailing out of individual banks to the FSA.

Buiter and Sibert claimed the Bank had contributed to the crisis by not taking action to increase liquidity in the interbank lending market that forms the foundation of the credit market as a whole. The loss of liquidity in this vital area is the result of fears among the banks about the problems faced by their borrowers, as well as potential problems on their own investments. Consequently they want large amounts of cash on hand and are reluctant to lend in the three-month credit market, even at rates approaching 7 percent.

Noting that the failure of Northern Rock, only the fifth largest mortgage lender, would not qualify as a “systemically significant event”—thereby justifying a Bank of England bailout—Buiter and Sibert put the rescue operation down to political motivations. The Chancellor, Alistair Darling, wanted to protect depositors and did not want a bank failure on his watch.

No doubt such political calculations played a part. But the actions of the Bank are in such stark contrast to the remarks of the governor only two days before the intervention that other motives suggest themselves.

It may well be the case that the Bank considered that, while the collapse of Northern Rock did not of itself pose a systemic threat, there may have been flow-on effects had it been allowed to go down.

An article in the *Observer* described the Northern Rock rescue as “the most potent symbol of the crisis shaking financial markets.” Northern Rock had never lent to high-risk American home-buyers and its bad debts on British mortgages were close to record lows, yet it required a bailout. What had been “one of the most admired business models in the mortgage market” now looked like an object lesson in the perils of over-ambitious expansion.

Economists in the City of London have warned that a decade of increased borrowing in Britain has left the economy dangerously exposed to a credit crunch. Danny Gabay, the director of a consulting firm, told the *Observer* that the UK economy was “doubly vulnerable” because of its “hugely overextended” consumer sector and 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.”

Jonathan Loynes, an economist at Capital Economic, a consultancy in London, in a comment to the *International Herald Tribune*, noted that unlike European banks, which had been burned because of their exposure to US subprime debt, Northern Rock had only a small proportion of subprime debt in its portfolio.

“The problems are potentially much wider now,” he said. “This means we have to worry about a wider range of institutions that aren’t directly involved in the credit crisis but are in a way innocent bystanders.”

The increase in interest rates sparked by the credit crunch will be passed on to home-buyers, leading to a slowdown in borrowing.

According to BNP Paribas economist Paul Mortimer-Lee: “First-time buyer activity seems pretty certain to show a sharp fall, which, since the whole market rests on the shoulders of the first-time buyer, is like throwing a spanner in the works of the whole market,” he said.

As US Treasury Secretary Hank Paulson holds discussions in London today with Chancellor Darling to discuss the credit crisis, no one believes the worst is over. Last week Paulson warned that the present financial shock is likely to last longer than any experienced over the past two decades. In a startling admission of the chaos that characterises financial markets, he said only when bankers understood the nature of asset-backed commercial paper and other complex financial products would confidence return.

And in another warning of more bad news, Jean-Claude Juncker, who chaired a meeting of European bankers and finance ministers on Friday, told Reuters: “I don’t think the worst is behind us.”