



Guest Editorial

The run on the Rock and its consequences

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In 1999 Howard Davies wrote, in a Financial Services Authority (FSA) Press Release, that ‘risk taking is an essential element in dynamic financial markets, and it would be both unrealistic and wrong to aim for a zero-failure regime. Regulators should, however, target a low level of failures that bring losses to retail savers and investors’. The consultation paper *Financial Stability and Depositor Protection: strengthening the framework* (published by the Bank of England, HM Treasury and the FSA, January 2008 Cm 7308)¹ states that ‘it is neither possible, nor desirable, to ensure that no bank will ever fail in any circumstance’. The House of Commons Treasury Select Committee has also stated that banks should be allowed to fail to preserve market discipline on financial institutions. In the case of the financially troubled Northern Rock in the United Kingdom (UK) there appears to have been no serious consideration by the government that the distressed bank would be allowed to fail.

This crisis, which appears to have been an unexpected event, raises a number of issues. The developments at Northern Rock, which started to publicly unfold in September 2007, led to a crisis of a proportion that could not have been previously conceived. The Northern Rock story has been widely reported and will not be set out here but the troubles at the bank provided the first test of the regulatory framework that was introduced by the Labour Government shortly after its election in 1997. To most observers this test has highlighted a number of serious failures and the need for some reforms. An initial Consultation *Banking reform — protecting depositors* — was

published by the Treasury in October 2007 and this was followed by a detailed report by the House of Commons Treasury Select Committee *The Run on the Rock* in January 2008. Shortly after that the Consultation Paper referred to in the first paragraph was published.

THE REGULATORY AND LEGAL FRAMEWORK

The new financial framework in the UK came into place after the election of the Labour Government in 1997 and a major piece of financial services legislation followed in 2000 — the Financial Services and Markets Act.

The relevant bodies that make up the financial sector regulatory framework, or safety net, are the Treasury (including the Chancellor of the Exchequer), the Bank of England and the Financial Services Authority. In addition to considering how these parties functioned during and prior to the Northern Rock crisis, it is also necessary to consider the role played by the Financial Services Compensation Scheme. The role played by Gordon Brown, the Prime Minister and former Chancellor of the Exchequer, in all of this remains far from clear. It is beyond the remit of an editorial such as this to consider the roles of each of the parties in any detail and what follows is a consideration of some of the key issues.

The FSA has responsibility for the prudential regulation and supervision of the financial services industry and therefore had responsibility for monitoring the activities at Northern Rock. The FSA has received much criticism, in

particular for failing to properly assess the risks posed by the business model being used by the bank. Such indicators as significant increases in profitability and in its share of the mortgage market appear not to have been identified as significant risks. The Bank of England, which has no role to play in the supervision or regulation of individual banks, seems to have been completely unaware of the developing problems at Northern Rock until sometime in August. This suggests a failure in communications between the parties.

The Bank of England, which has responsibility for the overall health of the financial system, has the responsibility of being lender of last resort. When it was initially approached by Northern Rock for financial assistance this was refused. The reasons given by the Governor for the refusal to lend were based on the traditionally accepted approach to this type of financial assistance. The role played by the Bank of England has also been criticised but once the dust has settled it may appear that the decision taken was actually more appropriate than it may have appeared at the time.

Underpinning all of this is a Memorandum of Understanding between the Treasury, the Bank of England and the FSA, which establishes a framework for cooperation between the three bodies in the field of financial stability. This is not set out in statutory form. The Treasury is responsible for overall institutional structure of financial regulation and informing and accounting to Parliament. It has no operational responsibility for the activities of the FSA or the Bank and 'shall not be involved in them'.

This tripartite arrangement did not work as well as had been hoped and this may be because, partly at least, the exact parameters of what each party is expected to do, and who has responsibility for what, is not set out with sufficient clarity. The tripartite arrangement is, in essence, a very sensible idea but perhaps it does need clearer guidelines to ensure that it works better in future.

CRITICISMS OF THE ROLES PLAYED BY THE VARIOUS PARTIES

The Prime Minister and Chancellor of the Exchequer

On Sunday the 17th February 2008, approximately five months after the run started, the Chancellor of the Exchequer announced that the troubled Northern Rock bank was to be nationalised with immediate effect. This in itself was not a surprising development but the timing of the announcement was quite surprising as there were two private sector bids still under consideration at the time.

The Prime Minister and Chancellor of the Exchequer have both been criticised for continuous indecision throughout the period and it is difficult to arrive at any other conclusion. The need for quick and decisive action in relation to a financially troubled bank is generally well accepted, and recommended in the Consultation Paper, but it appears that the relevant parties in the UK's financial safety net were unable to respond with the necessary speed for various reasons.

The possible use of an administration order was not given serious consideration and indeed the suggestion by the Prime Minister that administration was 'a route to a fire sale of assets' indicated a complete lack of understanding of the aims of the process. Administration, which has been used with good results in relation to a number of banks (including Barings Bank in 1995), was introduced as the primary measure for corporate rescue. Although the procedure was introduced by a Conservative administration, it was subjected to reform by the current government.

The FSA and the Bank of England

Both the FSA and the Bank of England have been criticised for their roles in the Northern Rock crisis. It appears that there was a lack of coordination and information sharing between the two bodies and this indicates a weakness in the tripartite system introduced by the Memorandum of Understanding. As mentioned

above it is likely that there will be further strengthening of this arrangement, perhaps by legislation.

The FSA has received significant criticism from many quarters as to its supervision of Northern Rock, which was regarded as a low-probability risk despite the business model it was operating, and it is difficult to understand how this assessment had been made. In future, the regulator will be expected to have a greater awareness of the various risks posed by particular business models.

The deposit compensation scheme

The failure of the compensation scheme was hardly surprising. The provision of 100 per cent cover to such a low level (£2,000) was an obvious weakness. Coinsurance of 10 per cent commencing at this relatively low level actually provided a valid incentive for Northern Rock shareholders to attempt to withdraw their savings, and many did. Their behaviour was totally rational. The coinsurance element was removed very quickly and will no longer be a feature of the UK scheme. Other issues remain however, the most important being the speed with which compensation can be paid. The UK scheme is not pre-funded and this makes quick payouts unachievable. Faster payouts are necessary and such a recommendation is contained in the Consultation Paper but further consultation regarding funding is to take place.

CONCLUDING REMARKS

It should not be forgotten that the primary responsibility for a bank being in financial difficulties must lie with that bank's management. Bank failures are often seen as a failure of regulation and while that may often be a factor the major cause is almost always the way in which the institution has been managed.

The nationalisation of Northern Rock is meant to be temporary in nature but at the time of writing it is far from certain how long this process will last, but the past experience

suggests that this could turn into a lengthy process. Will the British taxpayer be left having to pay a substantial sum or will the amount owing to the government be repaid in full? This is a legitimate question that is being asked by many commentators. To have taken this action much sooner would have been seen as a decisive and progressive development. It seems inevitable that the value of the business will have deteriorated during this period of delay.

What is now clear is that a number of reforms will take place during 2008. In the Consultation Paper a number of proposals and questions have been made and after the closure of the consultation process the way forward chosen by the government will be made clear.

That the failure of a mortgage bank such as Northern Rock could cause so many problems remains a matter of serious concern. London is considered to be one of the world's leading financial centres and the level of possible damage caused by this episode to its reputation internationally may not be apparent for some time.

It now seems inevitable that new legislation will be in place sooner rather than later and that it will include a special resolution regime aimed at minimising the potential impact of a failing bank on financial stability. Providing that it is well designed and realistic (and not rushed through without having properly thought through the issues in detail), this is a welcome development. There are, however, many commentators who wonder why the administration procedure that already exists, with the addition of some additional provisions for dealing with failing banks, would not be sufficient.

The need for a more effective compensation system is recognised in the Consultation Paper. As noted above coinsurance, perhaps the major weakness in the scheme, has gone. To be effective such a scheme has to be able to pay out quickly and the Consultation Paper has a suggested target of one week.

While it is absolutely necessary to have in place a framework to reduce the likelihood of banks failing it is also important that bad banks are allowed to fail and to deal with them promptly thereby preventing the type of damaging delays that were seen in the Northern Rock case. All of the parties involved now seem to be in agreement about this. However the failure of the Prime Minister and Chancellor to give serious consideration to it in the case of Northern Rock makes one wonder what might happen should

another UK bank find itself in a similar situation.

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NOTE

- (1) Whenever the term Consultation Paper is used it is this one that is being referred to.