Northern Rock & Financial Supervision

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This note outlines the events surrounding the difficulties encountered by the Northern Rock bank in summer and autumn of 2007. It sets out the background to the Northern Rock crisis, including information on the ‘credit crunch’ and on the tripartite arrangements for financial supervision. The note includes a timeline of the main events from the beginning of the difficulties in the financial markets on 9 August 2007 to the Bank passing into public ownership on 22 February 2008.

In the immediate aftermath of the collapse of Northern Rock, the Treasury Select Committee held a number of evidence sessions on ‘Financial Stability and Transparency”. They took evidence from the Bank of England, the Financial Services Authority, Northern Rock and the Treasury, as well as a number of experts and interested parties. Lengthy extracts from these sessions can be found in a separate Standard Note (Northern Rock Treasury Committee Sessions SN/BT/4708). The Committee published two reports as a result of this inquiry, one on The Run on the Rock, another on Financial Stability and Transparency. Their report on The Run on the Rock is considered in this note.

The Financial Services Authority (FSA) has also held an internal review into its supervision of the Northern Rock Bank. This found a number of failings in their regulation of the Bank. The FSA announced a “supervisory enhancement programme” in response to the review. This note sets out the main findings of the review and the FSA’s subsequent announcement.

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A. Northern Rock

1. Background

The Northern Rock bank (NRB) was one of several building societies which de-mutualised in 1997. Members of the society benefited to the extent that they were given 500 shares (some individuals received two allocations) worth about £1,500 on flotation (and £6,250 at the share’s peak in early 2007).

It was the seventh largest building society with assets of £13.7 billion. It had a 2% share of the total mortgage market but was already seeking to expand this, taking a 9.7% share of new lending in 1996. Even in 1997 it was described as “arguably the most efficient lender in the business”. The new bank differed from some of its contemporaries. It had a business plan which focussed upon mortgage lending “the aim is to create a virtuous circle in which lower costs lead to more attractive offers for savers and borrowers” rather than diversifying into associated activities such as estate agency or insurance. Also its funding strategy relied more heavily on wholesale market instruments – securitisation – than retail (savers) deposits.

NRB became a very successful company. It joined the FTSE 100 and was in the top five of mortgage lenders as the table below shows:

**Largest Mortgage Lenders, Ranking 2006**

<table>
<thead>
<tr>
<th>Name of group</th>
<th>Estimated market share £bn</th>
<th>(2005)</th>
<th>Name of group</th>
<th>Estimated market share £bn</th>
<th>(2005)</th>
</tr>
</thead>
<tbody>
<tr>
<td>(1) HBOS</td>
<td>220.0</td>
<td>20.4%</td>
<td>(1) HBOS</td>
<td>73.2</td>
<td>21.2%</td>
</tr>
<tr>
<td>(3) Abbey</td>
<td>101.7</td>
<td>9.4%</td>
<td>(2) Abbey</td>
<td>32.6</td>
<td>9.4%</td>
</tr>
<tr>
<td>(2) Lloyds TSB</td>
<td>95.3</td>
<td>8.8%</td>
<td>(4) Northern Rock</td>
<td>29.0</td>
<td>8.4%</td>
</tr>
<tr>
<td>(4) Nationwide BS</td>
<td>89.6</td>
<td>8.3%</td>
<td>(3) Lloyds TSB</td>
<td>27.6</td>
<td>8.0%</td>
</tr>
<tr>
<td>(5) Northern Rock</td>
<td>77.3</td>
<td>7.2%</td>
<td>(5) Nationwide BS</td>
<td>21.1</td>
<td>6.1%</td>
</tr>
<tr>
<td>(6) The Royal Bank of Scotland</td>
<td>67.4</td>
<td>6.2%</td>
<td>(6) The Royal Bank of Scotland</td>
<td>20.0</td>
<td>5.8%</td>
</tr>
<tr>
<td>(7) Barclays</td>
<td>61.6</td>
<td>5.7%</td>
<td>(8) Barclays</td>
<td>18.4</td>
<td>5.3%</td>
</tr>
<tr>
<td>(8) HSBC Bank</td>
<td>39.1</td>
<td>3.6%</td>
<td>(9) Alliance &amp; Leicester</td>
<td>12.6</td>
<td>3.7%</td>
</tr>
<tr>
<td>(9) Alliance &amp; Leicester</td>
<td>38.0</td>
<td>3.5%</td>
<td>(7) HSBC Bank</td>
<td>12.4</td>
<td>3.6%</td>
</tr>
<tr>
<td>(10) Bradford &amp; Bingley</td>
<td>31.1</td>
<td>2.9%</td>
<td>(11) GMAC-RFC</td>
<td>12.1</td>
<td>3.5%</td>
</tr>
</tbody>
</table>

Source: CML statistics

NRB’s interim results were published on 25 July 2007. The summary from the Chief Executive said:

Operationally NRB had a good first half in 2007. Mortgage lending has been particularly strong with a gross market share of 9.7% and a net market share of

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1 The others that year were Halifax (now part of the HBOS group), Woolwich (taken over by Barclays) and the Alliance & Leicester.
2 *Financial Times*, 2 September 1997
3 *Ibid*
18.9%, helped by improvements in retention of home moving customers, keeping customers coming to the end of their product deals and a strong mortgage market. Credit quality remains robust.

The outlook for the full year is being impacted by sharp increases in money market and swap rates seen in the first half. This has resulted in a negative impact on net interest income as mortgage pricing in the market generally has lagged behind increases in funding costs in the year to date. Action has been taken with changes in our swap transaction policies to minimise exposures in the future to significant changes in interest rates.

We are pleased to have achieved approval for use of our Basle II rating systems. This means that the benefits of Basle II enable us to increase our 2007 interim dividend by 30%. Going forward our dividend payout rate increases to 50% of underlying EPS from around 40%. Future capital planning, including the reduction of capital hungry assets, will allow us to return capital to shareholders through a share buyback programme.

The medium term outlook for the Company is very positive."4

However, on 22 February 2008 the NRB was taken into a period of "temporary public ownership". The next section sets out the events which led to the nationalisation of NRB.

2. Key events in the Northern Rock crisis

9 August 2007, “market disturbance” – Governor Mervyn King.5

14 August, privately the Financial Services Authority (FSA) disclosed concerns about NRB to the Treasury and Bank of England.6

13 September, although rumours about NRB had begun to circulate early in the summer (its share price had fallen, along with a generally declining stock market, 50% from its February peak to £8.00 by the start of August) the first official public indication of trouble came with a report from BBC news to the effect that NRB were in negotiations with the Bank.

14 September, a market profit announcement from the management of NRB confirmed these difficulties. It said:

It has now become clear that the global credit and liquidity markets have not recovered in the early part of September, and that there continues to be a severe liquidity squeeze. In the UK, this is demonstrated by 3 Month Sterling Libor currently running at over 1% higher than Bank Base Rate. In these circumstances, NRB has taken action to preserve liquidity and to maintain margins on its current loan book, while modifying its lending approach to avoid writing new business that is unprofitable in current conditions.

4 Adam J Applegarth, Chief Executive NRB
5 Treasury Select Committee, The run on the Rock, HC56-II 2007-08, Q32
6 Chancellor’s statement, HC Deb 11 October 2007 c462
Although NRB expects its new lending volumes to increase once the wholesale funding markets return to more normal volumes and prices, it must now plan on the basis that the wholesale funding markets will not return to historic levels in the short to medium term. In addition, the previously announced decision to dispose of more capital inefficient assets has been suspended but will be resumed once the pricing environment for such assets improves.\(^7\)

As it turned out the crucial problem for NRB was access to funds. On funding it said:

Global investor appetite in the medium and long term markets, for either senior unsecured or asset backed securities, is currently greatly reduced. […] While NRB has continued to raise new funds, these have been mainly in the short term wholesale debt markets and the amounts raised have not allowed NRB to refinance maturing liabilities as well as to write new business at previous levels. In view of the difficulties NRB has had in accessing longer term funding and the mortgage securitisation markets, the Company has been using its cash and other liquid reserves to support the funding of its business. NRB expects current market conditions to continue for some time.

In light of the above, NRB has concluded that it is important to ensure that additional standby liquidity arrangements are available. Accordingly, NRB has agreed with the Bank of England that it can raise such amounts of liquidity as may be necessary by either borrowing on a secured basis from the Bank of England or entering into repurchase facilities with the Bank of England. Such repurchase facilities would include securities that have prime residential mortgage assets as underlying collateral. The collateral that can be used under this ‘Repo’ facility is similar in nature to the collateral currently utilised by many Eurozone banks with the ECB. This additional source of funding will enable NRB to adapt its business model in line with the developing market conditions.

With respect to the accepted cause of global problems, NRB sounded confident.

As announced on 20 August 2007, NRB only has a £75 million direct exposure to the US sub-prime market which is all rated AAA, and a £200 million exposure to the US CDO market, within which there is indirect exposure to US sub-prime. Of the £275 million combined exposure, £193 million is rated AAA. Our combined exposure represents only 0.24% of total assets as at 30 June 2007.

[…]

The interim dividend will be paid as planned on 26 October 2007.

The announcement of the arrangement with the Bank had little obvious effect on public perceptions. The weekend papers were full of pictures of queues of depositors anxious to withdraw their savings from NRB branches around the country. The NRB internet site ‘crashed’ due to the volume of hits it was taking over the weekend.\(^8\)

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\(^7\) NRB Stock Exchange Announcement 14 September 2007

\(^8\) See for example, “Between Rock and a hard place - savers besiege bank: * Fears of property crash as lending squeezed: * Northern Rock shares drop 30% after rescue: * Bank websites down as customers panic”, The Guardian, 15 September 2007
**17 September**, the Chancellor, Alistair Darling, made a statement on the situation in which he announced that the Government would guarantee deposits in NRB. He said:

> I want to put the matter beyond doubt. In the current market circumstances, and because of the importance I place on maintaining a stable banking system and public confidence in it, I can announce today that following discussions with the Governor and the Chairman of the FSA, should it be necessary, we, with the Bank of England, would put in place arrangements that would guarantee all the existing deposits in NRB during the current instability in the financial markets. 

**19 September**, the Bank of England announced that they would conduct a series of auctions to inject liquidity into the capital markets. This announcement was regarded as a U-turn by many commentators. Some pointed out that had this happened earlier NRB may have been able to avoid its current problems.

**20 September**, the Treasury announced extended protections for NRB customers. The press notice of that day stated:

HM Treasury today confirms that the guarantee arrangements for existing deposits in NRB plc would cover all accounts existing at midnight on Wednesday 19 September. This guarantee covers future interest payments, movements of funds between existing accounts, and new deposits into existing accounts. The guarantee will also cover accounts re-opened in the future by those who closed them between Thursday 13 September and Wednesday 19 September, inclusive.

Since it would otherwise be unfair to other banks and building societies, the arrangements would not cover any new accounts set up after 19 September, other than re-opened accounts as set out above.

In the case of wholesale market funding for NRB plc, the Treasury confirmed that the arrangements would cover:

- existing and renewed wholesale deposits; and
- existing and renewed wholesale borrowing which is not collateralised.

The arrangements would not cover other debt instruments including:

- covered bonds;
- securities issued under the “Granite” securitisation programme; and
- subordinated and other hybrid capital instruments.

The guarantee in relation to NRB plc will remain in place during the current instability in the financial markets.

**23 September**, press reports indicated that NRB had borrowed ‘about £3 billion’ from the Bank of England facility.

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9 HM Treasury press notice 17 September 2007  
10 HM Treasury Press notice 20 September 2007  
11 Financial Times, 23 September 2007
25 September, after sustained comment and speculation, NRB announced that they would not pay the interim dividend due the following month; this move retained £59 million within the bank.

1 October, the FSA announced an extension to the cover given to NRB depositors under the Financial Services Compensation Scheme (FSCS). The change to the FSCS meant that all deposits up to £35,000 would be covered by 100% protection. Previously 100% of the first £2,000 and 90% of the next £33,000 were covered – a total of £31,700. The new rules can be found in the Compensation section of the Redress part of the full FSA Handbook. More information on the FSCS can be found in the Library Standard Note, Financial Services Compensation Scheme.

9 October, the Treasury announced a further extension of support for NRB. A press notice gave details:

HM Treasury, on behalf of the Tripartite Authorities, can today confirm that the guarantee arrangements previously announced to protect existing depositors of NRB plc will be extended to all new retail deposits made after 19 September, including those made from today. These arrangements will cover all retail deposits, including future interest payments, movements of funds between accounts and term deposits for the duration of their term.

These arrangements will be complemented by additional facilities through the Bank of England. The arrangements and revised facilities have been put in place at the request of NRB plc. They will allow the Company to continue to pursue the full range of its strategic options.

NRB plc will pay an appropriate fee for the extension of the arrangements, which is designed to ensure it does not receive a commercial advantage. As previously announced, the arrangements to protect depositors of NRB plc will remain in place during the current instability in the financial markets.

11 October, in a statement to the House, the Chancellor said:

…the FSA will shortly set out proposals for a review of the UK liquidity regime. As the Governor has said, all central banks face problems in providing support to banks in difficulty in a world where markets rightly expect high levels of disclosure and transparency. I can therefore confirm that if it proves necessary to clarify in Europe the legal and practical issues surrounding the way in which such support is provided and disclosed to protect financial stability, we will work with other European countries to provide that certainty. We will now review whether rules about swift takeovers of banks need to be changed.

When problems occur, however, we need to have a system in place that is clear and which reassures depositors. We will introduce legislation in the next Session to establish a new regime. With the FSA and the Bank, I am proposing the principles for the new regime in a discussion document published today. The new regime would

12 FSA Handbook, Specifically Comp 10.2
13 Library Standard Note, SN/BT/4466, Financial Services Compensation Scheme
14 HM Treasury Press notice 20 September 2007
mean that depositors would be insulated from a bank that had failed and would provide them with both greater compensation and certainty that their compensation could be paid out quickly.\textsuperscript{15}

The Chancellor wrote to the Public Accounts Committee setting out the basis for guarantees to NRB.\textsuperscript{16}

\textbf{19 October}, NRB Chairman, Dr. Matt Ridley resigned from the NRB Board. He was replaced by Brian Sanderson.

\textbf{16 November}, Adam Applegarth, CEO of NRB, resigned.

\textbf{16 November}, deadline for offers to acquire NRB expired.

\textbf{19 November}, statement by the Chancellor on the future of NRB in the light of the bids received for the company.\textsuperscript{17} The key points from the statement are shown below:

\textit{The Chancellor of the Exchequer (Mr. Alistair Darling): […]}

Before turning to our approach, let me deal first with the position on the guarantee arrangements to Northern Rock depositors provided by the Government and, secondly, with the loan facilities provided by the Bank of England to support Northern Rock and to maintain financial stability in general. First, we have made it clear that the guarantee arrangements already announced for depositors in order to safeguard their position will remain in place during the current instability in the financial markets. These guarantee arrangements were absolutely necessary. […] The guarantee will not be removed without proper notice being given to depositors.

Looking ahead, I have made clear that the Government will legislate for a new regime for protecting bank depositors. As the House knows, we have published a discussion paper on this legislation, and I very much welcome the offer of cross-party support for it. But it is important that we get it right. There are many examples, both here and in other countries, of legislation having been rushed through only to be regretted later. The current consultation finishes on 5 December. I will bring forward proposals in the new year when I have also had time to consider the outcome of the Treasury Committee’s work, as it has requested.

The second element of support is the Bank of England loan facilities. It is important to remind ourselves of why this support was provided in the first place. Northern Rock got into difficulties because it was almost totally reliant on getting very substantial sums from the securitisation and money markets on a continuous basis to do its business. When that lending became ever more difficult, it had no option other than to go to the Bank of England. Because of the possible impact on the stability of the wider financial system, it was right that I authorised the Bank of England to intervene. That, too, had cross-party support.

[…]

\textsuperscript{15} HC Deb 11 October c464
\textsuperscript{16} Deposited paper 2007/2120
\textsuperscript{17} HC Deb 19 November 2007 c959
The continuing support of the Bank of England has also given Northern Rock an opportunity to consider its strategic options. [...] I know that there has been interest in how much support the Bank of England is giving. The Bank publishes its balance sheet every week. However, in common with other central banks, it does not provide details of any operations because it believes that doing so would undermine its ability to provide such support. I understand the frustrations that that can sometimes cause, but to provide what would, in effect, be a running commentary on any operations would be likely to have adverse affects that none of us would want.

Having said that, I can tell the House that Bank of England lending is secured against assets held by Northern Rock, which include high-quality mortgages with a significant protection margin built in and high-quality securities with the highest quality of credit rating. The Bank is the senior secured creditor. The Financial Services Authority has said before, and continues to say, that Northern Rock’s main asset base—its mortgage book—is strong and sound.

As with any lender on this scale, we have ensured that the Bank’s lending is subject to significant conditions and controls to ensure that our interests are protected, and, in return for that facility, Northern Rock has agreed a number of controls, including not declaring, making or paying any dividend without the prior written consent of the Bank of England, and not making any substantial change to the nature of its business.

I now turn to the next stage. It is in the interests of everyone that the situation with regard to Northern Rock is resolved as soon as possible. [...] It is essential that the public interest is protected. That is why I have published today the principles that will underpin the Government’s approach, when assessing proposals from Northern Rock regarding its future.18 As I have already said, the Government have to agree to any such proposals. The principles make it clear that the Government have a clear duty to protect the public interest, and we will do so. However, I think that the whole House, and particularly Members representing the north-east, will want us to do everything we can within the constraints on us to resolve a very difficult position for Northern Rock.

Let me therefore set out our approach. First, we must protect the interests of the taxpayer. Substantial sums have been lent, and that money has to be repaid at an appropriate time and rate. The Government will consider proposals with a view to reaching the best outcome for the public purse. Secondly, we want to protect depositors. It is essential to do everything we can both to safeguard their interests and to maintain the service provided to them. Thirdly, we will maintain wider financial stability.

As I have made clear all along, the Government will now assess proposals from the company consistent with the approach that I have set out, and we remain closely engaged with the company as the best outcome for its future is assessed. As the company has acknowledged today, any proposals would have to be approved by the Government and, importantly, any proposal can be vetoed by the Government. In that way, the Government can ensure that the public interest is safeguarded. As I have told the House on previous occasions, any outcome must meet EU state aid rules.

18 Deposited Paper 2007/107
It would be quite wrong to dismiss any option now without proper consideration, as some have suggested we do. I continue to believe that it is right to use this time to explore the best outcome for the company and the public interest. I agreed to Bank of England support because I believed it was right to do so. I agreed to continue support to allow Northern Rock the time it needs to consider its strategic options because it was right to do so. […]

12 December, Liberal Democrat debate in the House of Commons which called for the nationalisation of NRB.19

14 December, Northern Rock CEO Adam Applegarth is replaced by long term NRB executive Andy Kuipers.

19 December, FSA published the consultation document Review of the liquidity requirements for banks and building societies.20

21 January 2008, the Chancellor made a statement which outlined how the potential private sector rescue of NRB would proceed and how the competing bids would be assessed. 21 He set out the future financial restructuring and ownership options for the bank. He began by stating that to date, there had been no cost to the taxpayer of existing government support for the bank; all existing guarantees, for savers and funding, would continue; the Government continued to favour a private sector solution but had not ruled out a period of nationalisation; putting the bank into administration had been rejected. He continued:

Despite intensive efforts over the last few months, and as a result of uncertain market conditions across the world, it has proved impossible for Northern Rock to find a purely commercial solution. In the autumn, market conditions were such that banks became increasingly reluctant to lend on terms that would have been acceptable. As the House will be aware, banks right across the world are having to make substantial provisions. While conditions are better now than they were before Christmas, they remain difficult, and the Government's financial advisers believe that there is no chance of achieving a private sector deal backed entirely with private finance in the near future.

[…]

My proposal today is one in which Northern Rock is owned and run in the private sector as a commercial bank, and where the Government provide a backstop guarantee to make private financing possible in the current market conditions. I believe that this company should be managed within private sector disciplines and management, provided that we can do so on terms that properly protect taxpayers' interests.

He explained in more detail how the proposal met the Government's objectives of protecting the taxpayer, protecting consumers and promoting financial stability. He continued:

19 HC Deb 12 December 2997 c371-418
20 “FSA publishes a review of the liquidity requirements for banks and building societies”, FSA website, 19 December 2007
21 HC Deb 21 January 2008 cc1207-10
To allow this financing structure to be explored, the Treasury and the Bank of England will make arrangements to extend the Bank of England's loan facility until 17 March, by which time we must submit a restructuring plan to the European Commission. The proposals would involve private sector participation in the financing of Northern Rock and would also provide the taxpayer with the ability to share in the potential upside returns, as business conditions improve, in return for the financial support provided to the company.

The Government will make their decision as to which proposal we can, as provider of support, accept, and with the Bank of England and the FSA, we will consider proposals received by 4 February from potential interested parties, including the company itself. Any proposals, either as a result of this support or public ownership, are highly likely to need state aid clearance and will therefore be dependent on approval by the European Commission.

The Government have already started discussions with the company and with the two parties that have publicly stated an interest in the company. The Government are also ready to have discussions with any other interested parties. […]

Northern Rock got into the difficulties it faced because of global market conditions. The Government agreed to Bank of England support for Northern Rock because of the destabilising risk to the rest of the financial system and also provided guarantees to protect depositors. Both of those objectives have been met. We now need to reach a solution that leaves the greatest risk with the company, yet will allow taxpayers to profit from any future sale.

Ideally, the best solution would have been a private sector one without any Government support, but in the current uncertain market conditions, that is not possible. Administration, with the resulting fire sale of the company's assets, would not be in the public interest. Temporary public ownership—nationalisation—remains an option, however even those who advocate it now see it as a stepping-stone to the return of Northern Rock to the private sector, which would involve Government support. In the meantime, the company would require continuing financial support, which would leave the public sector bearing all of the risk.

26 January, the Treasury Select Committee published their report, *The run on the Rock.*

29 January, the Government published its regulatory reform proposals—*Financial stability and depositor protection: strengthening the framework.* The proposals contained in the White Paper are intended to form the basis of legislation to be introduced in spring 2008.

17 February, the Chancellor announced:

The Government has today decided to bring forward legislation that will enable Northern Rock plc to be to be taken into a period of temporary public ownership. The Government has taken this decision after full consultation with the Bank of England

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23 HM Treasury, *Financial stability and depositor protection: strengthening the framework*, January 2008, Cm 7308,
The Government’s financial adviser, Goldman Sachs, has concluded from a financial point of view that a temporary period of public ownership better meets the Government’s objective of protecting taxpayers.\(^\text{24}\)

The draft *Banking (Special Provisions) Bill* was published the same day. The Bill was 17 clauses long.

**18 February**, NRB shares were suspended.

**19 February**, the *Banking (Special Provisions) Bill* had its second reading in the Commons.

**21 February**, the *Banking (Special Provisions) Bill* received Royal Assent.

The Act is not NRB specific. However, Alistair Darling told the House of Commons at the first reading of the Bill on 18 February that: “The Government have no intention at present to use the Bill to bring any institution other than Northern Rock into temporary public ownership”.\(^\text{25}\)

The Act defines the circumstances in which the Treasury can take a financial institution into public ownership. This can only occur if either of the following two conditions is met:

(a) maintaining the stability of the UK financial system in circumstances where the Treasury consider that there would be a serious threat to its stability if the order were not made;

(b) protecting the public interest in circumstances where financial assistance has been provided by the Treasury to the deposit-taker for the purpose of maintaining the stability of the UK financial system.

**22 February**, NRB moved into a period of “temporary public ownership”.\(^\text{26}\)

**10 March**, Estimates Day debate on ‘Northern Rock and Banking Reform’.\(^\text{27}\)

**11 March**, The *Northern Rock plc Compensation Order 2008* was debated in the Third Delegated Legislation Committee.\(^\text{28}\) This determines the framework within which compensation levels for the existing shareholders will be decided.

**31 March**, *Northern Rock plc Transfer Order 2008*\(^\text{29}\) was debated in the House of Commons.\(^\text{30}\)

**26 March**, FSA published the summary of a review conducted by their Internal Audit division into the supervision of Northern Rock.\(^\text{31}\) See page 22 of this note for more details.

\(^{24}\) HM Treasury press release, 17 February 2008

\(^{25}\) HC Deb 18 February 2008 c22

\(^{26}\) NRB press notice, *Temporary Public Ownership*, 22 February 2008,

\(^{27}\) HC Deb 31 March 2008 cc21-85

\(^{28}\) Draft Northern Rock plc Compensation Scheme Order 2008, 11 March 2008, cc3-39

\(^{29}\) For more information see Library Standard Note, SN/BT/4683, *Northern Rock plc Transfer Order 2008*

\(^{30}\) HC Deb 31 March 2008 cc575-599. The deferred division took place the following week, see HC Deb 2 April 2008 c814
B. Credit crunch

The problems which caused NRB to ultimately need to seek public help are now generally blamed on its over reliance on wholesale credit markets and the sudden “drying up” of these markets in summer 2007. Almost by definition with financial crises until they break mainstream opinion is silent. Financial crises are particularly affected by confidence and sentiment: until that confidence is lost or that sentiment turns, like the swan, above water all is serene and fine. After confidence is lost, there is no shortage of informed opinion to say how the crisis arose and how it was always an accident waiting to happen. This section concentrates upon the factual events in the crisis and on the developing ‘conversation’ between the authorities jointly responsible for managing the financial system. Economic factors are touched on only briefly. Colleagues in the Economic Policy Section can give more help on this aspect.32

The cause of the current troubles is generally sourced with the US mortgage market, in particular the ‘sub-prime’ market. Foreclosures and repossessions of such mortgages have risen sharply during the year and, despite a long term expectation that this would cause problems, this eventually impacted on world credit markets, apparently to their surprise.

The linkage between a mortgage foreclosure in Chicago and queues in northern England high streets is complicated. At its simplest, bundles of American mortgage assets were sold to investors (mainly investment banks) and then used to supply credit in the money markets more generally. When the valuation of the original ‘bundles’ declined (i.e. when foreclosures mounted) so did the value of the derived securities held by financial institutions world wide. Short of capital, such institutions, cut back on their own lending, in particular on inter bank loans which provide much of the short term liquidity that keeps the financial industry afloat. Furthermore, a new more cautious approach to risk resulted in existing credit becoming more expensive – interest rates rose.

In their March 2008 report, Run on the Rock, the Treasury Select Committee set out the origins of the current crisis in basic terms:

On 9 August 2007, the French bank BNP Paribas announced that three of its investment funds were no longer able to value a series of complex financial instruments backed by so-called “sub-prime” residential mortgages in the United States. This was the culmination of a series of announcements reflecting a growing loss of confidence among banks in Europe and the United States about their investments linked to the riskier lending in the US property market. It set of a chain of events, including a crisis in confidence in financial markets across the world, turbulence on stock markets, the run on Northern Rock, and a squeeze on credit and a crisis of confidence with a significant impact on the real economy.33

31 FSA Press Notice, FSA moves to enhance supervision in wake of Northern Rock, 26 March 2008. A summary of the review, the recommendations made by Internal Audit and the response of the executive of the FSA can be found on the FSA website.
32 The Economic Policy and Statistics Section can be contacted on x5510.
33 Treasury Select Committee, Financial Stability and Transparency, 3 March 2008, HC 371 2007-08, para 1
The Governor of the Bank of England set out his account in a memorandum (written before the crisis broke) in advance of an appearance before the Treasury Select Committee. The Governor commented:

Why have developments in one part of the US mortgage market proved so important for a wide range of financial markets? Sub-prime mortgages are one type of loan that banks have parcelled together into securities backed by the cash flows from those loans – a process known as securitisation. Those securities have been sold by banks to investors.

They have also been sold to investment vehicles, many of which have been established by the banks themselves. Many of these vehicles have financed their purchases by issuing short-term commercial paper.

Securitisation of loans has separated the information held by loan originators from those exposed to the risk of default – investors in asset-backed securities or commercial paper. The unexpected losses sustained on assets backed by US sub-prime mortgages have highlighted the potential costs to investors of uncertainty about the types of loans underlying the assets they purchase. So for the time being the markets in these instruments have either closed or become very illiquid. Vehicles financed by short-term commercial paper are holding assets which can no longer be traded in liquid markets. They now find that they have borrowed short to lend long – normally thought of as a function of banks.

As a result of this maturity mismatch, vehicles set up by banks and others are now finding it extremely difficult to obtain funding through asset-backed commercial paper. The markets are now withdrawing short-term funding from such vehicles, a process not unlike a bank run. Many investment vehicles have been forced to shorten the maturity of their commercial paper, making their borrowing even more short-term and their maturity mismatch even greater.

[...]

The vehicles can be taken back onto banks’ balance sheets. Banks as a whole are well capitalised and should be able to do this. Moreover, the funds that were directed to asset backed securities and commercial paper will now be available elsewhere. In the end, that funding will come back to the banking system, although between banks the distribution will differ. So the adjustment period may be awkward and, during it, banks are placing a premium on holding assets which can quickly be turned into cash.

The increase in demand for liquid assets during the adjustment period is one reason why, in all the major economies, yields on liquid assets like government securities have fallen. It also helps to explain why the compensation needed for banks to lend to other banks over periods longer than overnight has risen and why the volume of inter-bank lending has been increasingly concentrated at shorter maturities. Since the beginning of August, the spread between interest rates for 3-month inter-bank lending and central bank interest rates expected over that period has risen in all the major economies. At present, the average spread is 110 basis points in sterling and 90 basis points in dollars. This is the natural economic result of a change in the preferences of banks over the composition of the assets they wish to hold on their balance sheets.
In summary, the turmoil in financial markets since the beginning of August stems from a reluctance by investors to purchase financial instruments backed by loans. Liquidity in asset-backed markets has dried up and a process of re-intermediation has begun, in which banks move some way back towards their traditional role taking deposits and lending them. That process is likely to be temporary but it may not be smooth. During that process, demand for liquidity by the banking system has increased, leading to a substantial rise in inter-bank rates.\(^{34}\)

NRB has ‘Granite’, as its securitisation vehicle.

A detailed analysis was published by the Monetary Policy Committee in its September minutes.\(^{35}\) (Note this was before the NRB crisis became fully public.)

**C. Financial Supervision: The tripartite framework**

Responsibility for the maintenance of the financial system is shared between the Treasury, the Bank of England and the FSA. This is referred to as the tripartite framework.

The relationship between the bodies is governed by a Memorandum of Understanding (MoU) which can be found on the Treasury website amongst other places.\(^{36}\) Each of the bodies has unique functions. The Bank of England has the following core responsibilities:

i. ensuring the stability of the monetary system as part of its monetary policy functions. It acts in the markets to deal with fluctuations in liquidity;

ii. overseeing financial system infrastructure systemically significant to the UK, in particular payments systems whether based in the UK or abroad. As the bankers’ bank, the Bank stands at the heart of the payments system. It falls to the Bank to advise the Chancellor, and answer for its advice, on any major problem arising in these systems. The Bank is also closely involved in developing and improving the infrastructure and strengthening the system to help reduce systemic risk;

iii. maintaining a broad overview of the system as a whole. The Bank is uniquely placed to do this, being responsible for monetary stability and having representation on the FSA Board (through the Deputy Governor (financial stability)). Through its involvement in markets and payments systems it may be the first to spot potential problems. The Bank advises on the implications for UK financial stability of developments in the domestic and international markets and payments systems and assesses the impact on monetary conditions of events in the financial sector;

iv. undertaking, in exceptional circumstances, official financial operations, in accordance with the arrangements in paragraphs 13 and 14 of this Memorandum, in order to limit the risk of problems in or affecting particular institutions spreading to other parts of the financial system.

\(^{34}\) Memorandum from Bank of England to Treasury Select Committee, 12 September 2007

\(^{35}\) Bank of England MPC Minutes, 5 & 6 September 2007

\(^{36}\) Memorandum of Understanding between HM Treasury, the Bank of England and the Financial Services Authority,
The role of the FSA is:

i. the authorisation and prudential supervision of banks, building societies, investment firms, insurance companies and brokers, credit unions and friendly societies;

ii. the supervision of financial markets, securities listings and of clearing and settlement systems;

iii. the conduct of operations in response to problem cases affecting firms, markets and clearing and settlements systems within its responsibilities, where:
   i. the nature of the operations has been agreed according to the provisions of paragraphs 13 and 14 of this Memorandum; and
   ii. the operations do not fall within the ambit of the Bank defined in paragraph 2 above. (Such operations by the FSA may include, but would not be restricted to, the changing of capital or other regulatory requirements and the facilitation of a market solution involving, for example, an introduction of new capital into a troubled firm by one or more third parties.)

iv. regulatory policy in these areas, including that intended to promote the resilience to operational disruption of authorised firms and Recognised Bodies. The FSA advises on the regulatory implications for authorised firms and Recognised Bodies of developments in domestic and international markets and of initiatives, both domestic and international, such as EC directives.

The Treasury has the following role:

i. the overall institutional structure of financial regulation and the legislation which governs it, including the negotiation of EC directives;

ii. informing, and accounting to Parliament for the management of serious problems in the financial system and any measures used to resolve them, including any Treasury decision concerning exceptional official operations as set out in paragraphs 13 and 14; and

iii. accounting for financial sector resilience to operational disruption within government.

An important arm of the system is the Standing Committee on Financial Stability. This is chaired by the Treasury with representatives from all three arms attending. The normal (and extraordinary) modus operandi of the Committee is set out in the following paragraphs from the Memorandum:

11. Standing Committee meets on a monthly basis at deputies (official) level to discuss individual cases of significance and other developments relevant to financial stability. Meetings can be called at other times by any of the participating authorities if it considers there to be an issue which needs to be addressed urgently. Each authority is to have nominated representatives who can be contacted, and meet, at short notice.
12. A sub-group of Standing Committee co-ordinates the authorities’ joint work on financial sector resilience to operational disruption and maintains and tests tripartite arrangements for effective crisis management in an operational disruption.

13. In exceptional circumstances, for instance where a support operation is being considered, the Standing Committee meets at principals level, comprising the Chancellor of the Exchequer, the Governor of the Bank and the Chairman of the FSA (or senior alternates). The Bank and the FSA are each to assess, from the perspective of their distinct responsibilities and expertise, the seriousness of the crisis and its potential implications for the stability of the financial system as a whole. They will each provide their separate assessments to the Treasury, together with their views on the options available to the Chancellor. Standing Committee may then discuss the appropriate use of measures and ensure effective co-ordination of the response, while respecting the formal responsibilities of the three authorities (subject to paragraph 14).

Paragraph 14 is the section of the Memorandum that is of application to the fortnight from about the second week of September. It deals with a financial crisis:

Financial Crisis Management

14. In exceptional circumstances, there may be a need for an operation which goes beyond the Bank’s published framework for operations in the money market. Such a support operation is expected to happen very rarely and would normally only be undertaken in the case of a genuine threat to the stability of the financial system to avoid a serious disturbance in the UK economy. If the Bank or the FSA identified a situation where such a support operation might become necessary, they would immediately inform the other authorities and invoke the co-ordination framework outlined in paragraph 16 below. Ultimate responsibility for authorisation of support operations in exceptional circumstances rests with the Chancellor. Thereafter they would keep the Treasury informed about the developing situation, as far as circumstances allowed.

15. In any such exceptional circumstances, the authorities’ main aim would be to reduce the risk of a serious problem causing wider financial or economic disruption. In acting to do this, they would seek to minimise both moral hazard in the private sector and financial risk to the taxpayer arising from any support operation.

16. The authorities maintain a framework for co-ordination in the management of a financial crisis. This includes arrangements that determine which authority would take the lead on particular problems arising and for ensuring orderly communication with market participants and overseas authorities. Each authority would: assess the situation and co-ordinate their response within the framework agreed with the other authorities. The form of the response would depend on the nature of the event and would be determined at the time; and where possible and desirable to facilitate a solution to a problem, and hence reduce risks to wider financial stability, encourage negotiations between third parties whose agreement might be beneficial for the reduction or resolution of the issue, in its area of responsibility.37

37 Ibid
D. Treasury Select Committee report January 2008: The run on the Rock

1. Background

On 20 September 2007 the Treasury Select Committee (TSC) was due to take evidence from the Governor of the Bank of England on the MPC’s August Quarterly Inflation Report. Less than a week before, the run on Northern Rock occurred. At their 20 September meeting, the TSC decided to start an inquiry on Financial Stability and Transparency. Terms of reference were published in October 2007. The TSC held evidence sessions with all of the key players in the Northern Rock crisis, including the Chairman and Chief Executive of NRB, the Governor and Deputy Governor of the Bank of England, the Chancellor of the Exchequer, and the Chairman and Chief Executive of the FSA.

The Committee published two reports as a result of their inquiry. The first, The Run on the Rock, was published in January 2008 and focused on the events of the summer and autumn of 2007 and the lessons to be learnt. The second, Financial Stability and Transparency, was published in March 2008 and looked at the causes of the closing of certain financial markets in August 2007 (which had precipitated Northern Rock’s difficulties). This note looks at the main findings published in their January 2008 report.

The TSC has announced that it will take evidence from the FSA chairman and chief executive on the subject of Financial Stability and Transparency again on 6 May 2008. The Government has not yet responded to the Run on the Rock report.

2. Summary

The Summary of the TSC’s report gives an overview of their report:

**Overview**

The period from Friday 14 September 2007 to Monday 17 September saw the first run on the retail deposits of a United Kingdom bank since Victorian times. We analyse the causes and consequences of the run on Northern Rock, and the lessons to be learnt from it. We emphasise the advantages of legislative change on a cross-party basis and make proposals for such change, and for reforms of the Tripartite arrangements, on that basis.

**Northern Rock and its regulation**

The directors of Northern Rock were the principal authors of the difficulties that the company has faced since August 2007. The directors pursued a reckless business model which was excessively reliant on wholesale funding. The Financial Services Authority systematically failed in its regulatory duty to ensure that Northern Rock would not pose a systemic risk.

**Handling the support operation and stopping the run**

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The Chancellor of the Exchequer was right to view Northern Rock as posing a systemic risk to the financial system and to authorise the Bank of England’s support facility. However, the Tripartite authorities did not prepare adequately for that support operation. Those authorities and Northern Rock ought to have strained every sinew to finalise the operation and announce it within hours rather than days of the decision to proceed with the operation. The Tripartite authorities at deputies level failed to plan in advance for the announcement of the Government guarantee on Northern Rock deposits that proved necessary to stop the run.

Dealing with failing banks
We recommend a series of measures for handling ‘failing’ banks in an orderly manner and in a way that insulates taxpayers and small depositors from the risk of banks failing. We recommend that a relevant authority be given power to acquire information relating to individual financial institutions and to take action in relation to an institution in specified circumstances. We also propose a special resolution regime for failing banks to enable smooth administration of such a bank to be combined with arrangements to ensure that insured deposits are safe and accessible.

Depositor protection
A deposit protection scheme must be simple and transparent. The “co-insurance” model of deposit protection—whereby small depositors stand to lose some of their money in the event of a bank closing—is discredited. Ensuring the speedy release of funds under any scheme is of critical importance, and we propose measures to provide for this. We recommend the establishment of a Deposit Protection Fund to be funded by participating institutions.

Lessons learned
There was a significant failure of the Tripartite arrangements in September 2007, and lessons must be learned from that failure. The financial system in the United Kingdom would not be well-served by a dismantling of the Tripartite arrangements. However, the current arrangements lack a clear leadership structure or a strategy for effective communication with the public.

Reforms
A single authority ought to be given the new powers for handling failing banks, together with responsibility for the Deposit Protection Fund. There is a need for ‘creative tension’ within the regulatory system, and so these powers and responsibilities should not be granted to the Financial Services Authority. We propose the creation of a new post of Deputy Governor of the Bank of England and Head of Financial Stability. We set out how this new post and the accompanying Office will relate to the existing responsibilities of the Bank of England and to the other Tripartite authorities.40

3. The Northern Rock Bank and its regulation

The TSC concluded that the directors of Northern Rock were primarily responsible for the difficulties it had faced since the closing of certain credit markets in August 2007. Their business strategy had been described by the Governor of the Bank of England as “fatally flawed”.41 The TSC stated that:

40 Treasury Select Committee, The run on the Rock, 26 January 2008, HC 56-I 2007-08, Summary
41 Ibid, para 29
The directors of Northern Rock were the principal authors of the difficulties that the company has faced since August 2007… The high risk, reckless business strategy of Northern Rock, with its reliance on short- and medium-term wholesale funding and an absence of sufficient insurance and a failure to arrange standby facility or cover that risk, meant that it was unable to cope with the liquidity pressures placed upon it by the freezing of international capital markets in August 2007. Given that the formulation of that strategy was a fundamental role of the Board of Northern Rock, overseen by some directors who had been there since its demutualization, the failure of that strategy must also be attributed to the Board…

The TSC was also highly critical of the FSA in their regulation of the NRB. NRB was, according to Hector Sants, Chief Executive of the FSA, a “high impact bank, under close and continuous supervision”. However, the TSC found that:

The FSA has acknowledged that there were clear warning signals about the risks associated with Northern Rock’s business model, both from its rapid growth as a company and from the falls in its share price from February 2007 onwards. However, insofar as the FSA undertook greater “regulatory engagement” with Northern Rock, this failed to tackle the fundamental weakness in its funding model and did nothing to prevent the problems that came to the fore from August 2007 onwards. We regard this as a substantial failure of regulation.

The Committee went on to conclude that the FSA had “systematically failed in its duty as a regulator”:

The FSA did not supervise Northern Rock properly. It did not allocate sufficient resources or time to monitoring a bank whose business model was so clearly an outlier; its procedures were inadequate to supervise a bank whose business grew so rapidly. We are concerned about the lack of resources within the Financial Services Authority solely charged to the direct supervision of Northern Rock. The failure of Northern Rock, while a failure of its own Board, was also a failure of its regulator. As the Chancellor notes, the Financial Services Authority exercises a judgment as to which ‘concerns’ about financial institutions should be regarded as systemic and thus require action by the regulator. In the case of Northern Rock, the FSA appears to have systematically failed in its duty as a regulator to ensure Northern Rock would not pose such a systemic risk, and this failure contributed significantly to the difficulties, and risks to the public purse, that have followed.

4. The Tripartite arrangements

The Tripartite arrangements between the FSA, the Bank of England and HM Treasury were explained in detail above. The TSC considered the operation of these arrangements in their report. They concluded that the mere fact that there had been a run on a bank meant there were problems with the Tripartite arrangements:

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42 Ibid, para 31
43 Treasury Select Committee, The run on the Rock, HC 56-II 2007-08, Q 194
44 Treasury Select Committee, The run on the Rock, 26 January 2008, HC 56-I 2007-08, para 42
45 Ibid, para 66
We cannot accept, as some witnesses have suggested, that the Tripartite system operated “well” in this crisis. In terms of information exchanged between the Tripartite authorities, the system might have ensured that all the Tripartite authorities were fully informed. However, for a run on a bank to have occurred in the United Kingdom is unacceptable, and represents a significant failure of the Tripartite system. If the system worked so well, the Tripartite authorities should take a closer look at the people side of the operation.

Although we have concerns about the operation of the Tripartite system, we do not believe that the financial system in the United Kingdom would be well-served by a dismantling of the Tripartite system. Instead, we want to see it reformed, with clearer leadership and stronger powers.46

5. The need for additional liquidity in the financial markets and ‘moral hazard’

There have been some suggestions that the Bank of England should have provided additional liquidity to the financial markets with no penalty rate in the wake of the difficulties which emerged in August 2007. The TSC explained in their report that additional reserves were provided on 13 September 2007, after certain criteria were met.47

The Bank’s reluctance to respond to calls for additional liquidity during August 2007 was explained, in part, in the Bank’s concern about moral hazard. The TSC stated that:

In essence, this ‘moral hazard’ argument is that, should the central bank act, and effectively provide extra liquidity at different maturities against weaker collateral, markets would, especially if they liquidity was provided at little or no penalty, take it as a signal that the central bank would always rescue them should they take excessive risk and get into difficulties. Such a signal would lead to ever more risk taking, and the next crisis would consequently be greater than it would otherwise have been.

The TSC found that there appeared to be some disagreement within the tripartite authorities over the weight that should have been placed on the dangers raised by moral hazard. They compared the behaviour with the Bank of England with that of other central banks:

The Bank of England, the European Central Bank and the Federal Reserve each pursued a different course of action in response to the money market turmoil in August 2007. Only the Bank of England took no contingency measures at all during August, in order to protect against moral hazard... The European Central Bank appeared to attach far less weight to the moral hazard argument than the Bank of England. Instead it adopted a proactive approach in resolving what it saw as a practical problem of a faltering market resulting from banks losing confidence in each other. Although the European Central Bank injected no net additional liquidity in August, it did alter 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. In doing so, the European Central Bank appeared to satisfy the immediate liquidity demands of the Eurozone banking sector, whilst UK banks’ sterling demands went unmet. We are unconvinced that the Bank of

46 Ibid, paras 276-277
47 Ibid, para 81
England’s focus on moral hazard was appropriate for the circumstances in August. In our view, the lack of confidence in the money markets was a practical problem and the Bank of England should have adopted a more proactive response.

The TSC questioned whether extra liquidity would have saved Northern Rock. They concluded that:

We cannot know whether an open market liquidity operation of the kind asked for by a number of banks in August would have prevented Northern Rock’s need for emergency support from the Bank of England in September. It is most unlikely that any such lending operation in September … could have been of a sufficient scale to ensure that Northern Rock could have received the liquidity it then required. Such an operation would also have raised severe ’moral hazard’ concerns, signalling to the banking sector as a whole that public sector support would be made available in the event of any bank facing distress.48

6. The nationalisation of Northern Rock

The TSC published their report in January 2008, before the Bank was nationalised in February. The Committee did take evidence on the prospect of nationalisation. They wrote in their report that:

One of the potential routes for resolving the problems with Northern Rock has been nationalisation. However, this option has been regarded by the Tripartite authorities, according to Sir John Gieve, as “Plan B” after a private sector sale. However, in the event that Northern Rock were nationalised, Sir John Gieve told us that “it would be possible to pass many of its activities to other institutions in the private sector”.

The exchange with Sir John Gieve also covered the potential future denationalisation process. The exchange was as follows:

Q1736 Jim Cousins: Sir John, you have heard all the discussion about the nationalisation of Northern Rock and you have a considerable knowledge yourself of Northern Rock. How easy would Northern Rock be to denationalise?

Sir John Gieve: As you know, plan A is to complete the Virgin or Olivant approaches.

Q1737 Jim Cousins: I know about plan A.

Sir John Gieve: Plan B: if we are forced down the road of nationalisation, it would clearly be, as Mervyn said, as a temporary measure to then relaunch it in some form. I do not know whether it would be easy or not. We are concentrating on the bids we have got rather than the bids we might get in those circumstances.

Q1738 Jim Cousins: Do you think there could be a problem with denationalisation?

48 Ibid, para 95
Sir John Gieve: I am pretty sure that if the bank either went through an administration process or was nationalised, it would be possible to pass many of its activities to other institutions in the private sector.49

The Chancellor of the Exchequer gave evidence to the Committee on 10 January 2008. He was also questioned about nationalisation of the Bank:

Q1754 Chairman: In his evidence to us, Sir Callum McCarthy suggested that it would be better to pursue options for private ownership for Northern Rock, and I think that is widely agreed, before discussing any nationalisation proposals. Does the Government have any plans in place for taking over Northern Rock if it deems it necessary?

Mr Darling: Well, I have made it clear right since my statement in November when I set out the principles that would underpin our approach to the future of Northern Rock that all options, including nationalisation, are on the table, and I have always been clear about that because, if we cannot find a private sector solution, then we have got to keep all those options on the table. Now, I think all of us believe that a private sector solution would be highly desirable and indeed even many people who advocate nationalisation always point to it as being a stepping stone between where we are now and an ultimate private sector solution, but I think it is important that people understand that all options are on the table and they have been on the table.50

E. Financial Services Authority Internal Audit Report, March 2008

On 26 March 2008 the FSA published a summary of a review carried out by its internal audit division into its supervision of Northern Rock. An FSA press notice explained that:

The Internal Audit review identifies the following four key failings specifically in the case of Northern Rock:

- A lack of sufficient supervisory engagement with the firm, in particular the failure of the supervisory team to follow up rigorously with the management of the firm on the business model vulnerability arising from changing market conditions.
- A lack of adequate oversight and review by FSA line management of the quality, intensity and rigour of the firm's supervision.
- Inadequate specific resource directly supervising the firm.
- A lack of intensity by the FSA in ensuring that all available risk information was properly utilised to inform its supervisory actions.

The review concluded that, overall, the supervision of Northern Rock was at the extreme end of the spectrum within the firms reviewed in respect of these failings and that its supervision did not reflect the general practice of supervision of high-impact firms at the FSA.51

49 Treasury Select Committee, The run on the Rock, HC 56-II 2007-08, Q 1738
50 Ibid, Q 1754
51 FSA Press Notice, FSA moves to enhance supervision in wake of Northern Rock, 26 March 2008. A summary of the review, the recommendations made by Internal Audit and the response of the executive of the FSA can be found on the FSA website.
The phrase “extreme end of the spectrum” is used here to assert that the treatment given to NRB was exceptional, not that it was an exceptional institution. Other similar institutions were reviewed far more regularly as the table below, taken from the executive summary of the FSA’s Internal Audit Division report shows:

Close and Continuous Supervision Meetings – estimates made by staff based on various sources for high impact firms

<table>
<thead>
<tr>
<th></th>
<th>1 Jan – 9 Aug 2007</th>
<th>2006</th>
<th>2005</th>
<th>Period Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Average for Wholesale Investment Bank Division (WIBD) firms</td>
<td>13</td>
<td>24</td>
<td>18</td>
<td>55</td>
</tr>
<tr>
<td>Average for Major Retail Groups Division (MRGD) firms</td>
<td>22</td>
<td>29</td>
<td>23</td>
<td>74</td>
</tr>
<tr>
<td>Average for MRGD firms excluding the 5 largest banks</td>
<td>17</td>
<td>22</td>
<td>19</td>
<td>58</td>
</tr>
<tr>
<td>Average for 5 largest retail banks</td>
<td>43</td>
<td>59</td>
<td>41</td>
<td>143</td>
</tr>
<tr>
<td>Northern Rock</td>
<td>7*</td>
<td>1</td>
<td>0</td>
<td>8</td>
</tr>
</tbody>
</table>

* Out of which five meetings were held on one day and two were on the telephone

In its editorial comment, the Financial Times said that the FSA had basically been “too lenient”:

Much consternation and mirth will result from the comedy of bureaucratic errors that seems to have taken place at the UK’s Financial Services Authority in the years leading up to the collapse of Northern Rock. The gems include almost no contact between the two, staff turnover, no financial analysis, no risk plan and insurance experts put in charge of regulating a bank.

The reality is that, even if the correct boxes had all been ticked, Northern Rock would probably still have gone under. The FSA’s problems are more profound than process. An advocate of “risk-based” bank regulation, it has, basically, been too lenient. …

Those who champion the superiority of UK regulation should examine the price/earnings ratios of domestic UK banks, which are the lowest in Europe. The valuations indicate scepticism about earnings quality and an expectation of potential balance sheet distress. And those who doubt that the FSA was hampered by conventional thinking should note that it assumed that the Bank of England would, in a crisis, offer more liquidity to the market generally and bail out troubled banks.

It seems that the FSA may have been affected by moral hazard as well as the industry.

Hindsight is a wonderful thing. Two years ago, it would have taken a courageous regulator to force banks to take preventive measures against the unthinkable (interbank liquidity drying up) and to take a sceptical view of hybrid capital, off-balance sheet vehicles and structured credit products. But that is the quality of regulation the UK should aspire to.
An ideal bank supervisor would be agile, touch and a contrarian. These three boxes the FSA did not tick.52

The FSA also published the response of their executive board on 26 March. The summary of their response started by stating:

As we have already made clear in our evidence to the Treasury Select Committee, the failure of Northern Rock should first and foremost be attributed to the failure of its board and executive to create a durable funding model which could withstand the exceptional set of market circumstances that occurred in summer 2007. Nevertheless, the FSA acknowledges that its supervision of Northern Rock in the period leading up to July 2007 was not of sufficient intensity or appropriate rigour to challenge the company's board and executive on their risk management practices and their understanding of the risks posed by their business model.53

The FSA has announced a "supervisory enhancement programme". The main features are:

- A new group of supervisory specialists will regularly review the supervision of all high-impact firms to ensure procedures are being rigorously adhered to.
- The numbers of supervisory staff engaged with high-impact firms will be increased, with a mandated minimum level of staffing for each firm.
- The existing specialist prudential risk department of the FSA will be expanded following its upgrading to divisional status, as will the resource of the relevant sector teams.
- The current supervisory training and competency framework for FSA staff will be upgraded.
- The degree of FSA senior management involvement in direct supervision and contact with high-impact firms will be increased.
- There will be more focus on liquidity, particularly in the supervision of high-impact retail firms.
- There will be raised emphasis on assessing the competence of firms' senior management. 54

53 The FSA’s supervisory enhancement programme, in response to the Internal Audit Report on supervision of Northern Rock,
54 FSA Press Notice, FSA moves to enhance supervision in wake of Northern Rock, 26 March 2008