

The UK financial system: lessons from Northern Rock

There can be no doubts that the Northern Rock (NR) affair has sent shock waves through the financial system and raised many questions about the conduct of most “actors” within the system.

If we are to understand the current crises, we need to go back to the 1986 “big bang” which liberalized the financial markets in the UK, opened them up to competition and allowed organizations to offer a variety of products. We moved into a period where increased competition has led to innovation in financial products and organizational types, where loans can be sliced/diced and bundled up (securitized), where credit can be easily accessed, etc.

One part of the NR debacle was the closing up of the money markets as a result of massive defaults in the USA sub-prime mortgage market. In theory, by slicing up individual debts and repackaging them into new units – this allows them to be priced more cheaply through the benefit of diversification. But, rolling together ten pieces of separate garbage still gives one package/unit of garbage. Effectively, securitization has allowed firms to price risk more cheaply as the risk would ultimately be sliced, repackaged and passed on down the chain. This gave rise to loans to individuals (sub-prime) who would ultimately struggle to repay them.

The house of cards began to tumble when large numbers of US sub-prime mortgage holders began to default at the same time and this raised questions in the system about previous lending policies. While the number of mortgage defaults was causing concern, what caused more concern, and the ultimate seizure of the global money markets, was that nobody was quite sure who was bearing the risk because the process of slicing and repackaging risk and passing it on down the chain made it difficult to track who was holding what.

NR's business model

The basics of prudent banking have not changed since Roman times. Banks take deposits from customers and then lend a proportion to individuals and businesses. The risks faced by the bank depend on the quality of the lending and whether they have retained sufficient funds to meet the demands of the depositors. If depositors have confidence in the bank, the retained funds can be as low as 5-10 per cent – however, if confidence disappears through poor lending or suspicions that depositor demands will not be met, then anything less than 100 per cent retention may be insufficient.

Of course, banks can also borrow monies from other banks and financial institutions and this was the mechanism used by NR to rapidly grow its business. However, if other banks also have suspicions about the liquidity (i.e. not enough funds to meet short-term withdrawals) and/or the solvency (i.e. assets are not sufficient to cover liabilities) of another bank, then these sources of funds will also dry up – and this is what happened to NR. Banks are also supposed to have procedures which constantly monitor the levels and types of loans which are being made. However, aggressive growth models, bank size and competitive markets can all place strains on the monitoring process. In assessing the lending decisions of any bank, the following questions should be considered:

- Are sufficient checks in place when determining the levels and types of loans?
- Are the products sold via external agents and, if so, what are the incentive structures and checks/balances?

- What are the processes to chase payments, foreclosure, etc.?
- What are the decision making and review procedures?

All of the above eventually feed through to the quality of the assets on a bank's balance sheet and the following example of a home loan on a new flat illustrates the risks:

- The developer sells off plan at a 15 per cent discount but the price has been inflated to incorporate the discount and the possibility of an 85 per cent mortgage.
- The customer is able to borrow at 85 per cent of the full list price and this means that no deposit is required.
- In addition to not needing a deposit, a customer can self-certify his/her income (normally via a broker who organizes the mortgage) so he/she has sufficient income given the normal multiples.
- If the self-certified income is not sufficient, then some banks have been stretching the normal multiples (3-4 times income) to 6 or 7 times income.

The consequence of the above is that individuals have been able to buy the flat of their dreams not realizing that repayments will hurt once the introductory teaser rates lapse/interest rates rise and the dream turns to a nightmare when the inflated bubble prices deflate to less than their mortgage.

NR seems to have fallen foul of much of the above. Having moved from a northern-based building society to a listed bank, it pursued a business model of focusing on becoming a major supplier of mortgages to the UK housing market. It achieved rapid growth of its mortgage loan book through aggressive pricing and attacking the riskier segments of the market. It argued that this was possible through its efficient and low-cost operations. However, with the benefit of time it has become obvious that its margins were paper thin and it had relied on the money markets for its mortgage funds. In essence, it was taking risks with both its lending and borrowing.

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While it is easy to be critical of this extreme business model, one should not forget that it was a listed company with shareholders demanding returns, it was feted by the business press for its spectacular growth and it was part of a system which promoted easy credit and a “now” mentality.

However, while we can look to a wider set of factors, the basic decision making of NR looks questionable from a number of perspectives.

1. To rely on the money markets for 75 per cent of your funds is extreme from any perspective. It was even more extreme, when very few other lines of short-term credit were lined up and when one considers the aggressive expansion in the mortgage market in the first half of 2007 when other providers were starting to backtrack from this market.
2. The aggressive nature of the NR model is further illustrated by its “Together Product” which includes loans and a mortgage and can be 125 per cent of

mortgage value and the 5-6 times income multiples it accepted from mortgage customers.

3. While NR may have an average loan to value (LTV) of 60 per cent (not too extreme), this hides the fact that 30 per cent of its mortgage book has a LTV of more than 80 per cent and that 20 per cent of its new business in 2006/2007 had a LTV of more than 90 per cent. Such LTVs leave NR heavily exposed if the housing market starts to crack – and there are signs of this happening as a result of the crunch brought on, at least partially, by NR itself: while asset price inflation can have a life of its own, so can asset price deflation!

Lessons learned?

The past 20 years have seen the development of a financial culture which has emphasized the benefits of easy credit. Individuals and businesses have been encouraged to live beyond their means via access to easy credit and now the chickens of this unsustainable “consumption” are coming home to roost.

Every possible indicator of financial distress is on an upward trend and it is far from clear how all of this is going to be fixed. It is clear, however, that the government cannot bail out all of the victims of this period of largesse and nor should it. Bail outs bring with them the moral hazard of expectations that other crises will be bailed out and hence promote increasingly risky behaviour. While this should not preclude the government resolving crises which have true systemic impact, it should make it think hard about lending behaviours within the system and the resolution of their failure.

So, what have we learned from NR? First, we need to understand the detail of the chain of securitization. The originators of the loans in this process take on little risk as the loan is passed on and hence, there is little incentive to assess risks carefully. Consideration should be given to originators being obliged to hold some of the initial loans but in a market economy, this is easier said than done. Equally, the credit rating agencies may well need regulating so that their assessment processes are well defined and transparent. There is also the need to ensure that liquidity risk is understood and rated.

The second set of lessons refers to the regulatory framework. NR pursued an aggressive business model but the supervisory system seemed unable and/or unwilling to act. This casts doubts as to the efficacy of the current supervisory arrangements in that the FSA is clearly guilty of not understanding/reacting to the NR business model. Not one of the agencies emerges well from this saga – the FSA failed to spot the danger of the aggressive NR business model, the Bank of England (BoE) worried about the impact of its actions on future crises rather than dealing with the current crisis and Alistair Darling, the Chancellor, failed to reassure depositors in a timely manner.

Finally, it is worth re-emphasizing that the current crisis is just one reflection of a far wider set of changes which have taken place in western societies. The market economies of the west were built upon innovations in production and consumption which led to the “mass consumer society”.

This system has been further powered in recent decades by the innovations in the financial markets which have eased access to credit – essentially consumption in the present has been enhanced by borrowing from the future on a mass scale. This has moved individuals, organizations and systems into uncharted waters – we all know that there has to be a correction, we just do not know how deep and broad the correction is going to be – and the longer we wait, the deeper and longer it will be.

We may be wrong but we predict that the past couple of decades in the financial markets will go down in history as some of the most irresponsible.

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