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UK banking post-Northern Rock: A round-table discussion on the implications of the Northern Rock affair, with Eric Leenders (BBA), Gillian Tett (*Financial Times*), Christopher Fildes (*Evening Standard*), Phil Middleton (Ernst & Young), Peter Cooke and Charles Goodhart (LSE) held on Wednesday, October 3, 2007, at the City Club, 19 Old Broad Street, London, EC2N 1DS, from 12:30-2:15pm.

This round-table may become the nearest the UK gets to a forensic investigation into the near-collapse of Northern Rock (NR) and the lessons to be learned. Each of the people who spoke came up with different aspects of lessons but the overall feeling was that the regulatory system needed reform, that the changes should be considered rather than knee-jerk and that the implications for both wholesale and retail financial markets and for London as a financial centre were quite profound. Many panellists warned the pain would be felt next in the housing market, particularly in the buy-to-let sector.

The first speaker took a consumer's perspective, asking how something as important as the Bank of England (BoE) offering a line of credit to NR could have leaked at 10pm the night before. Such an event was foreseeable and a public relations strategy put in place, yet no one from the three members of the tripartite regulatory system – BoE, Financial Services Authority or Treasury – appeared on the media until the next week. Given the growth in Internet banking it was hardly surprising people who tried to access their account online and found the website crash, rushed to queue outside the branches. The silence also made people ask questions about potential compensation, and finding it capped at £31,700, joined the queues. The bottom line was that customers were left high and dry and voted with their feet. He said London was now the laughing stock of Europe after lecturing the Continentals on the excellence of their regulation for so long.

The second speaker said it was still unclear why NR had not been able to obtain funding in the market when other banks had. There was a striking similarity with the Japanese crisis 10 years ago over the collapse of Yamaichi. One institution failed, consumers panicked, the government issued a ham-fisted response and the recriminations began. The lesson is that while the psychological shock faces, it takes time to rebuild confidence especially in structured products. The tripartite regulatory system needs major surgery.

The third speaker picked up that theme saying removing responsibility for financial stability from the Bank was a self-inflicted wound. Leaving responsibility for one bank with the FSA in Canary Wharf but responsibility for the whole system at the BoE risked something slipping off in between. He asked a simple question: "Who is in charge?" After 9/11 it was clear the New York Fed was in charge; that was not the case in August 2007. He warned the Chancellor's open-ended guarantee to savers set a "hideous precedent". He suggested a bankers' mutual where the market set premium rates, favouring sound banks but penalising the suspect. However the final speaker said this would stop new entrants, favour large banks over small banks and allow them to capture market share.

The fourth speaker said there would be a flight to quality among investors. He doubted there would be a major impact on the UK markets but echoed the point made about the damage to London as a financial centre. He said the affair has raised questions over the tripartite system, the direction of Basel II, rating agencies' role, the validity of models and accounting treatments.

The fifth speaker said it was fair to say crises occurred every 10 years; few people remembered the lessons from the last one; it was hard to design a blueprint for a yet-to-be-known crisis; and banks always acted with the herd instinct. Against that background we needed a more effective mechanism for crisis management although it was also important not to rush to legislate. Transparency needed to be enhanced, particularly over the growth of large banking groups that were able to move risk around without leaving much trace. He said he too had criticised the removal of financial stability from the bank, instead favouring the FSA taking on consumer protection alone in its broadest sense. He said the tripartite system probably operated at too stratospheric a level to know what was really going on at ground level. He added more needed to be done about regulating liquidity levels, as that was root cause of the NR problem when the credit markets shut down.

The final speaker said liquidity was a key issue compared with 30 years ago when banks kept 25% of their assets in liquid form. Liquidity has declined steadily over the years such as that debt with a seven-year maturity can be funded with three-month asset-backed commercial paper. When banks became illiquid central banks were left to step in. He said banks should be responsible for their own liquidity. There should be clear principles that dictated sanctions when banks fell below certain levels but there should not be absolute minimum levels as that would add to the illiquidity. He said the issue should be remitted to Basel to see how much liquidity banks should hold. He said he doubted there would be any major reform of the tripartite system as Gordon Brown was its architect and he did not like to appear wrong.

One member recalled how in 1991 the BoE was aware of fragility in the system but didn't know what the cause was. It talked to all 120 small banks, identified the 40 at risk and found out exactly how many days worth of credit each had. When the BCCI crisis hit the BoE was covertly able to step in and keep the system running. Another member said the Internet meant that covert option was no longer realistic.

Another member said it was dispiriting to know that this tripartite system would have to cope with a major terrorism or business discontinuity event. He pointed out that the FSA was going through major personnel changes at the time of NR that must have weakened its response function. He warned there would be more market re-pricing of risk as explosions continued to go off in different parts of the system. Another said the major impacts would be a downturn in the property market, a chilling impact on the retail financial market that led to social exclusion.

Asked for their final thoughts, two of the speakers pinpointed buy-to-let as an unregulated market with a disaster potential akin the Lloyd's of London crisis. However the final speaker said the UK's failure to build homes would underpin house prices unlike in Spain where he said the rain would fall on second-homebuyers as that market turned.

Perhaps the key lesson was that Northern Rock was one outcome of the explosion in financial innovation over the last decade. There will be a flight to simplicity by investors rather than just quality as people realise the implications of the slicing and dicing of risk. Although painful in the short-term – especially for people recently employed in slicing and dicing – it may lead to a better financial system that is less dependent on alchemy.