Not the Rock of Ages

What should we make of the Northern Rock imbroglio?

by Peter Warburton

Peter Warburton

Was Northern Rock the victim of US financial folly, or of its own incompetence? Are there deeper ethical considerations, to do with sponsorship? Peter Warburton investigates

Northern Rock began life 150 years ago as the Northern Community Fund, formed by a group of shopkeepers. In 1968, it merged with the Rock Permanent Benefit Building Society and by the time it abandoned its building society status, it was the consolidation of 53 societies. Northern Rock floated on the Stock Exchange as a public quoted company, relinquishing its mutual status, on the 1st October 1997.

The company has a very significant regional footprint. It employs more than 5000 people in Newcastle and Sunderland and its charitable foundation has donated more than £170 million to 1500 organisations and charities across the region. From 2003, Northern Rock became the primary sponsor of Newcastle United, renewing in 2005 for a five-year commitment at a cost of about £25 million. The company also sponsors Durham County Cricket Club and Newcastle Falcons Rugby Club. Through its historical, charitable and sporting connections, Northern Rock has become integral to the regional economy. Little wonder then, that the overwhelming local reaction to its financial troubles has been a defence of its character and objectives. Newcastle offered Northern Rock the freedom of the city last October. It is tempting, therefore, to view Northern Rock as a victim of circumstances beyond its control: a righteous local hero cast down by the giants of the financial world.

This caricature neglects some important facts about the global financial markets and the recent development of mortgage finance on both sides of the Atlantic. The developed world, with the main exceptions of Japan and Germany, is in the grip of an unprecedented housing boom. Whilst this is not necessarily a house-building boom, it is a love affair with the ownership of property. There has been no comparable period in modern history when house prices have appreciated by so much, for so long and in so many countries simultaneously. One manifestation of this has been the boom in mortgage finance and the financial innovation which has blossomed around it. There is no argument that the epicentre of the 2007 mortgage crisis was the United States. During the past four years, mortgage offers have been extended to millions of borrowers with slender chances of sustaining the arrangement. Home loans have been configured in such a way as to make the initial payments affordable but not the full costs of home ownership. In other cases, loans have been granted in the absence of any evidence of income and to the neglect of the borrower's poor credit history. Over the past ten years, innovations in the provision of mortgages have migrated to the UK and, as a result, many of the problems also. Before we accept the account of Northern Rock as the aggrieved victim of US financial folly, we must examine the behaviour of the UK bank in terms of its own prudence, risk control and accountability.

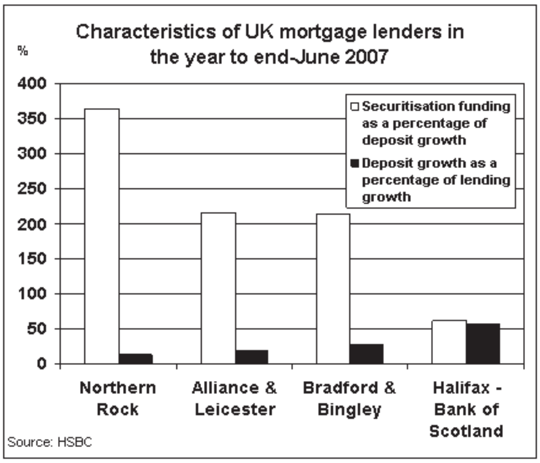
From tortoise to hare

Since leaving behind its building society past, Northern Rock has transformed from a staid mutual into an opportunistic financial institution. For those who had not followed its dramatic journey, the sense of incredulity at its demise was particularly great. It is not the purpose of this article to analyse the activities of Northern Rock in any detail but it will be necessary to grasp how its management embraced trends in financial sophistication and innovation with alacrity. Beneath the veneer of inherited conservatism, Northern Rock tested the boundaries of prudence and liquidity, building a 20% share of the new mortgage market in the UK at its zenith.

The characteristics of a building society are such as to provide relatively modest incentives to its top managers. In contrast, as a fully fledged bank, Northern Rock adopted exciting incentive schemes for its senior executives, comprising bonuses paid largely in shares and employee share options. Like any company where the remuneration of senior personnel is highly geared to the share price, the emergence of a rapid growth strategy follows naturally. In a competitive financial market, rapid organic growth can only be achieved by taking an aggressive market position in order to win a larger share of the business. Northern Rock elected to become extremely competitive in segments of the mortgage market and yet refused to accept the constraints of its lowly base of customer deposits. As a junior player in the banking system, Northern Rock found it difficult to attract retail deposits without offering very attractive saving rates. Clearly, a strategy based on offering the highest rates to savers and the lowest rates to borrowers would be a recipe for low profitability, dull share price performance and the disaffection of senior personnel.

Instead, Northern Rock identified three ways that it could expand its balance sheet and its profits. First, it began to borrow large amounts of money (tens of billions of pounds) in the international money markets. Here, because the bank enjoyed a strong credit rating, it could borrow on much the same terms as the much larger banks, such as Barclays and HSBC. A second avenue of innovation for the Rock was the greater use of securitisation of its loan book. Northern Rock parcelled up batches of its mortgages into separate securities or bonds, and sold these to investors. This gave the bank scope to originate even more mortgages and earn more fees. The third significant departure from its building society roots was to offer mortgages where the loan represented 100% or more of the value of the property and mortgages where borrowers were allowed to certify their own incomes. High loan-to-value mortgages imply a very confident view of future house prices, relying on home price appreciation to make the original loan more secure. Self-certified mortgages invite borrowers to exaggerate their incomes in order to qualify for a larger loan. This often leaves them financially stretched and vulnerable to default. It is estimated that between 5%-10% of Northern Rock's mortgage book consists of these more vulnerable mortgages.

By 2007, these three strands had intertwined to propel Northern Rock on an unsustainable growth strategy. Whilst other banks had engaged in similar activities, the chart shows that none had pushed the boat out to quite the same extent. When disaster struck, it punished Northern disproportionately and immediately. The fall-out from irresponsible mortgage origination in the US sent shock waves to the international money markets on which Northern was crucially dependent. It raised the cost even of retail deposits and it increased the pressures on marginal mortgage borrowers.



A moral critique of Northern Rock

While the demise of Northern Rock has been widely described as provoking the first run on a bank in England since Overend and Gurney in 1866, there are many respects in which Northern Rock is similar to other failed or humbled enterprises in the past ten years. Parmalat, the largest food company in Parma, Italy, was another regional champion which also sponsored the local football club. Parmalat foundered on the discovery of a fictional asset on its books to the tune of €4 billion. It became Europe's largest ever bankruptcy when it collapsed in December 2003. In America, two giant corporations known as Fannie Mae and Freddie Mac, have facilitated home ownership to low-income families for generations. However, in 2005, they were found to have boosted their profits using irregular accounting and derivatives practices. These profits had been the basis of significant payments to senior executives. Fannie Mae and Freddie Mac have subsequently had their managements removed and their wings clipped.

We cannot conclude from the nobility of the objectives of an enterprise that it has a sound and prudent basis from which to pursue them. In the absence of honest, sustainable and accountable business practices, there is always a temptation for size and philanthropy to be used as means of coercion in times of crisis. The potential for a financial failure to reflect badly on government, or to result in localised unemployment, has often been used as a plea for special treatment. It would be unthinkable for Fannie Mae to cease its lending because of the central role that it plays in the American economy. Parmalat believed that it was immune from failure because of its importance to the regional economy in Italy. While it would be incorrect to assert that Northern Rock was supported by the Bank of England for the sake of the North-East economy, the credibility of the UK government has become inextricably linked with the outcome of this imbroglio. It is therefore desperate for a resolution of the matter.

Could Northern Rock's sponsorship of Newcastle United be used as means of coercion in times of crisis?

The Puritans and the Quakers, among others, developed models of community involvement, social improvement and charitable work that rested upon strong business and ethical foundations. Both Rowntree and Cadbury enjoyed periods of rapid business growth without compromising their futures. They resisted the temptation to mortgage their business assets, preferring to accept the constraints of their business environment. Doubtless, they were guided by biblical injunctions regarding prudent business development, the importance of reputation, the appropriate use of debt and the obligations that attach to it. Proverbs 22 serves as a template:

Proverbs 22:1 "A good name is more desirable than great riches; to be esteemed is better than silver or gold." Northern Rock had a very good name and was highly esteemed, but sacrificed this in the pursuit of financial gain.

Proverbs 22:3 "A prudent man sees danger and takes refuge, but the simple keep going and suffer for it." The management of Northern Rock could not have been ignorant of the dangers inherent in their over-dependence on short-term loans from the money markets. There have been many brief intervals when such borrowings have suddenly become more expensive; these were warnings that should have been heeded.

Proverbs 22:7 "The rich rule over the poor and the borrower is servant to the lender." Northern Rock should have foreseen how its negotiating position would weaken if it was unable to renew its massive borrowings from the money markets.

Proverbs 22:26 "Do not be a man who strikes hands in pledge or puts up security for debts; if you lack the means to pay, your very bed will be snatched from under you." Financial sophistication is not a new invention; the complexity of Northern Rock's dealings in the debt markets exposed them to unnecessary risks.

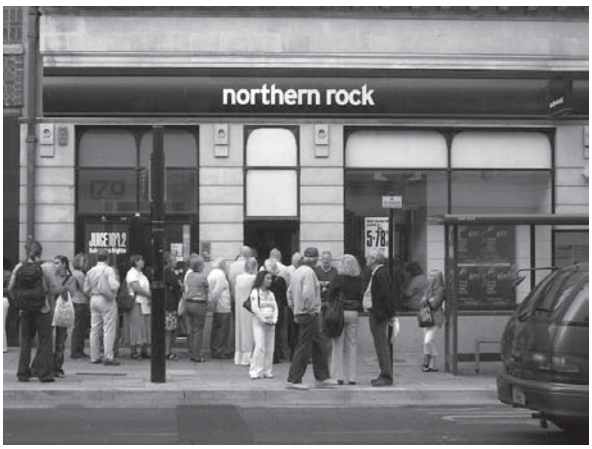
It would be inconceivable for Northern Rock to have stumbled in this way had it maintained its mutual status as a building society. It is notable that when Northern Rock customers scrambled to withdraw their deposits during those fateful days last September, most moved their money into building societies. Lacking shareholders, these are viewed by the public as being better aligned with the interests of their customers.

Broader ethical issues

Many other ethical issues are raised by the actions of the Bank of England to bail out Northern Rock as it became unable to renew its borrowings in the money markets and suffered a haemorrhage of its retail deposits. Arguably, Northern Rock has already received special treatment in having a guarantee of 100% protection provided to all its depositors. As things stand, other UK depositors are fully insured only up to £35,000 with a single institution. Furthermore, last December, the Treasury ordered the extension of its guarantee to a wide variety of other liabilities in order to prevent a downgrade of its credit rating, resulting in a total obligation of £55 billion. In January, a proposal was made by the Treasury to guarantee an issue of £25 billion of Northern Rock bonds, secured on its mortgages. If approved, this would represent an unprecedented and open-ended commitment on behalf of the taxpayer towards Northern Rock, lasting at least 5 years. At the time of writing, it is unclear whether even this will secure an independent future for the stricken bank or whether the government will be compelled to take it into administration. Should the bank enter administration, and have its assets auctioned off at a discount to book value, it is probable that they would not fully extinguish its liabilities. In both cases, it is likely that UK taxpayers will bear some portion of the cost of Northern Rock's failure.

Biblical teaching on debt and borrowing has many aspects. At the outset, there is a clear moral imperative on the borrower to make full repayment of all loans. Psalm 37:21 "The wicked borrow and do not repay, but the righteous give generously." The psalmist does not mince his words: the careless use of borrowed money, such that repayment is imperilled, constitutes an act of wickedness. The failure to repay is akin to an act of theft, depriving others of their savings and leaving them with lower future incomes. Bible teaching on mercy, forgiveness and restitution is set in the context of the gravity of the offence.

And what of Northern Rock's mortgage holders? Logically, they may be required to pay higher interest rates than obtainable elsewhere as the bank struggles to re-establish itself under new managers and probably new owners. Whatever the merits of Northern Rock's charitable and community activities, if its recklessness ultimately results in a subsidy from UK taxpayers and has impaired the circumstances of its mortgage borrowers for years to come, then it must be judged accordingly.



Small line of customers (presumably anxious investors and savers) outside a branch of Northern Rock in North Street, Brighton, late on Friday afternoon 14th September 2007.

Jesus gave two pieces of timeless advice to builders. First, to dig deep and lay solid foundations (Matt. 7:24-28); second, to count the cost in order to ensure completion (Luke 14:28-30). Northern Rock built an impressive tower on foundations designed to bear the weight of a much more modest structure. "The moment the torrent struck that house, it collapsed and its destruction was complete." While, at the time of writing, the destruction of Northern Rock is incomplete, the suddenness of its demise provides a salutary lesson in business development. ■

Peter Warburton is director of Economic Perspectives Ltd, an independent economic consultancy and economic advisor to Ruffer LLP, an investment manager.