To Northern Rock Shareholders

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Northern Rock Shareholders Action Group – Update No. 20

The Treasury Committee Report – No Whitewash!

On the 24th January the House of Commons Treasury Committee published its report on the crisis at Northern Rock under the title "The run on the Rock". The full report is available from http://www.publications.parliament.uk/pa/cm200708/cmselect/cmtreasy/56/56i.pdf on the internet. Here is a summary and some comments on the 180 pages for those who don't have the time to peruse it in full - although it does make interesting reading, particularly in analysing the mistakes that took place.

The report is highly critical of both the directors of Northern Rock and of the Government embodied by the Financial Services Authority (FSA) and the Tri-partite authorities. One has to bear in mind of course that the majority of the MPs on this committee are from the Labour Party, so it is perhaps not surprising that there is no wider analysis of the role played by the Chancellor of the Exchequer and Prime Minister in the affair. But here is what the executive summary says:

"*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*."

Does this analysis stand up to scrutiny? Let me try and answer that question.

The Role of the FSA

It is clear from the report that the FSA acknowledges that there were clear warning signs of problems at Northern Rock well before the crisis arose. But the FSA seemed to concentrate on ensuring sufficient "capital adequacy" rather than cash liquidity – for example Northern Rock obtained from the FSA a waiver for "Basel II" compliance on the 29th June 2007 which enabled it to increase its dividend substantially.

But capital cover was not a problem at Northern Rock – we know that its assets well exceeded its liabilities when it ran into trouble – and still do so. Although the FSA has a "Sterling Stock liquidity regime" to cover liquidity, it seems that this was not adequate in respect of the problems that Northern Rock faced. In addition, although the company did do some "stress testing" of its cash flow forecasts, these did not anticipate the kind of "fat tail risks" that financial professionals now worry about.

Fat tail risks are those where the expectation of rare events is very low, using the typical "normal" statistical distribution of random events, but where in reality they are much more frequent than would be predicted by normal mathematical models based on those statistics, i.e. disastrous events happen more frequently than expected. So in the case of Northern Rock, there was no expectation that the financial markets that Northern Rock was using to fund its mortgages would close down so completely and for so long.

In essence the problem was that neither the company nor the FSA had any systems that would anticipate the totally unknowable and unpredictable events that occurred. However the report does specifically say "*The current regulatory regime for the liquidity of United Kingdom banks is flawed*" and they say that reforms to the regulations cannot wait. One cannot be much more specific than that.

They also say that "*It was the responsibility of the FSA to ensure that the work of the Board of Northern Rock was sufficient to the task. The FSA failed in its duty to do this.".* It is difficult not to agree with those conclusions.

The Role of the Directors

There is a telling quotation from Adrian Coles, Director-General of the Building Societies Association in the report. He said to the Committee "*Had Northern Rock stayed a building society, it may or not may have been a successful institution but it would not have come to the sticky end that it appears to have come to in the way that it has*". It seems UK building societies have more conservative practices regarding liquidity.

Looking at the history of Northern Rock since it demutualised ten years ago, it is clear that the strategy to expand the business, to gain market share, to raise more funds to back even more mortgages, and so on, became more aggressive over the years. This was led by a forceful chief executive towards the end. The company became more reliant on short and medium-term wholesale funding and it had insufficient insurance and standby facilities to cover the risk of those sources drying up (although it did have some such insurance).

The report solely blames the Board of directors of Northern Rock for the formulation of the strategy that got them into these difficulties with particular criticism of the Chairman of the Board (Matt Ridley), the Chairman of the Risk Committee and the senior non-executive director, for failing to ensure that the company remained liquid and "*to act as an effective restraining force on the strategy of the executive members*".

But when you read the details of the report, it is less clear-cut than it might appear. The wording of the report suggests the directors were incompetent and failed in their duties, but that to my mind is far from the truth and is not backed up by the evidence that is provided. The directors clearly took prudent steps to model their business plans, and anticipate funding requirements. What they failed probably to anticipate, which really caused the problems that pushed Northern Rock over the edge, was the handling of their funding needs by the Bank of England, the mismanagement of the fateful announcement and the resulting "run" of retail depositors. More on this later.

One can of course by definition say the directors failed to anticipate the crisis, but it's always easy to criticise with hindsight. The key question is: would any normal set of intelligent and experienced directors have also failed to anticipate these problems and I suspect the answer is "yes". It seems more blame should be allocated to the FSA for permitting such a strategy by imposing lax rules than should to be assigned to the board, at least to me.

It's worth pointing out that the directors concerned have not been given the chance to publicly rebut the criticisms by the Committee, which are made behind the cloak of "parliamentary privilege".

The Experience and Qualifications of the Directors

The report also criticises the Chief Executive for having no qualifications as a banker (although of course he had much experience in the company) and also comments on the background of the Chairman. They say "*The FSA should not have allowed nor ever again allow the appointments of Chairman and Chief Executive to a high-impact financial institution where both candidates lack relevant financial qualifications*". However, the board did have other individuals such as Sir Derek Wanless who had very relevant experience.

I think this is a valid point to some extent. Personally I always get concerned about Chairmen of public companies who have no career background in the sector in which the company operates, but it is not unusual.

The Liquidity Crisis in August 2007

The report examines the events of August in some detail, including whether the Bank of England could have done more to provide greater liquidity in the markets used by Northern Rock to raise funds – as it is alleged other central banks did. It is clear that the Bank of England seemed much more concerned about "moral hazard" than were other banks. The report says "*We are unconvinced that the Bank of England's focus on moral hazard was appropriate for the circumstances of August*".

In essence the company could have reasonably expected some support from the Bank of England as "lender of last resort", but then found that avenue obstructed for some time. Also Hector Sants of the FSA said to the committee: "*it clearly is the case that if liquidity in smaller amounts had been available to Northern Rock earlier, then it is quite possible it would not then have subsequently needed to apply to the lender of last resort facility*" and the BBA made similar comments.

Note that even when Northern Rock did ask for the lender of last resort facility be made available, they expected not to have to use it, but the subsequent depositors "run" changed all that.

The Fateful Announcement and Subsequent Events

The report examines in some detail the fateful announcement by the company of the support from the Bank of England and whether a "covert" support operation could have been performed instead. They basically come to the conclusion that it would have been difficult to keep it quiet, so some announcement was probably required. However there was clearly some delay and confusion around the announcement.

As the report points out, the news was leaked by the BBC at 8.30 pm on the 13th September following rumours in the marketplace. This forced the company to bring forward the announcement to 7.0 am the next day.

What the report does not comment on is the way the BBC and other media presented the information, which was in their usual melodramatic manner. Although the RNS announcement was also poorly worded, not many members of the general public read those. Anyway as the Committee pointed out, the media coverage seemed to prompt depositors to withdraw their money. "*Panic was how it was seen*" in the words of Sir Callum McCarthy.

To quote from the report: "*In failing either to make an announcement earlier in the week or to put in place adequate plans for handling press and public interest in the support operation, the Tripartite authorities and the Board of Northern Rock ended up with the worst of both worlds."*

In my view it is odd that the committee does not heavily criticise the BBC for its leaking of the news and the way in which it was reported. Clearly the BBC knew that it was confidential information that had not yet been publicly disclosed – is this the action of a responsible organisation and commentator on the financial scene, or the act of someone who is keen to get their scoop out first? And the BBC suggesting depositors do not panic may have simply caused them to do so. The lack of any analysis in the report of the impact of media reporting on the crisis at Northern Rock also seems to be a gross omission.

Thereafter the committee criticizes the failure to anticipate the likely effect of the announcement and the delay in putting in place the deposit guarantees that eventually halted the run.

Yet Another Unfair Attack on Shareholders

The report contains yet another attack on the role of the shareholders in Northern Rock (indeed in any public company) that we have seen so frequently in the last few weeks in the press and other media.

Firstly they state "*the business model of Northern Rock was clearly stated*" based on what Sir Ian Gibson said to them. Perhaps it was, but that is a far cry from investors knowing the risk underlying that model. Did shareholders, particularly the 150,000 unsophisticated private individuals, really know all the risks associated with the strategy of the board? Even the board itself doesn't seem to have understood them, so it is nonsense to suggest that they would.

Investors were surely relying on the wisdom and experience of the board, backed up by the regulation by the FSA. And it is clear that the latter was deficient.

So the report goes on to conclude "*that shareholders as a whole must be viewed as taking a risk from which they sought a reward and for which they are now paying a price*". In effect they seem to be implying that it is no concern of theirs that shareholders lose all because the stock market is pure speculation – utter nonsense in my view. Investors rely on fair and adequate regulation of stock market companies and they should be adequately protected against deficient regulation. That is why we have argued all along that the Government has some moral if not a legal responsibility to promote and support the interests of shareholders in Northern Rock because the Government was ultimately responsible for many of the failures that contributed to the difficulties of the company.

Report Conclusions

The report goes on to make some recommendations about reforming the banking supervision regime and the protection of depositors. This is beyond the scope of my commentary here although we have already said that we believe some reform is necessary to ensure wiser and more expeditious decision making when such crises occur. Otherwise Northern Rock will not be the last British bank to suffer a run by depositors.

In summary, although there are many good points in the report by the Treasury Committee, it places too much emphasis on the alleged failings of the directors and too little on the defects in regulation and the media response to the crisis. It lines up the former directors as scapegoats when the failings are more systemic and arose from a combination of circumstances.

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