Northern Rock:
The Forgotten Harbinger of the Global Financial Crisis

During the early days of 2007, Northern Rock stood as the fifth-largest bank in the United Kingdom by mortgage assets; with £113.5 billion in assets, the bank had grown tremendously from its origins in the twentieth century as a simple building society. However, by August 2007, as troubles in the wholesale market[i] became apparent, Northern Rock informed the Financial Services Authority (FSA) that the bank had a liquidity issue. On September 14, 2007, a month after notifying the FSA about its funding problems, and after regulators failed to find an acquirer for Northern Rock, the Bank of England (the Bank) announced that it would be bailing out the bank by providing "emergency funding" to keep the bank operational (Hall, 22). At the time, several contemporaries criticized the Bank for its decision, citing Northern Rock's relative size in the U.K. financial system, the unwillingness of the Bank to provide sufficient liquidity assistance, and the Bank's perceived inflexibility in providing financing to potential acquirers. Although it ultimately faced several obstacles during its execution, the decision to bail out Northern Rock would prove the best available option by grappling with the systematic reliance on the wholesale market, addressing the spillover effects of the run on Northern Rock, and in working expediently given the legal barriers presented by U.K. law.

Although Northern Rock had a distinct business model, the bank can be seen as a paradigm of the type of financial institution that would ultimately face complications during the Global Financial Crisis—banks that demonstrated robust balance sheet growth fueled substantially by activity in the wholesale market. When Northern Rock went public in 1997, it had consolidated assets of £15.8 billion (Milne et al., 5). Over the next ten years, the bank would grow at an "equivalent annual rate of 23.2 percent" to become the eighth largest bank in the United Kingdom by the end of 2006. However, underpinning this extraordinary growth was an "unusual business model" that was clearly depicted in the way Northern Rock structured its balance sheet (Milne). On the asset side, Northern Rock concentrated on the "illiquid long-term mortgages" traditional to building societies (Milne 6). But on the liabilities side, the bank relied heavily on securitized and wholesale funding. Although the use of wholesale funding had become commonplace amongst U.K. banks, what was unusual about Northern Rock was the extent to which it relied on it: in 2006, the issuance of mortgage-backed securities accounted for two-thirds of the growth of the bank's balance sheet (Shin 108). Furthermore, as its balance sheet grew unabatingly, Northern Rock's deposit/loan ratio fell precipitously, reaching 31% in 2006 (the lowest of the ten largest UK banks). Of these retail deposits, more than three-fourths were non-traditional offshore, postal, and online accounts (Shin 109). This unique composition of Northern Rocks depositor base would play an integral role in the eventual run on deposits in 2007.

As a result of this unconventional business model, lapses in the wholesale market had a disproportionate effect on Northern Rock and led to a run in its wholesale funding well before the well-publicized bank runs in September of 2007. As the summer of 2007 progressed, and the sub-prime crisis compounded in the United States, "astute investors" began shorting Northern Rock stock as early as June of 2007 (Hall 27). As the wholesale market began to dry up, the bank found itself lacking the liquidity it needed to operate and the Bank was forced to step in as a "lender of last resort" for Northern Rock. Officially, the Bank created an "open ended facility which charged the bank a penal rate" and Northern Rock was able to use mortgages and mortgage-backed securities as collateral; in return, the Bank would indemnify Northern Rock against any losses (Hall 22).

In creating the open-ended facility, the Bank hoped to reassure Northern Rock's depositors. What ensued instead was the first bank run in the U.K. since 1878. People around the world watched as "depositors waited in line outside the branch offices" of Northern Rock to withdraw their money (Shin 101). Ironically enough, much of the run on deposits was still intangible; approximately seventy percent of the retail deposits lost was via postal, offshore, and internet/telephone accounts (Shin 109). These depositors chose banks purely by seeking the best interest rates and lacked loyalty to Northern Rock itself. Once it became evident that Northern Rock had run into problems, these depositors withdrew their money. Although dramatized on television, it is evident that this “old fashioned bank run” was a response to the liquidity crisis facing Northern Rock, not the “event that triggered its liquidity crisis,” a theory commonly cited in early media coverage of the run (Shin 102). Amidst this confusion, one thing was certain. Northern Rock had seen £10 billion withdrawn in a matter of days. As a result, the Bank was forced to extend its original announcement; on September 17, 2007, the U.K. Treasury announced that it would fully guarantee all existing Northern Rock deposits.

The decision to bail out Northern Rock shocked contemporaries who questioned whether the tripartite agencies (the FSA, the Bank, and the Treasury) had truly explored all options beforehand. One area of concern for opponents of the bailout was the size and importance of Northern Rock relative to other major English banks. Although Northern Rock had grown tremendously since its IPO in 1997, it was still much smaller than the premier U.K. financial institutions (i.e. The Royal Bank of Scotland, Barclays, HSBC) of the early twenty-first century. By the end of 2006, as Northern Rock approached its apex, it was still more than eight times smaller than the largest U.K. bank at the time, The Royal Bank of Scotland. In fact, Northern Rock only constituted approximately 2.5 percent of the total assets amongst the ten largest English banks. As a result, many argued that the bailout of Northern Rock could “certainly not be justified by the size or reputation of Northern Rock” which was at best a “medium-sized domestic bank,” akin to Bancorp or M&T Bank in the United States (Mayes et al 96). These detractors used the near failure of Baring Bank in 1890 as a litmus test for whether Northern Trust deserved to be saved. According to these critics, regulators should have examined whether Northern Rock was of "sufficient importance… that its failure would have damaged the reputation of [the English financial system]" (Milne, 20). If regulators found that Northern Rock did not meet this criterion, then the bank itself should have been allowed to "sink or swim" on its own (Milne, 20). Concurrently, the Bank should provide liquidity to the rest of the banking sector to "calm any subsequent panic" from the failure of Northern Rock (Milne 20). To critics, if Barings, a cornerstone of the financial architecture of the nineteenth century, had not merited a government bailout, surely a former building society in the northeast of the United Kingdom did not.

However, despite its size, the bailout of Northern Rock was not intended as an early iteration of saving a financial institution that was "too big to fail." Instead, it was a recognition by English regulators that, in a modern financial system, "banking and capital market conditions could not be viewed in isolation" (Shin 102). In many ways, the use of securitization and wholesale funding by Northern Rock was integral to its exploding growth in the early part of the twenty-first century. In the same period, U.K. banks as a whole almost doubled their use of wholesale funding, growing from a median use of 27.8 percent in December 2000 to 47.8 percent by December 2007 (Shin 104). Despite signs of overheating in subprime markets by the summer of 2007, Northern Rock had issued a "very positive outlook [for 2007]" as late as July 25, 2007 (Goldsmith-Pinkham 86). Yet, in a matter of weeks, "sophisticated lenders made the sudden choice to deny lending to a bank that had an apparently solid asset book and virtually no subprime lending." (Shin 102). To astute investors, Northern Rock's prolific use of the wholesale markets, though advantageous in more stable financial times, was now a threat to its existence. By taking a comprehensive view of the English financial system, regulators understood that this was not an isolated incident. Once investors had wrested enough profit from betting against Northern Rock, they would go after other English banks which relied heavily on wholesale funding.

Empirical evidence of the spillover effects during the Northern Rock incident bolsters the notion that the bailout of Northern Rock was not primarily driven by concern over the individual institution. Rather, by choosing to bail out Northern Rock, the Bank sought to instill market-wide confidence in a financial system that relied heavily on the wholesale market. On September 17, 2007, the same day that regulators announced that they would guarantee all existing deposits at Northern Rock, there was a "strong spillover effect on the rest of the banking system as confirmed by the negative abnormal returns for several U.K. financial institutions." (Pinkham 90). Integral to the magnitude of these spillover effects was not the size of the institution, but rather the use of wholesale markets by banks; banks that relied on wholesale markets were acutely affected (Pinkham 94). Although the bailout could not save Northern Rock, it was able to quell the spillover effects from the initial panic, as stock prices began to normalize again. By choosing to bail out Northern Rock, the Bank was not making a declarative statement that Northern Rock was "too big to fail." In fact, the size of Northern Rock probably had very little to do with their decision. Instead, the English government, cognizant of the link between the financial system and wholesale funding, sought to quell the market sentiment that further problems lay ahead for U.K. banks reliant on wholesale funding.

Other critics of the Bank's decision posited that British regulators failed to equip Northern Rock with the proper tools to resolve its own problems, forcing the bank to ultimately seek government assistance. When it became evident that problems in the wholesale market would persist and that Northern Rock would soon face a major liquidity issue, it attempted to resolve its own problems through the traditional channels of, "action in short-term money market and securitization of its debt" (Milne 13). In order to do this, there needed to be ample opportunity for the bank to tap into liquidity in the money markets. Typically, this market-wide liquidity was provided by central banks being “prepared to lend, at will, to banks, at a penalty rate of interest and against ‘good’ collateral, until the crisis subsides.” (Hall 29).

By mid-August, both of the Bank’s international counterparts, the U.S. Federal Reserve and the European Central Bank (ECB), had begun implementing this strategy. Despite this maxim and the proactive approach taken by the Federal Reserve and the ECB, the Bank initially refused to offer additional liquidity to the market, “other than through the [existing] standing facility” (Hall 24). Opponents of the bailout argued that, by failing to provide this kind of market-wide liquidity intervention, the Bank “forced Northern Rock to ultimately turn to the Bank for support” (Milne 14). In essence, by not providing sufficient liquidity, the Bank itself had necessitated the bailout of Northern Rock.

Despite the inability of Northern Rock to tap into money markets, similar problems in the United States and in Europe show that it is unlikely that a general provision of liquidity would have been sufficient to save Northern Rock. Both the Federal Reserve and the ECB had been proactive in offering additional liquidity to the money markets in order to safeguard banks from deficiencies in wholesale markets, but this did not stop several banks from experiencing liquidity problems. In the United States, where money was “made available… institutions had to close down and had been taken over by other banks.” (Milne 14). Additionally, in Europe, many of the “smaller German banks” ran into difficulties despite the additional liquidity in the markets (Milne). The failure of banks in these areas where additional liquidity was made available complicates the narrative that liquidity assistance would have solved Northern Rock’s problems.

Furthermore, this argument fails to anticipate the implications of providing sufficient liquidity assistance to the general markets. According to Mervyn King, Governor of the Bank, “a market-wide liquidity intervention” would have implicitly made the market the “lender of last resort for Northern Rock” (Milne 15). A comprehensive view of market conditions makes it apparent that the market could not have played this role effectively. First, throughout the summer of 2007, there had been a serious deterioration of the wholesale market, primarily in the international interbank market where "banks proved very reluctant to lend to each other, even at penal rates." This mutual distrust caused the wholesale market to virtually "seize up" as banks hoarded cash to meet, "contingent liquidity claims" (Hall 20). For Northern Rock, the situation was no different. In 2007 it saw a "substantial outflow of wholesale funds" through the "non-renewal of much of its short- and medium-term paper" (Shin 109). Given these overall market conditions and distrust by market participants, it is unlikely that the market could have acted as the lender of last resort for Northern Rock, even with more general liquidity assistance.

This argument also fails to credit the Bank for the provisions it implemented once liquidity problems became more evident in September 2007. Although the Bank initially refused to improve general lending operations, it eventually began to offer additional reserves to banks that did not meet target rates. By doing so, King posited that "the amount of liquidity that we [the Bank] have extended to the banking system is almost 30% higher" than it would have been without these additional reserves (Milne 14). By providing this liquidity through reserve requirements, the actions taken by the Bank were actually "remarkably similar" to those taken by the Federal Reserve and the ECB (Milne 15). Thus, policymakers argued that the Bank was offering more targeted liquidity to those banks that needed it rather than through general lending operations. Overall, given similar problems in the United States and Europe, the inability of the market to provide the liquidity Northern Rock needed, and actions already taken by the Bank, it is unlikely that an earlier extension of general lending operations would have saved Northern Rock.

Adversaries of the bailout also ridiculed the Bank's perceived rigidity in dealing with potential acquirers of Northern Rock, particularly in refusing to provide sufficient financing to bidders. Prior to the bailout in September, regulators began to pursue a "safe haven," for Northern

Rock in the form of a takeover by a major retail bank. Two institutions, including Lloyds TSB, showed interest in the bank. However, both buyers sought a loan, "which could have been as much as £30 billion without a penalty rate for two years" (Milne 16). Due to this exorbitant loan, the Bank refused to provide such financing and talks of a "safe haven" for Northern Rock quickly dissipated. In the aftermath, several detractors of the bailout, including Adam Applegarth, then chief executive of Northern Rock, strongly condemned the Bank's decision to refuse a loan to a potential acquirer. According to Applegarth, the run on Northern Rock would "not have taken place, in my view . . . if we had been able to announce an offer with a big retail brand" (Milne 15). Although Applegarth conceded that a takeover would have been a lengthy process, he also believed that a contingent offer with one of the major banks would have re-established confidence in Northern Rock and prevented the run on the bank.

Although the Bank initially preferred a private sector takeover, the request for a lending facility demotivated government officials. Applegarth and many Northern Rock executives believed that because an acquirer would forestall a run on Northern Rock, the request for a £30 billion loan might be granted. However, policymakers asserted that the detrimental optics of a loan facility to a potential acquirer would offset the beneficial effects of the takeover. To King, the optics of offering a loan facility to "any bank that will take over Northern Rock" would be a disaster. In particular, regulators felt that offering a loan facility to any acquirer would destroy any remaining confidence in Northern Rock by confirming fears that the bank would become inoperative without an acquirer. The Bank attempted to avoid this by denying the lending facility requested by potential acquirers, but later offering a similar one to Northern Rock itself.

In addition, the Bank would have faced extensive legal barriers in offering financial support to a potential acquirer of Northern Rock or with the takeover of a public company. In the midst of negotiations, potential acquirers all requested loan facilities that charged, "commercial rates"

(Milne 16). By lending to a bank on commercial terms, the loan facility would be defined as State Aid to the acquirer, which was illegal under European competition law (Ndong et al 57). According to these competition laws, if a facility was offered to the acquirer of Northern Rock, it would have to be offered to future acquirers who deemed the costs of acquisition too great. Legal barriers would also make the takeover of Northern Rock, a public company, by any bidder relatively slow and turbulent. The Bank intended to bring the acquirer and Northern Rock in concert over the weekend so that "depositors would have woken up on Monday morning to find themselves depositors of a larger and safer bank" (Milne 16). However, because Northern Rock was a public company, regulators were required to give shareholders, "enough time [to] consider various offers" (Ndong 57). This would have prolonged the takeover while Northern Rock grappled with insurmountable liquidity issues. The large loan amount requested by potential acquirers and the legal difficulties the Bank would have faced made a successful takeover improbable.

Although adversaries proposed several alternatives, the flaws in their plans made a bailout of Northern Rock the Bank's most attractive option. The events surrounding Northern Rock were a microcosm of the ensuing global financial crisis. Northern Rock grew exponentially in the early years of the twenty-first century by leveraging the wholesale market. When it became apparent that the subprime crisis in the U.S. would spread throughout Europe and wholesale markets began to wither, the bank became the target of astute investors who took note of its unusual business model. Those who opposed the bailout argued that Northern Rock should have been left to its own devices, that the Bank should have provided more general market liquidity, or that the Bank should have capitulated to potential acquirers of Northern Rock. Although Northern Rock was far from the largest bank in the United Kingdom, leaving the bank to fail was not a good option. Its bailout was crucial to instill confidence in the entire financial system, which, like Northern Rock, was dependent on wholesale funding. Furthermore, given the inability of the market to provide the liquidity Northern Rock needed and actions already taken by the Bank, it is unlikely that an earlier extension of general lending operations would have allowed Northern Rock to save itself. Finally, the costs and legal barriers made a private takeover of Northern Rock less beneficial than initially anticipated. As a result, although bailing out Northern Rock proved difficult, it was the best and most expedient way to confront systemic reliance on wholesale funding and stem the spillover effects of the run on Northern Rock given the limits imposed by British law.

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[i] Wholesale markets are a funding instrument typically seen as an alternative to retail deposits. In wholesale banking, institutions rely on a mixture of federal funds, foreign deposits, and borrowing in the public debt markets. This shifts the typical dynamic as institutions choose to rely on borrowing from other financial institutions rather than a traditional base. Banks turn to short-term deposits from other financial intermediaries (pension funds, money market mutual funds, etc) to invest in longer-term assets. In booms, this becomes an effective strategy, but in times when liquidity dries up in global institutional debt markets, such as the GFC, it can prove disastrous.