Ten years after the nationalisation of Northern Rock

John Kay reminds us of how the financial crisis unfolded 10 years ago.

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On 22 February 2008, the British government nationalised Northern Rock, a mortgage lender which a few years earlier had taken advantage of deregulation to transform its status from building society to bank. Northern Rock was an early victim of the global financial crisis which began in August 2007 with the failure of some hedge funds sponsored by the French bank Société Générale. A run on Northern Rock took place the following month – the queues formed outside branches as savers hoped to recover their money while there was still some left, a run which was only stopped when the government stepped in to guarantee deposits.

Northern Rock's principal problem

Northern Rock's principal problem, oddly enough, was not the poor quality of its lending, although the bank had been aggressive in promoting mortgages to people with little or no money of their own to contribute to the purchase. The issue was that the bank's funding strategy involved packaging mortgages to sell on to other banks – a process known as securitisation. When buyers belatedly became sceptical about the value of such securities, especially those based on subprime mortgages in the United States, the securitisation market simply dried up, and Northern Rock was unable to refinance its operations.

The financial crisis deepens

The crisis deepened throughout 2008, culminating in September with the bankruptcy of Lehman Bros, and the failure of other US financial institutions. In October, the British government rescued HBOS and the Royal Bank of Scotland, two of Britain's five major banks.

The fundamental problem was that banks have become wide-ranging financial conglomerates, using their retail deposit base, effectively guaranteed by governments, as collateral for a wide range of trading activities. When, as at Northern Rock, these trading activities were unsuccessful, the day-to-day operation of the payment system on which economic and social life depends was jeopardised.

Policy responses to the financial crisis

The policy response to the events of 2008 has three main components. The most obvious, though hotly contested, remedy is to separate retail banking from other financial activities. In 1933 Congress passed the Glass Steagall

Customers queue to remove their savings from a branch of the Northern Rock bank in Birmingham, 15 September 2007.
PHOTO: LEE JORDAN, WIKIMEDIA COMMONS.

Act, which imposed such separation, but that legislation was gradually eroded by industry lobbying and finally repealed in 1999. The Volcker rule, introduced by the Obama administration attempted to restore that separation, but has been reduced to near insignificance by that same industry lobbying. Britain has gone furthest towards introducing a 'new Glass Steagall', and from 2019 UK banks are required to 'ring fence' their retail operations. How effective the separation will prove remains to be seen.

Increased capital requirements

The second element of response is increased capital requirements – the amount banks must hold in reserve against a rainy day. The Basel committee, which co-ordinates international bank regulation, has laboured long to develop new and somewhat more demanding rules. The trouble is that the amount of capital which an institution such as Deutsche Bank would need to support the scale of its activities is far greater than investors are willing to provide.

More effective liability on executives

The third possible response is to impose more effective liability on the very well-paid executives responsible for these disasters. The last major failure of a Scottish bank before the twin collapses of the Bank and Royal Bank of Scotland was the 1879 bankruptcy of the City of Glasgow bank, and within months of that event all of the directors were in jail. Outside Iceland, where some of the individuals involved in the collapse of that country's entire banking system went to prison, and Ireland where prosecutions were brought but fizzled, only very junior employees have suffered criminal penalties following the events of 2008. Following a parliamentary report, financial services in Britain are now subject to a senior managers regime designed to assign personal responsibility. But, as with so much regulation, the outcome of this appears to be a great deal of paperwork and very little substance.

Will we repeat our mistakes?

So, are we safe? It is unlikely that there will be a straightforward repeat of the events of 2008. The regulatory changes will have some effect, and people rarely repeat the same mistakes immediately. But the underlying causes of financial crisis remain. Participants are gripped by some narrative – the expectation in the 1980s that Japan would rule the economic world, the claim in 1999 that there was 'a new economy', and the entirely false belief in the run up to 2008 that securitisation and better risk management enabled the risks of a far more complex management system to be effectively controlled. These exaggerated narratives give rise to bubbles which then burst, imposing, as at Northern Rock, burdens on people who are in no way involved.

And what is the equivalent narrative today? Look no further than the breathless articles on blockchain and cryptocurrencies which are landing on everyone's desks.

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