

ASSESSMENT 1

**BANKING FINANCIAL MANAGEMENT AND
FINANCIAL MARKETS (LCMB7012)**

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SUMMARY

The Northern Rock Bank was one of the victims of the 2008–2009 financial crisis. To overcome the financial stability of the UK economy, steps were made. There has been discussion on the study done on the reports and regulations put in place to regulate the Northern Rock. It has been argued what led to nationalisation and why banks couldn't function in the sector.

The laws and regulations that were put into effect in the UK also including the discussion and the results of their application.

The alterations in Northern Rock's financial scenarios have come to light after the firm was nationalised. The issues that cause bank failure are illustrated.

INTRODUCTION

In the UK, Northern Rock was the first bank run since the 1800s. After facing a saver run on their deposits in 2008, the UK government finally decided to nationalise this Newcastle-based mortgage company. In order to get the money it needed, to rely on the market of wholesale lenders, like other banks, and sell its existing mortgages rather than hang onto them.

Bank lending to one another was curtailed in August 2007 as a result of credit worries sparked by bad debts in the US housing market. As a result, Northern Rock started to run into issues while trying to get short-term capital and restructure current loans from wholesale lenders. The bankl wasn't able to repay its borrowings which were due and turned to the Bank of England for assistance.

Prior to becoming Northern Rock publicly traded, the Treasury did not do due diligence on the company, such as examining the viability of its whole loan portfolio, for example. The Treasury was alone in charge of choosing what course of action was in the best for taxpayers, even though it sought guidance from the Bank of England and Financial Services Authority and worked with them to find a solution.

BACKGROUND OF NORTHERN ROCK

Before been public and float its shares on the stock market in 1997, Northern Rock was a "building society," or jointly held savings and mortgage bank. Northern Rock was founded in the nineteenth century's 'cooperative movement,' along with other building societies in the UK. It was created as a consequence of the union of the 1865-founded Northern Counties Permanent Building Society and the 1850-founded Rock Building Society. Even the company's name, "Northern Rock," suggested a solemn firmness which indicated savings and mortgage bank.

According to Shin (2009), Northern Rock began as a regional company that catered to its local clientele, similar to other building societies in the United Kingdom. Newcastle upon Tyne in northern England served as the early headquarters for Northern Rock.

The bank primarily worked in the mortgage industry and specialized in providing house loans to customers. Both fixed-rate and variable-rate mortgage loans were available to customers, Acharya (2007). The bank charged interest on these loans, and the difference in interest rates between loans and deposits generated income for the bank. In addition to mortgages, Northern Rock also offered a variety of savings products, such as deposit accounts and Individual Savings Accounts (ISAs).

The securitized notes from Northern Rock had an average maturity of more than a year and were of (Chapman, 2020) medium to long-term maturity. The bank transferred some of its mortgage assets to the Granite Finance Trustees trust, which later signed a contract with the special-purpose companies "Funding" and "Funding 2." These special purpose corporations then signed loan contracts with a different note-issuing business, which actually issued the notes.

Total assets of northern rock increased from 17.4 billion pounds to 113.5 billion pounds in the nine years between June 1998 and June 2007 (on the eve of its disaster). Stated by Aldohni (2018), This increase in assets translates into a constant equivalent annual growth rate of 23.2%, which is a very quick rate of expansion. Northern Rock ranked as the fifth-largest bank in the UK based on mortgage assets. Once traditional sectors like shipbuilding and coal mining declined in the northeast, Northern Rock became a symbol of the region's comeback. (Wahlstrom,2018) Northern Rock became Newcastle United's main sponsor in addition to contributing to a well-known charitable trust. Because to all of these causes, Northern Rock's local customers showed fierce loyalty.

The bank's reliance on short-term wholesale borrowing has significantly expanded to sustain its ambitious and expanding mortgage lending. The bank had severe liquidity problems as a result of its inability to refinance its short-term loans during the summer 2007 economic crisis.

The UK government ultimately opted to nationalize Newcastle-based mortgage provider Northern Rock after experiencing a saving run on their deposits in 2008.

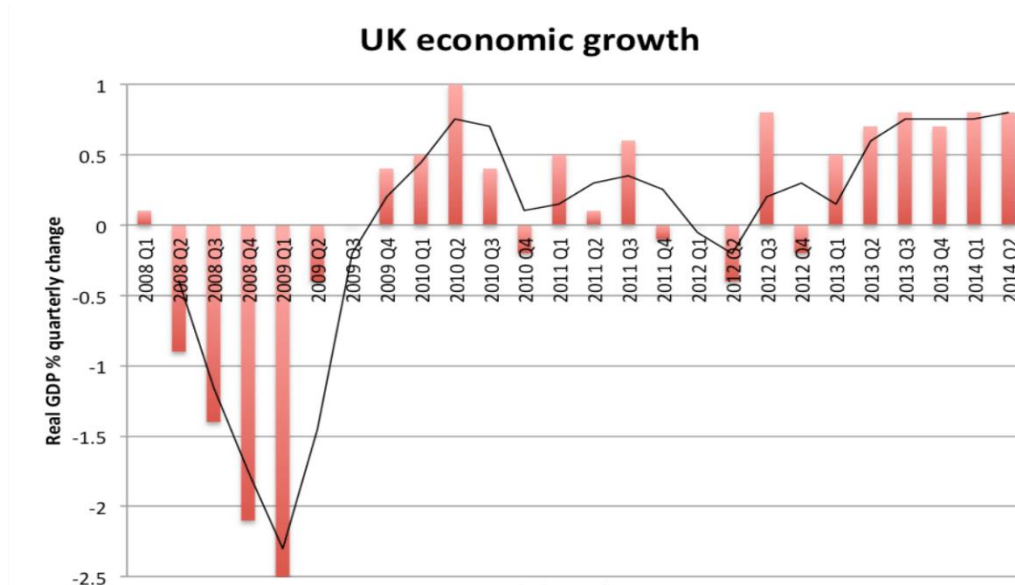
(Linsley ,2013) The mortgage lender Northern Rock was taken over by the British government on February 22, 2008, after it had used liberalization to

change its status from a building society to a bank a few years earlier. The bankruptcy of a few hedge funds funded by the French bank Societe Generale in August 2007 marked the beginning of the global financial crisis, which first had an impact on Northern Rock. Only when the government stepped in to guarantee deposits did the run on Northern Rock the following month come to an end. Outside banks, depositors formed a line to retrieve their funds while there was still any available.

FINANCIAL CRISIS IN THE UNITED KINGDOM DURING 2007–2008

The collapse of the American housing market led to the subprime mortgage crisis, also known as the financial crisis of 2007–2008, which was characterised by a major decline in liquidity on international financial markets.(Slack,2013) Numerous important commercial and investment banks, mortgage lenders, insurance firms, and savings and loan associations failed as a result of it—or came dangerously close to failing. The global financial system was destroyed by the Great Recession of 2007–2009.

One of the most severely impacted countries was the United Kingdom, which saw a decline in economic output and an increase in public debt. The UK's economy was dependent on growth in the financial industry, real estate, and retail sales since it lacked a significant industrial sector. Due to its dependence on a bubble in risky credit borrowing and lending that eventually exploded in 2008, its boom lacked substance. The repercussions of the financial crisis were most felt by these three companies. This ultimately meant that the UK economy suffered greatly as housing values dramatically declined and credit sources dried up. The UK's GDP (gross domestic product) started to fall in 2008, first by 0.6%, and the economy of the nation became unstable. Significant financial losses were incurred by several British institutions that made investments in American subprime mortgages. Consumer spending on goods and services decreased, which led to a dip in GDP.



Source : ONS- IHYQ , www.economicshelp.org

Above is the graph of UK economic growth drafted from Moroianu (2011) analysis , which shows a decline in GDP FOR 2008 to 2009. The GDP fall up to -1.5% in Q3 of 2008 from -0.6% it was in Q2 of that year. Again GDP fell by -2% in Q4 2008, according to statistics and the year 2009 experienced a severe recession that extended over -2.5% fall in GDP. The real GDP of all the major economies actually fell in 2008. Normal bank lending was significantly restricted by the banking crisis. As a result, consumer spending and investment both declined, sharply lowering real GDP. The UK economy finally emerged from recession in the final quarter of 2009 after six straight quarters of negative growth. (Lastra,2008) As GDP decreased for a second consecutive quarter in the third quarter of 2008, the economy had officially entered a recession. When the recession was at its worst, the GDP shrank by 2.6% in a single quarter (Q1 2009), which is the same rate at which the economy grew throughout the entire year 2007.

Other impacts of financial crisis on United Kingdom

Following are some other impacts which have affected United Kingdom in the year 2007-08 .

- **Unemployment:** (Linsley,2013) Unemployment did not decline along with the post-recession growth in GDP (which increased by 3% over the subsequent five quarters after the 2009 q2 trough). UK unemployment began to increase quickly in the second quarter of 2008, just one quarter after output started to decline. Instead, the

unemployment rate remained at 8% for a two-year period (Janson, 2009). Estimates of the unemployment rate, which are dependent on individual surveys, are subject to severe measurement error even if it appears to be rising again in the second half of 2011..

- **Property Market Collapse:** (Moroianu, 2011) Prices in the UK decreased from a peak of £184,000 on average in late 2007 to a low of just under £150,000 in early 2009. Following years of easy credit, the housing bubble that eventually burst in 2008 brought down Lehman Brothers in the US and Northern Rock in the UK.(Gehrig, 2018) The UK property market has recovered at an alarming rate since July 2009, when the 2008 recession officially came to an end.
- **Debt became unpayable:** When significant amounts of money are lent into the real estate market, housing costs and personal debt rise together. (Liff, 2018) All of the loans that banks provide come with interest payments, and because debt can sometimes grow more quickly than income, some borrowers wind up being unable to fulfil their obligations. At this point, they quit making loan payments, endangering the viability of banks.
- **Bankruptcies and Bank Losses:** (Faff,2019) The financial institutions found out that the interest rate for interbank lending had quadrupled over night while they were still borrowing. Additionally, the cost of credit insurance increased significantly. Businesses all throughout the world felt the effects as finance all but dried up, but the housing sector was particularly hard hit. (Tan and Parwada, 2019) In April 2008, Persimmon, one of the largest house builders in the UK, announced major layoffs. Due to the declining real estate market, sales had decreased by 20% that year, and as stated by Evemy (2009), they were trying to cut their losses. The company's share price immediately dropped after the disclosure that its revenues had already dropped by 24% from January to April. At the end of April, data showed that home sales in the UK decreased for the first time in more than 12 years.

IN NUMBERS: THE UK'S FINANCIAL CRISIS

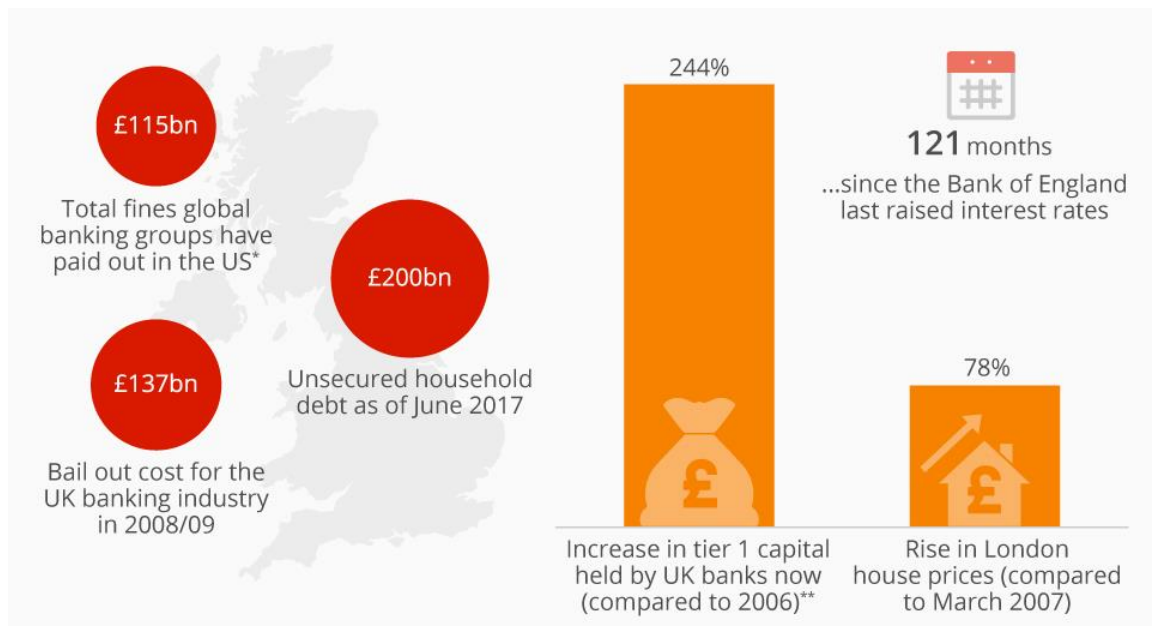


Figure : an overview of UK banking industry
(source: <https://www.statista.com>)

The graph displaying the quantification of the circumstance displays: The cost of rescuing the UK banking sector was £137 billion, whereas the \$115 billion fine paid by foreign financial institutions in the US. Since 2006, tier 1 capital for UK banks has increased from 4.3 to 14.8 percent. To strengthen the balance sheet in the case of a downturn that results in loan defaults, they have increased "the cash held back." Last but not least, during the past 10 years, the cost of residences in London has climbed dramatically: Real estate company Savills found that prices rose 78 percent and are now, on average, £478,142 in London, as opposed to the UK average, which was also claimed by Yorulmazer(2007) to be £209,971.

Because Northern Rock was one of the first major banks to experience financial problems and was overly reliant on short-term wholesale lending, its nationalisation was seen as a significant turning point in the global financial crisis.

The government's intervention in Northern Rock also prompted debate in the financial system, boosted regulatory scrutiny, and sharpened the focus on enhancing the financial system's resilience to forestall future catastrophes.

LAWS, REGULATIONS, AND AGREEMENTS PASSED AFTER THE 2008 FINANCIAL CRISIS IN UNITED KINGDOM

Various measures and policies were proposed and put into effect to help people recover from the financial losses caused by the 2008 financial crisis.

➤ THE DODD FRANK ACT :

Act of Dodd-Frank In response to the acts of the financial sector that contributed to the financial crisis of 2007–2008, the U.S. Congress approved the Wall Street Reform and Consumer Protection Act (Shin, 2009). It attempted to increase the safety of the American financial system for consumers and taxpayers. The Act will have a considerable impact on banks and other financial institutions with large US operations, including numerous UK-based banks. There are also substantial changes for non-US firms who have securities listed on a US stock market. (Aldohni,2018) However, the effects on non-US companies go much further than that, including those in the UK without sizable financial services operations or a US listing.

The Dodd frank act introduced a range of new regulation for financial firms, including capital and liquidity requirements and protection measures, these regulations have been adopted by UK regulators to contribute to their regulatory frameworks.

➤ SIMILAR MEASURE IMPLEMENTED LIKE VOLCKER RULE:

The Volcker Rule prohibits banks from making certain speculative investments that contributed to the financial crisis of 2007–2008 in order to safeguard bank customers, according to the National Audit Office, 2021. Basically, it forbids banks from doing short-term proprietary trading in securities, derivatives, commodities futures, and options on any of these products using their own accounts. The Volcker Rule was modified in August 2019 by the U.S. Office of the Comptroller of the Currency (OCC) to make it more apparent what securities trading by banks was and was not authorised. Federal Deposit Insurance Corporation claims. (FDIC) officials,

the Volcker Rule's requirements will be loosened, making it simpler for banks to make sizable investments in venture capital and similar funds.

The Financial Services (Banking Reform) Act was passed by the UK parliament in February 2014. A group's autonomous firms must ring-fence some retail banking activity. Then, for the ring-fenced retail banks, some activities are prohibited, such as trading in securities as a principal. The prohibition does not apply to ring-fenced retail businesses that control their exposure to changes in interest rates, currency exchange rates, default and liquidity risk, and commodity prices. Just in time for the nation's upcoming general election in May 2015, the UK statute is anticipated to go into force.

In response to 2010, the UK did enact analogous regulations in line with the Volcker Act. The guideline was not strictly adhered to in the UK, despite equivalent safeguards being taken there, such as segregating retail banking operations from investment banking activities.

➤ **FINANCIAL CONDUCT AUTHORITY**

Another recent regulatory organization,(Linsley,2013) the Financial Conduct Authority, is in charge of monitoring how individuals and banks behave. The FCA strengthened its regulatory monitoring of financial firms in order to protect the businesses' overall financial stability. It also passed laws and rules to safeguard consumers, regulating things like expensive credit, payday loans, and insurance products. Openness of the financial system will be aided by improved reporting and transparency standards and the disclosure of executive compensation.

➤ **FINANCIAL SERVICE COMPENSATION SCHEME**

- According to Janson (2009), the failure of five deposit banks in Autumn 2008, at the peak of the financial crisis, had an effect on more than 4 million retail bank accounts in the UK. Bradford & Bingley and Icesave, the UK online arm of Icelandic bank Landsbanki, were the two that stood out the most. FSCS was necessary to safeguard those banks' customers. Treasury (2013) The smooth transfer of 2.5 million Bradford & Bingley clients' accounts to Santander with no changes to their account conditions or

information. The online claims process designed specifically for more than 200,000 Icesave customers.

- The 2009 report "Banking Crisis: Dealing with the Failure of the UK Banks" by the House of Commons Treasury Committee highlighted the efforts done throughout the crisis: "The FSCS deserves credit for radically stepping up its reaction to the astronomical compensation demands brought on by the failure of five banks in a matter of months. We are quite happy with the FSCS's usage of a variety of original solutions to the specific issues they are now experiencing.
- In order to reassure depositors during the GFC, the UK modified its deposit insurance (FSA 2007c). As a result of these adjustments, coinsurance, a type of partial deposit insurance coverage, was discontinued, and the deposit insurance ceiling was increased (FSA 2007c; FSA 2008b). The FSCS still provides coverage for other types of financial institution disputes in the same way. Claims lodged against insurance companies and investment businesses continued to take co-insurance into consideration. (Edmonds 2009; FSA 2007a).
- After UK authorities raised the deposit insurance ceiling to GBP 50,000 in October 2008, the UK government took a number of additional safeguards. The UK government expanded its liquidity capabilities on October 8, 2008, when HMT stated that it will make at least GBP 200 million accessible under the Special Liquidity Scheme (Treasury, 2013). Additionally, the government set up a recapitalization facility, through which it gave accredited institutions Tier-1 capital.
- (Girodano 2016) The UK government publicly said on September 14, 2007, as Northern Rock was having financial issues, that it thought Northern Rock was still solvent (FSA 2007b). According to FSA authorities, the banking sector would be able "to withstand current market pressures" (FSA 2007b). Co-insurance, or partial deposit insurance, was eliminated by the FSA in the UK due to market uncertainty (FSA 2007c). At a period when the banks were under stress, this move was made to reassure depositors (FSA 2007c). The FSCS and the UK government stated that their actions looked to be successful while financial market crisis persisted throughout 2008 (BoE 2008b). According to the FSCS, following B&B's failure,

"business as usual for depositors and other customers of Bradford & Bingley, who need not have concerns about the safety of their money" (FSCS 2008a) was the message that was conveyed. A lack of clarity in its communication with depositors regarding ongoing claims and claim decisions was noticed by an independent investigator, and FSCS officials acknowledged that the public's awareness of the programme was poor during the crisis (FSCS 2009).

➤ **FINANCIAL SERVICES ACT 2012**

Below is a list drafted by Aldohni(2018) of the Act's primary characteristics:

- It established the Financial Policy Committee (FPC), the distinct Financial Conduct Authority (FCA), which took over the majority of the Financial Services Authority's responsibilities, and the Prudential Regulation Authority (PRA), which is housed within the Bank of England.
- The PRA will be in charge of managing the micro prudential regulation of systemically important firms, while the FPC will be in charge of monitoring and responding to newly developing systemic concerns. The FCA will control how financial services companies behave.
- The Bill brought "benchmark activities" under the FCA's regulatory limits and modified the tenure of the Governor of the Bank of England from two five-year terms to a single eight-year term. During a financial crisis, the Act provided the Chancellor clearer precedent.

➤ **THE PRUDENTIAL REGULATION AUTHORITY (PRA)**

The Prudential supervision Authority (PRA), a branch of the Bank of England, is in charge of prudential supervision and monitoring of banks, building societies, credit unions, insurers, and sizable investment businesses. It supervises and regulates financial institutions on a firm-by-firm basis. In all, the PRA regulates more than 1,500 financial firms (Wahlstrom, 2018). Following the 2008 financial crisis, it was established in 2013 as a subsidiary of the Bank of England under the Financial Services Act of 2012. In order to monitor and control the financial sector as a whole, the

Prudential Regulation Authority (PRA) also collaborated closely with regulatory organizations like the Financial Conduct Authority (FCA).

The PRA's three statutory goals are:

- i. To safeguard an adequate level of protection for policyholders (for insurers)
- ii. To advance the safety and soundness of these organizations.
- iii. To make it easier for businesses to compete effectively.

Through regulation, the PRA creates the standards and guidelines that it expects firms to follow and evaluates compliance with them. It assesses whether financial institutions continue to fulfil the threshold requirements, if policyholders are adequately protected by insurers, and whether financial institutions are stable and reliable. Additionally, it assesses possible risks that companies might pose to the stability of the economy in the future and takes action against those it determines to be the biggest risks. After the Financial Services Act of 2021 was passed, the Prudential Regulation Committee (PRC) took the position of the Prudential Regulation Authority (PRA).

➤ **FINANCIAL POLICY COMMITTEE**

The world financial crisis of 2008 demonstrated the significance of financial stability. (Parwada,2019) To preserve the financial stability of the UK at the time, the government had to "bail out" several institutions. Policymakers realized that concentrating on policing individual banks was insufficient once this revealed a vulnerability in the supervision of the financial sector as a whole.

In 2011, the FPC was established. The FPC aims to ensure that the UK financial sector as a whole is safe and sound, in contrast to the Prudential Regulation Authority (PRA), which examines the safety and soundness of individual institutions.

It has the authority to provide the Financial Conduct Authority and Prudential Regulation Authority binding orders. The PRA may receive instructions from the FPC directing banks, building societies, and significant investment firms to take certain steps. For banks, this includes the authority

to determine capital requirements (i.e., to modify the available funds that serve as a safety net against unforeseen losses).

The Financial Policy Committee (FPC) oversees the coordination of our efforts to promote financial stability. It recognises and monitors risks that imperil the overall stability of the UK financial system. 2020 (Kulkarni) It also has the ability to take steps to lessen such dangers. One example of this is the possibility for uncontrollable levels of debt and credit growth.

➤ **FUNDING OF LENDING SCHEME**

To encourage banks and building societies to rise their lending by providing funds at rates below the current market rates, the Funding for Lending Scheme (FLS) in July 2012. 2011 (Belingher) The HM Treasury and Bank of England announced FLS extensions on April 24th, 2013. Drawings under the Plan may be made up to the end of January 2015. This is done in an effort to improve the effect of the FLS, especially for small and medium-sized businesses, as the incentives in the Scheme will be heavily weighted towards Small and medium enterprises. The Scheme extension promotes higher lending to that segment of the economy by include non-bank credit providers, who in turn lend to the actual economy. (Liff,2018)This box discussed the possible impacts on real GDP as well as the ambiguity surrounding the transmission mechanism of this programme. Lower funding costs may immediately transfer into lower rates since the mortgage market is generally competitive and has standardised products; but, because corporate lending is more relationship-based and less standardised, rates may be less responsive.

By lowering interest rates and increasing the number of mortgages and commercial loans available, banks will have strong incentives to increase lending. (Park,2020) The more they lend, the more they may borrow from the Bank of England. The lowest borrowing costs are paid by banks that expand their lending, whereas greater borrowing costs are paid by banks that decrease their lending. The Bank of England will continue to provide data on the use of the FLS and loan data from the participants on a quarterly basis.

➤ **VARIATIONS IN CAPITALIZATION WITH INTRODUCTION OF BASEL III**

Along with banking regulations, government-led stress tests, Basel III was introduced. It followed on the heels of its predecessors, Basel I and Basel II, which outlined stricter regulations on capital as well as rules for calculating risk-weighted assets. (Puyol,2021) Basel III not only increased minimum capital requirements but also introduced stricter rules on what may constitute bank capital. These actions have considerably improved the quantity and quality of bank capital, have replaced and simplified the numerous complex hybrid capital instruments that were previously used. In order to boost bank capital ratios.

With well-defined own funds, such as common equity Tier 1, additional Tier 1, and other supplementary capital known as lower Tier 2 capital, bank capital structures are much simpler. This places the burden of responsibility for any potential resolution strategy of a given troubled institution on the aforementioned noteholders and establishes a hierarchy of loss absorption and capital subordination levels. The components of common equity Tier 1, which constitutes the fundamental layer of loss-absorbing capacity, consistently remain shareholders' equity plus retained earnings plus goodwill and other intangibles and dividend payments. Securities that absorb losses when a predefined regulatory capital level is breached make up additional Tier 1 capital. The most significant regulatory overhaul since 2008 has occurred here, in the formerly Tier 1 market. lower Tier 2 capital, also known as supplementary gone business capital. This capital is subordinate to holders of other senior and secured bonds, senior preferred bonds, covered bonds, and depositors but senior to holders of common equity Tier 1 and Additional Tier 1. Revaluation reserves, or surplus produced by an asset's upward revaluation, such as real estate owned, general loan loss provisions, and subordinated lower Tier 2 bonds make up lower Tier 2 capital. Lower Tier 2 debt is term debt that has been issued and has a minimum maturity of five years. In fact, the capital component of lower Tier 2 notes with maturities of under five years will amortize on an annual basis.

Therefore, following the 2008 financial crisis, the UK government worked on a number of laws, regulations, and contracts that have helped the country's economy expand and its banks function effectively.

RUN OF NORTHERN ROCK

To finance its ambitious and rapidly expanding home lending, the bank had grown increasingly dependent on short-term wholesale funding.

(Wahlstrom,2018) When the global credit markets frozen in the credit crunch of the summer of 2007, the bank was unable to roll over its short-term debt, leading to serious liquidity issues. Among the banks to encounter financial difficulties and become unduly dependent on short-term wholesale lending, Northern Rock's nationalisation was considered a pivotal event in the development of the global financial crisis.

A number of causes contributed to Northern Rock's failure in 2007–2008, including:

Business model: The financing of Northern Rock's mortgage loans was mainly reliant on short-term wholesale credit. This indicates that rather than depending on bringing in new deposits from depositors,(Linsley, 2013) it borrowed money from other financial institutions to fund its activities. It experienced liquidity issues since it was unable to cover its short-term loans during the global credit market freeze of 2007–2008.

less probability with high impact risk : The low probability, high impact risk was caused by Northern Rock's especially risky business strategy, which the supervising authorities does not appear to have effectively supervised. This technique worked for a many years because short-term financing could be rolled over on regular terms. The cost of lending would rise in balance sheet in comparison to the yield on mortgage loansand it would be impossible for the bank to securitize the mortgage assets that it had planned to securitize(Shin, 2009).

Securitization process : In the securitization process, which involves packaging and selling mortgages to investors as securities, Northern Rock played a crucial part. (Acharya,2007) This made it possible for the bank to sell more mortgages than it otherwise could have, but it also put the company at great danger of default, which started to happen in the year 2007. The bank's operations, including securitization, were heavily financed by the wholesale markets. Northern Rock was unable to acquire funding when these markets went into a freeze, which resulted in a bank run and the UK government taking over the institution.

The British Deposit Protection Scheme: a component of the Financial Services Compensation Scheme (FSCS), has been found to have significant flaws. The co-insurance principle meant that the FSCS would not prevent what it was intended to prevent, namely the withdrawal of deposits when concerns arose about a particular bank's safety. At the time, only the first £ 2000 of a deposit was fully protected, and then only 90% of the value of deposits up to a limit of £ 33,000. This turned out to be the system's primary fault line.

Structure-related flaws: In addition to inconsistent deposit protection policies, the UK also had two other significant structural flaws: it was virtually the only G7 nation without a special bank insolvency regime, and there was no ex ante Resolution model that could be used to resolve failing banks. Uncertainty is a particular issue with the latter, since it makes potential bidders more likely to bid against the interests of the taxpaying public in the event that bids are requested to "rescue" a collapsed bank.

This was seen in the instance of Northern Rock, when the government instituted a protracted process that ultimately resulted in the rejection of all bids submitted and the temporary nationalization of the bank.

Lack of diversification: Northern Rock's mortgage portfolio had a high concentration of risk due to the high proportion of interest-only and subprime loans (home loans made to borrowers with bad credit) among its mortgages. Due to its lack of diversification, the bank was vulnerable to suffering huge losses in the event of a property market crisis.

Northern Rock was not strong enough to hold its place in the market throughout the crisis and could not withstand the difficulties. The bank was nationalized as a result of the several factors that contributed to its failure making it impossible to run the company.

NATIONALIZATION OF THE NORTHERN ROCK BANK

In order to focus its search for a longer-term solution in response to retail deposits, the House of Commons Treasury Committee developed targets in September 2007. In 2007, the objectives were to protect the interests of taxpayers, protect consumers, and maintain financial stability.

- Closure (ceasing to take new deposits and write new mortgages) and
- solvent wind down (beginning the process of winding down the firm to sell assets to pay off creditors) were two possibilities that the Treasury examined.
- The Treasury also gave keeping a profitable firm in mind (either by locating a buyer in the private sector or by going public).

In the autumn of 2007, a number of companies indicated interest in buying all or a portion of Northern Rock. Virgin and Northern Rock management made their final offers in February 2008. By the end of 2007, it was clear that private bidders would find it difficult to secure the funding necessary to repay the Bank of England as the market situation continued to worsen.

Early in 2008, the Treasury had serious concerns about the viability of the private sector bids, notwithstanding the possibility of even bigger losses if Northern Rock was closed. The Treasury chose to take Northern Rock public in February 2008.

The Financial Services Authority's and the banks' economic models were unable to predict the wholesale funding markets' closure, which heralded the Northern Rock catastrophe, according to HM Treasury. However, warnings about the extent of credit expansion in the UK had been issued by the Financial Services Authority and the Bank of England. Prior to 2007, the Treasury made the assumption that if the financial markets were disrupted, borrowing costs would rise but that money would still be available.

TRADING IN FORWARD CONTRACTS DURING:	ANNUAL IMPLIED CHANGE (PERCENTAGE)			
	YEAR 1	YEAR 2	YEAR 3	YEAR 4
SEPTEMBER 2007	0.0	2.0	3.0	8.0
OCTOBER 2007	-6.5	-6.5	-6.5	-4.0
NOVEMBER 2007	-8.0	-8.0	-7.0	-4.5
DECEMBER 2007	-9.0	-10.0	-10.0	-7.0
JANUARY 2008	-9.0	-11.0	-11.0	-11.0
FEBRUARY 2008	-8.0	-11.5	-11.5	-9.0
MARCH 2008	-8.0	-13.0	-14.0	-11.0
BUSINESS PLAN: BASE CASE	-5.0	0	0	0
BUSINESS PLAN: RECESSION CASE	-10.7	-2.3	-6.5	1.8

Figure : business plan till march 2008 and recession case

(Sources :

<https://publications.parliament.uk/pa/cm200809/cmselect/cmpublic/394/394.pdf>)

Since putting Northern Rock under public ownership, the government has intended to let the business operate independently of the government for commercial purposes. In February 2008, a new Chairman was chosen, and by the end of the month, the board had nominated new members and fired any remaining incumbents. The first Northern Rock business strategy under public control rapidly turned out to be overly optimistic. Six weeks after the business was taken public, in March 2008, the Treasury approved the proposal. In August, the company disclosed losses of £585 million for the six-month period ending in June 2008, which were worse than the recession scenario used in the March 2008 business plan and £314 million greater than the base case projected.

Due to the worst case of recession , Some banks started to take action to improve their regulatory capital positions in response to the financial markets' persistent volatility and growing brittleness. The Treasury stated in August 2008 that some of the outstanding emergency loans to Northern Rock would be converted into equity investments to increase Northern Rock's regulatory capital, subject to approval by the European Commission for State Aid purposes. (Janson, 2009) The company estimated that up to £3 billion of debt might need to be converted for this purpose. The business reported a loss of £1.4 billion for the fiscal year that ended on December 31, 2008.

The Treasury has stated that its investment in Northern Rock would be transferred to a new holding company, UK Financial Investments Ltd., as soon as it is appropriate. The government's new shareholdings in other financial institutions as well as the government's relationship with Northern Rock and Bradford & Bingley will be managed by the new business, which is controlled entirely by the government. For example, the Treasury will continue to be in charge of deciding what to do with the taxpayers' holding in the future. The Treasury will continue to own and be responsible for all policy choices pertaining to the taxpayers' investment in Northern Rock.

All financial institutions that accept deposits are required by the Financial Services Authority to keep a minimum amount of capital as a safety buffer and to conduct day-to-day operations beyond this level. Any financial institution that suspects it may go over the limit must take steps to fortify its balance sheet. The Northern Rock management team requested an extra £3 billion in capital from the Treasury in July 2008 in order to improve its capital basis. The Treasury agreed to exchange up to £3 billion of the Bank of England loan into ordinary shares and convert £400 million of preference shares into ordinary shares, both of which are subject to clearance from the European Commission, which is currently pending.

Bradford & Bingley has a larger ratio of retail to wholesale funding same like Northern Rock. Since September 2007, it had managed to withstand a lack of wholesale funding. However, because a severe recession had not yet put the company's assets to the test, the market viewed them as having a higher default risk in the event that economic conditions deteriorated. Bradford & Bingley raised £400 million in a rights offering as market circumstances deteriorated further to prevent the company's capital from being depleted. After the rescue of US and UK banks and the demise of Lehman Brothers in late September 2008, public rumors about Bradford & Bingley's continued viability caused a loss of confidence and a sharp rise in customers withdrawing their money.

On September 27, the Financial Services Authority found that Bradford & Bingley no longer satisfied the criteria necessary to keep accepting deposits since market conditions continued to deteriorate, the company's outlook was becoming worse, and there were no prospects of improvement in the near future. As a result of this choice, the Financial Services Compensation

Scheme started to function, which was a choice Northern Rock had not had prior to the Bank and Treasury withdrawing their emergency support. The Tripartite Authorities were able to protect financial stability thanks to the Financial Services Compensation Scheme's activation without having to provide a failing private sector enterprise a substantial injection of public money.

NATIONALISATION CAUSED NORTHERN ROCK BANK TO BE INSOLVENT

UK Asset Resolution (UKAR) was founded in 2010 as a holding company for the closed mortgage books of Northern Rock and Bradford & Bingley following their nationalisations, according to the National Audit Office's (2021) report. The handling of clients had a significant role in choosing the winning bidder. As with all UKAR asset sales, all bidders had to accept a comprehensive package of customer protections before their offers could be evaluated in light of other factors.

The Financial Conduct Authority (FCA) provided a protection overseas provided a protection which will benefit the customers and the authority has oversees B&B, Northern Rock (NRAM), Mortgage Express, and Computershare.

UK Asset Resolution (UKAR) Ltd, which will continue to be owned by the government, will be in charge of handling any outstanding liabilities as well as fulfilling ongoing contractual duties to the firms' buyer.

The rest of the government's holdings of Northern Rock, which were nationalised during the financial crisis, have been sold.

Treasury representatives arranged the £5 billion sale of the two companies i.e Northern Rock (name changed to NRAM after nationalization) and Bradford & Bingley (B&B) and their outstanding loans to a group that included Citibank and Davidson Kempner Capital Management.

(Allen,2010) The agreement ends a multi-year process to gradually sell the assets that the government acquired when it bailed out banks during the financial crisis of 2007–2008. The two businesses have been associated with UK Asset Resolution (UKAR), a holding firm for their mortgage books, since 2010.

According to the government, customers will continue to repay their mortgages according to the same terms.

"UKAR's objective is to facilitate the orderly wind-down of NRAM and B&B while treating customers fairly," UKAR Chief Executive Ian Hares stated.

Therefore, the British government claimed that nationalisation was required to safeguard depositors and ensure financial sector stability.

FINDINGS AND CONCLUSION

The following are conclusions drawn from the study done on Northern Rock Bank during the financial crisis in 2008–2009, including the challenges it experienced and overcame.

The majority of Northern Rock's mortgage loans were funded by short-term wholesale credit. This means that rather than depending on taking in new deposits from clients, it borrowed money from other financial institutions to support its operations. It experienced financial issues as a result of its inability to renew its short-term debts during the global credit market freeze of 2007–2008. The bank was vulnerable to a quick loss of depositor confidence as a result of its aggressive lending practises and reliance on wholesale funding, which ultimately led to a bank run and caused the bank to request help from the UK government.

A number of other private sector bids for the entire firm or certain portions of it were taken into consideration after Northern Rock's failed efforts to find a buyer. No private bidder, however, was able to raise the funds necessary to move further on either premise. In order to help a buyer in the private sector get funding and repay the emergency support, the Treasury said in January 2008 that it would support the firm's issue of bonds.

Two proposals from the business community were received, but they would not have significantly benefited the taxpayer and would have required the Treasury to risk taking on a large amount of debt from tax payers over a protracted period of time. In February 2008, the Treasury decided, the firm should go public. The Northern Rock problem may have been leveraged in order to sell the bank. This would have allayed the worries of creditors and

depositors while enabling Northern Rock to continue operating. The UK government might have done more to rebuild trust in the financial system, such as guaranteeing bank deposits and supplying banks with liquidity.

The UK government passed rules in 2008 that allowed them to nationalise Northern Rock. The Act gave the government the power to confiscate Northern Rock and protect depositors' money. It was argued that this decision set a dangerous precedent for state meddling in the financial industry. Northern Rock made headway on a three-year plan to repay the emergency money and end the Treasury guarantee agreements by 2011–12 while it was still publicly owned in 2008. This was to be accomplished in large part by promoting early mortgage redemption with the intention of a subsequent return to private ownership. Beginning in 2009, the government declared that Northern Rock will increase its mortgage lending.

When they learnt about the support, Northern Rock customers waited up outside of branches, and over the course of a few days, (Moroianu, 2011) £4.6 billion was taken. By providing both small- and large-scale lenders with a variety of guarantees, the Treasury contributed to the situation's stability. This action lessened the immediate risk of problems spreading to other institutions because maintaining financial stability and regulatory control in the financial system were both necessary. Even though there were no easy solutions to the crisis, the event showed the need of taking pre-emptive measures to manage potential risks and restore public confidence in the financial system.

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