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The British Tripartite Financial Supervision System in the Face of the Northern Rock Run

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The British Tripartite Financial supervision system in the face of the Northern Rock run

The Northern Rock debacle – Britain's first bank run in 141 years – was the Tripartite regulatory system's first live ammunition test since its establishment in 1997. The aftermath of the crisis lists the destruction of Britain's fifth largest mortgage lender, the tarnishing of the Bank of England's well-established reputation, and the loss of confidence in the reformed regulatory system – a system that had been considered a paragon by policymakers and reformers around the world. As market observers, politicians, investors and bankers criticize not only the mortgage lender for its extreme business model - but also the Tripartite regulatory system for mishandling the crisis - it is important to piece the story together and draw lessons from it. This paper examines the Tripartite's management of the crisis and concludes that the separation between the roles of banking supervision and Lender of Last Resort, coupled by Britain's flawed deposit insurance scheme, account for the British regulatory system's mishandling of the funding shortage that escalated into a bank run.

1. The birth of the Tripartite system

In May 1997, Gordon Brown, the then Chancellor of the Exchequer of the newly elected Labour Government, announced a comprehensive monetary policy reform that granted the Bank of England (henceforth BoE) formal independence in the management of monetary policy. Three weeks later, a structural reform in the supervision and regulation of financial services followed, stripping the BoE of its long-standing role as supervisor and regulator of the British banking system and transferring it to the Securities and Investments Board (SIB). The structural reform entrusted the SIB with the authorities of eight different supervisory and regulatory agencies, including the BoE [1]. Renamed the Financial Services Authority (FSA)[2], it was transformed into Britain's sole financial regulator.

[1] Other agencies are the Building Societies Commission, the Friendly Societies Commission, the Investment Management Regulatory Organization, the Personal Investment Authority, the Register of Friendly Societies, the Securities and Futures Authority and the SIB itself. In addition, the SIB took over the role of the UK Listing Authority from the London Stock Exchange.

[2] The legislative infrastructure for the operation of the FSA was not complete before December 2001. The legislation further extended the FSA's responsibilities to include the protection of consumers against market abuse. In 2004, the FSA was entrusted with the supervision and regulation of the mortgage market and in 2005 took on the responsibility of regulating general insurance business.

The unification of financial regulation was motivated by a record of wanting coordination between different regulators (for example, the lack of effective cooperation between the BoE and the Securities and Futures Authority in handling the collapse of the Barings Group crisis in 1995 (see Board of Banking Supervision, 1995)) as well as by a number of arguments and considerations: the increasing blur of demarcation lines between bank and non-bank institutions due to financial innovations; supervisory duplications and potential regulatory arbitrage gains in the many cases where financial institutions answered to more than one regulator; the waste of resources for both the regulators and the industry induced by the multiplicity of regulators; the promotion of regulatory accountability, and finally, enhancing the effectiveness of British interests representation in European and international regulatory meetings.

The separation of banking supervision from the newly independent management of monetary policy was largely justified on the grounds of the strains for the BoE in possibly having to balance the needs of monetary policy and banking supervision. Monetary policy instruments, namely, the interest rate and the discount window, affect both price and financial stability - yet in opposite directions. Whereas a rise in the interest rate may be called for to combat inflation, it might adversely affect problematic debts, capital adequacy and the solvency of the banking system. In addition, monetary policy and banking supervision are of opposite cyclical nature. Assigning both responsibilities to one authority could give rise to conflicts of interests and thereby compromise at least one of them (see Goodhart and Schoenmaker, 1995). It is however important to note that the interdependence of price and financial stability requires information sharing, cooperation and coordination between monetary policymakers and banking supervisors; assigning the responsibilities for monetary policy and banking supervision to two separate authorities may hamper the achievement of macroeconomic and supervisory goals[3].

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[3] Bernanke (2007) argues that "… if macroeconomic and supervisory goals are interdependent, a single agency responsible for both objectives might be better able to take those interdependencies into account than could multiple agencies, each charged with a single goal". Syron (1994) and Ferguson (2000) argue that in the US, the two supervisory authorities external to the Federal Reserve fail to grasp the severe macroeconomic consequences that an excessively tight or lax supervision policy – or a change in supervision policy – may cause. Ferguson (2000) believes that the Federal Reserve's role as supervisor improves its monetary policy and vice versa. Syron (1994) claims that sensitivity for financial system stability could contribute to monetary policy. As an example he mentions the series of bank crises that occurred in early 1991 in New England; then, the Fed was quick to understand that banking regulations caused a credit shortage. This understanding contributed to the management of monetary policy. In the absence of such understanding, monetary policy would have been even less stimulating. Syron (1994), Greenspan (1994) and the Federal Reserve's Board of Governors (1994) express the concern lest an external supervisor, whose only preoccupation is the financial stability of a few institutions and who has no responsibilities on the macro level, may over-regulate and stifle financial innovation and risk taking.

The intended unification of financial regulation provided yet another argument for separating banking supervision from the BoE: a central bank with the responsibility for supervising and regulating the entire financial system – on top of its independence in conducting monetary policy – was considered too powerful.

A Memorandum of Understanding (MOU) signed in 1997 between the Bank, the FSA and the Treasury, constitutes the framework for cooperation between the three authorities. The MOU sets out the responsibilities of each party and the patterns of information sharing between them, in an attempt to eliminate potential coordination and cooperation difficulties. The four tenets underlying the MOU are: clear accountability, transparency, no duplication and regular flow of information. As a means of ensuring coordination and cooperation between the FSA and the BoE, the latter is required to appoint a Deputy Governor in charge of financial stability, who is also to be made Director of the FSA; the Chairman of the FSA is to be made a member of the Court of the BoE. The MOU also requires the establishment of a Tripartite Standing Committee on Financial Stability, consisting of the Chancellor of the Exchequer, the Governor of the BoE and the Chairman of the FSA; the Committee meets circumstantially to review and address potential macro- and microeconomic threats to financial stability. The Standing Committee developed a framework for the coordinated response of the three authorities to financial contingencies, namely, for the gathering of information, assessment of the situation, decision taking, action, monitoring and dissemination. In exceptional circumstances, the MOU states that ultimate responsibility for authorization of support operations rests with the Chancellor of the Exchequer. In 2006 the MOU's description of the BoE's role in ensuring financial stability was changed from "responsible for the overall stability of the financial system as a whole" to "contributes to the maintenance of the stability of the financial system as a whole".

2. The Northern Rock Crisis: Chronicle of a Run Unforetold

The classic textbook bank run is triggered by lending losses: a mass of depositors fearing that a bank is insolvent withdraw their deposits - thereby further destabilizing its financial standing. Yet Northern Rock PLC (henceforth NR) was considered solvent, well-capitalized, and having a good mortgage book with no retained exposures to sub-prime borrowers. The NR debacle presented the world with a new type of bank run: one induced by the bank's liquidity risk exposure. It was the mortgage lender's extreme business model of extensive reliance on wholesale funding that, in the face of this summer's global liquidity freeze, brought upon it a funding crisis.

The squeeze on global liquidity in general, and the NR crisis in particular, seemed to have taken everyone by surprise. Until last August, most market players and regulators perceived widespread problems in money markets to be most unlikely. The lack of preparation to this summer's events reflects the tendency of both regulators and market participants to believe that the dangers that lie ahead are pretty much the same that were encountered in the past. Yet in a world of ongoing financial innovations this assumption proves to be a problematic one.

This decade saw the advent of the "originate and distribute" model, often referred to as "wholesale funding" or "securitization": banks originate loans, package and classify them into pools and sell them to other capital market investors – rather than keep them on their books. The shift towards the "originate and distribute" model allowed lenders to increase the volume of business while transferring credit risk elsewhere. Regulators, considering the practice to be safe, let the banks hold moderate capital cushions against the volume of loans it generated - thereby further encouraging the trend. Yet the reliance on wholesale markets did harbor danger: it exposed banks to the risk of market disruption and liquidity dry up.

NR relied heavily – more than any big British lender - on the "originate and distribute" model: three quarters of its funds came from the wholesale market. Tapping global capital markets allowed the bank to price its mortgages more keenly than its home-bound competitors, and enabled it to grow within merely ten years from a small local lender into Britain's fifth largest mortgage provider.

A shift in monetary policy in August 2006 marked the beginning of NR's downturn. To curb inflationary pressures, the BoE raised its interest rate (see chart 1). As the BoE's monetary tightening began to weigh down on the banking sector, investors were starting to worry lest NR be adversely affected if it were unable to expand as planned. This put pressure on its share price (see chart 2). On June 27th NR announced a trim in its expected annual profit, intensifying investors' worries. Two days later, under the new international banking rules, the FSA allowed NR to hold less capital against its loans, while around the same time, prompting it to toughen its stress tests – simulations of extreme market conditions. A couple of months later, the eruption of the U.S. sub-prime mortgage market debacle and its possible fallout added to investors' forebodings, further deteriorating NR's share price.

Chart 1

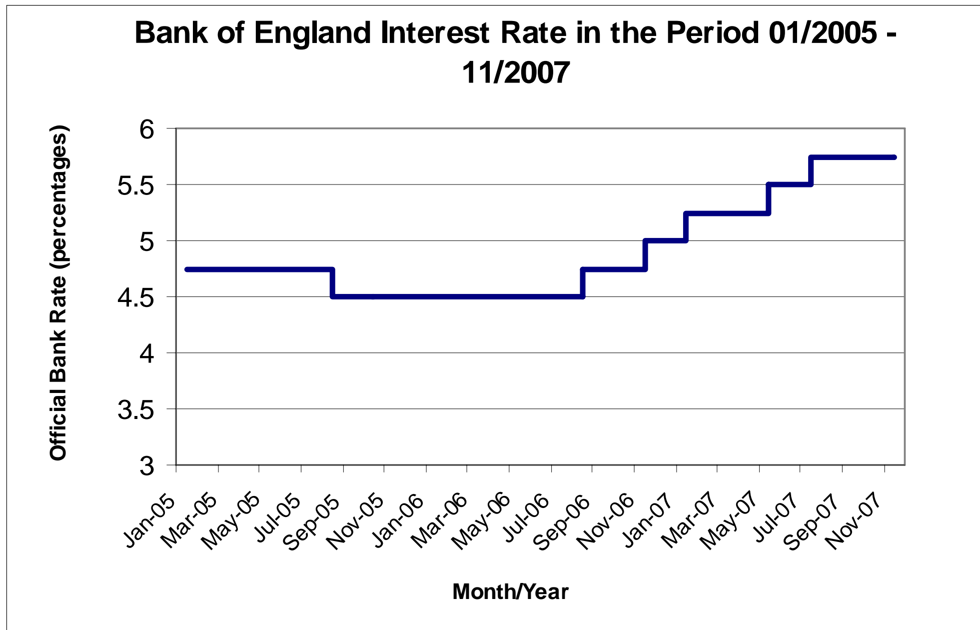
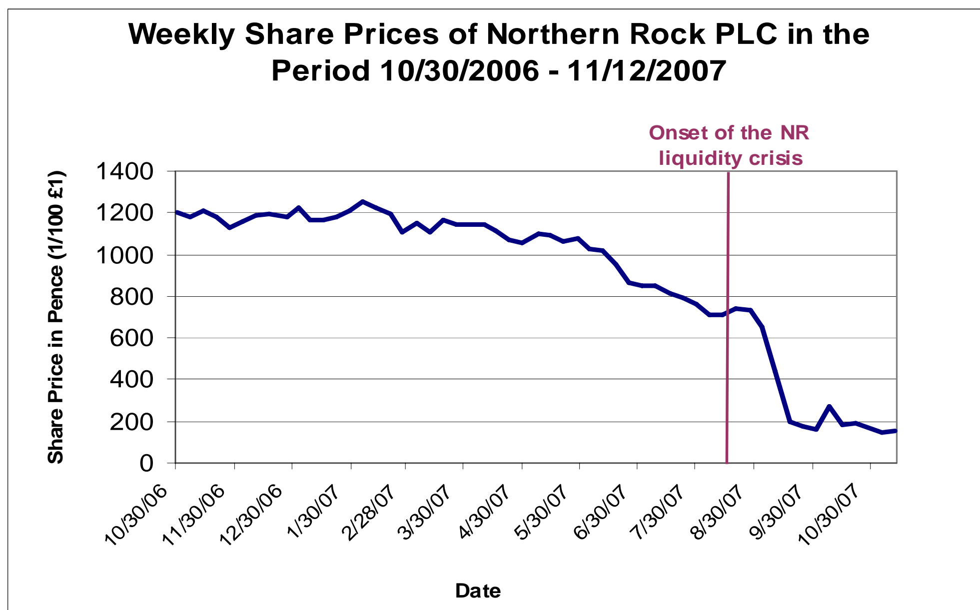


Chart 2



NR's rapid lending growth and funding model were fully transparent. Although claiming to have been completely taken by surprise by the events that led to the run on the mortgage lender, both the FSA and the BoE were aware of the risk embedded in its model. In January's Financial Risk Outlook, the FSA worried about "a reduction in the supply of and increase in the cost of liquidity". Three months later, in April 2007, the BoE noted in its Financial Stability Report that "There remains a significant pool of customer lending being financed by wholesale funding that needs to be renewed within a year." Rating agencies, too, considered liquidity to be NR's weakness. Yet none of the above mentioned bodies seemed to be overly alarmed by the liquidity risk inherent in NR's unorthodox funding strategy and its falling share price. The quality of NR's assets, its healthy capital position and cost efficiency all made the risk of a loss of access to liquidity appear rather remote. Neither the bank nor its regulators incorporated an extreme funding shortage scenario when testing the bank's ability to sustain shocks; that and more: the simulations carried jointly by the Tripartite authorities to assess the financial systems' resilience did not involve the banks as players, and thus, could not predict their behavior.

With its next securitization scheduled for September, the August 9 global liquidity freeze caught NR low on cash. It tried to diversify its funding sources around the world, yet global markets had dried up, and investors, alarmed by the U.S. sub-prime crisis, turned their backs on mortgage lenders. With merely £1.5 billion in committed credit lines and no access to ECB emergency liquidity, NR notified the FSA on August 13 that it was in trouble. The next day, the FSA passed the message on to the BoE and the Treasury, and the Tripartite gathered to discuss the problems that might arise if NR were to be unable to procure funding on wholesale markets.

The Tripartite's initial approach to dealing with the NR crisis was to have a stronger bank take over the beleaguered mortgage lender. Several financial institutions expressed an interest in NR; Lloyds TBS, a British bank, emerged as the most serious contender. Yet Lloyds TBS conditioned the deal upon a £30 billion funding support from the BoE - which the latter refused to extend. Although the regulators recognized the advantages of a takeover, they deemed it inappropriate to help finance a bid by one bank for another. The negotiations broke down, and NR was left to the mercy of a bailout.

Throughout the crisis, the BoE emerged as the Tripartite's hardliner. Emphasizing the risk of promoting moral hazard and resisting pleas by both the banking industry and the FSA, the BoE - unlike its American and European counterparts - refused to relieve the financial system by

injecting liquidity and accepting a wider range of collateral. The BoE also refused to intervene in the three months money market.

On September 13, a month after NR notified the FSA that it was in trouble, Alistair Darling, the Chancellor of the Exchequer, determined that the mortgage lender should be rescued; the BoE had to provide emergency assistance in spite of its strong public stand against bailouts. The news leaked, inspiring panic among NR depositors; the next day found the Government scrabbling to convey a public statement.

Far from having a placating effect, the official announcement stirred greater fears among NR's depositors, who raced to withdraw more than £2 billion from the beleaguered bank. The depositors' unnerved reaction to the bailout rumor was not senseless: Britain's deposit protection scheme fully guarantees only the first £2000 and freezes retail accounts, delaying compensation payments for at least six months. The run was contained only three days later, when Mr. Darling announced that all deposits with the mortgage lender – retail and wholesale - were fully guarantied, and that the guarantee would apply to any lender facing a funding crisis. NR is expected to borrow £30 billion from the BoE by the end of the year.

3. Handling of the crisis

Though it is hard to tell whether the crisis could have been prevented, it is clear that regulators - the FSA in particular – failed to translate concerns about NR's business model into regulatory measures. Insisting that the global liquidity freeze that led to the felling of NR was an "unknown unknown", the FSA nevertheless admitted that stress tests were deficient, that NR should have been dealt with more firmly, and that it had not properly considered the possibility of a general liquidity dry-up. That the FSA failed to require the imprudent lender to secure emergency funding is also to its discredit.

The BoE has been widely criticized for having slowed down the handling of the crisis. To these reproaches the Governor's main line of defense was that he had favored a covered, behind-the-scene operation over a public one, yet had his hands tied by the Market Abuse Directive, a European-inspired law enacted in the U.K in 2005. That the BoE was legally prevented from

conducting a clandestine rescue[4] , and that it took it so long to realize that, points to a serious flaw in the regulatory system's preparedness for crisis. These legal impediments – if they are indeed such – should be examined and tackled to assure that emergency assistance can be extended rapidly and effectively.

Although the BoE could have intervened in money markets soon after the liquidity crisis erupted in attempt to relieve NR and avoid a bailout, it is hard to reprimand it for having refused to do so. After all, the BoE is no longer responsible for the safety and soundness of individual financial institutions, and the demise of Britain's fifth largest mortgage lender could hardly be described as posing a systemic threat. Furthermore, there is no certainty that had liquidity been injected into the financial system, it would have found its way to the distressed bank. In view of this, the BoE's refusal to compromise its monetary policy stance for the sake of an individual bank – the oversight of which was no longer its responsibility - was far from illogical.

The NR debacle should be used as a focal point for reforms in the British Tripartite regulatory system. Though the debacle does not provide evidence in favor – or against – entrusting banking supervision to the central bank, it does point out serious flows in the Tripartite regulatory system and in Britain's Financial Services Compensation Scheme.

3.1 The Tripartite system

Until this summer, Britain's Tripartite financial regulatory system was largely praised and credited for attracting financial business to London, making the City the world's most prominent financial center. But the reformed system was far from flawless. The NR turmoil – undoubtedly a major regulatory fiasco – highlights significant deficiencies in the framework.

Advocates of the Tripartite model argue that it introduces checks and balances into the system – much like the separation of powers in democratic regimes - thereby promoting and fostering both macroeconomic and financial stability goals. Yet the effective and smooth functioning of such a system requires careful planning, lest the checks become immobilization and the balances – impediments. The NR debacle demonstrates well this point.

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[4] Charlie McCreevy, the Brussels commissioner responsible for the directive, denied that it prevented the BoE from extending clandestine assistance to the beleaguered bank. Ironically, not only wasn't the bailout conducted discreetly, but the news about it leaked prior to the official announcement - resulting in a run on NR.

The reformed framework, intended, among other things, to eliminate the potential for conflicts of interests, merely externalized them. Instead of being resolved by a single institution, conflicting interests – now coupled with conflicting agendas, views and opinions – are represented by separate agencies. In their zeal to protect their separate goals and assert their independence and authority, these agencies may engage in power plays, the implications of which are likely to be most harmful to public interests. This undesirable scenario materialized in the sorry handling of NR's liquidity shortage. The differences of opinion and approach between the BoE and the FSA – a hardliner central bank versus a soft-touch, principles-based regulator – slowed down and encumbered the handling of the crisis, further aggravating the situation instead of solving it. Precious time – which is of critical importance in a financial crisis - was wasted over disputes and indecision. At the onset of the crisis NR was an illiquid yet solvent bank; access to the discount window – a classic LoLR operation at little or no cost to the Government – would have relieved its funding shortage. As the weeks passed, the lender became an insolvent institution, the rescue of which called for a costly bailout[5]. The beleaguered bank – and most importantly its depositors – literally fell between three chairs. When the indecisive Tripartite eventually announced a rescue operation – the very announcement triggered a run on the bank.

The most problematic aspect of the Tripartite framework is that it separates the roles of banking supervision and LoLR. While the 1997 regulatory reform dismantled the BoE of its role as banking supervisor, it did not relieve the central bank of its role as LoLR of the banking system. Yet the two functions are highly complementary; the direct involvement of the LoLR in banking supervision assures that it has immediate access to all relevant formal and informal information, and that it is able to correctly interpret it and use it to effectively contain a crisis.

The Tripartite MOU states that the ultimate responsibility for the authorization of a bailout rests with the Chancellor. As bailouts are often political decisions and involve taxpayer funds, assigning the authority to command rescue operations of individual institutions to the Government makes perfect sense; yet the central bank should not be involved in the decision to bail out a bank if, as in the case of the BoE, it is no longer involved in the supervision of the banking system[6,7]. The Chancellor's imposition of a bailout against the will of the BoE took a toll

[5] Bagehot (1873) argues that while illiquid-but-solvent banks should be assisted by the LoLR (at a penalty rate and against good collateral), insolvent banks should be allowed to fail, rather than bailed out with public money.
[6] The central bank should nevertheless retain the role of LoLR of key financial institutions, such as the payments and settlements systems.

on the latter's reputation. Given the importance of reputation and credibility to an independent central bank's ability to control monetary aggregates, this may entail hazardous implications. The function of LoLR should therefore be restructured. An arrangement by which bailing out distressed banks would be the joint responsibility of the FSA – the chief supervisor of the financial system – and the Government, as representative of the taxpayer's interests, would merely require a BoE credit line, and would protect the central bank from messy, political bailouts.

3.2 The Financial Services Compensation Scheme

The NR crisis also revealed shortcomings in Britain's deposit insurance system, known as the Financial Services Compensation Scheme. The bank-funded scheme guarantees 100 per cent of the first £2000 and 90 per cent of the next £33,000 of each deposit. The process of claiming losses takes at least six months. This compensation pattern had undoubtedly been a contributing factor to the run on NR; had depositors been confident that they would be fully compensated, a run might have never occurred. Setting a higher limit for full compensation and allowing insolvent banks to pay depositors immediately would allow regulators to contain – and hopefully prevent – bank runs more effectively. In addition, banks' participation in funding the scheme should reflect the risks they take – as in the U.S., Canada and France. The management of the compensation scheme requires supervisory information, which makes the FSA the ideal candidate for the job; that in turn further stresses the need to assign the FSA the responsibility for bailing out banks.

4. Concluding remarks

The NR crisis – an embarrassing regulatory fiasco - brought to light significant shortcomings in Britain's Tripartite regulatory system. To prevent the repetition of this scenario, the LoLR function and the Financial Services Compensation Scheme should be restructured. The responsibility for bailing out an individual bank should be jointly assigned to the Government – as representative of the taxpayer's interests – and to the supervisor of banks. Since it is unlikely that the FSA would be dissembled and banking supervision reassigned to the BoE, the BoE should be relieved of the responsibility for bailing out individual banks. Such an arrangement will

[7] The Bank of Japan insists that the 1997 Japanese banking crisis demonstrates that the central bank cannot function as a LoLR for the banking system unless it retains the ability to monitor banks – even though a separate authority functions as the supervisor and regulator of the financial system.

protect the central bank from potential damages to its reputation and credibility – both essential to its ability to manage monetary policy. The Financial Services Compensation Scheme should also be reformed so that it would not exacerbate the risk of depositor panic. Higher compensation limits and immediate compensation payments are called for. Finally, financial innovations and off-balance-sheet activities, such as the "originate and distribute" model, should be closely monitored by regulators.

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