

# Bank of england role in credit crunch on the uk economy essay sample

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## Introduction

The credit crunch began when the US sub prime mortgages went under and triggered a spiral effect in the economies around the world. This was followed by the falling value of houses in Britain that has continued unabated to this day. Northern Rock succumbed to the crisis in September 2007 and was nationalized in February 2008. Consumer prices shot up in 2007 and even in the first half of 2008. In January 2008 Bear Stearns collapsed followed by Lehman Brothers in September of the same year. The Bank of England has since earmarked 50 billion pounds to purchase private assets (ANL, 2009)

## Failure to Deal with Northern Rock in Time

Northern Rock collapse was foreseen and the Bank of England failed to avert this systemic financial risk. Northern Rock relied more on funds from mortgages than on savings. When the crunch hit the market, Northern Rock failed to receive cheap funds that it needed and subsequently announced a 585.4 billion pounds loss in the first half of 2008 contrary to 10.7 billion pounds made in the first six months of 2007. It has since received a 25 billion pounds bail out loan from the Bank of England. As a result it paid off 9.4 billion pounds and still owes 17.5 billion pounds (BBC NEWS, 2008)

Northern Rock had pursued a persistent lending policy. The Financial Stability Report of 2007 given by the Bank of England said that Northern Rock was relying more on wholesale funding and would have faced serious troubles if the market liquidity conditions changed. These warnings were relayed to the Northern Rock and even discussed in their board meetings.

Northern Rock went public and assured the customers that they had taken the advice very seriously and were considering slowing down their pace of growth. Mr. Applegarth, Northern Rock CEO, proposed to sell the firm's commercial lending wing and the unsecured operations. He also pointed out that Northern Rock had started venturing in retail funding products from Denmark. Unknown to the Bank of England, Northern Rock was still chasing deals in wholesale funding and securitized products.

They later regretted that high value assets had predisposed them to the current financial crisis and termed the crisis as unforeseeable. Furthermore, there was no liquidity insurance policy in Northern Rock. It didn't purchase an enough insurance to cover all its range of products and Mr. Applegarth did admit that he had only insured a few of the products leaving the others to the dangers of market instability. But despite these shocks in the liquidity market Northern Rock continued to incautiously fund its projects. This negligence was based on the notion that if it collapses the Bank of England would step in and bail it out. Comfortable with this, it went on undeterred and eventually plunged into the centre of the credit crunch crisis. The Bank of England was fully aware of the unfolding scenarios at this giant firm but failed to enforce necessary rules to mitigate the crisis.

#### Weak regulatory framework of the Bank of England

About 17 billion pounds have been lost by shareholders after the Northern Rock predicament and has been blamed on the leading banks. Unfortunately none of them has been held liable by the Bank of England. The executives of

these banks have continued to pay themselves huge amounts which continue to keep the UK in the recession. These executives are now demanding the clients to pay back the debts, and worse still making conditions difficult for repayments not forgetting that they are the same who wooed the consumers into buying their mortgage products. Adam Applegarth, formerly at Northern Rock, left with over 760, 000 pounds plus a pension! Is the Bank of England still in control? (Brummer, 2008)

The Bank of England did not comprehend the full extent of the signals that exacerbated the current financial crisis. The bubble was taking root in the housing sector given the uncontrolled borrowing. The Bank over relied too much on the control of the monetary policy through the interest rates which had worked well since the 80's but failed during the 2007-2008 credit crunch. Interest rates had become a blunt instrument and some stricter control policies should have been invoked to protect the financial system (Pagnamenta, 2008)

Bank of England failed to Act on the Market Signals

Ashley says that the Monetary Policy Committee (MPC) was holding high rates of interest for a considerably longer period of time. When King, Governor of Bank of England was told about this he refused to re-adjust his economic model to cushion the UK against an eminent credit crunch. He dismissed such forecasts are mere fancy models. He forgot to understand that the British economy had been solely driven by high house prices with

high volume of credit and that the opposite was likely to occur if the trend changed (Edmund, 2008)

Mervyn King even predicted that the wages will appreciate given the rise in oil prices, clearly ignoring the warning issued by Branchflower. Unfortunately for King, over 80,000 people are losing their jobs every month barely five months after Branchflower sent a blaring signal. There is complete lack of coordination between the FSA, MPC (Monetary Policy Committee), Bank of England and the Treasury. For instance the Financial Stability Report of 2006 issued by the Bank of England's Risk Manager, Paul Moore, warned of an impending instability in the financial markets that firms were engaging in too much risky leverage. It was ignored by the other joint partners.

King supported of mortgage backed assets regime which literally transferred the risk to the investors. During the August Inflation Report, King hailed the current banking system clearly underscoring that it was less vulnerable to collapse because risks were not reflected in the balance sheets of these firms and sniffed at the old system as risky. He also said that the current system is less fragile due to securitization (Seager, 2009).

Though the real crisis far exceeded these predictions, Northern Rock and the banking system without forgetting the house prices, would have been salvaged if the Bank of England would have given an ear to these warnings. Money growth was on an upward trend after 2006, clearly setting the stage for a disaster. The bank did not move to implement proper monetary policies to reverse this growth. The FSA and the Treasury did receive this report but

failed to warn Northern Rock and other players in the industry in time over the financial policies they were pursuing (Edmund, 2008)

### Unprecedented Mortgage Backed Assets

Edmund (2008) says that the Bank of England was aware that the growing debt was portending a serious risk to the economy going by its Financial Stability Report of 2006. He notes that banks were more careful in lending to clients amounts not more than their deposits, but they suddenly changed by 2005 and started lend out 500 billion pounds not in their vaults. It goes without saying that if the clients defaulted, then these institutions will be in trouble.

The City had stepped up its dependence on wholesale funding clearly exposing it to danger in case of an economic melt down. Many commentators warned of a likely crisis, but these clarion calls of reason fell on deaf ears. The 2006 Financial Stability Report dismisses allegations that the credit crunch crisis was unpredictable both by the City and the Bank of England. It went ahead to say that a debt ridden economy would face a severe recession, wipe out 40 billion pounds of a 1/3 of banks tier one capital and bring the housing prices down by 25 % (Edmund, 2008)

Driven by appetites to increase their yields the mortgage firms were lending out 10 billion pounds per month against 5 billion from savers. The deficit in financing came from overseas financial institutions. This created an overwhelming overseas debt of 740 billion pounds (typically more than a half the GDP) between the years 2000 and 2006. The conversion of these dollar

investment into the pound strengthened the Sterling against the major world currencies. The Bank of England read nothing in these (Spencer, 2009)

Pennington (2008) said that the numbers of people plunging into debt were rising steadily a few years before the crunch and the Bank of England should have given it a thought early enough. Currently there is over 230 billions pounds unsecured credit owed in the UK.

Deputy Governor to the Bank of England, Sir John Gieve admitted that the bank knew about the unusual borrowing pattern but failed to intervene. He further notes that indeed mortgages were overvalued. As a result there are many arrears yet to be cleared on these overvalued properties. He presses for more regularized regime of the banking industry adding that interest rates have not been very successful in turning the economy around (Shropshirestar, 2008)

The Bank of England underestimated the likely implication of surge in credit and spiraling house prices. The increase in credit and robust house prices was not in tandem with the increase in prices, output and earnings as characterized by other booms (Winnett, 2008)

Northern Rock bailout depicts inconsistent monetary policies

This Mortgage lender firm was bailed out on September 13, 2007. The bail out extended a short term credit line to the ailing firm as a result of the joint tripartite effort between Financial Services Authority(FSA), the Bank of England and the HM Treasury. This credit was aimed at enabling Northern

Rock meet its financial obligations after the US credit crunch hit the UK market.

But the manner in which this credit line was extended raises fundamental questions. The collateral used for this credit line cast serious doubts if the firm's balance sheet is anything to go by. It is important to mention that if Northern Rock had satisfactory collateral, then it will have definitely been eligible for lending from the Bank of England (BOE) Standing Lending Facility. It secured its lending through the joint MOU between Treasury, The Bank of England, and the FSA. For a firm to be eligible for lending at the BOE Standing Lending Facility it must show proof for collateral that include euro-dominated and Sterling instruments given by the United Kingdom, European Economic Area central governments, US Treasury bonds, and the central banks. Now, these assets are seldom found anywhere on Northern Rock's Balance Sheets. The Bank of England defended this move and reiterated that it did lend against good collateral by invoking its Last Resort Lender Role (LOLR) principle. And that the failure of Northern Rock will lead to an economic turmoil including to its clients. It also claimed to have followed terms of Paragraph fourteen of the Tripartite MOU that Northern Rock collapse would have destabilized the UK financial system (Butler, 2007)

Contrary to these assertions, the conditions of LOLR and Paragraph four of the September 12th Paper of the MOU was not followed. To begin with, it is erroneous to claim that 113 billion pounds worth of assets suffered as a result of the liquidity crunch rather than its own insolvency. Prior to the credit crunch, Northern Rock pursued an aggressive and risky expansionist



strategy that saw it step up market share, fund 75% of projects in expensive markets and reduce interests on Mortgage loans. It basically depended on costly wholesale funds to finance a portfolio of low priced mortgages. Typically therefore its lending interest was less than the rate on investments. Furthermore, its share price had drastically dropped since February the same year. The proposition that if Northern Rock collapsed will send far reaching disturbances in the UK financial system was not well founded. Northern Rock is not too big to fail. It ranks fifth in the mortgage industry in making it not very significant. If Northern Rock fails it does not pose a severe threat to the economy. Bank of England decision was not well informed with the balance sheet information of Northern Rock. The fear of depositors was not well founded either. The depositors are under the Financial Services Compensation Scheme with a compensation amount of 31, 700 sterling pounds per person. Questions are being asked whether the taxpayer's money will be paid back (Buiter, 2007)

## Conclusion

The Bank of England is to blame for credit crunch crisis in United Kingdom for it knew well in advance the impending financial catastrophe. It is also essential to mention that there is complete lack of co-ordination between the three tripartite organization and this division was a major obstacle in the decision making process. The Bank of England should be vested with more powers beyond the administration of the traditional monetary policies to be able to deal with crisis in the financial system.

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