Nationalisation crunch led to a shortage of

Business, Industries

Nationalisation of Northern Rock was due to a lack offunding, the bank was heavily dependent on securitisation issuance and fundingfrom the wholesale markets. As defaults increased on the mortgages NorthernRock was faced with a crises of not receiving payment from its long term loans. The credit crunch led to a shortage of funds due to an increase in defaults insub-prime mortgages, banks and investors became less willing to lend to otherbanks particularly those that were involved in securitisation issuance.

NorthernRock failed to meet its short-term obligations which led to its customersrushing to withdraw their money, at the time Northern Rock had short term wholesale obligations of 60% . Due to its lack of funding Northern Rock reached outto lender of last resort the Bank of England for liquidity assistance, to providestability and reduce the bank run the labour government had to step innationalise Northern Rock. The nationalisation of Northern rock led to a number ofoutcomes some of which were positive and negative. Nationalisation of NorthernRock was intended to be a temporary solution that would provide stability untilmarket conditions improved and then the tax payer would gain on the sale of theassets acquired.

After the nationalisation Northern Rock was under pressure fromthe government and cut its interim dividend, at this point shareholder wealthhad been at a loss from the already falling share price. Other steps taken torestructure Northern Rock included breaking up the bank from its retail andasset management, the asset side of bank which contained the toxic assets wasto be held by the government and the rest sold off. Nationalisation not onlyaffected the share price and caused equity loss but structural changes had tobe made such as staff downsizing which resulted in job losses

and changes to managementsuch as Bryan Sanderson replacing Matt Ridley as chairman. The nationalisationof Northern Rock began to provide some form of stability and confidence asinterests from the private sector began to come in, one of them being theVirgin group interest which resulted in a sale of one part of the bank between£747 million and £1 billion. The nationalisation of Northern Rock was essential to itssurvival at a time of panic and instability it provided reassurance and helpedto restore confidence in the bank, it gave the perception that since it wasbacked by the government the government would not let it fail. However thesechanges were not beneficial to all stakeholders, shareholders lost their equitywhen the share price collapsed and , some shareholders such pensioners andthose who had self invested pensions (SIPS) in Northern rock lost all theirlife savings.

After nationalisation of Northern Rock shareholders lost controlof the mortgage bank, legislation was proposed that the government should not compensatethe shareholders for any value. The tax payer that helped fund the bailoutbenefited from the sale of assets from the Northern Rock Asset management sidethat received loans and was kept under the government. The nationalisation had a negative impact, it resulted inloss of wealth for shareholders and control of the mortgage bank to the public. Nationalisation of the bank was funded by the tax payer, eventually the taxpayer did benefit from the sale of banks assets but the initial funding costthe tax payer, returns on the initial funding was dependant on the governmentsability to find a buyer for the banksassets. After the 2008 financial crises it became more apparent thatchanges needed to be made to the financial system to

prevent another one fromhappening. Reforms were put in place such as the Dodd- Frank Act (2010)USA, it was designed to place majorregulations on the financial industry . Its main goals are to prevent banksfrom growing and becoming “ too big to fail”, It authorises oversight thatallows these banks to be broken down if they are seen to be a posing a systemicrisk. Under the Dodd Frank act better supervision has been put in place overbanks that pose a systemic risk, the act requires banks with over $50 billion inassets to submit to annual stress test with similar conditions to those thatwere experienced in the 2008 financial crises.

Another important change in the Dodd –Frank act was theVolker Rule which prohibits banks or other regulated intermediaries fromsponsoring or owning non regulated firms such as hedge funds, private equities. Its main purpose is to prevent banks that are big enough to receive federal ortax backing from engaging in risky trading activity, trading with high-riskderivatives without efficient risk management were one of the reasons banksincurred huge losses. In the run up to the 2008 banks were not the only ones whoplayed a major role in housing and credit bubble but rating agencies such asMoody’s and Standard & Poor who rated sub primes as safe, have also beenplaced under regulation by the Dodd-Frank act. Before the crises ratingsagencies would rate sub-prime as safe (AAA), banks would also receive highratings which allowed them acquire more funding from wholesale markets. There has also been an in increase in the capitalrequirements which requires banks to hold more capital in the event of a crisesit would be able to absorb the losses. During the crisis most banks hadinadequate capital to absorb the

losses and were highly over leveraged, withthese changes banks will be able reduce their losses.

Although an increase incapital would prevent banks from lending out more but it does help preventbanks from being over leveraged. Updates to other existing regulation were madesuch as the Basel Accord III, thiswas founded in 1974 (Basel Accord 1) with the purpose of ensuring thatfinancial institutions have enough capital to absorb losses. The new BaselAccord is an extension that focuses onincreasing bank capital and reducing bank leverage, before 2008 banks werehighly leveraged due to the low interest environment and had low capitalbuffers. In the UK we have seen changes in regulatory structures suchas the introduction of Prudential Regulatory Authority (PRA) which is over seenby the bank of England , its core function is to oversee banks or institutionsthat may pose a systemic risk to the financial system.

Changes in the UK such as ring-fencing that are still yet to beimplemented would see the separation of retail banking from investment banking, deposits would be kept in the ring fence and the trading activities outside thering. This helps prevent normal retail deposits from being affected by theinvestment banking activity. In the run up to 2008 financial crises banks wouldengage in risky activity when losses were incurred it wasn’t only theinvestment bank that was affected but also the retail bank, these changes helpto provide security to depositors. There are many factors that caused the 2008 financial crisessome of which are still being addressed. It helped to show the weaknesses onboth the private and public sector side. In

the public sector side it revealedregulatory and oversight weaknesses. Looking back as far as 1929 stock crash itresulted in Glass-Steagall act that separated commercial banking frominvestment banking due to the risky activity that banks had engaged in andunsound loan practices.

It was later removed by Bill Clinton which promotedfinancial liberalisation resulting in unsound loan practices such as sub primesand risky investments such as Collaterlised debt obligations. When all this washappening oversight was lenient, there was no oversight or understanding ofderivatives trading. Regulation plays a crucial role in preventing financialcrises but too much oversight does pose a treat towards innovation and growthin the financial industry. Changes in regulationsuch as Basil Accord, Dodd-Frank have tackled the issue of capital requirementswhich was a critical issue before the 2008 crises as banks didn’t havesufficient capital to cover their losses, but it doesn’t prevent banks fromengaging in risky activity. More emphasis should be placed on the need forbanks to act in an ethical manner that doesn’t result in loss of shareholderwealth, an example being Northern Rock. Although it was bailed out and itsassets were sold off and the tax payer recovered the loans but the shareholders were at a loss. NorthernRock growth objectives were often seen as being too aggressive they were moreconcerned with profit maximisation which was short termed rather than growingshareholder wealth which would be a long term objective.

The rescue of NorthernRock could be considered as a bad thing as it gives big banks the perceptionthat the government will always step in, in the event of a crises and even whengovernment steps in it doesn’t guarantee

that shareholders will retain value intheir equity. A separation of retail banking and investment banking will reducethe need for government intervention in the case of failure by the investmentbanking side the retail bank wouldn't be affected. This has been addressed byimplantation of ring fencing in the UK and Volker Rule in the USA. Some of the key issues that triggered the 2008 financialcrises have been addressed such the capital requirements and separation ofretail and investment banking but the banking culture of profit maximisationthat is short termed and agency problems hasn't been addressed, banks shouldable to take on a long-termed approach of maximising shareholder wealth.