

Northern Rock - what it all really means

There used to be a time when the building societies were considered to be the "cuddly bears" of the financial high street. Compared to the big banks, they were friendlier, mutual, and they were safe. The Northern Rock fiasco has been a stark reminder as to how things have changed. What can we learn from this?

The situation with Northern Rock was, of course, prompted by the so-called "credit crunch". All of a sudden we have gone from cheap, amply available credit and stable markets to credit shortages and investor panic. The short-term solution by central banks has been to flood financial markets with short-term liquidity.

The final outcome of the credit crunch has yet to be seen. There are those who say that the full impact on the world economy hasn't even started yet, and that we will see falling house prices and, possibly, recession. There are others who think everything will carry on regardless. To this extent it is too early to come to any full conclusions.

The credit crunch has, however, been a direct cause of Northern Rock's problems. Previously a humble building society based in the north-east of England, Northern Rock plc (as it later became) has over recent years become an aggressive player in the UK mortgage market. Its business model was basically dangerous in that rather than raising the money it passed on to lenders through deposit taking, most of its funds were raised from the money markets. This left it defenceless against a shortfall in funding when the money markets dried up.

What can we learn from all this? Well, at the moment everybody seems to be blaming everybody else. With the credit crunch the fault is variously put down to imprudent mortgage lenders, equally imprudent and deceitful mortgage borrowers, banks, rating agencies, hedge funds, not to mention villainous brokers driven by high commissions in selling sub-prime mortgage debt.

In the UK, and in the particular context of Northern Rock, the finger has been pointed not only at Northern Rock's management, but also at Gordon Brown for his shakeup of the banking regulatory system 10 years ago, the new Chancellor Alistair Darling, the Bank of England and the UK's Financial Services Authority. Certainly, in regulating Northern Rock it does look as if the FSA was asleep. Ironically, the panic at Northern Rock seems to have been caused by the very Bank of England announcement designed to prevent it. In managing the aftermath, both Alistair Darling and the Bank of England have performed complete U-turns in decisions they previously made.

But more importantly for the rest of us, what can we, the people, learn? Firstly, it is good to know that the British nation, despite being obese and generally going to pot, still knows how to form orderly queues, even whilst panicking about their hard-earned cash. You would have thought that the first old-fashioned run on a bank in



More seriously, the Northern Rock incident reminds us how little most of us really know about the organisations that look after our money. One bank or building society may look just like another, but Northern Rock reminds us that this is not the case. We should know more about these organisations, and we should take more care how and where we invest our money. Alistair Darling was quick to propose that the UK Financial Services Compensation Scheme would increase the limit on the country's bank deposit insurance scheme to £100,000 (although 10 days later he backtracked to a lower figure of £35,000). Whilst his announcement did appear to stop the run on the Northern Rock, his proposals have been widely criticised as further immunising both depositors and, indirectly, shareholders from their own recklessness.

This lesson does not just apply to bank and building society deposits. Whilst in the long term it is true that investment markets tend to go up, too many investors invest in stock markets and shares and enter investment schemes with very little understanding at company level of the investments and the risks involved. As long as that happens, and it probably always will, shocks to all sorts of systems will occur from time to time.



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