Botched rescue

The City's institutions have bungled the Northern Rock affair and should take lessons from their foreign counterparts, says **Tim Congdon**

In their handling of the Northern Rock affair the Treasury and the Bank of England seem determined to make mistake after mistake. Parties interested in acquiring the bank had to present their bids by 16 November. Newspapers described this date as "a deadline".

Reports also stated that the Treasury and the Bank of England required that the Bank's loan to Northern Rock end in February 2008. Officialdom wants the issue closed. (However, a confidential Northern Rock memorandum, circulated to potential bidders, envisaged continuing the loan facility until 2010.)

Are the Bank and the Treasury right to press – officially, at least – for early repayment of the loan? In banking, the shorter the time in which assets must be sold, the lower the price. Banks differ from other businesses in their very high leverage, with assets typically 20 times capital.

If a bank cannot fund its loan portfolio and is forced to dispose of assets in a hurry, it is likely to receive a lower price than if no time-limit were imposed. Plainly, if the assets sell for only 5 per cent less than their worth in a normal market, all its capital is eliminated.

In the case of Northern Rock, the UK authorities have a strong interest in ensuring that the bank's assets are unwound in an orderly fashion at the highest possible price. The point is that, by making the loan, the Bank of England has become Northern Rock's largest creditor (that loan had grown to £20bn by mid-November). In the first instance, the Bank does not have any funding cost on this facility, as it is the UK's sole issuer of legal tender notes and can create a deposit convertible into notes by a stroke of the pen.

If the Northern Rock loan is repaid in full, the Bank (and at a further remove the taxpayer) will make a profit and everyone will be happy; if Northern Rock cannot repay the loan and indeed suffers losses in excess of its capital, the operation will have been a failure, the taxpayer will be forced to pick up the bill and the reputations of both the Treasury and the Bank will be further tarnished.

The European Union's Market Abuse Directive has been invoked to justify demands that Northern Rock repay the loan by February. But this interpretation is questionable, not least because the loan is priced at well above market rates. Charlie McCreevey, the Brussels commissioner responsible for the directive, has denied that it prevented official central bank assistance in the course of an emergency. The European Commission has made no public statement to the effect that the Bank must seek early repayment of its facility to Northern Rock.

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In the current episode, the Bank of England's attitude to lender-of-last-resort loans has differed from other leading central banks.

When trouble loomed in the inter-bank markets in early August, both the ECB and the Federal Reserve added to banks' cash reserves in a pre-emptive effort to ease the strain and prevent inter-bank rates from surging. The Bank of England, however, refrained from intervening.

Moreover, the ECB has made clear that there is no hurry for banks to unwind the assistance. In an interview with the *Financial Times* on 12 November, José Manuel González-Páramo, the ECB executive responsible for money market operations, said: "To the extent that money markets remain subject to tension, we will stay there as long as necessary." He emphasised that "there is no deadline".

Ultimately, normality will return to inter-bank markets. Sooner or later, inter-bank rates at all points in the yield curve will move closer to the levels intended by the central banks, while banks will again feel relaxed about lending to other recognised institutions at inter-bank rates. But no one knows when normality will return.

Given the scale of Northern Rock's liabilities, which exceed £100bn, it is understandable that any bidder should seek standby help from the Bank of England.

If the Bank offered an open-ended credit facility at a reasonable rate of interest, the bidder would be able to fund Northern Rock's assets even if the inter-bank market remained semi-paralysed. A facility of this kind would increase the value of Northern Rock's assets and thereby make it easier for the bidder to repay the loan.

In the last major rescue of this kind – the so-called lifeboat for the secondary banks after the 1974 property crash – the key players imposed no deadlines, but waited for market conditions to improve before they disposed of assets. The lifeboat existed for several years.

While the resolution of the Northern Rock affair must be sensibly organised and subject to some sort of schedule, strict deadlines and time-limits are misplaced. Since the essence of any meaningful rescue is to give Northern Rock time to re-arrange assets and liabilities, artificial time-limits will undermine the operation.

The Bank of England has much to learn from the more flexible and pragmatic approach of the ECB and the Fed.

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