

Title: Northern Rock Final Essay

Module: Managing External Stakeholders

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“The current turmoil in the financial markets has all the characteristics of a classic banking crisis, but one that is taking place outside the traditional banking sector” said, Axel Weber, president of the Bundesbank as reported by financial times in article by Guha (2007). There has been turmoil in UK financial markets and at Northern Rock since August, 2007(BBC News, 2007a). This crisis has damaged the credibility and to a great extent business of Northern Rock, Britain’s fifth-largest mortgage lender (Times Online, 2007). This essay will attempt to analyse events happened at Northern Rock and in UK financial markets recently. Before that, it will first look into classical economic theory of profit maximisation and to what extent profit maximisation was the objective of Northern Rock.

Economists have put forward various theories to explain how firms behave in order to predict their reaction to events (Hornby et al, 2001). According to standard economic theories, profit maximization is considered to be the objective for commercial organisations (Hornby et al, 2001). This classical theory stems from the work Marshal (1890) in Hornby (1995) Principles of Economics. For any business firm, maximization of the profits is often considered as the implied objective and profit is also regarded as the yard stick for the economic efficiency of any firm (Skaggs, 2007). Therefore it is natural to retain and aim it as a goal for commercial organizations like Northern Rock.

Profit maximization borrows the concept of profit from the field of accounting and thus tends to concentrate on the immediate effect of a financial decision as reflected in the increase in the profit of that year (Oyolola, 2006). This is not necessarily correct because for a company like Northern Rock many decisions have their costs and benefits scattered over many years. Profit Maximization also ignores the risk which the firm undertakes in attempting to increase the profits (Heffernan, 2000). Profit Maximization as an objective is vague and ambiguous. It does not clearly specify whether the objective is long term or short term (Koplin, 1963). Sometimes businesses such as Northern Rock may require significant investment in setting up the distribution channel or building systems in place to defend competition which may have the short term effect of reduced profits for some years but a safe, stable business thereafter (McAleese, 2001). All these conditions imply that it is not practically possible to have profit maximization as a main objective for a firm like Northern Rock.

Also, profit maximization as an objective of the firm fails to deliver its feasibility in operational and practical terms (McAleese, 2001). Profit maximization theories assume that a firm acts rationally, pursues a single objective and there is no division between ownership and control and the manager who makes the decision (Hornby et al, 2001). These assumptions do not hold true in practical world and in a company like Northern Rock as proved by the famous works of Berle and Means (1932) in the USA and Florence (1961) in the UK. Modern business corporations like Northern Rock are seen as being run by managers who control the business and pursue objectives quite different from the owners (Hornby, 1995). So, it is reasonable to say that profit maximisation is not truly pursued by managers in companies like Northern Rock where the significant control is in the hands of managers.

Looking at Northern Rock’s financial performance, it’s profit after tax grew from 73 m pounds in 1997 (Northern Rock annual report, 1998) to 443 m pounds in 2006 (Northern Rock annual statement, 2006). There was almost 500% increase in profit from 1997 level, an almost 56 % average increase in profit every year. Northern Rock was very successful in

keeping its cost base down (Aldrick, 2007 and speedy, 2005), a condition necessary for pursuing profit maximisation (McAleese, 2001). But, at the same time there was also significant growth in Northern Rock assets. Its assets grew from 15.9 billion pounds in 1997 (Northern Rock annual report, 1997) to 101 billion pounds (Northern Rock annual report, 2006). Similarly, there was impressive growth in return on capital employed (from 4.8 % to 19.4 % in the same period), earning per share, and market share of the company since it became public in 1997. In terms of market share, it is 5th largest UK mortgage lender (Northern Rock company info, 2007). This data shows that Northern Rock was also pursuing other objectives like growth maximization, value maximization, target return on capital employed (ROCE), increasing size and dominance in the market.

So, it is reasonable to say that Northern rock was pursuing multiple objectives rather than just profit maximization. Profit maximization was one of the main objectives of the northern rock as reflected by the increase in profit after tax figure of last ten years of Northern Rock and also by company's importance on keeping the cost base down (Aldrick, 2007 and speedy, 2005). So, management was continuously stressing on profit maximisation. It appears that profit maximisation was one of the many key objectives of the Northern Rock but equal importance was given to other objectives like growth maximization, value maximization, ROCE, earning per share growth and increasing dominance in the market.

Northern Rock's main stakeholders are savers, borrowers, shareholders, employees, FSA, society and government (The Time 100 case, 2006). Savers were benefiting from the growth of Northern Rock because of its low cost base and high profits; it was able to pay a good competitive rate of return to its savers (The Time 100 case, 2006). But, Northern Rock was not a safe place to hold their investments due to risk it was taking and business model it was following to pursue its objectives (Kapali, 2007). Other major stakeholders of Northern Rock are its borrowers. Borrowers' expectations are good customer service and good value loans and mortgages. Northern Rock's profit maximization strategy was helping borrowers as they were getting low cost loans with a variety of products to choose from. So, Borrowers of Northern Rock were having nothing to lose from profit maximization strategy.

Employees expect good working conditions, promotion opportunities, job satisfaction. As Northern Rock was growing every year, it was providing good opportunities to excel for its employees (The time 100 case, 2006). Northern Rock CEO Adam Applegarth rose through various ranks to become CEO (Fletcher and Aldrick, 2007). Employees were also being benefited with the increasing share price of Northern Rock due to their employee stock options. However, the number of employees only increased from 4521 in 1998 to 5936 in 2006 while its profit grew from 73 m pounds to 443 m pounds in the same period according to its financial statements of 1997 and 2006. So, it is reasonable to say due to its stress on profit maximisation objective and driving cost base down (Aldrick, 2007a and Telegraph, 2007), Northern Rock was not creating many jobs for the society. Though, Society was benefiting from its good low cost mortgage products (Speedy, 2005).

Shareholders were getting good returns due to profit maximization objective of northern rock before the liquidity crisis. But, shareholders should always weigh return against the risk and some of the actions taken by the management were very risky (Kapali, 2007). Government was being paid taxes by the Northern Rock and tax paid by the Northern Rock has increased (Northern Rock financial statement, 1997 & 2006). Government also has the duty of making

sure that Northern Rock is treating its customers fairly and following all rules and regulations. Northern Rock was complying with all the rules and regulations set by the FSA.

The recent events at Northern Rock and UK describe the happening of a mortgage crisis. To understand these events, it is important to first look at global financial environment. The environment of any business consists of the market environment, characterized by the structure of the markets in which a firm operates, and the nonmarket environment, characterised by the legal, political, and social context in which the firm is embedded (Baron, 2003). So, it is important to do PEST and SWOT analysis to understand the events at Northern Rock and UK.

The Political environment including legal and regulatory has a great impact on any business, more so during a time of crisis in financial systems where trust and confidence in each other is very important. In UK, financial system is regulated by tripartite system of regulation between the bank, the FSA and the treasury. Although their roles are clear, there was no overarching authority when crisis struck (Aldrick, 2007b). In UK, there is also a concept of Deposit Insurance but deposit insurance provided only for the first £ 2,000 of savings, and there is no mechanism for freezing the activities of a troubled bank as it is in USA (Kay, 2007). With its guarantee to Northern Rock savers, the central bank in UK has turned the deposit insurance concept on its head (Kapali, 2007).

The Economic environment in which these events happened was highly uncertain (BBC News, 2007a). There was liquidity crisis in global financial markets (Kapali, 2007). This liquidity crisis started from US subprime market according to Credit Europe bank (2007) in its report on Global Economy Outlook. In Europe, the crisis probably began when French bank BNP Paribas suspended its three investment funds with exposure to trouble US subprime markets on August 9 this year (BBC news, 2007a). Following this, the share prices fell sharply and banks stopped lending to each other. To subvert the situation, the European Central Bank pumped \$ 130bn into the European Banking system. Not only the European Bank, but all major central banks around the world like Federal Reserve, The bank of Canada, Bank of Japan, Swiss National Bank, The reserve bank of Australia injected money into the financial markets (The Wall Street Journal, 2007). But, Bank of England did not inject any money into the UK financial markets at this point of time. Bank of England believed that bailing out commercial banks would “sow the seeds of a future financial crisis” (Giles et al, 2007). Bank of England and its governor Mervin King’s stand not to inject money into the system has been very controversial (Illing, 2007).

The fallout of this liquidity crisis due to melt down of US subprime market also reflects the openness in financial markets (Blanchard, 2006). Due to this openness of the financial markets, anything going wrong with one market like US subprime market might have its impact on global financial system. Following this liquidity crisis, UK mortgage banks raise their interest rates or withdraw their mortgage ranges. After a few days, London Interbank Offered Rate or Libor - reached 6.7975% for a loan over a three-month period (BBC News, 2007b) that is unusually high and it shows that banks were not willing to lend each other. Libor was even higher than the Bank of England’s emergency lending rate 6.75 % at that time (BBC News, 2007b).

According to Economics theory, there are two key problems in central bank acting as lender of last resort and injecting liquidity into the market (Illing, 2007). One is the risk of inflation i.e. there can be a conflict between price and financial stability. The other issue of acting as lender of last resort is the moral hazard effect. The central bank has the responsibility of helping the financial system without encouraging the bad behaviour (Wolf, 2007). Illing (2007) argues that injecting liquidity to support illiquid yet solvent banks works as a public good, providing insurance otherwise uninsurable exogenous risks. So, it is very difficult for any central bank to decide whether or not to inject liquidity into the system and when to do it.

Due to risk of inflation and moral hazard effect, the Bank of England did not inject money into the UK financial system and Bank of England Governor King (2007) defended its move through a letter to the Chancellor on 12 September, 2007. But, the very next day on 13 September Northern Rock seriously damaged the credibility of Bank of England's stance of not injecting money into the system. The BBC (2007c) revealed that Northern Rock has asked for emergency lending to the Bank of England in its capacity as lender of last resort. Bank of England granted its financial support to the Northern Rock (BBC News, 2007c). Northern Rock suffered a great damage following this news. It is arguable that Northern Rock should have informed and communicated this news itself to its stakeholders and the general public. Northern Rock's communication efforts have been criticised, according to Cleaver (2007), "Northern Rock's communication effort were almost a master class in how not to do things. It was classically compounded by that most harmful of plc diseases: the default is to say nothing, even as the business is so obviously in freefall".

Northern Rock customers tried to log into their accounts using Northern Rock's website but due to heavy traffic, customers could not log into their accounts and this communication channel of Northern Rock also failed (e-consultancy, 2007). Customers moved to the general media to find information about the events happening at the bank. Media reports helped in creating a panic that Northern Rock is in some danger and depositors might lose their money. Brand Northern Rock suffered a serious damage here.

The confusion, inaccessibility of accounts through internet and reports in media that depositors might lose their money, created panic among depositors of Northern Rock and they started queuing up at Northern Rock branches to withdraw their savings. Customers said they preferred to be safe rather than sorry (BBC news, 2007c). Northern Rock had a bank run first ever in last 150 years in UK (Ziauddin, 2007). The behaviour of Northern Rock customers can be explained to some extent by Game theory. Harford (2007) mentioned in his column in Financial Times that Northern Rock customers had decided to hunt rabbits. Hunting rabbits is a game in game theory.

Northern Rock was the only bank that suffered to a great extent during this ongoing liquidity crisis. Many Economists and analysts like Aldrick (2007a) and Kapali (2007) believe that Northern Rock Crisis had its origin in its risky business model and its marketing strategy. The bank's strength was that it kept the cost base down, by using intermediaries such as independent financial advisers to market its offers and by minimising its branch network, it has just 72 branches (Telegraph, 2007). Northern Rock's balance sheet as of June 2007 shows that wholesale funding accounted for as much as 80 per cent of its total funding base (Kapali, 2007). Wholesale funding was the most affected segment in the US subprime crisis (Credit Europe Bank, 2007) and it was a great threat for the Northern Rock business, so for

Northern Rock asset side of the balance sheet become illiquid (Kapali, 2007) and it had to cap in hand to the Bank of England asking for emergency funds.

In the end, there were arguably developments and eventualities of high intensity and not foreseen by anyone, which led to Northern Rock crisis and related events in UK but some of the risks taken by Northern Rock will not appreciated by its shareholders and depositors. Similarly, steps taken by Bank of England and tripartite system of UK financial system need a careful review and lessons need to be learnt.

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