

**Lessons from a momentous British week**  
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The third week of September 2007 will long be remembered in the history of financial crises: for the first bank run in Britain in more than a century; for the limits to complex arrangements in times of crisis; and for the lost battle of intellectual rectitude against pragmatism. All of this happened in Britain in just a few days. Here is the story and the lessons from it.

On Saturday 15 September, a photo on the front page of the newspapers pictured the clients of Northern Rock, a bank specialised in mortgages, queuing in the street to withdraw their money. It was a very quiet, very disciplined, very British type of bank run, but a run nevertheless. It was prompted by two events: rumours that financial institutions had got cold feet about lending to a bank whose assets portfolio was mainly composed of mortgages and mortgage-based products, and the attempt by the Bank of England to extend emergency lending to Northern Rock. As central bank governor Mervyn King later acknowledged, the attempted rescue had the effect of screaming "Fire!" in a crowded cinema. Northern Rock was heading for a default and the risk of panic spreading to other financial institutions was real.

The first lesson is thus both simple and frightening: in spite of extensive bank supervision, deposit insurance and the readiness of central banks to act as lenders of last resort, a bank run of the sort recorded in history books or seen in turbulent emerging economies can still take place. If this can happen in Europe's most financially sophisticated country, it can happen elsewhere.

Fortunately, banks are closed on Sundays, so Alistair Darling, Chancellor of the Exchequer, had time to reflect. The following Monday, 17 September, he issued a statement. "Northern Rock is solvent", he restated, and the Bank of England will support it through "short term liquidity difficulties". More importantly, he added that if needed, arrangements would be put in place to "guarantee all the existing deposits in Northern Rock". Three days later, on Thursday 20 September, the Treasury confirmed that all existing accounts and all those that had been closed during the panic would benefit from a government guarantee. He acted in this way because previous declarations meant to reassure customers had not been able to stop the run. It was only ended by the unequivocal pledge to rely on public funds to provide a 100 percent guarantee for deposits.

It is worth asking why the government, and not a specialised agency, had to step in. In Britain, responsibility for financial stability is split between the Treasury, the Bank of England and the Financial Services Authority (the watchdog in charge of bank supervision). According to a 1997 Memorandum of understanding between the three institutions ([http://www.hm-treasury.gov.uk/documents/financial\\_services/regulating\\_financial\\_services/fin\\_rfs\\_mou.cfm](http://www.hm-treasury.gov.uk/documents/financial_services/regulating_financial_services/fin_rfs_mou.cfm)), in times of crisis the Treasury must ensure that ministers are "able to take decisions without delays", the Bank's task is to "seek to ensure the orderly functioning of financial markets" and the FSA's role is to "monitor the health of financial institutions". This relatively untested arrangement was probably too complex to inspire much confidence until the Treasury seized the initiative and acted decisively.

The second lesson is thus that when panic has started to develop momentum, preventing the situation deteriorating requires resolve, clear responsibilities and eventually the commitment of real money. This lesson is relevant for Europe, especially as regards large banks operating

in more than one country. For such pan-European banks, responsibilities are shared between home and host country. Coordination is supposed to take place but it is not clear which country should be expected to commit money. Furthermore the (advisory) Committee of European Banking Supervisors includes no less than 51 members and interagency cooperation is governed by a web of more than 80 bilateral and multilateral MoUs. As observed by my colleague Nicolas Véron in a recent Bruegel paper ([http://www.bruegel.org/Public/Publication\\_detail.php?ID=1169&publicationID=4530](http://www.bruegel.org/Public/Publication_detail.php?ID=1169&publicationID=4530)), there is a significant risk that decisiveness would be absent in the event of a crisis hitting one of the pan-European banks whose assets are scattered across several countries. The British experience should serve as a reminder that risks are real, and should lead to the assigning to European structures of responsibility for supervising pan-European banks and for supporting them in times of crisis.

The next step in the crisis took place on Thursday, 19 September, when the Bank of England announced it would provide liquidity to banks for longer durations and against lower quality collateral than previously. This was exactly what Governor Mervyn King had argued against in a week-old memo to the chairman of the House of Commons' Treasury Committee. In that document (<http://www.bankofengland.co.uk/publications/other/monetary/treasurycommittee/paper070912.pdf>), dated 12 September, the academic turned central banker explained why he had taken a very different attitude from those of his counterparts at the ECB and the Federal Reserve. Since the start of the turmoil in financial markets, he had refrained from extending to banks in distress wholesale emergency liquidity at a rate below prevailing market rates, on the grounds that rescuing imprudent lenders would sow the seeds of future crises. In his memo, he restated his views at length, concluding that "injections of liquidity in normal money market operations against high collateral" [that is, lending to banks against high-quality assets such as government bonds or other securities involving minimal default risk] are unlikely to bring down the interest rate on the market for bank-to-bank lending. While admitting that "general injections of liquidity against a wider range of collateral" [that is, lower-quality assets such as mortgages or credit-based financial products] would probably achieve that goal, he added that such injections "would encourage in the future the very risk-taking that has led us where we are". This was a very thinly veiled criticism of the behaviour of the ECB and the Fed.

The Northern Rock episode in a way confirmed the Governor's fears. What the government eventually did was bail-out people who had put their money at a bank known for behaving somewhat recklessly. The memory of that episode will remain and customers are likely to pay less attention to the soundness of the bank they chose, in the expectation that government intervention will prevent any wealth loss. But ex-post, the Bank changed its view. The reason for this, Mervyn King explained to parliament on 20 September, was that confidence had been shaken by the Northern Rock crisis. It had, but this was nevertheless a U-turn that has dented the Governor's credibility.

The third and final lesson is that the business of central banking is a very, very delicate one. In refusing to take lower quality collateral, the Governor was trying to ring-fence liquidity assistance. He was right that for the central bank, to accept as collateral assets whose value was uncertain would have amounted to bailing out fragile banks and would have resulted in exposing the central bank's capital to the risk of losses – in effect to a provision of budgetary support. But his very cautiousness also contributed to deepening the crisis and eventually to forcing the government to step in. The Bank of England was – and remains – among the most sophisticated and intellectually consistent of all central banks. For that very reason, it is hit especially hard by its brutal conversion to pragmatism.