The need for greater focus on non-traditional risks: The case of Northern Rock

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Abstract This paper highlights the importance of managing and mitigating non-traditional risks such as reputational and strategic risk in the context of enterprise risk management. A case study approach is adopted to illustrate this issue, showing how the UK bank, Northern Rock, which recently suffered a dangerous run, was mired with reputational risk right from its inception, and had a business model that assumed 'dominant logic' and neglected potential risk elements. The paper argues that, due to the paucity of available data, measurability and knowability, non-traditional risks need immediate and constant attention. Unlike conventional risks, they cannot be modelled to esoteric limits with the help of computers. The combination of ignorance and a poorly structured approach to risk accentuates traditional risks such as market, credit and operational risk and cumulatively worsens the consequences.

Keywords: *reputation, Northern Rock, traditional, risk management, dominant logic*

INTRODUCTION

The global economic downturn boils down to the eroded level of confidence. Today, nobody is willing or rather in a position to trust another person. Even rumours can wreak untold havoc, as one top private sector bank in India recently found when its share prices plummeted due to unsubstantiated reports about its fortunes. Rumours cannot be avoided, but if an organisation has a good reputation for corporate governance, the impact of rumours can be mitigated. In the example of the bank in India, the market felt that, despite its reasonable reputation, it had not fully disclosed its sour exposures in its UK subsidiary. This illustrates the vulnerability of financial institutions to reputational risk.

This paper highlights the impact on reputation or brand due to organisations' misplaced judgment and helps in understanding how this affects enterprise risk management in terms of legal, policy, environmental, regulatory, compliance, brand and reputational risks. The case of Northern Rock's distress is analysed to illustrate that non-traditional risks can do more damage than the more familiar, traditional risks. The case highlights that it is difficult to single out any specific risk that may result in losses and that, in effect, risks work in conjunction with one another to exacerbate crisis. The paper discusses how important it is to identify these risks, fix a tolerance level and assign additional capital if the limit is breached.

Risk management in banks has long been revolving around the conventional Basel II definition of operational risk, credit risk and market risk. Although Basel II, Pillar 2 does explicitly name strategic risks, reputation risks and other non-standard risks, there is no specific approach for capitalising and providing for such risks.

Different types of risk factors represent differences in data availability, measurability and knowability. Financial and market risks, intermediated through financial institutions, and hazards, such as injury and life insurance risk covered by insurance companies, constitute data-rich exposures that are relatively easy to describe and quantify. Natural and man-made catastrophes, operational risks and strategic risks, such as general economic conditions, demographic trends, competitive moves, etc, are more difficult to describe because information on these phenomena is vague and incomplete, and consequently more difficult to discern. Other strategic risk factors, such as sovereign risks, market reputation, supplier relationships, customer relationships, political trends, social trends, technology developments and innovations, are only very loosely described, with little in the way of hard data. As such, true insights depend on qualified experts and the information networks the organisation maintains with external entities. Hence, as one moves from financial risks towards strategic risks, one sees a descending order of data availability and an associated increase in the difficulty of quantifying the exposures. It is difficult to pursue the complete quantification route in practice and the integrative analysis must be conceptual rather than quantitative as it incorporates some of the more unknowable types of risk. The further one moves towards strategic risk factors that are unknowable, the harder it is to quantify and thereby integrate the risk exposures into an overarching value-at-risk (VaR) measure.

It is imperative that banks recognise and manage risks posed by actions that could have an impact on their reputation or brand, besides legal risks that could arise from contracts, which may not be enforceable or may occur in the form of adverse judgments. For instance, contracts based on technological developments, innovative ventures and exotic financial instruments are loosely described with little data history. In the absence of hard data the true insights depend on qualified experts and information networks maintained by non-organisational actors.

It is thus important to learn from the Northern Rock debacle of July/August 2007, as it presents a clear example of 'uncertainty' — just at the time when bad things were beginning to happen in the financial world due to the subprime implosion in the USA.

NORTHERN ROCK PLC

Northern Rock was a small-time mutual building society from the old shipbuilding centre of Newcastle-upon-Tyne. It abandoned its mutual status and floated on the stock market as a bank in 1997. The society was expected to rely on charity to preserve a link with its mutual roots and gain considerably from this. Northern Rock found the magic world of market-based finance — it borrowed in the capital markets, lent the money to customers, then turned those loans into bonds and sold them off.

In 1993, Northern Rock came top in the UBS annual building societies performance survey that assessed the 20 largest building societies on the basis of 12 different performance ratios, including indicators of profitability, capital strength and market share performance.

But a greater punch emerges from how Northern Rock tried to mitigate the reputation risk that arose during its life cycle. Northern Rock embarked on targeted corporate sponsorship.

Adverse reputation

Within months of floatation, Northern Rock got into an ugly spat with the Office of Fair Trading (OFT), which accused it of arbitrarily changing the terms of its accounts and reducing the interest paid to its customers. It was accused of being 'cavalier' with depositors by amending rates and changing withdrawal terms and was criticised on a number of fronts including its products, service, management and ethics. In 1998, Northern Rock and Halifax were among the companies that suffered the worst press coverage, according to a survey from PressWatch. In 1996, the OFT forced Northern Rock to remove the early-repayment penalty clauses it had imposed retrospectively on some fixed-rate mortgages. The catalyst for the OFT statement was an avalanche of complaints from aggrieved savers following Northern Rock's consolidation of 11 postal accounts into three. The bank stated that it was being punished for publicising its changes more than the voluntary banking code required.

In 1997, in the run-up to its conversion from building society to bank status, Northern Rock came under fire for increasing its mortgage rates in anticipation of a rise in base rates that never materialised.

It was thus the bank's treatment of its savers rather than its borrowers that brought it unwelcome attention from politicians, regulators and the media.

Image makeover

Northern Rock's image makeover in early 2002 comprised glorifying its social and customer service commitment. It resurrected its image by championing corporate social responsibility through ultra-bold initiatives such as setting up dedicated programmes for gay and lesbian foundations. Through a programme of 'targeted givings', Northern Rock became known as 'the friendly funder' for difficult social issues, such as tackling domestic violence and reoffending by former prisoners. Some saw Northern Rock's ring-fencing of 5 per cent of pre-tax profits for charity as a kind of poison pill to deter predators from takeover attempts.

The business model that failed

In 2004, Northern Rock floated bonds that represented a shift away from the traditional HBOS template. But these bonds proved a hit and the structures became the norm. A bank with only 76 branches became UK's fifth largest mortgage lender by volume of loans outstanding. The market capitalisation of Northern Rock was above £5bn in February 2007. It grew assets and profits by 20 per cent annually. By the year end of 2007, Northern Rock had £25bn in customer deposits and £87bn in residential mortgage loans outstanding.

Unlike many of its counterparts in the USA, where lax lending practices had engendered a sharp rise in defaults and foreclosures, Northern Rock lent mainly to borrowers with good credit.

The company's business model, however, made it particularly vulnerable to the credit crunch. For one thing, it relied more than other UK lenders on its ability to package and sell its mortgage loans to investors, who began to shy away from mortgage-backed securities once concerns over risky US subprime loans began to spread.

It also depended heavily on short-term loans from other banks — rather than its deposits — to fund its mortgages. Northern Rock's borrowings from other banks exceeded customer deposits by more than three times. As a small 'monoline' mortgage bank, Northern Rock derived about 75 per cent of its funding from securitisation and the wholesale markets.

In mid-2007, Northern Rock's management was caught out by the increase in funding costs. Libor rates in the capital markets were anticipating higher future interest rates, but the bank was unable to pass these more expensive funding costs on to its new mortgage customers.

Moreover, Northern Rock suffered because it failed to hedge loans for the two-month period between the mortgage being taken out and subsequently being completely securitised. The bank operated this policy on the basis that at least 10 per cent of mortgages typically never make it to completion, which represents quite a squeeze on banks' net interest margins — a key measure of profitability. Larger mortgage lenders are usually part of more diversified organisations, which helps dilute the impact of more expensive funding costs. Northern Rock was generating 95 per cent of its profits from mortgages whereas rival HBOS was generating just 20 per cent of its profits from mortgages.

In early August 2007, Northern Rock started facing a liquidity crunch and by September this culminated in a run on its deposits. Northern Rock's franchise and public confidence was damaged. Its share prices plummeted and its market capitalisation stood at £1.8bn in September 2007. The Bank of England stepped in with an emergency line of credit of £10bn, against the collateral of mortgage-backed securities, the first such bailout in more than a decade. Despite all this, the panic and withdrawals continued.

CASE ANALYSIS

It would appear that, from the outset, Northern Rock failed to adopt or adhere to a risk-ranking framework and evaluate such reputational risk that is of considerable significance but low likelihood of occurrence. This is the very idea behind enterprise risk management — to address all risk factors that could affect the corporation's ability to achieve its strategic objectives.

The concept of dominant logic and the competency trap is worth a mention here. As explained by Torben Juul Anderson in his book, 'Global Derivatives — A Strategic Risk Management Perspective',[1] dominant logic is a common cognitive understanding assumed by managers of successful firms, and is characterised by the experiences gained within a specific environmental setting. It corresponds to what is known as a 'competency trap', where successful organisations overemphasise past success criteria and continue to refine their distinctive competencies to a point where they become obsolete. Northern Rock grew successful, but gradually its management layer probably became complacent, self-sufficient and self-contained in their own success criteria. They most likely focused plenty on the traditional risks, but unfortunately their business model was to keep rolling short-term debt into new short-term loans, allowing the long-term positions to continue. This is the dominant logic that managers/agents in Northern Rock assumed. It is also possible that potential risk elements were neglected, either out of ignorance or simply due to inconceivability on behalf of the managers. Often the collection and interpretation of subtle observations of changing conditions are more important than a large formal system that nobody pays attention to. Public memory retains the scars to reputation and compounds market and financial risks during crises.

Northern Rock was not a 'new-generation' bank or run-of-the-mill enterprise that lacked expertise and experience in its business. But this disaster throws light on the bank's misplaced strategic concerns. There seems to be no evidence of such robust and meaningful risk ranking, hazard simulation and stress-testing that form the hallmark of strategic risk management. In the case of larger organisations, the exposures are diversified and risk concentration is dispersed. But in the case of special purpose vehicles (SPVs) and special investment vehicles (SIVs) the risk gets diversified to the parent, hence absorption of losses is imperative as these exposures devolve to the parent's balance sheet in times of crisis.

When it comes to operational and strategic risks, the task of fitting the acceptable aggregate exposures and the associated risk limits to the overall risk profile determined by the executive board is slightly different as these exposures relate to longer-term business positions. There is still a need to list the significant risk factors and prioritise them but it is harder to reach a single number for the aggregate exposure because it is difficult to quantify these risks.

Northern Rock's downfall can be attributed to underestimation of reputational risk and the loss of public confidence. Eventually, Northern Rock developed dominant logic and fell into the competency trap. The operational and business conduct of the bank is replete with instances of restrictive and unhealthy practices that ruptured its credibility and reputation. Although it was rebuilt subsequently with substantial presence and visibility in the area of corporate social responsibility, the bank could not avert the panic run on its deposits despite the central bank's bailout scheme. Corporate social responsibility that does not reflect sound business logic is short-lived in public memory. The risk ranking of resource availability, economic conditions, interest rates and credit risk cannot be downplayed. A resources lifeline based on short-term funds to finance long-term assets is fundamentally flawed.

Reference

1 Anderson, T. J. (2006) 'Global Derivatives — A Strategic Risk Management Perspective', Pearson Education Ltd, Harlow.