

The role of non-core bank liabilities in signaling vulnerability may hold more generally, as its predictive power rests on the cyclical nature of the risk-taking by the bank itself. Figure 6 shows the liabilities of Northern Rock, the now notorious U.K. bank whose failure in 2007 heralded the global financial crisis. In the nine years from 1998 to 2007, Northern Rock's lending increased 6.5 times. This increase in lending far outstripped the funds raised through retail deposits (in light green), with the funding gap filled by wholesale funding (in dark green and light blue).

Although Northern Rock was an outlier in terms of its aggressive use of wholesale funding, its case illustrates the general point that the increase in bank lending outstrips the increase in core deposit funding available to a bank during a credit boom. As the boom progresses, the bank resorts to non-core

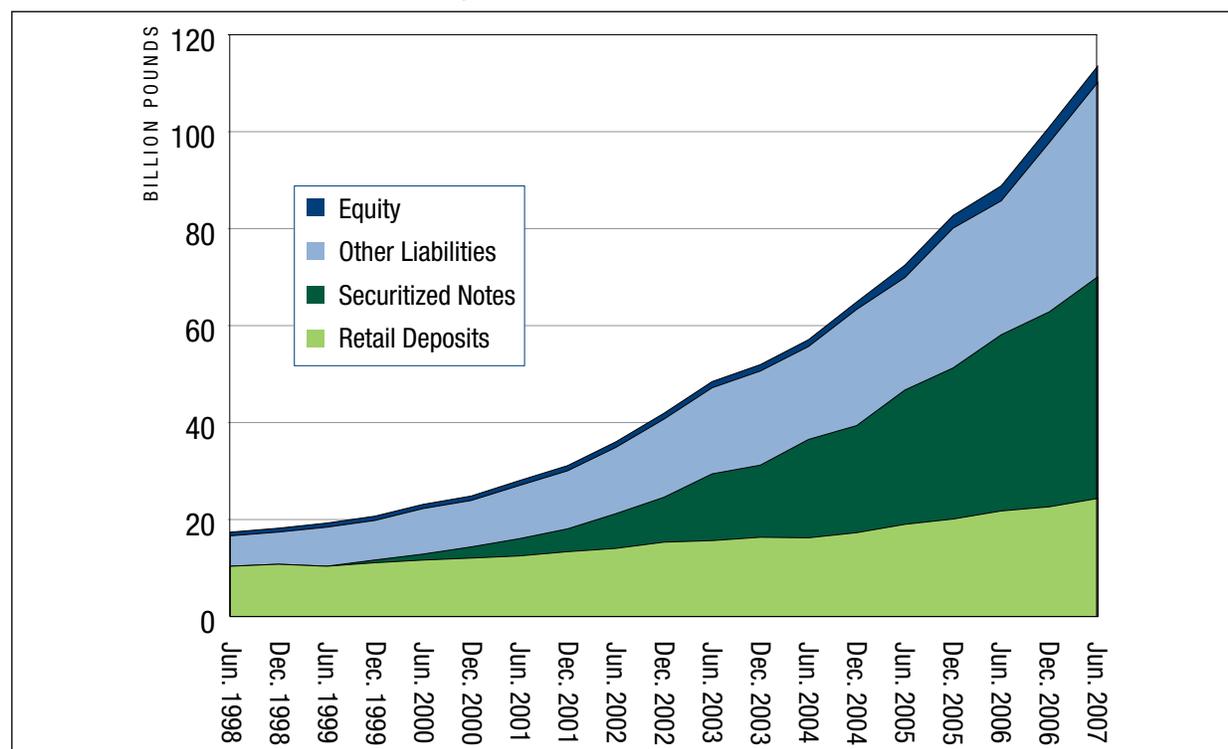
liabilities to finance its lending. As a rule of thumb, the higher the proportion of non-core liabilities, the greater the boom, and the greater the vulnerability to a setback.

Significantly, the composition of liabilities provides a better early warning of potential vulnerability than conventional asset-side indicators such as non-performing loans or Basel-style capital ratios. It is useful to recall that, in the case of Northern Rock, such ratios were perfectly healthy even on the eve of the crisis.

Cross-Border Banking Groups: Organizational Structure

The organizational structure of international banking also matters for the relationship between international capital flows and financial stability.¹⁶

FIGURE 6: Northern Rock's Liabilities, 1998 - 2007



Source: Shin (2009)

¹⁶ There are several types of claims in the BIS banking statistics. Cross-border claims are those extended to non-residents. International claims are cross-border claims plus local claims on affiliates of foreign banks in foreign currency. Finally, foreign claims are international claims plus local claims on affiliates of foreign banks in local currency. This last definition allows us to distinguish local versus foreign funding.