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Maximilian J. B. Hall

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Dept Economics
Loughborough University
Loughborough
LE11 3TU United Kingdom
Tel: + 44 (0) 1509 222701
Fax: + 44 (0) 1509 223910
http://www.lboro.ac.uk/departments/ec

BANK BAILOUT MARK II : WILL IT WORK?

by

Dr. Maximilian J. B. Hall

Professor of Banking and Financial Regulation,
Department of Economics,
Loughborough University

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ABSTRACT

On 19 January 2009, the UK Government unveiled a second comprehensive bank bailout plan. This followed the failure of its October bailout package to stimulate domestic lending, as intended. The various components of the new "rescue package" are duly explained and analysed in this article, which also addresses the likely future course of policy should the Government fail in its latest ambitions to stimulate lending and thereby revive the flagging economy

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Key words: UK banks; banking regulation and supervision; central banking; failure resolution.

INTRODUCTION

Whilst the comprehensive bailout package of October 2008 saved, at least temporarily, the British banking system from collapse, it failed to stimulate bank lending, as intended.[1] As a result, a desperate attempt was made by the Government in January 2009 to try to unblock lending channels as evidence emerged pointing to a serious contraction in the real economy and the withdrawal of foreign banks – Icelandic, Irish, EU and North American – and others (e.g. GE Capital) from UK loan markets. The package, revealed on 19 January (HM Treasury, 2009a), comprised seven elements, and was supported by the FSA's decision to tweak the rules relating to banks' (i.e. those which benefited from the October 2008 bailout) use of internal models to generate regulatory capital charges – by switching from a 'point-in-time' to a 'through-the-cycle' assessment basis, the probability of loan default can now be averaged over the economic cycle rather than being based on the most recent, and hence more dismal, data – in order to increase the banks' capacity to lend in the downturn (FSA, 2009).[2] The FSA has also indicated its willingness to treat a (post stress test) 4 per cent core tier one ratio (equivalent to a 6-7 per cent tier one ratio) as an "acceptable minimum", potentially providing further scope for an expansion in bank lending.

The detailed nature of the latest bailout package, which complements the Government's earlier introduction of a partial (50 per cent) guarantee on up to £20 billion of working capital loans to SMEs, is duly analysed in the next section before a wider assessment of the likely impact of the package and its chances of success is provided. The final section summarises and concludes.

THE BAILOUT PACKAGE OF JANUARY 2009

The first element involves the Government, in return for a fee payable in cash or preference shares and verifiable commitments to support lending to "creditworthy" customers, insuring some of the risky assets currently held by UK-incorporated, authorised deposit-takers against extreme, unexpected losses (HM Treasury, 2009b). Banks, however, will still be liable for a proportion – likely to be around 10 per cent – of any future losses on such assets beyond an agreed "first loss" amount before the insurance threshold is reached. And banks which have not yet written down such assets to reflect market prices will be asked to shoulder a higher proportion of possible future losses. The idea behind the scheme, which will be in place for at least five years and has recently been adopted in the US with respect to the bailouts of Citigroup and Bank of America, is to set a floor to the scale of losses which banks might incur on their *existing* loans and investments, thereby increasing certainty about bank solvency and enhancing financial stability. For the participating banks, this, in turn, should increase their willingness to lend as their need to hoard capital and liquidity against an uncertain future is correspondingly reduced. And, for the system as a whole, it should help de-freeze the interbank markets, thereby increasing each bank's capacity and willingness to lend.

The main problems with the scheme – which was preferred to the creation of a "bad bank", which would assume the illiquid toxic assets of the banks direct, because of the lack of up-front costs and the hope that merely offering to write the insurance will reduce the need for it as increased lending and economic activity are stimulated – lie in its practical application. For example, which assets should be insured, what premia should be charged and where should the insurance threshold be drawn? The initial focus will be on the banks' most toxic assets (e.g. CDOs and MBS, which will continue to fall in value as long as house prices decline), as well as commercial property loans. Loans to SMEs and residential mortgages (including buy-to-let) may also feature; and RBS is to be the "guinea pig". As for "price", this is the same problem which the US authorities faced with their Troubled Asset Relief Programme, or "TARP", whose focus was switched from buying up toxic debt to bank re-capitalisation direct (Hall, 2009b); too high a premium and the banks won't play ball, probably accelerating their full nationalisation, whilst too low a premium will saddle taxpayers with larger contingent liabilities. And, with respect to the establishment of the insurance threshold, again drawing it too low (i.e. forcing the banks to shoulder more of their unexpected losses) or too high will have the same effects as outlined immediately above for imposing too high/low a premium.

The second strand of the 'economy bailout' package, as the Government prefers to call it, involves an extension of the time limit on the £250 billion Credit Guarantee Scheme for bank funding, announced as part of the October bailout package – *see* note 1 – from end-April 2009 to end-2009. The focus here is on keeping open this line of attack on the currently-frozen interbank markets.

The third component relates to the introduction (to commence in April 2009) of a new guarantee scheme for triple-A rated asset-backed securities – initially involving new mortgages, but later to include corporate and consumer debt – as called for in the 'Crosby Report' (HM Treasury, 2008b). The intention here is to try and re-start the securitisation markets, thereby improving bank/building society and market liquidity and hence increasing bank lending capacity and reducing UK borrowers' cost of funds. Again, however, practical difficulties abound. How will the fees be determined (by auction, as suggested by Crosby?)? How long should the scheme last for? And how can market distortions be minimised (e.g. to limit the subsidisation of poor-quality credits)?

Fourthly, the Government, as owner, is to force Northern Rock to slow the rate of contraction in its lending activities, thereby reversing the previous policy of trying to extract the fastest possible repayment of the bank's loan from the Bank of England.[3] Whilst serving to limit the contraction in housing-related loans in the UK, and thereby limit house price deflation, the policy *volte face* does highlight the inherent contradiction in current government policy; on the one hand it wants to limit the severity of this recession by slowing the pace of credit contraction in the economy yet, on the other, it wishes to limit taxpayers' losses arising from its policy actions. Encouraging increased mortgage lending at a time when house prices are widely expected to fall by at least another 10 to 15 per cent on average before the floor is reached is not going to improve bank solvency; nor should would-be homeowners be induced to enter the housing market currently with the prospect of negative equity looming for an uncertain period of time. Similarly, forcing, exhorting or otherwise inducing banks to lend more to industry and individuals at a time of deepening recession, when output is plummeting and unemployment rising remorselessly, is again going to do little to boost individual banks' short-run profitability/solvency. Indeed, the danger is that adverse selection ensures that the banks end up with the credits that it least needs, as rising unemployment and falling demand create a new wave of "sub prime" (i.e. uncreditworthy) personal and corporate borrowers respectively. Moreover, it is not clear that stemming house price deflation, and hence slowing the pace of adjustment to a more sustainable level, nor indeed keeping Northern Rock going, either as a public or privately-owned entity, is in the long-term interests of either taxpayers or the UK economy.

Fifthly, the Government is set to revise the terms of its October 2008 bailout of RBS in recognition of the fact that demanding a 12 per cent coupon on the preference shares received – which must be redeemed before dividend payments to shareholders can resume – was too harsh (similar bailouts carried out subsequently elsewhere in the world have set the coupon payments at a much lower level (HM Treasury, 2009c). Accordingly, it is set to swap its preference shares for common stock as it boosts its stake in the bank from 58 per cent to 70 per cent, a move designed, in part, to stimulate the banks' lending activities by up to £6 billion.

Sixthly, in order to ensure the availability of long-term bank liquidity, the period for which banks can swap illiquid assets for Treasury bills under the new Discount Window Facility has been increased from one month to one year, for an incremental fee of 25 basis points (Hall, 2009a).

Finally, the Government has given the nod to the Bank of England to start lending directly to UK businesses, as the Fed has been doing in the US now for some months with respect to US corporates, through the purchase of "high quality" (i.e. investment grade or better) private sector assets (including corporate bonds, commercial paper and some ABS). Under a new "Asset Purchase Facility", the Bank will thus initially purchase, through a newly-created subsidiary, up to £50 billion of commercial paper (Bank of England, 2009), with the Treasury indemnifying the Bank against loss. The purchases, however, will be "funded" (i.e. "sterilised"), with the Treasury issuing Treasury bills to finance the purchases, thereby nullifying the impact of the purchases on the money supply. The door has been opened, however, for the Bank to move towards "quantitative easing" (i.e. unsterilised asset purchases, involving the "printing of money") should it prove necessary in the wake of its effective policy rates falling towards zero, a policy already prevalent in the US and adopted long ago in Japan in the face of seven years of deflation and near-zero nominal policy rates (Hall, 1999). Whilst the intention of the policy initiative is to widen large corporates' access to credit and reduce their costs of funding, the scale of potential losses that may ultimately fall upon taxpayers' shoulders is difficult to quantify. What seems "high quality" today may have lost its lustre by tomorrow if the rate of economic contraction continues at its current pace. And, if quantitative easing becomes a reality in the UK, the Bank needs to identify in advance a clear exit strategy if runaway inflation down the road is to be avoided.

A WIDER ASSESSMENT

Such, then, is the nature of the Government's latest plan for arresting economic decline and preserving financial stability. But what are we to make of it? Accepting the premise that economic recovery cannot occur before financial stability is restored and "normality" returns to lending channels,[4] is the current package of measures sensible? As alluded to above, when discussing attempts to re-invigorate mortgage lending, real concerns surround the wisdom of trying to slow the pace of adjustment to a more sustainable economy where house prices are lower, consumers and businesses are less indebted, the services sector (including financial services) is less dominant relative to manufacturing and the twin deficits – budgetary and the balance of payments – are more readily financeable.[5] Of course, overnight "deleveraging" to achieve this more sustainable equilibrium would impose intolerable burdens on the real economy, and firms and individuals, but the extent to which this pain can be avoided, rather than simply deferred – to future generations – is not clear. Already concerned at the impact of the Government's fiscal stimuli,[6] the markets are showing signs of alarm at the scale of the potential burden that bank/economy stabilisation initiatives are creating for the public finances, whatever the treatment of contingent liabilities in the national accounts. Whilst the Government's economic forecasts delivered at the time of the Pre-Budget Report have already proved to be woefully optimistic, as widely argued at the time, compounding market fears about the sustainability of current policy.[7] These fears extend to the possibility that, at some stage, a ratings downgrade for long-term UK sovereign debt will follow that recently meted out to Greece, Spain and Portugal, thereby raising gilt funding costs and further deterring potential investors. Moreover, the rising cost of insuring against the possibility of a UK Government default on its debts in the CDS market is evidence that some, at least, believe such a likelihood is certainly not negligible, raising the prospect – however remote – of the UK following the likes of Iceland, Hungary, Ukraine, Pakistan and others (possibly including Ireland further down the road) to the doors of the IMF. As noted by many (including the IMF – IMF, 2009),[8] and in defiance of government assertions to the contrary, the UK economy has always been one of the worst-placed industrialised nations to weather the current economic and financial storm because of the relative size of its housing bubble, the extent of its people's indebtedness and the significance of the 'City' and financial services more generally to domestic economic prosperity. And the Government's failure to better balance the books in the good times – a legacy of the Prime Minister's stint as Chancellor – has left the public finances seriously exposed to the worsening economic and financial climate.

As for the future direction of policy, and assuming some unconstrained action is possible, the current debate is focussing on the relative merits of full (but temporary) nationalisation of further elements of the banking sector compared with what some characterise as the "creeping nationalisation" of current policy. Further steps down this road – nationalisation of the whole system is impossible as the banks' assets amount to well over four times GDP – however, whilst giving the Government greater leverage over lending policy will not resolve the fundamental problem alluded to earlier. How can increasing bank lending in a severe downturn be reconciled with the objective of minimising taxpayer exposure to government bailouts? Is it unambiguously the case that, without such governmental action, current taxpayers would be even more exposed? And what about the plight of future generations of taxpayers? Is it the least bad policy option available but one that nevertheless promises, at least, to deliver a "tomorrow", some time in the future?[9]

SUMMARY AND CONCLUSIONS

The package of measures revealed on 19 January 2009 represents the Government's final attempt, short of full nationalisation of one or more of our leading banks, to re-invigorate lending to the domestic economy. This followed the failure of its October bailout plan to kickstart lending, as intended. As explained above, however, there are serious doubts surrounding the likely efficacy of the rescue package, and widespread market concerns about its likely impact on public finances. It remains to be seen if further steps down the road to nationalisation of the complete banking system, and the concomitant consequences of this action for taxpayers, can be avoided.[10]

Endnotes

[1] The package comprised: an increase, from £100 billion to £200 billion, in the amount of bank funding available under the 'Special Liquidity Scheme' of the Bank of England; a recapitalisation of the UK deposit-taking sector using £25 billion (later increased to £37 billion) of taxpayers' money in return for which banks had to restrict dividend payouts and executive compensation and commit to lending to small businesses and homeowners; and, in return for the payment of a commercial fee, a public guarantee of up to £250 billion of banks' new short- and medium-term debt issuance. [*See* HM Treasury, 2008a, for further details; and, for an analysis, *see* Hall, 2009a.]

[2] Whilst such a measure represents a further attempt to address the long-standing problem of "pro-cyclicality" within Basel II (*see*, for example, Hall, 2004), it is not without its critics. Firstly, it leaves the FSA open to the charge that it has been bounced into making the move, thereby compromising its perceived political independence. And secondly, as the experience with the savings and loans industry in the US in the 1980s revealed, relaxing capital requirements in a crisis is a policy fraught with danger, as is the recent decision to relax the mark-to-market requirements for some of the banks' trading book assets.

[3] Indeed, the bank has been so successful in meeting its targets that, controversially, staff are to be rewarded with bonuses of around 10 per cent. In order to repay the Bank of England so quickly, however – the debt outstanding to the Bank is now down to around £11.5 billion – the bank's actions have not only fuelled the contraction in mortgage lending in the UK but have also indirectly caused a reduction in the amount of new funding available to first-time buyers as much of the market's lending activity has comprised ex-Northern Rock borrowers re-mortgaging with other lenders.

[4] It should be appreciated, however, that some of the recent slowdown in domestic credit provision is due to a natural curtailment of credit demand as the recession bites.

[5] The Government, however, remains of the opinion that, despite record planned issuance of gilts - £146.4 billion in the financial year ending 4 April 2009, three times greater than in the previous year and the biggest annual amount ever, and averaging £134.2 billion over the next five years – and the dramatic rise in planned global public sector bond issuance (put at around $3 trillion for 2009, three times the amount raised in 2008), the UK Government will not face particularly acute problems, on either the price or quantity front. As reasons for this relatively sanguine view they cite: continued demand arising from investors' low appetite for risk; the apparent recent stimulus given to overseas sales by the fall in the value of sterling (36 per cent of outstanding gilt issuance was in foreign hands at end-September 2008); a relatively low level for the UK's current debt to GDP ratio compared with other industrialised nations; and the increased demand from domestic banks that will result from changes to the FSA's liquidity adequacy assessment regime (*see* FSA, 2008). The middle two of these factors, however, could change rapidly if market circumstances change (i.e. if fears of a deeper sterling crisis or of large scale losses on bank bailouts emerge; and, if and when risk appetite returns, investors may not necessarily favour UK public sector securities over UK corporate or overseas debt.

As for the deficit on the balance of payments, it is hoped that the sustained fall in the value of sterling, apart from reducing the risk of deflation appearing, will eventually boost the trade account, notwithstanding the decline in global demand, and act as an offset to falling sales of North Sea oil as reserves become depleted.

[6] The Pre-Budget Report, unveiled on 24 November 2008, revealed the Government's intentions. A £20 billion fiscal stimulus, amounting to around 1 per cent of GDP, would be delivered for just over a year to try and dampen the severity of the downturn (by around 0.5 per cent of GDP). The main expansionary forces derive from an immediate cut in VAT – from 17½ per cent to 15 per cent – programmed to last until end-2009, and the bringing forward of capital expenditure from future years. To convince the markets of the Government's commitment to returning to fiscal "responsibility" as soon as circumstances allow – 2015/16 is the suggested date – the Government simultaneously announced a series of deferred tax rises and planned expenditure cuts. On its own reckoning, however, the implications of its policies for the public finances are profound. Public borrowing is forecast to hit a record level of £118 billion (equivalent to 8 per cent of GDP) in 2009/10 falling to a "prudent" level only by 2015/16. And government net debt is forecast to reach 57 per cent of GDP by 2012/13, well above the current preferred limit of 40 per cent of GDP, exceeding £1 trillion for the first time in 2012. And these projections are based on what are likely to prove wildly over-optimistic assumptions concerning growth forecasts (*see* IFS, 2009) – the economy is expected to contract by between 0.75 per cent and 1.25 per cent in 2009, with growth resuming in the second half of 2009 to deliver growth of between 1.5 per cent and 2 per cent in 2010 and 3.25 per cent in 2011/12 and thereafter – and the scale of additional "efficiency savings" that can be squeezed from the public sector. As noted in footnote 5 above, the scale of additional gilt funding

that these projections imply may yet prove unsustainable; and foreign investors may balk at maintaining their investments at current levels even if yields are substantially raised to compensate them.

[7] The pound stood at a 23-year low against the US dollar of $1.35 at the close of business on 23 January 2009 after the announcement of a 1.5 per cent fall in GDP in the last quarter of 2008, confirming the UK to be in recession. On a trade-weighted basis, the pound is down by over 30 per cent since 2007. The sell-off reflected growing fears about the state of the real economy – unemployment had risen to a 10-year high of 6.1 per cent in the three months to November 2008, before the more recent surge in layoffs, which will almost certainly raise the December headline count above the 2 million level – and concerns about the likely impact of the Government's various support packages on already soaring government borrowing figures. Stock market activity also suggests there is a widespread feeling that RBS will soon end up totally in governmental hands, possibly joined by Lloyds Banking Group, and that Barclays Bank will need state support of one kind or another (as private investors balk at recapitalisation), thereby diluting existing shareholders' interests.

[8] The IMF's latest forecast for the UK is that GDP will fall by 2.8 per cent in 2009, a much larger contraction than that foreseen for any other advanced nation.

[9] The same dilemma faced the Bank of England in August/September 2007 when it agonised over whether or not it should extend the scope of its emergency liquidity provision in advance of Northern Rock's request for a liquidity lifeline (Hall, 2008). Although it was right to be concerned at the moral hazard implications of bailing out wayward bankers – long-run damage is almost certain to be done to the real economy, threatening future instability – critics argued that the circumstances at the time were so dire that, without such action, there would be no tomorrow, so what's the point of worrying about it now. In other words, action needs to be taken now to put out the fire; the debate about how to prevent another one occurring is of secondary importance.

[10] The Treasury is also thought to be working on the possible creation of a 'bad bank', as a complement to the existing package of measures.

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