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British Banking in Crisis

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The world is gripped by an international financial crisis, and the British banking industry, like that of the United States, has been heavily affected: During 2008, all large British banks were found to be capital deficient after markdowns.

The root of the problems of the British banks is the same as that of American banks: shaky mortgage-backed securities.¹ Often rated AAA when issued, these assets were undermined by rising mortgage default rates and their values dropped precipitously. When market trading all but stopped, the assets' values were difficult to gauge. The crisis expanded during 2007-08 when banking counterparties lost trust in each other and in their credit-default insurers. By August 2007, major U.S. and European banks were so cautious that a North Atlantic credit squeeze began.² Strains mounted in September 2008 when the failure of Lehman Brothers demonstrated that no counterparty was too large or important to fail.

The British government has aggressively sought to resolve problems at the banks through a mixed system of capital injections and asset guarantees. After recent mergers, four large banks remain: Barclays, HSBC, Lloyds Banking Group, and RBS.³ Two of these banks, Barclays and HSBC, have raised capital privately. The U.K. government has introduced a mixture of bank recapitalizations and asset insurance for the other two banks. In October 2008, the government injected capital into RBS and Lloyds by purchasing preferred shares with a high return of 12 percent. The banks also halted dividend payments. In January 2009, as an effort to boost the banks' lending, the interest on the preference shares was reduced to 5 percent and the RBS preference shares were swapped for ordinary shares, increasing the government stake in RBS to 70 percent. In exchange for capital injections, the government elicited a promise from the banks that they would sustain, at 2007 levels, their lending to small- and medium-size enterprises and households. Whether they have done so is controversial.

Some analysts assert that such lending has fallen because the banks tightened terms and widened margins between lending and borrowing (deposit and savings) rates. The banks maintain, however, that lending has been sustained and that individual customer complaints are due to an increase in overall demand following the withdrawal of foreign banks (e.g., Icelandic banks).⁴ Available data suggest that the banks have increased risk-adjusted loan-rate spreads over base and standard variable rates, such that the cost of borrowing has not fallen as fast as the Bank of England's base rate. Such action is understandable. Government capital injections

through fixed-rate preferred shares provide an incentive for the banks to widen margins and use retained profits to boost capital, seeking to pay off the government investment promptly while also seeking to avoid raising additional capital from the market, including foreign sovereign wealth funds. Further, institutional investors, which enjoyed sizable bank dividend payments in recent years, clearly desired to both minimize equity dilution and resume dividend payments as soon as possible. Of note, the retail banking business of the big British banks continues to be profitable (including RBS, which reported 2008 profits of £3.7 billion in its retail division); losses and write-downs are in the investment banking divisions.

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On February 26, 2009, the government agreed to inject into RBS £25.5 billion as capital and guarantee assets of £325 billion, increasing the government's ownership to near 95 percent.⁵ For Lloyds, the government agreed to insure up to £250 billion of assets, already holding a 43 percent ownership stake; on March 7, the government agreed to insure an additional £260 billion, pushing its likely ownership toward 75 percent. The asset guarantees are through the Asset Protection Scheme, a program to “provide protection against credit losses occurring on specified pools of assets above a certain threshold.” The Asset Protection Scheme assists banks because it postpones the need for immediate write downs (as would be required if assets were sold to a “bad bank”) and, although the first tier of losses must be absorbed by the bank's capital, the guarantee reduces the bank's risk-weighted assets.⁶ For both RBS and Lloyds, the government's stake is being managed by a special company set up by H.M. Treasury, called UK Financial Investments (UKFI); this company effectively operates as a separate government entity. The goal of the UKFI is to unwind the government's stake and, if possible, earn a profit for British taxpayers. The time required for the unwinding is highly uncertain, with rights holders likely to press legal claims for higher-than-offered valuations.⁷

How to evaluate the propriety and wisdom of the U.K. government's actions? We focus on three aspects:

i. Reversing the perception of extreme counterparty risk.

To reduce perceived counterparty risk, bank regulators must cut through the opacity of banks' balance sheets lest interbank lending which, in ordinary times, channels loanable funds to the most-eager borrowers, dries up. Forcing all banks to value their balance sheets using the same set of asset prices and loss assumptions can cut through the fog, on two accounts: Individual banks may find adequate disclosures difficult when some assets have no reference (market) prices, and disclosures may lack credibility if not certified by a banking regulator or other trusted third party. Well-meant regulatory changes also might be avoided. Reulators, seeking to avoid banks being rated as insolvent for regulatory purposes, relaxed *fair value* or *mark to market* accounting rules during 2008 in the United Kingdom, Europe, and the United States. Far from helpful, this change added to the opacity of bank balance sheets.

ii. Avoiding a credit crunch to small- and medium-size enterprises by supplying capital. A credit crunch threatens to bring on an economic downward spiral, as restricted credit supply induces failures among small- and medium-sized enterprises, which are largely dependent on banks for finance. Such losses further reduce and impair bank capital, which in turn portend further reduced lending, higher risk premiums, and increased collateral requirements.⁸ Halting the downward spiral is difficult unless banks can gain access to additional capital. The cost of raising new capital in the markets, however, may be prohibitive. Policy choices are one of two: have the government provide capital that will allow the banks to operate while gradually writing down the impaired assets (but with no expectation of increased willingness to lend until they had done so) or using a government-backed "bad bank" solution to take assets off banks' balance sheets, as was successfully done in the Nordic case. Generally, the "bad bank" solution works best after nationalization (imposing losses on shareholders).⁹ In the United Kingdom, the "bad bank" solution has been rejected (to date), perhaps because the U.K. government does not wish shareholders (primarily institutional investors such as insurance and pension funds) to bear the consequent losses for fear of the impact it would have on these increasingly fragile long-term savings vehicles.

iii. Aligning government actions with "best practice." How closely does the British government's response resemble the "best practice" lessons learned from the Nordic experience?¹⁰ The first lesson is that a political consensus for action is necessary—this appears to have happened. A second lesson is to conduct a transparent accounting of banks' balance sheets, allowing banks the option to recapitalize privately—in the United Kingdom, two of four have done so (in Sweden during the Nordic crisis, half their banks [three of six] also did so). A third lesson is to preserve the banking system's structure by preferring mergers and/or government support rather than closure and liquidation, without auto-

matically wiping out existing shareholders—this also has been done in the United Kingdom. A fourth lesson was to create a separate, independent agency to handle banking issues. The UK Financial Investments company appears poised to fill this role, working with the Financial Services Authority and the Asset Protection Scheme. ■

¹ Reviews are provided by Paul Mizen, "The Credit Crunch of 2007-2008: A Discussion of the Background, Market Reactions, and Policy Responses," Federal Reserve Bank of St. Louis *Review*, September/October 2008, 90(5), pp. 531-68; Financial Services Authority, *Financial Risk Outlook 2009*, Financial Services Authority, London, England, 2009; and International Monetary Fund, *Global Financial Stability Report*, 2008. A timeline of the financial crisis is available at <http://timeline.stlouisfed.org>.

² The crisis came abruptly to the U.K. public's attention during September 2007 when Northern Rock, a prominent mortgage originator, was unable to roll over short-term funding and requested assistance from the Bank of England. See A.W. Mullineux, "Lessons from Northern Rock and the North Atlantic Credit Squeeze," *Melbourne Review*, Melbourne Business School, May 2008, 4(1), pp. 7-12; "Lessons from Northern Rock and the Governance of Banks," *InFinance*, Finsia, Sydney, June 2008; and "British Banking Regulation and Supervision," *Journal of Financial Regulation and Compliance*, 2008, 14(4), pp. 375-82.

³ These four are the result of a decade of consolidation. Lloyds TSB was formed in a 1995 merger of Lloyds and the Trustee Savings Bank. HBOS (Halifax Bank of Scotland) was formed in a 2001 merger of Halifax bank and the Bank of Scotland. Lloyds TSB acquired HBOS in September 2008, when HBOS held a 20 percent share of the U.K. mortgage lending market. News sources reported that Prime Minister Gordon Brown encouraged Lloyds to acquire HBOS so as to foreclose a Northern Rock-style funding crisis at HBOS.

⁴ See, for example, "Banks and the Real Economy: Arm's Length," *The Economist*, November 27, 2008.

⁵ The *Financial Times* reports ("High Price of Government Support for RBS," February 26, 2009) that RBS issued to the government £6.5 billion in nonvoting but dividend-paying shares, will forego £5.4 billion of available tax credits plus all future tax credits resulting from losses, will absorb the first £19.5 billion of losses plus 10 percent of any excess above this amount, and committed to annual £25 billion increases in lending to households and firms.

⁶ Financial Services Authority, "Detailed FSA statement on the Capital Implications of the Government Asset Protection Scheme," Financial Services Authority, London, England, February 26, 2000.

⁷ Most recently, on February 13, 2009, the court ruled against claims by Northern Rock shareholders that the bank was a going concern at the time of its government takeover on September 13, 2007. Shareholders wished £3 per share; the government suggested zero. The two largest plaintiffs (hedge funds) were hindered by the fact that their shares were purchased in early 2008 when the bank already was in administration (i.e., conservatorship).

⁸ In response, the Financial Services Authority in January 2009 reduced regulatory capital requirements. The impact of this change has been tempered by pressures from institutional investors and rating agencies for the banks' to further increase buffer stocks of capital for bad debt provisions.

⁹ It should be noted that shareholders in the Nordic case were not automatically wiped out.

¹⁰ Richard G. Anderson, "Resolving a Banking Crisis, the Nordic Way," Federal Reserve Bank of St. Louis *Economic Synopses*, 2009, No. 10.

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