Assessment of the Banking Rescue Packages of the Member States:
The Case of the United Kingdom[1]

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31 January 2009

Executive Summary

- There is wide agreement that a good bank rescue package should do three things. First, impaired assets should be written down on or taken off banks' balance sheets. Second, banks that are insolvent and too big to fail should be recapitalised. Third, adequate liquidity should be provided.
- The United Kingdom was in a relatively poor position at the start of the financial crisis, compared to the euro area and the United States. It had a deposit insurance system and a central bank collateral policy that invited runs by bank depositors and wholesale creditors.
- The United Kingdom's first attempt at rescuing a bank was flawed: it encouraged a bank run, the bank was of no systemic importance, it gave the appearance that the government was pandering.
- The United Kingdom's current scheme is intended to recapitalise banks and to provide liquidity. But, unlike schemes elsewhere it does not remove toxic assets from banks' balance sheets.
- The United Kingom's bank rescue policy has an element of financial protectionism.

Lax regulation, poor corporate governance and a compensation system that favours excessive risk taking led many EU member financial institutions (hereafter, "banks") to be excessively leveraged. At the start of 2008, the leverage ratio (Tier 1 capital as proportion of assets) was about three percent in the United Kingdom and slightly lower in the rest of Europe. This meant that for a typical European bank, only a small decline in the average value of its assets or a sharp decline in the value of just a small fraction of its assets was enough to wipe out its equity and make it insolvent. With great uncertainty about both the value of banks' impaired assets and the importance of these assets in different banks' balance sheets it became unclear which banks were on the verge of insolvency and all banks became distrusted as counterparties. The market for interbank lending became dysfunctional and banks that have liquidity are now hoarding it. When banks are unable or unwilling to make loans to businesses and households, the consequence is recession and unemployment.

There is widespread agreement about the general features of an appropriate policy response to this or any other banking crisis. First, impaired assets must be written down or written off banks' balance sheets and banks must be classified as

[1] Briefing paper for the Committee on Economic and Monetary Affair's annual meeting with national parliaments.

solvent, insolvent and systemically unimportant or insolvent and systemically important. Second, banks that are insolvent and systemically unimportant should be allowed to fail and banks that are insolvent and too systemically important to be allowed to fail should be recapitalised. Third, central banks should ensure that the interbank market remains functional so that banks that are solvent and those that have been recapitalised have access to liquidity.

In this note I describe the United Kingdom's plan to rescue its troubled banks and loan markets. I assess the merits of the plan and compare it to plans implemented elsewhere.

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1. The Initial Reaction to the Crisis

Both the liquidity crisis that began in August 2007 and the credit crisis that began with the failure of Lehman Brothers in September 2008 caught policy makers, as well as researchers and market participants, by surprise. Thus, policy makers in the United Kingdom and elsewhere initially reacted to events in an ad hoc fashion.

In some important respects, policy makers in the United Kingdom were less prepared than policy makers elsewhere for a crisis. In the United States, the Federal Deposit Insurance Corporation guarantees that all depositors in insured banks are fully covered up to $100,000 and that payouts are made within days. In August 2007 the United Kingdom's deposit insurance scheme covered up to £35,000 but required a ten percent deductable after the first £2,000 and payouts could be delayed for over six months. Such a large deductable and length of time before a payment would be made was an invitation to a bank run. In addition, while the ECB accepted a range of public and private securities rated at least A- in its lending and repurchase operations, the Bank of England accepted only the highest grade collateral, effectively only UK sovereign debt or better. This made the Bank of England an inadequate lender of last resort and did little to forestall wholesale creditor runs. The tripartite arrangement, wherein the Bank of England, the Financial Services Authority and the Treasury shared responsibility for the financial system had probably hampered reform; it may have later hindered the ability of the authorities to respond effectively to a crisis.

The first serious test of the crisis for UK policy makers arose in late summer 2007. On 12 September, the UK's fifth largest mortgage lender, Northern Rock, was unable to refinance its maturing loans.[2] If Northern Rock had been located in the euro area, it could have borrowed from the ECB using its good quality mortgages as collateral. But, as it was located in the United Kingdom it was forced to ask for a government bailout. On 14 September, insisting that Northern Rock was solvent, the Chancellor authorised the Bank of England (as its agent) to make a loan to Northern Rock against appropriate collateral and at a penalty rate; the Bank of England announced that similar emergency funding would also be available to other institutions in similar circumstances. Their attention clearly focused by this usual action, Northern Rock depositors fled en masse on 17 September. Undoubtedly shaken by the widely televised spectacle of a 1930s-style bank run, on 17 September the government announced that *all* deposits held at Northern Rock would be guaranteed by the government. The government's initial pronouncement of Northern

[2] Some might think the Finanical Services Authority indolent or ingenuous for standing by while Northern Rock introduced its "Together" mortgage range, which let first-time buyers borrow nearly six times their income and 125 percent of a property's value.

Rock's health later proved sanguine; on 17 February 2008 the government nationalised the bank.

The government's first attempt at a bank rescue was flawed. Lending to a solvent but illiquid institution at a penalty rate is widely accepted good practice. However, the government's initial support of Northern Rock appeared to go beyond short-term liquidity provision and – as it turned out – Northern Rock was more than merely illiquid. Once this became obvious, Northern Rock should have been allowed to fail; as the institution was of no systemic importance there was no justification for recapitalising it.[3] In addition, while *ex ante* deposit insurance promotes efficiency by preventing depositor runs, providing it *ex post* merely redistributes money from tax payers to depositors who chose to hold large sums in uninsured accounts and looks suspiciously like politically motivated pandering.

While flawed, the rescue was swift and audacious. Financial crises can be or can contain elements that are bad outcomes associated with self-fulfilling expectations. To quell the fear in financial markets and restore confidence quickly and move away from these bad outcomes, it is often beneficial for a government to act boldly and decisively to signal its commitment. Thus, for the United States it was probably better that the imperfect Emergency Economic Stabilization Act of 2008 was passed with great celerity and bipartisan support than that a more perfect act had been passed after much dithering.[4] Unfortunately, in the case of Northern Rock, the drama of a special loan for the troubled institution had the unfortunate effect of focusing market attention on the likelihood that the bank might fail thus provoking, rather than preventing, a bad outcome based on self-fulfilling expections.

Later measures to rescue the banks and restore lending

The more recent UK bank rescue policies fall into two categories: those designed to recapitalise banks and those designed to restore bank lending. I examine both of these types of measures.

2.1 *The United Kingdom's Bank Recapitalisation Scheme*

On 8 October 2008 – five days after the US bank rescue plan was signed into law by President Bush -- the UK government announced its own plan for recapitalising its banks. Under the plan, Abbey, Barclays, HBOS, HSBC, Lloyds TSB, Nationwide, the Royal Bank of Scotland and Standard Chartered agreed that – in aggregate – they would increase their Tier 1 capital by £25 billion, giving each a Tier 1 capital ratio in excess of nine percent.[5] The banks could raise needed capital in the market or the government would make £25 billion available to this group of banks in return for preference shares or permanent interest bearing shares. In addition, the government made an additional £25 billion available to other UK incorporated banks or building societies which do substantial business in the United Kingdom.

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[3] This was not a one-off error due to haste: on 29 September 2008 the government sold part of the even smaller Bradford & Bingley to Santander and nationalised the rest.

[4] The act was initially rejected on 29 September; an amended version was signed by President Bush on 3 October.

[5] There is a tradeoff: increased Tier 1 ratios lower risk but can lead to curtailed lending. Nine percent does not seem unreasonable.

Participation in the recapitalisation scheme allows banks to participate in the government's liquidity schemes – detailed in the next subsection. Receiving government funding requires concessions from the banks on executive compensation, dividend policies and lending to small businesses and home buyers. The government also has the right to agree with boards on the appointment of new independent non-executive directors. On 3 November a special body, UK Financial Investments Ltd, was set up to manage at arm's length the government's stake in banks which accepted funds.

Terms for the recapitalisation were negotiable between banks and the government. The offer was taken up by HBOS, Lloyds TSB and RBS. In the case of Lloyds TSB and HBOS, it was planned that the government would own around 44 per cent of the proposed merged bank; in the case of RBS the government took a 57 percent share (which has since increased to over 70 percent). No cash bonuses were to be paid to any board member in 2008. Directors in HBOS were asked to relinquish their bonuses and directors in Lloyds TSB were to receive restricted stock instead of cash. Bonuses to RBS board members in 2009 were to be in stock and linked to long-term growth. The availability of lending to homeowners and small businesses was to be maintained at least 2007 levels, and greater support was to be given to people with difficulties making mortgage payments.

The government's recapitalisation scheme suffers from two main problems. The most severe is that it does not do the first thing that any good bank rescue package should do: write down or write off the toxic assets. From this point of view, the Swiss approach to UBS is more appealing. In November, UBS had an estimated \$60 billion in bad assets. The Swiss government split UBS into a relatively healthy bank and a "bad" bank, unloading \$60 billion of bad assets onto the bad bank. The bad bank had to raise \$60 billion to pay for the impaired assets. To do this, UBS raised new capital of \$6 billion by selling shares to the Swiss government and it invested these shares in the "bad" bank. The Swiss government then loaned the bad bank \$54 billion. From the point of UBS, they have invested \$6 billion that they are likely to lose, their shareholders were diluted by nine percent and they have gotten rid of \$60 billion in toxic assets. From the point of view of Swiss tax payers, they have made a not-very-promising investment of \$54 billion, they own a small part of UBS and UBS is now known to be a healthier bank – stripped of \$60 billion its bad assets. Other banks should be more willing to lend to it and it can get back in the business of lending to households and firms.[6] This contrasts with the UK banks that have increased capital, but still hold their toxic assets, and may not be viewed as uniformly healthy banks.[7]

A second problem with the UK's bank recapitalisation plan is the concessions banks must make. Banks may be discouraged from participating because of the conditions on salaries. If a board member knows that it is in the interest of shareholders for his bank to join, but that he will lose his otherwise hefty bonus by agreeing, he may act in his own self interest by voting against participation. In addition, it has been argued that the government ought to want the best managers

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[6] The problem with the "bad" bank solution is determining which assets are bad. Willem Buiter suggests an alternative: the government should create a "good" bank out of the (clearly) good assets and the deposits of the impaired bank. (Maverecon blog, *Financial Times*, 29 Jan 2009.)

[7] The description of the rescue draws on Simon Johnson and James Kwak, "Bad Banks for Beginners," *Baseline Scenario*, 21 Jan 2009.

possible for troubled banks. Thus, it must take care to pay them a competitive compensation. Finally, market efficiency dictates that economic considerations should determine who gets loans. Especially in difficult times, the government should not introduce further distortions by meddling in the lending decisions of banks. If the government wants to redistribute money from taxpayers, many of whom do not own homes, to homeowners who struggle to pay their mortgages, it is better to just do so than to order banks to allocate their lending inefficiently.

2.2 The United Kingdom's plans to get banks lending again

If a bank anticipates that is will be unable to borrow in the interbank market then it is likely to hoard the liquidity that it has, rather than make loans to households and firms. To restore bank lending the government has three options. First, it can ensure that toxic assets are removed from banks' balance sheets so that banks again trust each other as counterparties. Second, it can lend directly to banks and, third, it can insure counterparty risk so that banks become willing to lend to each other. As the UK government has not pursued the first policy, it is actively pursuing the second and third.[8] The government has attempted to ensure adequate provision of liquidity by acting directly as the counterparty of banks and by encouraging banks to trade with each other by guaranteeing bank debt. In addition to making it easier for banks to borrow, the United Kingdom has instituted a scheme that makes it easier to lend to its customers by guaranteeing certain asset-backed securities.

2.2.1 *The government's schemes to act as counterparty*

On 21 Apr 2008 the Treasury and the Bank of England announced a temporary Special Liquidity Scheme that was to last for only six months. Under the scheme, banks could swap high-quality, but illiquid assets for Treasury bills. Each swap could last for a year and be renewed for up to three years. The Bank was to charge a fee based on three-month Libor and the value of the assets was to be significantly greater than the value of the Treasury bills received. If the assets were down rated, the banks would have to replace them with high-rated assets or return some of the Treasury bills. The scheme did not cover securities backed by loans originated after the end of 2007 and was backed by the Treasury. On 6 October it was announced that the government had made over £100 billion available for the scheme. A wide range of securities would be accepted and the scheme would continue until November. On 8 October it was announced that the Treasury would make at least £200 billion available.

On 19 January it was announced that the Special Liquidity Scheme would cease as planned at the end of the month. It would be replaced by new Discount Window Facility, allowing borrowing for a year instead of a month for an extra fee of 25 basis points.

In addition, the government announced a qualitative easing policy, under which the government will exchange the government securities that it holds for high-quality private sector assets such as corporate bonds, commercial paper and even some asset-backed securities. The Bank of England (on its own account or on the account of the Treasury) will sell Treasury bills for money. The operation will then be

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[8] This is politically easier: it does not involve up-front expenditure.

sterilised (so that the monetary base is unchanged) by using the proceeds of the sale to purchase private sector assets.

2.2.2 *The government's scheme to act as guarantor of bank debt*

On 8 Oct 2008 the government announced a measure that it hopes will reduce the counterparty risk associated with longer term lending to banks. Under this measure, a borrowing bank pays a premium and the government guarantees its issuance of new debt. The fee any bank pays is related to the market's perception of its riskiness: the premium is a per annum fee of 50 basis points plus the bank's median five year Credit Default Swap spread during the previous year. This scheme is open to institutions participating in the bank's recapitalisation scheme, described in the last section. Thus, it is open to incorporated UK deposit takers or building societies, including subsidiaries of foreign banks, that do substantial business in the UK and which have sufficient Tier 1 capital relative to their assets. The government announced that it provisionally anticipated providing an amount equal to £250 billion. Given that the toxic assets remain on the banks' books, this is an appealing policy.

2.2.3 *The government's scheme to make lending to customers easier*

If a bank makes a loan to a customer it exchanges its own liquidity for a long-term asset. The bank can undo some of this change in its asset-maturity structure if it can securitize its loans. Unfortunately for banks, asset-backed securities are not especially popular at the moment, limiting banks' ability to do this. Thus, on 19 January 2009 the government announced that, beginning in April, it would provide full or partial guarantees to be attached to eligible AAA-rated asset-backed securities, including mortgages and corporate and consumer debt. Participants would be subject to following best practices and the securities would have to be transparent and backed by high-quality assets.

It is not obvious that this is an unambiguously great idea; it should be recalled that securitization by US banks was a major cause of the financial crisis. The point of banks is to act as an intermediary between borrowers and savers by collecting information about and monitoring the behaviour of borrowers. If banks are going to securitize their loans, this reduces or even eliminates the incentives of banks to act information gatherers and to make loans only to good quality borrowers. Administrators of the scheme need to ensure that the securities are not mixed, bundled and repackaged, but instead associated with a single primary lender so that lender has an incentive to maintain a reputation for selling good quality securities. In addition, it would be a good idea to further strengthen the banks' incentives to screen borrowers by requiring the banks to hold on to some or all of the worst quality or equity tranche of any security.

2.3 *The United Kingdom's plan and the rest of the world*

It is a widely held view that beggar-thy-neighbour policies such as tariff wars contributed the Great Depression of the 1930s. Thus, in evaluating the actions taken by policy makers it is important to ask not only what the effect is on the domestic banking system, but what the effect is on the rest of the world. In this area, the UK government does not score high marks.

Asking taxpayers to contribute vast amounts of money to the banks that caused the crisis is not a naturally popular idea; hence, as a sop to the voters, it is tempting for governments to attach populist conditionality to funding. Under the UK bank recapitalisation programme, for example, banks are supposed to maintain lending to homeowners and to small businesses and to provide support for "people struggling with mortgage payments to stay in their homes". Presumably, the government is talking about domestic homeowners and businesses. Thus, the government is asking banks to curtail cross-border lending: a beggar-thy-neighbour policy. The United Kingdom is not alone in pursuing financial protectionism, suggesting the need for more global regulatory coordination.

Any assessment of the response of the British government to the banking crisis should include something about the United Kingdom's treatment of Iceland. In late September, Glitnir – one of Iceland's three large banks – had a sizable amount of debt set to mature in mid October. Glitnir was unable to raise the money to pay the debt and the Icelandic authorities lacked the foreign exchange to make Glitnir a sizable enough loan. On 29 September it was announced that Glitnir would be nationalised. On 3 October British depositors staged a run on their Icesave accounts in a second Icelandic bank: Landsbanki. Landsbanki was placed in receivership on 7 October and, nationalisation plans abandoned, Glitnir followed on 8 October. This left one large Icelandic bank standing: Kaupthing. It is probable, but by no means certain, that Kaupthing would have failed. It had not experienced a run and the Icelandic government was working on refinancing plans. After a discussion with the Icelandic authorities who supposedly said that they would fully guarantee deposits in Iceland and would attempt to pay the minimum required deposit insurance to holders of accounts outside Iceland, the British authorities used their anti-terrorism laws to freeze the UK assets of Landsbanki. In addition, they seized the assets of Kaupthing's UK subsidiary and transferred them to the Dutch bank, ING. This ensured the collapse of Kaupthing on 9 October: a devastating blow for Iceland.