British government commits taxpayers to bailing out the banks

Jean Shaoul
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The government and the Bank of England have been forced to step in to bail out Britain's banking system, which is on the point of collapse.

The measures go beyond those taken by the US Federal Reserve or the European Central Bank in offering almost limitless liquid assets, in effect backed by future taxpayers' funds. They reflect the increasing financial turmoil and threaten to bankrupt the British government itself.

The Governor of the Bank of England, Mervyn King, announced a series of measures of a quite unprecedented scale and scope under a "special liquidity scheme". The Bank would accept the banks' AAA rated mortgage and credit card backed securities-which have in fact becoming untradeable and thus worthless—but not those related to the US sub-prime market. These AAAs would be swapped for short dated and highly liquid Treasury bonds for one to three years, at a discounted rate or "haircut", to use the City's jargon.

This facility would be available for up to six months, after which it would be reviewed, but would be limited to securities created up to the end of last year in order to discourage the banks from issuing new mortgage-backed securities. The banks will be able to sell the Treasury bonds for cash, thereby reducing their borrowing costs. The nature of the swap facility means that it is only available to large scale lenders who securitised their loans, not the small building societies.

The banks will have to pay a fee based on the inter bank lending rate, Libor, the rate banks lend to each other for 90 days and which is one percentage point above base rates. This rate will make it expensive to use.

The terms will be similar to those offered on the Bank's recent three month liquidity injection for AAA rated mortgage backed securities. These ranged from 4 percent for short term mortgage backed securities with less than three years to maturity to 22 percent for those with 10-30 year to maturity, with a further charge for non-sterling denominated securities. But since these AAA securities are now unsaleable, the banks will get short dated gilts that can be traded for cash. Britain's central bank on the other hand will be stuck with long dated and potentially worthless securities whose annual interest commitments it will have to honour at higher rates than public debt.

Furthermore, since the Bank does not have any Treasury gilts it does not issue them. That is the role of the Debt Management Office (DMO), a Treasury agency. This is therefore a government initiative, paid for by the broad mass of the British people, to prop up the banks.

While the Bank talked in terms of £50 billion, most commentators think that the initial call is more likely to be at least £100 billion. The governor admitted as much when he said, "Usage of the scheme will depend upon market conditions. Discussions with banks suggest that *initial* use of the scheme is likely to be around £30 billion" [emphasis added]. There would be "no arbitrary upper limit". In essence, the Bank will do whatever it takes to rescue the banks.

Since either sum is far more than the £63 billion that the DMO expected to issue for 2008-09 to meet the government's borrowing needs, the DMO will have to issue additional Treasury stock for the purpose. Moreover, the Bank has said that it will not disclose the use made of the swap facility as long as it lasts—despite this in effect being public money-in order to not to stigmatise those banks seeking financial support.

The announcement follows months of pleading, Prime Minister Gordon Brown's meeting with bankers on Wall Street and a series of meetings with bank CEOs at Downing Street last week. There the bankers held a gun to the government's head and, to use the *Financial Times*' Lex columnist's words, "warned the government of Armageddon" if the Bank of England did not reverse its publicly-stated refusal to rescue the banks from their own recklessness.

Chancellor Alastair Darling claimed that the government had taken these steps to increase liquidity and unfreeze the mortgage market—and make funds available to prospective home buyers who have been finding it hard to get a mortgage—thus preventing prevent the housing market from collapsing, and home owners findings themselves with negative equity. He also suggested that banks would be asked to pass on the effects of lower interest rates and greater liquidity to borrowers.

This is untenable. New mortgages were more than £370 billion in 2007 and the Bank was talking in terms of a £50 billion swap. The Bank and financial commentators immediately contradicted what was clearly the government's spin on the bailout. King was quite explicit. The scheme was not designed to encourage new mortgage lending, which is why mortgages signed in 2008 will not be accepted as collateral, but to provide the banks with greater funds, which they could lend, if they chose to do so. He has as yet issued no details about how much, if any, of the new cash can be recycled into new mortgages.

Despite his denials, King all but admitted that the banks were at the point of collapse—evoking images of a public run on the banks. King said, in response to criticisms for not acting earlier, that it had only been in recent weeks that the fragility of the banking system had been exposed, threatening painful effects on the wider economy if credit for households and small businesses dried up.

He said, "This is not to protect the banks but to protect the public from the banks. There is no way that the banks can access this [the swap facility] as a bottomless pit. It is not available for failing institutions. It is to restore confidence in the banking system as a

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whole."

The Band of England gave no indication of the conditions, if any, it had placed on the banks and building societies, in effect giving an open ended commitment to ensure the banks' financial viability.

The official line of the bankers, issued in a statement by the British Bankers' Association, was that they were "participating in this arrangement and expect it to make a significant contribution to alleviating the pressures in the UK money markets. Restoring confidence in the whole sale funding market will strengthen the financial system and the stability of our economy."

But privately, the bankers were more explicit. Strengthening "our economy" was code for re-building *their* capital reserves—which their own reckless practices had eliminated—and boosting their profits. They let it be known that the swap facility would merely allow them to maintain their present low level of lending rather than returning to the lending levels of 2007.

They also warned that the special liquidity scheme would not reduce the cost of mortgages, which would remain high relative to the Bank Rate, nor would it increase the amount of mortgage lending, which fell in March to 50 percent of that of March 2007. As far as they were concerned, if the government wanted to boost the mortgage and housing market, the Bank would have to cut interest rates.

But the currency markets would have none of that. The pound immediately fell by 1.5 percentage points, reducing sterling to 80 percent of what it was relative to the Euro a year ago. Should it fall further and more precipitously, the government and the Bank of England may be faced with no option but to increase the Bank Rate.

That the government had had to come to the banks' rescue was a tacit acknowledgement that the raft of measures taken over the last eight months at enormous cost to the taxpayer to prevent just such a collapse had failed and failed disastrously. These include shoring up and later nationalising Northern Rock, the UK's fifth largest mortgage lender, cutting interest rates, and injecting billions of pounds into the frozen credit markets,. The shareholders of the now nationalised Northern Rock in fact protested that they had been explicitly denied the very facilities that the Bank was now granting the banks.

The inability of these measures to resolve the crisis stems from the fact that the central problem is not one of liquidity, but solvency. The latest scheme—a mere drop in the ocean—will be no more successful. Indeed, the US Federal Reserve noted that in principle the mortgage credit risk lies with the banks, so that while the Bank's swap facility may help liquidity it will do little to help concerns about solvency.

Not only are Financial Services Authority and the Bank urging the banks to rebuild their capital reserves, something they have thus far resisted, but the banks face a wave of new write downs on their more exotic financial instruments which will affect their capital ratios.

Almost all Britain's high street banks, Barclays, Lloyds TSB, Royal Bank of Scotland, Halifax Bank of Scotland and Abbey, said they would use the swap facility, indicating just how systemic the financial crisis is. Estimates in the financial press suggest that will use at least £37 billion of the swap facility simply to rebuild their capital reserves.

The attempts of the authorities to shore up the banks come at the expense of the workforce, borrowers and the tax payers. The credit crunch will wipe out tens of thousands of jobs in the financial sector upon which one in ten Londoners depend and hundreds of thousands more as businesses are unable to access working capital to keep going.

Not a penny has gone to borrowers who are struggling with exorbitant interest and mortgage repayments based upon inflated house prices. The swap facility will, as the Council of Mortgage Lenders points out, do nothing to make more money available to existing or new borrowers. This will lead to falling house prices, leaving households facing negative equity on their over priced homes. As unemployment rises, they will be faced with the repossession of their homes.

Just as exposed is the government itself and thus the taxpayers. Public debt was about £576 billion at the end of the 2007 fiscal year and is set to rise much further. But this is only part of the total public debt, some of which—like the banks' infamous securitised assets—has been manipulated so as to be off balance sheet. There are also "contingent liabilities": guarantees, both explicit and implicit, to the private providers of public services, few of which are disclosed or subject to public scrutiny due to commercial sensitivity.

Off balance sheet debt and contingent liabilities include the debt resulting from the Private Finance Initiative, the debt guarantees for Network Rail, the cost of nuclear decommissioning and clean up, and nationalising Northern Rock, plus the myriad of soft guarantees and "support" underpinning the government's Public Private Partnerships. These, together with the Bank of England's swap facility, which looks set to rise, would double this figure, bringing it close to total GDP.

If or when these contingent liabilities materialise, they will crowd out expenditure on public services, leading to tax rise and service cuts on a scale never before seen.

These latest measures comes just a few weeks after the collapse of Bear Stearns, one of the US' largest financial institutions, which was rescued by bailout organised by the Federal Reserve, and rumours that Britain's Halifax Bank of Scotland (HBOS) was on the brink of collapse, precipitating a wave of share selling.

The swap facility was announced on the same day that Europe's second largest high street bank, the Royal Bank of Scotland (RBS), unveiled its plans to launch a £12 billion rights issue, the largest in European corporate history, larger even than the rights issue by the beleaguered Swiss bank, UBS. It is thought that some of the other banks and mortgage lenders may follow suit.

RBS also announced that it would sell off its highly profitable insurance arm. It is already in talks to sell off its train leasing operations, whose huge profits are dependent upon government subsidies, and which is expected to realise £3.5 billion, nearly ten times the price it paid for the company in 1997.

RBS has pledged a cost cutting campaign that will see a cull of thousands of jobs. It must also offer a massive fee to get the issue underwritten and price the new shares at a huge discount, increasing the number of shareholders and demands for future dividends by more than 60 percent. Bank shares, which had earlier risen in the wake of the |Bank of England's rescue, fell across the board as the implications of this sank in.

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