Bradford & Bingley: Britain's banking crisis worsens

Jean Shaoul
7 June 2008

The attempt of Bradford & Bingley (B&B), the UK's largest buy-to-let (BTL) mortgage lender, to raise more capital has stoked fears about the health of Britain's largest banks. It presages job losses and rent and mortgage repayment hikes for millions of families, as the banks seek to recoup their losses.

It comes just a few months after the government's rescue and nationalisation of Northern Rock and weeks after the government and Bank of England's unprecedented "liquidity scheme," under which it swaps the banks' AAA-rated mortgage and credit card-backed securities—which are in reality untradeable and worthless—for Treasury bonds at a discounted rate. Far from providing extra credit for homebuyers, the funds have been used to shore up Britain's banking system, which was on the verge of collapse because banks refused to lend to each other.

Only four weeks ago, Bank of England Governor Mervyn King was claiming that "the worst was over." B&B's lack of funds disproves this and testifies to a systemic and deepening financial crisis.

B&B transformed itself in 2000 from a high street building society to a listed company. It grew by more than 50 percent since 2003 by specialising in the BTL market in housing. With £40 billion worth of mortgages and only £22 billion deposits, it made up the difference with cheap short-term credit, now no longer available.

The credit crunch that followed the collapse of the US subprime mortgage market meant that it had to pay more to service its short-term debt under conditions where the BTL market had already started to plummet.

There were rumours for months that B&B was in financial trouble and needed more cash. On April 14, Chief Executive Steven Crawshaw denied that it would launch a rights issue. Then, just one month later, he announced that B&B was launching a rights issue whereby existing shareholders would be offered additional shares at a deeply discounted price equal to 82 pence a share compared to its then price of 158.75 pence. This would raise £300 million. He assured investors that trading was fine.

Within days, B&B was forced to admit that trading in 2008 was in the red. It had only just become aware of these losses because its management information systems were woefully inadequate, despite the high salaries paid to its top directors brought in to transform the "sleepy building society," with their much-vaunted superior private sector management techniques.

In the first four months of the year, B&B had made losses of £8 million—compared to profits of £107 million for the year 2007—due to higher interest charges, the failure to raise the cost of its loans fast enough, and rising arrears on BTL mortgages. It had made write-downs for its exposure to exotic financial instruments, collateralised debt obligations or CDOs, and other losses of about £300 million.

Arrears had risen by 36 percent, while the number of repossessions rose by almost 25 percent to 700. Bad debts on self-certified loans—known as "liar loans" in the US because they allow people to take out a large mortgage by falsifying their income—rose by 38 percent. There was a £15 million write-down for fraud. Much of the losses came from its subsidiary GMAC, which it had recently bought from US giant General Motors' finance arm without carefully checking the quality of its loans. This triggered a profits warning for the full year. CEO Crawshaw resigned after being diagnosed with angina.

All this was bad news not just for B&B but for all the other banks, particularly those with big commitments in the BTL and self-certified markets. Financial commentators were already expressing concern that the level of write-downs following the credit crunch was relatively low, giving rise to fears that the banks had not disclosed or even understood all their risky assets.

The B&B's rights issue announcement sent its share price and those of other banks tumbling. Alliance and Leicester and HBoS, the parent company of the Halifax, the largest building society, were particularly badly hit. Some £4 billion was wiped from the value of the banking sector.

This prompted open speculation that the UK housing and banking sector, along with that of the United States, faces meltdown.

Sandy Chen, the banking analyst at City stockbrokers Panmure Gordon, said, "This is not the bottom. The UK housing market—not just buy-to-let—is turning south. Two-fifths of households suffer from negative cash flows. They don't have enough income to finance their mortgages and bills. If they can't borrow their way out of the problems, things are going to get worse."

As fuel and food costs soar, more and more people will fall behind with their mortgages.

The BTL market has expanded dramatically in the last decade, as property developers have built apartment blocks in prime city centre and suburban sites for single and small householders unable to buy their own homes. In addition, while BTLs are largely owned by the corporate sector, about 1.1 million people in Britain,

up from 120,000 in 2000, are believed to have bought property to rent out after BTL mortgages became available to householders as well as institutions in the mid-1990s. For many, this was a way of providing a pension nest egg. But, as buyers came to the end of their two-year, fixed-interest mortgage deals, average rates increased to 6.94 percent compared with 6.17 percent just three months ago.

Many small and part-time landlords have found that their rents are not enough to cover their mortgage payments. Panic sell-off by landlords could trigger a property market downturn creating a full-scale rout.

A number of reports indicate that trends in the wider housing market are also worsening. Standard & Poor's, a credit ratings agency, reported that households more than three months behind on their payments had risen to 10.6 percent. Moody's reported defaults on good-quality borrowers, "prime" loans, were also rising, with the repossession rate up by 6.4 percentage points.

Citigroup estimates that a quarter of a million UK homeowners are now in negative equity. This could rise to more than 1 million by the end of 2009, affecting nearly 1 in 12 property owners with a mortgage. It says that property prices have fallen 7 percent since last autumn and will decline by 15 percent during 2008. Citigroup UK economist Michael Saunders points out that the British economy is showing signs of a slowdown while inflation is rising, making it impossible for the Bank of England to make significant cuts in interest rates.

A slump in the housing market will affect the value of the banks' assets, their mortgages, and thus their capital reserves.

The dramatic fall in B&B's share price meant its shares were trading at only 6 pence above the rights issue price, which would deter potential investors from taking up the rights offer and leave underwriters UBS and Citigroup, who were being paid handsomely at £24 million plus commission to do so, to pick up the rest. B&B's small shareholders would be particularly badly hit.

On Monday came an announcement that B&B had sold a 23 percent stake in the company to the Texas-based private equity firm TPG Capital for £179 million, 55 pence a share or 40 percent below the rights issue price and only 50 percent of the bank's book value. B&B's market capitalisation has fallen from £3.2 billion in March to £415 million.

At the same time, B&B announced an unprecedented change in the terms of the rights issue halfway through the process. Rather than leave the underwriters to bear the cost, the shares would now be offered at 55 pence a share, yielding £258 million.

Altogether B&B would raise about £400 million, £100 million more than planned under the original right issue. Since then, bank shares have fallen further as the implications have sunk in. It triggered sharp falls in European banks as well. Some commentators have questioned whether the hedge funds were making a concerted attempt to force down the banks' share prices.

Other leading British banks face similar difficulties to B & B. The troubled Royal Bank of Scotland (RBS) is finding it difficult to attract buyers for its insurance arm at the same time as launching a rights issue.

It appears that the financial regulators—the Financial Services Authority (FSA), the Treasury and the Bank of England—were closely involved in the whole affair. B&B's chairman Rod Kent said that the FSA had been "very, very involved. This is very serious. They were involved from the very beginning [last week]. We had a real crisis with our chief executive and a problem with our profits."The regulators wanted to avoid another Northern Rock situation and so forced B&B to accept the bid from TPG and renegotiate the terms of the rights issue.

While shareholders are outraged that the underwriters have in effect been bailed out at their expense, they have no option but to accept the decision to reduce the price the rights offer. The alternative would be insolvency. With both the BTL and the broader housing market in decline and the funds for new mortgages drying up, the future looks bleak for B&B. Financial commentators were predicting that TPG would seek to cut one third of its £280 million costs, heralding branch closures, job cuts and increased exploitation of the workforce.

TPG has form on this. After it took control of Gate Gourmet, the airline catering firm, there were a series of strikes at Heathrow and Dusseldorf airports. A major cause for concern is whether the £400 million B&B is raising is adequate for a capital buffer to cushion a crash in the housing market. Should house prices fall 20 percent and arrears increase threefold as they did in the early 1990s, then with its mortgages totalling £40 billion, £400 million would soon be eaten up. It is fears such as these that are panicking the City.See also:

British government commits taxpayers to bailing out the banks [26 April 2008]

Britain: Mortgage drought as economy faces plunge into recession [9 April 2008]