

# Lloyds TSB takeover of HBOS leaves Britain's banks in trouble

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Lloyds TSB's £12 billion takeover of Halifax Bank of Scotland (HBOS) Thursday followed a collapse of the UK's largest mortgage lenders' shares, which threatened to destabilise the entire British banking system.

With 20 percent of the mortgage market, HBOS has some 22 million customers and 72,000 employees. Lloyds is the fourth-largest mortgage lender with an 8 percent share.

The rescue package came amidst panic selling of shares on Wall Street, as confidence in the US and global financial system collapsed. In events that led many to recall the Great Crash of 1929, leading US financial institutions Merrill Lynch and AIG were bailed out in billion-dollar deals by the Bank of America and the US Treasury, while Lehman Brothers, America's fourth-largest investment bank, filed for bankruptcy protection.

Writing on the scale of the crisis in the *Times* on September 17, Anatole Kaletsky noted, "Two weeks ago nobody would have imagined that, before the end of the month, the Bush Administration would have nationalised the world's biggest insurance company, that two of the four biggest global investment banks would be out of business and that the US Government would take responsibility for three quarters of the country's new mortgage loans."

"Sadly," he went on, "the events of the past two weeks may be only the prelude, not the climax, of this amazing crisis."

This was clearly the concern of the markets and the Brown government in Britain. In two days of trading beginning Monday, HBOS had seen its share price fall by more than two thirds—recording a £7 billion loss by Tuesday evening—and at one point stood at just 88 pence.

According to the *Guardian*, after the Bank of England was informed by the US Treasury that Washington had decided not to bail out Lehman Brothers, the city's Financial Services Authority "trawled through the finances of British banks to see which were particularly vulnerable." The failure to rescue Lehman Brothers meant that the banks would not lend to each other, and the interbank lending rates was already beginning to rise rapidly.

In February, the Brown government had been forced to nationalise Northern Rock, the UK's eighth-largest bank, at the cost of more than £80 billion to the taxpayer. With HBOS almost 10 times the size of Northern Rock, neither the government nor the City wanted a similar scenario this time round. The *Guardian* reported that during a private event sponsored by Citigroup in London on Monday evening, Prime Minister Gordon Brown had met Sir Victor Blank, the chair of Lloyds TSB, and asked for his help. Lloyds TSB had been looking to expand and had been involved in tentative talks since July with HBOS.

On Tuesday morning, Brown met with Mervyn King, the Bank of England governor, and Alastair Darling, chancellor of the Exchequer. The Bank of England announced it would extend the special liquidity scheme it had introduced after the collapse of Bear Stearns for a further three months until January—a move previously ruled out by King. In the meantime, the FSA scouted for other potential buyers for HBOS, including HSBC.

With HBOS shares continuing to slide, it appears that only Lloyds TSB was willing to take on the ailing bank. As soon as the stock market closed Tuesday, talks began in earnest, paving the way for the deal to be announced Wednesday.

HBOS had been resisting Lloyds TSB's approaches for months. Since it was formed in 2001 as the outcome of a merger between the Bank of Scotland (formed in 1695 and the oldest surviving bank in the UK until this week) and the Halifax Building Society, HBOS had sought to position itself as a significant challenger to the "Big Four" high street banks of Lloyds TSB, Barclays, HSBC and the Royal Bank of Scotland.

But HBOS was dependent on money markets to fund 40 percent of its operations and had been particularly hit by the credit crunch following the sub-prime mortgage crisis. Earlier this year, several hundred of its senior managers had clubbed together to purchase 1.4 million shares at 446.25p. That £6 million had reportedly been reduced to just £2 million this week. Only a few weeks ago, HBOS raised £4 billion in a rights issue where there was only an 8 percent

take up, leaving the underwriters, mainly the high street banks, holding the rest.

The government intends to break the rules governing competition and mergers in order to ensure that deal goes through. Business and Enterprise Secretary John Hutton is to use emergency powers to prevent the deal being referred to the Competition Commission on the grounds of national interest. Fearing speculation on HBOS and other banks, the government also banned short-selling of bank shares aimed at driving down share prices to make a killing for three months.

Under the deal, Blank will become chairman of the greatly expanded entity, the Bank of Britain, controlling almost one third of the UK's savings and mortgage market and four times larger than any other bank as regards savings.

Lloyds TSB and the government dismissed reports of redundancies involving one third of the workforce and pledged to continue using HBOS headquarters in Scotland, but the deal sets out that "significant cost savings can be made by combining the networks and back offices of Lloyds TSB and HBOS." With plans to slash costs by £1 billion a year—equivalent to 10 percent of the banks' combined costs—union leaders believe the job cuts will be in the region of 21,000 and 28,000 out of a 140,000 workforce.

Such cuts take place under conditions in which the latest government figures showed the largest rise in the number of people unemployed and claiming benefit for 16 years. In the three months to July, some 138,000 were made redundant—a sharp increase over the 28,000 laid off in the three months to April. Some 1.72 million were officially registered as unemployed in July, taking the official unemployment rate up from 5.3 percent to 5.5 percent. In the last week alone, jobs have also been shed at the collapsed travel firm XL—the UK's third-largest travel operator—and Lehman Brothers in London. Referring to earlier warnings by David Blanchflower of the Bank of England's monetary policy committee that 2 million people could be out of work by Christmas, the *Guardian* editorialised, "at this rate we will be lucky if...[his two million forecast] is all that happens."

Even with such extensive government backing, it was immediately apparent that the crisis had not passed. Kaletsky had warned, "Even the apparent rescue of Halifax Bank of Scotland may result in a bigger crisis, if the drowning HBOS drags down its rescuer, Lloyds TSB.... If this fails, it will take down all Britain's banks."

He expressed little confidence in the viability of the new bank if it was not offered "some kind of firm government safety net"—paid for, of course, by the taxpayer—for shareholders and was instead a "pure private sector solution." If not, then "market attacks against HBOS will soon be revived and redirected against the merged bank,"

leaving "only one solution—nationalisation of the entire British banking system."

These predictions were swiftly confirmed when almost £2 billion was slashed off the value of Lloyds TSB's takeover of HBOS in initial trading and the bank's shares fell by 15 percent. Attention has also turned to other potential fatalities—most notably the Royal Bank of Scotland, which was also recently forced to raise additional finance through a rights issue and whose shares fell by 10 percent.

The *Scotsman* reported, "A source familiar with the situation yesterday warned that Scotland may be in danger of losing both its banks. 'This is a revolutionary day for the banking sector,' the source said. 'Nothing is ever going to be the same. Look at the state of the markets. There's still another shoe to fall—a merger of Royal Bank of Scotland with HSBC.' "

It is somewhat disingenuous to described RBS as merely a "Scottish" bank. One of the top 10 banking groups in the United States and amongst the largest in Europe, RBS is a target for speculation because, like HBOS, its loan book exceeded its deposit base. Reports indicate that the funding gap at RBS is £161 billion (HBOS was £198 billion) while it also "has a heavy exposure to the United States via its Citizens Bank subsidiary," the *Scotsman* reported.

Only the announcement by the US that it would buy billions of bad mortgage debts held by American banks produced a rally of Britain's banking share prices and of the London shares market. But the long-term picture remains fraught with danger, given the massive sums involved. The credit agency Standard & Poor's has predicted that US and European banks will suffer a second massive wave of losses from the credit crunch in the next few months, raising the present total from US\$378 billion to something nearer US\$500 billion.



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