How they managed to botch the bailout

The Bank of England has a lot to answer for. The competitiveness of British banks has been ruined

Tim Congdon

Is the Government's rescue programme beast or beauty for Britain's banks? The leap in share prices has been beautiful for short-term investors in the stock market. But a strong case can be made that the Government has been beastly to the banks, with dangerous long-term consequences for our financial sector.

What effect will the Government's actions have on the structure of the British financial system and, in particular, on the international competitiveness of the City of London? In a recent speech Paul Tucker, an executive director of the Bank of England, referred to a "social contract" between the Bank and Britain's commercial banks.

The heart of that contract used to be the lender-of-last-resort function. When a solvent and profitable British bank had difficulty funding its assets, the Bank of England was supposed to lend freely to that institution at a penal rate. The rate was to be high enough to encourage early repayment, but it was not to involve any attack on shareholders' rights.

Britain's bankers have been greedy, naughty and irresponsible in the past few years. Well, bankers are greedy, naughty and irresponsible everywhere and at all times. For all their faults Britain's banks are not insolvent or unprofitable. At the end of June this year the book value of the much maligned Royal Bank of Scotland's equity was more than £60 billion, while the total profits in 2007 of the eight institutions negotiating with the Treasury last Tuesday night was about £40 billion.

When the Northern Rock crisis broke last August, the Financial Services Authority responded appropriately. It tried to marry Northern Rock, which could not fund itself in the wholesale markets, with Lloyds TSB, which had a strong network of retail branches. But Lloyds TSB was worried that even the retail network might not be able to raise enough money, and sought to borrow from the Bank of England.

This would have been a classic lender-of-last-resort arrangement of a kind that the Bank of England had undertaken before. Alistair Darling is said to have vetoed the facility on advice from Mervyn King, the Governor of the Bank of England.

Since then King has insisted that it is not the Bank's job to provide long-term finance to Britain's banks. He seems to have repudiated the lender-of-last-resort role.

The damage to confidence has been done. The world believes that Britain's banks are bust or semi-bust, whether at the last reporting date (end-June 2008) they had shareholders' funds of £200 billion or not. The British Government seems to agree with the world that organisations with capital about three months ago of £200 billion may be bust, and has decided that these organisations must raise more capital if they want to access the Bank's facilities.

Potential private investors cannot overlook that this year the British State has nationalised two banks (Northern Rock and Bradford & Bingley) without their shareholders' consent. If the British State can bully banks to take actions that neither their management nor shareholders approve, isn't it understandable that the capital markets are reluctant to put more money in?

Banks are forced into the hands of the State. Superficially the "preferred capital" made available last week was rather like a long-term lender-of-last-resort loan, and optimists might say that the Treasury

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was performing a role that used to be the Bank of England's. The trouble is that the preferred capital was also poisoned capital.

The banks could access it only if they also handed over to the Government chunks of their equity, the £200 billion or so that belongs to their shareholders. As with Northern Rock and Bradford & Bingley, the Government is determined to drive a hard bargain. Its rhetoric is that the bankers must compensate the taxpayers for any rescue funds.

The trouble here is that British banks compete head-on with banks from other countries, where the governments are being more lenient. In the US the Bush Administration is avoiding nationalisation. A fair bet is that the nine banks identified as beneficiaries of yesterday's American package will be set softer terms than their British counterparts. In sharp contrast to the Bank of England, the Federal Reserve is lending on a massive scale for periods that may extend into a few years. It is acting as a lender-of-last-resort aggressively supporting America's banks.

Two conclusions cannot be avoided. The first is that it would have been better if the Bank of England had reacted to the recent troubles in the same way that it did, so brilliantly and effectively, in past crises. The support should have been pre-emptive and low-key, and it should have come as a traditional lender-of-last-resort loan. It ought to have been unnecessary for the Treasury to offer the strange mishmash of "money" that is now available on semi-confiscatory terms.

Secondly, the international competitiveness of Britain's banking industry is being destroyed. Nationalisation will cause undue caution and rigidity in banks' operations, while talented and experienced bank executives will seek to work elsewhere. In many cases they will emigrate.

New investors in British banking will be reluctant to come forward when the Government tries to privatise the assets it has taken from banks' existing shareholders. In the past 20 years Britain's economy has led the world in one, and only one, activity: international financial services. That leadership — and with it the prosperity of the City of London — is now in extreme peril.

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