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RESEARCH NOTE 35

TAXPAYERS' ALLIANCE RESPONSE TO THE GOVERNMENT'S £50BN BAILOUT

Key points

- The Government has turned to taxpayers to fund their £50 billion bailout of the banks without fully exploring other measures that could have contributed to resolving the financial crisis.

- A £50 billion capital injection commits significant amounts of taxpayers' money - **£2,000 per household in Britain**. This creates a number of issues:
  - Taxpayers' money will be **exposed to significant risk** for an extended period of time. Funds will need to be raised now and that borrowing will pose a significant risk to the economy over the medium term.
  - The authorities charged with protecting taxpayers' interests are **unlikely to be effective**, particularly if they are required to outwit financial institutions.
  - There will be a **huge public backlash** if this money is seen to be used inappropriately, to support high levels of remuneration and bonuses.

- Three responses the Government should have pursued first, and should now consider to limit the need for injections of taxpayers' money, include:
  - **Suspending mark to market rules** that cannot function effectively in the absence of a liquid market for many key assets. This would significantly ease the pressure on many banks' asset sheets. If mark to market had been in place during the 1980s all 10 of the largest US banks would have become insolvent.
  - **Big interest rate cuts:** While inflation is currently quite high it is widely expected to fall substantially in the coming year. Cuts in Bank of England rates might have a limited effect on market rates but it will help some borrowers more immediately and any effect on the market rate would be valuable.

- **Strengthening the credibility of deposit insurance:** 97 per cent of depositors were covered even before this week's increase in the deposit protection limit to £50,000; however it is understandable – in the wake of crises such as that at the Rural Payments Agency – that ordinary people are not entirely confident those guarantees protect their interests.

Comment from the TaxPayers' Alliance

Matthew Elliott, Chief Executive of the TaxPayers' Alliance, said:

> *"The Government is using taxpayers' money as an easy way out, and haven't fully explored other options that don't put £50 billion of our hard-earned cash on the line. With ordinary taxpayers' money at stake, they must put mechanisms in place to ensure that the money isn't frittered away on excessive bonuses and to make sure that it is not wasted. The Government must now explore other options to reduce the amount of taxpayers' money the banks need, including making deposit protection more credible, suspending mark to market regulations and cutting interest rates. The Government say they have the interests of hard-working taxpayers at heart, now they need to prove it."*

To arrange broadcast interviews, please contact:

Mark Wallace
Campaign Director, The TaxPayers' Alliance
mark.wallace@taxpayersalliance.com; 07736 009 548

To discuss the research, please contact:

Matthew Sinclair
Policy Analyst, The TaxPayers' Alliance
matthew.sinclair@taxpayersalliance.com, 07771 990 174

Context

For over a year there have been significant problems in global financial markets. Low interest rates and a long period of relatively benign economic conditions had encouraged a significant expansion in the availability of credit, particularly in home loans to risky borrowers.[1] Banking regulations around Basel II provided perverse incentives to push lending off balance sheet to evade its capital requirements.[2]

Falling assets caused serious damage to banks' balance sheets, leading to a drying up of credit. The perceived risks to banks' stability led to a freeze in lending between banks.[3] This created problems for a number of institutions but particularly those that had lent aggressively and relied on markets for a greater part of their funding, such as Northern Rock, or owned significant amounts of sub-prime debt securities. The tripartite institutions put in place by the Government – with responsibility for regulating the financial markets shared between the Bank of England, the Financial Services Authority and the Treasury – failed to control the problem.[4]

The crisis has been exacerbated significantly by relatively new financial rules. Mark to market accounting requires firms to value their assets at the value at which they could be sold. As there is effectively no market for many assets and only fire-sales are taking place, it produces exceptionally low values. The vast majority of mortgages, corporate bonds and structured debts are still performing but firms, that are otherwise solvent, are being forced to price them to fire-sale values. This makes those firms vulnerable to collapses in confidence and forced liquidation.[5]

The crisis has led to the collapse, nationalisation or forced takeover of a number of major companies, including Bear Stearns, Northern Rock, Washington Mutual, Fannie Mae, Freddie Mac, Lehman Brothers, Wachovia, Merrill Lynch, Bradford and Bingley and HBOS.

[1] Schifferes, S. *'Credit crunch costs '$1 trillion''*, BBC News, April 2008
[2] Smith, D. B. *Evidence to the IEA Shadow Monetary Policy Committee*, October 2008
[3] Spence, M. 'Will The Bailout Work?', *Forbes*, October 2008
[4] Lambert, R. 'Three-way system failed the big test', *The Times*, September 2007
[5] Wesbury, B. 'How to Start the Healing Now', *The Wall Street Journal,* October 2008

The Government's £50 billion capital injection

The British Government have announced that there will be £50 billion of capital provided to the major banks. This would provide a substantial injection of capital into those banks, at the price of diluting the stakes of existing shareholders. This will be done with preference shares, ensuring that taxpayers are repaid faster at the expense of limiting the potential upside if banks' share prices recover quickly, or by financing ordinary shares. It is hoped that this scheme will ask less of the authorities than buying up toxic debts and it should be possible to recover taxpayers' money as conditions improve.[6] At the same time, the Government will expand ongoing provision of liquidity, with £200 billion of short term loans made available.

The case for injecting capital is premised on the idea that a range of banks have a fundamental solvency problem; that they cannot be left to rebuild their capital from private sources. If this is the case, and it is hard to establish from the outside, then there may be a need for capital injections. However, any injection should be kept to a minimum for the following reasons:

1. It involves a large, up-front injection of taxpayers' money. Financing this without increasing taxes or pushing up inflation will be extremely challenging, particularly with an already massive public debt and large deficits.
2. The authorities are expected to negotiate the terms of any deal, manage the new shares and ensure that taxpayer value is defended and could clearly do a bad job.
3. There is likely to be significant public resentment of any deal that is seen to rescue banks with ordinary taxpayers' money. Particularly if public assistance is seen to support high remuneration for staff in the banking sector.

Proper controls, public and Parliamentary scrutiny and transparency will be needed to make sure taxpayers' money is not wasted. It would be wrong in principle, and probably wasteful in practice, for so much money to be spent without proper democratic control.

[6] Tyrie, A. 'Let's have a comprehensive banking rescue plan', *The Times*, October 2008

Other responses

There are three responses the Government should have pursued first, and should now consider to limit the need for injections of taxpayers' money.

1. Strengthening deposit guarantees

Many European countries – such as Ireland – have issued unlimited guarantees to reassure deposit holders that they will not lose out in the result of a crash.[7] The ongoing fear that banks will face a depositor run in the manner of Northern Rock, or prove unable to build up their base of deposits thanks to a lack of confidence, continues to paralyse financial markets.

In the UK, the limit of £35,000 on the amount that is guaranteed per person, for each institution they have deposited in, has been increased to £50,000 as of the 7th of October.[8] However, increasing the limit, or guaranteeing all deposits, ultimately creates a significant taxpayer liability and might not address the root of the problem.

- The old limit of £35,000 already covered 97 of depositors.[9] While the small number of people with large deposits do hold significant funds coverage would not seem to be the big weakness in deposit protection, particularly following the increase in the limit to £50,000.
- Compensation does not arrive immediately. The Financial Services Compensation Scheme aims to process claims within six months. That could easily be far too long for someone who needs their bank deposit to pay some emergency bill.
- The Government's ability to promptly deliver financial assistance may not be trusted. As of May 2008 around 9,000 farmers were owed a total of £190 million in payments that were meant to arrive last year and some have been told they will not receive payment until November.[10] In that context, it should not be surprising that people see a Government commitment to recompense them in a crisis as suspect.

Reassurance that protected deposits will be paid quickly may be of more value than increases in the limit and could reduce pressure on banks.

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[7] Peston, R. 'Full deposit protection is nigh', BBC News, October 2008
[8] Financial Services Compensation Scheme, *'Deposit claims FAQs'*, http://www.fscs.org.uk/consumer/faqs/deposit_claims_faqs/
[9] HM-Treasury, *'Financial stability and depositor protection'*, January 2008, A.28, pg. 107
[10] Northern Echo, *'Thousands of farmers still waiting for funding'*, May 2008

2. Suspending mark to market regulations

In the United States, steps have been taken to relax mark to market regulations. These regulations are designed to ensure that valuations of assets are fair and comparable across different countries. Unfortunately, as they rely upon the market to provide a price for an asset, they cannot function when that market ceases to function. As there is effectively no market for many assets and only fire-sales are taking place that produces exceptionally low values. The vast majority of mortgages, corporate bonds and structured debts are still performing but firms, that are otherwise solvent, are being forced to price them to fire-sale values. This makes those firms vulnerable to collapses in confidence and forced liquidation.[11]

The policy proposal is that these regulations be temporarily suspended and firms value assets based on their expectations of the value that can be realised from them. This does not provide the same objective standard but was the basis of most markets until very recently and is, in some circumstances, essential to economic stability. Every one of the United States' ten largest banks would have become insolvent in the 1980s had mark to market regulation been in place.[12]

The main objection to this proposal is that suspending mark to market implies covering up economic problems and failing to tackle bad debts. This ignores the simple fact that mark to market may not be providing an honest picture of the value to the banks of assets that are still generally expected to provide significant returns. Proposals to buy up toxic debts are defended on the grounds that most of the debts will, in the end, be paid so the taxpayer will not face an unreasonable burden. Suspending mark to market regulation simply means that we allow banks to recognise the true value of their assets, rather than politically recognising that these assets are undervalued and having the taxpayer buy them.

Mark to market regulation has been enacted in the UK through EU regulations. This may mean that it will be difficult to quickly suspend mark to market. The EU institutions will need to move more quickly than they do in other areas to avoid being a liability in attempts to get out of the credit crunch.

Even if mark to market rules can be suspended, confidence may not be restored while banks own the same toxic assets as they do now – even if the value of those assets is better represented on banks' balance sheets. For that reason, a suspension of mark to market should not be seen as a sure-fire way to end the financial crisis. However, it could play an

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[11] Wesbury, B. 'How to Start the Healing Now', *The Wall Street Journal*, October 2008
[12] Isaac, W. M. 'How to Save the Financial System', *The Wall Street Journal,* September 2008

importance part in restoring the system to health and reducing the need to commit taxpayers' money.

3. Cutting interest rates aggressively

There is a good case that interest rates were too low in earlier years, leading to excessive lending. Now that there is a shortage of lending and inflation appears likely to fall dramatically in the coming months, interest rates can be cut. The Federal Reserve has already made significant reductions to interest rates in the United States for those reasons.

It is clearly possible that cutting the recommended rate will have a limited impact because market rates will remain much higher. However, cutting the recommended rate will help some borrowers whose rates are linked to Bank of England rates and there could well be some effect on market rates, particularly over time. In recognition of that a majority of the IEA's Shadow Monetary Policy Committee recently called for cuts, and the most popular amount for a cut was 0.5 per cent.[13]

[13] IEA, 'Shadow Monetary Policy Committee E-mail Poll', October 2008

Conclusions

Completely nationalising banks is really an admission of failure after it has become impossible for a bank to continue to operate in the private sector. It exposes the taxpayer to significant and long term risk for little gain in terms of a boost to capital markets. That major firms were being nationalised and forced into mergers illustrated that earlier policy responses were not delivering the recovery policymakers clearly hoped for.

The major capital injection announced involves the use of large amounts of taxpayers' money and still asks a lot of authorities that will need to safeguard the taxpayer interest. The performance of those authorities in the run up to this crisis hardly suggests that they are up to the task.

While it may be necessary for taxpayers money to be used on a significant scale to resolve the financial crisis, taxpayers' interests are best served by focussing on cuts to interest rates, the suspension of mark to market rules and reforms to deposit protection. These do not require the risking of large sums of taxpayers' money in the hope that it can be safeguarded by regulatory authorities whose performance recently has been less than inspirational.

While no policy can promise a sure-fire recovery, politicians who have the taxpayer interest at heart must limit the need for taxpayers' money to be committed by exploring other plausible responses. When taxpayers' money is used proper controls, public and Parliamentary scrutiny and transparency will be needed to make sure it is used correctly.