

Marketplace



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‘Despite banker-bashing in the media, the British taxpayer ought to make a profit from the government’s intervention in the banking crisis’

In his latest State of the Union address, President Barack Obama said that, although the bail-out of the banking system was “about as popular as a root canal”, the government had implemented a “financial rescue programme”. What did he mean by the expressions “bail-out” and “rescue”?

If a shopper uses his credit card to buy something and clears the debit in his monthly statement, we do not say that the credit card company has “bailed out” the shopper or “rescued” him. If an individual takes out a mortgage from a building society to buy a house and repays it, we do not say that the building society has “bailed out” the individual and “rescued” her. If a company uses its overdraft to finance working capital and repays the overdraft when cash comes in, we do not say that the bank has “bailed out” the business, and we do not describe the sequence of events as involving “rescue” or “assistance” on either side.

More generally, when loans are taken out and repaid on time with interest, the creditor has no further claim on the debtor. Borrowers do not have to pay lenders some extra amount, assessed retrospectively, to compensate for risk. All this is surely common sense. However, when we come to transactions between profit-seeking commercial banks and the state, words change their meaning.

For over a century, since Bagehot’s 1873 classic *Lombard Street* to be precise, hundreds of textbooks have said that the central bank is a unique organisation which acts as banker to the banking system.

Sure enough, some central bank loans—so-called last-resort loans that may continue for many months and involve some risk of not being repaid—may carry special conditions. Nevertheless, if loans from the central bank to commercial banks are repaid, there is no need to strain the English language, and to talk about “bail-outs”, “rescues” and “government assistance”.

But in the current financial crisis, officialdom and the media have routinely said that when a British bank borrows from the Bank of England, or American banks from the Federal Reserve, they are being “bailed out”. Indeed, the Governor of the Bank of England, Mervyn King, has appeared to repudiate the Bagehot principles and said that the central bank does not have a role extending long-term loans to banks suffering from

a cash shortage. According to him, that job instead belongs to the government.

It gets worse. In 2007 and 2008 several UK banks, like many financial institutions around the world, had a severe cash crisis because of the closure of the international market in bank funds. In accordance with the Bagehot ideas and despite King’s hostility, these banks received cash loans from the Bank of England. But they were also forced to raise large amounts of equity capital in a hurry. Given the destruction of financial confidence, the sums could not be raised from the private sector. The government instead bought the shares and became a big investor in Britain’s troubled banks.

When pension funds invest in a rights issue from a company, they do not “bail it out”. When a private equity company pledges funds for a new start-up, it is not said to be “bailing out” that start-up. Investments are investments—they are not grants, gifts or charitable donations. However, the British state’s investments in the Royal Bank of Scotland and Lloyds are uniformly described in newspapers as “government support” that has “bailed out” the banks and their shareholders.

Of course, the government, like any other investor, could lose money on the bank shares it has acquired. But how likely is that? The riskiest of the banks now under government control is widely reputed to be Northern Rock. If the government does not lose money on Northern Rock, the probability is that it will not lose money on any of its bank investments. Yet on 10 January, the *Sunday Telegraph* ran an interview with Ron Sandler, the chairman of Northern Rock, headlined, “The taxpayer absolutely will be fully rewarded for the rescue of Northern Rock”.

Contrary to a mass of sloppily-worded newspaper reports, the US and Britain have not “given” any money to the banks. Instead, they have extended loans (most of them at an above-market rate of interest and now repaid), they have given guarantees on bank liabilities (none of them called, but with the banks paying guarantee fees) and they have invested in banks’ equity (on which they may well make a handsome capital gain a few years from now). Strange though it may seem, and despite a consensus fabricated by the banker-bashing media, taxpayers ought to make a profit on their governments’ crisis interventions in banking systems.