Is nationalisation of banks ever justified?

Second Prize – 1st Year Undergraduate Category

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Introduction

The financial crisis of 2008 onwards saw unprecedented pressure on our banking system. The free market model, reliant on liquidity and trade between banks and other financial institutions, broke down and the potential consequences on the 'real economy' were painfully obvious. In some ways, it was a perfect storm; as with most big crashes, the years prior were characterised by excessive confidence, overleveraging (both by financials, non-financials and households) and a sense of immunity to the pitfalls of our economic past. Gordon Brown, previously Prime Minister and Chancellor, is perhaps best quoted as an example of this hubris when he famously said, among many other variations, "we will not return to boom and bust".[1] He was hardly a lone figure in this regard, though; it is a truism in life that things are only obvious in hindsight.

Background

Given the rather exceptional economic circumstances the world is currently experiencing, then, it seems logical to begin any discussion on bank nationalisation with a review of the recent crisis. It is not without some irony that a macroeconomic event of this magnitude generates so much new data relevant to the understanding and development of economic theory; indeed, studying the nationalisation of banks in much of the last 20 years would have been a much less interesting task.

The main thrust of the reasoning for nationalisation of banks, by both the governments[2] directly responsible and most economic thinkers[3] comes from the perspective of financial stability. The interconnectedness of our financial sector, it is argued, means that a weakness in any link in the chain risks undermining the whole system. This is patently not an outcome desirable for any of the stakeholders

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[1] Channel 4, 2008 "No return to 'boom and bust' – will Brown ditch the old formula?" http://bit.ly/wLU5HM

[2] BBC News, 2008 "B&B Nationalisation is Confirmed" http://bbc.in/w8tGT2

[3] NY Times (Krugman) 2009, "Banking on the Brink" http://nyti.ms/wbJ2L

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in banks; a group which encompasses more or less the whole of society. One easy way of graphically illustrating this interconnectedness is by looking at the equity markets, as in Figure 1 below, which plots the share price of 3 of the largest UK banks.

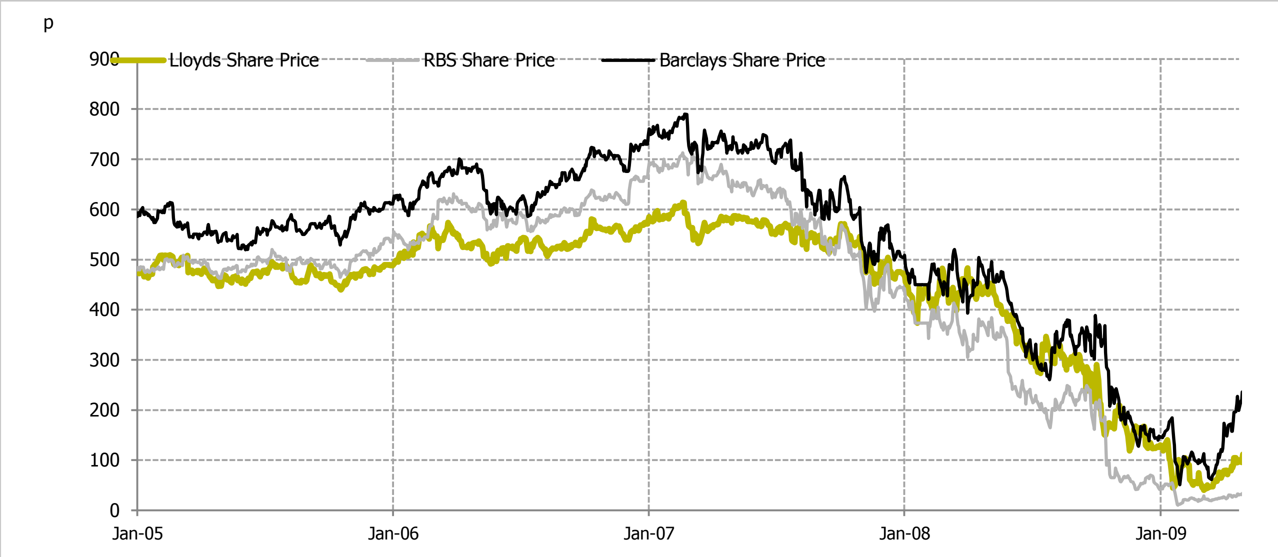

Figure 1: Share price of LLOY, RBS, BARC - Jan '05 to Apr '09. Data not adjusted for dilution.

It should be obvious to any casual observer that, at least in the eyes of the equity markets (largely driven by multinational, institutional investors) the fates of our banks are very closely entwined. As with much of economics, there are a multitude of other explanatory factors for such correlation – perhaps the causality is faulty, and the causal factor is actually a decline in the wider macroeconomy. That is almost certainly true. Perhaps asset markets are simply over correlated, either intra-sectorally or between broad asset classes. This is also an opinion gaining some traction. Even so, such co-ordinated downward runs, to such a low multiple of the previous price level - and earnings or book value, two common investing measures - must indicate some sort of fear for the long-term future of the banks in question, and seems to imply a great deal of interdependence. It is difficult to justify such low valuations using any sort of model without inputting either a significant - certainly non-zero - chance of business failure, large capital raising from the equity markets (signifying financial duress) or many years of losses.

Still, for those not masochistic enough to enjoy deriving any sort of logic from stock markets, they were by no means the only group in a state of fear about the financial system. A more familiar example of the complete collapse of confidence when banking stability is in question drove the extraordinary measures of early 2008, as Northern Rock found itself needing support from the Government. Mile-long queues of customers trying to withdraw their savings – despite assurances by the FSA that their money was guaranteed – contributed to the liquidity squeeze on the bank that finally led to state ownership. In this sense, the cyclicality of the whole situation is clear – in both bank funding markets (viewed in terms of LIBOR rates) and the more traditional method of customer deposits, weakness begets further weakness.

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Perceptions of Northern Rock's instability brought about mass withdrawal of savings and an increase in their borrowing costs. The prophecy of failure was self-fulfilling.

Northern Rock was, by all accounts, just a herald of what was to come. Bradford & Bingley in September 2008 preceded the colossal state intervention a month later, when the Government essentially nationalised RBS and Lloyds/HBOS. It should be noted that Lloyds and HBOS at this point were not the merged entity they are today – that was a deal waved through at the behest of the Government to supposedly shore up their balance sheets and maintain financial stability. The success or otherwise of that is left entirely up to reader, but at least some small regard should be given to the competitiveness of a sector now dominated by a firm with 30% share of the personal current account market.[4]

The UK Story

The situation the UK currently finds itself in, then, is a position of some historical note. The Government still holds significant amounts of the equity of both Lloyds (~40%) and RBS (~82%), as well as parts of the previously held Bradford and Bingley and Northern Rock.

The UK's banks are, by most measures, now rather safe. The European Banking Authority, who publish yearly stress tests, found all UK banks passing their most recent requirements. Their measure of resilience – the core tier 1 capital ratio – could perhaps best be described as looking at the amount of lending and speculatory activity, taking into account the relative risk of those activities (hence generating *risk-weighted* assets) and comparing it with the equity base - core tier 1 capital - of the bank. A higher ratio is obviously better, and Figure 2 shows that both RBS and Lloyds performed better than the median EU bank in the stress testing results.

Both banks passed the main, forward looking element of the test, too. This imposed a number of negative macroeconomic outcomes on the Eurozone, which naturally filters through to the balance sheets of banks, and sought to determine whether or not they would have sufficient tier one capital to absorb the shocks. The potency (or otherwise) of their 'adverse' scenario and the strenuousness of the tests make ample material for a further discussion, but suffice to say 8 banks of the 90 in the sample did not pass as Lloyds and RBS did.

Considerable emphasis is placed by the boards of both banks on derisking the balance sheet, though whether this is directly related to nationalisation or not is debatable. Certainly, it is hardly just Lloyds and

[4] UK Parliament, 2011, http://bit.ly/xqzXrg

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RBS whose management make noises in that direction – the market is simply responding to the wishes of shareholders, money managers and 'the city' in general.

Having ensured our banks and financial system are safe – or, at least, as safe as can be given a rather shaky currency union as our neighbour and a volatile global environment as the backdrop, the UK Government has received little credit for their actions. Indeed, most of the focus is on whether the 'investments' will realise a paper loss. This hardly seems rational.

The Bigger Picture

The simple fact of it is that bank nationalisation falls prey to exactly the same problem as much of mainstream economics – the absence of the counterfactual. What we would love to do, as economists and rational thinkers, is take two identical banks at the onset of the crisis, nationalise one and leave the other to the whims of the free market.

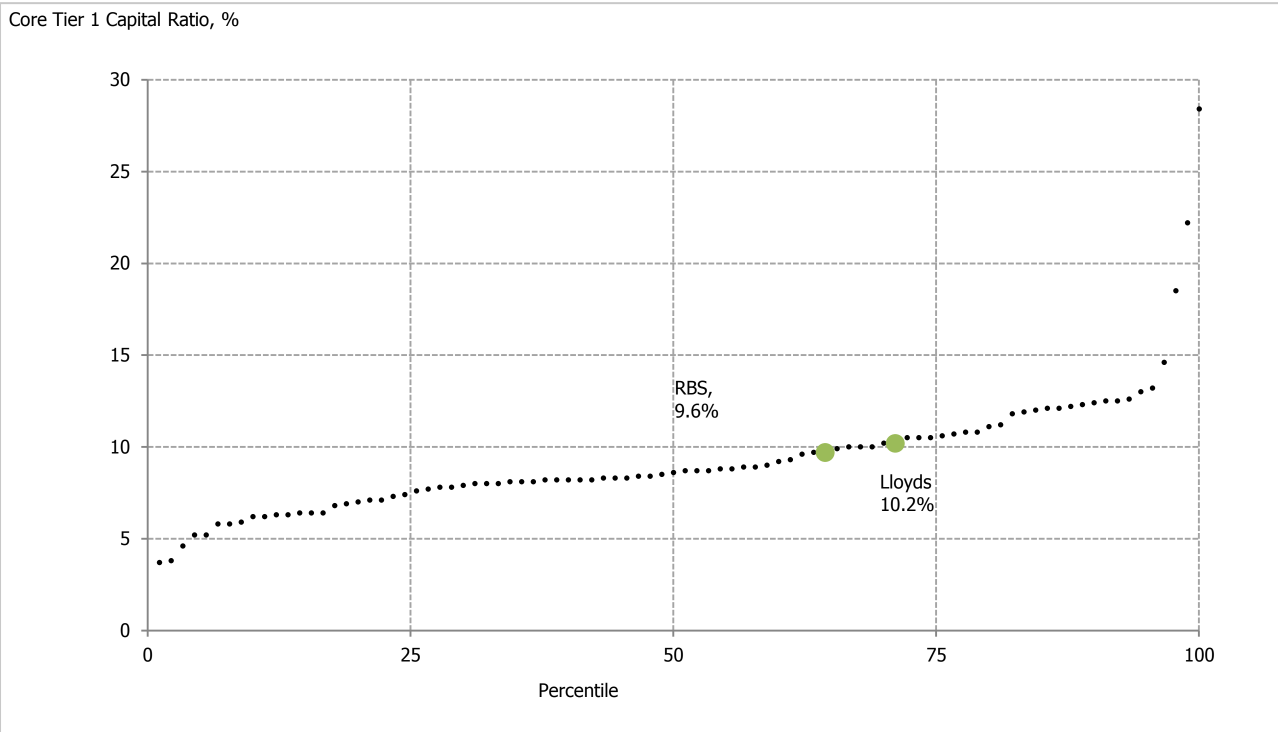

Figure 2: EBA 2011 Bank Stress Test; current core tier 1 capital ratio; RBS(left) Lloyds (right) highlighted. Source: EBA

Unfortunately, this idea crumbles at every level. It is practically and politically impossible to conduct such an experiment, a hopelessly naïve concept to hope to find two 'identical' banks and obviously morally rather questionable. One thing that any debate absolutely must involve, though, is a proper understanding of the alternatives. Much of the tabloid press, as I have already mentioned, focuses on how the taxpayer has 'lost out' on its investment in RBS and Lloyds. They note how the share price has

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plummeted, reducing the apparent value of the holdings, and grumbling in typical media style about how the taxpayer is somehow swindled by devious market participants.

This engenders a negative feeling towards the nationalisation by many people. But this should not be so. Judging the success or otherwise of a nationalisation by the paper profit the Government earns upon exiting the position is much like making the assertion that building hospitals is not worthwhile, because the market value of the hospitals does not give the Government a decent return on capital. It is patently absurd. The point of building hospitals is not to incur a profit on the buildings, it is to treat sick people. The point of nationalising the banks was not because the Government hankered after the city lifestyle of a fund manager for a few years, and saw the opportunity for a quick buck – it was to shore up financial stability.

Any discussion on the merits of nationalisation should take things as they were in 2008, then, in the middle of a catastrophic drop in confidence both in the markets and on the street. The simple fact of that analysis is that it is difficult to envisage any scenario whereby a bank should be left to fail. We should be under no illusions about white knights and market heroes – the British Government were the only institution big enough to bail out the failing banks. Furthermore, given the amount of money pumped into them, it should be obvious that the need was very much there. Recall that that particular 'crisis' was the hangover of reduced confidence caused by the subprime implosion. The Euro area woes of 2 years later were not just some small aftershock to the system – they were another sledgehammer to the foundations of the European banking system. One should be under no illusions that RBS and Lloyds would've managed to limp through without severely damaging the entire UK financial system.

One should also not be under the illusion that a bank failure is 'not a big thing'. Kupiee and Ramirez[5], 2009, studied the early 20th Century banking situation in America; their data suggested that:

> *"… a 0.14 percent (1 standard deviation) increase from the mean value of the liabilities of the failed depository institutions results in a reduction of 17 percentage points in the growth rate of industrial production and a 4 percentage point decline in real GNP growth. The reductions occur within three quarters of the initial bank failure shock and can be interpreted as an important component of the cost of systemic risk in the banking sector."*

Grossman's study[6] on the New Banking era starting in the mid-19th Century asserts that:

[5] Kupiee and Ramirez,2009, "Bank Failures and the Cost of Systemic Risk: Evidence from 1900-1930 http://1.usa.gov/Ah6uyT

[6] Grossman, 1993, "The Macroeconomic Consequences of Bank Failures under the National Banking System" http://bit.ly/zUlS21

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> *"Simulations suggest that a relatively small bank failure shock could lead to a 2% decline in real GNP, while the consequences of a large bank failure shock – a one-fifth decline in GNP – could be catastrophic."*

And while the temptation may be to disregard these analyses as out of date and not relevant to the modern economy, there is a convincing case that exactly the opposite is true. Banks today face, paradoxically, both far more competition and far less than they used to. Thinking globally, there are often local monopolies – Lloyds in the UK would be a neat example of this. Even though that may be the case, banking has become a worldwide activity – a UK bank's competitors are as much J P Morgan and Société Générale as RBS and Barclays. The reasons for this are manifold, but the core of the issue is that economic efficiency dictates it. Scale efficiencies create monopolies in financial services, and the ever-blurring lines between investment and retail banking hardly help this.

Far from the old analysis being irrelevant, it is even more pertinent today. The chain has far fewer links and each link is more integral to the whole structure. Short-termist thinking – and not just by the demonised bankers – incentivises an arms race, whereby it makes sense for banks to leverage their assets more and more to increase returns for shareholders.

A Societal Problem

It is an attractive and easy option for politicians to pin the blame on city types. They are an easy target – anyone who earns a lot is – and have been rather hindered by a few notable individuals throughout history acting with slightly less decorum or understanding than may otherwise be warranted.

It is a gross oversimplification to say that bankers caused the crisis, though. The Government debt issue, which is as much a problem as financial sector stability, was no fault of the bankers – that was short-termism on the part of politicians and, more fundamentally, ordinary people. It seems unlikely a party would have rode to power in the boom days of the 2000s on a pledge of fiscal prudence and no more expenditure hikes.

Equally, most people understand that markets need regulation, yet bankers managed to increasingly shake off state influence. Blaming the institutions for this is foolish – it is the mechanism of the markets to try and maximise returns for their shareholders. They did entirely as should have been expected of them. That the regulatory regime was not up to scratch is not their fault.

It strikes me, then, as not only wholly justifiable to nationalise the banks but wholly predictable, too. Humans did as they have done for hundreds of years, through the tulip boom of the 1600s to the Great Depression – they became overconfident in the promise of perpetual growth and did not see the risk of failure just around the corner. Markets mirror the human psyche, and that overconfidence fed through to

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the actions of our banks. They are not the all-seeing, perfectly calculating beasts that the free marketeers see them as – they are (in a rather theological way) created in our image, and fall prey to the same cognitive biases we do.

Looking Forward

If nationalisation is justified, then, one must make some sort of statement about what is to be done with the nationalised banks. Surely, it seems, we should use the market power the Government now has at its fingertips to improve conditions for the UK as a whole – to repair some of the damage they caused, if you will.

A common demand is for the Government to take a more activist role as shareholder of the nationalised banks[7], and to direct investment spending to bolster the wider economy – a national investment bank, as it is often referred to. This is an approach which represents a startling lack of foresight.

After all, if one were to look for what could best be described as the 'root cause' of the 2008 global downturn, most fingers point at the subprime crisis in America. Underpinning that particular mess was an incentive structure entirely of the state variety – two state run lenders being forced by Congress to lend more. In fact, in a twist that should've been obvious as deeply damaging in the long run, in 1996 Congress gave a target to Fannie Mae and Freddie Mac that 42% of their mortgage lending went to borrowers with income below the median in their area. In 2000 this became 50%, and in 2005 this became 52%.[8] This is one of many of the incentive structures designed to push lending to those who the market had deemed too risky to lend to.

If bank risk taking is a case of market failure, then, the above is surely just as potent a case of government failure. Government is in no position to direct investment spending. It may appear attractive in the short run, and is probably beneficial to GDP growth – but misdirected capital only serves to stoke the fires of a future bust.

The arms-length model the Government is adopting, then, seems best placed to minimise government interference in the market while ensuring financial stability. UKFI, the holding company responsible for managing the investments, is said to act like a "any value orientated shareholder".[9] In addition, the Government's decision to 'partly nationalise' - crucially leaving a small amount of the share capital as free float on the market to maintain a market price and market direction also seems logical and conducive to the aim of returning these businesses to private hands in the near future.

[7] Left Futures, 2010,"RBS bail out: Not again. This time, nationalise"- http://bit.ly/q6ODQJ
[8] Wall Street Journal, 2008, "How Government Stoked the Mania" http://on.wsj.com/3TpQdY
[9] Lloyds Banking Group, 2010 Annual Report, http://bit.ly/tuq08F

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Concluding Thoughts

By most measures, then, nationalisation seems to have been successful. The direct question of whether nationalisation is ever 'justified', then, follows from this – hopefully I have served to persuade that few cost-benefit analyses a government ever makes offer as potent a benefit (staving off financial catastrophe) with so little cost (investment, most of which will later be paid back).

The best scenario of all, of course, is the situation whereby banks never need to be nationalised, preventing the damaging moral hazard and 'too big to fail' mentality from distorting markets and hampering innovation and competition in financial services. This is something which requires rather extensive regulation on a global level. The likelihood of such legislation ever being agreed by all parties seems, sadly, rather low – it is a classic prisoners' dilemma whereby cooperation benefits all, but the cost of imposing regulation on your own financial sector is enormous if others do not.

Regardless of sad reflections on human incentives, then, the UK Government response to the 08 – present financial crisis was decisive, well thought-out and, crucially, market-orientated. The firms are very much still private, with the efficiency that brings and without the government's distortionary influence.

That strikes me as making the best of a bad situation – nationalisation is not merely justified, but earns my whole-hearted support.

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