Commentary: The Banking Crisis and the Economy

Martin Weale

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Introduction

The past few weeks have seen an intensification of the banking crisis in the United States, with the near failure of Bear Sterns, although some commentators hopefully say that the worst has now passed. In the United Kingdom the gap between the Bank Rate and money market rates has re-opened and is described as indicative of a reluctance of banks to lend to each other. In this commentary we seek to explain the fundamental factors behind recent developments in UK lending markets. We begin by describing the recent experience of the financial services industry in the United Kingdom and putting the crisis, which has been described as the worst since the Second World War, into some sort of perspective.

The bubble in the financial services industry

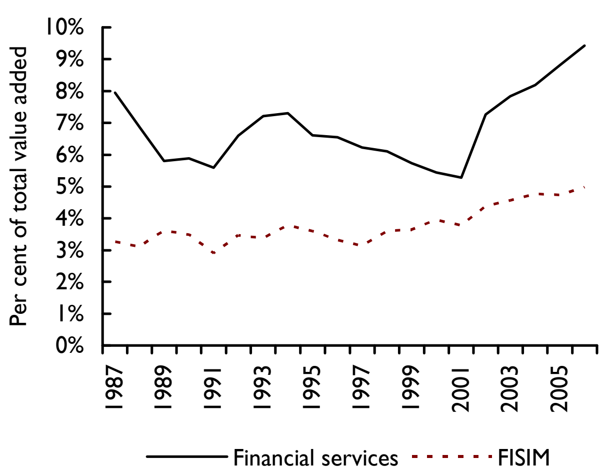
Figure 1 shows the value added by the financial services sector as a proportion of the total of value added in the UK economy. It also shows the magnitude of financial intermediation services indirectly measured (FISIM). This last component is a measure of the margins that financial institutions make by lending out at rates higher than they borrow. This component of their income is regarded as profit by the financial services industry. But since in the national accounts interest payments are treated as transfers, in the national accounts it has been deducted from financial institutions' perceptions of their profits in order to arrive at true value added by the sector.[1]

It is clear from the data that there has been a substantial bubble in the industry, with the importance of the industry coming close to doubling between 2001 and 2006. Data for 2007 are not yet available. Looking ahead it is likely that the share of the sector will fall back again; the fall of the exchange rate makes it possible for more conventional industries to take up the slack by expanding their export shares.

FISIM has also grown as a result of the bubble. If it falls back to its historic range of 3–4 per cent of value added, that will create at least 1 per cent of national income extra to accrue to the factors of production employed in these industries, providing a useful cushion against economic weakness.

With this background we now present a perspective of the magnitude of the crisis.

Figure 1. The bubble in the financial services industry



The crisis in perspective

Financial crises are recurrent features of market economies. Kindleberger (1978) suggested that they had become less frequent in the years after the Second World War than in the pre-war years. Nevertheless, recent crises have been large enough. In the banking crisis which enveloped Scandinavia in the early 1990s bank losses amounted to around 10 per cent of GDP in Finland but only 2 per cent in Sweden (Barrell, 2008). In the mid-1980s in the United States of America $160bn was lost in the Savings and Loans crisis, amounting to 3.8 per cent of US 1985 GDP. If losses in the current crisis reach the $1000bn forecast by the IMF, this amounts to

7.4 per cent of US GDP. Not all these losses are borne in the US since some foreign banks have invested in US mortgages. Up to half may have been exported in this way. This means that other countries are affected as well. UK losses have not been quantified to the same extent. But the likely magnitude of UK rights issues from banks points to losses of 2–3 per cent of GDP. The IMF figures assume that losses spread to assets beyond mortgages and it is by no means certain that this will happen.

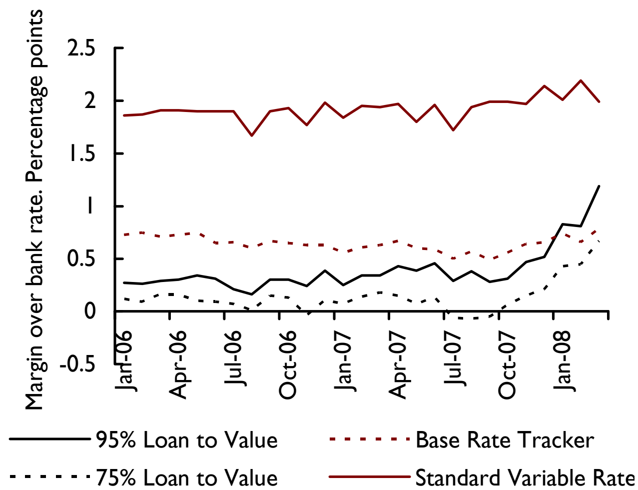
The losses are small compared with those arising from stock market movements. The 1973/4 crash resulted in a fall in the value of US equities of over 30 per cent of GDP and markets in other advanced countries were also affected, with probably a similar fall in the UK. However, stock market falls on their own are not directly associated with liquidity problems. And the destruction of banking sector capital may result in lending to other sectors being restricted. We look first at liquidity and risk.

Liquidity problems or risk reassessment?

It is widely believed that lenders are affected by a 'shortage' of liquidity in wholesale markets. But wholesale money markets bring together surplus or primary banks with an excess of deposits from non-banks and deficit secondary banks which do not have large deposit bases and obtain deposits in wholesale markets. The surplus banks are probably in a position to take over business from the deficit banks but they regard the sort of lending carried out by the secondary banks as risky. Thus HSBC announced it would provide mortgage lending on apparently favourable terms, but not with high loan-to-value ratios. If it lends money to secondary banks it has no control over how the money is used. If it captures part of their markets it does. There is a 'shortage' of finance for high loan-to-value mortgages not because wholesale markets have 'dried up' but because lenders have now understood that they are risky.

The nature of the risk reassessment can be seen from the changing pattern of mortgage rates. Rates on discounted mortgages have drifted up since the Autumn and the rise is particularly marked in mortgages for 95 per cent of house values. A naïve interpretation of this would be that in the past few months the risks associated with high loan-to-value mortgages have changed. But a better explanation is that lenders modelled risk badly. While house prices were rising they did not regard there as being a significant risk that prices might turn down

Figure 2. Mortgage rates: margins over base rate



Data Source: Bank of England web site.

because they assessed risk on the basis of relatively short-term data. In other words, they were too ready to believe that the economic environment had changed. Stagnating house prices have reminded lenders of the reality that high loan ratios are risky.

In 1991 – the worst year of the last housing slump – 0.77 per cent of mortgaged properties were taken into possession, compared with 0.23 per cent in 2007. The current foreclosure rate in the United States is over four times the UK figure for 1991. We consider causes of this subsequently.

However, as the graph shows, the margin on 75 per cent loan-to-value mortgages has also increased, albeit not as sharply as that on 95 per cent mortgages. With secondary banks apparently short of funds, the surplus banks find that they can raise their rates on even those mortgages which have more limited credit risk. Nevertheless, a fall of house prices of 25 per cent or more, making default on 75 per cent mortgages advantageous is obviously not impossible. In the early 1990s the average fall was 12 per cent, but the inflation rate was higher; the fall would have been just over 20 per cent if price inflation had been held to the old Bank of England target for the Retail Price Index excluding mortgage rates of 2 ½ per cent per annum. Thus, even with lower inflation, the 1990s slump would not have encouraged the average borrower of a 75 per cent loan-to-value mortgage to default. But lenders have to bear in mind that some house prices fall by more than average and that the defaults on houses which fall by more than average are not made up by any benefits from houses whose prices fall by less than average. In London in the early 1990s house prices on average fell by 20 per cent and some of them must have fallen by more than the average. With inflation kept to the current target, the fall would have been around 30 per cent. So mortgagees lending at 75 per cent loan-to-value ratio are undoubtedly also concerned about risks of negative equity and default. These concerns undoubtedly influence interest rates on mortgages.

The Bank of England liquidity scheme

On 21 April the Bank of England announced a scheme[2] to provide liquidity to money markets by swapping a range of securities, including mortgage and credit card debt, for UK Treasury Bills. The scheme is designed so that the credit risks associated with the swapped securities remain with the institution where they originate. Only high-grade mortgages issued before 31 December 2007 are eligible for the scheme. But of course, if it leads to generally lower rates in the interbank market, a wide range of lending institutions will benefit. The expectation is that about £50bn of mortgages will be swapped under the scheme, but the sum may well be higher.

On 30 June 2007 the outstanding value of mortgages issued by monetary sector institutions[3] was £807bn. By 31 December 2007 it had risen to £830bn. So one may well wonder why £50bn of credit is needed to clear an overhang of mortgages which should not exceed £23bn. The Council of Mortgage lenders data show gross mortgage lending of £99bn in the third quarter of 2007 and £87bn in the fourth quarter, but these data are gross of mortgages which are being repaid, either because borrowers redeem mortgages when they refinance or move house, or because most mortgage payments include payments of capital as well as income. It might be presumed that such receipts are available to meet new loans.

It is nevertheless easy to see why banks might feel they need the extra money. Northern Rock's problems arose because they relied heavily on wholesale funds, probably borrowed for three months at a time, to finance illiquid mortgages. Other lenders followed a similar approach – even if not to the same extent. The problems of the inter-bank market have meant that these banks face difficulty in raising new wholesale deposits to replace existing deposits as they mature. The swap facility at the Bank of England will be very useful to ease this problem, but it is not the same thing as easing an overhang. An alternative way of describing the same point is that money from redemptions and repayments is not available for new lending because banks have had to use it to repay maturing deposits in the inter-bank market.

Thus a reasonable conclusion is that the Bank of England scheme will make life easier for the banks. But it will not turn risky mortgages into safe mortgages and borrowers who want to borrow high loan-to-value ratios are likely to continue to find life difficult.

Capital losses and capital shortages

Following the losses that many large banks have made it is suggested that they are constrained by shortages of capital. In principle losses are bygones and do not affect the profitability of the business which might be generated by a marginal infusion of new capital. If this were in fact the case, the capital losses would be no more important in their impact than stock market declines of similar magnitude.

The difficulty is that new investors cannot insulate additional capital from the effects of as-yet undiscovered losses. The sovereign wealth funds which invested heavily in banks in the Autumn of 2007 have learned this lesson. Banks cannot recapitalise until investors are clear that there are no more abnormal losses to emerge and hence the pressure on them to admit to their losses. The fact that some securities cannot be valued of course makes this difficult. Capital will flow into existing banks only when new investors feel that existing equity is marked down sufficiently for the prospect of high expected returns to compensate for the risks of further losses. It will not flow in if investors believe that banks might be insolvent. The speed with which Bear Sterns' share price collapsed shows the risks involved. New investors in banking can, of course, protect themselves from existing losses by investing only in new banks. Barriers to entry in the banking business impede this as a form of resolution but, if the crisis continues, we may see spin-off banks raising new capital.

The total value of bank shares and other equity outstanding at the end of December 2007 was £135bn. Thus the £12bn rights issue from the Royal Bank of Scotland amounts to 8.9 per cent of this. The total value of shares and other equity outstanding of all incorporated businesses was £771bn. Even if the total value of rights issues by banks amounts to say £30–40bn, or the 2–3 per cent of GDP mentioned above, it is hard to see that this would disrupt financial markets substantially. But once banks have put themselves on a better financial footing, there is a question how the regulatory framework needs to change.

Credit controls and regulatory reform

Inevitably there is now a feeling that the current regulatory structure has not worked because banks have taken too many risks. Most of the discussion focuses on regulations imposed on banks, but there is a real question whether there should also be some sort of regulation of access to credit as a means of reducing the chance of a new credit bubble.

In the past, controls on lending have not been popular with lenders because they restrict their ability to take on business, and they have not been popular with voters either. The experience of the 1960s and early 1970s was that when one category of institution was controlled, similar unregulated organisations appeared and the controls were thus increasingly avoided. Largely on these grounds, the UK Treasury has rejected the idea of controls since they were lifted in the early 1980s. Other countries have also reduced the scope of controls in the past twenty or thirty years or so.

But it is possible to regulate some types of lending provided the regulations are designed so that lenders have an incentive to comply with them. A maximum loan-to-value limit on a mortgage raised on a property at the time of sale can be enforced by legislation that any mortgage higher than the permitted level would be registered at that level. It is hard to see that this could be avoided by artificial inflation of transaction prices. Loan-to-income ratios are harder to control because it is not always possible to give a precise definition of income.

A tax on credit could also be designed to be self-enforcing; if lenders had to show that it had been collected when they wanted to enforce debts then they would make sure that they collected the tax. Operating through the VAT mechanism, it would affect consumers but not most forms of intermediate demand.

Additionally, some sort of review is needed of the reserves that banks are required to hold as a function of the characteristics of the mortgages they issue. This will, of course, raise the costs of high loan-to-value mortgages compared with the situation of a year ago. But, as argued above, the margins on them have recently understated the default risks, and rates should have been higher. Here it is harder to see how self-enforcing mechanisms can be designed.

But it is important also to look at the incentives facing individuals and here there needs to be a general recognition of the instability associated with bad bankruptcy law. The UK government has been keen to encourage risk-taking in the belief that it is a good thing. Thus in 2002, a Treasury Minister, Melanie Johnson, said, in promoting what became the *Enterprise Act*, 2002, that,

> "Our proposed legislation will break down the barriers to entry through stronger competition. And it will support enterprise and encourage responsible risk-taking through a modernised, pro-business insolvency regime. The reforms will help reduce the stigma associated with honest failure."

This policy has succeeded spectacularly. Individuals have been taking substantial risks in property speculation with high loan-to-value mortgages. This may not have been the sort of activity that ministers had in mind when Parliament passed the *Enterprise Act*, but it is plainly risk-taking. There is no obvious dividing line between an individual, possibly owning one or two buy-to-let properties and a heavily geared property speculator, or entrepreneur as they would probably prefer to be called. The reality is that entrepreneurs and speculators often have poor judgement of risk, and regard the result of excessive risk-taking as honest failure.

But while the United Kingdom Government has played its part in encouraging 'responsible risk-taking' in the United Kingdom, much the bigger problem arises in the United States. There, by contrast to the United Kingdom, most mortgages are non-recourse. This means that, although the loan is secured on property, the borrower has no personal liability. A borrower who buys a house in effect buys call-option with the strike price equal to the amount of the mortgage. If the house is worth more than this the borrower can keep the profit, while if there is negative equity the lender bears the risk. This need not, in itself, matter. After all, people are used to trading in options. But if lenders misjudge the risks and have not set adequate reserves aside to meet them, then they can find themselves facing unexpected losses. The fact that the loans are non-recourse means that foreclosing a mortgage has fewer implications for a borrower than does defaulting on a credit-card debt or on a car loan and is a reason why some people, in contrast to the IMF, think that the crisis is unlikely to spread beyond the housing market. Some sources argue that, whatever the reality, mortgages are bound to be non-recourse in practice because it is difficult to pursue borrowers. But the experience of the United Kingdom in the early 1990s did not suggest that annual default rates remotely approached the incidence of negative equity. A part of that is undoubtedly that many people think they should not default on their debts. But it is also the case that, in the United Kingdom, default does not, on its own, eliminate the debt.

The fact that mortgages in the United States are non-recourse drives a clear wedge between foreclosure and bankruptcy. But bankruptcy proceedings themselves are more debtor-friendly in the United States than here, despite reforms introduced in 2005. Borrowers on below-median incomes, unless their unsecured debts are small, can typically default while retaining housing equity up to a value which varies from state to state but which is always at least US$125,000.

The Group of Seven has discussed ways of easing the credit crisis with calls for greater oversight of financial firms and greater transparency. It should be promoting international agreement on credit restriction, such as upper limits on mortgage loan to value. It should also set out good international practice for mortgage conditions and bankruptcy law. The global nature of the financial services industry makes this is an important way of reducing risk in the international economy.

The economic outlook

Given the nature of the crisis the economic outlook is surprisingly rosy, reflecting the fact that banking is not the whole of the economy. Dow (1998, p. 353) suggested that the 1990s recession was "entirely due to a reversal of the over-confidence that had been built up in the preceding boom years" with most of the weakness due to shortfalls in consumer spending and fixed investment. It is easy to see that the same process could play out again, but this time on an international and not simply on a national scale. Very tight credit limits both consumption and investment spending. While therefore consumers are not facing the same pressures as they did in the early 1990s – when mortgage payments took an average of 27 per cent of the income of housebuyers as compared to 20 per cent in 2006, the latest year for which the data are available – nevertheless many consumers are likely to find themselves unable to obtain credit. Thus whereas in the early 1990s it was the consumers' confidence which was reversed, in this case the reversal to the confidence of the lending institutions is more likely to be important.

It is clear that the credit position has worsened substantially since our last forecast in January 2008. At the same time it remains a matter of judgement how long-lasting and how severe the credit shortage is likely to be. Barrell and Holland (2008) showed how a combination of 4 percentage point higher risk premia on equity and higher spreads on loans to household and businesses, could take over 1 percentage point off UK growth this year and nearly 2 percentage points off next year, undoubtedly implying falls in output in some quarters. The impact of tight restriction on credit is, in general terms, similar. We do not expect the situation to be as bad as Barrell and Holland's scenario, but are now expecting growth of only 1.8 per cent in 2008 and 1.8 per cent in 2009. The implications of this for the public finances are impressive. We now expect the current government budget to remain in deficit until 2011 and the public sector net debt as a proportion of GDP to exceed 40 per cent at the start of the new decade.

NOTES

1 For more discussion of FISIM see Begg, Bournay, Weale and Wright (1997).
2 http://www.bankofengland.co.uk/markets/money/marketnotice080421.pdf
3 Series NNUT *Financial Statistics*

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