Peak Credit – and the UK Approach

Few people have by now not heard of "Peak Oil"- the theory that while oil reserves may yet be plentiful, there is a "peak" level of oil production which is either approaching, or possibly even here. It appears increasingly clear that the bursting of the US "Sub-Prime" Real Estate Bubble may actually have marked the point of "Peak Credit".

Banks as Credit Institutions

Banks operate as "Credit Institutions" who create – as interest-bearing loans - the credit which represents more than 97% of the developed world's money supply, the rest being notes and coin. They are also described as "credit intermediaries", or middlemen, extending credit to borrowers, and receiving credit from depositors.

But what Banks *actually* do is to provide an implicit guarantee to their depositors that their borrowers' credit is good. The "Interest" Banks charge for this covers interest paid to depositors, operating costs, and default costs, and usually – a handsome profit.

Interest-free "Trade" credit from sellers to buyers costs nothing to create. Bank credit costs nothing either: the true economic value Banks provide lies in their implicit *guarantees*. Bank regulators – overseen by the Basel-based Bank of International Settlements – specify and monitor amounts of "Regulatory Capital" which Banks must hold to support these guarantees.

Credit Outsourcing

The problem has been that Banks have been "outsourcing" their guarantees to investors: *permanently* through "securitisation"; *temporarily* through credit derivatives; and *partially* through insurance, by "monoline" (ie they only have one line of business) credit insurers, such as Ambac.

A much greater pool of credit has therefore been created than Banks could ever have sustained alone. Unfortunately this outsourcing has been so opaque that no-one actually knows who is at risk and investors have gone on strike, probably permanently.

We are now seeing the slow motion meltdown of the economies which brought us the Anglo Saxon "neo-liberal" economic model. This collapse is already peppered with collapses of major financial institutions, and is being held at bay by extraordinary measures being taken by Central Banks to provide "liquidity" to a monetary system which has to all intents and purposes "seized up".

Note here that the provision of "liquidity" (the flow of money) is not the same as the provision of the Capital which is intended to support that liquidity.

Massive losses caused by defaulted loans and derivatives have eroded Banks' Capital massively, leading to the injection of huge amounts of Capital typically through the issue of more shares or "Equity". For some Banks, this has not been possible, and there have been two major banking collapses, one in the UK – Northern Rock – and one in the US – Bear Stearns.

It is interesting both to look at the true facts of each case, as opposed to the public perception, and to compare the different approaches.

Northern Rock

The extraordinary images of depositors queuing to withdraw their money from Northern Rock was one of the defining moments of the "Credit Crash", and indeed, of the current UK Labour government.

Northern Rock built a very successful business in lending money to property buyers – many of them the poorer risks. Unlike most such mortgage lenders, Northern Rock sourced its deposits not from individuals – "retail" deposits – but from other Banks on the "wholesale" debt markets.

This was an extremely profitable business model, since it meant that Northern Rock did not need the extensive branch networks of its competitors. And of course no one dreamt that the good times would not continue to roll…

However, once it was clear to all in early 2007 that the US property bubble was over, Banks generally had a good look at the "toxic waste" that was on their balance sheets and said to themselves: "If this is what is on our Balance Sheet, what on earth have our competitors got on theirs?"

The result was that the "wholesale" market in inter-Bank loans essentially dried up almost overnight, and Central Banks were obliged to step in and fulfil their function as "lenders of last resort".

Financial Pornography

While the European Central Bank and the US Federal Reserve Bank appear to have fulfilled this function successfully, the UK's fragmented Trinity of the Treasury, Bank of England, and Financial Services Authority got it spectacularly wrong, and the result was that no private sector rescuer was forthcoming, and eventually the Northern Rock was nationalised.

Perhaps one of the most interesting aspects was in fact the role of the UK "tax-payer", who is widely perceived by Press and politicians alike to have "bailed out" Northern Rock and lost £ billions in doing so.

The fact of the matter is that the money which was lent to Northern Rock never went anywhere near taxpayers, but was in fact created as a loan by the Bank of England - in exactly the same way that the BoE creates notes and coin.

The outcome has been that the BoE has been receiving a return ("seignorage") consisting of its "base rate" (currently over 5% pa) from Northern Rock, plus penalty charges.

The Treasury, - which recently took on the management of Debt issuance -after 300 years of this function being successfully handled by the Bank of England – did not see fit to issue debt to "fund" this loan.

Instead, the BoE funded it directly from reserves, which had two effects: firstly, starving the UK banking system of liquidity – at a time when the opposite was necessary; and secondly generating extraordinary profits by allowing the Bank of England to fund its loans to Northern Rock at nil cost.

The Alchemy of Central Banking constitutes a form of Financial Pornography which no decent UK newspaper will print. The amazing fact is that the BoE has been raking in profits for the UK Treasury at the rate of over £20 million per week, and these seignorage profits probably now amount to between £500m and £1billion.

A Political Accident waiting to Happen

The UK government will be needing every penny of this Pool of profits since it faces an impending flood of defaults from the 800,000 or so borrowers to whom Northern Rock lent between 100 and 125% of property values to buy their homes in the last few years.

As UK property prices start a downward slide at unprecedented speed, virtually all of these borrowers now have properties worth less than their loan. Worse than this, the rates of interest on many of these loans is about to rise precipitously.

This is a political accident waiting to happen, and it is compounded by a very high profile lawsuit from the dispossessed shareholders. They take the view that the Bank of England should have continued to pump in the necessary liquidity to keep Northern Rock afloat.

It is all too clear that the UK solution of nationalisation has left an unexploded political bomb on the UK Chancellor's desk.

Moreover, some observers believe that there will be more collapses to follow Northern Rock. Bradford and Bingley – another former building society turned Bank is also in "intensive care" and we are seeing that even some of the UK's biggest banks, notably Halifax Bank of Scotland and Royal Bank of Scotland are now attempting to raise new capital to bolster their balance sheets.

This time, the UK may be better prepared, and indeed few noticed that the legislation passed in order to achieve the nationalisation of Northern Rock did not actually name that Bank, but was "open-ended" allowing the government to nationalise further banks without the need for further legislation.

In the US, of course, nationalisation is no longer a politically acceptable solution to banking crises and the US authorities are widely perceived to have handled things better using a "private sector" approach.

In the following article we will have a look at the extraordinary saga of the collapse of Bear Stearns and its "rescue" by the blue chip investment bank, J P Morgan to see if the US approach is in fact superior.

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