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UBS note on bank recapitalisation

Reducing Libor, improving lending conditions

The following note was provided to the Treasury by UBS, advisers to the government on bank recapitalisation and the credit guarantee scheme. It was written on November 1 2008

Reducing the cost of the CGS will allow £ Libor to fall quicker

Libor will fall significantly quicker if the cost of the CGS, under one year, is reduced; so that banks can borrow unsecured at an all-in cost which is less than Libor. Many countries have priced their CGS this way.

Libor is the cost of unsecured interbank deposits.

In normal credit markets, most banks are perceived by depositors as entirely safe. Any excess short term money is placed on deposit with the banking system and most banks can fund the major part of their requirements at levels around Libor. The interbank market then functions as a clearing mechanism to balance the supply of deposits around the banking system. (As noted later if the BoE would act as a bank this stress would be removed, though BoE would be taking the unsecured interbank credit risk that the deposit market is shunning.)

At present, many wholesale depositors remain wary of the banking system. As a consequence, the proportion of unsecured wholesale deposits available to the Sterling banking system as a whole has reduced over the past year. Every moment of credit crisis has seen Libor spike upward, as wary depositors have withdrawn money from the banking system and placed it in safer instruments, including the Treasury bills supplied by the SLS. This is why Libor remains high relative to base rate.

How could the CGS help reduce Libor?

As currently structured the CGS allows unsecured borrowing by banks.

It attracts investors who would not otherwise lend to the banks; instead of demanding security, they rely on the guarantee. This extra supply of effectively unsecured deposit money will reduce Libor rapidly.

Currently, including the guarantee fee, the cost to UK banks is more than Libor;

significantly more . Rationally, the banks will first fund using the interbank Libor market – bidding it above Libor as we have consistently seen HBOS, RBS and Barclays do – for short term funding, and only after that has been exhausted, do they turn to the CGS .

So, whilst the CGS is providing crucial access to funding, its broader economic usefulness is so far limited. It could be altered to increase significantly unsecured deposits in banks. That would bring Libor down. This would reduce the pricing of credit to the real economy – heavily Libor influenced – and steepen the curve – a critical stage in the rebuilding of the health of a banking system. A health that is required should they be willing and effective creators and transmitters of credit.

How large a reduction in the fee is required?

Over the past two weeks, HBOS and RBS have been using the guarantee to borrow in the commercial paper market – mainly from Central Banks, for mainly three months. They have been selling such paper at Libor less 100 basis points, and have sold £8 billion or more. This suggests that, to be certain of the effect described, the all-in CGS fee needs to be reduced meaningfully below 100 basis points, to ensure an all-in cost below Libor.

What is the best way to reduce the cost of the guarantee?

Adjust the technical pricing of the scheme to bring it into line with other Governments. The Netherlands, which had the benefit of the UK's lead, charge a flat fee of 50 basis points for the use of the guarantee below one year. Many others have followed suit – Germany will too (with a tweak) . This would level the playing field for the UK banks, and will have the biggest impact.

It may be easier politically to maintain the current scheme's core pricing mechanism (50 bps + median CDS) but vary the way the median CDS is calculated. A possibility is to use 1 year median CDS for guarantees below one year. Whilst continuing to use the current 5 year median CDS measure adjusted to a new sampling period, for longer borrowing, again as the Dutch have done. Comparing the second and third column of the table below shows this could reduce the sub one year fee substantially – HBOS for example by 78 bps. Adding the 50 basis points, the under 1 year CGS fee for HBOS would now be 76 bps, giving an all-in cost (against L-100 borrowing) of L-24 bps. For 1 to 3 years the cost of the guarantee is also reduced under the Dutch scheme – compare column 2 below to column 4.

Another, not recommended, alternative would be to remove the 50 bps flat fee, though HBOS and Nationwide would still be above 100 bps assuming no other changes were made.

Median Credit Default Swap levels

	UK Scheme		Going 'Dutch'	
Period	October 9 2007 - October 8 2008		January 1 2007 - August 31 2008	
CDS tenor	1-year	5-year	1-year	5-year

	UK Scheme		Going 'Dutch'	
Barclays	40	76	23	45
HBOS	62	104	26	25
HSBC	29	58	15	26
Abbey	38	71	16	31
Nationwide	68	114	31	60
RBS	44	80	19	35
Stan C	34	65	21	43
Lloyds	33	59	13	24

In basis points per annum. Does not include any 50 basis points supplement in the fee. UBS estimates based on MarkIt Partners data.

The UK led the way globally in devising comprehensive support for the banking system. Others have set the costs of the guarantee lower. If the UK does not follow suit in some way, our banking system will be disadvantaged. The full potential of your scheme to reconnect the base rate to the real economy – in other words giving the BoE back control of monetary policy – and so stimulate lending and growth will at best be delayed.

Will this not lead to too great a use of the CGS?

The current DMO quota scheme (7% of eligible liabilities, going to 10% if needed) would continue to be an effective use-control mechanism.

This is approximately the method being used in other countries.

HMT has already announced that it will keep the cost of the guarantee under review and adjust it as economic circumstances require. So no change is needed from the initial concept, or £250bn amount. The risk of higher use has to balanced against the benefits of reducing Libor.

This would be a major contribution to the stability of the banking system and to the health of the economy.

A stable banking system eases funding pressures on banks, reducing their need for the scheme. This works alongside the "confidence-in-banks" benefit of the HMT inspired increase in capital.

As confidence in the banking system returns, normal credit conditions will be re-established, removing any need for the CGS.

What more can be done to improve lending conditions?

If HMT is prepared to consider alterations to the CGS, it could use the opportunity to improve financing conditions to specific areas of the economy where funding stimulus is most needed, namely the housing market and lending to business. There was negative net lending to the housing market in August.

To do this, HMT could lower the CGS fee for its longer term use, where backed by newly-created highly rated collateral (ie encourages new lending). Such collateralised use of the guarantee scheme – it would come out of the current £250bn limit – would reduce taxpayers risk.

Looking at the housing market: Increasing the availability of mortgages for those moving home or facing a refinancing event is essential if the housing market is to stabilise. This will avoid payment shocks leading to forced house sales, repossessions and a downward spiral. Stabilising house prices is a necessary step before new demand returns. Which is in turn key for the stability of the banking system. The health of the mortgage market is also important to much of the SME market, as this sector raise their cheapest credit against residential housing collateral.

Such a development in mortgage and business lending would again be leading the World in its response to the financial crisis. Wide scale adoption would be likely.

In conclusion

Many of the points raised in this paper would require detailed challenge and stress testing. The main points can be summarised as:

Firstly getting Libor down is desirable and possible by tweaking the CGS, secondly this would create a level playing field with much of Europe and thirdly the introduction of a collateralised CGS will encourage lending to key parts of the economy by reducing the cost of use at the same time as reducing taxpayers risk.