Morgan Stanley

Government and the Financial Sector

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Please see other important disclosures starting on page 9

Scale of support and intervention has been very large

- SLS – up to £200 billion
- Bank of England balance sheet – up by £150 billion from end July 2007
- Bank of England Asset Purchase Facility – initially £50 billion
- Deposit protection expanded – now £50,000 per person, per institution
- Re-capitalisation- currently £37 billion
- Nationalisation – Northern Rock and Bradford and Bingley had assets worth around £150 billion
- Credit Guarantee Scheme – up to £250 billion
- Guarantee for asset backed securities ; initially £50 billion
- Asset Protection Scheme - ??

The scale of the support and intervention has been very large – but what might it cost taxpayers?

Simply adding all this together gives a figure plausibly in excess of £1,000 billion – 60% of GDP. Yet ultimately the support package may not cost taxpayers much.

- SLS – collateralised swap
- Bank of England Balance Sheet expansion? Various forms of liquidity provision are also against collateral.
- Deposit protection – first line of defence is FSCS, i.e. industry funded
- Credit guarantees? – fees charged and compliant with State Aid Rules
- Re-capitalisation and nationalisation? – government gets claims on assets.
- Guarantees on asset backed securities – will be auctioned
- Asset Protection Scheme - ?? Will charge a fee

The scale of the support and intervention has been very large – but what might it cost taxpayers?

- The scale of the intervention in the UK is enormous, but the long-term costs to taxpayers could well be small – they may even make a profit.

- But the downside risks are huge because the payoffs on the support measures are asymmetric: taxpayers are much more likely to make big losses than big profits.

- That is the nature of insurance.

- Taking on these big risks is something the government should not shy away from in the middle of a banking crisis. But this makes it essential to take steps to reduce the chances of such crises happening again.

Stopping it all happening again…

- Three reforms could help stop the current difficulties reoccurring.

- First, reintroducing housing costs into the measure of inflation targeted by the Bank of England might provide limited protection against housing bubbles.

- Second, capital adequacy requirements need to be higher in the long term and counter-cyclical.

- Third, better incentives are needed to promote responsible lending and borrowing.

Stopping it all happening again…

- First, reintroducing housing costs into the measure of inflation targeted by the Bank of England might provide some limited protection against housing bubbles.

- This is warranted in its own right since housing costs are an element of the cost of living
- Though realistically it would provide only limited value in enhancing financial stability
- Another tool – besides interest rates – is needed if the Bank is to fulfil its new responsibilities for financial stability.

Stopping it all happening again…

- Second, capital adequacy requirements need to be higher in the long term and counter-cyclical.
- Modigliani Miller theorem says that this is not damaging to banks and need not increase the cost of credit.
- Is Modigliani Miller crazy? Bankers and regulators have appeared to think so.
- What it says is quite consistent with what has happened..
- When banks are perceived to have very little equity capital 2 things happen: the cost of equity capital and of debt goes up a lot.
- Those things go into reverse when more equity is there…
- Counter-cyclicality of impact of capital requirements is helpful….

Stopping it all happening again…

- Third, better incentives are needed to promote responsible lending and borrowing.

- We need a mutual interest between lenders, intermediaries and borrowers in not having credit extended where there are high risks that it cannot be repaid.

- This is a question both of responsibility and of incentives.

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