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MONEY BOX SPECIAL

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LEWIS: Hello and welcome to this special live Money Box to discuss the dramatic developments this weekend on both sides of the Atlantic. Sunday's become the traditional day for government to take urgent action to try to repair the broken banking system. This weekend though is more dramatic than most: the Chancellor will soon announce the details of the rescue plan for our eighth biggest bank, Bradford & Bingley; and we're just hearing news from America concerning that hundreds of billions of dollars of taxpayers' money will be committed to buying up the bad debt they've been playing pass-the-parcel with. But let's start with Bradford & Bingley. When the Chancellor formally announces in a few hours' time that Bradford & Bingley is to be nationalised, it will be the end of a 20 year experiment. All 10 of the building societies which became banks between 1989 and 2000 will have disappeared - either bought up or nationalised. The company will be broken up with the mortgages held by the Treasury and the deposit side and branches sold on. With me is the BBC's Business Editor Robert Peston who reported yesterday that this would happen. Robert, what details have emerged today?

PESTON: Well not a great deal more since I disclosed that the government was going to nationalise Bradford & Bingley. I mean the structure of the deal remains the same. The loan book of Bradford & Bingley, which is as you know has got a lot of buy-to-let loans and self-cert loans which the City doesn't really like ...

LEWIS: Self-cert being loans where people just said, "My income is £100,000" and they believed them?

PESTON: That's right. And there's a fair amount of evidence that the arrears rates on those is not terribly nice; that people who've taken out those loans are finding it harder to keep up the payments. So future losses from those loans you know may not be very pretty as a result of that. I mean that is actually what laid Bradford & Bingley low. That's why it had to be rescued: because its credit rating was falling and there was a great risk of an outflow of billions of investors' money because the credit rating had fallen a bit lower; covered bonds would have become repayable, which would have been an absolute calamity. So effectively what it would have been is a colossal run on the bank. But, anyway, I'm slightly I'm afraid digressing. The key point is because they can't sell this loan book, that will be nationalised. It's between 40 and 50 billion pounds of loans going onto the public sector balance sheet, swelling the national debt by that amount. But they are trying to sell the savings business, and that is a very attractive business. At a moment when banks in general are short of cash, actually all those deposits are fantastically attractive. So the UK's and Europe's biggest banks have been brought in by the Treasury and have been told give us a bid; tell us what you'll pay for these 2.6 million customers and £20 billion of loans. And, as we speak, the bids are in. But ministers and officials are still agonising about which is the best bid on the table. They have not yet made a decision and I'm sitting here waiting to be told which one of these big banks ... Santander was in there, HSBC was in there, Barclays was in there. I have a faint suspicion Santander may carry it off, but it's not definite by any means. So we're just waiting to hear. And this is of some interest to 2.6 million people because they thought they had their savings with Bradford & Bingley. They're going to be told in the next few hours that actually their savings are being transferred to another bank altogether.

LEWIS: So that will be announced with the formal announcement of nationalisation in the morning?

PESTON: Unless there's ... Look, there is one alternative thing that could happen. You know the Government wants to be seen to be taking *dramatic* action to you know save ... to make sure that no depositor loses a penny, and it wants to be seen as sort of action men, action government. Now it is possible actually that when they look at all these bids, they think to themselves ah, this is an attractive business. Maybe we're

rushing a little bit too fast to sell this business. So maybe what they'll do in the end - I think it's very unlikely, but maybe - there's an outside chance at the end of the day they'll say right we'll nationalise the whole thing, not just the mortgage book, and then we'll spend a few days negotiating a bit longer with these people to make sure we get the best price. There's an outside chance they'll do that. But my understanding is they'd much rather get the deal done today, so that they can say to the outside world you know we're in charge of this event; events aren't controlling us.

LEWIS: Yes. And just briefly, how significant is it that we're going to see the end of the demutualization experiment?

PESTON: I think it's an astonishing, astonishing moment. I mean, Paul, you remember all that euphoria that surrounded the flotation of these building societies over the past you know almost 20 years. These were going to be the new fearsome forces in retail banking providing better deals for mortgage holders and savers. There's now, with the collapse of Bradford & Bingley, not a single one left as an independent. Worse than that - and this is the thing which I think has got to make our regulators and politicians think very hard - is that there's also a fair amount of evidence that demutualization has not only been a disaster for many of these building societies; it's been a disaster for the British economy. Because these building societies under pressure - which you know you can't blame investors for this - under pressure from investors to grow profits in the end took risks that they shouldn't have taken, particularly with the way they funded themselves. They went into the wholesale markets, they raised a lot of cheap money from international providers of finance both in the form of these asset backed securities and also in other forms of wholesale borrowing. They then provided cheap loans to purchasers of homes, which I'm afraid contributed to this bubble in the housing market, which has now been pricked, which has I'm afraid caused them terrific problems but of course it's also caused all of us tremendous problems because the weakness in the housing market is the weakness in our economy.

LEWIS: Robert Peston, thanks very much for that insight. Well with us is Jonathan Charley. He's Vice President of Financial Services at the consultancy EDS. Jonathan

Charley, just let me ask you first was it necessary to do this? Was it necessary to nationalise Bradford & Bingley?

CHARLEY: Well I think from everything that you know Robert said in terms of the way the share price was going down, there was a lack of confidence, no-one was prepared to take over Bradford & Bingley, that it was pretty inevitable that this sort of action had to occur. I guess the concern is - as Robert said it's being done very quickly - is whether they've really thought it through properly in terms of the long-term best interests.

LEWIS: And why wouldn't the banks themselves sort it out? I mean when a couple of building societies were in trouble a few weeks ago, Nationwide just quietly acquired them. Why couldn't the banks sort it out with a lifeboat, as they've done in the past, or just by buying it? There must have been a price on Bradford & Bingley they would have paid?

CHARLEY: Well of course the irony is that the banks had already been forced to own 30% of Bradford & Bingley because of the last flotation, so they already ...

LEWIS: They've lost that.

CHARLEY: They've lost that as well. So I think it was basically that they weren't wanting to take on what they could see as pretty poor quality loans without any protection or guarantee from the Government.

LEWIS: Justin Urquhart Stewart of Seven Investment Management is also with us. Justin, was this the best solution?

URQUHART STEWART: Was it the best solution? Probably, I suspect, probably the only really real solution because of what has happened. In any other circumstances a bank like this in days gone by, we could have had under the old regulatory regime a lifeboat being formed; but after what's happened with Northern Rock and the failure

we've had in that structure, then really I suppose it's the only alternative we've been left with.

LEWIS: Could it have been dealt with earlier though if other action had been taken 6 months ago? Because there have been rumours about Bradford & Bingley which they've always been very swift to quash, I have to say - rumours that they were in difficulty well for a year or more, haven't there?

URQUHART STEWART: Well I think you only have to look at the share price, to actually look at that and to actually see how disastrous that's been - a 90% drop in the share price - and a company which in terms of its business model no-one believed, the management really had not given us much faith in much of their management information they were passing out and seemed to be rather erratic in their behaviour.

LEWIS: Also with us is Gerard Lyons on the phone. He's Chief Economist and Group Head of Global Research at Standard Chartered. Gerard Lyons, can we afford this as a nation - taking on 40 or 50 billion pounds of mortgages?

LYONS: Well it's not an ideal situation, but the reality is that we have to afford it. Obviously this is not the position the Government would like to find itself in, but given all the possibilities, the best shock absorber, shall we say, is for the Government to take it on its books and as a result we will see an increased borrowing requirement. But the reality is that with the economy so weak, the Government's forecast has been blown out of the water. So whilst we can't in an ideal world sort of really take this on, the reality is that given the economic situation that we *have* to afford it and, therefore, I think the Government is doing the right thing.

LEWIS: But isn't this like someone who's completely broke saying, "Oh blow it, I'll just get the credit card out and spend some more"?

LYONS: Well the reality is that we're in a financial crisis. Every financial crisis is different, but the outcome depends on the economic fundamentals, the policy response and confidence. The fundamentals in terms of the falling housing market are

not good. Obviously confidence has been shot to pieces, therefore what we're left with is the need for a policy response. So the Government really can actually afford it in a sense.

LEWIS: (*over*) But is this a policy response? Is this a policy response or a panic response?

LYONS: Well the reality is that the Government will be taking on assets and those assets will fall in price in the near term, but as long as you're not a forced seller then as long as you can hold onto the assets then eventually they will come back up in price. And that's what happens globally whenever we do have government stepping in and taking on these sorts of situations.

LEWIS: But the assets are £40 billion of mortgages. Now, yes, they're assets if people carry on repaying them, but they're rather dodgy some of them, aren't they - self-certification, buy-to-let? They're only good assets if borrowers meet their payments.

LYONS: Yes and that's a similar situation to what's happening in the States. But there is a whole stream of assets. Some of them are not very good quality, as you've said, and they're the big question and it's a judgement issue as to how much the Government should pay for those assets. But some of the assets will be good quality as well.

LEWIS: Jonathan Charley, we've lost four banks - Bradford & Bingley being the latest one. What's this going to do to competition? Are we all going to pay a price in paying more for the services we get from the banks?

CHARLEY: Well clearly there's going to be a lot less choice on the high street for people in terms of loans and in savings products. The banks have for some time been having their margins squeezed because there was good competition in the market, so there will be an opportunity for them to increase their margins and I think we'll have less competitive pricing out there.

LEWIS: And Robert was talking about selling off the deposit business and the branches. Is there really a big value to be put on that? Is that going to be a short-term gain for the Treasury?

CHARLEY: Well I think it's going to be a short-term gain because obviously getting hold of those deposits is going to be great for the other banks, which is going to make them even more competitive. But at the end of the day those mortgages are still going to have to be funded; and if it means they haven't got a retail base, then they're going to have to go to the wholesale market, which means they'll be probably more expensive for us.

LEWIS: And Justin Urquhart Stewart, there are 900 and odd thousand individual shareholders. Many of them got the shares when they first were demutualised. They're going to have big losses, aren't they, and also the staff who took bonuses in shares and bought shares through the Save As You Earn Scheme?

URQUHART STEWART: Yes, the individuals who came in and were actually just going round carpet bagging the shares originally as these companies demutualised, frankly they should have known exactly what they were heading for; so the fact that they've lost so much, well that goes with the risk of actually punting on the market like that. The people I feel particularly sorry for are the staff, ex-staff - as we saw with Northern Rock - who won't necessarily be the most wildly sophisticated of investors and of course who've been given this as part of their retirement and actually have quite a significant proportion of their retirement money tied up in this one stock and they will see it being wiped out.

LEWIS: Okay, well stay with us all of you. We're going now to America because officials there seem to have finalised the details of *their* rescue package. We're going live now to the BBC's North America Editor Justin Webb. Justin, what deal has been done?

WEBB: Well the main section of the deal is the one that we've always been talking about - the \$700 billion bailout of the entire industry, which is largely going to

comprise the Government simply buying up as it were the useless assets, the bad debt; taking it off the balance sheets of those companies that want to take part in the scheme. There is going to be an element as well of insurance where the Government rather than buying up the assets actually provides an insurance policy and the asset remains in the hands of the company, and that's something that the Republicans have been keener on because basically they don't want the Government to own this stuff and in particular they don't want the Government to end up owning large amounts of property around the country if mortgage holders eventually can't repay their mortgages and they're repossessed by the company. So it's a bit of a compromise deal. It's not exactly what the administration want, but the guts of it frankly is what we've been talking about for the last week or so.

LEWIS: And is it going to do anything for those millions of Americans who do fear they *may* face losing their home? I think there were 2 million last year and over 3 million expected this year.

WEBB: What we understand is that there is going to be an agreement. And looking at the wording of it, I can't yet see how certain it is but there is going to be an agreement that the Government takes action - which I can't see entirely specified in the documents I've been wading through - but takes some kind of action to ensure that people are given every opportunity possible to stay in their homes. In other words, when the Government takes over a distressed asset - a mortgage, a useless mortgage - and the poor individual at the end of the road, in the home, is given every opportunity to try to keep paying that mortgage, which obviously suits the Government; but, more importantly for many American politicians, does something to tackle the entire housing mess.

LEWIS: And will these various additional clauses and compromises be enough to get the American voters on side because that's been a big problem? They all seem to be against spending 700 billion and bailing out the banks, as they see it.

WEBB: It's a very difficult one. I mean I think the American voters, if this works in the sense that the markets turn round and over the next few days rebound heavily -

confidence returns; people like Henry Paulson, the Treasury Secretary, say “We’ve dodged a bullet, everything’s going to be okay now” - I think the American people will come round to it. But you’re absolutely right to hint at the fact that at the moment the American people are 100% pretty much against it. It is *enormously* unpopular. I was down in a congressman’s office the other day and they’re getting call after call after call saying, “Do not spend our money on these fat cats” and they’ve got to make the case now to the American people that it isn’t just money for fat cats; it’s money for everyone.

LEWIS: Of course the problem is people can’t vote against it because all parties are in favour of it.

WEBB: (*laughs*) Well some Republicans aren’t and there will be some Republicans, I guarantee this, who go to the floor of the House of Representatives when the vote comes tomorrow, and say, “This is Socialism and we will have nothing to do with it” and they will be diehards. There’ll be hold outs right to the very end.

LEWIS: Justin Webb, thanks very much from Washington. Let’s go live now to New York to talk to Bob Brusca who’s Chief Economist at Fact and Opinion Economics. Bob, how is this emerging news going down in your field rather than with the public, with the people actually involved in these deals?

BRUSCA: Well you know this is not what the financial institutions wanted. The plan, as it was mooted by Paulson and Bernanke, asked for no constraints, asked for no judicial review, asked for Paulson basically to be in charge of everything, and they just wanted to set up these options and have the Government buy these securities from the banks and then let that be the end of it, so ...

LEWIS: So they wanted a real bailout without paying any price?

BRUSCA: Without any ... Totally unlike anything the Fed had done up to this point. The thing that surprised me so much was that Bernanke went along with this hook, line and sinker - partly because the idea of having reverse auctions is a process they

hope will lead to price discovery on these illiquid mortgages. The argument is made that because it's a distressed situation all of these mortgages are really being sold below fair value. They're being sold at what is market value, but the market value is depressed because there are so many of these things for sale and so they're trying to discover a better long-run price. And now, with all of these different covenants put in place, one wonders if the auction process first of all will work; and second of all, you wonder if the needy firms are going to participate. Now you know saying that you need to buy such a huge number of mortgages, looking for \$700 billion, suggests that you have much more than a liquidity problem. Rather you have a solvency problem. But now that you're going to put very stringent terms and conditions on taking these funds, including having a capital position in those firms, you wonder if firms are going to be so eager to participate. So it's going to be very interesting in these next couple of days to see exactly what happens in the US.

LEWIS: And are we going to see any improvement in the way these loans, these bits of paper really is what they are, are valued because we've seen some very strange claims about them, haven't we - that they are worth far more than they really were?

BRUSCA: Yes. Well again whenever you have a fire sale things get sold for less than fair market value, and that's what you have right now. You have this mark to market rule, which means that you have to mark the securities to whatever the market is for them. In the sense everybody has too many of them and nobody really wants to buy them, the price on the market is being depressed. And the argument the Treasury makes is that well you know if we bought them, we could actually afford to pay a higher price and the firms who sold to us would get a better price and we still wouldn't necessarily have overpaid because we're only going to pay the long-run price. But while this sounds nice in theory, in practice one really wonders what's going to happen and certainly a lot of taxpayers are suspicious that this is just going to wind up being a higher price that will go into the banks' pockets and CEOs would wind up having better earnings performance because of this, and pay themselves more money and on and on.

LEWIS: And what do you think will happen on the markets when they open

tomorrow?

BRUSCA: Well you know the markets in some sense are going to like this, but the particular financial firms that might be involved are going to be a difficult play because now it seems that we're under the old model, the Bernanke model where when the Fed intervened bad things happened to the CEOs and the share prices of the firms that participated in these deals. Rather than the new world where nothing bad happens, we're back into that previous world and so that suggests that you know while the rest of the market might like it, financial firms may not fare too well because they're going to be participating in this plan under strictures.

LEWIS: And Jonathan Charley of EDS, is this going to solve the problem for the banks in the United States?

CHARLEY: Well I think that's highly questionable because obviously it really also depends upon the housing market turning round. Now while house prices are continuing to fall, the problem will just be exacerbated still, so I'm not sure that it is the total solution.

LEWIS: I want to look now at the future and how this might pan out because we've looked at what's going to happen, but Jonathan Charley, are the banks going to change? I mean in a sense this all started - it's like the butterfly effect, isn't it - with commission driven selling of rubbish mortgages that should never have been sold and that somehow has infected the whole world? Is the banking system going to look at its whole way of being to try and stop this happening again?

CHARLEY: Well I think in many ways we're going to see the clock being completely turned back to sort of 20, 30 years ago where the banks chose which customers they'd lend to rather than the customers shopping around for deals and choosing which bank they'd go with - so with a lot less choice and probably higher prices. I think we're really going to go back to something we looked at probably 20 to 30 years ago.

LEWIS: And Justin Urquhart Stewart, you did say to us a week or so ago we're going to go back to what you called "Quaker Banking". Is that something you would agree with?

URQUHART STEWART: Yes, it's not necessarily going back to Captain Manner, but it is actually going back to the period where, as we were just saying, qualifying for it, turning up. You won't just get a mortgage. You're going to have to show that you've been a customer for some time, you've got a deposit, you've got a reasonable salary and the ability to pay off this loan in due course. And only then will you qualify to actually get it, so a lot less credit around. And whilst that may seem to be a more reputable way to behave - and I think it is - what it does mean is there's going to be a constriction on credit available to the economy and that could affect growth.

LEWIS: And are we though going to have to see a change, Bob Brusca, in the way the ratings agencies work, the way the regulation work, so that we actually stop this happening again, we stop this alchemy of turning bad debt into good debt by the banks?

BRUSCA: Well the rating agencies have done nothing other than pull a curtain over a bad thing and make it look like it's a good thing, so they have completely failed in what they were doing. These mortgage swaps that they did got more people into trouble. There are all kinds of insurance schemes that just didn't work; and most of our quantitative securities pricing, packaging these things up and using sophisticated securities models, these failed terribly. This is a great failure of quantitative economics and securities pricing on Wall Street. They really thought that they had put risk behind them and, oh, were they were wrong.

LEWIS: We've seen this major event in the States this weekend with this agreement. Is it over, Bob Brusca?

BRUSCA: Well no. The problem is that housing prices continue to fall and in fact the economy may be getting even weaker and the problem in the housing market could

accelerate, and I think it's all the more reason for them to want to get a package together before the economy weakens further. I'm very concerned about the economy here and as long as the economy and housing are declining, you can't stabilise these securities.

LEWIS: And Gerard Lyons, we're talking about the economy. Do you think that this is going to get worse or better now?

LYONS: I think it will get worse. This is a very important step that's taken place in the States and we should all welcome it, but I think we do have further problems to come. In particular the housing market, as has been mentioned, still has further to fall in the States.

LEWIS: But isn't it extraordinary that we can spend \$700 billion in the United States, or promise to spend it; we can spend tens of billions of pounds in the United Kingdom and you all seem to be saying it's going to get worse? Jonathan Charley?

CHARLEY: Well it obviously seems extraordinary, but I think the reality is that house prices and the housing market was so over-inflated ...

LEWIS: Well it was over-inflated because money was too easy. People could buy a much more expensive house than they could really afford, so the prices kept going up.

CHARLEY: And so, therefore, as credit becomes more difficult that's not going to encourage the house prices to go up. If anything, it's going to encourage house prices to go down further?

LEWIS: Justin Urquhart Stewart, is it over?

URQUHART STEWART: Not yet, no. We'll see a rally I suspect tomorrow, as we were hearing earlier, but it's a rally. All we've done with this process is taken the poison out of the wound. Now we have to actually start healing the wound and that's

going to take some time yet.

LEWIS: And do you think there's an appetite for healing the wound?

URQUHART STEWART: That'll only come from the fundamental issue of getting the asset prices, those property prices solid, so that the banks can then trust each other to start lending again. Only when that happens can we start healing.

LEWIS: Jonathan Charley, in a word literally are we going to see another failure?

CHARLEY: I don't think so, not yet.

LEWIS: That was a word. Thank you very much indeed. That's it from this special Sunday evening live Money Box. My thanks to Jonathan Charley of EDS, Justin Urquhart Stewart of Seven Investment Management, Bob Brusca of Fact and Opinion Economics, Gerard Lyons of Standard Chartered.

Now if you tuned in expecting to hear yesterday's Money Box, which is normally repeated at this time, you can still do so either directly on our website or by downloading the podcast. That's all at bbc.co.uk/moneybox and I'm sure we'd like to hear your views of the global crisis and these attempts to solve it this weekend. Vincent Duggleby's here tomorrow with Money Box Live, this week taking your questions on student finance. I'm back, perhaps as normal, next weekend. Producing this Sunday was Martin Bedford, the editor of Money Box is Stephen Chilcott, and I'm Paul Lewis.