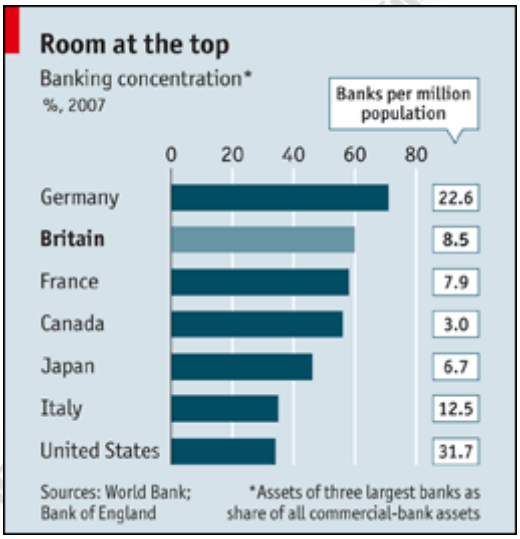
Chipped, not broken

The latest chapter in the banking rescue is less novel than it seems.

JUST over a year ago, as Britain's banking system suffered a near-death experience, the government resuscitated it with an emergency infusion of capital. This week Alistair Darling pumped in yet more money, leading to accusations that policy failures had brought about another big bail-out. The chancellor of the exchequer, for his part, made much of moves to create a more competitive banking market, forcing the two big banks that have gobbled up state aid—Royal Bank of Scotland (RBS) and Lloyds Banking Group (LBG)—to pay for it by shedding branches and customers.

In fact, this latest chapter in the banking rescue is neither a new bail-out nor the dawn of a new competitive era. The government's sudden interest in opening up the market was in any case the result of pressure from Europe (see article). And despite much hoopla before this week's announcement about breaking up the banks, it amounted to precious little.

Even at the start of the financial crisis, Britain's banking market was concentrated by international standards (see chart). But that crisis spawned a merger of a size that would have been laughed out of court in normal times. Lloyds, a relatively sound bank, was allowed to take over a teetering HBOS, in an attempt to avoid the public rescue of a bank that was close to collapse because of poor lending decisions and inadequate funding.



That attempt was futile and the joint concern swiftly ended up a ward of the state, reliant on taxpayer support. But it created a behemoth in retail banking, with market shares of around 30% in both current accounts and mortgage lending. Small wonder that the Office of Fair Trading, a competition watchdog, gave warning that the merger would result in a "substantial lessening of competition" in both areas. Gordon Brown's desperate government, however, chose to waive the rules.

Now LBG will have its wings clipped a bit, but only thanks to intervention from Neelie Kroes, the European Union's competition commissioner. Ms Kroes is getting tough with European banks that have received state aid and insisting that they pay their pound of flesh for it. The price for LBG is getting rid of at least 600 branches and its online business, Intelligent Finance. Its share of the personal current-account and mortgage market will fall by around five percentage points.

RBS is also to be punished for putting out the begging bowl. It will have to shed over 300 branches, almost all of them in England. The bank expects that its share of the personal

current-account market will decline as a result by two percentage points, and that its grip on the small and midsized business market will fall by five percentage points. RBS must also sell its insurance operations and its stake in a profitable commodities trader.

Lloyds and RBS have four years to divest the businesses, and existing big banks in Britain will not be allowed to buy the banking assets. But the changes are on a smallish scale and over a longish period. They will encourage competition, but from a starting-point made far worse by the government's mistake in waving through Lloyds's takeover of HBOS. And banking will remain highly concentrated.

Working through old woes

But if ministers' claims about enhancing competition were exaggerated, so too were opponents' jeers that the Treasury was presiding over another bail-out, for that had already occurred earlier this year. In January it was becoming clear that last year's rescue had not done enough to quell fears about the two banks, even though £20 billion ($33 billion) of capital had been injected into RBS and £17 billion into what was to become LBG, resulting in government stakes of 70% and 43% respectively.

The Treasury decided then to prop up the banks through an insurance policy called the Asset Protection Scheme (APS). The scale of coverage in this second bail-out was staggering. Altogether, taxpayers underwrote £585 billion of dodgy assets, of which RBS accounted for £325 billion and LBG for £260 billion. The two banks were to pay the first slice of any new losses, but would then have to contribute only 10% of subsequent ones, the remaining 90% being shouldered by taxpayers.

Although the broad outline of the scheme was announced in February for RBS and in March for LBG, neither bank formally joined it, as fiercely detailed negotiations ensued. Now Lloyds will slip out of the APS altogether, taking advantage of healthier markets to shore up its core capital by £21 billion, £13.5 billion of it through a massive rights issue. The government will put an additional £5.7 billion into Lloyds, in line with its 43% share in the bank. But the net cost will be just £3.2 billion, as LBG will pay £2.5 billion for the implicit protection it has enjoyed under the APS since March.

Lloyds's escape from the scheme reduces the amount covered by the APS by £260 billion. In contrast, RBS will stay in it, but the APS will cover £282 billion of its assets rather than £325 billion. Moreover, the bank will now have to pick up the bill for up to £38.7 billion of any new losses, rather than the £19.5 billion originally agreed.

If that sounds a better deal for taxpayers, the fact that RBS will receive a further capital injection of £25.5 billion does not. But, of this amount, £19 billion had already been planned in February and the remaining £6.5 billion—an insurance fee from RBS for APS coverage—was in effect going to be shouldered by the taxpayer too since the bank was in no shape to pay it. What is new is that the government will also make available an £8 billion line of "contingent" capital for RBS, just in case things should turn very sour indeed.

Excluding that £8 billion, the revised cost of bailing out both banks comes to £28.7 billion. Most of that had already been budgeted for earlier this year. Since the total coverage of the APS has been halved and its terms stiffened, Mr Darling had good grounds for claiming to MPs on November 3rd that "the likely cost to the taxpayer and the risks faced by the public finances have reduced markedly."

Auditoria cidadã da dívida — versão para não subscritores

After so much genuine drama in banking over the past two years, the commotion about this week's announcements was contrived. Now for the real task: creating long-lasting stability in the financial system by tightening regulation and increasing capital for all banks.

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