

Sir John Gieve, Bank of England

BANKS ON THE BRINK
Interview of BBC business editor Robert Peston with
Sir John Gieve , deputy governor of the Bank of England, financial stability

Q: John, if we go back to this momentous event, the collapse of Lehman Brothers in September, what was the impact of that on financial markets?

GIEVE: Well it was, it was huge, it was a huge shock because before that I think the markets had become accustomed to the idea that the authorities both, on both sides of the Atlantic were going to push liquidity out to the markets, to give most banks a chance to have the time to adjust, and that the failures would be caught, would be rescued or would be handled, managed, managed into resolution and Lehman's destroyed that confidence because here was one of the biggest banks in the world really being forced into bankruptcy.

Q: And so having allowed, Hank Paulson the US treasury secretary having allowed Lehman to collapse, what then did that do to the banking system?

GIEVE: Well I ran the weekend and of course we knew it was going to be a huge shock so events moved very quickly. I mean we started worrying particularly about the banks in Britain which would be put in the spotlight, particularly the ex-building societies, Bradford & Bingley and HBOS. They'd, they'd had a difficult summer, they'd seen share price difficulties around the rights issues and it was pretty clear that as people looked around, as – well who could be next – they were going to be in the searchlight.

Now on HBOS things moved extremely quickly and later that week we, we had the bid from Lloyds and the agreement that that should go ahead. In America it moved even quicker than that. I mean they, they'd already arranged a merger for Merrill's but the next day I think they had to rescue AIG and within the week they had to announce a comprehensive \$700 billion programme for the rest of the banking sector.

Q: Now these money managers were pulling their funds out of any bank perceived to be vulnerable. Really huge well known names were having tremendous difficulty keeping afloat funding themselves. How far did that you know, how close to collapse do you think several banks came over this period, and indeed how close did we come to collapse of the banking system?

GIEVE: Well I think we came right to, right to the brink. I mean it wasn't immediately clear on the Monday how serious it would be but – and initially we continued the policy of providing liquidity and we made various announcements to make that easier, to help banks

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and dealing with if you like the casualties, HBOS and Bradford & Bingley in particular.

But actually over, over the ten days after Lehmans failed, it became increasingly obvious that something more comprehensive was going to be needed because confidence was draining out of the system and although banks could cover their, their balance sheets, they were having to rely more and more on overnight funding so you got this snowballing effect of overnight funding which of course is, is highly vulnerable to a shock.

Q: I was talking to a big bank yesterday actually and they were saying to me it was extraordinary, their department, their treasury department which you know exists basically to get them the funds they need on a daily basis, I mean every night the sums of money they had to raise just to keep going for the next day got bigger and bigger. I mean quite, I mean you know the chap I was talking to just said that they'd never experienced anything, anything like it. How many banks do you think in the UK were in this position? Were they broadly all in this position of, of just seeing you know long, the availability of long-term funds just drain away?

GIEVE: Well I mean each bank is, is different and some of the banks were benefiting from this. They were attracting, they were seen as the safe havens and they were getting an inflow of deposits and their problem was what do we do with this money we don't need? And they started looking to deposit it with central banks in fact.

But several of our large banks, and I mean I don't want to go into names, were, were in real difficulty and you know were having hour by hour minute by minute to balance the books at the end of the day, and obviously we were talking very closely but it wasn't just happening here. It was happening in the States, it was happening in Europe and this time you'd seen Fortes fail, you'd seen Dexia fail, you'd seen Hypobank fail. I mean this was a genuine global loss of confidence and a seizure really in the money markets.

Q: The governor has said this was the worst banking crisis we've seen since the outbreak of the First World War. What does he mean by that?

GIEVE: Well he, he means that you have to go that, back that far to see such a loss of confidence in your core banks at the centre of the system, and obviously there have been more dramatic and damaging recessions and so on in the 30s but he's the economic historian and he says even in the 30s, certainly in this country, there wasn't that degree of loss of confidence in core central banking, banking institutions.

Q: And what would it have meant frankly if a few of these banks had collapsed, what would that have meant?

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GIEVE: Well it would have meant chaos in, in all sorts of ways. I mean millions of people hold their funds with these banks, millions of firms depend on them not just for loans but to process their payments and receipts, and the thought of trying to disentangle that on such a scale is very daunting. Obviously we've, we've tried to do it with some banks and I think first of all with Northern Rock but this year again with Bradford & Bingley for example and we've, we've used powers with the FSA and the treasury to do that in as clean a way as we can.

But you saw with Lehmans, the collapse of a real household name has a knock-on effect to everyone else so I say that one or two banks may have seen in the front line but if those banks had gone then I think you'd have seen a loss of confidence in even the biggest and soundest banks in the world.

Q: Because apart from anything else, you know if one of the big banks goes down the other banks are exposed to it. They've got, you know they all lend to each other. It would have been inconceivable that a big bank could go down and then not damage other banks you know possibly fatally.

GIEVE: Well you know the truth is we would have to have stepped in, the state would have to have stepped in and probably nationalised as they did in the case of Northern Rock but we will, you know what we try to do instead was to come up with a package which would provide the capital, the funding, support which would allow them to work, work out and work through this crisis in, in, in a commercial way.

Q: Was there a moment when in a sense the penny dropped and it became clear that a comprehensive rescue package for the system was required?

GIEVE: For the – when Lehmans failed, immediately after that weekend, it became clear that the odds on a sort of system-wide failure had increased and certainly in the bank we started to think about it. I know they did in the treasury and the FSA as well, and we started to talk together about what a system-wide package would look like. So if you like the contingency planning started then.

When did it become plain that, that there was no alternative? I think in the week before we announced it. I mean initially if you remember Hank Paulson announced his 700 billion and that had an initial effect of you know in the epicentre of this crisis, of calming things, but then the impact of that began to unwind and we saw continuing loss of confidence in, in money markets. So it was probably the week after Lehmans that what had been a contingency plan turned into the main plan.

Q: Yeah absolutely. Do you think in retrospect it was a mistake on the part of the US treasury to allow Lehman to fail?

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- GIEVE: Well I don't, I don't want to be critical because you take these decisions, they had to take the decision under huge time pressure. This wasn't a proper bank so some of the legal powers that exist in the United States for banks, this was an investment securities dealer so there were all sorts of complications. I do think that they, that they didn't foresee what an impact it would have.
- Q: Now when did the contingency of this rescue become a reality? What was it that then you know brought you all together, Bank of England, FSA and the treasury, to actually implement this?
- GIEVE: Well as I say, the, I mean the meetings started in the week after Lehmans. There was a tremendous amount of activity around HBOS, around Bradford & Bingley, around other banks who were facing real difficulties in the market on a sort of bilateral basis but the tripartite, the three authorities were talking about what, what was the next step, what would we have to do to tackle the system-wide crisis really from then on. So I guess that's about two weeks.
- Q: Was there a trigger, was there something that suddenly happened? Was there you know –
- GIEVE: No I think it was the progressive deterioration in money markets and the fact that you know we'd announced or they'd announced the merger between HBOS and Lloyds and yet the markets weren't, weren't beginning to flow. In fact they were getting tighter and tighter.
- Q: I mean I suppose what I found profoundly shocking at the time was the difficulty that an enormous bank, Royal Bank of Scotland, was having in rolling over its short-term funding. I mean that seemed to me at the time to be momentous.
- GIEVE: Well absolutely, and you know it, it always rolls a large amount of funding but normally this is routine. You know you've got it arranged pretty much by the middle of the day. There's no panic about it but as I say, it became a nail-biting business right up until the end of the day and obviously we were talking to them on, on a daily basis.
- So that was one factor but it wasn't just RBS. I mean remember what was happening in the States, what was happening in, in Europe as well. You could see that the banks were falling over.
- Q: No totally and of course HBOS was in a very similar position before the merger with – the takeover proposal was announced by Lloyds TSB. Now, you came together with the banks over the weekend to in a sense allocate the capital and to you know negotiate who would get what as it were. Give me a flavour of what those negotiations were like with the treasury, with the FSA, with the banks.

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GIEVE: Well the – we made the announcement of the plan, the availability of capital and so on on the Wednesday. What became very clear on the Thursday and Friday was that the, we needed to get on with it. You know we'd offered the cash. We needed to actually get it out there and RBS quite honestly was, was the, the leading candidate but we were also clear that if you just dealt with one, you'd leave the others in a rather exposed position, you know the caravan would move on and the searchlight would pick out Lloyds and HBOS and even Barclays.

And so really Friday and Saturday we began to get, and the treasury in the lead on this but again I thin it was a joint effort with the FSA and the Bank, we began to sort of line people up in different rooms on different floors for a series of meetings, and it was an extraordinary, it was an extraordinary weekend. There wasn't that much negotiation because someone described it as more a drive-by shooting.

Q: Yes Fred Godwin, the famous phrase, the negotiation was a drive-by shooting.

GIEVE: And that, you know it had to be like that. There was very little time. The government was announcing the terms on which it was prepared to come in and the banks had to think about it but they broadly had to accept it.

Q: As I understand it Peter Goodham, his famous phrase about the drive-by shooting, what he meant was banks were told we've done the sums, this is the capital you need. Is that broadly you know how it happened? I mean that's certainly what he's been saying.

GIEVE: Yes that, that, that, that's right. We had done some sums and between us we'd, we'd come up with what we thought was necessary and really there was only one provider. Now, for Barclays they were, they chose a different route. They thought they, that they were given the number and they, they said no we can raise this ourselves on the market so they took a different route to the other three.

Q: Do you yourself think that it was a good thing or a bad thing that Barclays decided to go its own way on this?

GIEVE: I don't want to get into commenting on individual bank strategies. They – they have been able to raise the money and I mean it's not been easy for them but they've done it and I'm pleased they've done it and you know what matters now is how they use it and what the implications are for the economy.

Q: And if you look at the whole package, there are these guarantees for the sale of debt by banks to help them raise more funds. There's the extension of the Bank of England's scheme for swapping mortgage assets for treasury bills. It's a package isn't it? Is it, is it possible to say that one element of the package is

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more important than the others or does it, is it something that as a whole you know you have to see to understand you know the point of it?

GIEVE: Well I think you needed all three parts. I mean the liquidity we'd started much earlier at the beginning of the year but we expanded that, so that's just trying to make sure that enough liquidity in the markets for banks to catch their breath and not concentrate at the end of each day. Then the guaranteed funding I think was a key part but so was the capital.

The point of the capital is that as we move into a downturn, banks will take losses. They will, some loans will go into arrears and what's more, the weight in the risk weighted system of capital requirements will increase, and so naturally at a time of recession these, these ratios tend to fall and what we wanted to make sure was that they, we bumped those up, the starting point up far enough so that there was plenty of room for them to fall before they got to any sort of critical level, and therefore that banks could continue to operate on the normal way giving credit to good propositions and didn't have to just concentrate on conserving capital.

Q: Do you think that this package has now achieved certainly its primary purpose of making it close to impossible that any big bank will now fail?

GIEVE: Well I think it achieved its first purpose which was to stop a really damaging downward spiral, and it did, if you look at the markets, it did restore confidence in the banks. I think it did that firstly because it was a good package and actually it's now been copied in most of the rest of the world. It did provide reassurance there was money on the table and I think it's been very important that we didn't just announce it but actually taken action, money has been raised.

But it was also of course a signal as to the authorities' approach and you know if necessary we have to stand ready to put in more capital and, and, and people are confident that we will.

Q: I mean there are some people who say that if we really want the banks to start lending not as they did in 2007 which some would say was you know a period of excess but just in a, you know more normal kind of way that'll support the economy, that more capital will have to go in. Do you agree with that?

GIEVE: Well the banks do have to rebalance their balance sheets. They, several of them became too dependent on wholesale funding, short-term wholesale funding so some rebalancing is required. What matters from an economy point of view is how quickly it happens. If everyone tries to do it instantly – you'll get such a squeeze on credit that that will, that will force the economy down unnecessarily.

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So what we need to do is to give them the time and space in which to do this rebalancing, and of course with time then they will make profits and those, that, those too can contribute to the process. So I see our task at the moment as trying to provide enough time and space for them to rebalance their balance sheets over a period of some years while still lending to good propositions, and what matters – we don't want to go back to the sort of lending that excessive lending we may have seen a few years ago but we do want firms who have good businesses to be able to raise reasonable money on normal terms in order to keep their businesses going.

Q: How pessimistic are you that we are seeing banks withdrawing credit from good business prospects and consumers who are perfectly credit worthy? How worried are you about 2009 being worse than it needs to be because there just isn't enough credit in the system?

GIEVE: Well obviously the credit squeeze which is, is real and has been real now for a year is a major factor in the economy and that's what we're trying to address through interest rates, through the government's fiscal package, through the recapitalisation package and we have to stand ready to do, to do more than that.

I think what's happening to banks is a mixed picture at the moment. Some are still lending, are still expanding their lending. Some are expanding it where they have to because they've got contractual commitments to provide overdrafts or committed facilities but are tightening up where they've got some discretion and others are just trying to hold their balance sheets flat so it's a mixed picture and I see this new lending panel as having a major role in really going below the aggregate figures and getting a good understanding of what's going on.

Q: I mean you've worked in the treasury for many years, been deputy governor here for a few. Now to what extent do you feel slightly powerless to deal with these problems given that the institutions you're dealing with, the banks, are global? And I mean just take one example, if you force banks to provide you know – not talking about the government forcing but you know banks to provide credit to a particular sector like small business, well reality is if they do that, chances are the banks will then provide less credit elsewhere, might be in the UK, might be outside the UK but in a sense highlights that a national central bank or a national regulator is quite constrained in what it can do in this kind of global crisis. Do you feel, do you think, do you get a sense of feeling in a sense much more powerless than you've ever felt before, or somebody holding your position would have felt before?

GIEVE: Well one thing I do agree about is that this is definitely a global crisis. Its roots are in the imbalances that grew up in the early part of this century. It's affecting the whole economy, we've got a

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recession now in Europe, America, Britain and a downturn right across the world, and so to that extent of course we can't be impervious to what's going on especially an open economy like Britain.

Does that mean we're powerless? No, I mean there are lots of things we can do and we're doing them. We're – and those, those things can have an effect. Interest rates, certainly margins have widened so we need to take that into account in setting our interest rates and that's why we've reduced interest rates by two percentage points over the last two months. You've seen the government announce a major fiscal package just this last week. The recapitalisation of the banks is another extraordinary step.

These are things we can do and I, I mean obviously there are downside risks. That's why we're doing it but there are certainly effective instruments.

Q: If we can just get back to the origin of all this, you know you've described it as, you know a lot of our problems as being due to this credit squeeze and the credit squeeze followed a credit bubble and my view would certainly be that you know, the biggest cause of the mess we're in was indeed the pricking of that bubble. How do you think it is that for example the Bank of England was unable in the run-up to August of 2007 when we first saw this squeeze take hold, was unable to prevent that bubble expanding to the extent that it did and ultimately causing all the damage that it's done?

GIEVE: Well first of all we did, we did see something coming. We did spot the global imbalances, we worried about them. We did spot some crazy borrowing going on, asset prices looking unsustainable and we said actually for a couple of years before the crash that a correction was coming.

Q: But you didn't, you didn't stop some of this crazy lending.

GIEVE: We, but we didn't think it was going to be anything like as, as severe as it's turned out to be. I mean two, two questions you asked there. Why, why didn't we see that it was so serious? I think that's because we, perhaps we hadn't kept pace with, with the extent of globalisation so the, the upswing here didn't involve the big increases in earnings and consumption and activity which we saw in previous booms.

We saw the credit, we saw the house prices but we did see a fairly stable pattern of earnings prices and output. And I think that one of the main lessons from this is that we, we need to develop some new instruments which sit somewhere between interest rates which affect the whole economy and activity, and individual supervision and regulation of individual banks, and maybe we, we need to develop something which bridges that gap and directly

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addresses the financial cycle and prevents the financial cycle and the credit cycle getting out of hand.

Q: And so what you're saying here is we need to find tools to prevent banks and other lenders lending too much?

GIEVE: Yes, what we've seen in the last year is that the financial cycle has got too big and it's having real economic effect, even at a time when as I say in many ways the economy has been through quite a well behaved period of, of steady growth and steady consumer inflation.

So what I want is, precisely is a policy instrument and there are various being discussed at the moment here and elsewhere, is, is an instrument which affects, makes it expensive for banks to expand rapidly in the upswing and also provides them with a bit more of a cushion in the down swing so they're not so badly affected.

Q: But it is odd, I mean I, your financial stability reports are always excellent as an analysis of what's going wrong and I remember reading them in the run-up to the, you know the crisis that began in the summer of 2007 and you were saying you know banks are lending too much money too cheaply. And you could understand that for most people, there's something slightly odd about the Bank of England saying this is a big problem and yet seeming to be powerless to do anything about it. It does seem a bit odd.

GIEVE: Well the, you're covering two points here. We had two instruments really at that point. One was interest rates and the other was persuasion, and on the interest rates side we, we did put interest rates up and we did expect there to be a downturn in the economy and the question is well why didn't you do it more fiercely earlier?

And I think the answer to that is if we'd used interest rates to try and address this asset price credit growth, we would have been holding down the level of activity elsewhere in the economy, in manufacturing, in other services, holding down the level of employment at a time when consumer price inflation and earnings were, were stable and reasonably low, and, and people would have said you know this is a wilful reduction in the prosperity of the country.

Now that's why I think we need to complement interest rates which are a blunt instrument - you set one interest rate for the whole economy - with something which is more financial sector specific. But you know this is a major, a major storm we haven't seen the like of for a hundred years. It would be very surprising if we weren't learning some lessons from it, and we are.

Q: No no, absolutely, but are the days gone really where there's any, I mean I remember when I was first a journalist, you know the

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governor of the Bank of England was this sort of remote incredibly fierce figure and there was absolutely no doubt that the people who ran the banks in this country you know, if the governor said I'd like this to happen, chances are it would happen.

Now this is not a sort of personal criticism of you know, you know Mervin or you but is it just that in a globalised world banks are, no longer feel sort of British in the sense that they did back then and that somehow therefore it's just impossible for any figure whether it's the chancellor or the governor or the head of the FSA to have the kind of authority over banks that if he says don't behave in this way, you know it just doesn't carry the weight that it did. Is that an issue?

GIEVE: Well I mean I think the days of the club in which the bank governor acted as club chairman and got the guys together and they all agreed – I mean those have actually long gone and I don't think it is possible to recreate that. London is a big international centre, as you say, some, even some of our big domestic lenders are now owned abroad and of course the biggest lending bubble in all this was not here. It was in sub-prime related assets from the US.

So difficult for us to sort of seize control of that market if it's not happening in the States, so I mean we're not powerless but we have to have more explicit and more formal use of powers perhaps than in the old club, club rules days.

Q: No I can absolutely, absolutely see that. And – if we now look out to you know 2012, 2013 when we hope we're sort of through the adjustment process, what do you think our banks, the City of London will look like then?

GIEVE: Well obviously the priority for the moment is, is, is to get the banking system working properly again doing the lending that it, you know the economy needs it to do but on a stable basis with full confidence and that's what we're concentrating on at the moment, quite difficult to see how this is all going to work through and if I look back to my predictions you know five years ago, I'm not sure I would have foreseen this.

So – but let's have a go. I think that actually these have been years, the last ten years have been years of great success in the world economy. We've seen tremendous growth, the opening up of new markets in China and India, and a real growth in the living standards of millions and millions of people, and we should – so in a sense what we're seeing is a very successful period for the world economy but an unbalanced period and what we're experiencing now is a very painful and severe rebalancing.

But I hope that we can get back onto the course that we, of growth worldwide that we've seen over those ten years. I am not a pessimist in the long term. I think that the possibility of China and India continuing to catch up in living standards with the west is a

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real one and one we should go for so I'm – now in a world that's growing rapidly, I think there are still going to be powerful forces building up the financial hubs in that global economy and I expect London to be one of those.

So long-term, I'm optimistic. Short-term, we've got a tremendous job to do to get things back on the rails.

Q: And if as seems likely the banks pull out of some of the more speculative activities, some of the kind of innovation that led them to completely misunderstand the kind of risks that they were running, if that bit of now looks like not just froth but you know rather toxic froth as it were is swept away, how much smaller will the City be as a result of that, because I mean that was a big chunk of what the City did?

GIEVE: Well I think there are two, two points there. First of all I think banks will be more cautious and rightly so, and we'll see perhaps more correspondence between deposit growth and lending growth. As far as the City is concerned, absolutely, we're going to see, we've seen the last of the CDO square I suspect and the structured credit markets are going to look very very different and much smaller, I've no doubt about that.

But really London's success depends on whether or not the world economy is growing and whether the international banking world is growing, so it will prosper if the world economy prospers.

Q: And just to go back to that package that rescued the banking system, at the moment something like £600 billion of taxpayers' money committed in the form of either loans or guarantees or indeed in the form of capital. That may rise given the kind of things that the treasury is now looking at to help out particular sectors. How long do you think it'll be before taxpayers are in a sense free of this burden, taxpayers get their money back again?

GIEVE: Well as you said, this is a commitment. It's, it's loans, it's equity, it's an investment of a sort and whether the taxpayer finally picks up a big bill or actually makes a profit, we've yet to, yet to see. But I mean this is going to take a period of years.

As you know our special liquidity scheme offers funding for up to three years and that runs out in the first part of next year so we, we imagine that that will then run down over a period of three years and I, I would expect the same is true about the guaranteed funding. As for the equity stakes, we'll have to see how quickly the, the equity markets recover for banking stocks.

Q: Do you think, your best bet, taxpayers will get their money back?

GIEVE: Well I think it'll be a mixed picture. I mean I think the, the – there are some books, Northern Rock, Bradford & Bingley, which the taxpayer's now holding which clearly have a level of defaults in

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them, not quite sure how that will balance out against the residual of the capital. As for the more mainstream banks, yes I think they've got a commercial future and I'm sure that in time they will, as for example the Swedish banks have after their crisis, revive and start building and growing as commercial entities again.

Q: The drive-by shooting thing, were you in the room when Fred said that?

GIEVE: Yeah.

Q: You couldn't just describe that scene in that room?

So what was, all the bank chief executives were round the table were they?

GIEVE: No no no, this was, this was, this was a discussion with RBS.

Q: Oh just RBS on their own.

GIEVE: So I mean this was the –

Q: It was you and what –

GIEVE: Yes it was, it was Hector was there, I was there, I think probably Tom Scholar and John Kingman from the treasury were there, and we were, it was a bit after we'd announced the terms and the numbers and there was a bit of discussion about, about you know how exactly was it going to be twenty billion or could it be a little bit less or something and we were saying no, I think twenty billion's the right number.

And someone referred to the negotiation and Fred said you know I thought very cruelly, it's more a drive-by shooting than a negotiation. And – yeah I did remember that.

Q: Is there anything else of that sort that sort of stands out?

GIEVE: Well the – the – nothing terribly funny I'm afraid. I suppose the other episode which I could say is a little before the package was agreed when the treasury had put together a team of investment bankers and we and the FSA were there sort of talking about the terms of the credit guarantee scheme, and got a call saying well you've got to come back to the bank because there's a crisis in X bank, you know and you know we've got to sort that out.

That captured something of the, of the drama of those days you know, serious decisions on future policy and taxpayers' money at one end of town and bailing out, keeping people afloat in the interim back at this end of town.

Q: Would that have been Bradford & Bingley at that stage?

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GIEVE: No I'm not going to tell you who it was.

[...]

GIEVE: I mean the treasury were leading and we were their sort of outlyers, sort of Hector obviously as regulator and me as you know pushing the numbers up.