PRICE**VALUE**PARTNERS

Things that go bust in the night

"At the end of [Sir Fred Goodwin's] presentation, there was someone with their hand thrust up very enthusiastically, and he was looking at his BlackBerry as he spoke, and he said, 'Sir Fred, if the opportunities available to you are so exciting and if everything is going so well at the bank, why has the share price fallen 35% since you started speaking ?'"

- Manus Costello on RBS' finest hour, in *The Bank That Almost Broke Britain*, BBC2, 2 October 2018.

The great festival of failed finance anniversaries continues. We've had the commemoration of the bankruptcies of Lehman Brothers and Long Term Capital Management (20 years in the case of the latter), so it was inevitable that a 10 year remembrance of the near-extinction of RBS would pop up just in time for Halloween.

The definitive backstory of RBS has been wonderfully told by John Lanchester for the *London Review of Books.* Here are some highlights:

> During the 17th century, Scottish investors had noticed with envy the gigantic profits being made in trade with Asia and Africa by the English charter companies, especially the East India Company. They decided that they wanted a piece of the action and in 1694 set up the Company of Scotland, which in 1695 was granted a monopoly of Scottish trade with Africa, Asia and the Americas. The Company then bet its shirt on a new colony in Darien – that's Panama to us – and lost. The resulting crash is estimated to have wiped out a quarter of the liquid assets in the country, and was a powerful force in impelling Scotland towards the 1707 Act of Union with its larger and better capitalised neighbour to the south. The Act of Union offered compensation to shareholders who had been cleaned out by the collapse of the Company; a body called the Equivalent Society was set up to look after their interests. It was the Equivalent Society, renamed the Equivalent Company, which a couple of decades later decided to move into banking, and was incorporated as the Royal Bank of Scotland. In other words, RBS had its origins in a failed speculation, a bail-out, and a financial crash so big it helped destroy Scotland's status as a separate nation..
>
> About twenty years ago I bumped into Alan Hollinghurst at a party at the Poetry Society. He greeted me with the words, 'Hello. I'm going to tremendous, Basil Fawltyish lengths to avoid being introduced to Sir Stephen Spender,' whose collected poems he had just given an unglowing review. 'Tremendous, Basil Fawltyish lengths': that phrase stuck with me. It comes to mind when I look at Anglo-Saxon attempts to

address the crises in their respective financial sectors. The UK and US plans are different, as I've said, but at their heart they both show the governments going to tremendous, Basil Fawltyish lengths in order to avoid taking the troubled banks into public ownership. Our governments are prepared to pay for them, but not to take them over.

There are four reasons for the reluctance to take over the banks, of which the first isn't a real reason but a piece of political bullshit.

1. Because the government would be bad at it. This is the only reason governments are willing to give in public, and it fails the most elementary test of all: only a professional politician can say it with a straight face. Bad at running the banks, compared to the bankers who broke capitalism? Please. But this is the closest they can get to admitting the first real reason, which is:

2. Because if the banks were taken over, then every decision they take would come at a potential political cost to the government. Your state-owned mortgage lender is threatening to repossess your house, after you fell behind on the payments? Blame the government. Your firm is laying off half its workforce because the bank won't roll over its loan? Blame the government. This, of course, is in addition to all the other economic things for which people are already blaming the government. People are grumbling now, but to nothing like the extent they would if the banks were directly owned by the state. Politicians simply aren't willing to take on the responsibility for the banks' actions.

3. They also don't want to admit the extent to which we are all now liable for the losses made by the banks. Guess what, though: it's too late. The 30 per cent collapse in the value of sterling over the last months is something which is only just beginning to be noticed by the public at large; but it is unlikely to go away as quickly as it arrived [it's almost as if not all sterling crises happen as a result of referenda to leave the EU]. The reason sterling has crashed is simple: the markets are pricing in the fact that we the taxpayer are on the hook for the losses made by our banks. The markets assume that we can't or won't default on our government debts – that would mean we simply can't afford to pay back the amount we're currently borrowing. They're probably right about that. But Alistair Darling's desperately grim Budget made it clear just how deep in the mire we are. As for how bad it is, and how quickly it's gone bad, well: in March last year, at the time of the Budget, the projected deficit for 2009-10 was £38 billion. By 24 November, the projected deficit was £118 billion. In the Budget on 22 April, Darling admitted that the real figure is going to be £175 billion. The total projected borrowing for the next four years is £606 billion. National debt will hit 79 per cent of GDP – the highest peacetime figure ever. The economy is going to have its worst year since 1945. The debt is going to cost in the range of £35 to £47 billion a year to service. That's just the debt alone; we're going to be spending more on debt than we are on the entire transport budget. Perhaps New Labour might consider changing its motto from 'Education, education, education' to 'Debt, debt, debt'..

4. Because it would be so embarrassing. Some of the embarrassment is superficial: on the not-remembering-somebody's-name-at-a-social-occasion level. The Anglo-Saxon economies have had decades of boom mixed with what now seem, in retrospect, smallish periods of downturn. During that they/we have shamelessly lectured the rest

> of the world on how they should be running their economies. We've gloated at the French fear of debt, laughed at the Germans' 19th-century emphasis on manufacturing, told the Japanese that they can't expect to get over their 'lost decade' until they kill their zombie banks, and so on. It's embarrassing to be in a worse condition than all of them..

To hear Jeremy Corbyn in the full pomp of his 'greed is good'-bashing anti-capitalist Labour conference messiah worship you could be forgiven for thinking that the RBS debacle and associated banking crisis took place during a Conservative administration – as opposed to after 14 years of a Labour one.

As it happens, the Great Banking Bailout of 2008 may never have been required, due to a technical issue of which few at the time were even aware. All that talk of ATMs failing to work may just have been nonsense. As we asked in *Investing Through the Looking Glass*:

> Why did the UK government feel obligated to bail out Britain's banks? The cost to the country was immense: underwriting the banks' losses drove the UK national debt from 60% of GDP to 150% of GDP. One answer is that the government felt an obligation to maintain the integrity of the UK inter-bank payments system. But the payments system was already largely ring-fenced from the banks themselves. As the author and investment strategist Guy Fraser-Sampson points out, both BACS and CHAPS, the two main forms of customer to customer bank transfers within the UK, operate outside the banking system as non-profit subsidiaries of the Bank of England. It can hardly be beyond the wit of man to separate the ATM network and remaining payment systems from the banks, provided the political will exists. For as long as the payment systems remain in the hands of the banks, they can hold government to ransom any time they like.
>
> If inter-bank payment systems could be separated from the banks themselves, there would be barely any need for bank regulation whatsoever. In an environment where banks can fail without damaging society, their capital adequacy suddenly becomes markedly less relevant. Banks could operate like any other commercial firm, with directors assessing how much risk they wish to embrace in the normal operation of their business. A failing bank could then be placed into administration or liquidation and undergo the same insolvency process as any other type of business.

But as we all know, that is not how it went down.

Never let a good crisis go to waste, they say. Well, somebody sure flunked that one. The tragedy of 2008 is that by failing to grasp the nettle of an overextended banking sector and by refusing to replace banks' senior management or allow the free market to inflict the appropriate penalties on creditors and shareholders, western governments allowed a mindset to become established in the public – not entirely undeservedly – that crony capitalism was walking abroad through the chancelleries of all the "developed" economies. Such austerity measures as were brought in haphazardly to right the fiscal ship disproportionately impacted on the poor. QE and most notably ZIRP undoubtedly disproportionately boosted the fortunes of the already rich at the expense of those without meaningful assets to begin with. By artificially inflating the value of property, ZIRP did more than any other policy response to the financial crisis to drive an explicit wedge between the asset-rich and the asset-poor, and to exacerbate genuine as opposed to socialistically presumed and therefore bogus wealth inequality. Trample on people's prospects to improve their lot and their quality of life and

they tend to get righteously angry, and vote accordingly – not out of logic, but out of confected passion stoked by disingenuous but highly convincing politicians.

10 years on, British voters have been, over the last two weeks, treated to two markedly different visions of our economic future. One of them effectively continues socialism's long march through the institutions, and it will likely lead to an economic train wreck and a currency crisis if implemented. The other offers random, piecemeal titbits towards improving people's lives, like allowing restaurant staff to keep more of their tips. But, Boris Johnson's efforts perhaps aside, there has been no grand, socially-unifying vision that reiterates the enormous benefits of free enterprise culture and lightly regulated free market capitalism – the one thing that has improved the lives of more numbers of millions throughout the world than anything else in history. What a disgrace. What a stunning opportunity lost.

www.pricevaluepartners.com @timfprice

Tim Price is co-manager of the VT Price Value Portfolio and author of 'Investing through the Looking Glass: a rational guide to irrational financial markets', extracts from which appear in this article. You can access a full archive of these weekly investment commentaries here.

Price Value Partners manage investment portfolios for private clients. We also manage the VT Price Value Portfolio, an unconstrained global fund investing in Benjamin Graham-style value stocks and specialist managed funds.

Important Information

Price Value Partners Limited (PVP) acts as investment manager to its professional client VT Price Value Partners ICVC (the Fund). PVP is not in a marketing group with Valu-Trac Investment Management Limited who act as Authorised Corporate Director (ACD) to the Fund. PVP also acts as investment manager to private individuals, classified as both professional and retail clients. PVP makes this information available under its responsibilities as investment manager. PVP has approved the above information in accordance with Section 21 of the Financial Services and Markets Act 2000 and its Treating Customers Fairly policy (a copy of which is available on request). The ACD makes use of an exemption under the Financial Promotions Exemption Order to provide this information to investors (or potential investors) of the Fund. Accordingly, PVP has made this document available for your general information. You are encouraged to consider the risks detailed in the Fund prospectus and any investment management agreement originated by PVP and seek independent financial advice before acting. We have taken all reasonable steps to ensure the above content is correct at the time of publication. Any views expressed or interpretations given are those of the author personally. Please note that PVP is not responsible for the contents or reliability of any websites or blogs and linking to them should not be considered as an endorsement of any kind. If you no longer wish to receive these commentaries, please let us know and we will remove you from our distribution list, which is opt-in exclusively. We have no control over the availability of linked pages. Price Value Partners Ltd. is authorised and regulated by the Financial Conduct Authority, registered number 629623.

Ref 75/2/KC0310.