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YOU'VE BEEN A VERY BAD BANK

Over the past few months every week seems to have brought new proposals from the UK's Treasury for saving the creaking banking system. If Prime Minister Brown and Chancellor Darling were competing in the *Bank Rescue Plan Olympics* they would be odds on to take the gold. Their last plan proposed a kind of insurance scheme for the bad assets of the banks', where this scheme would cover some portion of the losses on these assets. The idea being that once assured that that they were protected from their own irresponsible behaviour of recent years, they would begin lending again to households and corporates. If the plan achieved this objective, then some semblance of normality might return again to the world and new mortgages would no longer be as rare as a snow leopard in Kensington High Street, or central bank humility.

But rather than insuring these bad assets, an alternative could have been simply to buy them directly from the banks – thus removing them from their books entirely. This would create a "bad bank", that is, one composed entirely of impaired assets, put together by the government and funded by the ever benevolent tax payer. A few weeks ago, the UK government dismissed this option as being unnecessary. They believed instead that the insurance approach would be both more effective in terms of opening up lending channels again and in terms of cost too. However, they seem to have changed their collective minds' again. The UK's Treasury are now considering opening up "Bad Bank plc" for business – though you won't be seeing a Bad Bank branch in your High Street any time soon.

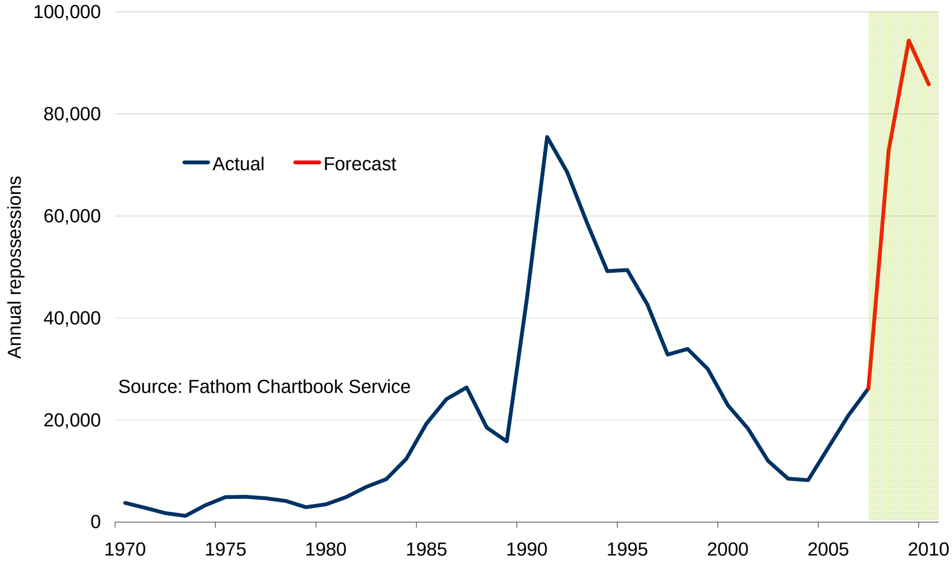
In creating a bad bank the government would be effectively cleansing the existing banks, making them "good banks". These good banks would then hope to get back to business as normal – paying dividends to their toothless shareholders, awarding bonuses to their greedy executives and purchasing the occasional work by Cezanne to brighten up the CEO's office. This plan sounds crazy, but it just might work.

But rather than buying up the securitised assets from the banks in the hope that the banks themselves will reopen the credit channel it might be better to buy the underlying, damaged collateral directly. In the UK the most obvious damaged asset on which many of these securitised bank assets are based is residential property.

Fathom has proposed that the government should buy houses directly. It should pay for these houses by borrowing; initially by issuing bonds to the domestic private and overseas sectors. And if the government is going to conduct quantitative easing, which we believe it will eventually be forced to do, it may as well use the newly minted cash to buy up UK residential property. The houses (homes) that they should buy are those inhabited by owner occupiers that would otherwise have them repossessed by their bank or building society.

This week's chart shows annual repossessions in the UK going back to 1970. So far the worst year for property repossessions has been 1991 when nearly 80,000 people lost their homes. We believe that this time could be much worse. As the chart shows our forecast is for repossessions to peak over 2009/10 at around 95,000. What the chart does not show is the stress for those that live in constant fear that their home will be repossessed.

Annual UK property repossessions: actual and forecast



Under our proposals the government would purchase the house that would otherwise be repossessed and then rent it back to its former owners at a market determined rent. In the event that they could not afford the rent, then social security would step in as it would under more usual circumstances of this kind. If taken up on a large enough scale then our scheme would put a floor under all those securities held by banks that are ultimately based upon residential property. This would help to stabilise the banking sector. It would also have the added benefit of reducing the social impact that would arise from wide scale repossessions, given that the former owners would at least be able to stay in their homes.

A policy of this kind would be an admission that the Thatcherite experiment of encouraging every one into thinking that they could and should own their own homes, went too far. In effect it would be an admission that this goal was only really attainable for many while debt was cheap and abundant. It would also lead to an increase in state-owned residential property, an asset that has been in increasingly short supply since the first council homes were put up for sale nearly thirty years ago.

We do not believe that this is a perfect solution to the UK's problems. Some would no doubt regard this as a way of rewarding those that were reckless with their borrowing. But in our view if the policy is enacted on an appropriate scale it would help to stabilise the banking sector and the economy, and ultimately help to reduce the human misery that comes with losing one's home. And therefore we believe it would be far better than creating a bank that likes to say "*Give us all your toxic assets*".

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