Credit Crunch!

The Bank of England has unveiled details of its plans to restart the money markets and prevent further damage to the UK banking system as the global 'credit crunch' begins to bite even harder.

Last week, the Bank confirmed it would make around £50bn available to help deal with the effect of the credit crunch and keep the mortgage market afloat. The Special Liquidity Scheme will allow banks to temporarily swap their high-quality mortgage-backed securities for UK Treasury Bills.

Mervyn King, governor of the Bank of England, says: The Bank of England's Special Liquidity Scheme is designed to improve the liquidity position of the banking system and raise confidence in financial markets while ensuring that the risk of losses on the loans they have made remains with the banks.

Under the scheme, banks can swap their mortgages for a period of one year, which can be renewed up to a total of three years. The Bank of England says the risk of losses on the loans remains with the bank and the banks can only swap assets that existed at the end of 2007 and cannot finance new lending.

Banks have been nervous about lending to each other as the normal security, mortgages, now have questionable value due to problems in the US sub-prime market and banks have become unwilling to lend to each other as a result. Treasury Bills are backed by the Government, meaning banks are far more likely to accept them as security.

However there are a number of critics saying the taxpayer will lose out if the mortgage assets turn out to be worth less than the Bank of England has paid for them. To help prevent this, the Bank of England says banks must swap assets of significantly greater value than the Treasury Bills issued to help protect the public sector.

It is perceived to be necessary for urgent action to be taken to unblock the mortgage market and to break the crippling effects of the credit crunch. However, we cannot have a situation where the banks are able to privatise their profits and nationalise their losses. In addition this bears all the signs of political interference in attempting to control the direction of free markets and I can't help but feel that we may suffer later on from the 'law of unintended consequences'. Although what this may be we will have to wait and see…

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