Yale University

EliScholar – A Digital Platform for Scholarly Publishing at Yale

YPFS Documents

Browse by Media Type

12-4-2009

Maintaining financial stability across the United Kingdom's banking system

United Kingdom: National Audit Office: Comptroller and Auditor General

Follow this and additional works at: https://elischolar.library.yale.edu/ypfs-documents

Recommended Citation

United Kingdom: National Audit Office: Comptroller and Auditor General, "Maintaining financial stability across the United Kingdom's banking system" (2009). *YPFS Documents*. 1571.
https://elischolar.library.yale.edu/ypfs-documents/1571

This Document is brought to you for free and open access by the Browse by Media Type at EliScholar – A Digital Platform for Scholarly Publishing at Yale. It has been accepted for inclusion in YPFS Documents by an authorized administrator of EliScholar – A Digital Platform for Scholarly Publishing at Yale. For more information, please contact elischolar@yale.edu.

National Audit Office

REPORT BY THE
COMPTROLLER AND
AUDITOR GENERAL

HC 91
SESSION 2009–2010

4 DECEMBER 2009

Maintaining financial stability across the United Kingdom's banking system

Our vision is to help the nation spend wisely.

We promote the highest standards in financial management and reporting, the proper conduct of public business and beneficial change in the provision of public services.

The National Audit Office scrutinises public spending on behalf of Parliament. The Comptroller and Auditor General, Amyas Morse, is an Officer of the House of Commons. He is the head of the National Audit Office which employs some 900 staff. He and the National Audit Office are totally independent of Government. He certifies the accounts of all Government departments and a wide range of other public sector bodies; and he has statutory authority to report to Parliament on the economy, efficiency and effectiveness with which departments and other bodies have used their resources. Our work leads to savings and other efficiency gains worth many millions of pounds: at least £9 for every £1 spent running the Office.

National Audit Office

Maintaining financial stability across the United Kingdom's banking system

Ordered by the House of Commons
to be printed on 2 December 2009

Report by the Comptroller and Auditor General
HC 91 Session 2009–2010
4 December 2009

London: The Stationery Office
£14.35

This report has been prepared under section 6 of the National Audit Act 1983 for presentation to the House of Commons in accordance with Section 9 of the Act.

Amyas Morse
Comptroller and
Auditor General

National Audit Office

1 December 2009

This report provides Parliament with an explanation of the measures taken since the nationalisation of Northern Rock to stabilise the UK's banking system, the role of the Treasury in designing and implementing these measures, and the nature of the costs, risks, and liabilities falling on the taxpayer.

© National Audit Office 2009

The text of this document may be reproduced free of charge in any format or medium providing that it is reproduced accurately and not in a misleading context.

The material must be acknowledged as National Audit Office copyright and the document title specified. Where third party material has been identified, permission from the respective copyright holder must be sought.

Printed in the UK for the Stationery Office Limited
on behalf of the Controller of Her Majesty's Stationery Office
P002326949 12/09 7333

Contents

Summary **4**

Part One
Why public support for banks was necessary **11**

Part Two
Oversight of the support programme **16**

Part Three
The impact of the support and the expected costs **28**

Appendix One
Summary of the support schemes **41**

Appendix Two
Timeline of key events **44**

Glossary **47**

Appendices Three – Eleven
Published on the NAO's website

The National Audit Office study team consisted of:

Phil Airey, Colin Ratcliffe and Jonathan Tang assisted by Jayna Hirani and Doug Neal under the direction of Peter Gray

This report can be found on the National Audit Office website at www.nao.org.uk/bankingsystem09

For further information about the National Audit Office please contact:

National Audit Office
Press Office
157-197 Buckingham Palace Road
Victoria
London
SW1W 9SP

Tel: 020 7798 7400

Email: enquiries@nao.gsi.gov.uk

Summary

1 Banks are vital to the functioning of the economy. The deposits they hold are a key part of the payment mechanism for households and businesses, and they play a central role in the settlement of billions of transactions every year. In 2007, financial markets suffered a sustained period of instability, causing difficulties for banks across the world, precipitating a global credit crisis and an economic downturn. In response, governments have intervened to support their financial systems.

2 In the UK, the Treasury set a number of key objectives: to maintain stability in the financial system; to protect depositors; and to protect taxpayers' interests. During 2008 and 2009, the Treasury, working with the Bank of England and the Financial Services Authority (the Tripartite Authorities), introduced a range of measures to:

- maintain liquidity to allow banks to pay claims and outstanding borrowings as they fell due;
- ensure that major banks would have sufficient capital to cushion them from losses caused by a potential further deterioration in the financial markets; and
- encourage banks to lend to creditworthy borrowers.

Scope of this report

3 This report provides Parliament with an explanation of the measures taken since the nationalisation of Northern Rock, the role of the Treasury in designing and implementing the measures, and the nature of the costs, risks and liabilities falling on the taxpayer. We have not evaluated the value for money of the measures because too little time has elapsed to form conclusions about their success, either individually or collectively. In addition, this report does not consider:

- the causes of the credit crisis or the regulatory regime operated by the Financial Services Authority, which at present are outside our statutory audit responsibilities, and have been examined by others;
- the Bank of England's role in respect of monetary policy and the stability of the financial system, which are also outside our statutory audit responsibilities;
- support from the Department for Business, Innovation and Skills to non-financial companies; and
- the Asset Protection Scheme, which was being negotiated and amended during our fieldwork.

Key findings

Scale of the challenge

4 **The scale of the support provided by the taxpayer is unprecedented in modern times**. In addition to the support provided to Northern Rock, the Treasury:

- purchased £37 billion of shares in RBS and Lloyds Banking Group (£2.5 billion of preference shares in Lloyds Banking Group were subsequently redeemed), and in November 2009, agreed to purchase up to an additional £39 billion of shares in both of these banks;
- indemnified the Bank of England against losses incurred in providing over £200 billion of liquidity support;
- agreed to guarantee up to £250 billion of wholesale borrowing by banks to strengthen liquidity in the banking system;
- provided approximately £40 billion of loans and other funding to Bradford & Bingley and the Financial Services Compensation Scheme; and
- agreed in principle in January 2009 to provide insurance covering nearly £600 billion of bank assets, reduced to just over £280 billion in November 2009.

5 **The Treasury's net cash outlay for purchases of shares in banks and lending to the banking sector, including Northern Rock, will, after allowing for measures announced in November 2009, amount to about £117 billion**.

6 **In early October 2008, the Treasury rescued HBOS and RBS, two of the UK's largest banks with a combined balance sheet worth some £3 trillion, over twice the UK's annual GDP**. At the same time, the Tripartite Authorities were resolving difficulties at Bradford & Bingley and the UK operations of Icelandic banks. The complexity of problems across the financial sector, the speed with which events unfolded, and the global nature of the crisis, presented the Treasury with a challenge unprecedented in recent times. It needed to work quickly and effectively to identify the risks for UK institutions, how global events impinged on those risks and, within very tight timescales, weigh the available options and decide on courses of action.

Extent to which plans had been made

7 **Following the nationalisation of Northern Rock, the Treasury was better placed to handle the difficulties emerging at individual banks**. By early 2008, the Authorities had agreed a broad approach towards handling institutions in difficulty. The Authorities identified those institutions that were at risk, stayed in close touch with them, and drew up outline plans for dealing with individual institutions should they get into difficulty. The statutory powers under which the Treasury nationalised Northern Rock allowed it to act quickly to resolve problems, for example, at Bradford & Bingley and the UK operations of Icelandic banks. However, the full extent of the crisis at the beginning of October only became fully apparent just a few days before.

8 **From Autumn 2007, the Authorities were aware of the potential weaknesses at HBOS, the UK's largest mortgage lender, and as early as March 2008 had begun to formulate specific plans should that bank get into difficulty**. HBOS was seriously affected by the market turmoil following Lehman Brothers collapse in mid-September 2008. As HBOS' position weakened on 16 September, the Treasury considered informing HBOS that it would be closed to new business, unless a rescue could be arranged. During the night of 16/17 September, HBOS reached outline agreement with Lloyds TSB on a possible takeover. The combined entity now has approximately 30 per cent of the UK's mortgage lending market.

9 **The sudden deepening of the crisis in early October 2008 meant that the Treasury had to implement wider support measures quickly**. In late September, increasing turmoil in world markets prompted the Authorities to start preparing plans to support the liquidity and solvency of the wider banking system. The proposals announced on 8 October to provide additional capital (Bank Recapitalisation) and to guarantee banks' wholesale borrowing (Credit Guarantee Scheme) were put in place rapidly. In particular, experts and stakeholders we consulted considered that the Treasury had designed and implemented the Credit Guarantee Scheme well.

10 **At the height of the crisis, the Treasury provided an £18 billion indemnity to the Bank of England for emergency support to RBS and HBOS that peaked at over £60 billion**. At the start of October 2008, internal papers prepared by the Treasury suggested that RBS's capital position was reasonably strong but noted that the bank was increasingly dependent on short-term wholesale funding. By early October 2008, the Treasury had to authorise the Bank of England to provide not only HBOS, but also RBS with support to meet liquidity needs. After 13 October, any additional lending to HBOS and RBS was conducted under an indemnity from the Treasury as the Bank considered that it could not undertake lending on the scale required without such an indemnity. The indemnity, which at its peak covered £18 billion of the emergency support, provided protection to the Bank of England that was in addition to over £100 billion of collateral that it had received from the two banks. Both banks were charged fees for the use of the emergency support facilities. The Treasury's indemnity was in place for two months, and by mid-January 2009, the emergency support had been replaced with other funding, including using debt issued under the Credit Guarantee Scheme.

11 **The indemnity for the Bank of England's emergency support to RBS and HBOS was not reported to Parliament, as would normally be expected under long-standing procedures put in place by the Treasury to control the use of public money**. This indemnity would normally have been notified to Parliament as a contingent liability before it was granted. Because of the considerable sensitivity of the support operation at the time, the Treasury judged that it was not in the public interest to follow procedures that allow for confidential notification to the chairs of the Committee of Public Accounts and the relevant departmental select committee.

Success of the measures

12 There have been no disorderly failures of UK banks, and no retail depositor in a bank operating in the UK has lost money. The Treasury has to date achieved two of the Government's objectives, namely maintaining financial stability and protecting retail depositors.

13 There is no single measure of success, but a range of indicators have since stabilised and improved. The Treasury has yet to put in place formal arrangements to evaluate the success of the support provided. Success of the support will be linked closely with sentiments and events in world markets. By November 2009, a range of indicators such as the benchmark interest rates for wholesale funding, bank share prices and the perceived risk of defaults had eased. Whilst the bulk of support has been used to strengthen RBS and Lloyds Banking Group, the banking sector as a whole has to date benefited from improved confidence.

14 Lending to businesses in 2009-10 is not likely to meet targets. At the end of September 2009, RBS and Lloyds Banking Group were meeting their retail mortgage lending commitments. However, there was a shortfall in overall lending to businesses. Although the Treasury is monitoring progress and meets each of the banks regularly, the only formal sanction available if targets are not met is a potential refusal to extend guarantees for wholesale borrowing under the Credit Guarantee Scheme.

Likely cost to the taxpayer

15 In the 2009 Budget, the Treasury estimated that the final net cost to the taxpayer might lie within a range from £20 billion to £50 billion, depending on the length and depth of the economic recession and the strength of any recovery. The final net cost to the taxpayer will depend primarily on the scale of any losses arising from the Asset Protection Scheme, and on the prices at which the Government eventually disposes of its holdings in RBS and Lloyds Banking Group. However, following Lloyds Banking Group's decision not to enter the scheme and changes to the terms under which RBS will participate, the estimated net cost is likely to be lower.

16 Since 2007, there has been a consolidation in the UK banking sector that may have a significant impact on competition. Compliance with State Aid rules will require RBS and Lloyds Banking Group to dispose of parts of their businesses over the next four years. Responsibility for managing the shareholdings in RBS, Lloyds Banking Group, Bradford & Bingley and Northern Rock rests with UKFI, a standalone company established by the Treasury. UKFI's objective is to protect and create value for the taxpayer as shareholder, with due regard to financial stability and promotion of competition. In line with UKFI's objectives, any future sale process will need to balance the consequences for the structure of the industry and competition in the UK market against the proceeds secured for the taxpayer.

Action by the Treasury to assemble the skills and resources required

17 The Treasury increased the number of staff working on financial stability issues and was able to deal with the crisis of October 2008, although the team was stretched. Our previous report on the nationalisation of Northern Rock found that the Treasury had been severely stretched in terms of the availability of people with relevant skills and experience. Between February 2008, when Northern Rock was nationalised, and May 2009 the number employed on financial stability issues expanded from around 20 to just under 120 staff.

18 By April 2010, the Treasury expects to have spent £107 million on advisers, some of whom had to be employed at short notice. In total, just under £100 million is expected to be refunded by the banks. The requirement for expertise often arose at short notice and, given the uncertainties, the precise nature and extent of the work was often not known at the start. Two sets of financial advisers were appointed, initially on retainers of £200,000 a month for a year. The Treasury considered that the retainers were appropriate in circumstances where it needed external advice at short notice but the precise nature of the advice was uncertain. The appointments also included provisions for the payment of success fees of up to £5.8 million, but the contracts did not define success, instead leaving payments to the sole discretion of the Treasury.

Conclusion

19 If the support measures had not been put in place, the scale of the economic and social costs if one or more major UK banks had collapsed is difficult to envision. The support provided to the banks was therefore justified, but the final cost to the taxpayer of the support will not be known for a number of years. The Treasury estimated in April 2009 that there may be a loss of between £20 billion and £50 billion, the wide range reflecting the inevitable uncertainty involved in such an estimate. The major determinant will be the prices obtained for the taxpayers' current holdings in the various banks.

20 Having learnt lessons from its handling of Northern Rock, the Treasury was better resourced to contain the wider crisis that erupted in Autumn 2008, but was inevitably stretched. The Treasury now has to juggle a variety of new roles: as major investor, or owner, of a number of banks; guarantor of borrowings by banks in the wholesale markets; and insurer of assets owned by RBS. These are in addition to its traditional role as overseer of policy on financial regulation and the principal economic department. All of this will create new challenges for the Treasury's capacity in what have already been demanding times. To manage these potentially competing responsibilities effectively, it will need a very clear view of what success will look like, the mechanisms to monitor and assess the options open to it, and the skills to take this forward.

Recommendations

21 The following recommendations are intended to assist the Treasury as it addresses these new challenges:

a **The final value for money of the support will depend not just on the prices obtained for the bank shares, but also on ensuring that customers get a fair deal in a competitive market for financial services**. To comply with State Aid rules, RBS and Lloyds Banking Group will dispose of some of their assets. UKFI, in consultation with the Office of Fair Trading, should review the extent of the disposals taking into consideration wider economic factors. The prices obtained from the shareholdings should only be one factor in the equation, with due regard being paid to future competition in the banking sector and the long-term impact on consumers.

b **The support provided has been unprecedented, but there are currently no formal arrangements in place to evaluate what has been learned from the measures taken**. As the crisis begins to subside, the Treasury, working with the Financial Services Authority and the Bank of England, should evaluate the success of the support provided as a whole, together with the individual measures, to ensure the knowledge gained and lessons learned are captured for future policy makers. A full assessment, however, is unlikely to be completed for several years.

c **While this report records recent trends in benchmark interest rates for wholesale lending, we were unable to gather data on changes in the volume of lending in these markets**. Changes in the overall volume of borrowing by UK banks on the wholesale money markets are a forward indicator of potential liquidity risks. In October 2009, the Financial Services Authority announced proposals to introduce a new liquidity reporting regime which will gather such data. The Treasury should ensure that the data is considered by the Tripartite Authorities on a regular basis and pre-emptive action taken where necessary.

d **The contracts for financial advisers included fixed monthly retainers over a period of up to 12 months, followed by the payment of success fees at the sole discretion of the Treasury**. Where an adviser has to be appointed at short notice to help with a crisis situation, it may well be necessary to pay a fixed retainer, but such an arrangement should not be for long. Once the scope of the work becomes clearer, the adviser should be paid only for work requested and completed. Where a success fee is provided for, criteria must be agreed at the earliest opportunity by which success is to be determined. In instances such as this, where criteria for success will be unclear, it is not good practice to enter into such an agreement in the first place or to leave payment solely to the discretion of the procuring authority.

e **There has been a considerable growth in the scale and complexity of the Government's investments and partnerships with the private sector**. There is now a range of public sector bodies, including amongst others, Partnerships UK, the Shareholder Executive, UKFI and the Asset Protection Agency, with responsibility for companies in which the Government holds a key interest. While the creation of separate bodies, with clear objectives, can be an advantage, there are potential downsides. In particular, there is a risk that potential economies of scale are being missed and that valuable expertise is being spread too thinly. We therefore recommend that the Treasury conducts a review by the end of 2012 to determine whether there is scope to achieve efficiencies.

Part One

Why public support for banks was necessary

1.1 In the past, banks raised funds to lend to customers from money held on behalf of retail and commercial depositors. Over the past 20 years or so, many banks have made increasing use of two other sources of funding:

- wholesale funding, in which financial institutions and others provide short to medium-term loans (wholesale funding); and
- selling longer-term assets, such as existing mortgages, to investors through a process known as securitisation[1].

The importance and vulnerabilities of banks

1.2 Banks are vital to the functioning of the economy. The deposits they hold are a key part of the payment mechanism for households and businesses, and by allocating savings to borrowers, they promote economic growth. The failure of a major bank has the potential to leave individuals and businesses unable to access savings, raise finance or meet ongoing payments. By impacting adversely on consumer confidence, such a failure has the potential to spread across the financial system, causing significant negative effects on the wider economy.

1.3 Banks are highly vulnerable if they lose the confidence of their depositors. Depositors' funds can usually be withdrawn on demand, but loans to borrowers are longer-term. If large numbers of depositors start withdrawing their funds, the combination of short-term liquid liabilities and longer-term illiquid assets creates a cash flow crisis for banks.

1.4 Banks are also vulnerable if the value of their assets decline. As with other businesses trading with limited liability, banks are required to remain solvent in the sense that the value of assets should exceed the value of liabilities. The difference is capital. To maximise returns, major UK banks have operated with capital of between four and nine per cent of asset values. Consequently, a relatively small reduction in the value of assets will have a disproportionately large effect on a bank's capital (Appendix Eight on the NAO's website).

[1] Securitisation involves the raising of funds from investors by selling bonds backed by a bank's assets, usually outstanding mortgages.

The crisis in the financial markets

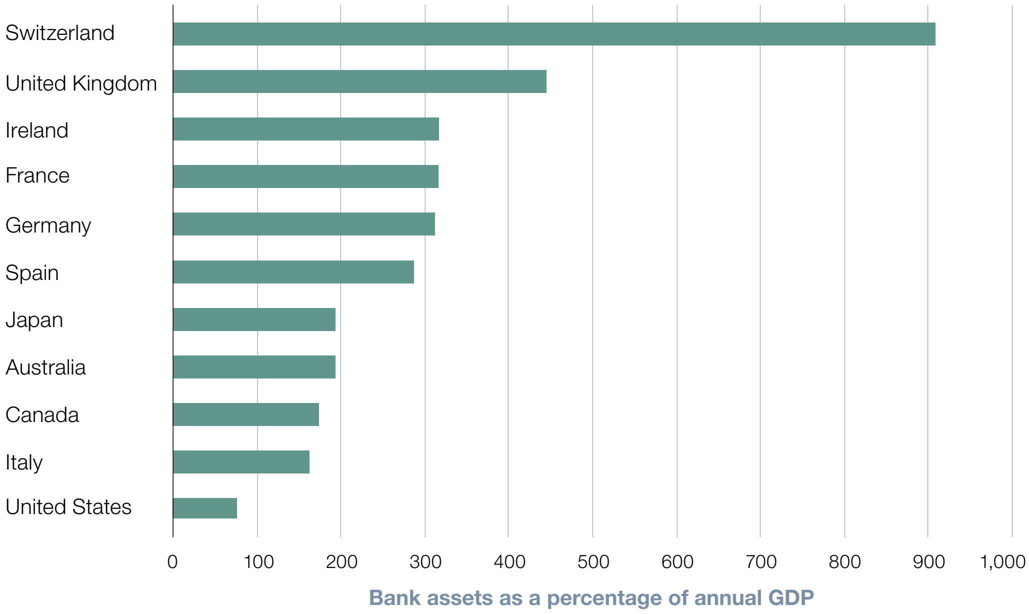
1.5 Banks have expanded their balance sheets rapidly since the 1990s, and assets of UK-based banks by June 2009 were over four times greater than the UK's gross domestic product (£1.4 trillion) (**Figure 1**).

1.6 Banks have become increasingly reliant on the use of short-term wholesale markets to fund new assets. The short-term nature of these funds, however, requires the banks to source new funds on a rolling basis. The success of this business model is dependent on:

- there being sufficient funds available in the wholesale funding and securitisation markets; and
- the rate of interest on the funds borrowed in these markets being lower than the interest earned from the assets created.

1.7 In Summer 2007, the world's financial markets entered a period of turbulence triggered by fears of exposure to American sub-prime mortgages. Financial institutions and investors reduced their purchases of mortgage-backed assets, effectively closing an important source of funding. Consequently, the value of such assets started falling.

Figure 1
UK banks' assets far exceed the UK's annual gross domestic product

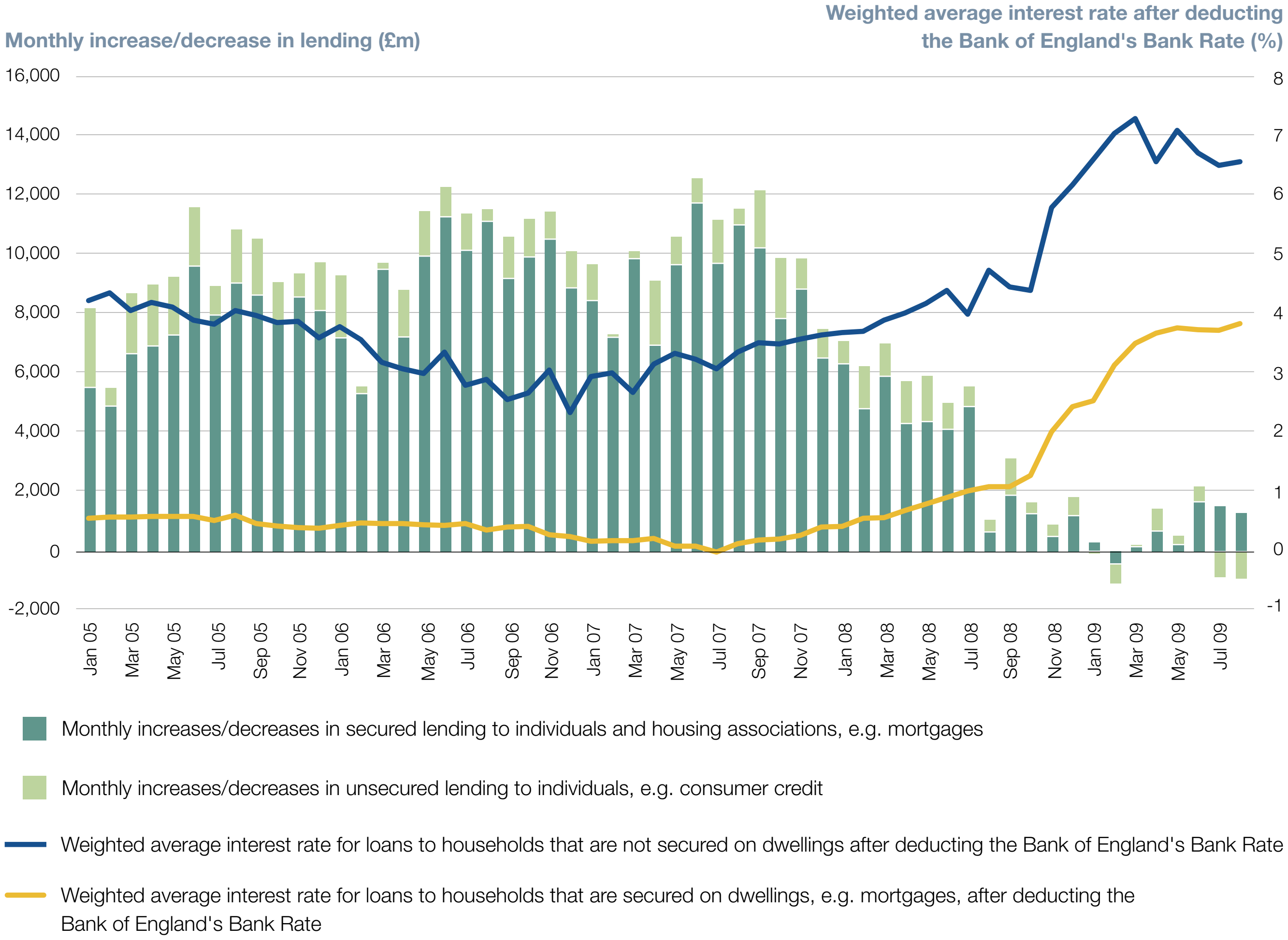


Source: Bank of England (Financial Stability Report, June 2009: Chart 3.17 on page 53)

1.8 Banks began to retain cash to meet their own liquidity requirements. The resulting shortage of liquidity across the global banking system undermined the financial health of institutions that used the wholesale markets to help fund their lending to individuals and businesses. The margin over the Bank of England's Bank Rate that banks charged borrowers, particularly individuals, began to increase, reflecting heightened credit risk and reduced supply of wholesale funding, leading to credit tightening across the wider economy. Consequently, the growth in lending to individuals and businesses in the UK began falling in late 2007 and in some months repayments have exceeded the value of new loans. While increases in the margin after October 2008 were offset by falls in the Bank Rate, the downturn in the housing market and a general weakening in the economy continued to depress demand for loans. (**Figure 2** and **Figure 3** overleaf).

Figure 2

The growth in lending to individuals began to fall in late 2007



Source: Bank of England

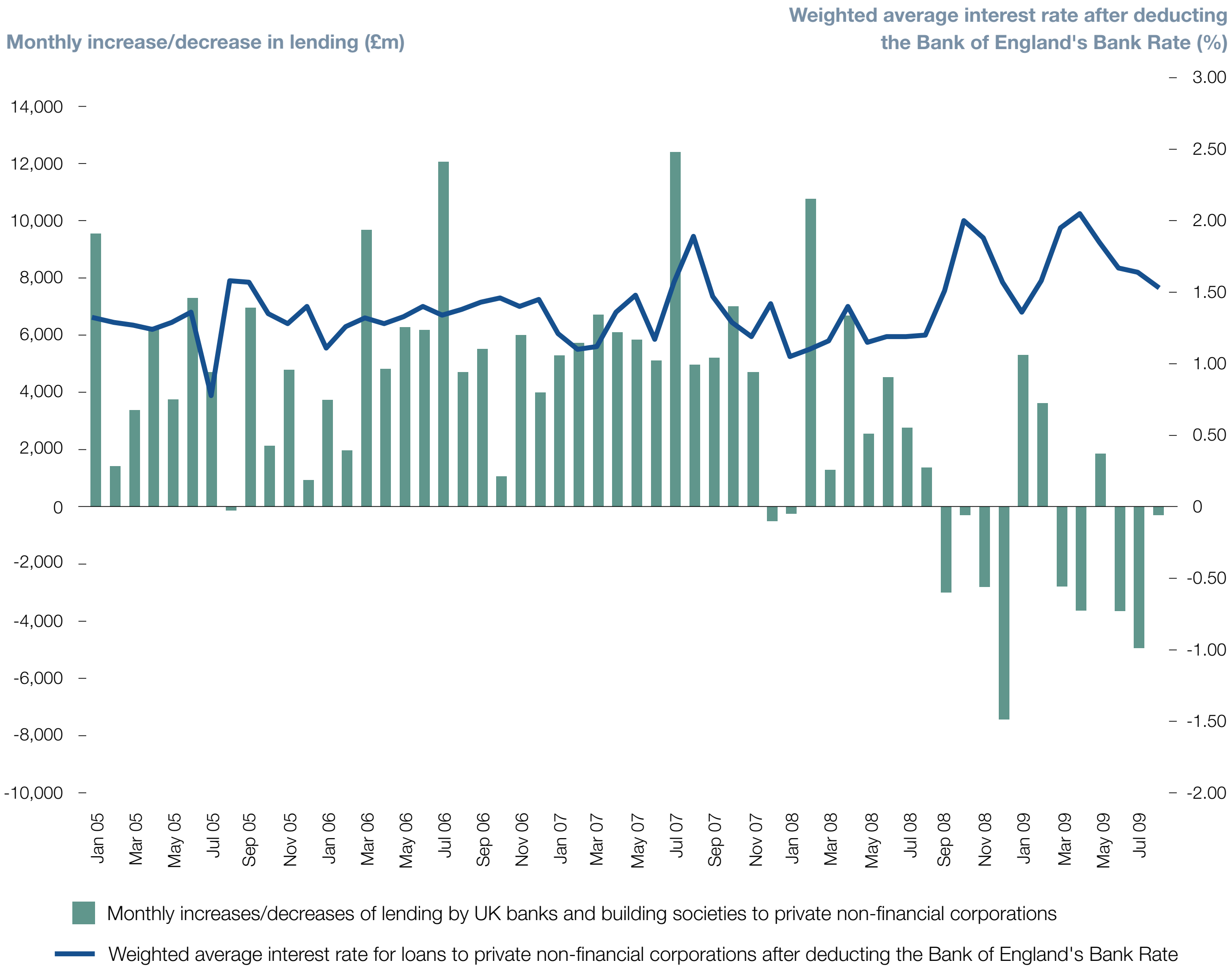
The Treasury's objectives

1.9 The Treasury, the Financial Services Authority, and the Bank of England – the Tripartite Authorities – took action to counter the adverse consequences of the global financial crisis. The Treasury's objectives were to:

- stabilise and restore confidence in the financial system;
- protect depositors' money;
- protect taxpayers' interests; and
- ensure continued lending to creditworthy borrowers.

Figure 3

The growth in lending to non-financial businesses has also decreased



Source: Bank of England

Summary of measures taken

1.10 The Tripartite Authorities:

- increased liquidity in the banking system;
- facilitated orderly resolutions of those individual financial institutions that experienced difficulties;
- announced wider measures to improve solvency and liquidity across the banking sector in October 2008; and
- announced a further set of measures in January 2009, which were amended in November 2009.

1.11 In designing the measures, in the midst of extreme instability, the Authorities were aware of the risk of moral hazard. While preserving the UK's financial stability required support for banks that would otherwise fail, such support could be construed as rewarding inappropriate risk taking. The Authorities sought to limit moral hazard by letting the costs of failure, as much as possible, fall first on owners of failed banks and senior management, rather than creditors or the taxpayer.

1.12 Appendix One summarises the key measures, and details are contained in Appendices Three to Seven, published on the NAO's website. Appendix Two presents a timeline of events and key market data. Appendices Nine and Ten, also published on the NAO's website, outline: the actions taken by countries across the world; and our methodology.

Part Two

Oversight of the support programme

2.1 This Part considers:

a the extent to which contingency plans were made and implemented;

b action taken by the Treasury to assemble the skills and resources it needed; and

c the operational management of the support measures.

Contingency planning and implementation

2.2 Financial stability in the UK is a shared objective of the Treasury, the Bank of England, and the Financial Services Authority – the Tripartite Authorities:

- The Treasury is responsible for the structure of financial regulation, the governing legislation and for accounting to Parliament for the management of problems in the financial system, and measures to resolve them. Responsibility for authorising exceptional support operations rests with the Chancellor of the Exchequer.

- The Bank of England provides liquidity insurance to the banking system and may provide emergency liquidity support in the circumstances set out in a 2006 Memorandum of Understanding between the Tripartite Authorities. An objective of the Bank is to contribute to assessing risk and enhancing the stability of the financial system. The Banking Act 2009 gave the Bank specific responsibilities for the oversight of certain inter-bank payment systems and the operation of a Special Resolution Regime for banks in difficulty.

- The Financial Services Authority regulates most financial services' markets, firms and exchanges. It also responds to problems at particular firms, for instance, by changing regulatory requirements and facilitating the injection of new capital from other parties.

2.3 The crisis at Northern Rock in September 2007 revealed shortcomings in the statutory arrangements then in place to deal with a bank in difficulty. The Authorities had been aware since 2005 that the existing legislative framework would not be sufficient in a crisis. Following further work in 2006 and 2007, and reflecting lessons from Northern Rock, they decided that a special resolution regime should be developed. The Banking (Special Provisions) Act became law in February 2008 and gave the Treasury power to take a bank or building society into temporary public ownership, or transfer all, or part of its business to another owner. In February 2009, this Act was replaced by the Banking Act 2009. The new Act provided for the Financial Services Authority to determine when the powers in the Act can be exercised and for the Bank of England to decide whether to exercise certain stabilisation powers, including the sale of all, or part of a business to a private sector purchaser, or a transfer to a "bridge bank", pending a final resolution. The Treasury retains the right to take a bank into temporary public ownership where there is a serious risk to the financial system.

2.4 Shortly after the nationalisation of Northern Rock, the Treasury considered that plans needed to be updated to take account of: the risks posed by difficult market conditions; what might happen if those risks materialised; and what the Authorities would need to do to protect financial stability. By March 2008, the Authorities had developed a set of options for dealing with a bank in difficulty (**Figure 4**).

Figure 4

Escalating options for dealing with a bank in difficulty drawn up by the Authorities in March 2008

Planned action	Description
Regulatory action	The Financial Services Authority can relax capital or liquidity requirements if a problem is short term, or where a solution is imminent.
Sale to another bank	The favoured option where appropriate and possible. The Financial Services Authority would work with the bank to identify potential buyers.
Emergency Liquidity Assistance	An emergency loan from the Bank of England is an established means of dealing with a liquidity problem at a bank. High quality security would be required and a penal rate of interest would be charged.
Guarantee arrangements	A standard tool under which the Treasury would guarantee deposits to counter a run on retail deposits or wholesale funding.
Loans	The Treasury would authorise the Bank of England to provide loans beyond those available under Emergency Liquidity Assistance. To enhance the likelihood of the loans being repaid, controls over the business strategy of the borrower would be a condition. To protect the Bank of England from potential losses, the Treasury may also have to provide the Bank with an indemnity.
Capital injections	A direct financial commitment with an immediate call on public funds to buy shares.
Public ownership	Using powers under the Banking (Special Provisions) Act 2008, the Treasury could have taken temporary public ownership of a bank or building society with the aim of facilitating a sale of the whole or part to another bank. If a partial sale were completed, the remaining assets and liabilities could have been retained in public ownership until a buyer was found or until the assets and liabilities matured.

Source: The Treasury and the Financial Services Authority

2.5 The actions taken by the Authorities during 2008 broadly reflected the options identified in Figure 4 and can be divided into three phases:

- providing liquidity support to the banking system as a whole to prevent a wider decline in confidence, and resolving individual banks in difficulty;
- resolving difficulties across the banking sector, following the collapse of Lehman Brothers in September 2008; and
- aiding recovery from the wider economic effects of the credit crisis.

Liquidity support to the banking system as a whole, and stabilisation of individual banks in difficulty

2.6 From Autumn 2007, the Authorities' focus was to identify failing institutions at the earliest opportunity, to support the liquidity of the banking system as a whole, and to monitor developments closely. The Financial Services Authority identified banks that might be vulnerable because they were reliant on wholesale funding, or where the value of loan assets was likely to decline. The Authority considered Bradford & Bingley, Alliance & Leicester, HBOS, and a number of smaller institutions to be at risk and developed specific plans for potential takeovers, keeping itself informed about possible purchasers.

2.7 In early 2008, the Authorities also became aware that Icelandic banks operating in the UK were vulnerable. The Financial Services Authority raised concerns about one firm in particular, both to the firm's management and the Icelandic regulator. Specific concerns were raised with other Icelandic banks later in the year.

2.8 After the difficulties encountered by Bear Stearns in March 2008, confidence in the financial markets deteriorated further, and given the impaired wholesale funding markets, there was a risk that financial institutions could fail without access to liquidity. In response, the Treasury approved the Bank's introduction in April 2008 of the Special Liquidity Scheme under which the Bank would exchange highly liquid Treasury Bills for assets held by banks that in the crisis had become less liquid. The Treasury also indemnified the Bank against potential losses. By improving liquidity in the banking sector, the risk of a disorderly failure of a bank was reduced.

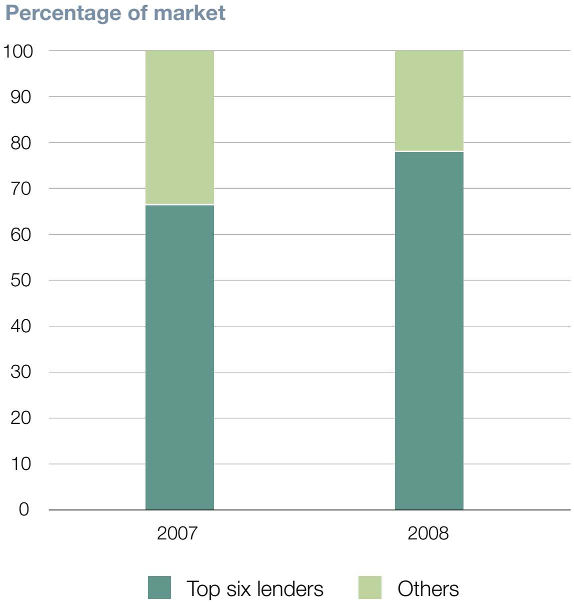
2.9 During 2008, a number of vulnerable firms were taken over by stronger institutions. They included: Santander's purchase of Alliance & Leicester and Nationwide's takeover of the Cheshire and Derbyshire Building Societies. Plans prepared specifically by the Authorities were implemented to resolve difficulties encountered by Bradford & Bingley and Icelandic banks operating in the UK.

2.10 Over Summer 2008, the Financial Services Authority's close monitoring of HBOS continued as the bank sought to become less reliant on the wholesale funding markets. The Financial Services Authority sought to arrange a managed sale of HBOS and contacted potential buyers in the UK and overseas. In the event of a downturn in confidence in the bank, a managed sale of HBOS was the preferred option but considered unlikely given the size and nature of the bank. A takeover by a UK-based institution would raise competition issues and the Authorities were not aware of interest from investors outside the UK. Temporary public ownership of the bank was seen by the Authorities as a possible, last resort solution.

2.11 In the immediate aftermath of the collapse of Lehman Brothers in September 2008, while market confidence in all banks weakened, the impact on HBOS was most severe. The Authorities' monitoring identified a heightened risk of a run on the bank. On 15 September, the Treasury reviewed the Government's powers to take account of financial stability when considering whether a proposed takeover was in the public interest. As HBOS's position continued to weaken on 16 September, the Treasury considered informing the bank that, unless it found a private sector solution, it would be closed to new business. During the night of 16/17 September, HBOS and Lloyds TSB agreed a takeover deal. Lloyds TSB's view was that it would be important to the success of the deal that liquidity support to the merged institution would be no less than that provided to the two banks individually, and that the deal would not be referred by the Office of Fair Trading, or the Secretary of State for Business, Innovation and Skills to the Competition Commission. The combined entity would have some 30 per cent of the UK mortgage market, about twice that of its nearest competitor, Santander, and reinforced increasing consolidation within the UK's mortgage market. (**Figure 5**).

Figure 5

The six largest banks in the UK's mortgage market increased their market share to 78 per cent in 2008 from 66 per cent in 2007



Source: Council of Mortgage Lenders

NOTE

Top six lenders were Lloyds Banking Group, Santander, Nationwide, Barclays, RBS, and HSBC.

Resolution of difficulties across the banking sector

2.12 By the last week of September, the Authorities recognised that liquidity support through the Special Liquidity Scheme and dealing with troubled institutions on a case-by-case basis was not sufficient to sustain financial stability. The Authorities therefore decided to prepare contingency plans to deal with the possibility of a further deterioration in confidence.

2.13 Given the importance of banks to the economy there was no "do nothing" option, and the Authorities considered that temporary public ownership of a bank in difficulty should only be a measure of last resort. The Authorities reviewed two options to improve solvency. The first was a scheme under which the public sector purchased non-performing assets from the banks, a scheme similar to that which had been proposed by the Administration in the United States. The second involved additional injections of capital into banks by existing or new shareholders, including if necessary the Government. The UK Authorities preferred recapitalisation.

2.14 The objectives of recapitalisation were to restore confidence between banks, to encourage the resumption of lending by UK banks to the real economy, and to place most of the consequences of raising new capital on existing shareholders. Recapitalisations had been a common feature of past financial crises and could be implemented sooner than a scheme involving asset purchases, which are inherently more complex. The Treasury recognised that an asset purchase scheme might also be needed and that it should be worked up. The Treasury, however, was concerned about announcing a poorly specified scheme that could potentially create avoidable uncertainty in the markets. In the first week of October, the Authorities worked up details of a recapitalisation scheme. In response to the liquidity crisis, the Treasury also designed a Credit Guarantee Scheme,

2.15 At the end of September, HBOS found that it was unable to fund itself fully on the wholesale funding markets. On 1 October, the Bank, with Treasury's approval, agreed to provide HBOS covertly an uncommitted support facility initially for up to £10 billion in return for some of HBOS's high quality mortgage assets. At the same time, internal papers prepared by the Treasury suggested that RBS's capital position was reasonably strong, but noted that the bank was increasingly dependent on short-term wholesale funding. Less than a week later, however, the Authorities unexpectedly found that RBS too could no longer access the wholesale funds it needed. Again the Bank had to step in, covertly providing liquidity support to RBS from 7 October. During October and November, the emergency support peaked with the Bank providing £25.4 billion of support to HBOS and £36.6 billion to RBS. To protect the taxpayer, RBS and HBOS had to provide the Bank of England with assets with balance sheet values of over £100 billion. The banks were charged fees for the use of the facilities. By 16 January 2009, both banks had replaced the emergency assistance with other funding, including using debt issued under the the Credit Guarantee Scheme, and the facilities ended.

2.16 It is normal practice where a government department proposes to incur a contingent liability for Parliament to be informed beforehand. In circumstances where confidentiality is required, a department needs to inform the Chairs of the Committee of Public Accounts and the relevant departmental select committee beforehand. The initial support provided to HBOS was undertaken by the Bank, with authorisation from the Treasury under the terms of the Memorandum of Understanding between the Authorities. The Bank was prepared to bear the risks itself and therefore did not request an indemnity from the Treasury which, in turn, did not need to inform Parliament.

2.17 The level of support increased throughout early October, and after 13 October additional lending to HBOS and RBS was conducted under an indemnity from the Treasury as the Bank considered that it could not undertake lending on the scale required without such an indemnity. The indemnity provided additional cover to the Bank of England beyond the collateral of over £100 billion provided by HBOS and RBS. The indemnity was in place for two months, and at its peak, covered £18 billion of the support provided. It should have been notified to Parliament as a contingent liability before it was granted. Because of the considerable sensitivity of the support operation at the time, the Treasury judged that it was not in the public interest to follow procedures that allow for confidential notification to the chairs of the Committee of Public Accounts and the relevant departmental select committee.

2.18 The Chancellor announced proposals for a Recapitalisation and a Credit Guarantee Scheme on 8 October. Under the Credit Guarantee Scheme, the Treasury agreed to guarantee up to £250 billion of debt raised by banks in the wholesale money and capital markets, and under the Recapitalisation Scheme announced that £50 billion was available and invested £37 billion in RBS and Lloyds Banking Group.

2.19 While preparing system-wide interventions, the Authorities continued to track vulnerable institutions and plan interventions where needed. Using powers under the Building Societies Act 1997, the Financial Services Authority facilitated the merger of the Yorkshire Building Society with the Barnsley Building Society, and the merger of the Skipton and Scarborough Building Societies. When a number of Icelandic banks collapsed in October 2008, the Authorities implemented prepared plans to contain the implications for UK depositors. In March 2009, the Authorities oversaw the orderly resolution of the Dunfermline Building Society. The Authorities have also worked with the banking sector to consider alternative and more flexible capital investments. In June 2009, the West Bromwich Building Society benefited from this work, when it took action to strengthen its capital position.

Action to help recovery from the wider economic effects of the credit crisis

2.20 During late 2008, confidence in the banking system remained weak and conditions in the wider economy worsened, in part due to a shortage of credit. In response, the Chancellor announced on 19 January 2009 a set of further measures that the Authorities had been developing. The measures included:

- **Asset Protection Scheme.** After considering options of further capital injections into banks and a scheme to purchase non-performing assets, the Treasury opted to increase banks' capital and ability to lend by offering to insure assets on the banks' balance sheets. RBS and Lloyds Banking Group agreed in principle to participate in the scheme. Ahead of reaching final agreements, the Treasury conducted due diligence on the assets to be placed in the scheme, and entered into detailed negotiations with the banks to ensure that the terms would be consistent with European Union State Aid requirements.

- **Restructuring the Government's shareholdings in RBS and Lloyds Banking Group.** To remove the need for the banks to pay fixed dividends on Government-held preference shares, the Treasury agreed to convert these shares into ordinary shares, thereby increasing the Government's stake in RBS from 58 per cent to 70 per cent. In the case of Lloyds Banking Group, the Government's shareholding did not increase because the change was offset by capital injections from other shareholders.
- **Extending the window for using the Credit Guarantee Scheme.** In response to concerns expressed by banks that they might not be able to issue the full amount of Government guaranteed debt, the Treasury agreed to extend the window for new drawdowns of guarantees under the scheme from April 2009 to December 2009.
- **Asset Backed Securities Guarantee Scheme.** Responding to recommendations following a review of mortgage funding, the Treasury launched a scheme to guarantee newly issued AAA-rated mortgage backed securities. By late November 2009, the scheme had not been used.

2.21 The announcement of the Asset Protection Scheme, along with an improvement in financial market conditions, helped to restore confidence in the banking system. In November 2009, negotiations were completed and a number of major changes made:

- Lloyds Banking Group will not participate in the Scheme and intends, instead, to raise additional capital from its shareholders including the Government in a fully underwritten offer.
- RBS will participate in the Scheme under revised terms. The quantity of assets insured are to be reduced and RBS will bear a larger first loss. The Treasury will inject additional capital of £25.5 billion into the bank.
- To fulfil State Aid requirements, the Treasury and the European Commission agreed that both banks would dispose of assets over a period of four years.

The Treasury's capacity to tackle the crisis

2.22 In reacting to the credit crisis, the Treasury needed to:

- ensure that it had sufficient staff resources to handle the work;
- consider whether it needed external advisers; and
- manage information relating to the design and implementation of the support measures.

Internal resources

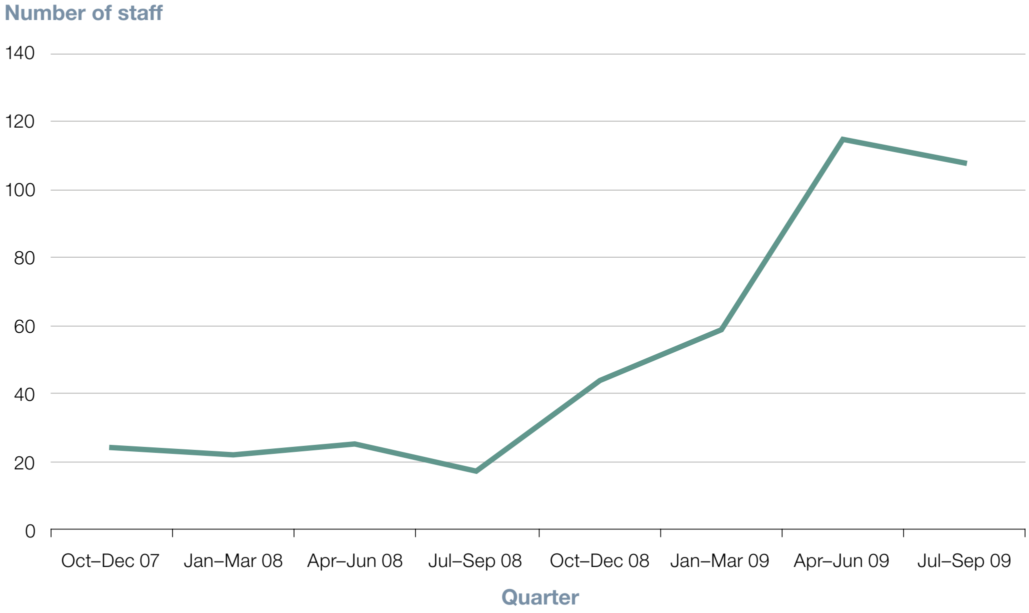
2.23 Prior to the difficulties at Northern Rock, the maintenance of financial stability had not been, in terms of staff numbers, a major part of the Treasury's work. Responsibility within the Treasury lay chiefly with its financial stability team, comprising a senior civil servant and a team of 16 officials, plus access to the Department's internal legal teams. By mid-October 2007, the Treasury had around 24 officials working on Northern Rock plus support from external advisers. Despite this expansion, during 2007, the Treasury had been severely stretched to deal with the challenges posed by the developing financial crisis.

2.24 As market conditions deteriorated, the Treasury recruited additional staff from October 2008. The Treasury was, therefore, better resourced to handle the crisis but was inevitably stretched. **Figure 6** shows the build up of resources.

2.25 By the end of September 2009, approximately 108 people were working on support to the banking sector, reporting to the Treasury's second permanent secretary. From January 2009, most of the additional staff were preparing the Asset Protection Scheme. This expansion was made possible by drawing in staff from other parts of the Treasury, other Government departments, and by seconding approximately 40 staff from the private sector, mostly from PricewaterhouseCoopers and Ernst & Young.

Figure 6

The number of staff working in the Treasury's Financial Stability Unit



Source: HM Treasury

External advisers

2.26 In addition to advice received from the Bank of England and the Financial Services Authority, the Treasury bought in specialist legal and financial advice (**Figure 7**) that would not ordinarily be available to it. Between September 2007 and 31 March 2010, the cost of professional advice, including that on Northern Rock, is expected to total £107 million, of which the Treasury intends to recover just under £100 million from the banks, the vast majority from RBS and Lloyds Banking Group.

2.27 The Treasury appointed the legal firm, Slaughter & May, in September 2007 to provide advice on Northern Rock. The Treasury considered that the firm provided high quality advice on the handling of the crisis at Northern Rock, and the firm's experience was seen as significant if similar problems arose at other banks. The contract with Slaughter & May was therefore extended. In October 2009, the Treasury put in place a framework for appointing legal advisers from a panel of firms that qualified after submitting successful bids in an open competition.

2.28 The sudden need to implement the Recapitalisation Scheme in October 2008, at the same time as dealing with difficulties at Bradford & Bingley and Icelandic banks, meant that the Treasury had to appoint professional banking advisers quickly. Five banks submitted proposals that were discussed by a panel of senior officials. The Treasury appointed two banks within four days of receiving the proposals.

Figure 7
Expected cost of advisers used by the Treasury between September 2007 and 31 March 2010

Adviser	Scope of work	Fees (£m)
Slaughter & May	Commercial legal advice	32.9
Credit Suisse	Financial advice on a range of measures, including Recapitalisation and Asset Protection Scheme	15.4
PricewaterhouseCoopers	Advice on Asset Protection Scheme	11.3
Ernst & Young	Due diligence on Asset Protection Scheme and Northern Rock	8.7
KPMG	Due diligence on Asset Protection Scheme	7.7
Blackrock	Valuation advice on Asset Protection Scheme	7.4
Deutsche Bank	Financial advice on a range of measures	5.3
Citi	Financial advice on Asset Protection Scheme	5.0
BDO Stoy Hayward	Valuation of Northern Rock	4.9
Goldman Sachs	Financial advice on Northern Rock	4.5
Morgan Stanley	Financial advice on Bradford & Bingley	1.5
Other Advisers		2.5
Total		**107.1**

Source: National Audit Office analysis of HM Treasury records

2.29 Credit Suisse was appointed to provide advice, with Deutsche Bank to be called on as required. Both banks were appointed on retainers of £200,000 a month for a year, although the Treasury had the right to terminate the contracts with ten days notice. While the Treasury recognised that paying retainers for such a long period of time could have been a high cost way of securing advice if the need for advice was lower than envisaged, it considers that such retainers can be justified. In the case of these two contracts, there was an immediate need for advice, but the precise nature of the advice was uncertain. The Treasury has told us that it has tightened its procedures for defining the advice that it requires, by preparing proper statements of requirements, where practicable.

2.30 The terms on which both banks were appointed included the payment of success fees: £1.5 million for Credit Suisse and £110,000 for each month worked by Deutsche. The success fees may be paid at the end of the contracts but neither contract defined success, instead leaving payment to the discretion of the Treasury. Credit Suisse was also engaged under a separate contract to advise on the Asset Protection Scheme on a retainer which increased to £300,000 a month from June 2009 plus further success fees totalling £3 million, at the Treasury's discretion. No decision had been taken by the end of October 2009 on whether success fees would be paid. Other advisers, principally for the Asset Protection Scheme, were appointed under fixed price or time-based contracts.

2.31 The Treasury intends to recover most of its advisory costs from RBS and Lloyds Banking Group. When the latter withdrew from the Asset Protection Scheme, it agreed to reimburse its share of the advisory costs, in addition to an exit fee of £2.5 billion. RBS also has an obligation to meet its share of the advisory costs.

Knowledge management

2.32 In 2006, the Treasury commissioned one of its senior managers to review knowledge management in the department. The review found that there was no consistently applied system for document retention or to promote good practice. The report recommended improvements. While action was taken, including the appointment of knowledge managers, we encountered delays in receiving the information needed during our examination of the nationalisation of Northern Rock. We again encountered difficulties and long delays in obtaining evidence relating to the Treasury's actions after Northern Rock was nationalised.

2.33 The Treasury has recognised the importance of consistently applied document retention standards, particularly in light of fast-moving events and frequent changes in staff. It has introduced systems across the department to help strengthen knowledge management and has put in place resources to enhance record keeping for the Asset Protection Scheme.

Operational management of the support measures

2.34 A variety of arrangements (**Figure 8**) have been put in place by the Treasury to manage the different elements of the support programme:

- **Credit Guarantee Scheme and Asset-Backed Securities Guarantee Scheme.** The Debt Management Office, an agency of the Treasury, manages the day-to-day operations.

- **Shareholdings in Lloyds Banking Group and RBS.** In November 2008, the Treasury set up United Kingdom Financial Investments Limited (UKFI) as an arm's-length company to manage the taxpayer's shareholdings.

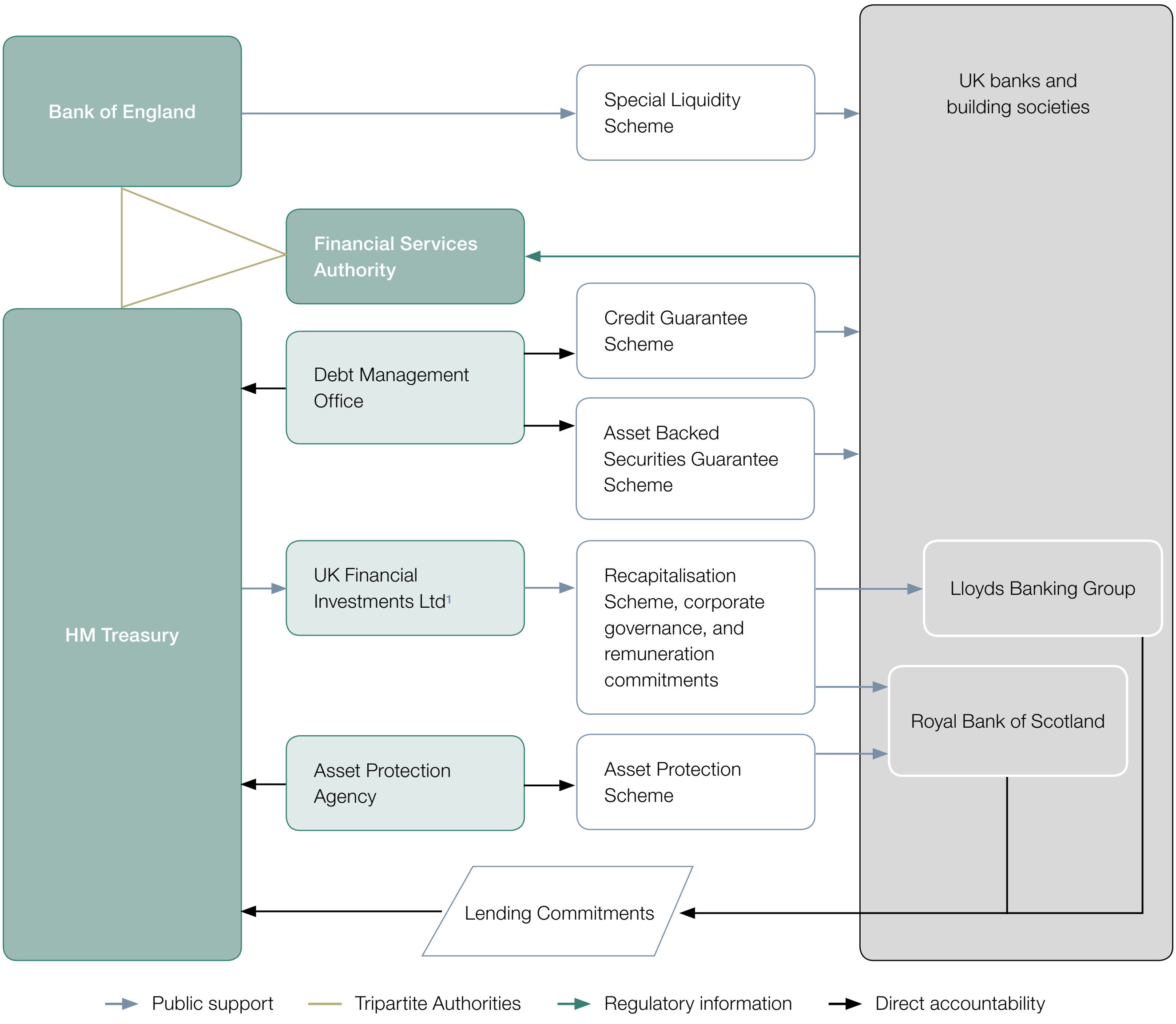
- **Asset Protection Scheme.** This scheme will be managed by a new agency of the Treasury, the Asset Protection Agency.

2.35 UKFI has the objective of protecting and creating value for the taxpayer as shareholder, ultimately through sales of the shareholdings. In doing so, any future sale process will need to balance the consequences for the structure of the industry and competition in the UK market against the proceeds secured for the taxpayer. UKFI is monitoring compliance with non-lending commitments that the banks made when they agreed to join the Recapitalisation Scheme, including remuneration of board members. The company is also responsible for the taxpayers' investment in Bradford & Bingley and will take responsibility for Northern Rock in due course.

2.36 The Government decided not to use the Shareholder Executive, a part of the Department for Business, Innovation and Skills, to undertake this role. There was a need to demonstrate to other shareholders in RBS and Lloyds Banking Group that the shares would be held on a commercial basis, rather than for policy ends. Creating an arms-length relationship from the Treasury and other Government departments was considered the best means of achieving this.

2.37 Overall, the arrangements outlined in Figure 8 are complex. By separating out the various functions to arm's-length bodies, the Treasury has sought to define their distinct roles; to ensure that commercial information is used appropriately; and to ensure that the core Department is better equipped to focus on policy. While the creation of separate bodies, with clear objectives, can be an advantage, there are potential downsides. In particular, there is a risk that potential economies of scale are being missed and that valuable expertise is being spread too thinly.

Figure 8
The management of the support schemes


Bank of England
Special Liquidity Scheme
UK banks and building societies
Financial Services Authority
Credit Guarantee Scheme
Debt Management Office
Asset Backed Securities Guarantee Scheme
HM Treasury
UK Financial Investments Ltd[1]
Recapitalisation Scheme, corporate governance, and remuneration commitments
Lloyds Banking Group
Royal Bank of Scotland
Asset Protection Agency
Asset Protection Scheme
Lending Commitments
Public support
Tripartite Authorities
Regulatory information
Direct accountability

Source: National Audit Office

NOTE

[1] UK Financial Investments Ltd is also responsible for managing the Government's interests in Bradford & Bingley and Northern Rock.

Part Three

The impact of the support and the expected costs

3.1 This Part of the report considers:

a the measures of success for the support provided;

b the conditions attached to the support; and

c the expected net costs for the taxpayer.

Measurement of success

3.2 The support measures were designed to improve confidence in the UK's banking system, and thereby maintain financial stability. The maintenance of financial stability involved:

- maintaining **liquidity** to allow banks to meet customer withdrawals of cash, and to repay outstanding borrowings in the wholesale markets when they fell due;
- ensuring that the major banks were **solvent** in the sense that they had capital to cushion themselves from losses caused by a further deterioration in the financial markets; and over a longer timescale; and
- encouraging banks in receipt of support to continue to lend on a commercial basis to creditworthy borrowers, thereby reducing further deterioration in the economy, which could in turn lead to further liquidity and solvency issues across the banking sector.

3.3 The maintenance of liquidity and solvency are intertwined. For instance, liquidity support can give banks time to recapitalise through new share issues and asset disposals. On the other hand, the Recapitalisation Scheme would also have eased liquidity concerns by assuring potential creditors that a soon to be recapitalised bank stood a better chance of remaining solvent if market conditions worsened.

3.4 The measures put in place in the UK sit alongside action taken by other governments. The success of the measures is therefore linked closely with sentiments and events in both domestic and world markets and drawing a direct link between individual measures and changes in market indicators would not be valid. It is, however, possible to track what is happening across a range of indicators and draw some broad conclusions.

3.5 The ultimate success of the measures can only be judged once the banks have been weaned off the various support mechanisms. In the longer term, success will also depend upon whether banks have changed their business models to avoid the risky behaviour that led to the crisis.

3.6 In July 2009, the Treasury recognised that further work was needed to develop detailed performance measurement and reporting systems. While indicators were still being developed in November 2009, the following paragraphs report upon changes in liquidity and solvency in the UK's banking sector over the course of the crisis.

Liquidity

3.7 A leading indicator of stresses in banking sector liquidity is increases in the margin between the quoted London Inter-Bank Offered Rate (LIBOR) and the Bank of England's Bank Rate, because LIBOR is in part determined by the supply of funds. The margin is only a proxy because other factors influence it, including the demand for funds in the market and lenders' perception of risk.

3.8 For the ten years prior to the crisis, LIBOR for borrowing funds for three months was, on average, about 10 basis points (0.1 per cent) above the Bank of England's Bank Rate. The margin over the Bank Rate has since fluctuated widely (**Figure 9** overleaf). During October 2008, it peaked at 170 basis points. Since then it has fallen steadily, and by late November 2009 was 11 basis points above the Bank Rate.

3.9 Not only was each bank's cost of borrowing increasing, but the duration of their loans was falling, reflecting increased uncertainties over the financial health of banks. This resulted in banks having to find increasingly larger amounts of shorter-term money as loans matured and could only be replaced with short-term borrowing.

3.10 To an extent, liquidity in wholesale funding remains a potential issue with some banks better able than others to borrow at LIBOR. The support schemes made vital liquidity available to the banks and, for some, allowed them time to stabilise their position and for others, to avoid a disorderly collapse. We could find no publicly available information on changes in the overall volume or maturities of bank wholesale borrowing. Data should be available to the Authorities in future through the Financial Services Authority's recently announced plans to enhance its monitoring of the liquidity position at individual banks.

Solvency of the major banks

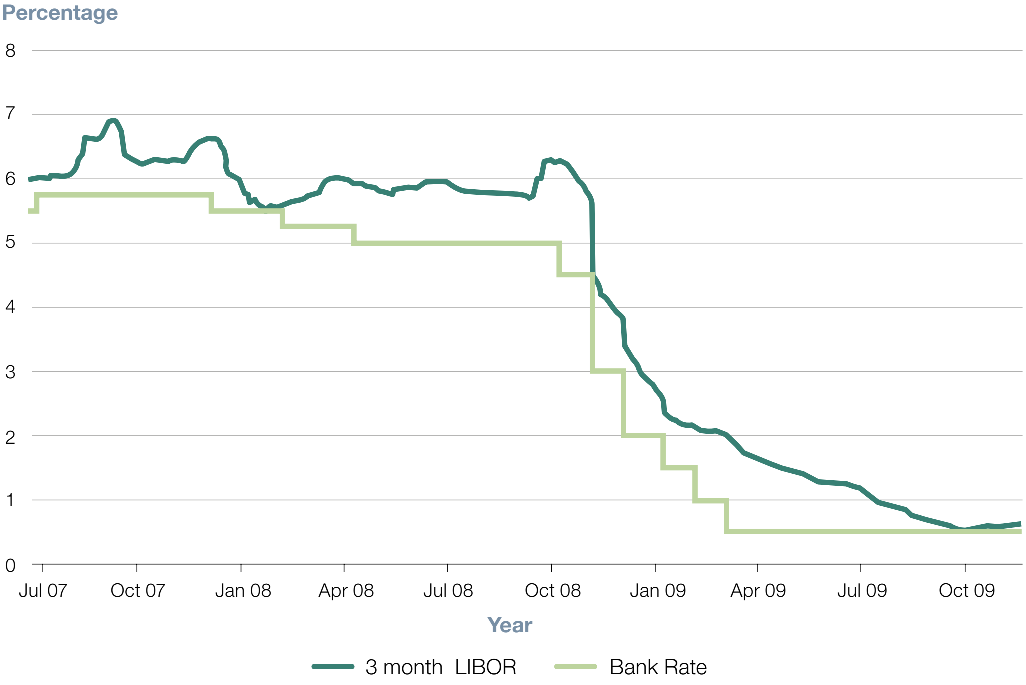
3.11 The primary measure of solvency of a bank is its capital ratio which is expressed as a percentage of risk-weighted assets on the balance sheet. Secondary measures include the price at which investors are willing to buy shares in a particular bank and the cost of insuring longer-term lending to a bank.

Capital adequacy

3.12 Major UK banks have suffered losses in the value of their assets. Action was taken to repair balance sheets, either through the Government's Recapitalisation Scheme, other forms of capital raising or, in the case of RBS, through additional capital injections linked to its participation in the Asset Protection Scheme (**Figure 10**). During the first six months of 2009, all major UK banks increased their capital ratios (**Figure 11**).

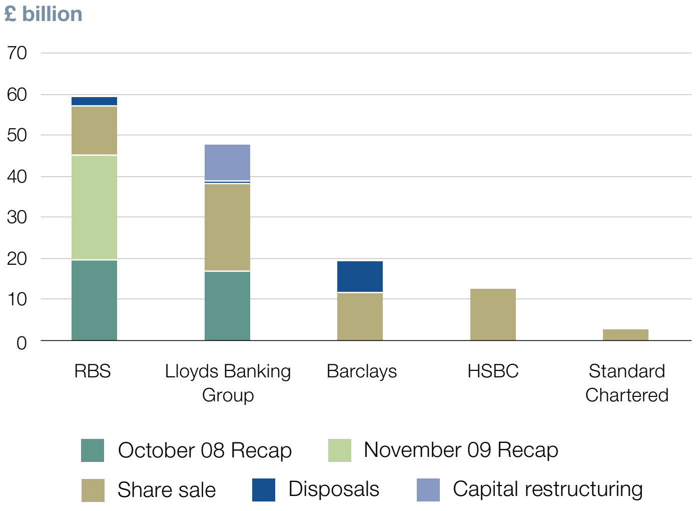
Figure 9

Three-month Sterling LIBOR and the Bank of England's Bank Rate



Source: British Bankers' Association, Bank of England

Figure 10
Capital raised by UK banks since January 2008



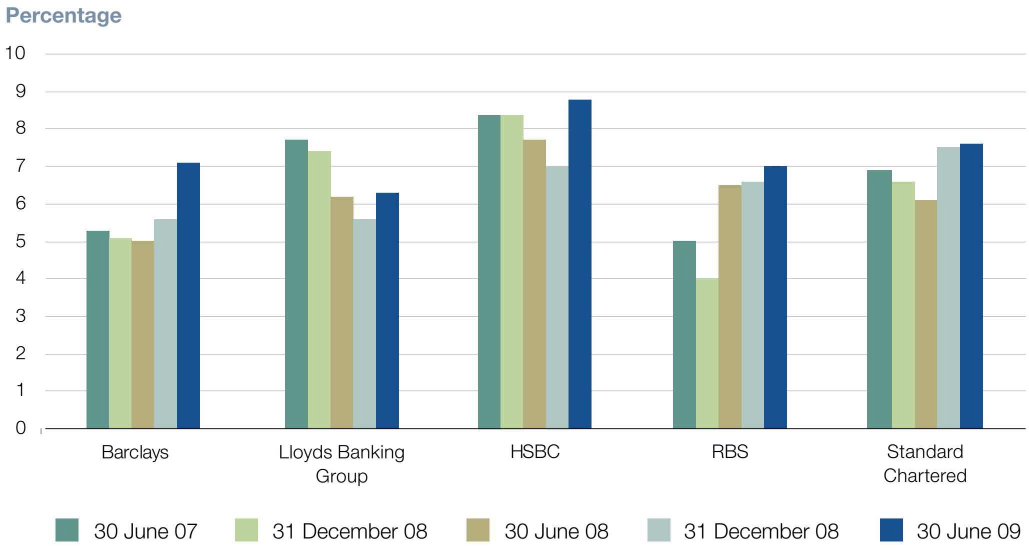
Source: Banks’ public announcements

NOTE

1 The £4 billion of capital raised by HBOS in its share sale in April 2008 is included in the bar for Lloyds Banking Group.

Figure 11
UK banks’ core capital ratios

UK bank core Tier 1 ratio



Source: Half-yearly public reporting of results by the five banks

3.13 The impact of the Recapitalisation Scheme is difficult to distinguish from the impact of the other interventions both national and global. In the immediate aftermath of the recapitalisations of RBS and the Lloyds Banking Group, the market value of their shares continued to weaken. From their lows in March 2009, however, the share prices of the two banks had, by October 2009, outperformed the FTSE 100 (**Figure 12**).

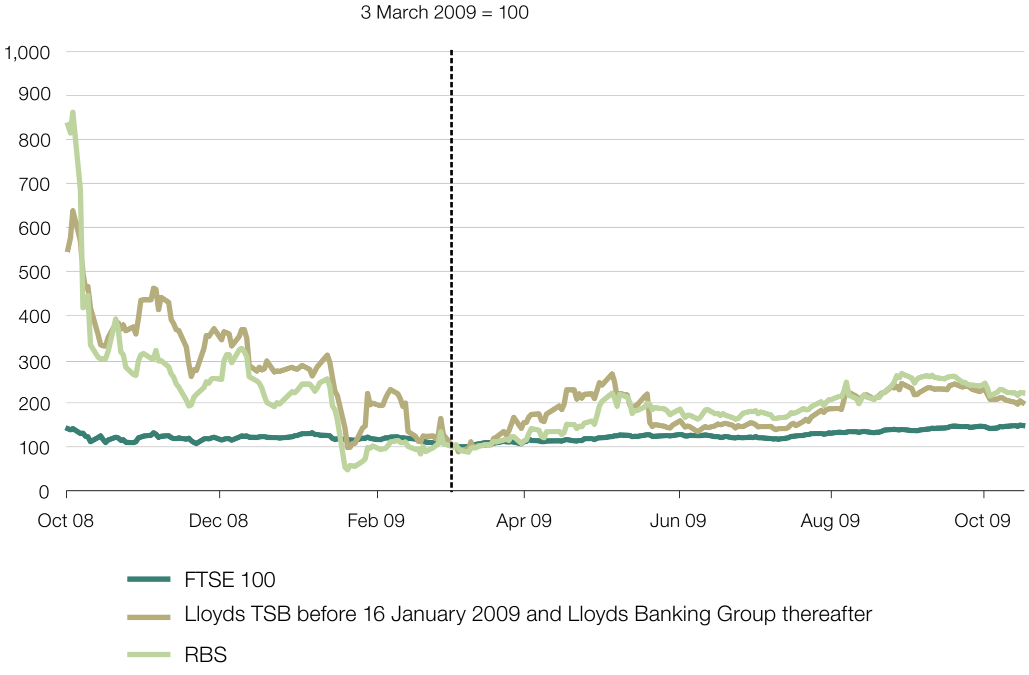
Longer term lending to banks – cost of insurance for default

3.14 The market price for obtaining insurance against the risk of a bank defaulting on repayment of debt obligations (known as Credit Default Swaps) has fallen since March 2009. This fall indicates that investors' perception of the likelihood of banks defaulting has reduced, although the perceived risk is still greater than the pre-crisis level (**Figure 13**).

Figure 12

Performance of the FTSE 100 and the performance of shares in RBS and Lloyds Banking Group

Change in value based on prices indexed at 100 on 3 March 2009



Source: Published market indices and share prices, National Audit Office indexation

The conditions attached to public support for the banks

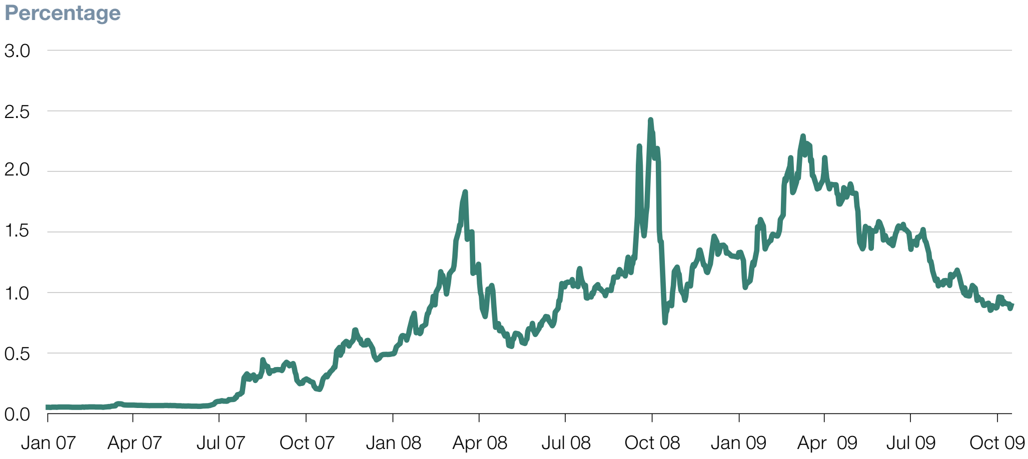
3.15 In return for public support, the banks agreed to a number of conditions required by the Treasury. The restrictions on remuneration and changes in corporate governance are outlined in Appendix Eleven, which is on the NAO's website. The following paragraphs cover the commitments to continue to lend to creditworthy customers.

3.16 Many banks have a funding gap, the difference between the amounts held as deposits and the amounts lent to businesses and individuals. This funding gap, normally financed using the wholesale funding markets, grew significantly from 2000, peaking at £841 billion in 2008. As the wholesale funding markets closed during 2008, the banks needed to find alternative methods of funding or restrict lending.

3.17 In a recession, banks will in any case be more selective in their lending and will charge more for doing so, partly reflecting heightened risk of borrower default. This response helps to preserve a bank's capital, but if all banks react similarly then the impact on the supply of credit will depress economic activity, leading to business closures and more defaults on loans than might otherwise be the case.

Figure 13
The price of insuring against default by a major UK bank has continued to fall since March 2009

Average UK banking sector Credit Default Swap spreads[1]



Source: Markit, banks' published accounts, National Audit Office calculations

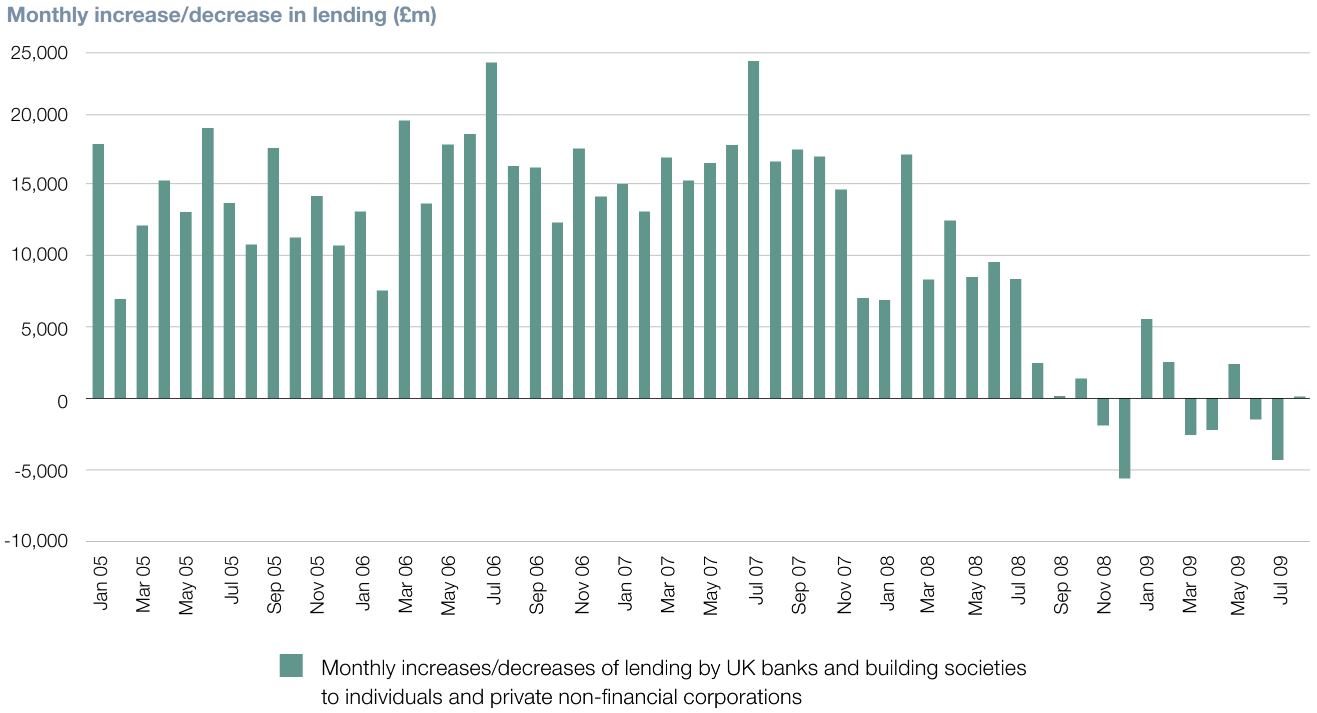
NOTE
[1] Credit Default Swap spreads weighted by assets.

3.18 To monitor lending by all banks and to promote best practice across the industry, the Government established a Lending Panel[2] in November 2008. The Bank of England, on behalf of the Lending Panel, collects lending data covering the major UK lenders. **Figure 14** shows that net lending to businesses and individuals by UK banks fell significantly from the second quarter of 2008. The fourth quarter 2008 and the second quarter 2009 were both periods of net repayments.

3.19 In negotiating the Asset Protection Scheme, the Government agreed legally binding lending commitments with Lloyds Banking Group and RBS. Lloyds Banking Group committed to lend an additional £14 billion (of which £3 billion would be for residential mortgages and £11 billion for lending to businesses). RBS agreed an additional £25 billion of lending (£9 billion for residential mortgages and £16 billion for businesses). The additional lending would be on commercial terms, and subject to market demand, over the 12 months from 1 March 2009. These lending commitments still apply following changes to the Asset Protection Scheme announced in November 2009.

Figure 14

Monthly increases/decreases in lending to individuals and non-financial businesses by UK resident banks and building societies



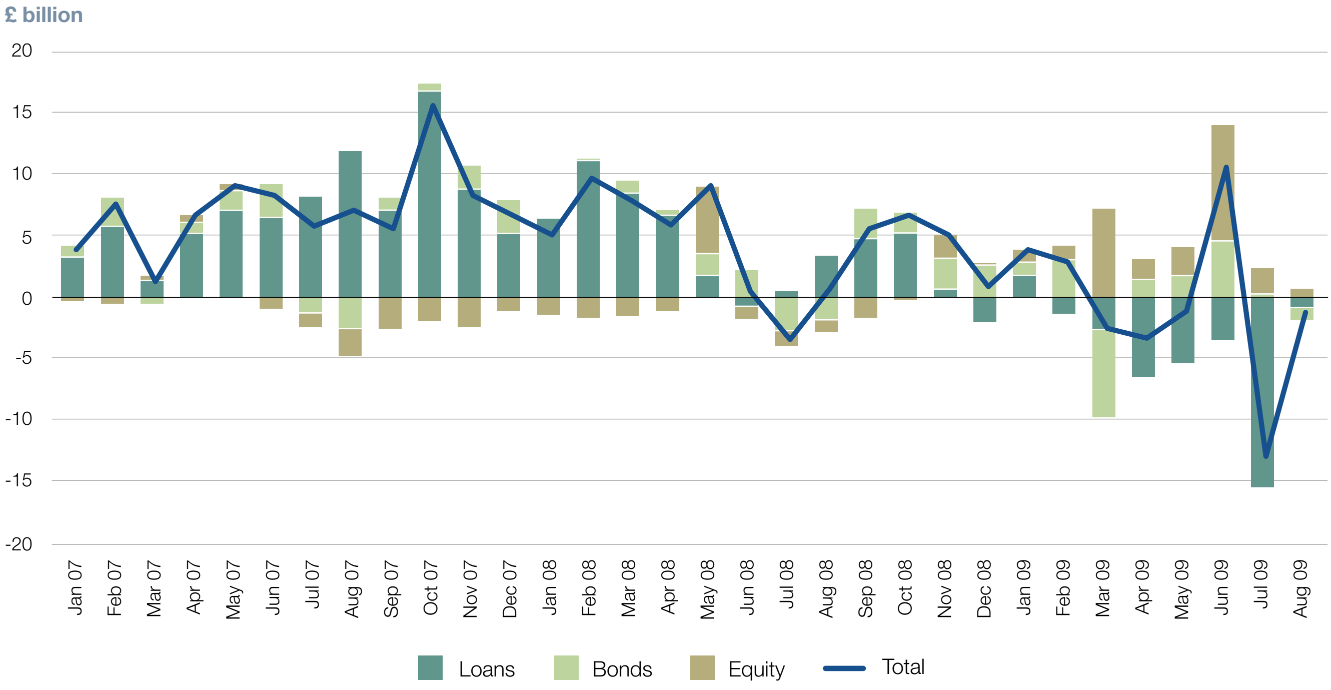
Source: Bank of England

[2] The Lending Panel was established to monitor lending to businesses and households and to promote best practice in dealing with borrowers facing financial difficulties. It includes representatives from lenders, consumers, regulators, trade bodies and debt advisers.

3.20 The lending commitments are being monitored by the Treasury. At the end of September 2009, both RBS and Lloyds Banking Group were on track to meet their residential lending commitment targets. In the period March to September 2009, the amount of debt repaid by businesses to Lloyds Banking Group exceeded the amount that the bank had lent, but lending is forecast by the bank to recover and then to meet the target over the remaining five months to the end of February 2010. However, RBS is falling short on its business lending target. Gross lending to all businesses by the bank from March to September 2009 was lower than the level of repayments, resulting in a net reduction in loans outstanding of £9.1 billion, in comparison with the value of loans outstanding at the end of 2008. Performance so far in 2009 suggests that RBS's commitment to lend an additional £16 billion to businesses by February 2010 will not be achieved.

3.21 In addition to borrowing from banks, large businesses can raise finance through the capital markets by issuing new shares or long-term debt in the form of bonds, which are bought by investors. During the first eight months of 2009, in improving market conditions, UK businesses repaid £33 billion of loans and issued £30 billion worth of equity and bonds (**Figure 15**).

Figure 15
Net funds raised by UK businesses



Source: Bank of England

3.22 RBS and Lloyds Banking Group have advertised that loans to small and medium-sized businesses are available, but lending to this sector is not on track to meet targets. The potential shortfall is of particular concern given that these companies have limited access to alternative sources of finance, such as the capital markets. There was a fall in total outstanding balances on loans as companies retained existing assets rather than replacing them. Higher interest margins and fees on bank loans may also have acted to reduce demand. The Bank of England's Trends in Lending report, published in October 2009, noted that loan margins over the Bank Rate for small and medium-sized enterprises had flattened off, having drifted upwards during the first part of the year. The Bank's regional agents reported that fees charged on new business or renewed lending facilities remained at high levels, compared to before the crisis. Although the Treasury is monitoring progress and meets each of the banks regularly, the only formal sanctions available if targets are not met is a potential refusal to extend guarantees for wholesale borrowing under the Credit Guarantee Scheme.

The expected net costs for the taxpayer

3.23 Quantifying accurately the economic and social consequences of a major bank failure in a developed economy such as the UK would be impossible. Such calculations are always highly sensitive to the underlying assumptions, and can only be broad-brush estimates. It is highly likely that the consequences of a major bank failure would have been far greater than the estimated cost of the support measures put in place.

3.24 In considering the case for providing support to the banking sector in early October 2008, the Treasury used research by the International Monetary Fund[3] (IMF) to illustrate the scale of possible consequences of a systemic banking crisis. Averages calculated in the IMF paper, if applied to the UK economy, suggested that:

- Output loss, measured by extrapolating trend growth in the UK's Gross Domestic Product, over four years from the start of a systemic banking crisis, could be of the order of £280 billion.
- That public sector borrowing might need to increase by £200 billion to make up the shortfall in tax revenue caused by a downturn in the economy.
- The Government's financial outlay supporting financial institutions, net of recoveries, would be approximately £180 billion.

3.25 No two financial crises are the same and the experiences of different countries varies considerably. The outcome is influenced by the timing and nature of the interventions. As a consequence, the IMF averages hide a considerable range of actual outcomes.

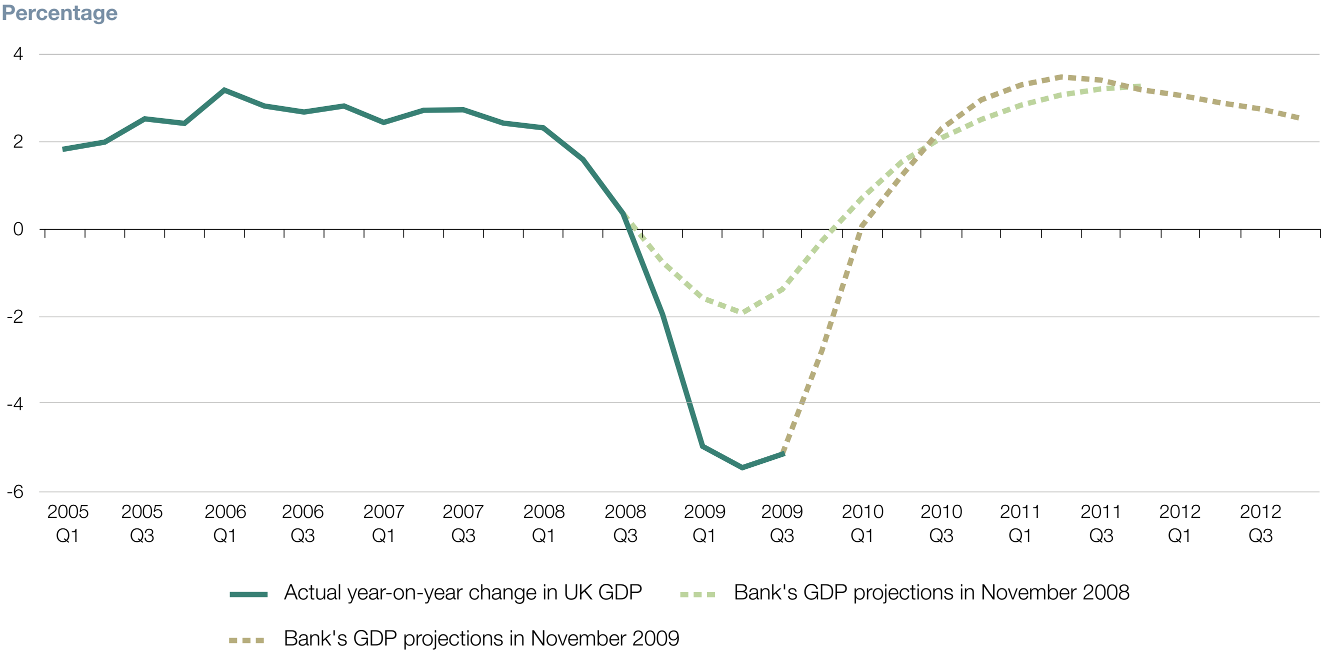
[3] A draft copy of the paper: *Systemic Banking Crisis: A New Database*, International Monetary Fund working paper WP/08/224.

3.26 Since the preparation of these figures, the impact of the bank crisis on the wider economy, as reflected in estimates of the UK's Gross Domestic Product has been more severe than thought likely (**Figure 16**). Furthermore, a comparison of net borrowing forecast in Budget 2008 with Budget 2009 suggests that the increase in public sector borrowing will be closer to £320 billion, rather than £200 billion.

3.27 It is not possible to estimate with any certainty the net cost of the Government's support of the UK's financial system. There are indirect impacts which would have to be factored into any calculation. Such impacts include, for example, the increased cost to the UK Government of borrowing to fund a higher than expected fiscal deficit. By the end of 2009, however, the Government's gross cash outlay is expected to be about £131 billion (**Figure 17** overleaf). As a result of this outlay, the Treasury:

- is a major shareholder in RBS (an economic interest of 84 per cent) and Lloyds Banking Group (43 per cent);
- is the sole shareholder in Northern Rock and those parts of Bradford & Bingley not transferred to Santander; is a creditor in the administration of the Icelandic banks and is due to receive repayments from the Icelandic Government; and
- is receiving repayments of loans provided to Northern Rock, and will receive repayments of loans from Bradford & Bingley and the Financial Services Compensation Scheme.

Figure 16
The performance of the economy has been worse than thought likely in late 2008



Source: Bank of England

NOTE
Growth projections are based on the medians of forecast probability distributions.

Figure 17

By the end of 2009, the Treasury's gross outlay is expected to be £131 billion to support the UK's banking system

Support	Financial outlay (£bn)
Purchases of shares in RBS (recapitalisations announced in October 2008 and November 2009 – in addition, up to a further £8 billion of shares may be purchased if RBS's capital ratio falls below a set level)	46
Purchases of shares in Lloyds Banking Group (recapitalisations announced in October 2008 and November 2009)	23
Loan to, and capital injection in Northern Rock	20
Loans to the Financial Services Compensation Scheme, working capital facility for Bradford & Bingley and other debts	37
Interest on debt raised to fund the above support measures	5
Total	**131**

Source: National Audit Office

3.28 The Treasury has also provided guarantees and indemnities covering over £600 billion of loans and other financial assets. In return, it has received or will receive fees from the banks. By the end of 2009, the Treasury expects to have recovered nearly £14 billion in fees, loan repayments or other redemptions (**Figure 18**), leaving a net outlay of around £117 billion.

3.29 At Budget 2009, the Treasury provisionally estimated that final net losses across all the financial sector interventions may lie within a range from £20 billion to £50 billion. The estimate was set out as a range because of inherent uncertainty over the potential outcomes from these interventions. The high end of the range was included in the fiscal projections in Budget 2009. The Treasury has said it will update this estimate in the 2009 Pre-Budget Report.

3.30 Estimating what the eventual cost will be is dependent upon a range of factors, including risks that may or may not materialise over a number of years. Two key factors are:

- The timing and prices at which the shareholdings in RBS and Lloyds Banking Group are sold; and

- The size of any losses under the Asset Protection Scheme.

Figure 18

By the end of 2009, the Treasury expects to have recovered approximately £14 billion in fees, interest payments, and loan repayments

Institution/Scheme	Recoveries	£ billion
RBS	Commission for underwriting rights issue	0.22
	Redemption of preference shares	0.02
Lloyds Banking Group	Commissions for underwriting rights issues	0.32
	Redemption of preference shares	2.54
	Fees for Asset Protection Scheme until withdrawal	2.50
Northern Rock	Fees for Government guarantee	0.37
	Interest payments	0.25
	Loan repayments	4.45
Bradford & Bingley	Fees for Government guarantee	0.20
	Interest payments	0.20
Credit Guarantee Scheme	Fees	1.38
Financial Services Compensation Scheme	Fees, interest payments and repayment of principal	1.22
Emergency Liquidity Assistance to HBOS and RBS	Fees from the Bank of England for the Treasury's indemnity	0.02
Other		0.18
Total		**13.87**

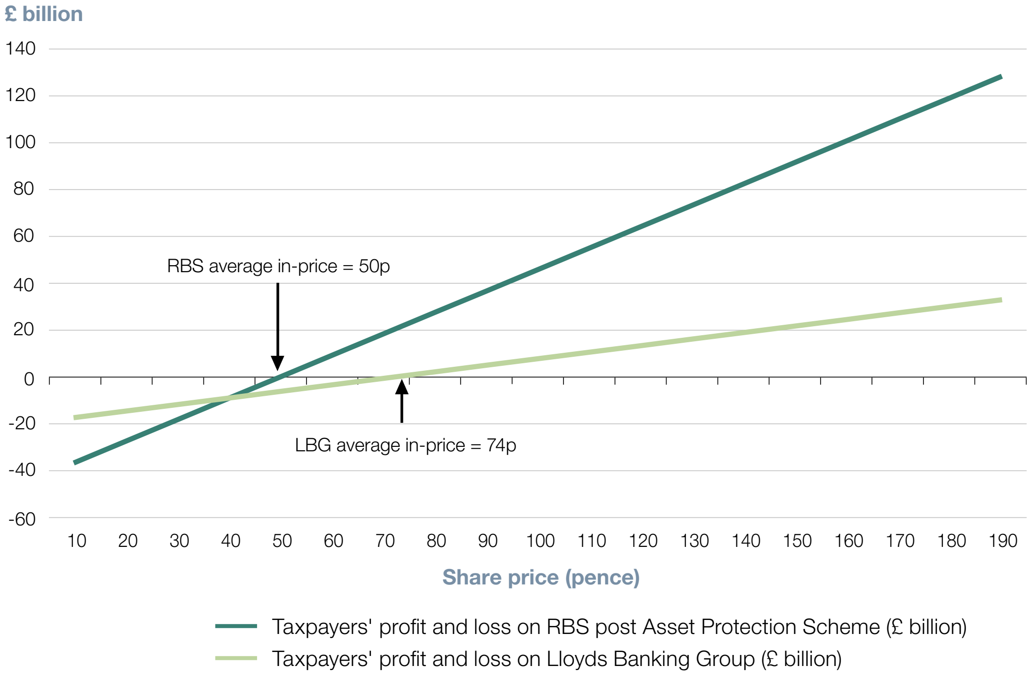
Source: National Audit Office

3.31 Figure 19 shows the taxpayer's profit and loss on its holdings in RBS and Lloyds Banking Group based on different share prices. For every 10 pence increase in the prices obtained for the shares, taxpayers would secure an additional £9 billion from the sale of shares in RBS, and an additional £3 billion from Lloyds Banking Group shares. On 27 November 2009, the market prices of RBS's and Lloyds Banking Group's shares implied a loss for the taxpayer of £18 billion.

3.32 In its annual report 2009, the Treasury indicated that it had made a provision of £25 billion for expected losses from the Asset Protection Scheme. This estimate was based on a preliminary analysis of a sample of assets that RBS and Lloyds Banking Group proposed to include in the scheme. Economic and market conditions would clearly affect the timing and size of potential losses. Following Lloyds Banking Group's withdrawal from the Scheme, and changes to the terms under which RBS will participate, the estimated loss is very likely to be lower than originally expected.

Figure 19

Potential profit or loss for the taxpayer at different share prices



Source: National Audit Office analysis

Appendix One

Summary of the support schemes

Appendix Two

Timeline of key events

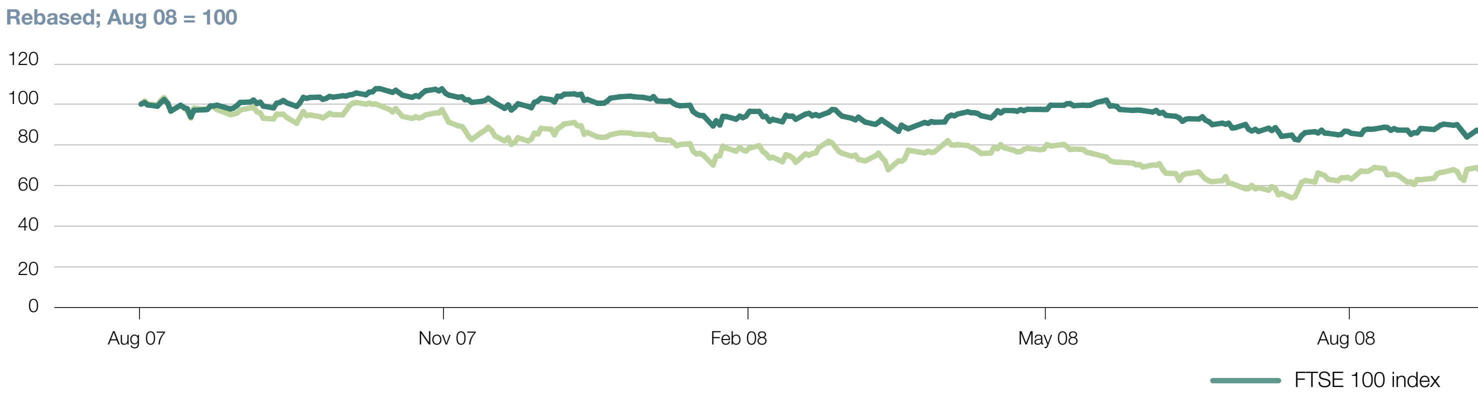
Summary of the support schemes

	Special Liquidity Scheme	Recapitalisation	Credit Guarantee Sch
Date announced	21 April 2008	8 October 2008	8 October 2008
Why needed	Inter-bank lending and securitisation markets were impaired. Banks had on their balance sheets an overhang of illiquid assets which they could not readily sell or use to secure borrowing.	UK banks were inadequately capitalised.	The cost of borrowing in and loan durations short the financial health of ba
What it is meant to do	To improve the liquidity position and confidence in the UK banking sector.	Ensure that banks would be able to bear future losses.	Restore confidence in U
What is at stake	£185 billion of Treasury bills were lent to the banks under the scheme.	The Government injected £20 billion into RBS and £17 billion into Lloyds Banking Group.	Up to £250 billion of gua raised in wholesale mark
Key success measures	Keeping at bay a generalised liquidity crisis. A fall in the cost of inter-bank borrowing relative to the Bank Rate. Greater confidence in the UK banks as evidenced by a fall in Credit Default Swap spreads.	RBS and Lloyds Banking Group remain solvent with continued financial stabillity in the banking sector.	Scheme can be used wi supports continued finan incentivises banks to re- markets as they recover.
Potential taxpayer return	Fee income of £573 million to February 2009. (Bank of England's annual report 2009)	Dependent on proceeds from future sales.	Fees from participants in
Developments since announcement	Scheme closed to further drawdowns at the end of January 2009, but will remain in place until 2012 to provide participants with continuing liquidity support.	Further capital injections of up to £39 billion were announced in November 2009.	At the end of 2008, mark remained fragile. The sc extended. Pricing was a introduction of other gua internationally.
Exit strategy	As the asset swaps expire, participants will return the outstanding Treasury Bills to the Bank in exchange for their collateral.	United Kingdom Financial Investments Ltd will sell the shares when it is most beneficial to taxpayers.	Scheme closes in Decem

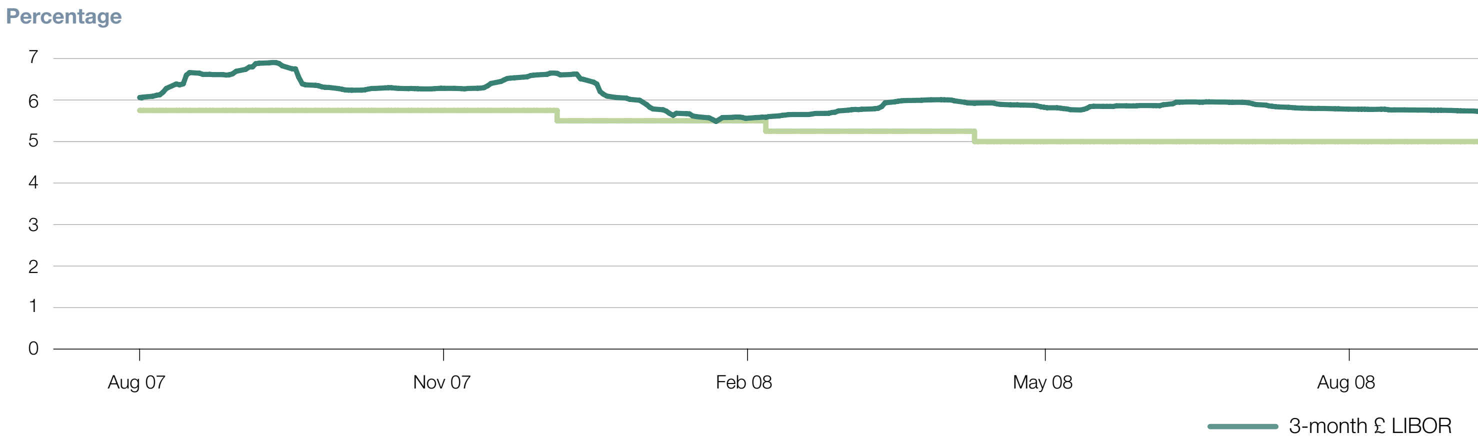
heme	Asset Protection Scheme	Asset Backed Securities Guarantee Scheme
	19 January 2009	19 January 2009
the market escalated tened, as fears about nks increased.	The losses on assets were using up the banks' capital so they were reluctant to lend further.	The market for mortgage backed securities effectively closed, restricting banks' access to funds.
K banks.	Restore confidence in the banks and get credit flowing again.	Improve access to wholesale funding and promote sustainable markets over the longer-term.
rantees for debt kets.	The taxpayers' maximum liability under the scheme is just under £200 billion.	No take-up so far.
thout stigmatisation; ncial stability; and enter unguaranteed .	Increased lending to the real economy.	Securitisation market shows sign of revival; increased mortgage lending.
the scheme.	Fees from RBS.	Fees from participants in the scheme.
ket conditions heme was therefore djusted following rantee schemes	The scheme was finalised in November 2009. Lloyds Banking Group withdrew and RBS will participate on revised terms.	
mber 2009.	RBS can only exit the Scheme with the approval of the Financial Services Authority.	Scheme will close 31 December 2009.

Timeline of key events

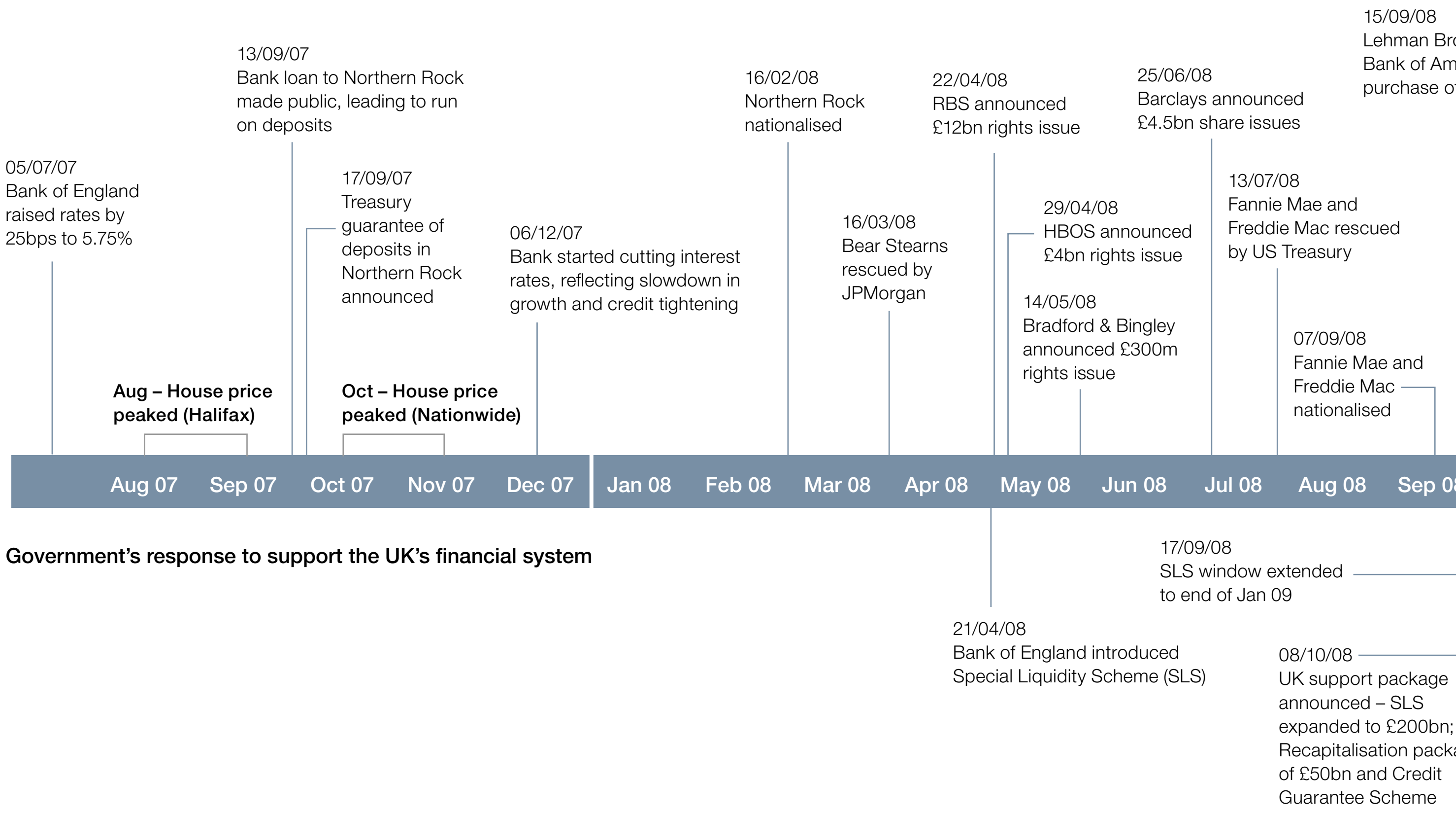
Performance of UK bank shares and the FTSE 100 index since August 2007



Three month Sterling LIBOR and the Bank of England's Bank Rate



Major events during the credit crisis



05/07/07
Bank of England raised rates by 25bps to 5.75%

Aug – House price peaked (Halifax)

13/09/07
Bank loan to Northern Rock made public, leading to run on deposits

17/09/07
Treasury guarantee of deposits in Northern Rock announced

Oct – House price peaked (Nationwide)

06/12/07
Bank started cutting interest rates, reflecting slowdown in growth and credit tightening

16/02/08
Northern Rock nationalised

16/03/08
Bear Stearns rescued by JPMorgan

22/04/08
RBS announced £12bn rights issue

29/04/08
HBOS announced £4bn rights issue

14/05/08
Bradford & Bingley announced £300m rights issue

25/06/08
Barclays announced £4.5bn share issues

13/07/08
Fannie Mae and Freddie Mac rescued by US Treasury

07/09/08
Fannie Mae and Freddie Mac nationalised

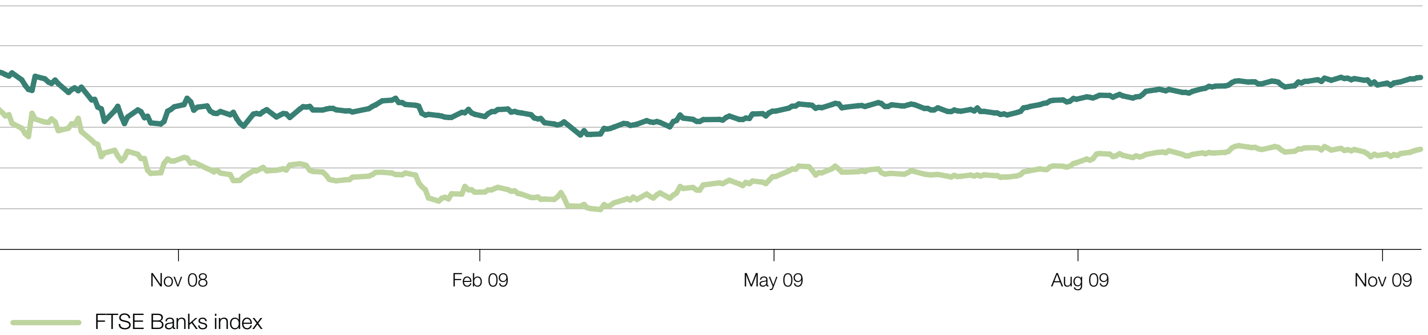
15/09/08
Lehman Bro
Bank of Am
purchase o

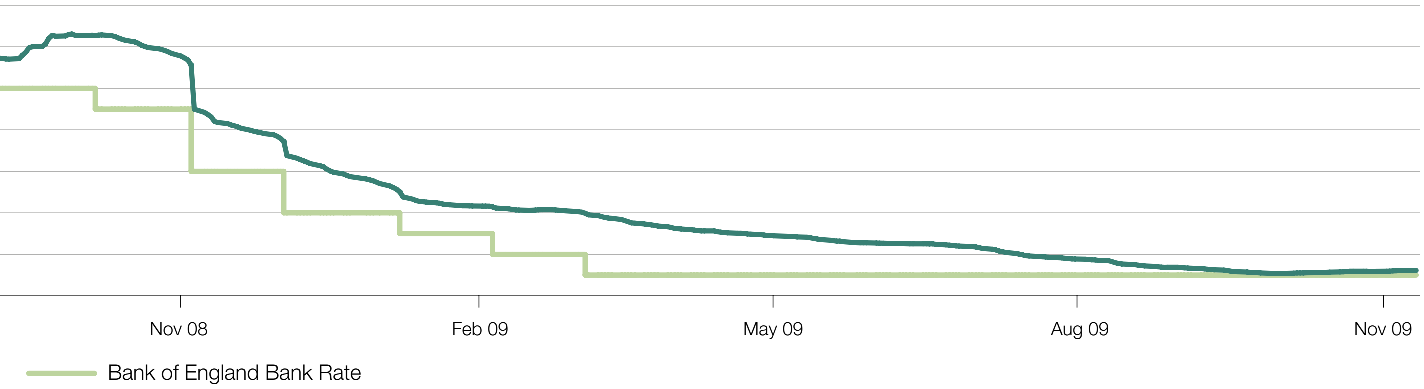
Government's response to support the UK's financial system

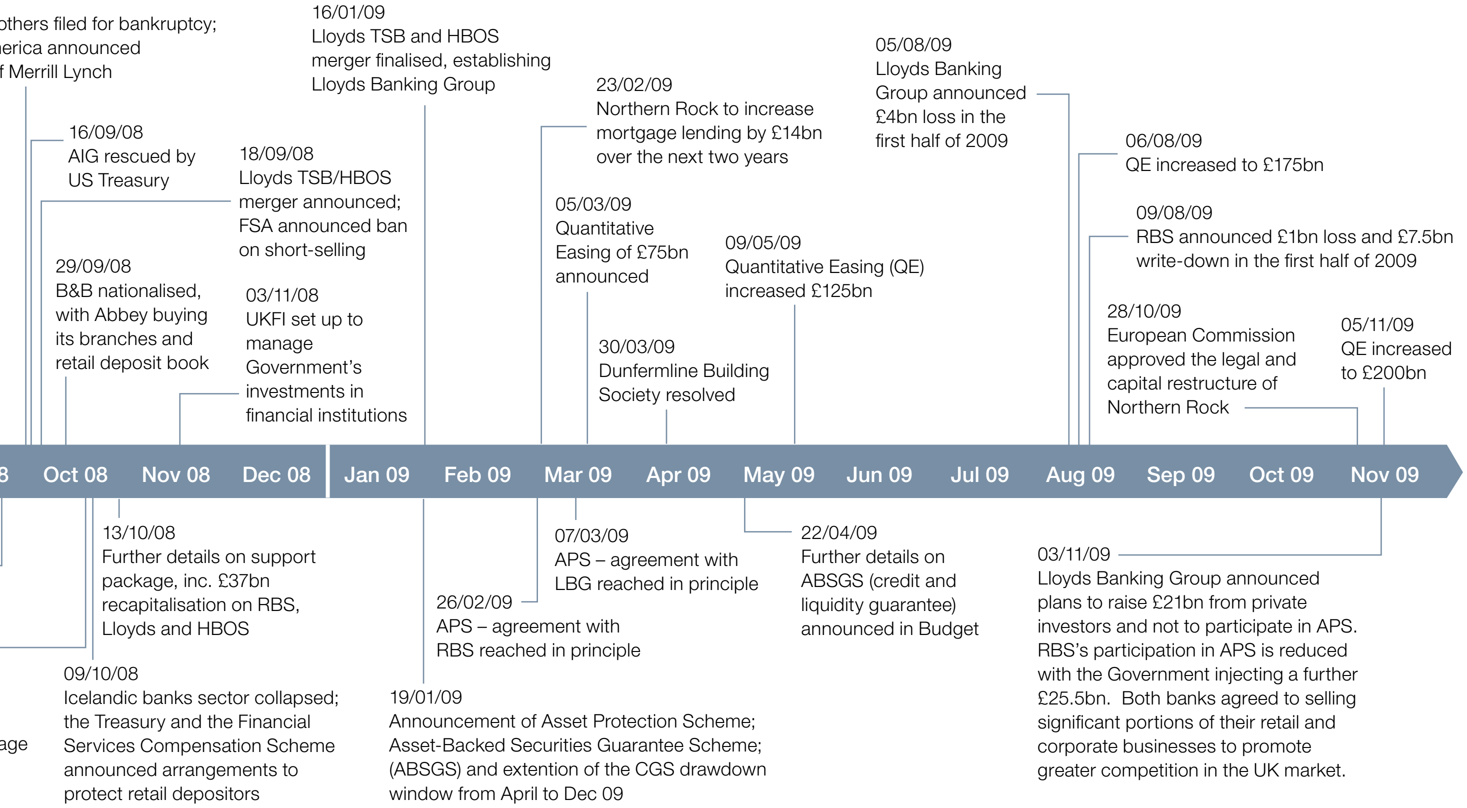
21/04/08
Bank of England introduced Special Liquidity Scheme (SLS)

17/09/08
SLS window extended to end of Jan 09

08/10/08
UK support package announced – SLS expanded to £200bn; Recapitalisation packa of £50bn and Credit Guarantee Scheme







others filed for bankruptcy;
erica announced
f Merrill Lynch

16/09/08
AIG rescued by
US Treasury

29/09/08
B&B nationalised,
with Abbey buying
its branches and
retail deposit book

18/09/08
Lloyds TSB/HBOS
merger announced;
FSA announced ban
on short-selling

03/11/08
UKFI set up to
manage
Government's
investments in
financial institutions

16/01/09
Lloyds TSB and HBOS
merger finalised, establishing
Lloyds Banking Group

23/02/09
Northern Rock to increase
mortgage lending by £14bn
over the next two years

05/03/09
Quantitative
Easing of £75bn
announced

30/03/09
Dunfermline Building
Society resolved

09/05/09
Quantitative Easing (QE)
increased £125bn

05/08/09
Lloyds Banking
Group announced
£4bn loss in the
first half of 2009

06/08/09
QE increased to £175bn

09/08/09
RBS announced £1bn loss and £7.5bn
write-down in the first half of 2009

28/10/09
European Commission
approved the legal and
capital restructure of
Northern Rock

05/11/09
QE increased
to £200bn

13/10/08
Further details on support
package, inc. £37bn
recapitalisation on RBS,
Lloyds and HBOS

09/10/08
Icelandic banks sector collapsed;
the Treasury and the Financial
Services Compensation Scheme
announced arrangements to
protect retail depositors

age

26/02/09
APS – agreement with
RBS reached in principle

07/03/09
APS – agreement with
LBG reached in principle

19/01/09
Announcement of Asset Protection Scheme;
Asset-Backed Securities Guarantee Scheme;
(ABSGS) and extention of the CGS drawdown
window from April to Dec 09

22/04/09
Further details on
ABSGS (credit and
liquidity guarantee)
announced in Budget

03/11/09
Lloyds Banking Group announced
plans to raise £21bn from private
investors and not to participate in APS.
RBS's participation in APS is reduced
with the Government injecting a further
£25.5bn. Both banks agreed to selling
significant portions of their retail and
corporate businesses to promote
greater competition in the UK market.

Glossary

Asset Protection Agency	An agency set up by the Treasury to run the Asset Protection Scheme on its behalf.
Asset Protection Scheme (APS)	An insurance scheme established by the Treasury to restore confidence in UK banks by providing protection against future losses on their insured assets.
Asset Purchase Facility (APF)	Established by the Bank of England, with an indemnity from HMT. The APF has two objectives: first, to improve liquidity in corporate credit markets; and second, it is also used for monetary policy purposes to inject money directly into the economy (in this case the purchases of assets are financed by the Bank creating money, rather than by the issuance of Treasury Bills. Also known as Quantative Easing).
Asset-Backed securities (ABS)	A financial asset backed by a pool of loans such as mortgages or credit-card loans.
Asset-Backed Securities Guarantee Scheme (ABSGS)	Announced by the Treasury in January 2009 to kick-start the Asset Backed Securities market and support lending in the UK economy.
Bank Rate	The official interest rate set by the Monetary Policy Committee and paid on commercial bank reserves at the Bank of England.
Capital (adequacy) ratio	A measure of a bank's capital as a percentage of a bank's risk weighted assets. Used by regulators to determine a bank's ability to cover unexpected losses.
Credit Default Swap (CDS)	A tradable financial instrument which provides a form of insurance for lenders against a borrower defaulting on a loan.
Credit Guarantee Scheme (CGS)	Announced by the Treasury in October 2008 to guarantee UK banks' borrowings in the wholesale funding markets.
Debt Management Office (DMO)	An agency of the Treasury which manages the issuance and redemption of gilts and Treasury Bills. The DMO is also responsible for day to day management of the CGS and ABSGS.
Financial Services Compensation Scheme	A compensation scheme for customers of financial services firms which have stopped trading or have been declared in default, and are unable or likely to be unable to pay claims against them.
Lending Panel	Established by the Treasury to monitor lending to both businesses and households, and to promote best practice across the industry in dealing with borrowers facing financial difficulties.
London Inter-Bank Offered Rate (LIBOR)	An interest rate benchmark for wholesale borrowings by financial institutions, calculated by the British Bankers' Association.
Liquidity	The ability to buy or sell an asset (usually for cash) in the market without having a material affect on the asset's price. In the context of financial institutions' funding needs, liquidity can also mean the ability to fund increases in assets and meet obligations as they become due.
Mortgage-Backed Securities	A type of Asset-Backed Security which is secured by a portfolio of mortgages.
Non-performing assets	A loan under which the borrower has failed to make interest or principal payments for a certain period of time (90 days is often used).

Open Market Operations (OMOs)	UK banks and building societies undertake to hold target balances (reserves) at the Bank of England. Ordinarily, open market operations are used to provide the banking system with the amount of central bank money needed to enable reserves scheme members to achieve their reserves targets. But OMOs can also act as a form of liquidity insurance to the banking system.
Ordinary shares	Shares which do not have any pre-determined dividends. Ordinary shareholders have voting rights at general meetings but cannot receive dividends unless the dividends on any preference shares are paid first. They also rank behind preference shareholders in a liquidation scenario.
Partnerships UK	Established by the Treasury to work with the public sector in supporting complex procurement projects, developing procurement and investment policies, supporting individual infrastructure projects, developing public service commissioning models and investing in projects and companies.
Preference shares	Shares which usually pay fixed dividends. Preference shareholders have higher priority than ordinary shareholders if the company is liquidated.
Recapitalisation Scheme	Announced by the Treasury in October 2008 to provide capital to participating banks in exchange for ordinary and preference shares.
Rights issue	Existing shareholders are given the right to buy a proportional number of new shares at a given price (usually at a discount to the current market price of the shares).
Risk-weighted assets	A measure of a bank’s total assets weighted by the riskiness of each type of asset. It is often used to determine the minimum amount of capital that a bank is required to hold.
Securitisation	The process by which an issuer, often a bank, creates a financial instrument by combining other financial assets, repackaging and usually dividing them into different tiers according to their degree of risk before selling them to investors.
Shareholder Executive	Created in September 2003 to improve the Government’s performance as a shareholder in Government-owned businesses and to provide a source of corporate finance expertise within Government.
Solvency	The ability of a business to meet its obligations, as measured by the relative size of its assets and liabilities.
Special Liquidity Scheme	A temporary scheme set up by the Bank of England in April 2008 to provide liquidity support to UK banking system. It works by allowing banks and building societies to swap illiquid mortgage-backed assets and other assets, for liquid UK Treasury bills, for a period of up to three years. The scheme will close in January 2012.
Sub-prime mortgages	A type of mortgage granted to borrowers with low credit ratings.
Treasury bills	Zero-coupon debt securities issued by the UK government with maturities of up to one year.
United Kingdom Financial Investments (UKFI)	A company set up by the Treasury to manage the Government’s investments in financial institutions including RBS, Lloyds Banking Group, Northern Rock and Bradford & Bingley.
Wholesale funding/ borrowing	A general term for funding sourced from wholesale market participants (for example, financial institutions, money market mutual funds and overseas/ local government entities). Individual funding agreements may vary in size, maturity and nature (for example, whether through debt issuance or bilateral lending agreements).

FSC
Mixed Sources
Product group from well-managed forests and other controlled sources
Cert no. TT-COC-002251
www.fsc.org
© 1996 Forest Stewardship Council

Design and Production by
NAO Marketing & Communications Team
DP Ref: 009095-001

This report has been printed on Consort 155 and contains material sourced from responsibly managed and sustainable forests certified in accordance with FSC (Forest Stewardship Council).

The wood pulp is totally recyclable and acid-free. Our printers also have full ISO 14001 environmental accreditation this ensures that they have effective procedures in place to manage waste and practices that may affect the environment.

Published by TSO (The Stationery Office) and available from:

Online
www.tsoshop.co.uk

Mail, Telephone, Fax & E-mail
TSO
PO Box 29, Norwich, NR3 1GN
Telephone orders/General enquiries: 0870 600 5522
Order through the Parliamentary Hotline
Lo-Call 0845 7 023474
Fax orders: 0870 600 5533
E-mail: customer.services@tso.co.uk
Textphone: 0870 240 3701

The Parliamentary Bookshop
12 Bridge Street, Parliament Square,
London SW1A 2JX
Telephone orders/General enquiries 020 7219 3890
Fax orders: 020 7219 3866
Email: bookshop@parliament.uk
Internet: http//www.bookshop.parliament.uk

TSO@Blackwell and other Accredited Agents
Customers can also order publications from:

TSO Ireland
16 Arthur Street, Belfast BT1 4GD
028 9023 8451 Fax 028 9023 5401

£14.35

ISBN 978-0-10-296319-9

9 780102 963199