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Maintaining financial stability across the United Kingdom's banking system

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.