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The Asset Protection Scheme

Summary

1 Since 2007, economies around the world have suffered financial shocks leading to a number of bank failures. In October 2008, the Treasury announced a package of measures to support the UK banking system. A key element involved purchases of shareholdings in the Royal Bank of Scotland (RBS) and Lloyds Banking Group (Lloyds) totalling £37 billion.

2 By providing banks with additional capital to withstand the economic conditions at that time, the October 2008 measures avoided a collapse of the UK banking system. However, the economic downturn continued to intensify, undermining market confidence in the value of banks' assets. As banks remained unsure about the value of assets on their balance sheets, the Treasury was concerned that they would respond to this uncertainty by retaining capital. Banks' reduced willingness to lend was seen as a risk to economic recovery, which could in turn lead to further declines in the value of banks' assets.

3 In January 2009, a further set of measures was announced, including an Asset Protection Scheme (the Scheme) which would protect banks against exceptional losses on loans, mortgages and other financial assets. In November 2009, the Treasury agreed that:

- RBS would place £282 billion of assets in the Scheme. To ensure that RBS could absorb further losses, the Treasury injected additional capital of £25.5 billion, with a promise of up to a further £8 billion if needed.
- Lloyds would not participate further in the Scheme, but would instead raise additional capital from shareholders, including the taxpayer, and pay a fee of £2.5 billion to exit the Scheme.

4 We have previously reported on the nationalisation of Northern Rock, and in December 2009 and 2010 published overviews of the subsequent measures taken to maintain financial stability. This report on the Scheme considers whether the Treasury:

- based its decision making on a robust assessment of the options;
- maintained financial stability by ensuring that the banks would have enough capital in a severe economic downturn;
- protected the taxpayer interest as far as possible; and
- encouraged lending to the wider economy.

Key findings

Options analysis

5 A range of options, including public ownership and purchases of banks' assets, were considered. The Treasury judged that taking a major bank into public ownership carried significant risks, including a further fall in confidence in other banks, and therefore considered this a last resort. Implementing an asset purchase, rather than a protection scheme, for major banks would have taken longer to set up and would have involved the transfer of legal ownership of assets, many of which were located outside the UK. An asset protection arrangement had the advantage of not requiring, in itself, an immediate cash call on the Exchequer.

6 The maintenance of financial stability was key in the final decision to go ahead with the Scheme. Before finalising the Scheme, the Treasury considered whether an alternative of a larger capital injection might be better value for money. In the event of a severe economic downturn, such a change might have reduced the cost to the taxpayer, but would not have provided as much certainty to the markets that RBS would remain solvent. As a consequence, the risk to financial stability was judged to be too great and the Scheme was implemented.

Maintaining financial stability

7 The Treasury's actions reduced the risks faced by the banks as the economy suffered a steeper downturn than expected in late 2008 and early 2009. Following the announcement of the Scheme in January 2009, market sentiment towards the supported banks stabilised. To date, the Scheme has contributed to the Treasury's aim of maintaining financial stability.

8 As a result of the support, through capital injections and the Scheme, ordinary shareholders saw the value of their holdings reduced considerably but some private holders of bank capital were to a degree protected. International agreements on bank capital allow some types of borrowing by banks to be counted as capital if, among other conditions, the debt is subordinated to the claims of other creditors in the event of insolvency. Because the Government's intervention avoided insolvency, holders of subordinated debt were not put at immediate risk, although the market value of their holdings declined. In addition, the banks did not suspend interest payments or early repayments of the debt, which they had a right to do in a financial crisis, for fear of putting future funding from such sources at risk. With support from the Treasury, both banks exchanged or bought back subordinated debt during 2009-10, increasing capital by over £5 billion. Further buy-backs and exchanges of subordinated debt by both banks could increase core capital further.

Protecting the taxpayers' interest

9 Under the final agreement with RBS, the Treasury agreed that:

- RBS bears the first £60 billion of losses (termed the "first loss");
- the Treasury meets 90 per cent of losses incurred thereafter (termed the "second loss"); and
- RBS will pay annual fees subject to an overall minimum fee on exit of £2.5 billion or, if higher, 10 per cent of the capital relief provided by the Scheme.

First loss

10 The Treasury set the first loss equal to its estimate of the losses likely to be incurred by RBS under the most likely economic scenario. The Scheme therefore only provides protection against further losses if the economy performs below expectations. By September 2010, losses stood at £37 billion. Setting the first loss at or above the expected loss was crucial in providing the right incentive to the bank to manage assets effectively – up to the first loss, all losses are borne by the bank. The Treasury conducted extensive due diligence on the assets proposed by RBS for the Scheme – a highly complex task encompassing assets held across the world – and designed a series of stress scenarios which were used to calculate a range of possible losses. An early estimate of losses by the Asset Protection Agency, established by the Treasury to oversee the Scheme, suggests that the first loss was set at a reasonable level.

11 Both banks encountered major difficulties in providing the Treasury with data on their assets within the timescales set, particularly in terms of the volume of data and the format required. Where the data was judged to be insufficient, the Treasury adopted a conservative view of potential losses or refused to allow the assets into the Scheme. As the legality of some covered assets at the time could not be confirmed beyond reasonable doubt, the Treasury's Accounting Officer sought and was given a direction by the Chancellor of the Exchequer to proceed with the Scheme.

Second loss

12 If the first loss is exceeded, RBS will have less financial incentive to stem further losses although the bank considers it will still have a legal and moral obligation to manage the assets as best it can. The Treasury decided against RBS bearing a higher percentage of second losses as this would have required a higher injection of capital upfront to strengthen the bank's position. Any payments by the taxpayer for second losses will, however, be delayed by two years from the point at which the loss is realised, providing time for any recoveries on assets to be offset. More significantly, second loss payments must be repaid by RBS if it wishes to exit the Scheme before December 2099.

13 The taxpayers' position would be particularly vulnerable if losses were to exceed about £73 billion. Our estimates suggest that, up to this tipping point, RBS will have a financial incentive to exit the Scheme long before December 2099, taking account of the annual fees that it would have to pay to stay in. If losses were, however, to exceed about £73 billion, RBS would have an incentive to stay in the Scheme until the end, rather than incur a large and immediate repayment to the Exchequer. After this point the remaining incentives on RBS to stem any further losses are unlikely to be effective. Losses of this magnitude would only occur in seriously stressed economic circumstances, the probability of which has reduced since the Scheme was announced in January 2009.

Fees

14 The £2.5 billion exit fee agreed with Lloyds was set at a level that would meet regulatory capital requirements and avoid jeopardising the rights issue. The exit fee was equivalent to an annual return of 16.4 per cent on the capital benefit obtained by Lloyds. This rate of return was approximately 2 per cent higher than the bank's cost of capital in late 2009, but was below returns that might have been demanded by investors during the early part of 2009, when economic conditions were difficult. On the basis of a cost of equity of 20-30 per cent a year, the fee could have been fixed within a range of £3-4.5 billion for the period that the bank benefited from the Scheme. The Treasury, however, accepted that Lloyds would not have been able to secure shareholder approval to pay a higher fee, pass the Financial Services Authority's stress test, and successfully proceed with its proposed capital raising exercise. The Treasury judged that overall value for money would be better secured by exit rather than keeping Lloyds within the Scheme. Our analysis suggests that the fee paid was at the upper end of the range paid by Bank of America when it exited the US Asset Guarantee Program.

15 In light of the deal reached with Lloyds and likely market perceptions, the Treasury decided a minimum exit fee for RBS of £2.5 billion was appropriate. In setting the fee at this level, the Treasury aimed to charge the maximum fee possible, consistent with leaving RBS well-capitalised and securing the primary objective of financial stability, and to ensure that the pricing structure maintained an incentive on RBS to exit as quickly as possible.

16 The Treasury's analysis underpinning the minimum RBS exit fee did not include the breadth and depth of analysis we would expect, given the amounts at stake. But even with a more complete analysis, the Treasury would still have had to consider the risks to financial stability. Our examination suggested that, in its analysis of the fee, the Treasury did not consider all the risks being covered by the taxpayer and hence the fee that might have been appropriate if wider considerations had not been paramount. For instance, our analysis of cash flows suggested that a minimum fee in the range £1.4-4.4 billion could have been justified without breaching minimum capital requirements, with the weight of analysis pointing towards the upper end of the range. But if the Treasury had conducted this analysis to inform its judgement, it would have had to judge the impact of a different fee on broader financial stability, market perceptions and the overall pricing structure. In addition, the Treasury would have had to obtain approval from the Financial Services Authority on the adequacy of RBS's capital position.

Scheme rules

17 RBS is required to manage the assets in line with detailed requirements set out in the agreement, including the need to obtain approval from the Asset Protection Agency on key decisions involving major assets. Ultimately, the Agency has power to replace the asset managers or take over the management of the relevant assets. In practice, the extent to which assets are managed in the interests of the taxpayer if the first loss of £60 billion is breached will depend heavily on the incentives built into the pricing structure, the ability of the Agency to obtain the information it needs to assess whether taxpayers' interests are safeguarded, and the willingness of the Agency and RBS to work together effectively.

Lending commitments

18 Both banks achieved targets for mortgage lending in the first year of operation, but there was a shortfall of £30 billion against targets for lending to businesses (£8 billion for Lloyds and £22 billion for RBS). As part of the Scheme, Lloyds and RBS agreed to meet lending targets for 2009 and 2010. While the fall in business lending could have been due to a combination of a lack of demand and a shortage of supply, recent research by the Bank of England suggests that there is evidence of a tightening in credit supply conditions from mid-2007, as well as weaker credit demand. Changes have been made to the targets for the second year of operation to reflect changes in borrower behaviour, particularly the greater use of alternative sources of finance by larger businesses. The Treasury considered introducing a range of potential sanctions if targets were not met but decided that all would face insurmountable difficulties. The Treasury has few levers through the Scheme to encourage either bank to deploy extra resources to meet the targets.

Conclusion on value for money

19 Along with capital injections into the banks, the announcement of the Scheme had a beneficial impact on the financial markets, helping to achieve the Treasury's aim of maintaining financial stability. By avoiding the huge economic and social consequences of the failure of a major UK bank, the Scheme was a key component in delivering value for money.

20 The Treasury did well to maintain flexibility in developing and negotiating the Scheme as more information on the assets became available and 2009 unfolded. With the exception of weaknesses in the Treasury's analysis of potential fees for RBS, the principal elements of the Scheme, particularly the first loss, were based on a robust assessment of the incentives that impact on value for money, and on as complete information as was available at the time on the underlying assets. Value for money in the longer term will depend heavily on the incentives built into the pricing structure to encourage good asset management.

21 Overall, the global economy remains highly uncertain, and much will therefore depend on the Asset Protection Agency's ability to hold RBS to its commitments to manage the assets well. As it stands now, the Scheme has contributed to financial stability, the Treasury's overriding aim. But the Scheme has, so far, only been partially successful in encouraging lending to creditworthy borrowers on the scale originally envisaged.

Recommendations

a **The Treasury put considerable effort into assessing the overall pricing structure for RBS's participation in the Scheme, in particular the level of first loss, but there were gaps in its analyses supporting its assessment of fees.** The Treasury should explore the use of approaches to challenge the breadth and depth of key analyses and enable it to step back and re-examine some of the assumptions implicit in its thinking. This challenge should include consideration of the potential upside for the taxpayer as well as the risks.

b **To avoid potential funding difficulties, the banks did not exercise features of subordinated debt designed to preserve capital in adverse economic conditions, leaving ordinary shareholders and the taxpayer to bear the risk.** With support from the Treasury, the banks have bought back some of their subordinated debt at discounts, leading to increases in their capital ratios. However, a substantial level of subordinated debt remains outstanding. The Treasury should work with the Bank of England, the Financial Services Authority and international authorities to develop new debt instruments that will support banks' capital resources in a crisis.

c **Over the past three years, the Treasury has accumulated much knowledge and practical experience of dealing with banks in difficulty.** Before that experience is lost, the Treasury should capture the lessons learned in putting the Scheme together. Where relevant it should also share the lessons with the Bank of England.