National Audit Office

REPORT BY THE COMPTROLLER AND AUDITOR GENERAL

HC 676
SESSION 2010–2011

15 DECEMBER 2010

HM Treasury

Maintaining the financial stability of UK banks: update on the support schemes

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Amyas Morse
Comptroller and
Auditor General

National Audit Office

13 December 2010

Our December 2009 report *Maintaining financial stability across the United Kingdom's banking system* provided a summary of the actions the Treasury took to support the UK banks through the financial crisis. This report updates our 2009 report, to provide an overview of the current position.

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Contents

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This report can be found on the National Audit Office website at www.nao.org.uk/support-for-banks-2010

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CORRECTION

In figure 1, on page 7, the figures for Special Liquidity scheme December 2010 and Credit Guarantee Scheme December 2010 were given as 115[3] and 110[3] respectively. They should have been given as 110[3] and 115[3] respectively. A corrected table is shown below.

Figure 1

Changes in the scale of support since our 2009 report

	December 2009 (£bn)	December 2010 (£bn)[1]
Guarantees and indemnities[2]		
Asset protection scheme	280	131[3]
Credit Guarantee scheme	250	115[3]
Special Liquidity scheme	200	110[3]
Loans to the Financial Services Compensation Scheme, Bradford & Bingley, and others	37	35
Cost of shares		
RBS[4]	46	46
Contingent RBS share purchases	8	8
Lloyds	21[5]	21
Total scale of support on basis set out in 2009 report	**842**	**466**
Other support to the wholly-owned banks		
Loan to Northern Rock	16	22
Guarantees to Northern Rock	24	16
Capital and contingent capital in Northern Rock plc and Northern Rock (Asset Management)	–	3
Guarantees to Bradford & Bingley	10	6
Unused commitments		
Contingent capital for other firms	13	–
Asset Backed Securities scheme	50	–
	955	**512**

NOTES

1 Figures collected from numerous sources, including some dated between September and December 2010. We do not believe there are any material changes to the figures between the production of these figures and December 2010. Totals do not add up due to rounding.

2 Our 2009 report focused on the scale of support provided. The 2009 numbers are therefore the cap placed on the schemes and share purchases when they were announced. The actual level of support did not reach these levels.

3 Asset Protection Scheme as at 30 September, Special Liquidity Scheme as at 30 November, and Credit Guarantee Scheme as at 1 December 2010.

4 Includes the dividend access share at cost.

5 Restated from £23 billion in the 2009 report, which netted the redemption of preference shares against the cost of the rights issue of December 2009. The 2009 report included capital and loan repayments in its calculation of cash recovered from the banks. This report states the value of loans and share purchases net of principal repayments.

Source: Treasury and Bank of England

January 2011 | LONDON: The Stationery Office

Summary

Key facts and background

In 2007, financial markets entered a sustained period of instability, causing difficulties for banks across the world, precipitating a global credit crisis, a widespread economic downturn and, by 2010, concern over certain Eurozone Governments' ability to service their debt obligations. The Treasury, like many other finance ministries around the world, took actions to:

- protect depositors in banks suffering insolvency or a severe decline in market confidence;
- maintain liquidity to allow banks to pay claims and outstanding borrowings as they fell due;
- ensure that systemic 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.

The Treasury's support to the banks included:

- **Recapitalisation of Lloyds Banking Group (Lloyds) and Royal Bank of Scotland (RBS)** through a series of transactions eventually acquiring 83 per cent of RBS (but 68 per cent of the voting rights) and 41 per cent of Lloyds (of both ordinary shares and voting rights).
- **Lending money to the Financial Services Compensation Scheme** so it could guarantee customer deposits of up to £50,000.
- **Lending directly to insolvent banks so they could repay customer deposits of over £50,000**, including to London Scottish Bank, Dunfermline Building Society and the Icelandic Banks – Heritable, Kaupthing Singer and Friedlander, and Landsbanki.
- **Nationalising Northern Rock and Bradford & Bingley** to protect their depositors and facilitate the orderly unwinding of their obligations and the Treasury's guarantees.
- The **Special Liquidity Scheme**, introduced in April 2008, to increase the liquidity of UK banks. It is a Bank of England scheme, supported by a Treasury guarantee, and allows banks to swap assets for more liquid Treasury Bills in return for a fee.
- The **Credit Guarantee Scheme**, introduced in October 2008, to help restore investor confidence in bank wholesale funding by guaranteeing certain unsecured debts in return for a fee.
- The **Asset Protection Scheme**, announced in January 2009, to protect assets on banks' balance sheets. RBS and Lloyds initially agreed in principle to join, but in the end only RBS joined.
- The **Asset Backed Securities Guarantee Scheme** to guarantee high-rated mortgage-backed securities.

1 Our December 2009 report *Maintaining financial stability across the United Kingdom's banking system* provided a summary of the actions the Treasury took to support the UK banks through the financial crisis. It concluded that the final cost to the taxpayer of the support will not be known for a number of years, but that those costs were justified on the basis that not intervening could have cost far more.

2 Part of our intention in producing the 2009 report was to bring together all the information on the various schemes and provide an overview of their scale. The report set out some £850 billion of support provided as a mixture of guarantees, shares and loans to the banks; and within this the £117 billion of cash the Treasury had invested in banks at that point. These figures were in addition to the £16 billion lent, and £24 billion of guarantees to, Northern Rock, and £10 billion guarantees to Bradford & Bingley.

3 A year later, the taxpayer remains heavily exposed to the banks through the Treasury's support schemes, shareholdings and loans to the banks, but we now have much more information about the scale of those exposures and the likely final cost to the taxpayer. This report updates our 2009 report, to provide an overview of the current position on the support to the banks. It focuses on:

a the fall in the maximum amount that could be paid by the taxpayer through the schemes, were the supported banks, loans and assets to fail;

b the increase in the cash Treasury has invested in, and received from, the banks;

c the challenges in reducing the level of taxpayer support to the banks quickly; and

d an update on the developing Treasury capacity to manage the schemes.

This report does not attempt to evaluate the value for money of the support schemes, nor look at the wider impact of the financial crisis, including the impact of declining revenue receipts and the government deficit, the recession, or new monetary policies such as quantitative easing.

4 We expect we will continue to update Parliament on the status of the support schemes so long as they remain material to the public finances. We also intend to provide a series of more focused evaluative reports on the value for money achieved by individual parts of the support schemes. In March 2009, we produced such a report on *The nationalisation of Northern Rock.* We hope to publish a report shortly on the Asset Protection Scheme and, in early 2011, on Treasury's stewardship of the wholly-owned banks Northern Rock and Bradford & Bingley.

Key findings

On taxpayers' maximum exposure and the cost of the schemes

5 **Since our 2009 report, the net amount of cash currently invested in the banks has increased by some £7 billion to a total of £124 billion, but the maximum amount that could be paid by the taxpayer through the schemes, were the supported banks, loans and assets to fail (taxpayers' exposure), has fallen from £955 billion to £512 billion (Figure 1).**[1] Some support schemes have closed to new entrants; some of the guaranteed debts and assets in the schemes have matured and been repaid; and some guarantees to bank depositors and wholesale funders have been removed. Whilst banks have started to repay some of the Treasury loans, the Treasury has invested a further £8.5 billion in Northern Rock to finance the restructuring of the bank into a mortgage book in wind-down and a bank to sell. This will be the subject of our upcoming report on the *Stewardship of the Wholly-Owned Banks*.

6 **We now believe the most likely scenario is that the taxpayer will not have to pay out significantly on its guarantees.** The Treasury originally estimated that, using the then available facts, the total cost of support would be between £20 billion and £50 billion mostly arising on the expected loss in the Asset Protection Scheme. The current expectation is that there will not be an overall loss on the Asset Protection, Special Liquidity or Credit Guarantee Schemes. This is a central expectation, however, and further shocks could still lead to significant losses for the taxpayer.

7 **The value of shareholdings are inherently volatile. The paper loss on the shares in RBS and Lloyds was £12.5 billion as at 1 December.** The eventual proceeds to the taxpayer will be highly dependent on the prevailing share price and success of the Treasury's divestment of these holdings.

8 **Meanwhile, the Government is paying some £5 billion a year (£10 billion so far) in interest on the Government borrowing raised to finance the purchase of shares and loans to banks. This ongoing cost is material in terms of the overall public finances and deficit.** This £5 billion a year was not included in the Treasury's previous estimates of the loss to the taxpayer, because the Treasury does not consider them to be direct costs. The estimated £5 billion a year interest on this debt is 11 per cent of the total £44 billion forecast to be paid in interest on public sector debt in 2010-11. The schemes are not themselves, however, a significant component of the £149 billion public sector deficit forecast in the June 2010 budget.

9 **These financing costs have to date been offset by the £9.91 billion in fees and interest that the Treasury has received from the various support schemes and loans.** This income will fall in future as the guarantees are removed, however, whilst the financing costs will continue so long as the share investment and loans are in place. There may also be dividends from the banks once they have cleared their state aid conditions.

1 Fallen from some £842 billion to some £466 billion on a like-for-like basis with our 2009 report.

Figure 1
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Source: Treasury and Bank of England

10 The Treasury retains the unquantifiable ultimate risk of supporting banks should they threaten the stability of the overall financial system. The outstanding £512 billion is only on the explicit support already provided. Further intensification of financial instability may require additional intervention.

On the continuing success of the measures and current financial stability

11 UK banks appear to have survived further external shocks in 2010, but financial markets have not fully regained the confidence in the banks they had before the financial crisis and charge a premium for investment in those banks that received most support. The resilience of UK banks has continued to improve over 2010, despite continuing difficult market conditions. The banks have so far survived external shocks from the Eurozone sovereign debt crisis and the slow recovery from the recession. There have also been no new major UK crises, institutional failures, or Government-led resolutions. However, the cost to UK banks of raising their long-term funding (over base rates), and the cost to investors of insuring their investments in UK banks, remain as high as in the first stage of the financial crisis in 2008. This is particularly true for RBS and Lloyds which have received most of the support.

On reducing the level of support and maximising the return to the taxpayer

12 The Treasury aims for the support schemes to be temporary. Winding the support down quickly, however, will be challenging and it is likely that the Treasury will be committed to at least some of its guarantees, loans and share investments for years to come:

a Treasury and the Bank of England are encouraging UK banks to reduce their dependence on taxpayer support for funding (i.e. the Special Liquidity and the Credit Guarantee Schemes). Current levels of new issuance, however, are not sufficient to replace UK banks' maturing debts over the next two years alone, so a number of banks are seeking to adapt the required quantity and make-up of their funding through, for example, increased customer deposits or reducing their assets. The Treasury, the Bank of England and the Financial Services Authority are working with the UK banks to assess the individual and collective credibility of their strategies for meeting this refinancing challenge.

b Treasury is looking to find a way of divesting its investments in its loans to, and shares in, the banks, despite difficult market conditions; the considerable scale of these investments compared to previous privatisations and share sales; and considerable regulatory and political uncertainty about the future of the banks.

c Treasury is working to recoup its loans to banks and the Financial Services Compensation Scheme. The banks' ability to repay the loans is dependent on the performance of their underlying troubled loans to their borrowers over the course of the run-down of their books.

13 **In 2009, we reported that 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. The Government is making progress in how it will strike this balance.** The Government has established the Independent Commission on Banking to consider reform of the banking system to promote financial stability and competition. It is due to report in September 2011. The G20 group of countries is finalising international agreement on measures to strengthen the resilience of banks against further losses. Many of the issues being considered, including structural reform and further requirements to capitalise systemically important banks, may well have a material impact on the share price of the publicly owned banks. It is also possible that, as a major shareholder, the Treasury will be called upon to participate in further capital injections into the banks were they to be required.

On Treasury's ongoing role and capacity

14 **Becoming a shareholder and creditor in the banks has created a new role for the Treasury which can conflict with its wider regulatory and economic policy functions.** The Treasury is ultimately responsible for macro-prudential regulation including the ongoing financial stability of the UK banks; the framework for the institutional regulation of each bank; and macro-economic and fiscal policy. Its interest in protecting and enhancing taxpayer value in its new roles as shareholder and creditor to the banks could at times conflict with these wider responsibilities. It manages these tensions through a mixture of confidentiality and institutional arrangements, including clear separation of its creditor and shareholder functions from its regulatory functions in separate arm's-length bodies. Treasury's creation of UK Financial Investments, with a remit to manage the shareholdings in RBS and Lloyds as if it were an institutional investor, is designed to protect taxpayer value by insulating the banks from political interference and enhancing other investors' confidence. It involves, however, the deliberate restriction of the influence that the scale of its holdings would normally provide.

15 **The Treasury is reducing its capacity devoted to financial stability.** Its team working on financial stability grew from around 20 to 108 by September 2009. There are now 41 staff within Treasury focused exclusively on financial stability and further reductions as part of the spending review are possible. Meanwhile, the Treasury proposes to confer responsibility for macro-prudential regulation, including monitoring financial stability, on the Bank of England.

Conclusion

16 We concluded in our 2009 report that 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 would be so large as to be difficult to envision. The support provided to the banks was therefore justified, but the final cost to the taxpayer of the support would not be known for a number of years.

17 It is now a year on and we have more information. The maximum amount the taxpayer could now pay out through the schemes has fallen significantly and the most likely scenario is that the taxpayer will not pay out on the guarantees. Yet the scale of the maximum exposures are so large, still £512 billion, that even risks with small probabilities of occurring require very careful management. In particular, Treasury needs to encourage banks to take the steps necessary to remove their dependence on taxpayer supported wholesale funding. Furthermore, the taxpayer is particularly exposed to fluctuations in the share price of RBS and Lloyds and the ability of the Treasury to divest its shareholdings successfully.

18 It is likely that a substantial proportion of these schemes and investments will be with us for some time. In the meantime, the Government carries an estimated £5 billion a year cost of financing the shares and loans, and may have to invest more in the future to protect the current value of its investments.

Recommendations

19 The Treasury is reorganising the regulatory structures for managing financial stability and reducing its own staff working in this area. We therefore make the following recommendations:

i Our previous reports showed how the Treasury had not retained sufficient capacity on financial stability prior to the financial crisis. It now needs to determine the steady state level of resources it needs to: maintain oversight as the ultimate risk taker on financial stability; manage the schemes it has in place; manage the challenges of removing support to the banks in the years ahead; and build effective working relationships with the new teams in the regulators.

ii As the Treasury winds down the number of staff working on financial stability, it becomes even more important that those remaining have a deep understanding and expertise in the subject. The Treasury should focus on keeping a core team of experts on financial stability, with limited turnover of staff, and career structures that allow staff to develop within the area.

iii The Treasury intends to restructure financial regulatory arrangements, including creating new responsibilities on financial stability for the Bank of England. As it does so, it is important that it captures and passes on all it has learnt since the start of the financial crisis. Last year, we recommended the Treasury undertake a full formal assessment of the financial crisis and the support schemes. The Treasury should also undertake an interim assessment to capture lessons now, before staff move on.

20 The fees for the Credit Guarantee Scheme were fixed in the midst of the financial crisis when markets were distorted. The Treasury should review the fees it charges in the light of current market rates for the cost of insuring against a bank default.

Part One

The current taxpayer position on the support schemes

The contingent liabilities and cash outlay

1.1 Our 2009 report brought together information on the support to UK banks and quantified the scale of the support as some £850 billion, including £730 billion of guarantees, £67 billion of purchased shares and £37 billion of loans to banks. Of this a net £117 billion had been paid in cash. Since our 2009 report, the scale of support has fallen because:

- **a** the Credit Guarantee and Special Liquidity Schemes have closed to new entrants, and the maximum potential exposures fell by £126 billion from Treasury's initial cap on the schemes to the actual value of the assets and debts included when the schemes were finalised;
- **b** £99 billion of assets and debts in the Credit Guarantee Scheme and Special Liquidity Scheme have matured or been called since the schemes were finalised;
- **c** the value of assets in the Asset Protection Scheme fell from £280 billion to £205 billion at 31 September 2010, and the terms of the scheme have been announced, such that Treasury now only bears the risk on 90 per cent of the total value of the assets after the first £60 billion (i.e. £131 billion);
- **d** the £50 billion Asset Backed Securities Scheme was not used. It was launched some six months after the Credit Guarantee Scheme, and institutions may have considered its all-in costs to be higher;
- **e** the Treasury has removed over £7.5 billion of guarantees from depositors and investors in Northern Rock plc and £4 billion of guarantees from depositors and investors in Bradford & Bingley;

f the Treasury no longer recognises a £13 billion contingent liability to support the capital of smaller banks through the recapitalisation fund;

g the Treasury has injected another £8.5 billion of loan into Northern Rock (Asset Management) and converted £1.4 billion of its existing loan to form the share capital of Northern Rock plc, to fund the split of Northern Rock into two companies.[2] It has also promised up to £1.6 billion to support the capital of Northern Rock (Asset Management) if needed; and

h banks and the Financial Services Compensation Scheme have collectively repaid £3 billion of their loans from the Treasury.

1.2 The total amount of cash used to support the banks as at 1 December 2010 is £124 billion, consisting of £124 billion of shares and loans, and an estimated £10 billion of interest paid out to finance those shares and loans, less some £10 billion of fees and interest received-in. However, the maximum *additional* amount the Treasury could pay out under the guarantees it has given has fallen from £838 billion to £387 billion. This exposure is mostly made up of Treasury guarantees on the Asset Protection, Credit Guarantee and Special Liquidity Schemes (**Figure 2** overleaf).

1.3 These costs exclude any UK contributions to international stability packages as a result of the Eurozone sovereign debt crisis.

The current paper loss on RBS and Lloyds shares

1.4 The 90.6 billion shares in RBS were purchased at an average cost of 50.53 pence each and the 27.6 billion shares in Lloyds cost 74.4 pence on average. The ordinary shares traded at 39.88 pence and 64.05 pence respectively as at 1 December 2010 (**Figure 3** on page 15), so the taxpayer would have made a loss of £12.5 billion had the Treasury been able to sell the entire holdings at the then market price. In practice, selling large tranches of shares at once would be likely to deflate the market price.

2 For simplicity, although Northern Rock plc and Northern Rock (Asset Management) are now independent entities, this report often uses the term Northern Rock to mean both banks and its predecessor body.

Figure 2
Current exposures, positions and fee income on the support schemes

Scheme by institution	Upper limit on contingent liabilities as at 1 December 2010[2, 3] (£bn)	Net loan and capital injections (cash)[1] as at 1 December 2010[2] (£bn)	Fees and interest up to 1 December 2010 (cash)[2] (£bn)
RBS			
Underwriting share issue fee			0.30
Redemption of preference shares			0.27
Re-capitalisation (shares and contingent capital)[4]	(8.00)	(45.80)	0.32
Asset Protection Scheme[5]	(131.00)		1.40
Lloyds Banking Group			
Underwriting share issue and commitment fee			0.38
Redemption of preference shares			0.23
Re-capitalisation (shares)[4]		(20.54)	
Asset Protection Scheme			2.50
Northern Rock (and Northern Rock Asset Management)			
Re-capitalisation (shares and contingent capital)	(1.60)	(1.40)	
Loans		(21.86)	0.50
Guarantees	(16.16)		0.11
Bradford & Bingley			
Guarantees	(5.50)		0.33
Loans		(11.31)	0.28
Sector wide schemes			
Credit Guarantee Scheme[5]	(115.00)		2.53
Special Liquidity Scheme[5]	(110.00)		0.24
Financial Services Compensation Scheme		(19.07)	0.52
Other loans to support deposits		(4.45)	
Totals	**(387.26)**	**(124.43)**	**9.91**
Estimated accumulated interest paid to finance shares and loans			**(10)**

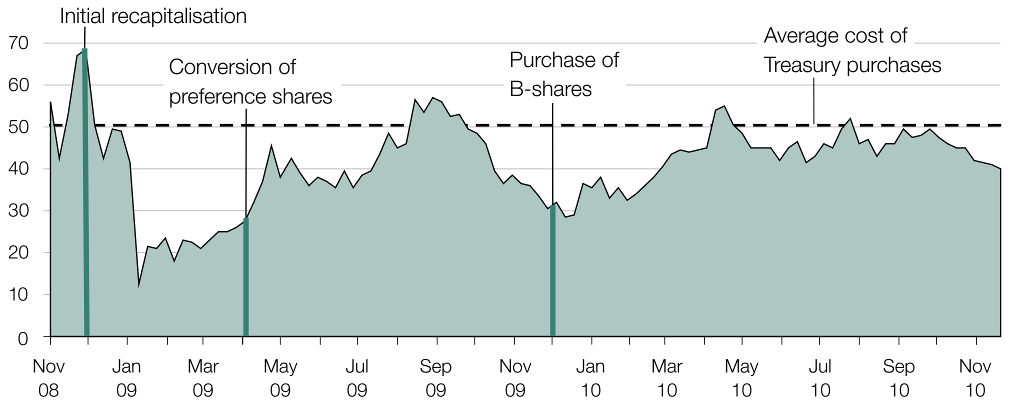
NOTES
1 Table does not show the repayment of loan principal or redemption of share capital.
2 Figures collected from numerous sources, including some dated between September and December 2010. We do not believe there were any material changes between the production of these figures and December 2010.
3 There are also various un-quantified contingent liabilities on the directors' indemnities, Bradford & Bingleys' contingent capital and compensation schemes for the former shareholders of the nationalised banks.
4 Net of redeemed preference shares. The premium on redemption is included in the third column.
5 Asset Protection Scheme as at 30 September, Special Liquidity Scheme as at 30 November, and Credit Guarantee Scheme as at 1 December 2010. Rounded to the nearest £1 billion.

Source: National Audit Office Exchequer receipts, Treasury Accounts and Estimates, and financial accounts of the various banks

Figure 3
Share prices are volatile, and currently below the price paid by the Treasury

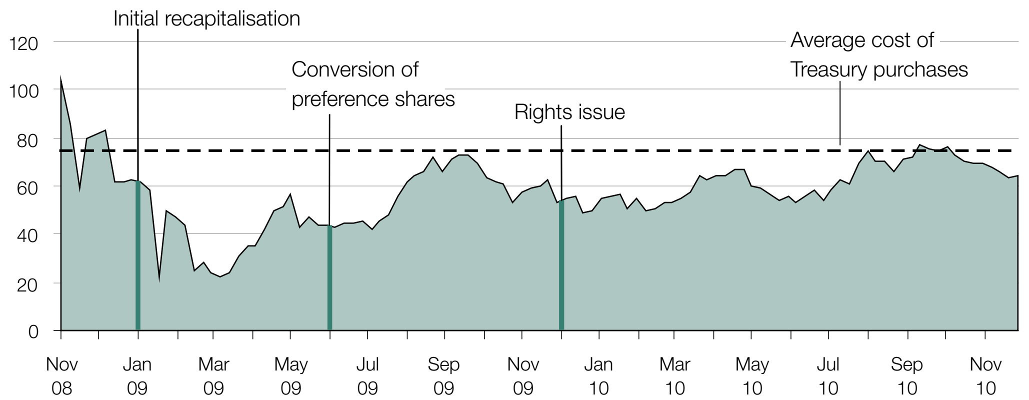
Royal Bank of Scotland

Share price (pence)



Lloyds Banking Group

Share price (pence)



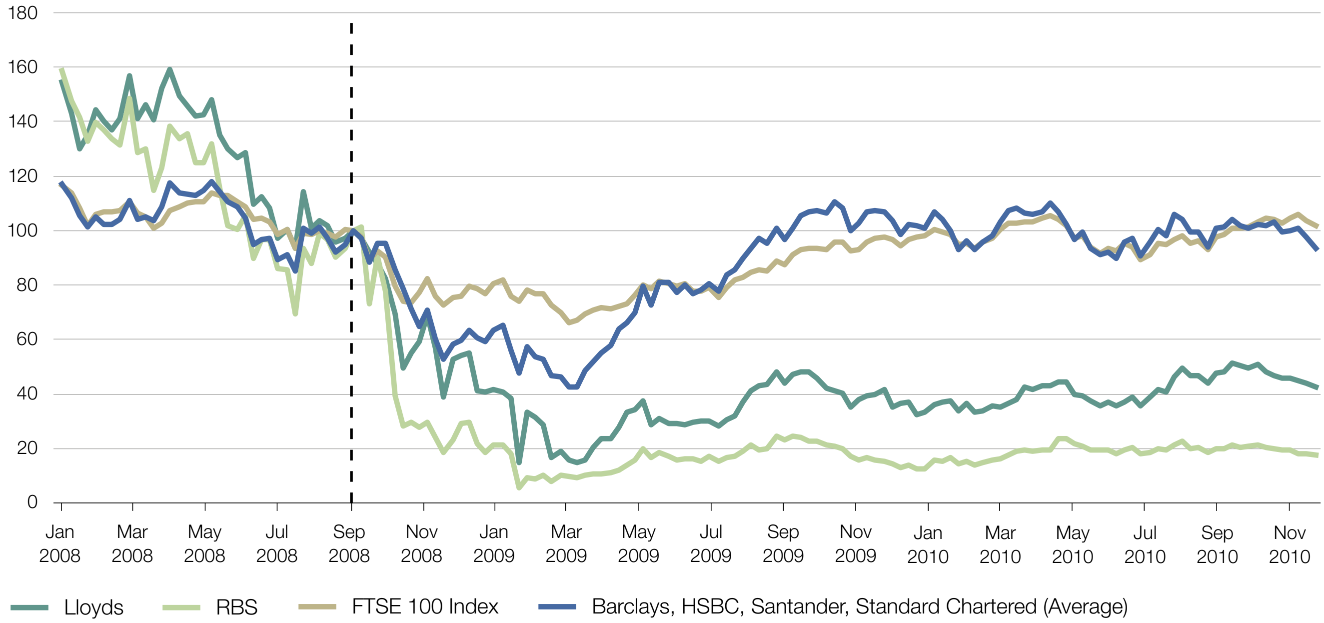
Source: Bloomberg, Treasury, National Audit Office

1.5 This paper loss on the RBS and Lloyds shares is volatile, but the shares have not recovered from the financial crisis at the same pace as their competitors (**Figure 4**). The actual profit or loss will depend on the share price at the time of sale, which could be higher or lower than the current value and is particularly vulnerable to events in the general economy and any further shocks to the banking sector. It is possible that the price of the Treasury's shares may increase, especially if the economic recovery strengthens, and this could generate a considerable return to the taxpayer. For every 10 pence increase in the prices obtained for the shares, taxpayers would secure an additional £9 billion on RBS and £3 billion on Lloyds. However, before the shares are sold, the banks will remain exposed to credit risks and other potential shocks which could reduce the current share price, especially if the economic recovery weakens.

1.6 The share price would need to rise to cover the costs of holding the shares. The Government borrowing raised to finance the recapitalisation of RBS and Lloyds costs £2.8 billion per year (included within the £5 billion overall finance costs of the support schemes shown below). As a result of European Commission state aid conditions the shares in the banks do not currently pay dividends (Appendix Four online). To cover that finance cost until they pay a dividend, the price of RBS shares would have to increase by just over 2 pence and the price of Lloyds shares by just over 3 pence for every year Treasury held the shares. To generate a reasonable return for the risks accepted, a higher return would be required.

Figure 4
RBS' and Lloyds' share prices have not recovered in pace with their major UK competitors

Relative change in share prices since September 2008 (September 2008 = 100)



Source: National Audit Office analysis of Bloomberg

The fees charged on the schemes

1.7 The fees charged to banks under the Credit Guarantee Scheme to guarantee new wholesale debts were designed to be on a commercial basis, not so large as to prevent banks from using it, but sufficient to provide a reasonable return for the risks associated with the guarantee. The Treasury also reviewed and reformed the terms of the scheme in December 2008, to reflect market developments and international experience.

1.8 The Treasury did not intend to charge the ruling market rate for the risks covered by the Credit Guarantee scheme; it considered the market price in September and October 2008 to be excessive, caused by a dislocation in wholesale funding markets, and that a stressed historical rate was a more accurate reflection of the risks involved. This provided the banks using the scheme with the advantage not only of being able to access wholesale funding when it might not otherwise be available, but at a cheaper rate than the bond markets were trading their existing debt. We estimate this latter benefit is substantially more than £1 billion. Market prices for insuring debt remain substantially higher than the fees charged by the Treasury.

1.9 The Bank of England fees on the Special Liquidity Scheme are also designed to compensate for the risk of loss on the scheme. The Bank of England manages the risk of loss by reviewing the amount of collateral it requires on a daily basis and requires a large amount of collateral to back drawings relative to the risks. As the fee charged to the banks is based on daily market rates and a minimum of 20 basis points which has been charged since September 2009, the fee does not provide a commercial advantage to the banks. From this fee the Bank of England pays a share to the exchequer for the theoretical cost of issuing the Treasury Bills in increasing the Government's overall cost of raising debt.

1.10 We will cover the fees charged under the Asset Protection Scheme in our forthcoming report.

Expected total cost of support to the banks

1.11 The 2009 Budget forecast that the expected total cost of supporting the banks would be between £20 billion and £50 billion. The Treasury revised this down in the June 2010 Budget to £2 billion, on the basis that although there was then a paper loss on the shares, it expected a net benefit on the Asset Protection Scheme and the aggregate costs of other schemes would not be material. In our view, the Treasury could also include the finance costs in this estimate of the direct cost of the schemes.

1.12 The current central expectation on all the Special Liquidity, Credit Guarantee and Asset Protection Schemes is that the Treasury will not have to pay out significantly. Its view is that the Special Liquidity Scheme has sufficient collateral behind the debt; that on the banks' current plans they can service the senior debt in the Credit Guarantee Scheme; and under the Asset Protection Scheme, RBS will bear the expected losses on the asset pool of up to £60 billion. Further shocks to the banking sector generally and particularly to RBS and Lloyds could result in significant payments. In practice, a loss on the Credit Guarantee and Special Liquidity Schemes would only be likely in the event of a failure of a bank participating in the schemes, which would be likely to have wider implications.

1.13 The Treasury believes it will also recover all of the loans to the various banks and the Financial Services Compensation Scheme, although this is dependent on the successful run-down of their assets and the Compensation Scheme recouping its costs through levies on the remaining banks, and may therefore take many years.

1.14 In addition, there are also substantial financing costs arising from the additional government borrowing raised to fund the purchase of shares and loans. The Treasury loans paid to the Financial Services Compensation Scheme, Northern Rock, Bradford & Bingley and other banks are also subsidised, with the approval of the European Commission, below both a commercial rate for long-term debt and the Government's cost of borrowing.

1.15 Including the financing cost on the shares set out in paragraph 1.6, we estimate that the total financing costs of the stability measures are currently £5 billion per year.

1.16 To date, the financing costs have accumulated to approximately £10 billion of interest payments. This has been offset by the £9.91 billion of fees and interest received on the guarantees and loans. In future, the fees are likely to fall, as they include large one-off payments on the Asset Protection Scheme of £2.5 billion, and the size of the guarantees outstanding is falling. On the other hand, financing costs will continue so long as the shares and loans remain in public ownership. Some of this may be offset in future if RBS and Lloyds start paying dividends.

Impact on the public finances

1.17 The standard statistics of government debt are designed to exclude those effects from the schemes that are temporary. The implication of this treatment is that reducing the schemes or selling shares in the banks may not greatly affect the recorded debt levels. The overall impact on the level of debt from sales of the banks will be the difference in the price paid by the Treasury and that received on sale.

1.18 The estimated £5 billion interest in 2010 on the borrowing needed to finance the support schemes is included within the total £44 billion forecast to be paid in interest on all public sector debt in 2010-11, but the £5 billion cost of these schemes is only a small part of the £149 billion deficit forecast in the 2010 Budget.

Part Two

The financial stability of the UK banks since the implementation of the support schemes

2.1 Our 2009 report highlighted that whilst the Treasury had been successful in meeting its objectives of maintaining financial stability and protecting taxpayers, the banks were not meeting Treasury targets on lending.

2.2 By the end of 2010, the financial stability of UK banks has not substantially changed. Despite the slow recovery from the recession and continuing market turbulence including the Eurozone sovereign debt crisis (**Figure 5**), the resilience of UK banks has continued to increase. No institutions have required resolution since the finalisation of the Asset Protection Scheme.

Figure 5
The Eurozone sovereign debt crisis

During 2010, concerns about rising Eurozone government deficits and debt levels have led to periods of market instability, often referred to as the sovereign debt crisis. This has driven the cost of government debts issued by certain countries – notably Greece, Portugal, Spain and Ireland – and the cost of insuring against the default of those Governments, to rise significantly.

In May 2010, Eurozone countries and the International Monetary Fund (IMF) lent $110 billion to Greece. The UK did not directly participate, although it is a major shareholder in the IMF.

The Eurozone countries then agreed to establish support measures to build market confidence in all Eurozone sovereign debt. EU Finance Ministers established the European Stabilisation Mechanism with a loan facility of up to €60 billion. This is in addition to the IMF loan facilities of €250 billion. At the same time, Eurozone Finance Ministers also created the Financial Stability Facility with the power to sell bonds backed by guarantees issued by its members up to €440 billion. The UK currently contributes to the Mechanism but not the Facility, but the UK Government has said it will not participate in the Mechanism after 2013.

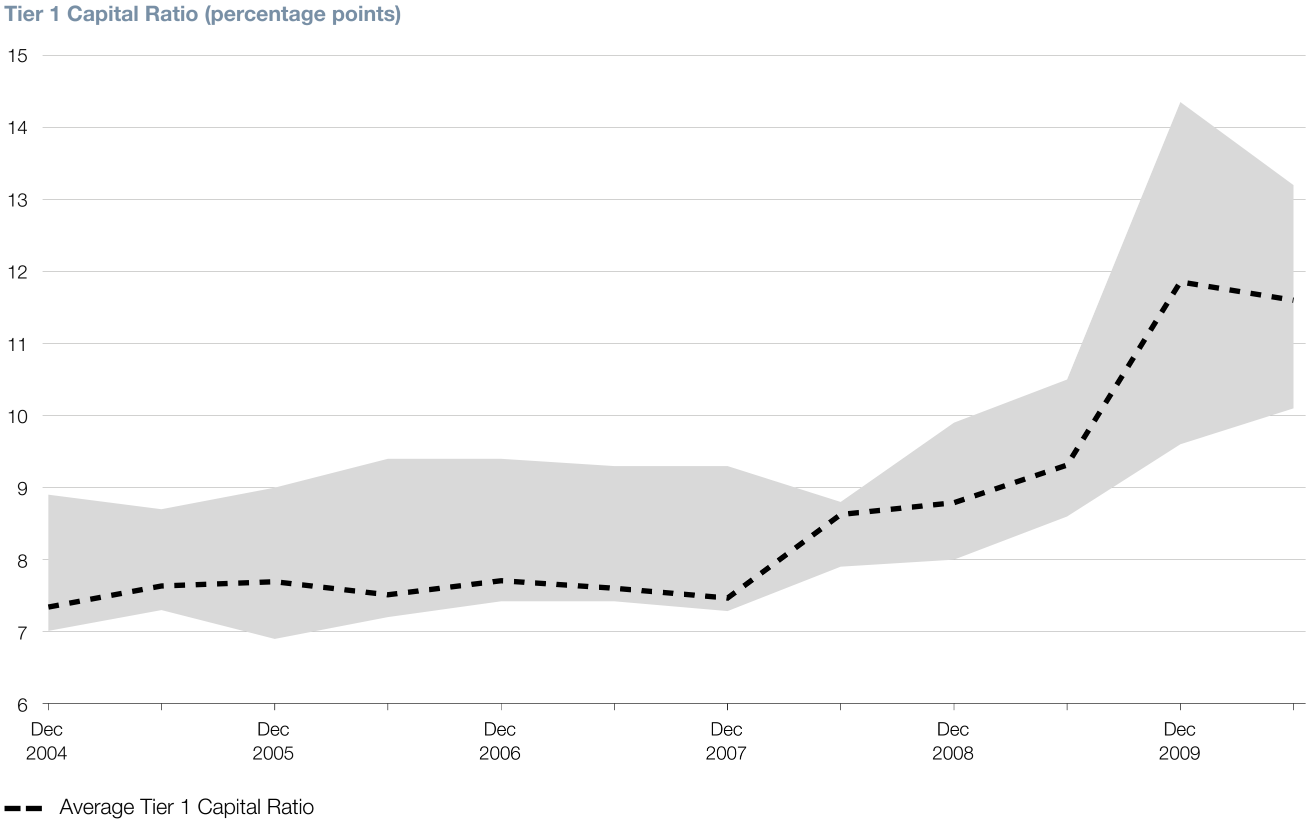
In November 2010, the IMF, the EU, and Eurozone countries agreed an €85 billion financial assistance package for Ireland. The UK will participate through the Mechanism and as an IMF shareholder. On the basis that the UK and Irish economies and financial systems are highly interlinked, the UK Government also agreed in principle to lend £3.25 billion directly to the Irish Government. The detailed terms and necessary legislation for this loan were still to be finalised at the time this report was sent to print.

Source: Analysis of various financial commentary, Treasury

2.3 All the major UK banks have increased their capital levels over the past two years (**Figure 6**). Capital includes their shareholders' funds and is an indication of the bank's ability to absorb losses.

2.4 Banks have also increased their holdings of liquid assets over the past two years, such as high-quality government bonds and central bank reserves, so they have more resources they can readily use to meet their short-term obligations as they arise. The Bank of England estimates that the top six UK banks increased their holdings of liquid assets from £175 billion to £425 billion over the course of 2009. A significant proportion reflects the Bank of England's monetary policy interventions (Quantitative Easing). Much of the remainder was financed through the Special Liquidity and Credit Guarantee Schemes, and will need to be refinanced as these facilities are withdrawn.

Figure 6
UK banks have continued to increase their capital



Shaded area indicates high and low range for Tier 1 Capital ratio for the largest UK banks (Barclays, HSBC, Lloyds, RBS, Santander, Standard Chartered)

Source: Published accounts of major banks

2.5 Investors' perceptions of the risk of investing in banks remain high, as represented by the cost to banks of obtaining long-term finance (over base rates) and insuring against a bank defaulting on its debts. Although these costs fell from their peak in 2009, throughout 2010 they remained as high as in the summer of 2008, which was when some banks around the globe were reporting difficulties, but before the failure of Lehmans (**Figure 7** on pages 21 and 22). Investors also continue to demand greater pricing differentials between institutions than was the case before the crisis. This is a particular issue for institutions in receipt of most support.

2.6 We will report further on lending in our upcoming report on the Asset Protection Scheme.

Figure 7
UK banks' cost of raising finance remains high

The premium on 3-month LIBOR compared to base rate (a measure of the banking sector's riskiness) has crept up over 2010

3-month LIBOR versus Base Rate (percentage points)

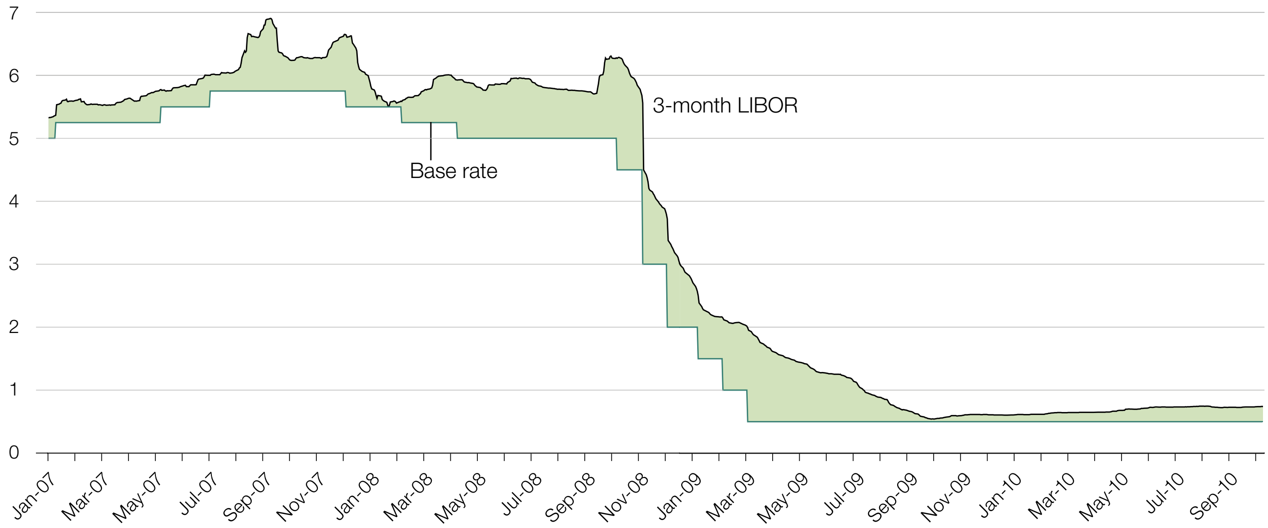
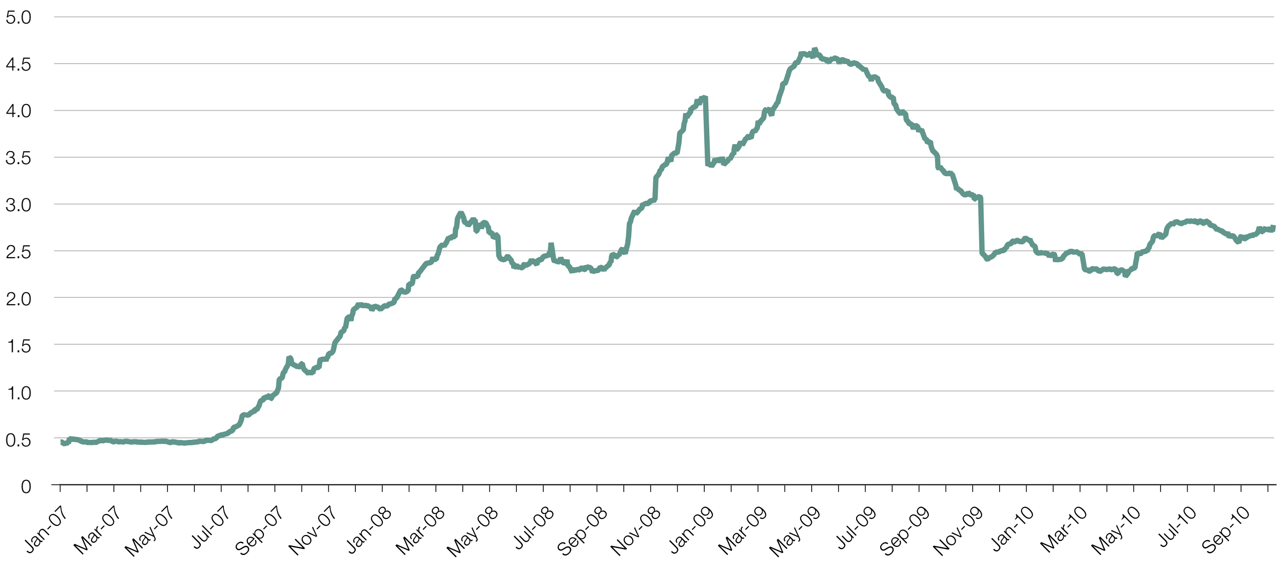


Figure 7
UK banks' cost of raising finance remains high (continued)

The premium banks pay on their debt over government debt is about the same as in 2008

Comparison of major European banks and UK Government bond 2-year yields (percentage points spread)



Annual cost of insuring 5-year senior debt against default (basis points)

Shaded area indicates high and low range for Credit Default Swap rates for European Union banks with net assets over £50 billion (Abbey, Barclays, BNP Paribas, HSBC, Lloyds, RBS, Santander, Standard Chartered, HSBC, Unicredit).

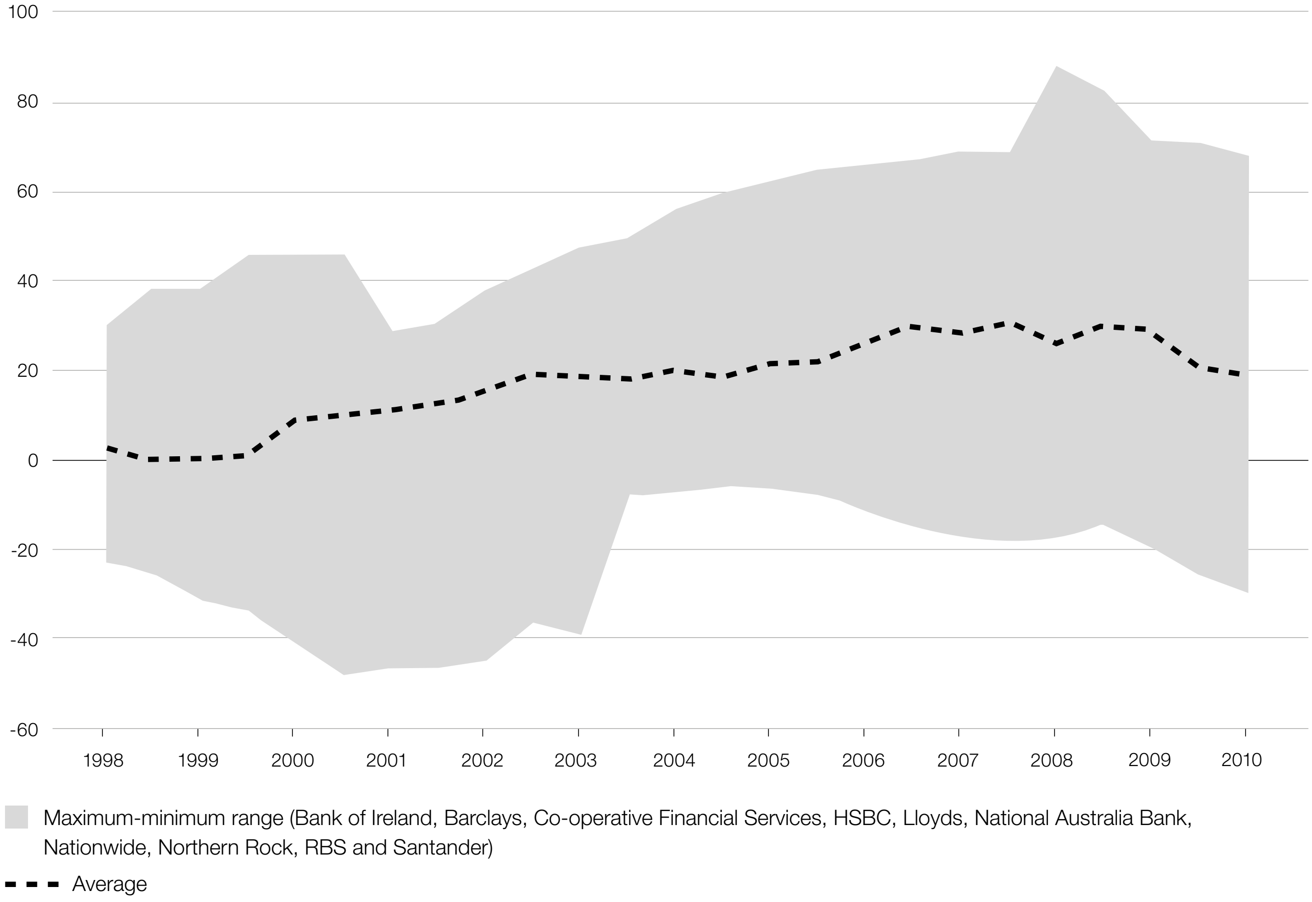
Source: Bloomberg

Figure 8

Dependence on wholesale funding has risen over the past ten years

The customer funding gap is the difference between the amount banks take in deposits from their customers and the amount they lend out to customers. Banks are dependent on wholesale funding (funding from other banks and institutions) to cover this gap.

Customer funding gap as percentage of customer loans and advances[1]



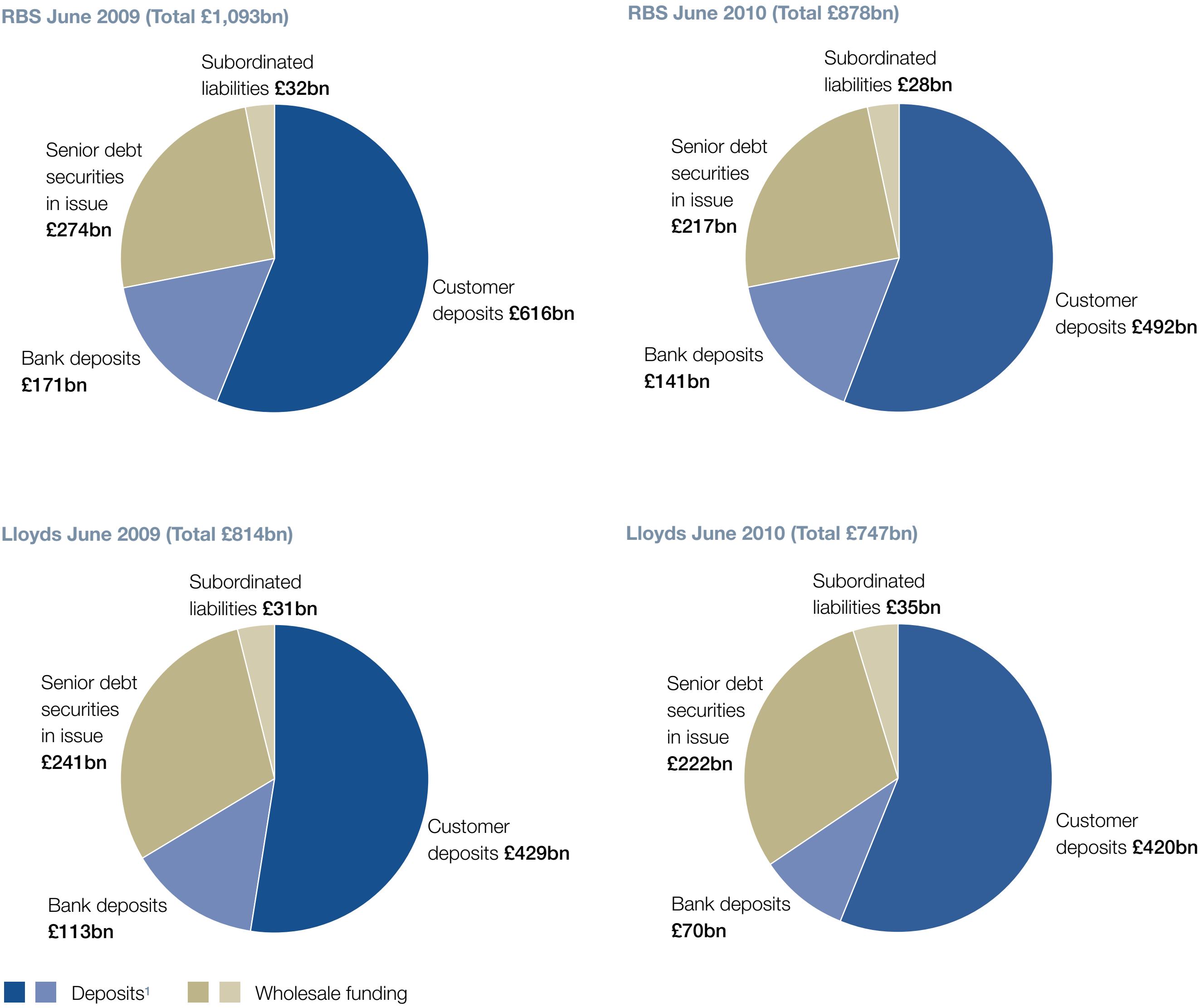
NOTE

1 Customer funding gap is calculated as customer loans less customer deposits, where customer refers to all non-bank borrowers and depositors.

Source: Bank of England

Figure 8
Dependence on wholesale funding has risen over the past ten years (continued)

Whilst RBS and Lloyds have reduced their balance sheets, their reliance on wholesale funding has yet to decrease significantly



NOTE

1 Deposits may include repurchase agreements (repos) which are normally also deemed wholesale funding.

Source: RBS's and Lloyds' published half year results

Part Three

Reducing the guarantees and divesting the shares

3.1 The Treasury aims for the support schemes to be temporary and to reduce taxpayers' maximum exposure to, and the cash cost of, the schemes as soon as possible, within the constraints of its wider considerations to maintain financial stability, promote competition, and protect taxpayer value in the investments. However, removing the support will be challenging and likely to take some time.

Weaning the banks off wholesale funding support (Credit Guarantee and Special Liquidity Schemes)

3.2 The Special Liquidity and the Credit Guarantee Schemes were designed to help banks temporarily fill the funding gap created by the breakdown of the wholesale markets (**Figure 8** on pages 23 and 24). The Special Liquidity Scheme was designed to end in January 2012 and the Credit Guarantee Scheme to end in April 2012. The hope was that by this time the wholesale funding markets would have recovered. The Credit Guarantee Scheme was later amended to enable banks to rollover up to one-third of the maximum guaranteed amount until April 2014, to try to avoid all the banks having to refinance all their funding from the schemes at once.

3.3 There remains a significant amount of bank funding dependent on the two support schemes; some £115 billion of debt in the Credit Guarantee Scheme and £110 billion in the Special Liquidity Scheme (**Figure 9** overleaf).

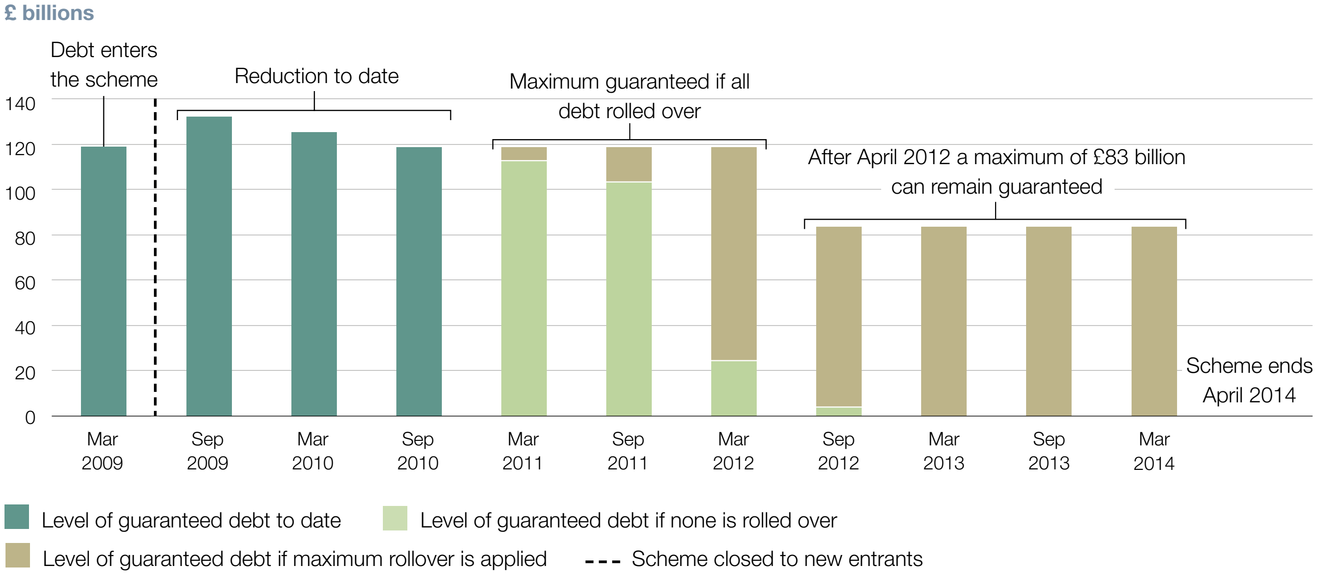
3.4 The Credit Guarantee Scheme does not provide a right of early repayment, which means that the banks cannot exit their obligations to Treasury under the scheme, including the payment of fees, ahead of time. With the drawdown window for new issuance closed, outstanding debt issued under the scheme continues to fall with all of it currently expiring by 2012 (although collectively institutions are able to rollover up to £83 billion of existing debt for a further two years). All debt issued under the scheme must have matured by April 2014 (Figure 9).

3.5 Special Liquidity Scheme drawings can be repaid early. The use of the Special Liquidity Scheme fell slowly at first, but has now started to reduce at a faster rate. The Bank of England has reiterated its intention for the scheme to close in January 2012. Separately, the Bank of England has introduced a Discount Window Facility to provide liquidity insurance to the banking sector as part of its permanent operations.

Figure 9
The reducing use of Government support for wholesale funding

The bulk of debt in the Credit Guarantee Scheme is not due to reduce until November 2011

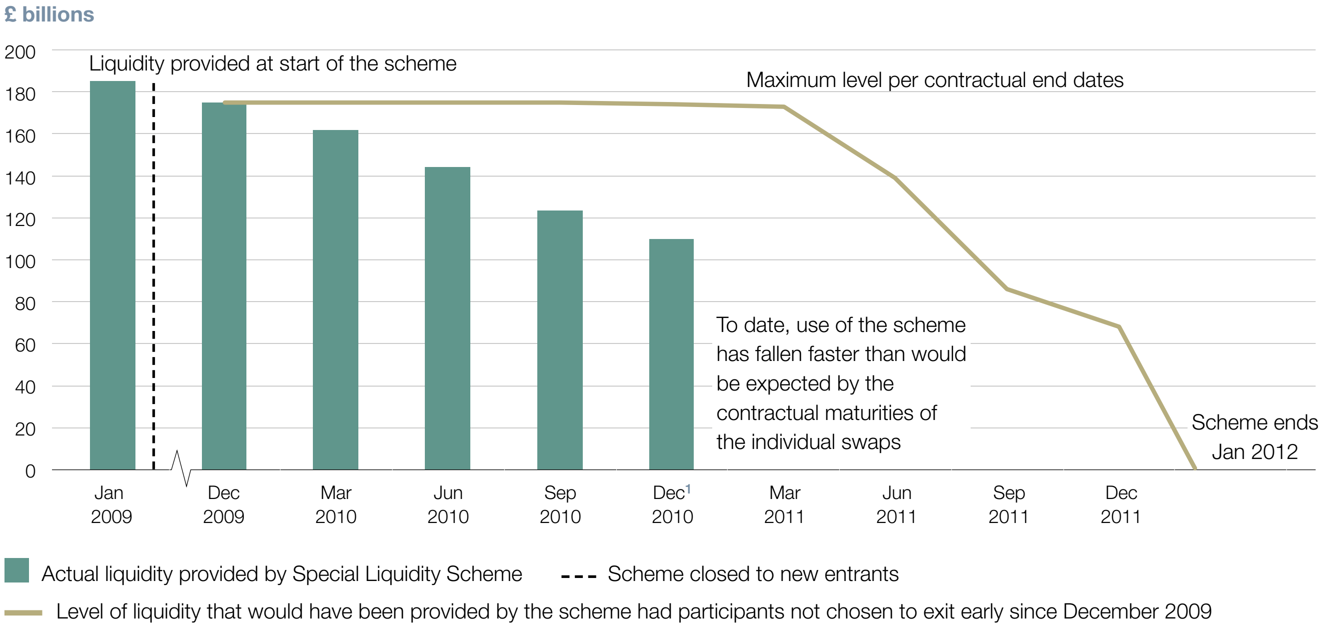
Debt guaranteed by the Credit Guarantee Scheme



Source: Treasury

The Bank of England reports that use of the Special Liquidity Scheme is falling

Liquidity provided by the Special Liquidity Scheme



NOTE

1 Given as at 30 November 2010.

Source: Bank of England

3.6 UK banks will also need to replace a considerable amount of unsupported wholesale finance. The Bank of England estimated in June 2010 that the major UK banks have around £480 billion of unsupported debt that will mature or be called by the end of 2012.

3.7 Much of this maturing debt is short term, raised in the aftermath of the financial crisis when long-term debt was not available. The Bank of England believes that the banks need to increase the term of their funding or risk perpetuating this build-up of maturing debt. In parallel, changes in UK bank liquidity regulation require more liquidity to support short-term funding, so banks may elect to increase the term of their funding.

3.8 Replacing maturing funding is likely to require some banks to restructure their balance sheets. As at June 2010 some £750 billion of supported and unsupported wholesale funding was due to mature by the end of 2012. Both the current and pre-crisis rate of new issuance would not be sufficient to replace these maturing debts and swaps alone, and therefore banks are also seeking to reduce their assets, increase their retail deposits, or use new funding products (**Figure 10** overleaf). Special Liquidity Scheme participants have also agreed to revised schedules which provide for a smoother repayment of drawings under the scheme than that suggested by contractual maturities.

3.9 The challenge of refinancing banks' maturing debts is not confined to the UK. In October 2010, the International Monetary Fund, referring to banks globally and particularly to those in Eurozone countries, reported:

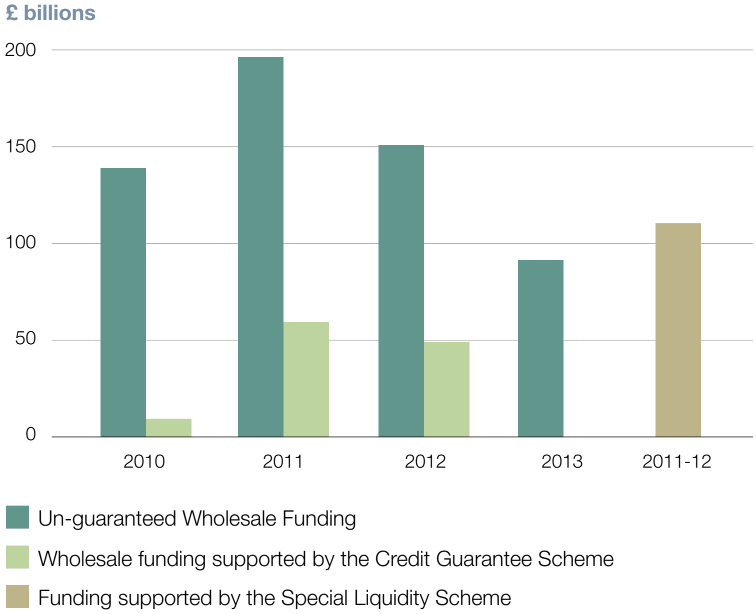
> *"On the bright side, bank regulatory capital ratios have improved and global write downs and loan provisions have declined … There has been less progress, though, in dealing with the imminent bank funding pressures: [globally] nearly $4 trillion of bank debts will need to be rolled over in the next 24 months. As a consequence, exits from extraordinary financial system support, including the removal of government guarantees of bank debt, will have to be carefully sequenced and planned."*[3]

3.10 RBS and Lloyds have announced plans to reduce the use of wholesale funding by reducing their assets (and hence the amount of finance they need to raise). As at 30 June 2010 RBS had a further £174 billion of asset disposals (excluding derivatives) remaining to achieve its December 2008 target of £258 billion, and Lloyds had a further £117 billion of asset disposals remaining to achieve its original target of £200 billion by 2014. Each of them has confirmed that as of 30 September 2010 they were on course to achieve their plans.

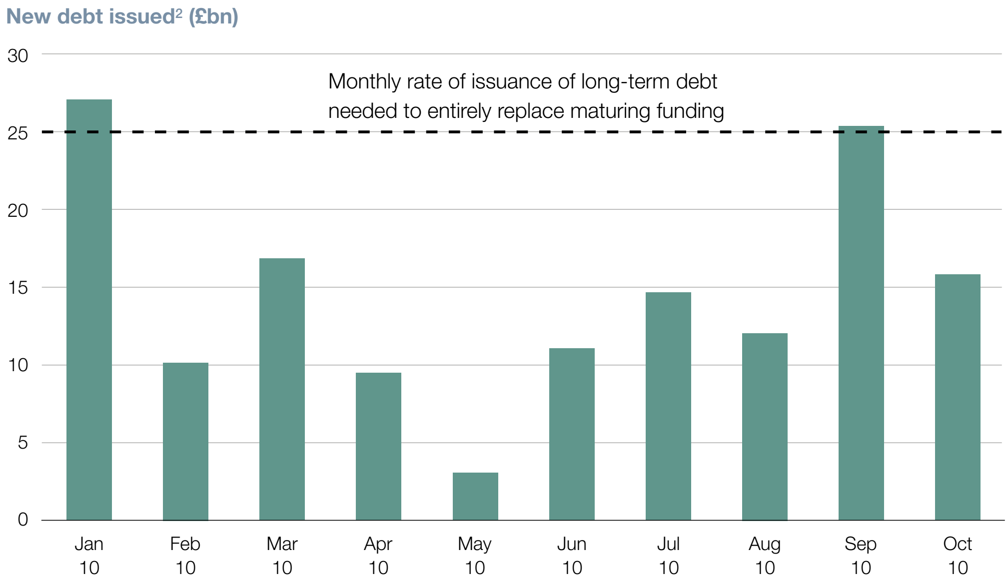
3 *Global Financial Stability Report, Sovereigns, Funding, and Systemic Liquidity*, International Monetary Fund, October 2010.

Figure 10
Maturity profile of senior debt and the rate of new issuance

The major UK banks[1] have some £750 billion of funding maturing over 2010-2013



Some banks are likely to need to restructure their balance sheets because current rates of new long-term debt issuance are not sufficient to replace all the maturing debt



NOTES
1 Major UK banks are here defined as Barclays, Santander, National Australia Bank, Lloyds, Bank of Ireland, Nationwide, RBS, Co-operative Financial Services.
2 Monthly long-term debt issuance by Major UK banks. This excludes the issuance of short term and privately placed debt.

Source: Bank of England, Bloomberg

3.11 This strategy is congruent with RBS's and Lloyds' obligations emanating from their need to implement State Aid commitments and divest the non-core parts of their business as part of their commercial restructuring. The European Commission ruled that the support schemes and aspects of the government share purchases represent State Aid – i.e. public subsidy that distorts competition by favouring certain businesses. In giving permission to provide this support, the European Commission laid down specific conditions for how the State Aid should be contained and reduced over time. Treasury is responsible for ensuring these conditions are met. The banks are making good progress on these (Appendix Four online), with several sales commercially agreed, but will need to complete these sales and identify and attract suitable buyers for the other parts of the business they are required or choose to divest.

3.12 The Bank of England, however, has pointed to the risk that "in aggregate, banks' funding plans make optimistic assumptions about system-wide deposit growth and envisage reductions in lending."[4]

The difficulty of divesting shares in the banks quickly

3.13 The Government regards its shareholdings in RBS and Lloyds as temporary and hopes to dispose of them in an orderly manner and with due regard for financial stability, promoting competition and creating value for the taxpayer. The Treasury, through its arm's-length body UK Financial Investments Ltd, is exploring a divestment strategy for its shareholdings in the banks.

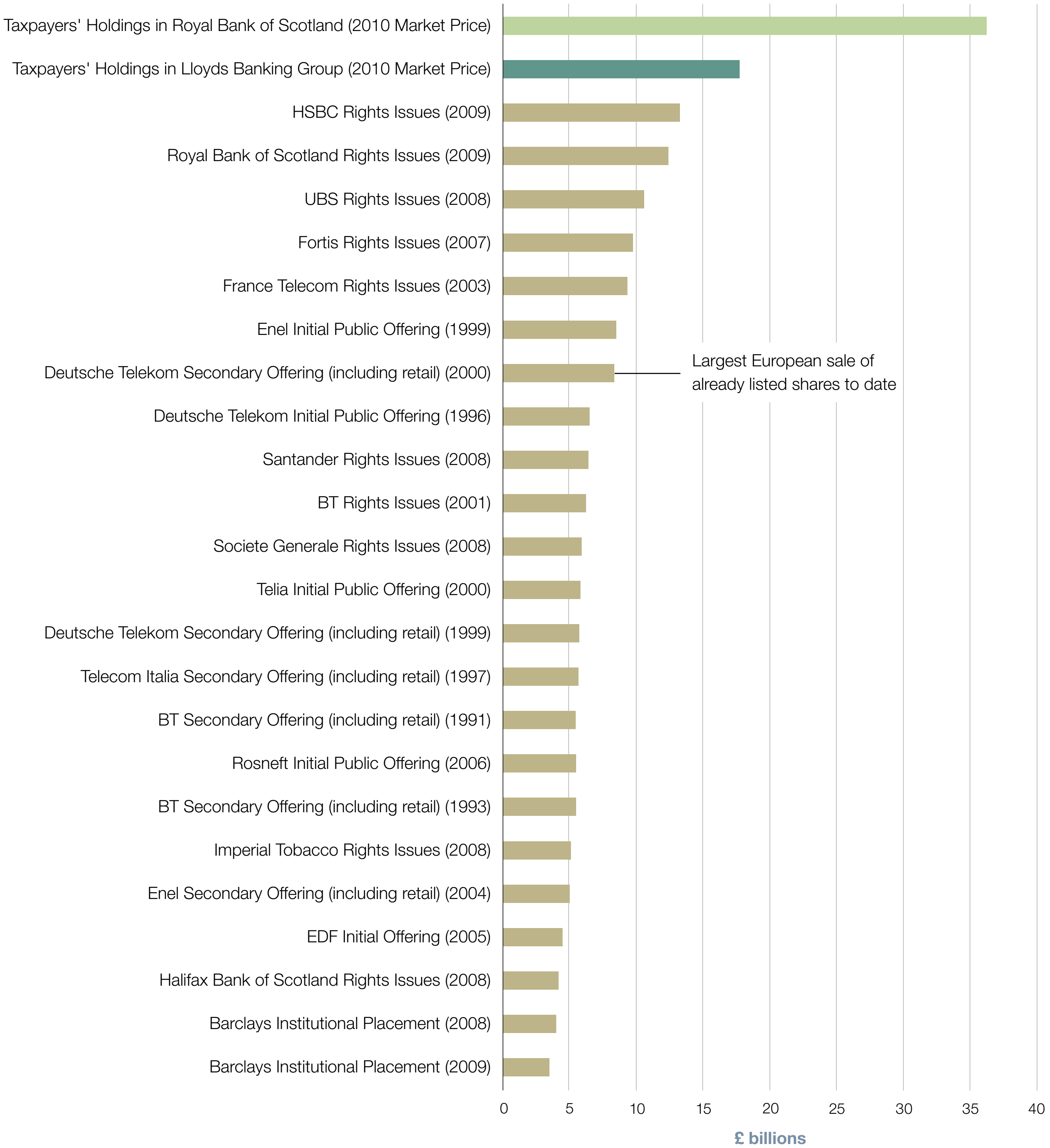
3.14 In addition, under the State Aid agreements with the European Commission, the Treasury has also agreed to sell the viable parts of Northern Rock. We will discuss this in our forthcoming report *Stewardship of the wholly-owned banks* (expected early 2011).

3.15 It is likely that the Treasury will need to sell the shares in stages. The total value of the shares is over six times larger than the largest European sale of already listed shares (**Figure 11** overleaf). There are a range of options facing the Treasury as to how it will divest taxpayers' holdings. UK Financial Investments has said that it is likely that shares will be sold to investors in the public equity market.

3.16 The remaining regulatory and policy uncertainties may also constrain the timing of future sales (paragraph 3.18 – 3.20). It will be difficult to achieve sales until the Government has made its own policy intentions clear.

4 *Financial Stability Report, Issue no. 27*, Bank of England, June 2010.

Figure 11
The size of taxpayers' holdings in RBS and Lloyds dwarfs previous European secondary share offers



Source: UK Financial Investments, Bloomberg

3.17 Other countries have already begun to divest shareholdings acquired during the financial crisis. For instance, the US Treasury has sold its $45 billion shareholding in Citigroup in stages through the US market, at a profit of $12 billion. It has also sold part of its holdings in General Motors. The Swiss Government has sold its Swiss Francs 6 billion shareholdings in UBS through selling shares to international investment institutions. The US Government is planning other disposals including its shareholdings in AIG and Chrysler. Conversely, during 2010 the Irish Government has increased its shareholdings in Allied Irish Bank.

The difficulty of maximising the proceeds from a sale

3.18 In 2009 we noted that, in line with UK Financial Investments' 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. There remains significant uncertainty around how the Government will pursue its financial stability objectives, but it is making progress in establishing its policy and regulatory reform (Appendix Three online).

3.19 Banking failures and mergers as a result of the financial crisis led to a consolidation in the UK banking sector, with six UK banks and building societies holding 88 per cent of retail deposits and five UK banks and building societies holding 82 per cent of mortgages (**Figure 12** overleaf). Consolidation is often taken as a proxy indicator that competition has declined. Many are concerned that this reduction in competition has adversely affected consumers. It has also increased systemic risk by making the remaining major UK banks more systemically important.

3.20 The Government set up the Independent Commission on Banking in June 2010 to examine questions about the structure of the UK banking sector, and to make recommendations by the end of September 2011, on measures to promote stability and competition in banking. Much of the political and regulatory uncertainty surrounding the UK banking sector will persist until the Government makes its response. It may decide that promoting competition requires structural reform of the banking sector, including changes to the taxpayer owned banks.

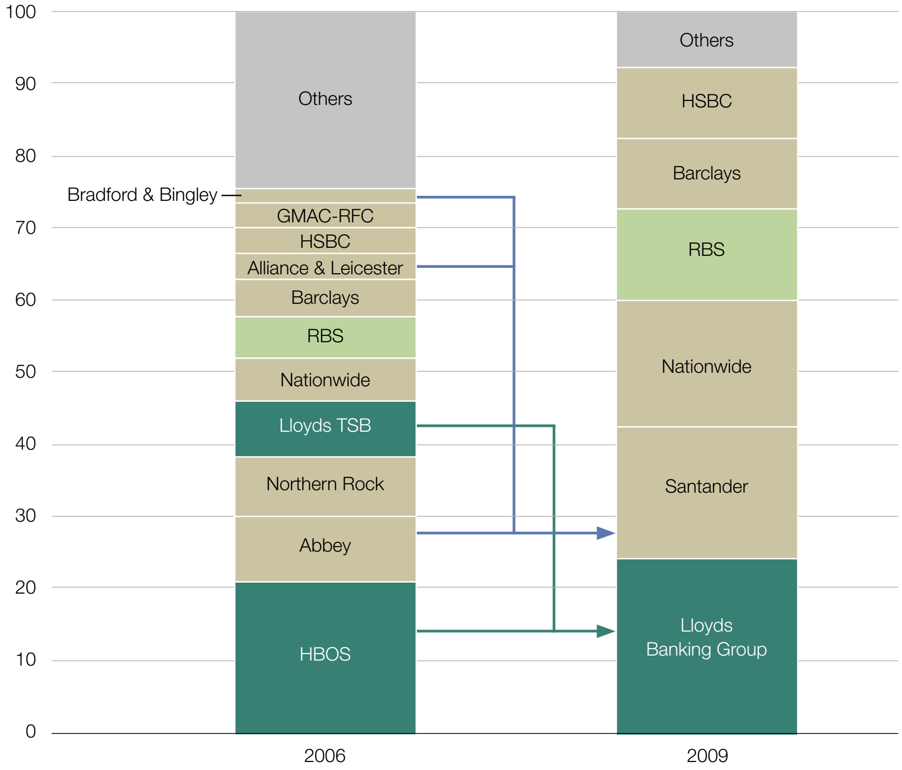
3.21 UK banks will also need to plan how to meet increasing capital adequacy and liquidity standards. Although the major UK banks are amongst the best capitalised European banks according to the 2010 Committee of European Banking Supervisors stress tests, much of the practical detail of the new standards remains to be worked out, especially for systemically important banks. In addition, UK regulators may yet impose additional national capital requirements that banks will need to meet.

3.22 There are already indications that strong banks may use meeting the requirements early to secure competitive advantage. The Treasury may need to defend taxpayer value in the banks as RBS and Lloyds work to meet the evolving capital and liquidity standards. For example, the Treasury may be called upon to participate in future capital injections into the banks were they to be required.

Figure 12
The consolidation in the banking market

The UK mortgage market has become more consolidated since the financial crisis

Market Share for new gross mortgage lending (percentage)



Source: Council of Mortgage Lenders

Part Four

The Treasury's ability to handle the challenges

Roles and responsibilities

4.1 As we reported in 2009, the Treasury has to juggle its economic and regulatory policy functions with its new functions as shareholder, creditor and guarantor to the banks. These can at times conflict and cause tensions within its decision-making.

a **Economic and regulatory functions.** The Treasury determines economic policy and is responsible for the overall functioning of the economy, in which the banks play an important role. The Treasury has ultimate regulatory and legislative responsibility for the banking sector. The Treasury represents the UK in many multilateral bodies with an interest in financial stability and global regulation including the G20.

b **Shareholder and creditor functions.** The Treasury owns large shareholdings in the listed banks, Lloyds and RBS, and owns all of the Northern Rock and Bradford & Bingley banks. It has lent substantial sums to the Financial Services Compensation Scheme, Northern Rock, Bradford & Bingley and other banks.

c **Guarantor.** The Treasury acts as a guarantor, through the debt issued under the Credit Guarantee Scheme, its indemnity to the Bank of England against loss through the Special Liquidity Scheme, and through the Asset Protection Scheme. The Treasury also carries the risk that it is ultimate guarantor for systemically important financial institutions, and may have to act were another major banking failure or financial crisis to occur.

4.2 As it moves towards the implementation of transactions to reduce the Government's exposure to the banking sector, the Treasury is taking steps to manage all of its roles, with their often conflicting pressures, whilst complying with its own legal and regulatory obligations. The Treasury has implemented a range of confidentiality and institutional arrangements to manage these tensions, including delegating day-to-day running of some functions to different arm's-length bodies.

4.3 The Treasury has established UK Financial Investments Ltd as an arm's-length subsidiary of the Treasury to manage its creditor and shareholder interests in the banks on a commercial basis. It set UK Financial Investments the objective of developing and executing a strategy for disposing of taxpayers' investments in the banks through sale, redemption, buy-back or other means, and to protect and create value for the taxpayer as shareholder and creditor.

4.4 As such, the Treasury has mandated UK Financial Investments to use the shareholdings as an institutional investor in RBS and Lloyds and not as an economic policy regulator. Officials involved in UK Financial Investments are separated by institutional arrangements from those involved in regulation and economic policy. UK Financial Investments is required not to intervene in day-to-day management of the banks. The Treasury retains close supervision of UK Financial Investments, and has the power of veto over significant investment decisions. UK Financial Investments' shareholder access and powers over RBS and Lloyds are, therefore, deliberately restricted to preserve and create taxpayer value in the businesses. This was designed to increase other investors' confidence in the banks by demonstrating the Treasury would not use its shareholder status to further its other responsibilities and would insulate the banks from political interference (**Figure 13**).

4.5 In addition, UK Financial Investments manages taxpayers' loans and shareholdings in the wholly-owned banks where it is the sole shareholder. We explore this further in our forthcoming report *Stewardship of the wholly-owned banks*.

Figure 13

Using shareholder powers to influence the banks' governance and remuneration

The RBS and Lloyds boards and management remain independent and responsible for the day-to-day management of their companies, including governance, pay and bonuses rewarded to staff. UK Financial Investments engages with the management, using its shareholder influence to ensure proper scrutiny. It consults with other institutional investors and has voted in all shareholder votes.

UK Financial Investments' clear remit helps it to make decisions in its engagement with the banks' board and management. For instance, with the aim of preserving and creating taxpayer value in the businesses, it takes the view that remuneration should be as low as possible whilst protecting the value of the investment. It wants to create the right incentives and promote retention, whilst not rewarding failure.

As befits a major institutional investor in a listed company, UK Financial Investments votes on the remuneration report as an indication of supp ort to the board, but does not explicitly approve individuals' remuneration. It engages with the banks' remuneration committees, who are responsible for setting the pay and rewards of board members, to negotiate a suitable remuneration structure. In doing so it has collected and used its own data to judge the suitability of the remuneration package proposed by the banks. UK Financial Investments also works with the boards of RBS and Lloyds to improve their governance structures and find suitably qualified independent non-executives.

In addition, the terms of Asset Protection Scheme gave UK Financial Investments power to approve the overall quantum and structure of RBS's 2009 bonus pool. UK Financial Investments did this following a detailed independent assessment of the proposals made to it by the Board of RBS. The Board of RBS, who have to act in the interests of all shareholders, confirmed that the proposals represented the minimum necessary to protect taxpayers' investment in the bank. UK Financial Investment does not have this power over 2010 bonuses.

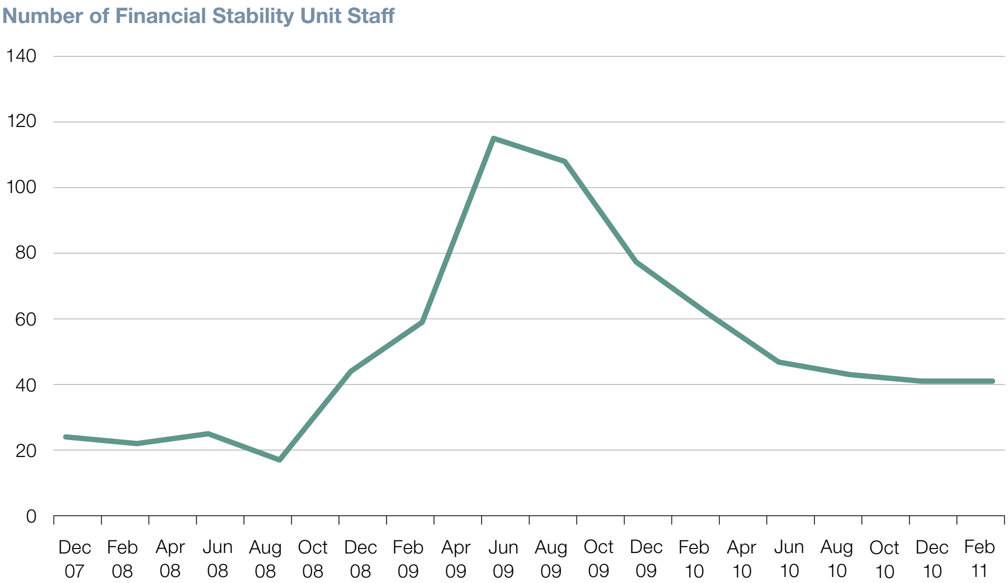
Source: UK Financial Investments' Framework Document and Investment Mandate, interviews with UK Financial Investments' officials

Capacity and capability

4.6 Managing its responsibilities in relation to the crisis and its aftermath has required the Treasury to build up its internal capacity in financial stability, but the amount of resources it devotes to financial stability is now falling. Our previous report showed how the financial stability team grew from around 20 to 108 over a two-year period. Since September 2009, however, the Treasury has reduced its number of staff working exclusively on financial stability to 41, supported by the other teams across the Treasury (**Figure 14**). The Treasury is also placing reliance on the 16 staff in UK Financial Investments and 51 staff in the Asset Protection Agency.

Figure 14

Treasury staff working exclusively on financial stability has fallen significantly



Source: HM Treasury

4.7 The Treasury faces three particular challenges in managing its future capacity:

a **The impact of reductions.** As a result of the October 2010 Comprehensive Spending Review the Treasury will be reducing its administrative expenditure by 33 per cent and reducing its overall staffing levels from circa 1400 to 1000 by 2015. This is likely to affect the staffing and resource levels available to devote to financial stability. The Treasury expects to manage this alongside the gradual withdrawal of the support schemes and the proposed regulatory restructuring.

b **Ensuring knowledge retention.** There continues to be a high level of turnover amongst staff working on financial stability both within the Treasury and UK Financial Investments.

c **Restructuring.** The Treasury has set out proposals to restructure the regulation of the banking sector. Any institutional restructuring carries the risk of the loss of individuals, and their accumulated knowledge, if they do not take up roles in the new structure.

Appendix One

Methodology

Method	Purpose
Literature Review of market analysis, commentary, and published documents A substantial amount of material is published about financial stability. We have made particular use of macro-prudential monitoring reports by the Bank of England and the International Monetary Fund.	**To identify:** • Developments in financial stability and challenges faced by the Treasury.
Document review We reviewed documentary evidence provided by the Treasury and UK Financial Investments, including key submissions and supporting papers.	**To identify:** • The Treasury's objectives. • The options considered by the Treasury. • The Treasury's assessment of the risks. • The means of protecting the taxpayer from unnecessary risk. • The Treasury's capacity and capability.
Financial Analysis We reviewed published financial statements from banks; market information; Treasury and Bank of England reports and financial records; and exchequer information from our Comptroller function.	**To identify:** • Current exposures and costs on the support schemes.
Interviews We interviewed officials from: • The Treasury; • Bank of England; • UK Financial Investments; and • The Financial Services Authority.	**To identify:** • Actions current taken by the Treasury and others. • Treasury's response to previous recommendations.

Glossary

Asset Protection Agency	An agency set up by the Treasury to run the Asset Protection Scheme on its behalf.
Asset Backed Securities	A financial asset backed by a pool of loans such as mortgages or credit card loans.
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.
Financial Services Compensation Scheme	A compensation scheme for customers of financial services firms that have stopped trading or have been declared in default, and are unable or likely to be unable to pay claims against them.
Impairment	When the value of an asset (e.g. mortgage) is reduced, for instance because there is a risk to the likelihood of the borrower meeting the terms and conditions of the loan or the loan being repaid. Impairment ultimately results in a reduction (or loss) to a company's capital position by the amount impaired.
Issuance	When a new financial instrument is created.
Liquidity	An asset is liquid when it is easily tradable. In the context of financial institutions' funding needs, liquidity means the ability to meet obligations as they become due through the use of liquid assets (e.g. cash).
London inter-bank offered rate (LIBOR)	An interest rate benchmark for wholesale borrowings by financial institutions, calculated by the British Bankers' Association.
Macro-prudential economic regulation	A regulatory framework which looks at stability of the financial system as a whole rather than at individual institutions.
Maturity (of a debt)	The point at which a financial instrument expires.
Mortgage Backed securities	A type of Asset Backed Security which is secured by a portfolio of mortgages.

Preference shares	Preference shareholders have higher priority than ordinary shareholders if the company is liquidated. The shares usually pay fixed dividends.
Public Sector Deficit	Refers to an annual shortfall between Government spending and tax receipts.
Quantative Easing	A monetary policy involving the injection of money into the economy to meet the inflation target through the purchase of assets by the Bank of England.
Recapitalisation	The Treasury provided capital to Lloyds and RBS in exchange for ordinary and preference shares.
Refinancing	Occurs when an existing loan or obligation is replaced with a new loan under different terms and conditions.
Repurchase agreement (repo)	A sale of a security together with an agreement for the seller to buy it back at a later date, normally at a greater price to represent interest.
Rights issue	Where a company raises capital by issuing further shares. Existing shareholders normally have the opportunity to buy a portion equivalent to their existing stake.
Senior debt	Debt that takes precedence in a liquidation.
Solvency	The ability of a business to meet its obligations.
Sovereign Debt	A debt issued by a government.
Subordinated debt/liabilities	Debt that comes after senior debt in precedence in a liquidation.
State aid	Government intervention that distorts competition, within the EU.
Tier 1 Capital	A measure of banks' capital, forming a key part of a bank's regulatory capital requirements.
Treasury bills	Zero-coupon (i.e non-interest bearing) debt securities issued by the UK Government which have maturities of up to one year.
United Kingdom Financial Investments Ltd	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.
Unsecured debt/borrowing	Debt or loans given by the lender without collateral in the form of a charge over the borrower's assets.
Wholesale funding/borrowing	A general term for funding sourced from financial markets (for example, financial institutions, money market mutual funds and overseas government entities).
Yield	The rate of interest received by an investor on a financial instrument, relative to its market and redemption values.

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