National Audit Office

HM Treasury

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

Appendices Two to Four

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Appendix Two

The Treasury's progress against our previous recommendations

Report	Recommendations	Progress
Learning lessons from the crisis		
NAO	The Treasury, working with the Financial Services Authority and the Bank of England, should evaluate the success of the support measures provided. Maintaining Financial Stability (HC 91 2009-10)	The Treasury believes that it is currently too early for such an exercise, as a key part of success is a period of continued financial stability. It agrees that there will be lessons to be learned for future policy makers and that it is good practice to conduct a formal assessment of the success of these measures.
PAC	The Treasury and UK Financial Investments should take on board lessons learned from past reports on privatisations and other asset sales when selling taxpayers' interests in the banks. Maintaining Financial Stability (HC 190 2009-10)	The Treasury agrees that careful judgement will be required when selling taxpayers' interest in the banks. UK Financial Investments is considering a range of relevant UK and international precedent transactions, both public and private sector, to inform its disposal strategy. The NAO has shared generic lessons from its previous audits of privatisations with the Treasury and UK Financial Investments.
PAC	The Treasury, working with UK Financial Investments, should establish clear criteria to assess how well its investment strategy balances its financial and economic objectives. Maintaining Financial Stability (HC 190 2009-10)	The Treasury established UK Financial Investments with a mandate to develop and execute an investment strategy for disposing of the investments in an orderly and active way within the context of protecting and creating value for the taxpayer as shareholder, whilst paying due regard to the maintenance of financial stability and acting in a way that promotes competition. The Treasury retains the right to amend UK Financial Investment's mandate.

Report	Recommendations	Progress
PAC	The Treasury should, with the Bank of England, commission additional analysis to discover why the banks are not meeting the agreed lending targets and should devise effective and enforceable sanctions if the banks continue to fall short of their commitments. Maintaining Financial Stability (HC 190 2009-10)	The Treasury, working with the Bank of England and the Department for Business Innovation and Skills has undertaken a range of analysis on supply and demand factors in credit provision. Their research has not, however, reached a definitive answer as to whether the fall in business lending was due to a lack of demand, shortage of supply or a mixture of the two. The Treasury has considered introducing a range of sanctions to penalise institutions that do not meet lending targets, and ultimately further access to the Credit Guarantee Scheme could be withdrawn. Currently it considers that such sanctions would not be beneficial and might inhibit further lending.
Evaluating firms in difficulty and challenging information from firms		
NAO	The Tripartite Authorities have reviewed the lessons to be learned from scenario testing and set agreed action plans and targets. They should now review progress against these targets at suitable intervals. Maintaining Financial Stability (HC 91 2009-10) and Northern Rock (HC 298 2008-09)	The Treasury has increased its efforts to prepare contingency plans and run scenario exercises since the start of the Financial Crisis. It now undertakes in-depth simulation exercises around twice a year, undertakes live contingency planning for firms deemed to be at risk, and maintains institutional assessments and dialogue with the Authorities on all systemic firms. It has built lesson learning into this process, translating lessons into new approaches (under the umbrella of the Authorities' standing committee), with key lessons reviewed by the deputies of the Committee (senior officials from each of the Authorities).
NAO	The Treasury should use data from the new liquidity reporting regime in its decision making process. Maintaining Financial Stability (HC 91 2009-10)	The Treasury now regularly receives liquidity-related data from the Financial Services Authority as part of its financial stability role, and says that this informs its decision-making on an ongoing basis.
PAC	The Treasury should challenge the information it receives on the quality of a business in difficulty. It should identify the type of information likely to be needed and the timescales within which such information can be collected. Northern Rock (HC 394 2008-09)	The Treasury now has in place internal guidance on the types of information that it needs from firms in the process of contingency planning, and the Authorities have used the powers available to them to gather information. Alongside existing powers, the special resolution regime of the Banking Act also introduces further information gathering powers, including entering the firm and extracting information. The Treasury has increased its efforts to challenge the quality of the information it receives, and challenges information which is relevant to the Treasury's objectives.

Report	Recommendations	Progress
NAO	When the Treasury steps in to provide support to a company, it should evaluate systematically the risks to the taxpayer, decide what information it will need, and use its influence as owner, or major creditor, to manage these risks robustly. Maintaining Financial Stability (HC 91 2009-10)	The Treasury now evaluates the risks to the taxpayer as part of the live monitoring of firms by the Authorities. The Treasury also conducts a systematic risk assessment as part of its live contingency planning. This includes an assessment of the information it needs and how it will use that information. Contingency planning also includes potential actions to mitigate risks.
NAO	The Treasury should use future scenario testing exercises to trial the actions that would be needed in the time available to it to properly assess and validate the information it receives on the quality of the on underlying business of a financial institution in difficulty. Northern Rock (HC 298 2008-09)	The Treasury now includes information gathering as part of its simulation exercises and contingency planning. This includes timing of information requirements and feasibility of information gathering from different sources.
NAO/ PAC	The Treasury should vigorously challenge the assumptions underlying any future business plans presented by Northern Rock. It should also undertake formal assessments before placing reliance on work undertaken by Northern Rock's advisers and the Financial Services Authority. Northern Rock (HC 298 2008-09 and HC 394 2008-09)	Since the reports in 2009, the Treasury has increased the challenge it makes to business plans from Northern Rock. The Treasury conducted due diligence work on Northern Rock's plan for restructuring, and tested the plan using stress tests equivalent to those used by the tripartite authorities. In developing the Asset Protection Scheme, Treasury conducted due diligence review of the capital position of the banks. UK Financial Investments now has day-to-day responsibility for monitoring Northern Rock performance and for challenging and approving revised business plans.
Working with advisors		
NAO/ PAC	With regards to adviser fees, the Treasury should:	The Treasury is not currently retaining advisors (except for legal advice), however:
	• give due consideration to the length and use of monthly fixed retainers and criteria for success fees;	• The Treasury has put in place a framework agreement for legal advice and is in the process of setting up the same for corporate finance advice which it hopes to have in place by the end of 2010-11.
	• put a robust contract in place at the earliest opportunity;	• The Treasury has developed its approach towards the discretionary element of corporate finance advisers' fees, formally assessing the performance of advisors before awarding success fees.
	• develop further its proposed framework arrangement for recruiting advisers; and	• The Treasury accepts that where possible the criteria for payment of fees should be defined in advisors' contracts.
	• not slavishly follow industry practice, particularly when agreeing advisers' remuneration. Northern Rock (HC 298 2008-09 and HC 394 2008-09)	• The Treasury accepts that this type of success fee should not be included in contracts, although they believe that discretionary fees, and fees based on qualitative assessments may be appropriate for incentivising performance.

Report	Recommendations	Progress
NAO	The Treasury should be in a position to validate the analyses prepared by external advisers, drawing on expertise from within the Treasury and public sector to do so. Northern Rock (HC 298 2008-09)	Throughout the Asset Protection Scheme design, the Treasury worked with the Bank of England and Financial Services Authority to direct and challenge analysis provided by advisers, to ensure they understood and could support and defend the outputs. For example, the Treasury worked with the advisors for due diligence on RBS to understand their analysis and methodology and had frequent challenge meetings to understand their assumptions.
PAC	Departments should retain the power to examine the financial models developed by their advisers and use this access to gain a thorough understanding of how these models work, their underlying assumptions and the impact on the resulting financial analyses. Northern Rock (HC 394 2008-09)	When developing the Asset Protection Scheme, the Treasury commissioned and developed a capital model for RBS. The Treasury commissioned and retained the model.
Capacity		
PAC	The Treasury should examine whether its own expertise and capacity is sufficient for the tasks it faces and ensure these skills are properly focused on core areas of responsibility carrying greatest risk. Northern Rock and Maintaining Financial Stability (HC 394 2008-09 and HC 190 2009-10)	The Treasury continues to focus on how to develop and maintain in-house some of the additional skills and capability necessary. It believes it has also learnt a lot from the advisors it has worked with on financial stability over the last three years.
NAO/ PAC	Given the scale and complexity of the Government's partnerships and investments in place, the Treasury should: • conduct a review by the end of 2012 on whether there is scope to achieve efficiencies between organisations; and • not lose sight of responsibilities and accountabilities to ensure good value for money. Maintaining Financial Stability (HC 91 2009-10)	The Treasury is reviewing its allocation of resources as a result of the 2010 Spending Review. It currently believes that both UK Financial Investments and the Asset Protection Agency remain necessary arm's length bodies. The Treasury has undertaken to keep the scope of achieving efficiencies between organisations under review.

Report	Recommendations	Progress
NAO	The Treasury should continue in future crisis situations, to appoint officials with sufficient seniority to marshal the necessary resources, make clear the Treasury's position to third parties and act as a focus for overseeing the response at official level. They should also examine the training and development provided to such officials. Northern Rock (HC 298 2008-09)	Since 2007, the Treasury officials have built up considerable experience in managing financial crisis. This has been supplemented by drawing in officials from across government and with staff from the private sector via secondment, and through working with advisers. In the case of the Asset Protection Scheme, a steering board composed of senior officials was established to provide oversight and direction. A Challenge Group was also set up to provide critical challenge to decisions.
Other recommendations		
NAO	In complying with State Aid rules by disposing of RBS and Lloyds assets, UK Financial Investments should take into consideration wider economic factors. Maintaining Financial Stability (HC 91 2009-10)	The Treasury remains responsible for ensuring banks comply with their state aid rules. The terms of the state aid agreements prevent the sale of Lloyds and RBS retail asset to large incumbent banks, thereby ensuring that the divestments enhance competition. Alongside the business divestments, the Treasury has initiated several new policies to promote competition in banking including the Independent Commission on Banking's detailed analysis of competition and the Green Paper entitled *Financing a private sector recovery*.
NAO	The Treasury should put in place adequate arrangements for filing, storing and accessing the electronic and paper records generated. Northern Rock (HC 190 2009-10)	The Treasury says it recognises the importance of consistently applied document retention standards, particularly in light of fast-moving events and frequent changes in staff. It has introduced systems across the department with the aim of strengthening knowledge management and put in place resources to enhance record keeping for the Asset Protection Scheme and other interventions.
PAC	The Treasury should notify the Chairman of PAC of any provisions, indemnities or contingent liabilities as they arise. Maintaining Financial Stability (HC 394 2008-09)	The Treasury agrees that it is important that the normal disciplines of parliamentary reporting are respected wherever possible. In any future highly sensitive cases, the Chairman of the PAC and the Treasury Select Committee will be briefed orally. A secure confidential record of the meeting will be kept and the Comptroller and Auditor General will be kept informed.

Report	Recommendations	Progress
PAC	We urge the Treasury to direct, by legislation if necessary, the Bank of England to appoint the Comptroller and Auditor General to be its auditor. The Comptroller and Auditor General should also be given unfettered power to audit the work of the Financial Services Authority. Maintaining Financial Stability (HC 394 2008-09)	As announced to Parliament on 22 October 2009, The Financial Services Authority has decided to appoint the Comptroller and Auditor General as its financial auditor from 2010-11. As announced in the Treasury's July 2010 consultation document "A new approach to financial regulation: judgement, focus and stability", the FSA is being replaced with two new regulators, the Prudential Regulation Authority which will be a subsidiary of the Bank of England, and the Consumer Protection and Markets Authority. Both will be subject to full audit by the National Audit Office who will also have the power to conduct value for money studies. The Treasury recognises, in principle, the powerful case for public audit of public money in respect of the Bank of England, to assure Parliament that its supply of funds has been used as intended. The Treasury will consider further how far it is possible to extend this principle.

Appendix Three

Current financial stability regulatory reform

There is considerable work in progress in determining the future shape of the tax and regulatory environment around UK banks, which aim to prevent another financial crisis and will affect the future structure, shape, and growth of the banks:

- **Increases in capital adequacy standards.** In November 2010 the G20 approved new global standards for capital adequacy known as Basel III. The new rules require banks to hold more "Core Tier 1" capital – the highest quality loss absorbing capital, including the shareholders' reserves. There might be additional capital requirements which have not yet been decided for the systemically important banks. In addition the rules will allow national supervisors to require the banks to hold a countercyclical buffer of capital in times of excessive credit growth, which they can use during periods of financial distress which if breached, will restrict the bank's ability to make distributions to investors and employees. National regulators will be able to set more demanding standards – the Swiss Central Bank has already done so – although the EU may require consistent standards through the Union.

- **Increases in liquidity standards.** The Financial Services Authority has also introduced a new liquidity regime which is based on individually determined requirements for larger banks and building societies to hold set amounts of very liquid assets, such as high quality government bonds. The regime will be phased in over time and the authorities will need to manage the introduction of the regime and monitor its operation. Both European and international regulators are doing more work on liquidity standards and UK financial institutions will need to adjust to the increased requirements.

- **Changes to UK financial regulation.** The Treasury is consulting on proposals to change the current institutional structure for financial supervision. It wants to consolidate responsibility for maintaining financial stability within the Bank of England, by creating a new Financial Policy Committee and establishing a Bank of England subsidiary for Prudential Regulation (with operational responsibility for supervision of financial institutions) and an independent Consumer Protection and Markets Authority (responsible for supervising the conduct of financial institutions and markets). The Government has said it will publish draft legislation in mid 2011.

- **EU financial regulation.** The EU has legislated to create a new structure for EU-wide regulatory supervision, which will begin operation on 1 January 2011. There will be a new European Systemic Risk Board, based in Frankfurt, which will be responsible for monitoring financial stability throughout the EU. There will also be new European Supervisory Authorities for the banking; securities; and insurance and occupational pensions sectors, based in London, Paris and Frankfurt respectively. The EU regulators will not, in general, supervise individual financial institutions and markets, but will have powers to act where a national regulator is not applying EU law or there is disagreement between national regulators; the securities regulator will have enhanced powers to intervene in the operation of securities markets.

- **US reform legislation.** The US Congress has passed the Dodd-Frank Wall Street Reform and Consumer Protection Act in July 2010. The Act makes the most extensive changes to the regulation of US financial services since the 1930s. Changes affect non-US banking groups with operations or subsidiaries in the USA, which include a number of UK banks. The Act brings in restrictions on banks trading for their own account or investing in private equity or hedge funds and requiring the segregation of some derivatives activities into a separate subsidiary. The Act does not, however, require more extensive structural change in financial institutions.

- **A permanent banking levy.** The Government has published draft legislation to introduce a levy on the banks with effect from 1 January 2011. The levy will be structured with the intention of encouraging banks to adopt more stable forms of funding. The Treasury hopes the levy will raise some £2.5 billion a year. There are also ongoing talks within the European Union on coordinating banking levies.

Appendix Four

Progress towards compliance with EC State Aid Agreements

Summary requirement	Progress to date
The wholly owned banks – Northern Rock and Bradford & Bingley	
Restrict the competitiveness of the banks by limiting new mortgage lending, capping the size of overall retail deposits and restricting where products rank in Moneyfacts.	New lending has remained within limits (£3.1 billion for 2009). Retail balances have not breached the cap but have reduced (£19.5 billion in January to £17.6 billion in June 2010). The 2010 Moneyfacts rankings did not include any Northern Rock products.
Return the viable parts of Northern Rock to the private sector.	Northern Rock plc has been established as a new entity and is preparing for a return to private sector ownership in due course.
Stop paying interest or principal on subordinated debt whilst in receipt of State Aid, unless contractually obliged.	Northern Rock (Asset Management) and Bradford & Bingley stopped payments to subordinated debt-holders where contractually able to do so. This also stops payments on dividends.
Lloyds Banking Group	
Reduce the size of the Balance Sheet by disposing of at least 600 branches within 4 years of state aid approval, disposing of the TSB and Intelligence Finance brands, reducing assets by £181 billion by 2014.	Lloyds has announced the sale of all Scottish and Cheltenham & Gloucester branches but have yet to identify further branches in England & Wales. Lloyds have until 18 November 2013 to complete the branch disposals. Lloyds is seeking to exceed the requirement and reduce assets by £200 billion by 2014.
Stop payments of coupons or call options on hybrid securities until 31 January 2012.	Payments were stopped on 31 January 2010. This also stops payments on dividends.

Summary requirement	Progress to date
RBS	
Reduce its assets to approximately £1 trillion or less by the end of 2013, including disposing of 318 branches, and certain named brands. Restrict further acquisitions in relation to the businesses divested.	The bank has made some progress, but sales are yet to complete and further divestment is still required. The bank agreed in August 2010 to sell 318 branches to Santander and to sell 80 per cent of Global Merchant Services. The latter sale is expected to complete by the end of 2010 pending approval from European and American regulators. In February 2010 it sold the European and Asian operations of Sempra to JP Morgan and the US operations to Noble (pending regulatory approval). RBS Insurance is being prepared for sale.
Restrict where RBS ranks in the annual Global All Debt League Table.	Latest position is 8th (October 2010).
Stop paying interest on hybrid capital instruments for two years.	RBS stopped discretionary payments on capital instruments from 30 April 2010. This also stops dividends being paid.

Source: EC State Aid ruling and public statements by the banks