REPORT BY THE
COMPTROLLER AND
AUDITOR GENERAL

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

Report by the Comptroller and Auditor General

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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.