

# UK GOVERNMENT BANKING SUPPORT MEASURES INCLUDING REFORM OF UK BANKING REGULATIONS

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# Overview

- UK Government recapitalisation and funding facilities
- Bank of England liquidity facilities
- Banking Act 2009
  - special resolution regime
  - bank insolvency procedure
  - bank administration procedure
- Rights issues and other private sector funding alternatives
- Other EU regulatory developments
- Long term implications for the banking industry

# UK Government Recapitalisation Scheme

- Launched on 8 October 2008
- UK government can make capital investments of up to an aggregate of £50bn in “Eligible Institutions” to increase Tier 1 capital and strengthen their finances
- Investments may take the form of preference shares or permanent interest bearing shares
- “Eligible Institutions” are UK incorporated banks, including UK subsidiaries of foreign banks that have a substantial business in the UK. The initial list of Eligible Institutions includes:
  - Abbey National
  - Barclays
  - HBOS
  - HSBC
  - Lloyds TSB
  - Nationwide
  - Standard Chartered
- HMT has established UK Financial Investments Limited to hold its shareholdings in Eligible Investments

# UK Government Recapitalisation Scheme (cont.)

- In return for investing under the GRS, the government requires a number of commitments from participating banks:
  - to maintain competitively priced lending to homeowners and small businesses at 2007 levels for three years
  - to support schemes to help struggling mortgage borrowers stay in their homes and support the expansion of financial capability initiatives
  - not to pay cash bonuses to board members for 2008 and to review executive compensation policies to link them to long-term value creation and restricting the potential for “rewards for failure”
  - to give HMT the right to agree with the board of directors on the appointment of new independent non-executive directors
  - to amend dividend policies

# Credit Guarantee Scheme

- Launched on 13 October 2008 and amended on 15 December 2008
- HMT will, for a fee, guarantee new issuances of short or medium-term debt securities by Eligible Institutions to help refinance their funding obligations
- Initial uptake of the CGS was estimated at £250bn
- 15 December amendments reduced the fee payable by a bank for the use of the CGS, extended the maximum guarantee term to five years and widened the range of eligible currencies
- On 19 January, the drawdown window was extended to 31 December 2009. After that date, participating institutions may roll over guaranteed debt until 13 April 2012 and thereafter, one third of such debt until the final maturity date
- Final maturity date is 9 April 2014

# Credit Guarantee Scheme (cont.)

- Issuance must be by an Eligible Institution (as defined under the GRS) prior to 31 December 2009
- Issuance must be an Eligible Institution which must also maintain a level of Tier 1 Capital in amount and form deemed appropriate by HMT
- Only one entity within a single banking group may participate in the CGS
- The debt instruments must qualify as an “Eligible Scheme Liability”:
  - be senior debt instruments with standard market terms
  - must not be a complex instrument
  - must be either a certificate of deposit, commercial paper, bond or note
  - be denominated in an eligible currency
  - have a maturity date no later than 13 April 2012 with possible roll-over of a third of the debt to 9 April 2014 with government consent
- Fee is 50 basis points plus 100% of bank’s median 5 year CDS spread during July 2007 to July 2008 as determined by HMT

# Asset Backed Securities Guarantee Scheme

- Originally announced on 19 January 2009
- Scheme intended to commence in April 2009 subject to EU State Aid approval
- Eligible Institutions under the CGS may issue new asset backed securities guaranteed by HMT subject to certain conditions
- Aimed at improving banks' access to the wholesale funding markets, and in particular, supporting mortgage lending

# Asset Protection Scheme

- Announced on 19 January 2009
- HMT subsequently published a detailed statement on its operation of the APS (including a term sheet) on 26 February 2009
- Enables participating banks to insure a proportion of eligible assets through HMT
- Aim is to reduce uncertainty as to the value of the relevant assets and free up the healthier part of the bank's commercial business to continue lending
- UK incorporated authorised deposit takers, including UK subsidiaries of foreign institutions, may participate in the APS
- To be able to participate, the entity must have more than £25bn of "eligible assets" on their balance sheet

# Asset Protection Scheme (cont.)

- Eligible assets includes:
  - corporate and leveraged loans
  - residential and commercial property loans
  - structured credit assets including RMBS, CMBS, CLOs and CDOs
- In return for a fee, HMT will provide the participating bank with protection against future credit losses on eligible assets to the extent they exceed a “first loss” amount
- In addition, participating banks must retain a further exposure of 10 per cent. of losses exceeding the first loss amount
- Other requirements are imposed on the participating bank including:
  - the bank must give a commitment to increase the lending they provide to credit-worthy borrowers
  - to develop a sustainable long-term remuneration policy consistent with the detailed principles in the FSA’s Code of Practice on Remuneration Policies published for consultation on 26 February 2009

# Asset Protection Scheme (cont.)

- Eligible institutions had until 31 March 2009 to apply to participate in the APS
- RBS announced on 26 February it was participating in the APS:
  - £325bn of assets insured for a 2 per cent. fee (£6.5bn) paid for in non-voting equity shares
  - RBS “first loss” piece is 6 per cent. of the value of the assets (£19.5bn)
  - RBS retains the risk of 10 per cent. of the losses above the first loss piece
- Lloyds announced on 7 March 2009 it was also participating in the APS:
  - £260bn of assets (83% HBOS legacy loans) insured for a 6 per cent fee (£15.6bn) paid for in non-voting B shares convertible at HMT’s option into ordinary shares
  - Lloyds “first loss” piece is 9.6 per cent. of the value of the assets (£25bn)
  - Lloyds retains the risk of 10 per cent. of the losses above the first loss piece

# Bank of England Short-Term Lending Facilities

- On 20 October 2008 the BoE replaced its daily standing facilities with two new facilities:
  - operational standing facilities (providing overnight lending facilities similar to the standing facilities)
  - a discount window facility allowing banks to deposit eligible collateral in return for borrowing (usually up to 30 days) UK government securities
- Requirement that BoE publish weekly reports as to utilisation of such facilities has been removed
- With effect from 2 February 2009, the maturity of the discount window facility was increased to 364 days for an additional fee of 25bps

# Eligible Collateral and Auction Mechanism for Long-Term Repos

- BoE Consultation Paper published on 16 October 2008- “The Development of the Bank of England’s Market Operations”
- BoE proposals set out in the paper included:
  - that eligible collateral for BoE’s routine monthly long-term repos will be permanently widened to include certain high quality non-sovereign securities
  - a revised auction mechanism for long-term repos under which banks bid separately against two sets of collateral – one high quality sovereign and supranational securities and the other the wider class of eligible collateral

# Asset Purchase Facility

- Initially announced by Government on 19 January 2009
- Details of APF subsequently outlined in exchange of letters between Alistair Darling and Mervyn King dated 29 January 2009
- BoE published a market notice on 6 February 2009 outlining how it intends to operate the APF
- On 11 February 2009, the BoE published the following:
  - application form and questionnaire for applicants seeking to become counterparties to the commercial paper facility
  - terms and conditions for counterparties in the APF
  - a set of pro forma documents including the form of parent company guarantee, the form of legal opinion on any guarantee provided in connection with the APF and forms of eligibility documents

# Asset Purchase Facility (cont.)

- Under the APF, the BoE will make purchase of high quality private sector assets up to £50bn
- BoE may only purchase assets if satisfied there is a viable private market demand initially covering sterling denominated commercial paper, corporate bonds and debt
- To implement the APF, the BoE has established a wholly owned subsidiary - Bank of England Asset Purchase Facility Fund Limited
- The APF Fund will only purchase from companies which make a material contribution to economic activity in UK

# Asset Purchase Facility (cont.)

- Principal aspects are the commercial paper facility (“CPF”) and the corporate bond secondary market scheme (“CBSMS”)
- Under the CPF, the APF Fund will purchase investment grade commercial paper issued by eligible UK companies at a minimum spread over risk free rates
- Covers initial issuance in primary market and purchases from eligible counterparties in the secondary market
- There are other eligibility conditions relating to the issuer, features of the commercial paper, a purchase limit for each issuer and application and settlement procedures
- Non-bank financial companies qualify, in principle, as eligible issuers if they can convince the BoE they make a significant contribution to corporate financing in the UK
- Leveraged investment vehicles are not eligible issuers under the CPF

# Asset Purchase Facility (cont.)

- To be eligible under the CPF, commercial paper must meet certain requirements including:
  - be denominated in sterling
  - have a maturity of three months if a primary issuance or have a maturity of three months or less if sold in the secondary market
  - not have non-standard features including extendibility or subordination
  - have a minimum short term credit rating of A-3/P-3/F-3 from at least one of S&P, Moody's and Fitch
  - not be asset backed commercial paper
  - be issued directly into Crest, Euroclear or Clearstream

# Asset Purchase Facility (cont.)

- On 19 March 2009, BoE published a market notice and relevant documents concerning the CBSMS to be implemented from 25 March 2009
- Under the CBSMS, the BoE will make regular small purchases, via reverse auctions, of a wide range of high credit quality
- Issuer must be a UK incorporated bank or non bank financial company that makes a significant contribution to corporate financing in the UK
- Issuers cannot be building societies, leveraged finance companies and companies within groups that are predominately credit institutions or investment banks

# Asset Purchase Facility (cont.)

- Eligibility criteria for eligible corporate bonds under the CBSMS includes:
  - it must be conventional senior unsubordinated debt (no convertibles, exchangeables or otherwise complex bonds)
  - minimum long term credit rating from at least two of S&P, Moody's and Fitch of BBB-/Baa3
  - minimum issue amount of £100m
  - must be issued at least one month before purchase by APF Fund
  - maturity of at least 12 months (but not perpetual debt)
  - cleared and settled through Euroclear/Clearstream
  - must be listed on an EU stock exchange

# Banking Act 2009

- Came into force on 12 February 2009 and implements
  - Special Resolution Regime (specifically the “stabilisation options”)
  - Banking Insolvency Procedure
  - Bank Administration Procedure
- Establishes Banking Liaison Panel, to advise HMT on
  - effect of the SRR, BIP and BAP on banks, their customers and the financial market generally
  - exercise of its powers to make secondary legislation under Banking Act
  - a code of practice
- Includes representatives from HMT, BoE, FSA, FSCS and the banking industry

# Special Resolution Regime

- Replaces previous temporary special resolution regime provided by Banking (Special Provisions) Act 2008
- Provides HMT, BoE and FSA with new tools to deal with failing banks and building societies
- Gives 3 stabilisation options:
  - transfer to private sector purchaser
  - transfer to publicly controlled bridge bank
  - transfer to temporary public ownership
- Each option is to be achieved by the use of one or more of the “stabilisation powers”, in other words the power to transfer some or all of the shares of a failing institution and the power to transfer some or all of the assets and liabilities of a failing institution

# Special Resolution Regime (cont.)

- Objectives of the SRR:
  - protect and enhance stability of UK financial system and public confidence in stability of UK banking system
  - protect depositors
  - protect public funds
  - non-interference with property rights
- Stabilisation powers can be exercised only if:
  - the bank is failing, or is likely to fail, to satisfy the threshold conditions (within meaning of section 41(1) FSMA 2000)
  - having regard to timing and other relevant circumstances it is not reasonably likely that action will be taken by or on behalf of that bank to enable it to satisfy the s.41 threshold conditions
- FSA determines whether the above conditions (the “SRR threshold conditions”) are met, and in doing so disregards any financial assistance provided to the bank by HMT or BoE
- Before reaching a determination on the second SRR threshold condition, FSA must consult with HMT and BoE

# Special Resolution Regime (cont.)

## BoE

- Further specific condition to be fulfilled before BoE may order transfer to private sector purchaser or bridge bank is that the exercise of the power is necessary, having regard to:
  - stability of UK financial system
  - maintenance of public confidence in stability of UK banking system
  - protection of depositors
- Before determination of the above, and the appropriate action, BoE must consult FSA and HMT
- If HMT notifies BoE it has provided financial assistance to the bank to reduce threat to stability of UK financial system, then above conditions don't apply, but in that case BoE can only use a particular stabilisation power if:
  - HMT recommends BoE to exercise that stabilisation power to protect the public interest
  - in BoE's opinion, exercise of that power is an appropriate way to achieve such protection

# Special Resolution Regime (cont.)

## HMT

- Further specific conditions to be fulfilled before HMT may order a transfer into temporary public ownership:
  - exercise of the power is necessary to resolve or reduce a serious threat to the stability of the UK financial system
  - exercise of the power is necessary to protect public interest, where HMT has provided financial assistance to protect stability of UK financial system
- Before determination of the above, HMT must consult FSA and BoE

# Special Resolution Regime (cont.)

## Partial Transfers

- Power to order partial transfers of assets and liabilities creates potential problems for:
  - set off and netting arrangements – if some financial contracts covered by the arrangements are transferred to another entity, but others remain with the failing bank, this destroys mutuality and leads to banks having to account for their exposure under their financial contracts on a gross (rather than net) basis
  - holders of security interests and structured finance arrangements – the holder of a security interest would not be able to be certain of its ability to enforce if secured assets were transferred to another entity. Similarly, the prospect of partial transfers of assets subject to structured finance arrangements would render those arrangements unrateable
  - creditors of the failing bank – they may have concerns that a partial property transfer of “good” assets would leave them worse off than in “whole bank” liquidation

# Special Resolution Regime (cont.)

- Banking Act 2009 (Restriction of Partial Property Transfers) Order 2009
  - set off and netting arrangements and title transfer financial collateral arrangements are “protected rights” and may only be transferred in whole and may not be modified or terminated so long as they relate to financial instruments, deposits or loans, but don’t relate to retail deposits, liabilities of retail customers to banks or subordinated debt
  - secured liabilities can only be transferred together with the benefit of the related security interests and property subject to security interests can only be transferred together with the related secured liability and the benefit of the related security interests
  - capital market arrangements (i.e. collateralised securities issues, such as securitisations and covered bond) may only be transferred in whole and may not be modified or terminated, unless they relate solely to deposits
  - other provisions, such as to protect integrity of investment exchange and clearing house contracts
- Banking Act 2009 (Third Party Compensation Arrangements for Partial Property Transfers) Regulations 2009 provide for payment of compensation to “pre transfer creditors” left in the residual failing bank after the partial property transfer, where they are left worse off than in a “whole bank liquidation”. It provides for appointment of an independent valuer, and principles for conducting the valuation.

# Bank Administration Procedure

- Established by Part 3 of the Banking Act 2009
- Applies where there has been a transfer of part only of a failing bank's business under the SRR, leaving an insolvent residual entity
- Designed to ensure that essential services and facilities continue to be provided to transferee bank so that it can operate effectively
- Like normal UK administration procedure, intended to be temporary and provides automatic moratorium to prevent action being taken against failing bank during the administration. However, provides for specific information sharing and consultation with BoE during "Phase 1"
- Application is made by BoE for bank administration order
- Once BoE notifies bank administrator that transferee bank no longer requires such services or facilities, reverts to "normal" administration, in other words objective is to rescue the residual bank as a going concern or if that is not reasonably practicable, to achieve a better result for the residual bank's creditors than would result from a winding up
- In latter case, administrator is not permitted to realise residual bank's assets, following a transfer to a bridge bank, unless BoE agrees they may be realised

# Bank Administration Procedure (cont.)

- Bank Administration (England and Wales) Rules 2009 enacted by HMT in February 2009, makes provisions for
  - applications for Bank Administration Orders and necessary supporting statements and documents
  - bank administration process
  - court procedure and practice in relation to the bank administration procedure
  - details of existing “normal” Insolvency Rules that apply to bank administration procedure
- Bank Administration Procedure now extended to building societies, with necessary changes, pursuant to:
  - Building Societies (Insolvency and Special Administration) Order 2009, which amends insolvency provisions of Building Societies Act 1986 to give effect to Banking Act 2009
  - Building Society Special Administration (Scotland) Rules 2009 which amends the Insolvency (Scotland) Rules 1986

# Case Study – Dunfermline Building Society

- 28 March 2009 FSA decided threshold conditions under SRR were met, having consulted with HMT and BoE
- Competitive bidding process held over weekend 28-29 March 2009
- BoE, in consultation with FSA and HMT, decided transfer of majority of the business to Nationwide BS was best solution
- Nationwide agreed to take on Dunfermline's deposit liabilities in return for payment from HMT (to be reimbursed by FSCS)
- All retail and wholesale deposits, branches, head office, residential mortgages (other than social housing loans and related deposits), and all Dunfermline staff, transferred to Nationwide
- Social housing portfolio transferred to a bridge bank owned by BoE
- Remainder of Dunfermline's assets placed into building society special administration under new rules introduced following on from Banking Act 2009
- Certain variations made to the application of other laws to Dunfermline, to facilitate smooth outcome, such as the Transfer of Undertakings (Protection of Employment) Regulations 2006 and Pensions Act 2004 and exonerating directors of bridge bank from liability

# Bank Insolvency Procedure

- Introduced by Part 3 of the Banking Act 2009
- Largely based on existing liquidation provisions of Insolvency Act 1986, as amended by Enterprise Act 2002
- Used where liquidation of assets and closure of bank considered the best option for creditors
- Principal objectives are to:
  - provide ability to commence insolvency proceedings promptly in respect of an insolvent bank, in order to prevent a bank “run” or other financial system instability
  - protect the position of depositors

# Bank Insolvency Procedure (cont.)

- So long as bank has eligible depositors (eligible for protection under Financial Services Compensation Scheme), application can be made by BoE, FSA or Secretary of State for a bank insolvency order based on one or more of the following grounds:
  - bank is insolvent (Ground A)
  - winding-up would be in the public interest (Ground B)
  - winding-up would be fair (Ground C)
- So long as FSA is satisfied that SRR threshold conditions are satisfied
  - BoE can apply for a bank insolvency order if Ground A or Ground C applies
  - FSA can apply for a bank insolvency order if Ground A or Ground C applies, and BoE consents

# Bank Insolvency Procedure (cont.)

- Secretary of State can apply for a bank insolvency order if Ground B applies, in other words to protect depositors and the public interest, even if the bank is not technically insolvent
- Principal objectives of bank liquidator are:
  - first, to work with the FSCS to ensure that eligible depositors are paid under the FSCS or their accounts are transferred to another financial institution
  - second (i.e., subject to the first objective), to facilitate an orderly winding up of the failed bank to achieve the best results for its creditors as a whole

# Bank Insolvency Procedure (cont.)

- Following a Bank Insolvency Order, a liquidation committee must be formed by representatives of BoE, FSA and FSCS until the first objective is achieved. The initial liquidation committee will have the right to consent to certain proposed actions by the liquidator and must make a “full payment resolution” when the first objective has been achieved (entirely or as far as is reasonably practicable).
- Once the full payment resolution is passed, the liquidator must call a meeting of the creditors, who may then choose to elect new members to the liquidation committee. This will oblige representatives of BoE and FSA to stand down (who will still be entitled to attend future meetings of the liquidation committee and receive reports from them) although the FSCS representative can remain
- Only a duly qualified insolvency practitioner can be appointed as bank liquidator

# Bank Insolvency Procedure (cont.)

- Bank insolvency (England and Wales) Rules 2009 establish procedures for a court hearing and appointment of bank liquidator in each case as promptly as possible.
- Rule 72 provides for automatic set off of mutual credits and debits, similar to Rule 4.90 of the “normal” Insolvency Rules 1986
- Explanatory notes to the rules state that changes are being considered to the FSCS, such that payouts by FSCS would be made to each depositor on a “gross” basis, i.e. not setting off in respect of any right of the failed bank to claim amounts from that depositor, up to the agreed compensation limit. Set off would only be applicable to account balances above the compensation limit. Therefore, Rule 73 hardwires in similar provisions, to apply if FSCS changes to a “gross” basis

# SRR Code of Practice

- Published by HMT in February 2009. It provides guidance on the use of the SRR, including the BIP and the BAP, and in particular:
  - how the SRR objectives are to be understood and achieved and how they are to be balanced
  - which “SRR tools” are appropriate for different circumstances
  - what sort of information should be provided in the course of the consultations
  - how the FSA should determine whether the second SRR threshold condition is met (i.e. that it is not reasonably likely that failing bank will meet its threshold conditions)
  - giving of advice from one relevant authority to another
  - guidance on the provisions of the Banking Act 2009 dealing with the different types of compensation orders that can be made, and principles of valuation of compensation and appointment of independent valuer

# Investment Banks Holding Client Assets

- Part 7 of the Banking Act authorises HMT to make new insolvency regulations relating specifically to investment banks holding client assets, with a view to making it easier for client assets to be returned following an investment bank insolvency
- Banking Liaison Panel currently undertaking review of what such regulations would need to cover and is due to conclude review in summer 2009

# Other EU Developments and Implications for Banking Industry

- Capital adequacy and risk management
  - amendments to the Capital Requirements Directive
  - European Commission consultation on possible changes to strengthen capital requirements in the trading book, raising capital charges for certain securitisation exposures and upgrading risk management and disclosure standards for securitisation positions
  - CEBS consultation on principles for risk management

# Other EU Developments and Implications for Banking Industry (cont.)

- **Future Supervision**
  - Larosiere Report on cross border financial supervision in Europe
  - Turner Review and FSA Consultation Paper
- **Remuneration and Incentive Structures**
  - FSA Code of Practice

# Turner Review Recommendations

- More capital and counter-cyclical
- Tighter liquidity regulation
- Regulation of “shadow banking”
- Regulation of credit rating agencies
- Overhaul of remuneration policies
- Major reforms to European banking regulation, including new European regulatory authority and increased host member state powers
- Heightened emphasis on senior risk management personnel
- Major changes in FSA’s supervisory approach

# Remuneration and Incentive Structures

- FSA Code of Practice - Firms must ensure their employees' remuneration packages are established, implemented and maintained in a way that is consistent with effective risk management
  - appropriate constitution of remuneration committees
  - input from risk management/compliance functions into remuneration procedures
  - structure remuneration of risk management functions so as to be independent from business
  - bonus pools based on risk and capital-adjusted profits
  - adherence to good risk management and regulatory compliance to form significant part of assessment process
  - higher emphasis on fixed element of remuneration
  - where bonus is major part of total remuneration, majority should be deferred
  - assessment of performance for long term incentives should be risk adjusted
  - deferred element of bonus should be linked to whole firm's performance

# Any Questions?

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