Supplementary Estimate and Consolidated Fund (Appropriation) (No 3) Bill: or how we rescued the banks.

Standard Note: SN/BT/4862

Last updated: 14 October 2008

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Section Business & Transport Section

This note describes the immediate package of financial measures announced by the Government to stabilise the UK banking system at the height of the financial crisis. It relates to the rescue package for banks and not to the reforms to regulation which followed. More detail including the longer term consequences of the rescue can be found in another Library note *Government bank rescues: financial consequences (SN05748).*

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The bail out

Ever since the failure of the Northern Rock Bank the Government has looked for both long term measures and short term fixes for the various aspects of the ongoing financial crisis. The *Banking Reform Bill* which has its second reading on 14 October deals with several procedural aspects of the mechanism for preventing banks from either getting into trouble or for better dealing with the consequences of failure.

The *Supplementary Estimate and Consolidated Fund (Appropriation) (No 3) Bill* is the vehicle through which the government intends to invest substantial funds into the banking system in a full scale recapitalisation of troubled banks.

The Chancellor announced the plan in a statement to the Commons. He said:[1]

> I shall set out to the House the detail of today's announcement, which covers both liquidity and capital. I turn first to the funding of the banking system, or liquidity. The Bank of England will continue to supply sufficient short-term funds, which from today will include unlimited dollar funds available to banks to be swapped for sterling funds, and continued loan operations through the special liquidity scheme. Additionally, I have announced today the details of the Government guarantee scheme for new lending between banks, an essential part of banks' resuming lending to people and businesses. The guarantee under the scheme will be provided by Her Majesty's Treasury directly. It will be temporary, covering new lending issued during a six-month period, but that period is renewable. It will be priced on commercial terms, which can be varied at the Treasury's discretion but will initially be set at a premium of 50 basis points above the recent average cost of default insurance for each of the participating banks. In other words, it is risk based.
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> The guarantee scheme will be available only to those banks and institutions that participate in the Government's recapitalisation scheme, as I made clear last week. The banks taking part in the scheme are given the option of raising capital in the open market, in the usual way, or through the Government's bank reconstruction scheme. When raising capital through the reconstruction fund, the participating banks receive an investment from the Government in return for shares.
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> […]
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> Let me now outline how HBOS, Lloyds TSB and RBS will be recapitalised through the bank reconstruction fund. Subject to take-up by existing shareholders, the Government will take significant shareholdings in these banks—in one case, a majority stake—and in line with normal commercial practices, the Government, on behalf of taxpayers, will have appropriate representation on their boards. These shareholdings will be managed on a fully commercial basis by an arm's length body with a precisely defined remit to act in the interests of taxpayers. Government support in respect of these three banks is tied to conditions covering executive pay and dividend policies, and conditions have also been agreed with them on the level of lending to small businesses and home buyers. We are making it clear that there will need to be a strong focus at these recapitalised banks on making available lending for small businesses and home buyers. These conditions are set out in the individual agreements with the banks, copies of which will be placed in the Library.

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1 HC Deb 13 October 2008 c539-541

> In the case of Lloyds TSB and HBOS, the Government will purchase both ordinary and preference shares once the merger is complete. HBOS will receive up to an £8.5 billion investment in newly issued ordinary shares on completion of the merger. The Government will also invest up to £4.5 billion in newly issued ordinary shares of Lloyds TSB at completion. At the same time, we will invest up to an additional £4 billion in preference shares in the merged institution, with £3 billion of which being invested in HBOS and £1 billion in Lloyds TSB. In return for this investment, which potentially represents around 44 per cent. of the proposed merged bank, the Government will appoint two independent board members. No cash bonuses will be paid to any board member this year. Directors in HBOS will be asked to relinquish their rights to bonuses, and directors in Lloyds TSB will receive restricted stock instead of cash for any 2008 bonus entitlements. The availability of lending to home owners and small businesses will be maintained at at least 2007 levels, and greater support will be given to people experiencing difficulties with their mortgage payments to help them stay in their homes.
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> For RBS, the Government will take up to £15 billion of ordinary shares and £5 billion of preference shares. This potentially represents a 63 per cent. interest in the bank, in return for which the Government will appoint three independent board members. Again, no bonus will be awarded to any board member this year, and any bonus paid next year will be in stock and linked to long-term growth in the bank. Mortgage and small and medium-sized business lending availability will be maintained at 2007 levels for the benefit of people up and down the country. These steps will help to put RBS on a stronger footing and allow it to build on its core retail banking operation.

As the statement says the detailed points about the agreements with the individual banks are set out in the individual agreements contained in Deposited paper 2008/2350.

These are substantial documents and would appear, at the time of their deposit 10 am, 14 October, to still contain draft elements and be partially incomplete. Some elements however, are worth noting are:

The Lloyds and HBOS shares are being bought at premiums to their nominal value. The precise figures appear to be undecided at time of writing. They will share equal rights with existing preference share holdings. Dividends from HBOS will fall in two periods. First, a period of up to five years will be fixed at 12%. The second period will be 7% plus LIBOR rate until their redemption. Lloyd's dividends will be 7% plus LIBOR for the duration.

The agreements include *Conditions Terms Sheet.* The LloydsTSB/HBOS conditions include:

1. Remuneration (Public)

    - Remuneration of Board of Directors

    For HBOS, no cash bonuses for 2008. If part of contractual arrangement, Board Directors relinquish these voluntarily.

    For Lloyds, no cash bonuses for 2008. Bonuses for 2008 for Lloyds Board of Directors may be paid in stock. If part of contractual arrangement, Board Directors relinquish these voluntarily.

    Going forward, for the merged group, in addition to complying with the ABI industry best practice code, remuneration will consider long-term value creation and take account of risk. Reward for board members will take into account

internal relative compensation packages and perceived fairness in the current economic climate.

No rewards for failure; where a Board Member loses the confidence of the Board, they should be able to be dismissed at a cost that is reasonable and perceived as fair.

- Commitment to FSA Code on risk based remuneration

2. Corporate Governance (Public)

- HMG will work with the board on its appointment of 2 new independent directors. Should the Government holding of the combined entity fall below 25%. HMG would only expect to be consulted on the appointment of one independent director. Should the Government holding of the combined entity fall below 10%, HMG would not seek to be consulted on the appointment of any independent directors.

3. Commercial – for HMT/OFT

- Ask OFT to report quarterly on competition in the UK sector and take action where appropriate

4. Lending (Public)

- Mortgages

  A commitment to immediately restore and maintain the availability and active marketing of competitively priced mortgage lending (other than in the non-conforming market) over the next three years at a level at least equivalent to that of 2007.

  General commitment to participate in industry initiatives and to comply with government codes/guidance

  make available a sum [tentatively £15m-£20m] to be agreed for the next 12 months share equity/shared ownership schemes to help people struggling with mortgage payments to stay in their homes, either through individual bank schemes or paid in a central fund run by industry;

  make available a sum to be agreed [tentatively £3m] for the next 12 months to support ongoing expansion of financial capability initiatives.

- SMEs

  A commitment to immediately restore and maintain the availability and active marketing of competitively priced lending to SMEs at a level at least equivalent to that of 2007.

  Publish an annual report on:

  - overall lending to SMEs

  - overdraft facilities and loans to SMEs: volumes, value and rates

- foreclosures of debt finance to SMEs
- appropriate lending of Small Firms Loan Guarantee Scheme
- Application and use of EIB global loan facility to secure additional liquidity specifically for SME lending.

Note that the condition imposing limits on bank lending for EU state aid rules, the GDP limit will be 2.7%.[2] Similar conditions are imposed on Royal Bank of Scotland.

On the question of remuneration and governance the FSA produced a new set of guidance on 13 October. In a 'Dear CEO' letter it said:

> There is widespread concern that inappropriate remuneration schemes, particularly but not exclusively in the areas of investment banking and trading, may have contributed to the present market crisis. In the private sector, bodies such as the Counterparty Risk Management Group (CRMPG) have identified remuneration structures as one of the possible driving forces behind current problems.1 The International Institute of Finance (IIF) reached a similar conclusion and has issued Principles of Conduct which they think should be adopted by firms.2
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> 2. The FSA shares these concerns. It would appear that in many cases the remuneration structures of firms may have been inconsistent with sound risk management. It is possible that they frequently gave incentives to staff to pursue risky policies, undermining the impact of systems designed to control risk, to the detriment of shareholders and other stakeholders, including depositors, creditors and ultimately taxpayers.
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> 3. The FSA has no wish to become involved in setting remuneration levels: that is a matter for Boards, which should ensure that they have effective structures in place to set remuneration policies and monitor remuneration levels throughout the firm. However we want to ensure that firms follow remuneration policies which are aligned with sound risk management systems and controls, and with the firm's stated risk appetite.3
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> Action for firms
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> 6. Many firms have a remuneration process with a year end review. Planning for that review may already be underway. I urge all firms, whatever the timing of their remuneration reviews, to consider carefully their remuneration policies, especially in light of recent market developments. If the policies are not aligned with sound risk management, that is unacceptable. Immediate action will be required to change the policies.
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> 7. The criteria set out in the annex provide a benchmark for this exercise. We would expect firms to avoid (or to be implementing plans to eliminate) bad or poor practices concerning the measurement of performance, the composition of the remuneration and governance arrangements.
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> 8. We would further expect firms to be moving towards good practice. We recognise that performance-adjusted, deferred compensation arrangements are complex to

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[2] Library estimate

design: nevertheless, if they are not already in place we expect firms to be considering actively how they might be incorporated into remuneration structures within a specified time period.

Action by the FSA.

9. During September the FSA held a number of high level discussions with London-based firms about remuneration policies. Between now and the end of the year we will arrange a further round of visits to all recipients of this letter. Our aim will be to gather more specific information about remuneration practices in your firm to assure that bad practices are not present and to seek further input on what would constitute good practice.

10. In the early part of next year we will communicate our findings regarding good practice to you, and have a further discussion with you about them, if appropriate. We will also publish our general findings about remuneration structures in the London market, on a no-names basis.

11. We believe that given the events of the past year firms recognise the need to review their remuneration policies and to take steps to change them if necessary. We believe that in working with the industry we can assist and encourage this process.

12. Changes to remuneration policies formed part of the recommendations of the report of the Financial Stability Forum[4], and the subject remains under active discussion internationally. The FSA is taking a prominent part in those discussions. We are mindful that to be effective action on this subject needs to be taken internationally. We hope to be able to report on the international work in our published report early next year.

The Annex referred to is set out at the end of this note.

The 'Out of Turn' Supplementary Estimate produced by the Treasury to meet the financial costs of the rescue package lists the major items of expenditure.[3]

Changes in annually managed expenditure	£ billions
Financing of Bradford & Bingley deposit book transfer to Abbey	4.60
Payment to ING for transfer of retail deposits of UK subsidiaries of Icelandic banks Kaupthing and Landsbanki	0.60
Purchase of RBS shares (£15 Bn ordinary, £5 Bn preference)	20.00
Purchase of Halifax/Bank of Scotland shares (£8.5 Bn ordinary, £3 Bn preference)	11.50
Purchase of shares in Lloyds TSB (£4.5Bn ordinary, £1Bn preference)	5.50

The reaction of the markets to the overall announcement was generally positive although the share prices of the banks reflect more the diminution of shareholder capital via the new issuances rather than a commentary on the plan itself. Shares in HBOS fell 27.5% on Monday 13th October; RBS 8.4% and Lloyds TSB 14.5%.

[3] HC 1061 2007/08

The *Financial Times* commented that:

> The government was last night sitting on a paper loss of more than £2bn after investors took fright at the terms of its £37bn bail-out of three of the country's largest banks.
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> Even as the FTSE 100 index soared, shares in Lloyds TSB, HBOS and Royal Bank of Scotland slumped as investors absorbed the full cost of the bailout, agreed on Sunday after a weekend of frantic negotiations.
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> Unless the shares recover in the next few weeks, the sell-off makes it increasingly likely that shareholders in the three banks will reject the opportunity to buy some of the stock, leaving the government with 60 per cent of RBS and as much as 43.5 per cent in the combination of Lloyds TSB and HBOS, which are pressing ahead with their merger. The market reaction took some gloss off Gordon Brown's claim, made earlier in the day, that the government was buying bank shares "at the bottom of the market".
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> Alistair Darling, chancellor, said the government was "not in the business of running banks" and would sell its stake in the three high street banks when conditions improved. He said that the taxpayer could turn a profit on the deal, through appreciating share prices and coupons on preferred shares and fees.
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> However, investors were spooked by the government's decision to ban three banks from paying dividends to ordinary shareholders until they had fully redeemed a total of £9bn in preference shares, which pay a fixed 12 per cent interest rate.
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> There were concerns that the government would restrict the banks' ability to make commercial decisions. John Varley, chief executive of Barclays, said: "The fact is that those [banks] that have government shareholdings will be more constrained in their strategic and operational flexibility than those that have not."
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> The three banks have promised to maintain lending to housebuyers and small businesses at 2007 levels. The government will be consulted on the appointment of three non-executive directors at RBS and two board members at the combined Lloyds TSB-HBOS.[4]
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> Shares in HBOS slumped 27 per cent to 90p, 23.6p below the price at which the government has committed to invest £8.5bn, while Lloyds TSB shares fell more than 14 per cent to 162p, 11.3p below the price at which it is placing shares with the government. RBS shares, which dropped 8 per cent, closed at 65.7p - just above the placing price of 65.5p.

[4] Financial Times 14 October 2008.

Appendix

FSA 'Initial Thinking' on remuneration procedures

Bad or poor practice (firm view)	Good practice (initial thoughts)
Measurement of performance for the calculation of bonuses	
Calculated on the basis of revenues, without any counterbalancing risk controls	Calculated on profits, and by reference to other business goals if appropriate
Does not take risk or capital cost into account	Uses a measure of risk-adjusted return. Measure likely to be based upon economic capital calculation, and should take proper account of a range of risks including liquidity risk.
Performance assessed entirely on the results for the current financial year	Performance assessed on a moving average of results (link to deferred compensation, see below)
Employee bonuses calculated solely on the basis of financial performance	Bonuses awarded take into account appraisal of other performance measures, including risk management skills, adherence to company values and other behaviours
Composition of the remuneration	
Bad or poor practice (firm view)	Good practice (initial thoughts)
Remuneration which has little or no fixed component.	Fixed component of the remuneration package to be large enough to meet the essential financial commitments of the employee.
Paid wholly in cash	Appropriate mix of cash and components which are designed to encourage corporate citizenship and alignment of interests between those of the employee and those of the firm. (For example shares, or appropriately priced share options).
No deferral in the bonus element	A major proportion of the bonus element is deferred so that the impact of the performance (see 1 above) in one year on the firm/unit's long term profits can be established
Performance adjusted deferred compensation	
Payout of the deferred element is not linked to the future performance of business undertaken in previous years.	A significant proportion of the deferred compensation element to be held in a trust or escrow account, from which funds can only be vested according to rules which take account of the performance of business undertaken in earlier years.
	Deferred compensation is determined by a performance measure which is calculated on a moving average over a period of several years.
Performance adjusted deferred compensation schemes can be waived/ not enforced despite evidence of poor performance or wrong doing.	Performance adjusted deferred compensation schemes are legally robust and contractually enforced
Governance	
Bad or poor practice (firm view)	Good practice (initial thoughts)
No independent oversight of remuneration policies or of remuneration awards to executives or senior staff	Board level remuneration committee with majority of non-executives. Committee has effective control of remuneration policies across the firm and of individual remuneration awards above a certain threshold
No process, or no transparent process for managing conflicts of interest	Areas such as HR and Risk have strong and independent role in setting compensation for the business areas.
Business areas can determine the compensation of staff in risk and compliance	Compensation for staff in risk and compliance is determined independently of the business areas.
Staff have an ability to influence unduly the valuation of their own positions and hence the determination of performance measures. Ability also to front load profit from transactions	Valuations and risk reporting subject to independent verification
Incomplete separation of duties between front and back office: ability of the front office to influence back office procedures. (See also SYSC 5.1.6R to 5.1.11G on the segregation of functions).	Overall control of the back office vested in operations.

Source: FSA website: http://www.fsa.gov.uk/pubs/ceo/ceo_letter_13oct08.pdf