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MORRISON | FOERSTER

News Bulletin

February 4, 2009

UK Government's Banking Support Measures

Part I: UK Government's package of financial support for the UK banking industry ("Bank Rescue Package")

With the credit crunch rapidly deteriorating into a full-scale global financial crisis, the UK's HM Treasury ("HMT") announced on 8th October 2008 a comprehensive package of measures to help support the banking industry financially and to strengthen depositor protection, with the aim of stabilising the UK financial system. [1]

The initial package of measures were approved by the European Commission on 13th October 2008 under the state aid rules under Article 87 of the Treaty establishing the European Community (commonly referred to as the "EC Treaty"), which HMT immediately proceeded to implement.

On 19th January 2009, the UK Government ("Govt.") announced a second rescue package for UK banks,[2] extending some of the existing measures as well as introducing new ones, following renewed turbulence in bank share prices. These further measures are aimed at stimulating lending by banks to the economy, which the initial £400 billion bail-out package in October 2008 failed to induce.

As part of the same initiative, the Financial Services Authority ("FSA") on 19th January 2009 issued a statement[3] clarifying its regulatory approach to bank capital requirements as set out in its previous statement dated 14th November 2008[4] in relation to the initial package of bank recapitalisation and related support measures launched by the Govt. on 8th October 2008. In order to counteract the 'procyclical' effects of Basel II capital framework, FSA will allow banks to measure the credit risks on their loan portfolios on a 'through the cycle' basis rather than a 'point in time' basis and to reduce their Tier 1 capital and core Tier 1 capital during an economic downturn to 6-7% and 4%, respectively, of their risk-adjusted assets.

We summarise below the various measures comprising the Bank Rescue Package (as they are currently implemented or, subject to European Union ("EU") approval, soon to be implemented), as well as the pending Banking Bill which is designed to reform the UK banking regulation by addressing the issues highlighted by the ongoing crisis.

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[1]. HM Treasury press notice 100/08 dated 8th October 2008 entitled "Financial support to the banking industry," http://www.hm-treasury.gov.uk/press_100_08.htm.

[2]. HM Treasury press notice 05/09 dated 19th January 2009 entitled "Statement on financial intervention to support lending in the economy," http://www.hm-treasury.gov.uk/press_05_09.htm.

[3]. FSA Statement on Regulatory Approach to Bank Capital dated 19th January 2009, http://www.hm-treasury.gov.uk/press_05_09.htm.

[4]. FSA Statement on Capital Approach Utilised in UK Bank Recapitalisation Package dated 14th November 2008, http://www.fsa.gov.uk/pages/Library/Communication/Statements/2008/capapp.shtml.

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Government Recapitalisation Scheme ("GRS")[5]

The GRS was launched on 8th October 2008 and enables the Govt. to make capital investments of up to an aggregate of £50 billion in "Eligible Institutions", in order to help increase their Tier 1 capital and strengthen their finances. These investments may take the form of preference shares (or permanent interest bearing shares).

"Eligible Institutions" mean UK incorporated banks (including UK subsidiaries of foreign banks) that have a substantial business in the UK. The initial list of Eligible Institutions published by HMT include HBOS, RBS, Lloyds TSB, Barclays, Nationwide, Standard Chartered, Abbey National, and HSBC. Other UK incorporated banks may also apply to be included in the GRS.

In return for the investment, the Govt. will require a number of commitments from the banks concerned:

- to maintain competitively priced lending to homeowners and small businesses at 2007 levels for the next 3 years;
- to support the Govt. in connection with schemes to help struggling mortgage borrowers stay in their homes and to support the expansion of financial capability initiatives;
- for 2008, not to pay any cash bonuses to board members and going forward, to review executive remuneration policies to link them to long-term value creation (taking account of risk) 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; and
- to amend dividend policies.

Pursuant to the GRS, HMT initially made investments totalling £37 billion in the preference shares of RBS (£20 billion, amounting to a 58% holding) and of the Lloyds Banking Group (£17 billion, amounting to a 43.3% holding) formed by the Govt.-sponsored merger of HBOS and Lloyds TSB completed on 16th January 2009. The intention of these investments is for both banks to raise their Tier 1 capital ratios above 9% (compared with the minimum Basel II requirement of 8%). The terms of the preference shares purchased by the Govt. require payment by both banks of a fixed 12% p.a. dividend and an undertaking not to pay any dividend on ordinary shares until those preference shares have been fully repaid.

In addition, these banks have committed to maintain competitively priced lending to homeowners and small businesses at 2007 levels, and the Govt. has established a Lending Panel comprising lenders, consumers, trade bodies, regulators and the Bank of England (the "BOE") in order to monitor lending by banks taking advantage of the GRS.[6]

On 19th January 2009 HMT announced that it has agreed to convert £5 billion of its preference share investment in RBS into ordinary shares in order to boost RBS's core Tier 1 capital and to enable RBS to increase its lending to the real economy by another £6 billion in the next 12 months (i.e., over and above existing commitments).[7] The

[5]. HM Treasury press notice 105/08 dated 13th October 2008 entitled "Treasury Statement on Financial Support to the Banking Industry," http://www.hm-treasury.gov.uk/press_105_08.htm. *See also* HM Treasury's Guidance on HMT Treasury Credit Guarantee Scheme and Bank Recapitalisation Fund, http://www.hm-treasury.gov.uk/fin_stab_credit_guarantee_scheme.htm.

[6]. HM Treasury press notice 126/08 dated 25th November 2008 entitled "Statement on Banks and Building Societies," http://www.hm-treasury.gov.uk/press_126_08.htm.

[7]. HM Treasury press notice 06/09 dated 19th January 2009 and entitled "Treasury statement on restructuring its investment in RBS to deliver further bank lending to industry and homeowners," http://www.hm-treasury.gov.uk/press_06_09.htm.

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conversion does not involve any injection of new capital but will raise the Govt.'s stake in RBS by a further 12% to about 70%. A similar offer has been extended to the Lloyds Banking Group.

HMT has repeatedly stated its intention to dispose of all its investments under the GRS in due course. To this end the Govt. has set up an independent holding company named "UK Financial Investments Limited" ("UKFI") to manage its shareholdings in RBS and Lloyds Banking Group (and any other Eligible Institutions) on a commercial basis, in order to maximise value for UK taxpayers.[8] The Govt. also intends that UKFI will in due course manage its investments in Northern Rock plc and Bradford & Bingley plc, both of which banks are wholly owned by the Govt.[9]

HMT has stated that "transparent arrangements" will be implemented to ensure that its role in the investment decisions is clearly defined.[10]

Credit Guarantee Scheme ("CGS")

The CGS was initially launched by HMT on 13th October 2008 as part of the initial package of Govt. measures to support UK banks in the face of the global banking crisis.[11] Under the CGS, HMT will guarantee, in return for a fee and subject to certain conditions, new issuances of short-term or medium-term debt securities by Eligible Institutions, in order to help refinance their funding obligations. The initial uptake of this scheme by eligible banks has been estimated to amount to £250 billion.

The CGS was amended on 15th December 2008 in light of further market developments and the measures being implemented by other EU member states. In particular, the amendments reduced the fee payable by the bank to the Govt. for the use of the CGS, extended the maximum term of guarantee to 5 years (by way of a roll-over of the instruments) and widened the range of eligible currencies.[12]

On 19th January 2009 HMT proposed to extend the drawdown window of the CGS (during which period Eligible Institutions may issue new guaranteed debt) from 9th April 2009 to 31st December 2009. Thereafter, participating institutions may keep rolling over up to 100% of their guaranteed debt until 13th April 2012 and thereafter up to one-third of such debt until 9th April 2014.[13] The final maturity date of 9th April 2014 and all other features of the CGS will remain unchanged.

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[8]. HM Treasury press notice 114/08 dated 3rd November 2008 entitled "New company to manage Government's shareholding in banks," http://www.hm-treasury.gov.uk/press_114_08.htm.

[9]. *See* letter dated 3rd November 2008 from the Chancellor Alistair Darling to The Rt Hon John McFall MP, Chairman of the Treasury Committee, http://www.hm-treasury.gov.uk/d/ukfi_letter_031108.pdf.

[10]. HM Treasury press notice 105/08 dated 13th October 2008 entitled "Treasury Statement on Financial Support to the Banking Industry," http://www.hm-treasury.gov.uk/press_105_08.htm. *See also* HM Treasury's Guidance on HMT Treasury Credit Guarantee Scheme and Bank Recapitalisation Fund, http://www.hm-treasury.gov.uk/fin_stab_credit_guarantee_scheme.htm.

[11] HM Treasury Credit Guarantee Scheme Market Notice dated 13th October 2008, http://www.dmo.gov.uk/documentview.aspx?docname=cgs/press/mktnotice08.pdf&page.

[12] HM Treasury Market Notice: Review of the Government's 2008 Credit Guarantee Scheme dated 15th December 2008, http://www.dmo.gov.uk/documentview.aspx?docname=cgs/press/mktnotice151208.pdf&page. *See also* HM Treasury press notice 138/08 dated 15th December 2008 proposing "Changes to Credit Guarantee Scheme," http://www.hm-treasury.gov.uk/press_138_08.htm. *See also* European Commission press release dated 23rd December 2008 entitled "State aid: Commission approves modifications to UK financial support measures to the banking industry," http://europa.eu/rapid/pressReleasesAction.do?reference=IP/08/2057&type=HTML&aged=0&language=EN&guiLanguage=en.

[13]HM Treasury's press notice 05/09 dated 19th January 2009 on "Statement on financial intervention to support lending in the economy," http://www.hm-treasury.gov.uk/press_05_09.htm; DMO announcement dated 19th January 2009 on "Extension of Drawdown Window for the Government's Credit Guarantee Scheme," http://www.dmo.gov.uk/documentview.aspx?docName=/gilts/press/pr190109a.pdf.

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HMT's Rules of the 2008 Credit Guarantee Scheme effective 13th October 2008,[14] as subsequently amended, impose the following conditions for participation in the CGS:

1) *Issuance Period*

The CGS covers new issuances by "Eligible Institutions," prior to 31st December 2009 ("Issuance Period"), of short to medium term Eligible Scheme Liabilities (as defined below).

2) *Eligible Institutions*

As under the GRS, "Eligible Institutions" are defined as UK incorporated banks (including UK subsidiaries of foreign banks) which have a substantial business in the UK, but these institutions must further maintain a level of Tier 1 capital in amount and form deemed appropriate by the Govt. (whether by Govt. subscription or private investors) to qualify for the CGS. Only one entity within a single banking group will be allowed to participate in the CGS.

3) *Eligible Scheme Liability*

To qualify as an "Eligible Scheme Liability," the debt instruments must, among other things,

(a) be senior unsecured debt instruments with standard market terms (whether stand-alone or off programmes), *excluding* any complex instruments, which fall within one of the following categories: (i) certificates of deposit, (ii) commercial paper and (iii) bonds or notes;

(b) be denominated in one of Sterling, Euro, US dollars, Yen, Australian dollars, Canadian dollars or Swiss francs; and

(c) have a maturity date no later than 13th April 2012, subject to a possible roll-over of part of the guaranteed debt up to the CGS end date of 9th April 2014 with Govt. consent.

Furthermore, the terms and conditions of the instruments should not contain any cross-default or cross-acceleration provisions, nor any call option for the issuer. Once approval is granted under the CGS and the Eligibility Certificate is issued, the instruments must be issued within 30 days and the proceeds of the issue must be applied to refinance the institution's wholesale funding obligations as they mature.

4) *Payment of fees*

A fee will be charged for participation in the CGS, of 50 basis points plus 100% of the bank's median 5-year Credit Default Swap ("CDS") spread during July 2007 – July 2008 as determined by HMT,[15] payable to HMT. There may also be an incremental fee payable for non-Sterling issues.

If the application is approved, HMT will issue an "Eligibility Certificate" to the applicant bank under the CGS, which will signify that the specified instruments are unconditionally and irrevocably guaranteed by HMT to ensure their timely payment.[16]

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[14] HM Treasury Rules of the 2008 Credit Guarantee Scheme, http://www.dmo.gov.uk/documentview.aspx?docname=cgs/press/cgsrules.pdf&.

[15]. This reduces the fee payable by the bank (and its cost of funding), as compared to the original formula using its median 5-year Credit Default Swap spread "in the year to 7th October 2008."

[16] *See* HM Treasury Credit Guarantee Scheme Deed of Guarantee dated 13th October 2008, http://www.dmo.gov.uk/documentview.aspx?docname=cgs/press/cgsdeed.pdf&page .

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Issuers are obliged to notify HMT of the guaranteed liabilities which they issue under the CGS, and HMT maintains a list of such liabilities.[17]

FSA has confirmed that these guaranteed bonds and notes would have a zero risk-weighting for capital adequacy purposes (under the "Standardised Approach" of Basel II, which enables banks to calculate their credit risk in a standardised manner supported by external credit ratings).

Asset Backed Securities Guarantee Scheme ("ABSGS")

On 19th January 2009, in addition to extending the CGS, the Govt. announced a new guarantee scheme commencing in April 2009 under which Eligible Institutions under the CGS may issue new asset backed securities ("ABS") guaranteed by HMT, subject to certain conditions.[18] The ABSGS is based on Sir James Crosby's recommendations[19] as a means of improving banks' access to wholesale funding markets, thereby supporting lending to the wider economy (particularly mortgage lending).

Under the ABSGS, HMT will, in consultation with issuers and investors, provide full or partial guarantees for eligible triple-A rated ABS, including mortgages and corporate and consumer debt. Only "transparent" structures and "high quality" assets will be eligible, so master trusts and non-prime and high LTV mortgages are likely to be excluded.

Further details are expected from the Debt Management Office ("DMO") in due course.

BOE Liquidity Facilities

Changes to short-term lending facilities

On 20th October 2008,[20] BOE's "Standing Facilities" (which allowed banks to borrow money from BOE on a daily basis) were replaced with two new facilities:

- Operational Standing Facilities, which are overnight lending facilities similar to the previous Standing Facilities.
- Discount Window Facility ("DWF"),[21] which is a new facility that allows banks to deposit eligible collateral in return for borrowing (normally for 30 days) UK Govt. securities (such as treasury bills), providing financing against illiquid assets during financial market turbulence. In exceptional circumstances, BOE also retains the discretion to lend sterling cash, rather than UK Govt. securities.

After August 2007 operational use of the existing lending facilities was being perceived by the market as a sign of financial difficulty. In order to avoid such stigmatisation, BOE will no longer be required to publish weekly

[17] *See* HM Treasury's Guaranteed Liabilities list, http://www.dmo.gov.uk/index.aspx?page=CGS/CGSLiabilities.

[18] HM Treasury's press notice 05/09 dated 19th January 2009 on "Statement on financial intervention to support lending in the economy," http://www.hm-treasury.gov.uk/press_05_09.htm; DMO announcement dated 19th January 2009 on "Guarantee Scheme for Asset Backed Securities," http://www.dmo.gov.uk/reportView.aspx?rptCode=D8D&rptName=39721344&reportpage=Press_New.

[19]. *See* HM Treasury's "Mortgage finance: final report and recommendations" dated 27th November 2008, http://www.hm-treasury.gov.uk/d/pbr08_mortgagefinance_1010.pdf.

[20] Bank of England Market Notice, "Operational Standing Lending and Deposit Facilities; Discount Window Facility" dated 20th October 2008, http://www.bankofengland.co.uk/markets/marketnotice081020.pdf.

[21] *See also* Bank of England Discount Window Facility - Quick Reference Guide, http://www.bankofengland.co.uk/markets/money/discount/quick_reference_dwf.pdf.

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returns as to utilisation. Its disclosure obligation as regards the new facilities will be limited to the average use of the facilities, to be reported at the end of certain periods.

On 19th January 2009 BOE announced that it will extend the DWF, by increasing its maturity from 30 days to 364 days, for an additional fee of 25 basis points, as from 2nd February 2009.[22] The extension is aimed at allowing banks continued access to long-term liquidity after the Special Liquidity Scheme[23] closed on 30th January 2009.

Permanent extension of eligible collateral and a revised auction mechanism for long-term repos

As part of the Bank Rescue Package, BOE published on 16th October 2008 a consultation paper entitled "The Development of the Bank of England's Market Operations,"[24] proposing to overhaul the existing framework for its market operations to address the inefficiencies which were highlighted by the ongoing banking crisis.

Inviting views from market participants and other interested parties by 27th November 2008, the consultation paper set out BOE's proposals to extend the eligible collateral permanently and to revise the auction mechanism for long-term repos (as well as to amend its short-term lending facilities described above), as follows:

- Eligible collateral for BOE's routine monthly long-term repos will be permanently widened to include not only very high quality sovereign and supranational securities (to which BOE auctions have been previously limited) but also certain high quality non-sovereign securities.
- A revised auction mechanism will be introduced for long-term repos, whereby the banks would be required to bid separately against two sets of collateral, one being high quality sovereign and supranational securities and the other the wider class of eligible collateral.

In due course BOE will finalise its proposed revisions to its market operations framework in light of the comments received.

Asset Purchase Facility ("APF")

On 19th January 2009 the Govt. announced[25] that BOE will establish the APF, with effect from 2nd February 2009, through a specially created fund under which it will be authorised, and indemnified, by HMT to purchase high quality private sector assets of up to £50 billion. Further details of the APF have since been set out in an exchange

[22] Bank of England Market Notice: Discount Window Facility dated 19th January 2009, http://www.bankofengland.co.uk/markets/marketnotice090119.pdf.

[23]. Bank of England Special Liquidity Scheme Market Notices dated 3rd February 2009, http://www.bankofengland.co.uk/markets/marketnotice090203c.pdf and dated 21st April 2008, http://www.bankofengland.co.uk/markets/money/marketnotice080421.pdf, Addendum to Bank of England Market Notice dated 14th August 2008, http://www.bankofengland.co.uk/markets/sls/sls-addendum080814.pdf . *See also* Bank of England Market Notices dated 8th October 2008 (Sterling Long-Term Repo Operations; US Dollar Repo Operations; The Special Liquidity Scheme), http://www.bankofengland.co.uk/markets/marketnotice081008.pdf and 13th October 2008 (Sterling Long-Term Repo Operations; US Dollar Repo Operations; The Special Liquidity Scheme: Haircuts), http://www.bankofengland.co.uk/markets/marketnotice081013b.pdf as well as Bank of England News Releases: Special Liquidity Scheme dated 3rd February 2009, http://www.bankofengland.co.uk/publications/news/2009/006.htm and 17th September 2008, http://www.bankofengland.co.uk/publications/news/2008/053.htm.

[24] A consultative paper by the Bank of England, "The Development of the Bank of England's Market Operations" (October 2008), http://www.bankofengland.co.uk/markets/money/publications/condococt08.pdf.

[25] HM Treasury's press notice 05/09 dated 19th January 2009 on "Statement on financial intervention to support lending in the economy," http://www.hm-treasury.gov.uk/press_05_09.htm.

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of letters dated 29th January 2009 between Alistair Darling, the Chancellor of the Exchequer, and Mervyn King, the Governor of BOE.[26]

Under the APF, BOE will make purchases of high quality (i.e., "of equivalent standard to investment grade") private sector assets for which BOE is satisfied that there is a "viable private market demand" (or a "genuine private demand in normal conditions"). The purpose of the APF is to increase the availability of corporate credit by reducing the illiquidity of the underlying instruments. The APF will be financed by the issue of UK treasury bills and the DMO's cash management operations.

Initially BOE will focus on corporate bonds, commercial paper and debt securities issued under the CGS. However, purchases of syndicated loans and ABS created in "viable securitisation structures" are also contemplated under the APF. HMT has the right to approve the list of eligible assets under the APF and any amendments to the list proposed by BOE.

The APF may also be used for monetary policy purposes (e.g., to meet the inflation target) by BOE's Monetary Policy Committee, subject to the Chancellor's consent.

BOE will publish a market notice in the week commencing 2nd February 2009 which will set out the mechanism whereby BOE will conduct its purchases under the APF.

Asset Protection Scheme ("APS")

On 19th January 2009 the Govt. announced its intention to offer protection, similar to insurance, against exceptional future credit losses on certain portfolios of defined assets which are most affected by current market illiquidity (see further below).[27] Under the APS HMT will, for a fee, provide the participating institution protection against future credit losses on eligible assets to the extent they exceed a "first loss" (similar to an "excess" in a normal insurance policy), provided that the institution must retain a further residual exposure in the region of 10% of the losses exceeding the "first loss."

The fee is expected to be paid by the issue of capital instruments (not ordinary shares) to HMT, although HMT may consider accepting cash. Both the fee and the "first loss" amount are expected to be set on a case-by-case basis, based on HMT's estimation of the likely performance of the relevant assets.

The APS will initially be made available to UK-incorporated authorised deposit-takers (including UK subsidiaries of foreign institutions) with more than £25 billion of eligible assets.

The assets eligible for the APS may be designated in any currency, but must have been held on an institution's balance sheet (or that of an affiliate) as at 31st December 2008. They will be assessed by HMT on a case-by-case basis and are expected to consist of those assets having the greatest uncertainty as to future performance. Initially they are likely to include commercial and residential mortgage loans, structured credit assets (including certain ABS), certain other corporate and leveraged loans and any closely related hedges. HMT may consider other asset classes for inclusion in the future.

The 'protected' assets will remain on the institution's balance sheet and continue to be managed by it. However, they will be required to be "ring-fenced" to give HMT control over actions in respect of them (e.g., enforcement and disposal).

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[26] *See* two letters dated 29th January 2009 exchanged between Alistair Darling, Chancellor of the Exchequer, HM Treasury, and Mervyn King, Governor, Bank of England setting out further details of the Asset Purchase Facility, http://www.hm-treasury.gov.uk/d/ck_letter_boe290109.pdf and http://www.bankofengland.co.uk/markets/apfgovletter090129.pdf.
[27] HM Treasury's press notice 07/09 dated 19th January 2009 on "Statement on the Government's Asset protection scheme," http://www.hm-treasury.gov.uk/press_07_09.htm.

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Other requirements imposed on an institution taking advantage of the APS include adequate capitalisation and funding, a sustainable business model and delivery plan, and that the institution has a credible senior management team with a demonstrable ability to deliver them. HMT will also require the institutions to agree to verifiable lending commitments to creditworthy borrowers, as well as public disclosure in relation to asset books. Furthermore, HMT will require open access to all information it considers necessary in connection with the APS and require regular reports from the participating institution.

The duration of the protection under the APS is expected to be not less than 5 years and consistent with the particular assets and their tenor.

No further details of the APS are expected until the last week of February 2009.

Mortgage lending and Northern Rock

The Govt. on 19th January 2009 announced that Northern Rock will be given an extension to repay the outstanding £11.5 billion Govt. loan (originally £26.9 billion but £15.4 billion has been repaid), so that it need no longer pursue a policy of rapidly reducing its existing mortgage book. [28] The Govt. will also consider other measures to kickstart the mortgage market.

Part II: The UK Banking Bill

Proposed reforms of the UK banking regulation

The Banking Bill[29] was introduced to the House of Commons on 7th October 2008 and is now being rushed through the Parliament, with a view to taking effect in February 2009.

It is designed to provide for a *permanent* statutory regime for HMT, BOE and FSA (collectively, the "Tripartite Authorities") to intervene in respect of failing banks, partly replacing the Banking (Special Provisions) Act 2008 which expires in February 2009.[30]

The Banking (Special Provisions) Act 2008 was introduced in February 2008 as a temporary measure to enable the nationalisation of Northern Rock and was subsequently deployed also to nationalise Bradford & Bingley.

The Banking Bill is divided into 8 parts, and the key parts are summarised below:

Part 1: Special Resolution Regime ("SRR")

A permanent SRR will replace the temporary SRR under the Banking (Special Provisions) Act 2008.

There are 3 "stabilisation options" under the permanent SRR, whereby part or all of the bank's business, shares, assets, rights and liabilities may be transferred in a pre-insolvency scenario, either:

- to a private sector purchaser ("PSP");

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[28] HM Treasury's press notice 05/09 dated 19th January 2009 on "Statement on financial intervention to support lending in the economy," http://www.hm-treasury.gov.uk/press_05_09.htm. *See also* Northern Rock press release dated 19th January 2009 entitled "Northern Rock Strategic Review," http://companyinfo.northernrock.co.uk/corporateCommunications/news/article.asp?newsID=226.

[29]. Banking Bill, http://www.publications.parliament.uk/pa/cm200708/cmbills/147/2008147.pdf. Explanatory notes to the Banking Bill, http://www.publications.parliament.uk/pa/cm200708/cmbills/147/en/2008147en.pdf. Banking Bill: Impact Assessment, http://www.hm-treasury.gov.uk/d/banking_bill_ia081008.pdf.

[30]. Banking (Special Provisions) Act 2008, http://www.opsi.gov.uk/acts/acts2008/ukpga_20080002_en_1.

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- to a publicly controlled "bridge bank" (which will be wholly owned by BOE); or
- to temporary public sector ownership (i.e., nationalisation).

The first and second options are exercisable by BOE (after consulting HMT and FSA). The third option is exercisable by HMT (after consulting BOE and FSA) once FSA determines that its 2 "Threshold Conditions" (i.e., the minimum standards for firms to become and remain authorised by FSA) are satisfied.

The "stabilisation powers" granted under the SRR may only be exercised if deemed necessary based on certain 'public interest' conditions (e.g., stability of the UK financial system, public confidence in the UK banking sector and the protection of depositors).

Part 1 also covers:

- assessment of compensation for transferors of shares or other property and for other third parties affected by the transfer; and
- how the SRR is applied to building societies and credit unions.

On 9th October 2008 HMT established a new Banking Liaison Group ("BLG") comprising representatives from HMT, FSA, BOE, Financial Services Compensation Scheme ("FSCS"), and the banking industry to help prepare the secondary legislation for the SRR as well as to keep SRR powers and regulations under review (to be updated with financial developments).

HMT must issue, following prior consultation with BOE and FSA, a Code of Practice (the "Code of Practice") governing the Tripartite Authorities' use of the stabilisation powers, or the Bank Insolvency Procedure or the Bank Administration Procedure described below, having regard to the following stated objectives of the SRR:

- stability of the UK financial system;
- public confidence in the UK banking system;
- protection of depositors;
- protection of public funds; and
- non-interference with property rights.

The SRR is applied to building societies in a modified way and may be extended to credit unions.

Part 2: Bank Insolvency Procedure ("BIP")

The BIP is based largely on existing "liquidation" provisions of the Insolvency Act 1986, as amended by the Enterprise Act 2002. It provides for the orderly winding up of a failed or failing bank, including fast compensation payments from the FSCS to eligible depositors, or the transfer of deposit accounts to another financial institution. The procedure applies only in cases where the failed bank has eligible depositors under the FSCS.

An application for a court order appointing a person as a liquidator to a bank ("Bank Insolvency Order") can be made by BOE or FSA (with BOE's consent) upon either of 2 grounds:

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- the bank is insolvent (i.e., unable, or likely to become unable, to pay its debts as they fall due)[31]; or
- winding up the bank would be "fair" (i.e., a modern equivalent of "just and equitable").

In addition, the Secretary of State may apply for a Bank Insolvency Order on the ground that winding up the bank would be in the public interest (i.e., although the bank is not technically insolvent, winding it up would protect customers and the general public).

The court will appoint a qualified insolvency practitioner to act as bank liquidator, who will then be charged with 2 objectives:

- 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, as quickly as possible; and
- 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.

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 reasonable practicable).[32] 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.

The BIP may later be extended to building societies and credit unions.

The provisions of the Company Directors Disqualification Act 1986 are to be extended so that they apply also to the BIP.

Part 3: Bank Administration Procedure ("BAP")

The BAP is based on existing "administration" provisions of the Insolvency Act 1986, as amended. This procedure is to be used where there has been a transfer of only a <u>part</u> of a failing bank's business, assets or liabilities to a PSP or bridge bank under the SRR, leaving an insolvent residual entity. It is designed to ensure that essential services and facilities continue to be provided to the PSP or bridge bank to enable it to operate effectively during the transition period.

Like the BIP, the BAP can only be initiated by a court order ("Bank Administration Order") and BOE may make the application for a Bank Administration Order if:

- BOE has made a <u>partial</u> transfer using SRR stabilisation powers or intends to do so; and
- it is satisfied that the residual bank is, or is likely to be, left insolvent (i.e., unable to pay its debts as they fall due), as a result.

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[31]. Definition of inability to pay debts (i.e., insolvency) under section 123 of Insolvency Act 1986 applies. *See* section 80(4) of the Banking Bill, http://www.publications.parliament.uk/pa/cm200708/cmbills/147/2008147.pdf.

[32]. Section 87 of the Banking Bill, http://www.publications.parliament.uk/pa/cm200708/cmbills/147/2008147.pdf.

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The court may appoint a qualified insolvency practitioner as a bank administrator to administer the affairs of the insolvent residual bank, whose 2 objectives are:

- first, to provide support to the PSP or bridge bank by ensuring continuing supply of such services and facilities as are necessary to enable it to operate effectively; and
- second, once the first objective is no longer required, the "normal" objectives of an administration, i.e., either to rescue the bank as a going concern, or, if this is not reasonably practicable, to achieve a better result for the creditors than in an immediate liquidation. In relation to this second objective, the bank administrator may only realise assets of the (insolvent) residual bank that are contained on a list agreed by BOE and the bank administrator.

Like the BIP, the BAP may be extended to building societies and credit unions in time and the Company Directors Disqualification Act 1986 will be extended to apply to the BAP.

Part 4: Financial Services Compensation Scheme ("FSCS")

Part 4 amends Part XV of the Financial Services and Markets Act 2000 ("FSMA") to enable FSA to amend the FSCS.[33] In addition, FSA is empowered to make rules relating to contingency funds provided they are not inconsistent with HMT's regulations.

Specifically, FSA is given new powers to make rules to facilitate the speedy payout of depositor compensation (under the FSCS) or transfer of accounts to other banks (under the SRR). In this connection, FSA may also make rules to enable the FSCS to treat claims as having been made without the need to wait until they are actually made, and to enable the FSCS to settle claims on a class basis without reference to the individual maximum claim limits that would otherwise apply.

In order to enable the FSCS to deal with significantly greater claims than originally envisaged, HMT is given the powers, by way of regulation:

- to introduce pre-funding of the FSCS by the banking industry, through imposition of levies to build up contingency funds ahead of possible defaults triggering compensation payments under the FSCS and to invest the levies collected in the National Loans Fund ("NLF");
- to use the FSCS to contribute to the costs of the SRR; and
- to use the NLF to make loans to the FSCS.

Part 5: Inter-Bank Payment Systems ("IBPS")

Problems in the IBPS have the potential to spread through the financial system with repercussions on the wider economy. HMT has therefore been granted the power to make a "recognition order" in respect of an IBPS where any deficiencies in its design or disruption of its operation would be likely to threaten the stability of, or confidence in, the UK financial system, or have serious consequences for business or other interests throughout the UK.

[33]. The change to the FSCS compensation limit from £35,000 to £50,000 per eligible depositor on 7th October 2008 was a matter for the FSA under its existing FSMA powers, not the Banking Bill. FSA Press Release dated 3rd October 2008 "Compensation scheme to cover savers' claims up to £50,000," http://www.fsa.gov.uk/pages/Library/Communication/PR/2008/114.shtml.

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Currently BoE undertakes oversight of the IBPS systems on a non-statutory basis. In relation to 'recognised' IBPS, Part 5 gives BOE a formal (i.e., statutory) oversight role and permits the use of supervisory methods not specified in Part 5. BOE retains its power of informal (i.e., non-statutory) oversight of 'non-recognised' IBPS.

FSA has a statutory responsibility for the regulation of recognised clearing houses, which contain embedded payment systems.

These provisions are not expected to result in a significant change in BOE's practice.

Part 7: Miscellaneous

Part 7 lays down a number of miscellaneous provisions, including the following:

- Governance of BOE (amending Part 1 of the Bank of England Act 1998).

  A Financial Stability Committee ("FSC") will be established as a sub-committee of BOE's court of directors ("COD"), to be responsible for:

  - making recommendations to the COD on the implementation of BOE's financial stability strategy;
  - advising on and monitoring BOE's exercise of its stabilisation powers and its functions relating to IBPS; and
  - performing any other functions delegated to it by the COD.

- FSA's functions.

  Part 7 sets out provisions linking FSA's functions under the proposed new Banking Act with its functions under the FSMA 2000. In particular, these include FSA's obligation to collect information relating to the stability of individual firms or the UK financial system.

- Financial assistance to building societies.

  HMT may by order modify the Building Societies Act 1986 to facilitate the provision of financial assistance to building societies by HMT, BOE, another European Economic Area (EEA) central bank or the European Central Bank.

- Power to make regulations on financial collateral arrangements.

  HMT has the power to make regulations concerning financial collateral arrangements, i.e., arrangements under which financial collateral is used as security (e.g., cash or securities) in respect of a loan or other liability, which provisions may extend the application of the Financial Collateral Arrangements (No. 2) Regulations 2003.[34]

Parts 6 and 8 of the Banking Bill deal with banknotes issued by certain authorised banks in Scotland and Northern Ireland and general provisions (e.g., index of defined terms), respectively.

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[34]. Financial Collateral Arrangements (No. 2) Regulations 2003, http://www.opsi.gov.uk/si/si2003/uksi_20033226_en.pdf.

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Proposed amendments to the Banking Bill

In the 2008 Pre-Budget Report published on 24th November 2008,[35] the HM Treasury proposed the following amendments to the Banking Bill:

Nationalisation of banking group holding companies

To extend HMT's power temporarily to nationalise a bank (part of its stabilisation powers under the permanent SRR) to include banking group holding companies.

Special insolvency procedure for investment firms holding client money or assets

To introduce, by way of secondary legislation under the Banking Bill, a new special insolvency procedure for investment firms which hold client money or assets. The detailed arrangements (such as the definition of investment firms and the treatment of client money and assets) will be reviewed by the BLG (which has been established to keep the SRR under review) by the summer of 2009, and followed by consultation on the draft secondary legislation.

Outlook

The Tripartite Authorities have been working hard for the swift passage of the Banking Bill for effective implementation from February 2009.

Although the immediate effect of these measures and proposals has been to restore some stability to the UK banking sector at least temporarily, there have been concerns and controversy over the extraordinary powers sought by the Tripartite Authorities under the Banking Bill. The situation has not been helped by the rush to push the Banking Bill through the Parliament which would limit proper debate and consideration of the issues.

Partial property transfers under the SRR, which permit the Tripartite Authorities to cherry-pick the assets of a failing bank and transfer away the 'good' part of its business whilst leaving behind the 'bad' untransferred assets and liabilities with a residual bank, have been particularly controversial.

The British Bankers Association have expressed serious reservations concerning the potentially negative effects of the power to transfer a part of a failing bank under the SRR, which could alter the rights of third parties such as the contractual or other private rights of shareholders, employees and creditors (e.g., their security interests or rights of set-off and netting). In their view, this would upset the legal certainty necessary for counterparties to have the confidence to do business with UK banks and impact negatively on pricing and risk management arrangements.

Responding to these concerns, on 6th November 2008 HMT published a consultation paper proposing certain safeguards for partial property transfers under the SRR,[36] which includes the draft secondary legislation and the draft Code of Practice. The results of the consultation are yet to be published. The proposed safeguards include the following:

- **Safeguards for set-off and netting**. Contracts covered under set-off or netting agreements would be protected from disruption in a partial transfer (subject to certain exceptions).

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[35]. 2008 Pre-Budget Report published by the HM Treasury on 24th November 2008, http://www.hm-treasury.gov.uk/d/pbr08_completereport_1721.pdf.

[36]. HM Treasury consultation paper dated 6th November 2008 on "Special resolution regime: safeguards for partial property transfers," http://www.hm-treasury.gov.uk/d/specialresolutionregime_061108.pdf.

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- **Safeguards for security interests and structured finance**. Holders of security interests (including holders of all types of floating charges) would be protected, to guard against the risk of security granted in their favour becoming unenforceable as a result of a transfer. It is also proposed not to disrupt structured finance arrangements by partial transfers because of their nature and importance.
- **A new third party compensation mechanism**. To compensate creditors left in a residual bank, so they would be no worse off than they would have been in a whole bank insolvency.
- **Restrictions on the scope of partial transfers.** The Tripartite Authorities may limit the scope of partial transfers to certain types of partial transfers. These limits may be placed in the Code of Practice on the Tripartite Authorities' practice when using the stabilisation powers (and the BIP and BAP set out in the Banking Bill) and/or future secondary legislation.

We will continue to provide updates on any further official announcements by the UK Govt. or other related developments concerning the financial support for the UK banking industry and its regulatory reform.

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