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YEAR THREE OF THE CRISIS

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by

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ABSTRACT

With 'green shoots' giving way to more definite signs of recovery in the global economy - most leading nations have already emerged from recession, with the UK being the latest – and with the global financial system back on an even keel (stock markets around the globe have recovered most of the ground lost after the collapse of Lehman Brothers in the Autumn of 2008 and credit markets have thawed out to a degree following the stabilisation of house prices in the West) now is perhaps a good time to bring to a close my survey of the sub-prime-induced credit crunch and the damage it wrought around the World. Internationally-co-ordinated action on the fiscal, monetary and financial fronts and a determination to resist protectionist tendencies appear to have successfully pulled back the World economy from the brink of depression and the financial system from near collapse. Of course, the real recovery is likely to be weak and protracted and unemployment, as a lagging indicator, is likely to continue its remorseless rise, albeit at a slower pace, for some time yet in most parts of the globe, but the worst does seem to be behind us. Wary of damaging the nascent recovery, policymakers are still developing their "exit strategies" – from extraordinary fiscal and monetary stimuli and state intervention in the financial system – rather than implementing them, with much discussion being devoted to how to reform financial regulation with a view to preventing a recurrence of a similar-style systemic collapse. These and other policy issues thus necessarily appear prominently in the analysis below. For now, without being complacent, our political masters can congratulate themselves for having spared their citizens from an even worse maelstrom, but much remains to be done if history is not to repeat itself and taxpayers are to be shielded from the consequences of financial "excess" in the future.

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1. INTRODUCTION

Since the excitement of Autumn 2008, following the collapse of Lehman Brothers in the US, markets, financial systems and economies have finally stabilised. This is due, in large part, to a successful international co-ordination of monetary, fiscal and financial policies plus a shared determination to avoid moves towards unilateral protectionism. The policies which brought us "back from the brink" are duly analysed within, the paper also incorporating – as on previous occasions – a daily diary of the most significant events occurring around the world.

With respect to the UK, the focus is mainly on financial policy, although the ramifications for public spending, debt and borrowing of the fiscal stimuli provided since November 2008 are addressed in detail. Likewise, the extension of emergency liquidity by the Bank of England through an expanded 'special liquidity scheme' and a £200 billion 'Asset Purchase facility' are also analysed in detail.

As regards financial policy, the starting point of the review is the continued evolution of failure resolution policy post-Northern Rock. This covers both ad hoc solutions, embracing further nationalisation (i.e. of Bradford and Bingley) and the brokering of takeover rescues (e.g. of HBOS by Lloyds TSB), and comprehensive system-wide bailouts. With respect to the latter, the first was introduced in October 2008 in the wake of the extreme financial fragility induced by the decision to let Lehman Brothers disappear. It involved a massive infusion of additional liquidity to the markets, state guarantees of new bank debt issuance, and state-funded recapitalisation of struggling banks (i.e. RBS, HBOS and Lloyds TSB). A second industry bailout then proved necessary in January 2009, in
part because of the failure of the former to stimulate bank lending. The latter package involved, *inter alia*, the introduction of a new 'Asset Purchase Facility', the forerunner to "quantitative easing", whereby institutions could sell gilts and corporate securities to the central bank, and state insurance of banks' toxic assets under a so-called 'Asset Protection Scheme' (in the end, only RBS entered the Scheme).

Apart from considering failure resolution, domestic financial regulatory reform is also addressed in detail in Section 2 of this paper. The starting point for discussion is the 'Turner Review' of March 2009 which acted as the catalyst for reform and also provided the blue print for the Government's White Paper on the subject, duly published in July 2009. The latter, in turn, was followed by the introduction of the Financial Services Bill to Parliament in November 2009, following the adoption of a new Banking Act in February 2009, with a new 'Special Resolution Regime' as its centrepiece. The Conservative Party's White Paper (July 2009) on the subject is also discussed at this juncture given the likelihood that they will be returned to office next Spring and their plans to abolish the FSA as we know it, returning micro-prudential regulation (along with the provision of new macro-prudential powers) to the Bank of England. Finally, within the review of major domestic developments, both Sir David Walker's proposed reform of corporate governance arrangements – his final report was delivered in November 2009 – and the FSA's initiatives on finance sector remuneration and new liquidity rules are considered in depth.

The penultimate section of this paper covers the main post-January 2009 financial developments to have taken place outside the UK. With respect to the US, the analysis covers both regulatory reform and financial policy. On the former front, an assessment of
the administration's White Paper of June 2009, which built on the blue print set out in the
Treasury's proposals of March 2009, is provided, highlighting the extent to which the
Fed's supervisory powers would be expanded should Congress approve the plans.
Moreover, President Obama's latest (January 2010) proposals – for the introduction of a
10-year levy on large financial institutions to recoup the costs of finance industry support,
and for the imposition of additional size limits and activity restrictions on banks – also
feature in the discussion. As for developments in financial policy, the focus is mainly on
the evolution of failure resolution policy, matching the discussion in Section 2 in relation
to UK policy. The part-nationalisation of Citigroup, the recapitalisation, following stress
tests, of struggling institutions using residual 'TARP' funds (most, however, was repaid by
end-2009), the $1 trillion expansion in the 'TALF' facility, the $1 trillion plan to remove
toxic assets from banks' balance sheets (under the so-called "legacy securities" and "legacy
loans" plans) and the introduction of a $300 billion programme of quantitative easing, are
all subjected to close scrutiny.

Finally, the major initiatives adopted outside the UK and US are also highlighted.
These embrace the work of the G20, the Financial Stability Board (FSB), the EU and, last
but by no means least, the Basel Committee. With respect to the first-mentioned set of
initiatives, the final communiqués of both the London and Pittsburg summits are dissected.
The FSB's work on finance industry compensation and procyclicality in the financial
system is also addressed alongside the European Commission's proposals of October 2009
for reforming the EU financial regulatory and supervisory framework. And lastly, the
Basel Committee's attempts to reform Basel II in the light of the deficiencies revealed in
its design and operation during the financial crisis are covered in detail. The discussion
duly relates to: the agreed "enhancements package" of July 2009, which amends all three
pillars of Basel II in the light of crisis experience and is due for full implementation by end-2010; (ii) the agreed revisions to the market risk framework of July 2009, which also have to be adopted by end-2010; and (iii) the December 2009 proposals for new liquidity requirements and otherwise strengthening the resilience of banking systems.
2. MAIN DOMESTIC DEVELOPMENTS

2.1 Failure Resolution Policy

The policies adopted with respect to institutional 'failure' can be divided into those which represent ad hoc responses to individual cases and those designed to tackle systemic problems. The analysis below is thus split in this way.

2.1.1 Ad hoc responses to individual cases

Post-Northern Rock, the official ad hoc responses to "banking" failure comprised both brokered takeover-rescues and further nationalisation. The former actions are summarised in Table 2.1 and discussed in more detail in Hall (2009b). They relate to the Alliance and Leicester, HBOS, and a number of building societies, culminating in the takeover of Dunfermline Building Society by the Nationwide Building Society in March 2009. With respect to nationalisation – outside its extension under the industry bailouts considered below – the only institution to be affected post-Northern Rock was the Bradford and Bingley, another former building society brought to its knees by a crash in profits due to its exposure to the UK property market (especially with respect to "buy-to-rent" and "self-certified" mortgages), a ratings downgrade, a precipitous fall in its share price (which disrupted its rights issue process) and a failure to find a 'White Knight' from amongst the UK banking community. Accordingly, in June 2008, the Government took over the £42 billion mortgage book, to be wound down in due course, the bank's branches were sold to Banco Santander and the UK banking industry was asked to (eventually) fund the £14 billion transfer of the insured deposits to Banco Santander.
2.1.2 Comprehensive system-wide bailouts

As discussed in detail in Hall (2009b), the first industry bailout was introduced in October 2008. The £400 billion package, comprising a major (£100 billion) extension in the Bank of England's 'Special Liquidity Scheme' (see Section 2.3 below), the provision of government funding (£250 billion) to guarantee new short- and medium-term bank debt insurance and state-funded bank recapitalisation (£50 billion), was designed to restore financial confidence, stability and credit flows to UK businesses and individuals. In the event, some £37 billion was spent recapitalising UK-incorporated banks – see Table 2.3 – which led to the Government, on behalf of the taxpayer, assuming stakes of 58 percent and 43.5 per cent in RBS and Lloyds Banking Group (the post-HBOS/Lloyds TSB-merged entity) respectively.

Because this package failed to deliver its intended objectives, with respect to both credit provision (despite the "conditionality" attached to the support given) and financial stability, a second comprehensive bailout package (termed a 'lending support package') proved necessary. Accordingly, in January 2009, a seven-part package was introduced which, together with the fiscal stimulus package announced in the Pre-Budget Report of November 2008 (see Section 2.4 below) and the provision of a 50 per cent guarantee on up to £20 billion of working capital loans to SMEs, was designed to support the wider economy. Of particular interest within the package – see Hall (2009b) for further details and analysis – was the establishment of a new "Asset Purchase Facility" at the Bank of England, considered in more detail in Section 2.3 below, and the introduction of a new scheme to insure banks against extreme, unexpected losses on their existing loans and investments in order to increase banks' capacity and willingness to lend. The latter, known as the 'Asset Protection Scheme', access to which would be provided in return for a
fee payable in cash or preference shares, a promise to adopt a remuneration policy consistent with the FSA's new Code of Practice on remuneration policies (see Section 2.2.1.3 below) and agreement on verifiable commitments to support lending to "creditworthy" customers, would see the Government's economic interests in RBS and Lloyds Banking Group potentially rise to 84 per cent and 77 per cent respectively (see Table 2.4 for more details). In the event, although private investors in RBS did indeed snub the subsequent placement and open offer of shares, leaving the Government to exchange its preference share holdings for equity and thereby raise its stake in the bank to 70 per cent, Lloyds Banking Group fared better in its push for private funding. For, following strong market support for its own open offer and placing, it managed to secure sufficient funding to allow for a £2.6 billion repayment of the Government's holdings of preference shares, leaving the Government's equity stake in the banking group at 43.5 per cent.

Although the Government had hoped to finalise the details of the banks' membership of the APS by the Summer of 2009, this proved impossible. Indeed, it wasn't until November of that year that the details of the final deliberations were made public [see HM Treasury, 2009a and 2009b]. As far as Lloyds Banking Group was concerned, it was announced that it would no longer participate in the APS, due to improved market conditions, and would instead raise additional private sector capital to meet the FSA's capital requirements i.e. £21 billion (later raised to £22.5 billion) through a record-breaking £13.5 billion rights issue and the swapping of £7.5 billion (later raised to £9 billion) of existing debt for contingent capital (convertible bonds that become equity in the event of a crisis, that is when core capital falls below five per cent of risk-adjusted assets). However, in return for enjoying implicit taxpayer protection since the signing of an "in-
principle" agreement in March 2009, the group will pay a fee of £2.5 billion to the Treasury. Moreover, like RBS, the banking group agreed to comply with an additional set of commitments laid down by the Treasury, in return for the receipt of taxpayer support, and to accede to the restructuring demands made by the EU under its 'State Aid' requirements – see below. As far as the impact on the taxpayer is concerned, the Treasury argues that the likely costs of state support and impact on public finances have been reduced markedly because of Lloyds' non-participation in the Scheme (which, together with the cut in the size of RBS's protected assets – see below – reduces contingent liabilities by over £300 billion), although the loss of the proposed "entry fee" (£15.6 billion, less the £2.5 billion exit fee) and the up-front payment of £5.7 billion (net of an underwriting fee) to acquire new shares at the rights issue just sufficient to keep the state's stake in the bank at the original 43.4 per cent (thereby allowing the taxpayer to maximise his potential return from forced "investment") does increase taxpayers' direct exposure. The Treasury duly estimates that the share purchases involved under the revised APS arrangements will increase the central government's net cash requirement for 2009/10 by around £13 billion, relative to that announced in the 2009 budget, ceteris paribus.

As for RBS, the bank is to remain in the Scheme, but subject to revised terms which reflect the Government's "due diligence" carried out since February 2009, the FSA's latest 'ARROW' tests, the requirements of the EC's State Aid guidelines and improved market conditions. The revisions involve RBS in accepting a larger "first loss" than originally envisaged (i.e. £60 billion, including £21.3 billion of historic losses, compared with £42.2 billion, which includes £22.7 billion of historic losses) and a smaller protected portfolio (i.e. £282 billion rather than £325 billion). However, the bank will enjoy an up-front capital injection of £25.5 billion in non-voting 'B' shares, equal to the capital commitment
announced in February 2009, although this then comprised only £13 billion in up-front capital, with a further £6 billion to be drawn at the option of the bank and £6.5 billion of capital taken as a fee by the Treasury. Moreover, the bank no longer has to forego up to £11 billion of certain tax losses over the next five years as a *quid pro quo* for the increased first loss, although it now has to pay an annual fee of £0.7 billion for the first three years, followed by £0.5 billion per year thereafter for the remaining life of the Scheme; and an exit fee, which will be the larger of £2.5 billion (less cumulative fees paid) or 10 per cent of the actual regulatory capital relief received by the bank while in the APS, must also be paid. Finally, to protect against a worst-case scenario, the Government will provide a contingent capital commitment of up to £8 billion, to be drawn down in two tranches and only in exceptional circumstances i.e. where RBS's Core Tier 1 capital ratio fell below 5 per cent. In return for this, RBS will pay a fee of 4 per cent per year. Consistent with the "in-principle" agreement reached in January 2009, the net effect of the Treasury's provision of capital will be to raise its economic interest to 84.4 per cent, although the Government's ordinary shareholding will be capped at 75 per cent (at end-December 2009 it stood at 70.3 per cent). If the full £8 billion of available contingent capital is drawn down, the state's economic interest would rise to 87 per cent.

With respect to the commitments agreed to by the banks in return for receiving taxpayers' support, these embrace the following: (i) continuation of the existing commitment to increase lending to businesses and homeowners by a total of £39 billion; (ii) a commitment to ensure charging for current accounts and overdrafts is transparent and fair; (iii) adherence to a 'Customer Charter' for lending to small- and medium-sized entities to reinforce their commitment to meeting all reasonable applications for finance from viable businesses; (iv) a promise not to pay discretionary cash bonuses in relation to 2009
performance to any staff earning above £39,000; (v) agreement by executive board members to defer all bonus payments due for 2009 until 2012, to ensure that their remuneration is better aligned with the long-term performance of their banks; (vi) a promise to honour existing commitments with respect to the implementation of the G20 remuneration principles, the FSA’s Remuneration Code and any relevant provisions accepted by the Government arising from the Walker Review; and (vii) a prohibition on the payment of dividends or interest on existing hybrid instruments for a period of three years unless there is a legal obligation to do so.

Finally, to promote greater competition in UK banking and to satisfy EU State Aid rules – agreement has been reached in principle with the EU Competition Commissioner but the College of Commissioners has yet to give its seal of approval – the banks have agreed to divest a significant proportion (nearly 10 per cent in the case of retail operations) of their retail and corporate banking assets over the next four years. Moreover, the assets can only be sold to small or new players in the market. In the case of Lloyds Banking Group, this will involve divestment of a retail banking business with a 4.6 per cent share of the personal current accounts market in the UK plus nearly 19 per cent of the Group’s mortgage assets, through disposal of: all Lloyds TSB branches in Scotland; additional Lloyds TSB branches in England and Wales, with branch-based customers; all Cheltenham and Gloucester savings and certain Cheltenham and Gloucester mortgages; the Intelligent Finance business; and the TSB branches. In all, at least 600 branches will be sold. As for RBS, the bank has been forced to divest parts of its UK branch and corporate business (i.e. the RBS branch network in England and Wales, the NatWest branches in Scotland and Direct SME customers across the UK), RBS insurance, Global Merchant Services (a card payment acquiring business) and its interest in RBS Sempra Commodities
(a leading global commodities trader). The Williams & Glyn's brand name will also be sold. The banking divestment will involve the disposal of 308 branches in the UK (representing 14 per cent of the Group's UK retail network), and effectively reduce RBS's UK market share by 2 percentage points in retail banking, 5 percentage points in SME banking and 5 percentage points in the mid-corporate markets.

The market response to the announcement of the revised APS arrangements was mixed. Lloyds' escape from its clutches was generally welcomed as it indicated a renewed private sector appetite for bank stock, although some fretted over the apparent disappearance of some of the toxic assets initially offered up for protection. Similarly, RBS's claim that its credit impairments may now be plateauing should have been welcomed by both private investors and taxpayers alike. Nevertheless, only time will tell if further state support proves necessary, particularly for RBS – although the bank believes a draw-down on the contingent capital 'insurance' is highly unlikely, the slowness and feebleness of the recovery may yet deliver additional, unanticipated bad debts – and whether the additional state investment proves worthwhile. Moreover, it isn't totally clear if the "pay now, save later" policy foist on the taxpayer is really the good deal it is cracked up to be given the impact on the current borrowing requirement, which is already testing gilt investors' nerves.

As for the other commitments forced on the recipient banks, the provisional deal reached with the European Commission vis-à-vis divestments may impair the banks' (especially RBS's) ability to recover given some of their best assets are being disposed of. Moreover, the hoped-for improvement in competition may be short-lived as there is no guarantee that newcomers will be able to operate in a profitable fashion, thereby
threatening their long-term existence. Finally, the reaffirmation of lending commitments reached last February does not guarantee that they will be adhered to (lending targets with respect to corporate lending are unlikely to be met – see National Audit Office, 2009, p.35); and the alleged crackdown on bonuses is a sham as senior executives will still receive their bonuses in three years time and "guaranteed" cash bonuses will still be allowed to go through this year, and all despite a supposed ban on the payment of bonuses, in cash or shares, imposed on the banks last February!
2.2 Regulatory Reform

Since the enactment of the new Banking Act in February 2009, with a new 'Special Resolution Regime' at its heart – see Appendix 2.1 - the debate about how to reform the UK’s financial regulatory and supervisory framework has intensified. A major catalyst for this was the publication of Lord Turner's 'Review' in March 2009, which was followed by the Government's White Paper on financial reform in July. The same month the Conservative Party revealed its own White Paper on the subject, with both the Bank of England and the Financial Services Authority contributing to the debate at frequent intervals. The purpose of this section is to review and analyse these documents and viewpoints before coming to a conclusion about the most appropriate way forward on the domestic financial regulatory front.

2.2.1 The Turner Review

In October 2008 Lord Turner was asked by the Chancellor to review the causes of the current crisis, and to make recommendations on the changes in regulation and supervisory approach needed to create a more robust banking system for the future. Lord Turner duly delivered his Review in March 2009 (FSA, 2009a), focussing on the long-term rather than the short-term macroeconomic challenges facing UK policymakers. A brief summary of his Review is provided in Appendix 2.2, the main recommendations of which are analysed in more detail below and in the FSA's accompanying Discussion Paper (FSA, 2009b). The analytical framework used by Lord Turner is consistent with the taxonomic 'template' established by the Financial Stability Forum (FSF) (re-established as the Financial Stability Board (FSB) in April 2009), which called on member institutions to focus on the following areas in reforming their financial systems with a view to increasing the resilience of financial markets and institutions: (i) strengthening prudential oversight of
capital, liquidity and risk management; (ii) enhancing transparency in financial markets and institutions and the valuation of financial instruments; (iii) changing the role and use of credit ratings; (iv) strengthening the authorities' responsiveness to risks; and (v) developing robust arrangements for dealing with stress in the financial system (FSF, 2008).

2.2.1.1 Capital Adequacy

Some of the most important of Lord Turner's recommendations relate to the issue of bank capital adequacy and stem from the deficiencies in the Basel I/II processes revealed during the financial crisis. Accordingly, he calls for the following:

(i) an increase in both the quality and quantity of overall capital in the global banking system, resulting in a significant increase in minimum regulatory requirements;

(ii) a significance increase (i.e. by several times) in capital required against trading book activities and a fundamental review of the market risk capital regime, including its reliance on VaR measures for regulatory purposes (for a review see Hall, 1995);

(iii) a reduction in unnecessary procyclicality under the Basel II regime (see European Central Bank, 2009, pp.143-150);

(iv) the introduction of a counter-cyclical capital adequacy regime, with capital buffers increasing in economic upswings and decreasing in recessions; and

(v) the introduction of a backstop maximum gross leverage ratio to guard against excessive growth in absolute balance sheet size.
Given its role in promulgating the international "rules of the game" on the capital adequacy front, the Basel Committee on Banking Supervision has already acted to address the revealed deficiencies in the Basel II process, thereby supporting most of Lord Turner's recommendations. Accordingly, on 13 July 2009, the Committee issued an agreed final package of measures to enhance the three pillars of the Basel II framework and to strengthen the 1996 rules governing trading book capital. The measures are part of a broader programme designed to strengthen the regulatory capital framework by promoting the build-up of capital buffers that can be drawn down in periods of stress, strengthening the quality of bank capital, introducing a backstop leverage ratio, mitigating any excess cyclicality of the minimum capital requirement and promoting a more forward-looking approach to provisioning. A consultative proposal on this broader programme was promised by the first quarter of 2010 [it was actually delivered in December 2009 – see Section 2.2.2.5 below].

Under the "enhancements" package (Basel Committee, 2009a), the Committee has agreed revisions to each of the three pillars of Basel II in the light of the financial crisis. Revisions to Pillar 1 minimum capital requirements will involve, *inter alia*, raising the risk weights for resecuritisation exposures (the so-called collateralised debt obligations (CDOs) of asset backed securities (ABS)) to better reflect the risk inherent in these products, as well as increasing the credit conversion factor for short-term liquidity facilities to off-balance-sheet conduits. The Committee is also requiring that banks conduct more rigorous credit analyses of externally-rated securitisation exposures. Under the revisions to Pillar 2 (which governs the supervisory review process), supplemental guidance has been issued addressing the flaws in risk management practices revealed by the crisis. Accordingly, it raises the standards for: firm-wide governance and risk-
management; capturing the risk of off-balance-sheet exposures and securitisation activities; managing risk concentrations; and providing incentives for banks to better manage risk and returns over the longer term. It also incorporates the FSF's 'Principles for Sound Compensation Practices' issued in April 2009 by the Financial Stability Board (FSB, 2009b) – see below. Finally, under the proposed enhancements to Pillar 3 (market discipline), the Committee calls for strengthened disclosure requirements for securitisations, off-balance-sheet exposures and trading activities. Banks and supervisors were expected to implement the new Pillar 2 guidance immediately, and were given until the end of 2010 to implement the new Pillar 1 and Pillar 3 standards. The Committee also agreed to keep in place the Basel 1 capital floors beyond the end of 2009.xii

Meanwhile, the agreed revisions to the Basel II market risk framework governing trading book activities (Basel Committee, 2009b) were designed to address the problems revealed during the crisis of a significant build-up of leverage in the trading book, as banks arbitraged the relatively-low capital charges on trading book activities compared with the banking book, wherein significant losses were incurred. This was, in part, due to the failure of the existing framework, based upon the 1996 Amendment to the Capital Accord (see Hall, 1996), to capture some key risks. Accordingly, the Committee has supplemented the current VaR-based trading book framework with an incremental risk capital charge, which now covers both default risk and migration risk, for unsecuritised credit products (see Basel Committee, 2009c). For securitised products, the capital charges of the banking book will apply with a limited exception for certain so-called "correlation trading" activities. These measures should reduce the incentive for regulatory arbitrage between the banking and trading books. Finally, the Committee has called for a complementary stressed VaR requirement, which requires banks to calculate a stressed
VaR taking into account a one-year observation period relating to significant losses in addition to the VaR measure based on the most recent one-year observation period. This requirement has proved necessary because most banks' trading book losses during the crisis significantly exceeded the minimum capital requirements derived using VaR models. It should also help reduce the procyclicality of the minimum capital requirements for market risk. The new trading book rules must take effect in complying jurisdictions by the end of 2010.

2.2.1.2 **Liquidity Adequacy**

In recognition of the significant role played by liquidity strains in the generation and transmission of financial turmoil during the crisis and the failure of both regulators and institutions to contain liquidity risks, Lord Turner recommends that the regulation and supervision of bank liquidity should be recognised as being of equal importance to capital regulation, apart from being fundamentally reformed. Accordingly, he calls for the introduction of a more intense and dedicated supervision of individual banks' liquidity positions, including the use of stress tests defined by regulators and covering system-wide risks. He also recommends that consideration be given to the introduction of a 'core funding ratio' to ensure sustainable funding of balance sheet growth. [For the Basle Committee's latest proposals on liquidity regulation see Basel Committee, 2009d.]

2.2.1.3 **Remuneration**

Given the strong *prima facie* case that inappropriate incentive structures played a role in encouraging behaviour which contributed to the financial crisis (FSA, 2009a, Section 2.5(ii)), it is unsurprising that Lord Turner focussed on measures designed to reduce the incentives for risk-taking provided by such incentive structures. Lord Turner thus
recommends that remuneration policies for top executives and traders should be designed to avoid incentives for undue risk-taking; and that risk management considerations should be closely integrated into remuneration decisions. He argues that this can be achieved through the development and enforcement of UK and global codes. [For a survey of finance industry attempts to date to reform compensation policies see IIF, 2009, Section IV.]

With respect to a UK code, the FSA had, in fact, already published a draft code in February 2009 (FSA, 2009f), before the publication of Lord Turner's Review. This, however, was superseded by a refined version of the draft code in March 2009 (FSA, 2009g), which was put out for consultation. This duly resulted in the publication of the final version in August 2009 (FSA, 2009h). The objectives of the principles-based Code, which will apply to certain large banks, building societies and broker-dealers, are to force boards to "focus more closely on ensuring that the total amount distributed by a firm is consistent with good risk management and sustainability" and to ensure that "individual compensation packages provide the right incentives". In this way, it is hoped to sustain market confidence, promote financial stability and protect consumers. The Code, which covers the areas of governance, the measurement of performance (including risk adjustment) and the composition and structuring of remuneration, is also designed to be consistent with the remuneration principles/guidelines developed in international fora, and with Sir David Walker's Review of corporate governance (HM Treasury, 2009c and 2009d), which is discussed below (see recommendations 28 to 39 of Appendix 2.3). Enforcement of the Code will involve the FSA in linking required Risk Mitigation Plans to an integrated assessment of remuneration policies within the standard risk-assessment process ('ARROW') and, if necessary, increasing a firm's Pillar 2 capital requirements. The
FSA recognises, however, that the effectiveness of its new approach will depend, in part, on gaining widespread international agreement to publish and enforce similar principles in all other major markets.

Looking at the final version of the Code in more detail, the agreed "rule" within the Code states that "a firm must establish, implement and maintain remuneration policies, procedures and practices that are consistent with and promote effective risk management". This is complemented by eight principles, the first seven of which apply to all employees, with principle 8 only applying to senior management and employees whose activities have or could have a significant impact on the firm's risk profile.

Principle 1, which relates to the role of bodies responsible for remuneration policies and their members, states that:

"A remuneration committee should:

(a) exercise, and be constituted in a way that enables it to exercise, independent judgment;

(b) be able to demonstrate that its decisions are consistent with a reasonable assessment of the firm's financial situation and future prospects;

(c) have the skills and experience to reach an independent judgment on the suitability of the policy, including its implications for risk and risk management; and

(d) be responsible for approving and periodically reviewing the remuneration policy and its adequacy and effectiveness."

Principle 2, which covers remuneration procedures and the input of risk management and compliance functions, states that:
"Procedures for setting remuneration within a firm should be clear and documented, and should include appropriate measures to manage conflicts of interest.

A firm’s risk management and compliance functions should have significant input into setting remuneration for other business areas."

**Principle 3**, which relates to the remuneration of employees in risk and compliance functions, states that:

"Remuneration for employees in risk management and compliance functions should be determined independently of other business areas.

Risk and compliance functions should have performance metrics based on the achievement of the objectives of those functions."

**Principle 4**, which relates to profit-based measurement and risk adjustment, states that:

"Assessments of financial performance used to calculate bonus pools should be based principally on profits.

A bonus pool calculation should include an adjustment for current and future risk, and take into account the cost of capital employed and liquidity required."

**Principle 5**, relating to long-term performance measurement, states that:

"The assessment process for the performance-related component of an employee's remuneration should be designed to ensure assessment is based on longer-term performance."

**Principle 6**, which relates to non-financial performance metrics, states that:

"Non-financial performance metrics should form a significant part of the performance assessment process.

Non-financial performance metrics should include adherence to effective risk management and compliance with the regulatory system and with relevant overseas regulatory requirements."
Principle 7, which concerns the measurement of performance for long-term incentive plans, states that:

"The measurement of performance for long-term incentive plans, including those based on the performance of shares, should be risk-adjusted."

Although full compliance with this principle is not being sought by January 2010, firms are expected to have initiated a review by then of how well their long-term incentive plans take account of future risks.

In its amended guidance, the Code cautions against the use of unadjusted 'earnings per share' and 'total shareholder return' metrics, which can both be boosted by increasing leverage.

Finally, Principle 8, which relates to remuneration structures, states that:

"The fixed component of remuneration should be a sufficient proportion of total remuneration to allow for a firm to operate a fully flexible bonus policy."

The accompanying guidance also makes it clear that it is good practice for a firm (or a part of it) which makes a loss in any given year to have the flexibility not to pay a bonus, for a portion (at least two-thirds, for 'significant' bonuses) of bonuses to be deferred for at least three years, and for a significant proportion of the variable component of remuneration to be linked to the future performance of the firm and, where practicable, the employer's division or business unit, or otherwise the business undertaken by the employee.

The media response to the publication of the Code was generally rather negative. This was due, in part, to the Code's failure to tackle the issue of the scale of bankers' pay, implying the capping of bonuses, but Lord Turner and the FSA have argued all along that this is not an issue for the long-term nor for bank regulators, although it is a legitimate issue of public concern (particularly with respect to taxpayer-supported institutions) but
one that should be addressed by politicians. This stance, however, overlooks the fact that the size of the bonus pool, rather than individual payments, is of relevance to regulators as it affects capital adequacy; and it would have carried more conviction had the final version of the Code not been watered down compared with the original. Moreover, some worry about the lack of legally-binding rules – although, it could be argued, that a principles-based approach founded on "recommendations" is superior as it reduces the incentives for "gaming" and allows for greater flexibility - and the damage that still might be done to the City of London if widespread international agreement on the adoption of similar proposals cannot be secured (a danger already acknowledged by Lord Turner, as outlined above, and responsible for the watering-down undertaken). And it is not clear how the degree of risk generated by non-compliance will be calculated, nor how the additional capital requirement will be calibrated.

Lord Turner's apparent frustration at policymakers' unwillingness to tackle this issue at a time of general resurgence in bonuses due to a revival in the profitability of investment banking operations (due, in part, to reduced competition, post-crisis, and state-provided subsidies of various kinds) subsequently led him to 'open his heart' to *Prospect* magazine, which published the interview on 26 August 2009. In the article, he expresses his concerns about the prospect of the City returning to "business as usual" (e.g. paying out large bonuses, offering 'golden hellos' and adopting short-term policies again), with politicians seeming to lack the will to radically transform the system to prevent a recurrence of the previous excesses. Arguing that the financial sector has grown too big for society (as was the case in Iceland), that it has destabilised the UK economy and that some of its activities (e.g. some derivatives trading and "churning") are socially worthless or worse, he suggests the introduction of an internationally-agreed 'Tobin-style' tax on financial
transactions to curb excessive profits and pay in the financial sector if higher capital requirements fail to adequately address the consequences for financial stability. While he was right to highlight the dangers associated with a bloated financial sector and of a return to 'business as usual' in the City – so soon after the havoc wrought on the real economy, the near-terminal blow dealt to the financial system and the irreparable damage done to the public finances by bankers' gross mis-management and insatiable greed – and right to consider alternative remedies to the problems posed by the payment of excessive bonuses for financial stability if higher capital requirements fail to do the job, he was misguided in favouring the solution that he did.\textsuperscript{xx} For, even G20-sponsored action risks damaging the interests of the UK economy, while the tax itself would prove a very blunt instrument, affecting all transactions (socially-desirable or not) equally, would lead to higher costs for consumers and would reduce liquidity in financial markets. Predictably, howls of anguish could be heard from the vested interests in the City, led by the British Bankers Association but backed by the Investment Management Association, the Association of British Insurers, the CBI and the Mayor of London, suggesting Lord Turner had hit a raw nerve. Hopefully, the brave, but nevertheless welcome, act by the senior regulator will spark a wider debate on the issues involved.

2.2.1.5 \textbf{FSA's Supervisory Approach}\textsuperscript{xxi}

In recognition of the failings of the past\textsuperscript{xxii} and of the need to shift its primary focus from the regulation of individual institutions ('micro-prudential' regulation) to combining this with a strong focus on the overall system and on the management of systemic risks across the economic cycle ('macro-prudential' regulation), Lord Turner calls for a completion of the 'Supervisory Enhancement Programme' put in place in the aftermath of the near-collapse of Northern Rock (FSA, 2008b). This will involve: an increase in resources
devoted to high impact firms and, in particular, to large complex banks; a more detailed focus on business models, strategies, risks and outcomes, rather than primarily on systems and processes; a focus on the technical skills, as well as the probity, of approved persons; increased analysis of sectors and comparative analysis of firm performance; further investment in specialist prudential skills; the introduction of more intensive information requirements on key risks (especially liquidity risks); and a new focus on remuneration policies. These changes should be further reinforced, according to Lord Turner, by development of capabilities in macro-prudential analysis and a major intensification of the role played by the FSA in balance sheet analysis and in the oversight of accounting judgements. These are deemed necessary to respond to the challenges posed by the crisis as it has developed since March 2008.

Given the developments in the deposit-taking industry after the nationalisation of Northern Rock, which saw the nationalisation of Bradford and Bingley and the brokering of takeover-rescues of Alliance and Leicester and HBOS (by Banco Santander and Lloyds TSB respectively) and a number of building societies (see Hall, 2009b), there must be a fear that the FSA's failings with respect to Northern Rock were not a one-off. As Lord Turner himself concedes, the FSA had traditionally focussed on the supervision of individual institutions rather than the whole system, on ensuring that systems and processes were correctly defined, rather than on challenging business models and strategies and on the probity of approved persons rather than on an assessment of their technical skills. Moreover, the organisation was biased in favour of conduct of business regulation compared with prudential regulation, with bank prudential regulation being dominated by considerations associated with the agreement and implementation of Basel
II. As a result, emerging problems, such as the rapid build up in trading book risk and liquidity risks, were missed.

This does not fully explain, however, why so many "warning signs" were missed (Garcia, 2009). The fear is that the FSA were cowed into acceptance of the oft-repeated political demands (including by the current Prime Minister) for 'light touch' regulation, deemed necessary if the City was to preserve its traditional pre-eminent status amongst financial centres and continue to contribute to the nation's prosperity via tax payments, employment, invisible earnings, etc., etc. Such political/industry 'capture' of the regulator was evident in the days when the Bank of England had responsibility for banking supervision – witness their failings with respect to BCCI and Barings (see Hall, 1999a, Chapters 11 and 12 respectively) – and appears to have been carried over into the FSA. The likelihood, as conceded as a possibility by Lord Turner in his interview with Prospect magazine alluded to earlier, where he warns that the FSA should be "very, very wary of seeing the competitiveness of London as a major aim", is that this objective had indeed conflicted with its regulatory remit. This would help explain the FSA’s reluctance to challenge banks' strategic objectives, especially with respect to growth, organically (Northern Rock) or by merger (RBS's takeover of ABN Amro). In other words, the FSA was reluctant to bring the party to a premature end given the apparent wealth creation that had occurred during the boom period of 1993 to 2007, the very 'benign economic era' in which the FSA had been established; and excessive bonuses were tolerated as a necessary 'by- product' of said wealth creation.

Of course, under Lord Turner's stewardship, things appear to be improving, as a more intensive and intrusive style of supervision is embraced. Indeed, judging by the industry
complaints about its latest measures – sitting in on bank board meetings, demanding more data, questioning business plans, challenging judgments of senior executives, challenging bonus payments, widening and toughening its 'fit and proper' tests for approved persons, and increasing its activities (via fines and criminal cases) to deter fraud and malpractice – this step change has already been made. But, as explained below, this frantic activity may be all too late, as the likely winners of next year's national elections, the Conservative Party, have promised to dismantle the organisation as we know it, leaving it to focus solely on issues of consumer protection. This is reminiscent of the Bank of England's belated attempt to put things right after the collapse of Barings (see Hall, 1999a, Chapter 12), an endeavour that did not impress the incoming Labour government of 1997 – hence the transfer of regulatory and supervisory responsibility to a newly-created, unified agency, the FSA. It seems history is about to repeat itself, but with the regulatory responsibility moving in the other direction. Only time will tell if this proves to be a sensible policy.

2.2.1.6 Firm Risk Management and Governance

As demonstrated before and during the crisis, internal risk management was often ineffective and boards of financial institutions routinely failed adequately to identify and constrain excessive risk-taking. Clearly then, there is a need to increase the standards of risk management and governance in financial institutions. Although Lord Turner was happy to await the outcome of the Walker Review (see immediately below) before deciding on the necessary changes to be made to the FSA's rules and processes, promising specific proposals by the fourth quarter of 2009, he nevertheless indicated his main areas of concern. These relate to the need to improve the professionalism and independence of the risk management function, to embed risk management considerations in
remuneration policy, to raise the skill level and time commitment of non-executive
directors, and to enhance the ability of shareholders to constrain firms' risk-taking.

As anticipated by Lord Turner, the (interim) Walker Review (HM Treasury, 2009c),
was published a few months after his own Review. Sir David Walker had been asked by
the Prime Minister in February 2009 to review corporate governance in the UK banking
industry (later extended to the whole finance industry), in the light of the banking crisis.
Thirty-nine recommendations were duly made to enhance corporate governance with a
view to reducing the likelihood of a similar catastrophe striking the UK economy again.
These recommendations of Sir David's Interim Report were then the subject of
consultation with interested parties, the final report appearing in November 2009 (see HM
Treasury, 2009d).

The interim recommendations were grouped under five headings: board size,
composition and qualification; functioning of the board and evaluation of performance; the
role of institutional shareholders: communication and engagement; governance of risk;
and remuneration. Five key themes were also identified. Firstly, the Combined Code of the
Financial Reporting Council (FRC), embodying the principle of "comply or explain",
remains fit for purpose, although tougher capital and liquidity requirements and a tougher
regulatory stance on the part of the FSA are required. Secondly, the principal deficiencies
of financial industry boards related much more to patterns of behaviour than to
organisation. More should be done to promote an environment whereby the executive can
be challenged. This will require, *inter alia*, changes to board composition and a materially
increased time commitment from both non-executive directors (who need more
experience, training and support) and the Chairman of the Board (who should be put up
for re-election each year). Thirdly, board level engagement in the high-level risk process should be materially enhanced, particularly with respect to the monitoring of risk and discussion leading to decisions on risk appetite and tolerance. Board level risk committees, separate from audit committees, should be set up to ensure executives do not take any unnecessary risk. Fourthly, there is a need for fund managers and other major shareholders to engage more productively with their investor companies with the aim of supporting longer-term improvement in performance. Boards, in turn, should be more receptive to such initiatives. And finally, given the clear evidence of defective control and serious excess in some circumstances, substantial enhancement is needed in board level oversight of remuneration policies, in particular in respect of variable pay, and in associated disclosures. The remit and responsibility of board remuneration committees should be extended beyond board members to cover the remuneration framework for the whole entity, for those whose pay exceeds that of the average board level remuneration. Not less than half of expected variable remuneration should be on a long-term incentive basis with vesting, subject to performance conditions, deferred for up to five years.

Media reaction to the publication of the Review was mixed. Although commentators generally applauded Sir David’s attempts to address the systemic threat posed by granting bonuses that encourage excessive risk-taking by, for example, calling for a higher proportion to be deferred, and for longer, and the other measures recommended to restrain excessive risk-taking, a number of concerns were voiced. For those wishing for a more draconian approach to be taken to the award of bonuses there was considerable disappointment. No cap on bonuses was proposed and a ‘clawback’ of bonuses was only sanctioned in cases of misstatement or misconduct, not subsequent poor performance. Similarly, on pay disclosure, there is no requirement that individual, high-earning bankers
be identified, only that the number of employees earning above certain thresholds be published. And those who want Chief Executives to be barred from becoming Chairmen were also disappointed. The general criticism was thus that the Review was not tough enough nor prescriptive enough. Industry reaction, on the other hand, understandably focussed on the perceived damage that might be done to their personal interests. Concerns about the potential damage that might be done to the UK financial services industry if similar proposals are not introduced in competing jurisdictions were widely voiced. Some also raised fears about the likely increased difficulty to be faced in filling non-executive positions given the substantially increased burden they would face under the new regime. And yet others complained about the extension of the remit of non-executives into areas traditionally the preserve of management alone.

Sir David Walker's final set of recommendations – see Appendix 2.3 – emerged in November 2009 (HM Treasury, 2009d). The number of recommendations remained the same as provisionally proposed – although Recommendation 15 was deleted, numbers 38 and 39 were combined, and numbers 18 and 20 split into two parts – and they were grouped in the same way as before. However, a number of material changes were made to some of the recommendations. For example, Recommendation 3, concerning the time commitment of NEDs, was watered down in the final version compared with the original following industry pressure. Accordingly, the minimum 30 to 36 days, for all NEDs originally recommended became relevant only for several NEDs. Similarly, the final version of Recommendation 7, concerning the time commitment of the Chairman of a financial board, watered down the previous proposed minimum of two-thirds to around two-thirds, and narrowed its application to the Chairman of a major bank only – for a Chairman of a less complex or smaller bank, insurance company or fund management
entity, the required time commitment should be "proportionately less" and dependent on "the balance and nature of their business". Contrariwise, the final version of Recommendation 8, relating to the desirable attributes of a Chairman of a BOFI board, was beefed up compared with the provisional version. 'Convincing leadership experience in a significant board position' without relevant financial industry experience will now only be acceptable if "there is an adequate balance of relevant financial industry experience among other board members". Moreover, all Chairmen should now be provided with "appropriately intensive induction and continuing business awareness programme". Similarly, Recommendation 10, concerning the proposal to force the election of the Chairman of a BOFI board on to an annual basis, was now being recommended for consideration with respect to the election of all board members.

With respect to the role of institutional investors, perhaps the main material change related to the involvement of the FSA when there was material cumulative short-run changes in the share register. The previous recommendation, number 15, that the FSA consider contacting major selling shareholders to understand their motivation, has now been dropped, with a requirement that the FSA be informed by boards in such scenarios being tagged on to Recommendation 14. Finally, with respect to remuneration, a number of material changes were made in Sir David's final report compared with the interim report. For example, the final version of Recommendation 29, concerned with the terms of reference of the remuneration committee, now argues that it should be extended to the oversight of remuneration policy and outcomes of all "high end" employees without defining what "high end" means. In the original version, the recommendation related to "all executives for whom total remuneration in the previous year or, given the incentive structure proposed, for the current year exceeds or might be expected to exceed the median
compensation of executive board members on the same basis". The less prescriptive policy recommendation will not, however, be used by firms to limit the scope of the scrutiny of remuneration committees compared with original intentions as the median, estimated at around £2 million, exceeds the newly-proposed reporting threshold of £1 million. For, in relation to the disclosure of "high end" employees' remuneration, the new version of Recommendation 31 clarifies the nature of the "bands" for which the number of executives and the main element of their salary, cash bonus, deferred shares, performance-related long-term awards and pension contributions must be disclosed by the remuneration committees from the 2010 year of account onwards. The bands (for total remuneration) are "£1 million to £2.5 million", "£2.5 million to £5 million" and in bands of £5 million thereafter. As previously argued, however, the names of the employees affected will not be disclosed. Finally, with respect to the "clawback" provisions of Recommendation 33, Sir David retains the original proposal that bonus clawback only be entertained in circumstances of "misstatement and misconduct" and not, as preferred by others, also in circumstances of "under-performance", investment-related or otherwise.

2.2.1.7 European Regulatory and Supervisory Arrangements

The final area of Lord Turner's Review to be covered in this section is the European dimension to the reform debate. At the moment, most aspects of financial services regulation are expressed in EU Directives associated with the 'Single Market', which then have to be transposed into national law (see Hall, 1997). These Directives set minimum standards which Member States can choose to exceed on a national discretion basis (under the principle of 'super equivalence'). In addition to the Directives, three committees (the 'Lamfalussy Committees'), representing national authorities, play important consultative roles. Supervision of financial entities remains entirely in the hands of national authorities,
with cross-border activities supervised in accordance with the allocation of responsibilities between home and host authorities agreed in the *Basle Concordat* in 1975, as subsequently amended in the light of flaws exposed in the regulation and supervision of Banco Ambrosiano Holdings, prior to its collapse in 1983, and of BCCI, prior to its closure in 1992 (see Hall, 1999, Chapter 3, for further details). Deposit insurance, subject to harmonised minimum standards, and crisis management arrangements are also operated on a national basis, the latter subject to 'State Aid' rules.xxv

In terms of 'architecture', this system survived until 2009 when the Jacques de Larosière 'Taskforce' reported (February 2009). This body argued against the adoption of a pan-EU regulatory body in favour of the creation of two new bodies – a 'European Systemic Risk Council' (ESRC), later (i.e. in September 2009) confirmed as the 'European Systemic Risk Board', and a 'European System of Financial Supervisors' (ESFS). The purpose of the ESRC, which would comprise ECB officials, national monetary authorities and EU officials, would be to co-ordinate the supervision of systemic risks which threaten overall financial stability and advise upon appropriate remedies. This would improve on the current system which is inevitably nationalistic in nature and focuses on individual institutions. The second institution, the ESFS, comprising separate authorities for banking, securities and insurance, would decide on compulsory minimum EU-wide standards designed to stop 'regulatory arbitrage' between Member States, provide binding mediation between disagreeing national authorities, co-ordinate the operation of 'colleges of supervisors' for systemically-important cross-border institutions and licence and supervise some EU-wide institutions, such as rating agencies and clearing houses. National authorities would remain in charge of day-to-day supervision, as before, and could still impose tougher standards if desired. Finally, the Taskforce recommended the development
and operation of a global financial stability early warning system by the IMF, with the assistance of the ESRC and central banks. The European Commission duly accepted the Taskforce's recommendations in March 2009 but called for much speedier implementation – the Taskforce envisaged the process lasting a number of years.

Lord Turner, in his Review, however, claims 'this philosophy to be inadequate and unsustainable for the future' (op.cit., p.100), citing the failure of Landsbanki as an example of how existing single market rules can create unacceptable risks to depositors and/or taxpayers. Accordingly, he argues that either national powers are increased, implying a less open single market, and/or there needs to be a greater degree of European integration. He prefers a mix of both, favouring more national powers in the areas of capital and liquidity adequacy assessment, possibly to include home country power to require local subsidiarisation of institutions where there are concerns about whole bank soundness and/or about the capacity of home country fiscal authorities and deposit insurance schemes (see also FSA, 2009b). This would protect the interests of UK depositors and taxpayers.

As for the 'more Europe' option, Lord Turner suggests two possibilities for consideration; greater cross-European co-ordination of supervisory approaches and of macro-prudential analysis, and greater co-ordination of deposit insurance arrangements. With respect to the former, Lord Turner calls for the creation of a new EU institutional structure to replace the Lamfalussy Committees. A new independent body should be created with regulatory powers to act as a standard setter and overseer of supervision. It should also be involved, alongside central banks, in macro-prudential analysis, while leaving the primary responsibility for supervision with national authorities. [Note the similarities with the de Larosière recommendations.] And, with respect to the latter, he suggests that the option of introducing pan-European arrangements for the deposit
insurance of banks operating cross-border in branch form should be considered in more detail.
2.2.2 The Government's White Paper on Financial Reform

On 8 July 2009 the UK Government set out its proposals for reforming UK financial regulation (HM Treasury, 2009f). The reform recommendations, designed to strengthen the financial system for the future, followed the Government's analysis of the causes of the financial crisis and a summary of the action already taken to restore financial stability in the UK (a critique of which is provided in Hall, 2009a and 2009b), embracing the introduction of a new 'Special Resolution Regime' for banks in the Banking Act of February 2009,\(^{xxviii}\) the reform of deposit protection arrangements, the brokering of takeover-rescues of ailing institutions, the nationalisation of failed institutions and the introduction of two industry-wide, bailout schemes involving, *inter alia*, state-funded recapitalisation of weak banks and capital protection through the 'Asset Protection Scheme'.\(^{xxix}\)

The further reforms proposed are designed to "strengthen regulation and supervision, and support corporate governance so that, in future, financial crises will be less likely and less damaging" (*op.cit.*, p.16). They are intended to deliver:

- more effective prudential regulation and supervision of firms;
- greater emphasis on monitoring and managing system-wide risks;
- greater confidence that the authorities are ready and able to deal with problems when they do arise; and
- greater protection for the taxpayer when an institution needs to be resolved" (*ibid.*, p.10).

The Treasury's proposals (a summary is presented in Appendix 2.4 of this paper) are grouped together under four main headings: (i) proposed changes to the governance, coordination and regulatory framework of the UK's financial authorities; (ii) the
Government's strategy for dealing with systemically-significant institutions; (iii) the Government's strategy for managing systemic risk more broadly; and (iv) the Government's plans to strengthen financial regulation and supervision at the international level. Each area will now to be addressed in turn. [Consumer protection and competition issues – addressed in Chapters 8 and 9 respectively of the White Paper – are not considered further, here.]

2.2.2.1 Proposed Changes to Governance, Co-ordination and Regulatory Framework

With respect to co-ordination, the Government has proposed that a new statutory committee, the 'Council for Financial Stability' (CFS), replaces the existing 'Standing Committee', to formalise and strengthen the co-ordination between the Bank of England, the FSA and the Treasury. The objectives of the new Council, to be chaired by the Chancellor, will be to analyse and examine emerging risks for financial stability and co-ordinate the appropriate response. To increase public transparency and accountability, the minutes of the standing meetings will be published quarterly, and an annual report will be published and sent to Parliament. The CFS will also co-ordinate the UK Authorities' position on EU and international financial stability and regulatory policy issues, and its Terms of Reference will replace the existing Memorandum of Understanding, as last amended in March 2006. The external members of the governing bodies of the Bank of England and the FSA will also be used to provide additional outside expertise.

In relation to the subject of governance, the Government will await the outcome of the FSA Board's review (due before end-2009) of its functions before making any explicit proposals for reform of the FSA's governance arrangements but, in the interim, it is to be given an explicit financial stability objective. This will complement the existing objectives
set out in the FSMA to provide a more explicit recognition of the FSA's expanded role in maintaining and enhancing financial stability.

As for enhancing the regulatory framework, the Government is proposing a number of measures. Firstly, it plans to strengthen the FSA's prudential regulation and supervision of banks through endorsement of all Lord Turner's recommendations with respect to enhancing capital and liquidity adequacy assessment (see Appendix 2.4). It also endorses Lord Turner's planned enhancement of the FSA's SEP, as the FSA's supervisory approach becomes more intrusive and systemic. [On 2 July 2009, the FSA announced a change to its organisational structure to better align it with its new functional model.] It will also take action to strengthen the FSA's powers in relation to authorised firms and individuals found guilty of misconduct, and to allow it to take emergency action to place restrictions on short selling and to require disclosure of short selling outside the regulatory framework governing market abuse. Finally, to better protect taxpayers/depositors, it is proposing the eventual (but not before 2012) introduction of an element of pre-funding into the deposit-taking sub-scheme of the FSCS, following full consultation with interested parties. The Government will also bring forward proposals regarding the governance and accountability of the FSCS.
2.2.2.2 **Reforms Proposed as Part of the Government's Strategy for Dealing with Systemically-Significant Institutions**

Although the Government recognises the need to deal effectively with systemically-significant (or "high impact") firms, it agrees with Lord Turner that the appropriate solution is not to impose artificial limits on a firm's size or breadth of activities through, for example, the imposition of 'Glass Steagall-type' regulations. Rather, it prefers to strengthen market discipline and infrastructure, and enhance prudential regulation and failure resolution mechanisms, as explained below.

The Government's proposals are designed to do two things; to reduce the risk of systemically-significant institutions failing and, if they do fail, to reduce the impact of their failure. On the first front, the Government is focussing on strengthening market discipline by using the work of the Walker Review and the FSA's Code of Practice (backed by the FSB's code of practice agreed at the G20 Pittsburg Summit in September 2009) to provide guidance on the standards of discipline expected in corporate governance and remuneration respectively. Additionally, it will urge the FSA to establish and maintain dialogue on governance issues with the non-executive directors of boards. It is also relying on an enhancement of the FSA's prudential regulation and supervision, both generally – as proposed by Lord Turner in respect of stricter regulation and supervision of capital and liquidity adequacy – and specific to systemically-significant firms through the imposition of additional capital charges relating to the size and complexity of the firm (see FSA, 2009i, for a discussion of the issues involved). The latter charge would, in effect, "internalise" the firms' higher costs of failure. The Government recognises, however, that international co-ordination on the last point is necessary if regulatory arbitrage is to be avoided and, accordingly, supports the deliberation of the issue at international fora.
With respect to the reduction of the impact of such firms' failure, the Government again has a dual plan of attack. Firstly, to strengthen market infrastructure (through, for example, enhancing the legal and operational infrastructure of the CDS market, as supported by Lord Turner) and, secondly, to enhance failure resolution mechanisms. The latter, in turn, is to be secured through the introduction of a new insolvency regime for investment banks, xxxiii following the introduction of the new SRR for deposit-takers in the Banking Act of February 2009, and by forcing banks to draw up internal failure resolution plans ('living wills') to facilitate their unwinding at short notice, should that prove necessary. The nature of these internal resolution plans – the quality of which, the Government argues, should be taken account of in the FSA's overall assessment of the prudential risks borne by a firm and, if necessary, in its regulatory requirements – which will inevitably impact on corporate structure (and hence on tax payments and profitability) and the cost of capital (due to rating agency downgrades), will be the subject of consultation, but the Government is committed to the eventual adoption of the idea and is planning legislation this year to deliver it – see Section 2.2.3 below (see also Basel Committee, 2009e). xxxiv

2.2.2.3 Reforms Proposed as Part of the Government's Strategy for Managing Systemic Risk More Broadly

The crisis has demonstrated how the accumulation of systemic risk across financial markets can have serious macroeconomic consequences. The Government thus wants to make sure that, in addition to securing the health of individual institutions, central banks and regulators pay close attention to:

• how the complex inter-linkage across financial markets, and financial institutions' tendency to respond in common ways, can threaten stability;
• the cyclical nature of risk-taking in financial markets, which can cause the extent and nature of threats to financial stability to fluctuate over time; and

• the links between the financial system and the wider economy” (op.cit., p.77).

While recognising that, to be effective, any policy changes need to be adopted and co-ordinated internationally, the Government is working closely with the Bank of England and the FSA, as well as with its international counterparts (including the FSB), to develop an appropriate approach to mitigate the adverse consequences for financial and macroeconomic stability of the pro-cyclical behaviour of financial institutions and markets.

In order to improve the management of systemic risk across markets and institutions, the Government advocates the following: enhancing transparency by improving accounting standards; improving the liquidity, transparency and robustness of wholesale markets (and, in particular, securitisation and over-the-counter (OTC) derivatives markets); and increasing the regulatory focus on systemic risk.

The increased focus on transparency (e.g. with respect to financial institutions' risk exposures) is deemed necessary to enhance market discipline, facilitate better risk management and enhance market liquidity in distressed conditions. Accordingly, the Government endorses the FSF’s accounting recommendations in this area (to take effect by end-2009) and agrees that the FSA should engage with firms and auditors to ensure more consistent approaches in the valuation of financial instruments across firms. As for the increased focus on wholesale markets, the crisis clearly demonstrated the need to look more systematically at those key markets in which financial institutions operate and take a considered approach to the systemic risks they pose, especially in respect of liquidity.
To avoid illiquidity in securitisation markets, the Government believes greater product standardisation and transparency are necessary to attract a broader class of investors (additional to banks and their conduits). And, with respect to OTC derivatives markets, the Government hopes to enhance their robustness and functioning through securing agreement on the introduction of a centralised clearing house for most products, with those deemed not suitable for such action (i.e. because they are bespoke, illiquid or new) being subject to bilateral collateralisation and risk-appropriate capital charges to mitigate counterparty risk. Requirements to increase the amount of due diligence done by investors in structured products, which should be facilitated by greater standardisation, will also serve to enhance the robustness of securitisation markets.

Finally, to ensure a greater regulatory focus on systemic risk, the Government advocates enhanced monitoring and supervision and the creation of a responsive and dynamic regulatory boundary. With respect to monitoring, the Government expects the FSA to increase its focus on understanding the nature of the inter-relationships and networks between firms and proactively identifying systemic vulnerabilities, and in monitoring and assessing how systemically-important markets might trigger or amplify a shock. If additional information-gathering powers are necessary, the Government will legislate for this. As for enhanced supervision, the Government will review and amend the FSA's objectives and the principles of good regulation to clarify that the FSA's regulatory and supervisory approaches should include an enhanced focus on monitoring, assessing and mitigating systemic risks, and that its regulatory decisions take into account the wider economic costs of financial instability; while the FSA's enforcement powers will be enhanced and extended to, inter alia, allow it to take action to address systemic risk and
protect financial stability. Meanwhile, in agreement with Lord Turner, the Government argues that the regulatory perimeter should be determined according to the principle that financial activities should be regulated according to their economic substance and the risks they pose, not their legal form. This suggests a closer scrutiny of off-balance-sheet vehicles\textsuperscript{xxxvii} and hedge funds\textsuperscript{xxxviii} at the minimum. Moreover, the regulatory perimeter will need to be kept under review because of the industry's continuous financial innovation.

The final area of systemic risk management that has exercised the Government is that associated with the economic cycle. Concern about "pro-cyclicality", or the co-movement between lending conditions and the cycle, has led to calls to amend regulation in order to dampen excessive credit provision and risk-taking in the financial system which can amplify an economic upturn, and to ensure that banks are more resilient to economic shocks when they occur to prevent amplifying an economic downturn. The Government is thus working together with the FSA and the Bank of England and in international fora – e.g. the FSB and the European Systemic Risk Board (ESRB) (see below) – to develop these so-called "macro-prudential" tools. The Government favours the use of a complementary "backstop" maximum leverage ratio and the build-up of counter-cyclical capital buffers in good times, as argued for by Lord Turner, the latter to be achieved ideally through appropriate prudential regulation rather than by changing accounting standards (to allow, for example, for 'dynamic provisioning'). This, however, does not deal with the tendency for financial markets to amplify economic cycles through, for example, the creation of asset price "bubbles". The Government thus believes that more should be done to prevent this by, for example, linking capital requirements to indicators of risk in the financial sector or wider economy and firm-specific indicators, such as the growth in
individual banks’ lending activities or their liquidity profiles. These additional tools can be used to complement the action already taken by the FSA and that planned by the Basel Committee (see Basel Committee, 2009f) and the IASB to ensure that international regulatory and accounting standards (focussing on risk-based capital requirements and mark-to-market accounting respectively) do not act to unnecessarily amplify the inherent pro-cyclicality of the financial system.

Apart from the above measures, the Government is also determined to improve banks’ access to funding during economic downturns or crises, an important source of contagion during the recent crisis. While increased transparency of bank exposures may help in this respect – as mentioned above – further measures are needed to expand banks’ sources of capital, other than from governments. One possibility being considered is for the FSA to be given the authority to order, in the event of a systemic crisis, banks to convert some of their debt (subordinated?) into equity.

Finally, the Government believes that an element of discretion, additional to rules-based policy, will be required if the inherent pro-cyclicality of financial markets is to be effectively constrained. Tools, such as the re-setting of leverage ratios or the imposition of prudential add-ons to regulatory capital requirements, might thus be used in response to the emergence of threats for financial and macroeconomic stability. As for the institutional responsibility for these and any other tools endorsed by the Government, this will be decided once international agreement has been reached on what the new tools should be, and how they are to be used. [As discussed below, however, the Conservatives, likely to form the next Government, have been less coy about their preferred choice of macro-prudential regulator!]
2.2.2.4 Reforms Proposed to Strengthen Financial Regulation and Supervision at the International Level

The recent crisis has demonstrated the need for strong domestic regulatory systems to be complemented by enhanced supervision of international firms and markets through robust international standards, close co-operation between authorities, and a more coherent international regulatory architecture. While much has already been done in these areas, the Government believes there is still scope for a further strengthening of regulation and international co-operation, particularly in Europe. Their recommendations for delivering this are considered below.

In the light of the recent crisis, the Government believes that it is necessary to improve the authorities' ability to identify systemic risks within the EU and the quality (and scope) of rules applying to firms as well as to ensure proper enforcement of those rules. While welcoming the outcome of the European Council's deliberations of June 2009 on structural reform of the EU regulatory and supervisory system (draft legislation was proposed by the European Commission in September 2009 – for the Treasury Committee's views see House of Commons, 2009b) it believes more should be done. In particular, it wants to see a reduction in the number of national discretions available in Directives, in order to secure a more level playing field and increase the effectiveness of regulation, and a strengthening of the rules and safeguards governing cross-border branching in the EEA. With respect to the latter, the Government is concerned, like Lord Turner, with the quality of supervision exercised by the Icelandic authorities and the inadequacies of their deposit guarantee scheme, and is calling for changes, there and elsewhere, to both reduce the likelihood of bank failure and the cost of failure should it occur. In relation to the former, the following policies are suggested for adoption: ensuring that minimum standards are
strong and applied consistently to cross-border groups; strengthening information exchanges between home and host authorities, with host supervisors having access to micro-prudential information relating to the overall financial position of a group; and ensuring that peer review and supervisory audit of cross-border supervision take place. In addition, other countries might like to follow the UK's lead and ensure that foreign branches operating in their jurisdictions are self-sufficient for liquidity purposes, unless their parent companies meet certain criteria (this policy will soon be implemented in the UK by the FSA). With a view to reducing the costs of failure, the Government argues that Member States (and, indeed, all countries) should possess minimum and compatible resolution toolkits (along the lines of the UK's new Banking Act), should develop and agree winding-down plans for significant cross-border banks, and should establish co-operation agreements between deposit guarantee schemes to enhance their operational effectiveness. [The European Commission is considering setting up a pan-EU deposit guarantee scheme.]

Apart from these measures, the Government also wants to see stronger enforcement of EU rules, including through better-quality supervision. The establishment of supervisory colleges, combined with supervisory audit, peer review and binding home-host mediation should all serve to further this end but appropriate implementation will be crucial. The Government also believes that, prior to the creation of the European Supervisory Authorities, the existing Level Three committees need to be better resourced to deal with the important jobs at hand – notably, in connection with the registration of credit rating agencies and the drafting of the Solvency II Directive - and that, in the longer-term, a single rule-making body should be created to improve the quality of regulation in the EU.
With respect to the wider need for closer international co-operation and cross-border supervision, the Government believes that more should be done to build on the recent initiatives adopted in respect of the creation of supervisory colleges for large cross-border firms, implementation of the FSF principles for cross-border crisis management and the launching of an 'Early Warning Exercise' (EWE) by the IMF/FSB to identify macro-financial vulnerabilities and propose policy responses. Accordingly, to further promote international macro-prudential supervision, the Government calls on the IMF and FSB to undertake the following:

- draw upon the relative strengths of each institution (it is vital that the FSB is a full partner to the EWE and uses its expertise to propose appropriate regulatory responses to the macro-prudential risks identified by the IMF);
- identify both quantitative and qualitative assessments of risks, focussing on those with potential cross-border effects;
- have a clear signalling system based on the likelihood and impact of a possible event;
- be a forum for articulating concrete policy responses to risks identified, particularly those that require co-ordinated as opposed to unilateral action; and
- draw on risks and advice identified in other appropriate reports.

Moreover, with respect to crisis management, there is a need to ensure that international rules facilitate rather than hinder appropriate action by national authorities, and that there is international consistency in approaches to cross-border bank resolution arrangements.
2.2.3 The Conservative Party’s White Paper

Given the Conservative Party’s current standing in the polls, and hence the strong likelihood that it will form the next government in the summer of 2010, its proposals for financial reform are of obvious interest to all concerned. As explained below, its proposals, drafted in July 2009 in the wake of the submission of a review by Sir James Sassoon on the Tripartite system, are radical, embracing the abolition of the FSA and the Tripartite system, the creation of a new Consumer Protection Agency and the handing of micro- and macro-prudential regulatory powers to the Bank of England (for a summary see Appendix 2.5).xlviii

The proposed reforms can usefully be divided into those associated with changing the regulation "architecture" and those associated with a change in regulatory policy. The latter, in turn, can be divided into micro- and macro-prudential reforms. As far as the architecture is concerned, the proposed changes are seismic. The FSA would be abolished, its micro-prudential powers being handed over to the Bank of England (to be carried out by a new "Financial Regulation Division")xliv and its consumer protection remit would be transferred to a new Consumer Protection Agency, which would also take over the regulation of consumer credit from the OFT. The abolition of the FSA would, in turn, mean that the triggering of the Special Resolution Regime (SRR) introduced under the Banking Act 2009 would also pass to the Bank, which is currently only responsible for its operation, and result in the abolition of the Tripartite system. With respect to the latter, the current Standing Committee would be replaced by a new "Financial Policy Committee,"1 housed within the Bank, which would be responsible for monitoring systemic risks, operating new macro-prudential regulatory tools and executing the SRR for failing banks. Finally, a single senior Treasury minister would be given responsibility for European
financial regulation, where efforts would be concentrated on reducing barriers to entry to increase opportunities for UK financial firms.

With respect to changes to regulatory policy, changes to existing micro-prudential policy and the introduction of new macro-prudential tools are both proposed. On the former front, the Conservative Party endorses Lord Turner's recommendations for:

- the imposition of additional capital and liquidity requirements on banks to reflect an institution's size and complexity;
- the imposition of "much higher" capital requirements on high-risk activities, such as large-scale proprietary trading;
- using capital requirements to crack down on risky bonus structures; and
- the introduction of an internationally-agreed 'backstop' leverage ratio to constrain bank lending.

It also accepts the case for the preparation of "living wills" by institutions to assist in their orderly unwinding in the face of insolvency, as argued for by the Governor of the Bank of England and subsequently by Lord Turner, and recently endorsed by the Government (see HM Treasury, 2009h). As for macro-prudential policy, the Conservative Party argues for international co-ordination in the development of a macro-prudential "toolkit" which should comprise, \textit{inter alia}, counter-cyclical capital requirements, as called for by Lord Turner and supported by the Government. It also promises to introduce additional safeguards against the risks created by complex or interconnected institutions through greater use of central counterparty clearing, the creation of a more appropriate balance between exchange-traded and over-the-counter securities, and greater financial transparency.
Finally, it is worth noting that the Conservative Party are also keen to enhance competition in the financial services industry, matching the current Government's belated focus on this area, in part due to the European Commission's "State Aid"-related concerns with the Government's approach to bailing out domestic banks (see Hall, 2009a). Accordingly, and with a view to introducing a greater degree of diversity and competition into the UK banking sector, the OFT and the Competition Commission will be asked to conduct a focussed examination of the effects of consolidation (increased during the financial crisis because of official bailout policies) in the retail banking sector. The findings will help to inform strategies for disposing of state-held stakes in banks. The Conservatives will also look at measures to enlarge the activities of credit unions.
2.2.4 The Way Forward

In the light of the discussion presented above, it is clear that there is a high degree of consensus as to what should be done to enhance financial regulation and supervision and to prevent a recurrence of the type of financial crisis recently experienced around the globe. At the domestic level, this will require a strengthening of regulation and supervision along the lines already implemented by the FSA under its 'Supervisory Enhancement Plan', subject to the enhancement noted by Lord Turner and the Treasury. This should deliver a more intrusive and risk-focused style of regulation that is concerned both with individual institutions and the systemic consequences of their joint actions. In addition, as for other jurisdictions, it will require fundamental reforms to both micro-prudential and macro-prudential policy of the type set out in Part B of Appendix 2.6. Action demanded in the former sphere of operation embraces, inter alia, a strengthening of capital and liquidity adequacy assessment and a closer focus on systemically-important institutions; while action required on the latter front will see the introduction of counter-cyclical capital and liquidity requirements and accounting measures.

As for the additional safeguards needed, again there is a clear consensus as to what should be done in the future – see Appendix 2.6, Part C. The ‘wish list’ comprises:

- greater regulation and tighter monitoring of credit rating agencies;
- greater use of central counterparty clearing for (standardised) derivative instruments (including CDS), and exchange trading;
- improved accounting standards;
- extension of the regulatory perimeter to include all systemically-important financial institutions (such as hedge funds);
• tighter regulation and supervision of off-shore financial centres;
• stronger corporate governance (including in relation to remuneration); lvii
• enhanced failure resolution regimes for investment banks and cross-border banks;
• enhanced international co-ordination of the supervision and resolution of cross-border banks;
• enhanced market discipline (including through increased disclosure); and
• home supervisors enjoying increased powers under the EU 'Single Market' for financial services.

Where there is much disagreement, however, is over the most appropriate regulatory architecture to adopt. The debate, at a domestic level, is summarised in Appendix 2.6, Part A. Given the strong likelihood of the Conservatives winning the next election, it is sensible to start with a consideration of their radical proposals as these are what we are likely to end up with. lviii

The first issue to address is who should be in charge of micro-prudential supervision. In the academic literature, this has sparked debate on two fronts; should the central bank be involved and, if not, is a single authority preferable to a number of functionally-focussed agencies covering, for example, banking, securities and insurance?lix With respect to the former debate (see, for example, Goodhart and Schoenmaker, 1995, and Peek, Rosenberg and Tootell, 1999), the trend in the developed world has been to enforce the separation of function for the following reasons:

• that the occasional but inevitable bank failure will always taint banking regulators, whatever their degree of culpability, thereby damaging the credibility of the monetary authority;
• that tensions, created by potential conflicts of interest, can arise if the two functions are jointly administered by the same organisation (the main fear is that interest rate increases, necessary for monetary tightening in the face of an upsurge in inflationary pressures, may be compromised because of fears about the health of the domestic banking and financial system);

• that the central bank should not be distracted from its primary role of ensuring monetary stability through control of inflation; and

• that the change is necessary to elicit a much-needed change in supervisory culture.

Finally, there are those who worry that too much power is vested in the hands of unelected officials.

Contrariwise, those who argue for the continuing involvement of central banks in banking supervision point to the following:

• that there are economies involved in combining the two functions in a situation where the central bank will still be held responsible for ensuring overall financial stability and for activating the lender of last resort facility, if circumstances dictate, and continue to be involved in crisis management;

• that valuable information, from a supervisory perspective, is routinely gleaned from the central bank's intervention in financial markets;

• that benefits derive from the moral authority of the central bank which allows it to employ moral suasion, in addition to statutory powers, to secure prudential objectives;

• that confidential bank supervisory information can usefully inform decision-taking by the monetary authority by enhancing the accuracy of macroeconomic forecasting;
that great difficulty would be faced by the replacement body in finding alternative staff (the danger is that the reform exercise merely results in a relocation of existing central bank staff, especially in the short run, with little or no enhancement in efficacy of supervisory policy); and

that measures can be taken to enhance the accountability of central bankers to address the fears about concentration of power in the hands of unelected officials (indeed, the same fears surface in any informed debate about enhancing the independence of central banks shorn of supervisory responsibilities).

With respect to the debate about the optimal number of regulatory bodies (see, for example, Briault, 1999 and 2002, and Abrams and Taylor, 2000), those who favour the unification of regulation within a single body, emphasise the following:

- economies of scale and scope (e.g. due to the more efficient allocation of supervisory resources, the pooling of supervisory expertise under one roof, the elimination of supervisory overlap which causes the duplication of supervisory effort, the provision of a single port of call for financial conglomerates seeking authorisation, the merging of support services, such as personnel, administration and documentation, and the rationalisation of computer systems, etc.) which, in the longer term, will deliver lower supervisory costs and hence fees to regulated institutions;

- the introduction of a harmonised approach to compensation and Ombudsmen schemes;

- more able to adapt to changes in the market place (e.g. to the provision of more complex financial products and towards financial conglomeration and universal banking);

- better able to assess overall risk inherent in the financial system;
• reduces problems associated with co-ordination and co-operation between regulatory agencies' specialist divisions, and facilitates international regulatory co-operation;
• removes opportunities for regulatory arbitrage and reduces the possibility of regulatory capture (but, unfortunately, does not eradicate it, as the FSA proved!);
• facilitates the delivery of regulatory neutrality (because of the increased consistency of treatment of regulated firms and the harmonisation of rulebooks);
• increases the transparency of regulation for consumers/investors;
• increases the accountability of regulators (e.g. for performance against statutory objectives, for the regulatory regime, for the costs of regulation, for its disciplinary policies, and for regulatory failures); and
• the creation of a new supervisory culture unashamedly concerned solely with delivering cost-effective regulation and supervision in accordance with statutory objectives.

Those who oppose the creation of a single regulator (outside the central bank) meanwhile point to the following fears/concerns:
• that a bureaucratic leviathan, divorced from the industry it regulates, may result;
• that the economies of scale and scope may be more meagre than anticipated;
• that the effective integration of the different functional regulators/supervisors, with very different cultural backgrounds, under one roof may prove difficult to manage – moving to a single location doesn't guarantee effective communication and co-operation;
• that insufficient differentiation between retail and wholesale/professional investors may result;
• that any benefits of inter-agency competition would be lost;
• that a loss of specialist knowledge of supervisors (of both firm-specific and industry-specific information) may result;
• that increased transparency and the higher profile of the regulator may encourage irresponsible behaviour by the regulated and investors (i.e. induce moral hazard) if they believe that the risk of an institution being allowed to fail has been reduced (better education of the public can reduce this fear);
• that regulation may lack focus (i.e. on the objectives of supervision);
• that possible difficulties in recruiting and retaining supervisors with the right blend of knowledge, experience and specialist skills may arise (enhanced development and career prospects, however, limit this risk);
• that a loss of important synergies between central banking and banking supervision, leading to less effective supervision and crisis management, may result;
• that problems are likely to arise in co-ordinating the activities of the central bank, the Treasury and regulatory agencies; and
• that there is a risk that the intensification in supervision to be ushered in under the new regime may damage the international competitiveness, and hence attraction, of financial centres, such as the City of London.

So much then for the traditional academic debate, which led most to conclude (see Goodhart et al., 1998) that there is no magical, "one size fits all" formula for delivering the optimal institutional framework governing the regulation and supervision of financial intermediaries, but what has the recent crisis taught us that might alter the balance of argument? As regards responsibility for regulatory "failure", the global evidence is that central banks, such as the US Fed (in its supervision of Citigroup, for example), are no
less susceptible to incompetence than, say, the FSA (in its supervision of Northern Rock, for example). Moreover, the Bank of England came in for severe criticism in the early stages of the crisis for its handling of the lender of last resort liquidity facilities (see Hall, 2008b) and for downplaying its financial stability mandate. This suggests a 'knee jerk' reaction to the FSA's failings, involving returning micro-prudential supervision to the central bank (which, ironically, lost it in part because of its own failings with respect to the supervision of BCCI and Barings – see Hall, 1999, Chapters 11 and 12 respectively), may be unjustified. Moreover, the large but necessary costs incurred in effecting institutional change are no guarantee of success, as policies/people are likely to prove more important than structure. What is clear, however, is that the hoped-for change in supervisory culture – from one based on trust amongst like-minded industry colleagues to a more intrusive, questioning and adversarial approach (Hall, 2001b) – failed to materialise following the handover of the regulatory reins to the FSA in 1997. For whatever reason, as noted earlier, the FSA proved susceptible to special pleading from Government and industry alike for "light touch" regulation – a clear case of political and industry capture of the regulator – in a mistaken belief that to act otherwise would damage the long-term health of the economy through a reduction in the competitiveness of the City. Under Lord Turner, however, there is a clear recognition that this approach was mistaken and, given the introduction of the SEP (post-Northern Rock) and its subsequent enhancement, that regulatory culture at the FSA has finally changed in the direction originally envisaged. Accordingly, I personally believe (see Appendix 6, Part A, last column) – like the Bank of England, the FSA and the Government – that the Conservatives would be wrong to transfer responsibility for micro-prudential regulation back to the central bank.
The choice of institution to discharge newly-granted macro-prudential powers, however, is somewhat different. In the run-up to publication of the Government's White Paper, "turf wars" broke out between the Bank of England and the FSA as to who should receive the new powers. The Governor of the Bank argued vociferously (for example, in his Mansion House speech of 17 June 2009) that the Bank did not have sufficient powers to allow it to fulfil its newly-acquired financial stability mandate (see also Bank of England, 2009b). Specifically, it wanted to be in charge of triggering the 'Special Resolution Regime' (the current preserve of the FSA) as well as having operational responsibility for it, and to be given the new macro-prudential powers identified in the Turner Review. In contrast, Lord Turner argued (for example, in his appearance before the Treasury Select Committee on 23 June 2009) that responsibilities for macro-prudential regulation should be shared between the FSA and the Bank to avoid "wasteful, competitive behaviour", a view first espoused in his earlier Review. The Government, meanwhile, is happy to await international agreement on what the new macro-prudential toolkit should be and how it should be used before determining institutional responsibility for the new regime, a stance backed by the Treasury Committee (House of Commons, 2009c, p.58, para.24). [Cynics might argue that, to do otherwise, would be futile given the almost inevitability of a change in government this Summer, with the Conservatives committed to awarding the new powers and responsibilities to the Bank (a new 'Financial Policy Committee' would be created for the purpose).] Personal preference, despite favouring the FSA's retention of micro-prudential powers, is indeed for such powers and responsibilities to be given to the Bank, to allow it to deliver on its financial stability mandate which, I suggest, should not be diluted by the Government's proposal to give the FSA its own statutory objective for financial stability, which threatens to blur accountability. Such an arrangement would mirror to a degree that planned for adoption at
the EU level, where the central bank members of the new 'European Systemic Risk Board' are charged with monitoring and advising on (but not implementing) policies to be adopted by Member States to mitigate systemic risk, while the 'European System of Financial Supervisors' will focus on the co-ordination of supervision at the micro-level.

Closely aligned to the debate about the division of responsibilities for micro- and macro-prudential regulation is the question over the future of the current "Tripartite Arrangements" based on the "Memorandum of Understanding". In the Conservatives' model, a new 'Financial Policy Committee', comprising Bank officials and independent members, would replace the current Standing Committee of Bank, FSA and Treasury officials. In contrast, the Government has proposed (HM Treasury, 2009f, paras 4.7 to 4.22) that a 'Council for Financial Stability', comprising representatives from the current Tripartite Authorities (but also benefiting from outside expertise) and chaired by the Chancellor, replace the existing Standing Committee and that its terms of reference replace the Memorandum of Understanding. [A draft of these terms of reference was published alongside the Financial Services Bill in November 2009, which also contained provisions relating to the introduction of a new, explicit financial stability objective for the FSA, the enhancement of the FSA's powers, restrictions on bonuses (i.e. a ban on multi-year guaranteed bonuses, mandatory deferral of most bonuses and clauses allowing banks to claw back bonuses in certain circumstances) and living wills (so-called 'Recovery and Resolution Plans'.] Its objectives will be to analyse and examine emerging risks to UK financial stability and co-ordinate the appropriate response, as well as to discuss and co-ordinate the UK authorities' position on EU and international financial stability regulatory policy issues. Increased accountability and transparency – the minutes of the regular standing meetings will be published, subject to confidentiality constraints posed by market
sensitive information – are assumed to deliver advances on the current regime. As for the views of the FSA and the Treasury, officials from both of which were at pains not to criticise the Tripartite Arrangements in their appearances before the Treasury Select Committee in the early days of the crisis (see Hall, 2008b), the FSA has since (see above and in evidence given to the Treasury Select Committee on 27 June 2009) praised the virtues of reconstituting the Financial Stability Committee as a joint committee of the Bank and the FSA, while the Bank has called for new protocols covering communication and information-sharing, especially with the FSA. Neither has commented, however, on the revised Tripartite Arrangements.

Clearly then, there is much disagreement over how to reform the current Tripartite Arrangements and the 'Memorandum of Understanding' on which they are based. Like the House of Commons Treasury Committee, however, I believe that, despite the system's obvious failure with respect to Northern Rock, little good would come from its dismantling (Hall, 2008b). Accordingly, personal preference is for a re-defining of the roles and responsibilities of the current Standing Committee members with a strengthening of lines of communication, and clarification of who is in charge overall – the Treasury. The impression one gets from its operation in the run up to and during the crisis is that no one was in overall control with each party possessing an effective power of veto (hence, for example, the delay in the Bank's provision of emergency liquidity support to Northern Rock and the market more generally). The current situation, where the Prime Minister is apparently hardly on talking terms with the Chancellor because of the former's failed attempt to move the latter at the last Cabinet reshuffle, the Governor of the Bank and the Chancellor are similarly distanced and the Bank and the FSA are still at loggerheads over who should do what in the brave new world, is clearly untenable. Much
damage is being done to the UK’s reputation for providing a lead on what constitutes strong, cost-effective regulation, while the evidence of a dysfunctional Government is damaging the credibility of the administration in its attempts to fashion an internationally-agreed response to the financial crisis. The sooner relationships between the interested parties are returned to normality, albeit subject to a redefinition of roles and responsibilities, the better.

The final main area of disagreement over financial architecture relates to deposit protection arrangements. For, while the Government and the FSA (and possibly the Bank of England) are happy to allow the FSA to continue to run the FSCS, as amended from time to time, the Conservatives will pass the mantle to either the new Consumer Protection Agency or the Bank of England (to facilitate failure resolution). My own preference, as argued elsewhere (see, for example, Hall, 2009c), is for the creation of a new 'Deposit Protection Agency' which would assume responsibility for administration of a new Deposit Protection Scheme (no longer a sub-scheme of the FSCS) and for resolving failed institutions, as is done in the US by the FDIC. In this way, the deposit protection function would be aligned more closely with failure resolution but separated from the monetary policy and prudential supervision functions, with the last-mentioned being split between the Bank and the FSA along macro/micro prudential lines. This would, of course, necessitate agreement on the nature of the co-operation and co-ordination required between the four agencies and the drafting of protocols to deliver it.
2.2.5 Summary and Conclusions on Regulatory Reform

As the financial crisis subsides and the global economy slowly recovers from its worst shock in over 60 years, there must be a danger that complacency sets in and banks return to pre-crisis modes of behaviour. This must not be allowed to happen if history is not to repeat itself and trust is to be restored with customers. Of course, over-regulation and a stifling of (useful) innovation and entrepreneurial activity should also be avoided but the world has to accept that, in the future, the interests of ordinary citizens require that state-subsidised risk-taking be substantially reduced. Primarily effected through increased capital charges, to more closely reflect risk-taking (including the operation of risky bonus structures) but also to internalise the costs of being "too-big-to-fail" or "too-interconnected-to-fail", such action will inevitably lead to lower rates of return on capital and assets and thereby cause a reduction in both size (assisted by a maximum leverage ratio) and profitability and hence remuneration. The real challenges, however, have yet to be faced – the calibration of these additional charges (see FSA, 2009k) and the timing of their implementation. Improved regulation of liquidity has also been shown to be essential, at both the micro and macro level. Apart from enhanced micro-prudential supervision, a simultaneous focus on macro-prudential regulation and supervision has also proved necessary, both to reduce systemic risks and to reduce the degree of pro-cyclicality inherent in financial regulation (where accounting reform can also help). The most appropriate financial architecture to deliver all this, however, has yet to be resolved.

Closely allied to these issues is the design of failure resolution mechanisms, where arrangements for dealing with failed investment banks and large, cross-border institutions have yet to be added to the armoury provided by the 'Special Resolution Regime' introduced under the Banking Act of February 2009. And agreement on the introduction of
"living wills" by such institutions would greatly facilitate orderly resolution of failed entities, at minimum cost to society.

Failings in corporate governance and market discipline were also contributors to the severity of the crisis and both are now being addressed, although it remains to be seen how effective the proposed reforms turn out to be.

Consumer protection issues have, of course, also come to the fore in the wake of the obvious abuse perpetrated prior to the crisis, and with this a call for enhanced depositor protection. While the latter has already been delivered, much still remains to be done to maximise the cost-effectiveness of compensation arrangements. Additionally, with the consumer in mind, there is now a clear need to re-focus on competition issues given the ever-increasing consolidation being witnessed in the domestic banking industry, a situation worsened by the failure resolution policies adopted by the authorities.

And, of course, much of this will ideally be done under an internationally-agreed approach, to minimise opportunities for regulatory arbitrage and thus protect the domestic market share of international business.

At the end of the day, it will be down to ordinary people – regulators, central bankers, supervisors, auditors, compliance officers, board members, etc. – to deliver what society expects from reform, whatever the design of policy and the form of the institutional architecture and financial infrastructure put in place to facilitate it. It can only be hoped that, like the bankers and the traders, they are incentivised to act in accordance with the
wishes of the majority and prove up to the task of restraining the actions of those who should perhaps now be dubbed the 'Destroyers of the Universe'!
2.3 Bank of England's Emergency Liquidity Operations

Apart from its usual money market operations, which have been used to deliver the policy rate set by the Monetary Policy Committee – which was cut to a 315-year low of 1 per cent in February 2009 and to 0.5 per cent the following month, where it has remained ever since – the Bank has engaged in a variety of extraordinary actions to pump liquidity into the system since the Autumn of 2007 following an initial reluctance to act (see Hall, 2009b). This has involved, *inter alia*, an extension in the period of emergency lending from overnight to three months, a widening of the range of acceptable collateral, the use of public auctions to dispense the funds, the offering of dollar-denominated funds, and, more recently, the introduction of two new schemes – the 'Special Liquidity Scheme' and the 'Asset Purchase Facility'. The purpose of these schemes is explored immediately below.

With respect to the 'Special Liquidity Scheme', which was unveiled on the 21 April 2008, the objectives were to remove the fear of bank insolvencies arising from illiquidity, thereby stimulating interbank lending, to ease liquidity problems and, as a side effect, to bear down on three-month interbank rates. Contrary to government assertions, the Scheme was *not* designed to boost mortgage lending or prevent a housing market correction, nor to bail out weak banks or building societies. The Scheme works by allowing banks and large building societies to swap their illiquid securities backed by mortgages made before 1 January 2008, or by credit card debts, for Treasury bills for a period of up to 364 days. The Bank's, and thus the taxpayers', interests are protected by the following measures: only triple-A-rated paper will be accepted by the Bank; the banks retain all of the credit risk on their ABS (value-impaired securities must be replaced with additional triple-A-rated securities or the Treasury bills otherwise returned immediately); the ABS accepted by the Bank will be subject to a discount (or "haircut") on their market value of between 1p. and
20p. in the pound, the Bank having the right to change the size of the discounts on a daily basis; and the Bank charging the banks entering into the swap arrangements a fee, calculated as the gap between the three-month LIBOR rate and the secured three-month gilt repo rate, subject to a minimum charge of 0.2 per cent. Originally, £50 billion was made available under the Scheme but this was subsequently increased to £200 billion as part of the industry bailout package of October 2008. By the end of January 2009, £185 billion of assistance had been provided under the Scheme (see the entry for 3 February 2009 in Table 2.2 for further details). The Scheme is due to be wound up by October 2011 at the latest, and will be replaced by a permanent system of liquidity support for troubled banks. This will be additional to the existing 'Standing Facilities', which were modified in October 2008 (see entry for 16 October 2008 in Table 2 of Hall, 2009a) to include, inter alia, a new "discount window facility" which allows banks to swap their less liquid assets for government bills for a period of one month (increased to one year in January 2009) in return for the payment of a fee which reflects the size of the loan, the term of the loan and the quality of collateral offered.

As for the Asset Purchase Facility (APF), this was introduced as part of the second industry bailout package introduced in January 2009 (see Section 2.1.2 above). Under the scheme, the Bank would initially purchase, through a newly-created subsidiary, up to £50 billion of "high quality" (i.e. investment grade or better) private sector assets, such as commercial paper (Bank of England, 2009c), with the Treasury indemnifying the Bank against loss. The purchases, however, would be "funded" (i.e. "sterilised"), with the Treasury issuing Treasury bills to finance the purchases, thereby nullifying the impact of the purchases on the money supply. The intention of the policy initiative was to widen (large) corporates' access to credit and reduce their costs of funding, thereby boosting the
real economy. Through the creation of the APF, the Government also opened the door for the Bank to move towards "quantitative easing" (i.e. unsterilised asset purchases), involving the creation of base money, widely characterised as the "printing of money") should it prove necessary in the wake of its effective policy rate falling towards zero, a policy already prevalent in the US and adopted long ago in Japan in the face of seven years of deflation and near-zero nominal policy rates (Hall, 1999b).

In March 2009, the Bank announced the formal start of its quantitative easing policy. With a view to boosting the (broad) money supply and raising nominal spending in the economy to around five per cent per annum, the Bank said it would purchase up to £75 billion of gilts of between five and 25 year maturities, with the possibility of another £75 billion of purchases (of gilts and corporate securities) to follow. The gilt purchases, apart from directly boosting the money supply or base money, according to whether the seller is from the non-bank private sector or banking sector respectively, would hopefully reduce gilt yields with knock-on-effects for corporates' cost of funding. By 9 April 2009, some £26 billion had been spent, mostly on gilts, although yields had not fallen as much as hoped for and a two-tier market in corporate debt had emerged, with only the yields on the highest-quality bonds falling, as the Bank's corporate bond purchase were exclusively focussed there. By 7 May 2009, £51 billion had been spent on gilts, about £1 billion on corporate bonds and £4 billion on commercial paper, with the Bank committing itself to a further £50 billion of purchases. Of this expanded £125 billion facility, by 8 June 2009, £77 billion had been spent on government bond purchases, £2.2 billion on corporate bond purchases and £700 million on commercial paper purchases (which can now include such securities backed by trade receivables, equipment leases and short-term consumer credit). By 3 July 2009, the Bank's gilt purchases had topped £100 billion, at £103 billion, with £3
billion being spent on other securities; and by end-July the full £125 billion had been spent. On 6 August 2009, the Bank (i.e. the Monetary Policy Committee) announced a further £50 billion expansion of the scheme, raising the total to £175 billion (£25 million above the previously-authorised limit) because the recession was proving deeper than anticipated and, despite some easing of credit conditions, lending to businesses was continuing to fall and the spreads on such loans remained relatively high. By the 8 October, £158 billion had been spent, all bar £2 billion on government bonds. Finally, the Scheme was expanded in November 2009 by a further £25 billion, taking the total amount of unsterilised Bank purchases to £200 billion.

While it is probably too early to come to any definitive conclusion about the success or otherwise of the APF, whose effects on the real economy may take upwards of six to nine months to materialise, existing evidence questions its overall effectiveness despite the stabilising effects of the massive injection of liquidity. Firstly, with respect to its impact on bond yields, although some corporate bond yields have fallen, there has been little change in gilt yields (buoyed by concerns over the volume of future public debt issuance) compared to their levels in March 2009 before quantitative easing began. This, however, begs the question of what they might have been had the policy not been introduced, to which there is no clear answer. Secondly, with respect to its impact on broad money (M4, after stripping out distortions, is the preferred indicator of the Bank), the huge increase in bank reserves (they rose by over £111 billion, or nearly 2,000 per cent, in the three months to end-July 2009) has not translated into a meaningful surge in broad money, which grew by 3.7 per cent, at an annualised rate, in the second quarter of 2009 for example compared with a 3.3 per cent increase in the first quarter. This mirrors the Japanese experience of the 1990s, as banks chose to hoard their new-found liquidity rather than expand lending in a
recession and their customers (personal and corporate) continued to "deleverage". As a result, the Bank is known to be examining the merits of slashing interest paid on banks' cash reserves held at the central bank, which amounted to £161 billion at end-July 2009, possibly to negative levels. Moreover, with the Bank focussing its purchases almost exclusively on public sector assets, presumably to protect the quality of its balance sheet (unrealised capital losses on bond purchases amounted to £3.6 billion by mid-January 2010), little direct assistance has been provided to private capital markets, to the consternation of the IMF. In the process, it has become the dominant player in the market (it now owns more than 20 per cent of the gilts in existence), thereby reducing liquidity and increasing volatility – although it has helped to absorb, along with the banks, the dramatically-increased net new issuance necessitated by the ballooning public deficit (see Section 2.4 below). Whether or not to further expand the size of the programme and the timing of the eventual unravelling of the programme – reminiscent of the run-down of the "bill mountain" in the 1980s once the policy of "overfunding" had been abandoned (see Hall, 1983) – are the crucial decisions facing the authorities in the short- to medium-term respectively. Although the threat of deflation has not yet totally disappeared and the recovery remains fragile (Bank of England, 2009d), nifty footwork will eventually be required to prevent persistent overshooting of the inflation target and reduce the risk of another asset price bubble emerging. The CPI, for example, was 2.9 per cent in December 2009 compared with the target of 2 per cent, having jumped, by the largest amount ever, from 1.9 per cent the previous month. While this unexpected rise is only expected to be temporary, reflecting the price falls of a year earlier arising from the temporary cut in VAT to 15 per cent, the drop in petrol prices and retail discounting in the face of recession, the trend rise in the CPI has been consistently under-estimated by most analysts in recent months.
2.4 Fiscal Policy

The UK Government was one of the first, after the US and China, to recognise the need for a substantial fiscal stimulus to offset the contractionary effect of the sub-prime-induced credit crunch. This was initially reflected in the Chancellor's announcement of 29 October 2008 that he was suspending Labour's "fiscal rules" – relating to the previous policies of confining borrowing over the economic cycle to the financing of investment and capping the debt to GDP ratio at 40 per cent – to allow for increased borrowing and lending during the downturn to mitigate the severity of the credit crunch's effects on the real economy. The volte face in policy was subsequently confirmed by the Prime Minister on the 10 November 2008 on the grounds that extraordinary times demand extraordinary policy actions, repeating the Governor of the Bank of England's justification for its (eventual) adoption of unconventional measures on the monetary policy front.

The Government's full intentions were revealed shortly afterwards, with the delivery of the Pre-Budget Report on 24 November 2008 (HM Treasury, 2008). A £20 billion fiscal stimulus, amounting to around 1 per cent of GDP, would be delivered for just over a year to try and dampen the severity of the downturn (by around 0.5 per cent of GDP). The main expansionary forces derive from an immediate cut in VAT – from 17½ per cent to 15 per cent – programmed to last until end-2009, and the bringing forward of £3 billion of capital expenditure from future years. To convince the markets of the Government's commitment to returning to fiscal "responsibility" as soon as circumstances allow – 2015/16 was the suggested date – the Government simultaneously announced a series of deferred tax rises and planned expenditure cuts. On its own reckoning, however, the implications of its policies for the public finances were profound. Public borrowing was forecast to hit a record level of £118 billion (equivalent to 8 per cent of GDP) in 2009/10 falling to a
"prudent" level only by 2015/16. And government net debt was forecast to reach 57 per cent of GDP by 2012/13, exceeding £1 trillion for the first time in 2012. And these projections were based on what are likely to prove wildly over-optimistic assumptions concerning growth forecasts (see IFS, 2009; House of Commons, 2008b) – the economy was expected to contract by between 0.75 per cent and 1.25 per cent in 2009, with growth resuming in the second half of 2009 to deliver growth of between 1.5 per cent and 2 per cent in 2010 and between 2.75 per cent and 3.25 per cent in 2011 and thereafter – and the scale of additional "efficiency savings" that can be squeezed from the public sector.

As for the funding implications of the fiscal stimulus, the Government, however, remained of the opinion that despite record planned issuance of gilts - £146.4 billion in the financial year ending 4 April 2009, three times greater than in the previous year and the biggest annual amount ever, and averaging £134.2 billion over the next five years – and the dramatic rise in planned global public sector bond issuance (put at around $3 trillion for 2009, three times the amount raised in 2008), the UK Government would not face particularly acute problems, on either the price or quantity front. As reasons for this relatively sanguine view they cited: continued demand arising from investors' low appetite for risk; the apparent recent given to overseas sales by the fall in the value of sterling (36 percent of outstanding gilt issuance was in foreign hands at end-September 2008); a relatively low level for the UK's current debt to GDP ratio compared with other industrialised nations; and the increased demand from domestic banks that will result from changes to the FSA's liquidity adequacy assessment regime (see FSA, 2009d). The middle two of these factors, however, could change rapidly if market circumstances change (i.e. if fears of a deeper sterling crisis or of large scale losses on bank bailouts emerge; and, if and
when risk appetite returns, investors may not necessarily favour UK public sector
securities over UK corporate or overseas debt.

Apart from a rise in the cost of insuring in the credit default swaps market against
default by the UK Government on its debt – it stood at 97 basis points on the 26
November 2008 compared with 52 basis points for US Government debt – the first sign of
possible market unease over the state of public finances came with the Government's
failure to sell all of the gilts put up for auction on 25 March 2009. This was the first time
in seven years and only the fourth time since auctions began in 1986 that this had
happened. While the shortfall in demand may have resulted, in part, from the maturity of
the gilts offered for sale – 40 years to maturity instead of the usual five to 25 year
maturities – the fear was that this might be a sign of things to come as investors undertake
a fundamental re-appraisal of the risks involved in investing in UK gilts.

The delivery of the Budget on the 22 April 2009 (HM Treasury, 2009i) confirmed the
widespread fears over optimistic growth forecasts raised at the time of the Pre-Budget
Report's publication. For, at least for 2009, the Government had finally fallen into line
with independent forecasters, now forecasting a contraction of between 3¼ per cent and
3¾ per cent (although this was thrown into doubt only two days later following the release
of figures showing that the UK economy contracted by 1.9 per cent in the first three
months of 2009 alone, subsequently revised to 2.4 per cent) compared with a figure of 3.7
per cent as an average of independent forecasters and an IMF forecast of 4.1 percent (IMF,
2009b), later raised to 4.25 per cent (IMF, 2009c, p.4). Moreover, forecasts for 2010 and
beyond were way out of line with independent forecasters. For example, in 2010 the
Government expected growth to resume at a rate of between 1 per cent and 1½ per cent,
only slightly less than forecast in the Pre-Budget Report the previous November. In contrast, the average of independent forecasters stood at a meagre 0.3 per cent; while the IMF (ibid.) believed the UK economy would actually contract by 0.4 per cent. More worrying, was the size of the bounce expected in 2011 – growth of between 3¼ per cent and 3¾ was anticipated compared with an average independent forecast of 1.9 per cent. And beyond 2011, trend growth of 2.75 per cent per annum was assumed. Although the Government's forecast for 2009 proved accurate – output contracted by only 0.7 per cent in the second quarter, by 0.3 per cent in the third quarter, then rose by a 0.1 per cent in the fourth quarter – the forecasts beyond then are less believable (House of Commons, 2009d, p.11), with even the Governor of the Bank of England predicting a slow and modest recovery. More realistic growth assumptions, as well as more conservative estimates for public sector efficiency savings (House of Commons, 2009e) and the costs of financial stabilisation policies (i.e. direct bank support, guarantees and emergency liquidity provision), would see the already worryingly high public sector borrowing and debt figures spiral even higher. On the Government's own estimates, public sector net borrowing was now expected to be £175 billion in 2009/10, equivalent to 12.4 per cent of GDP, £173 billion in 2010/11 (11.9 per cent), falling to £97 billion (5.5 per cent) in 2013/14. And the budget was not expected to return to "balance" until 2017/18, two years later than forecast only last November. Meanwhile, public sector net debt is forecast to increase, as a share of GDP, from 59 per cent in 2009/10 to 79 per cent in 2013/14, after allowing for potential losses on financial stabilisation initiatives already undertaken of around £50 billion (equivalent to 3½ per cent of GDP). Although the Government argued the latter was a conservative estimate, and will be lowered following the revised APS arrangements, the IMF put the likely losses at nearer £135 billion (over 9 per cent of GDP)
in April 2009 (IMF, 2009b, pp.44/45) on gross liabilities exceeding 60 per cent of GDP (IMF, 2009d, p.18). [See also National Audit Office, 2009, pp.36-40.]

Overall, the April 2009 budget provided for some fiscal easing, equivalent to about 0.5 per cent of GDP, in 2009/10 followed by a tightening of 0.8 per cent of GDP until 2013/14. The immediate stimulus reflected the support provided for industry, the housing market and the unemployed. The planned fiscal tightening for the medium to long term was reflected in the forecast for public spending, which, as a proportion of GDP, was expected to fall from 48 per cent in 2009/10 to 39 per cent by 2017/18. Annual growth in real public sector spending was being cut from its current level of 1.2 per cent to 0.7 per cent by 2011; and capital expenditure, in cash terms, was being halved from £44 billion this year to £22 billion in 2013/14, with public sector net investment falling to 1¼ per cent of GDP by 2013/14. Even deeper cuts and/or greater tax rises were postponed through the adoption of over-optimistic growth forecasts.

Despite the Prime Minister's clear pronouncements in the run up to the Budget that a further substantial stimulus would be delivered, in the event the Government backtracked in the face of opposition from the Bank of England and others amid fears about the impact on public debt and borrowing levels. Such action proved prescient for, the following month, Standard and Poor's lowered, for the first time since 1978, its medium-term outlook for UK debt from "stable" to "negative" on concerns that net government debt might shortly approach 100 per cent of national income and stay there (IMF, 2009c, p.26). Loss of its "triple A" rating for medium-term debt would make life difficult for the Government as it tries to sell record amounts of gilts to fund its burgeoning budget deficits at "reasonable" rates of interest. Although Fitch Ratings, in July 2009, also announced that
its triple A rating for UK government debt was under threat for similar reasons (i.e. because a more aggressive medium-term fiscal consolidation strategy than that set out in the 2009 Budget was necessary), the ratings agencies have since rowed back from such "threats" in the light of politicians' (of all persuasions) clear recognition of the need for stronger and faster fiscal consolidation. As noted by the IMF (2009d, p.6) and the House of Commons (2009d, p.30; 2009e, p.44) however, the credibility of such plans would be enhanced by early clarification of the necessary adjustment. Accordingly, the current political debate surrounding the state of the nation's finances focuses on both the timing of the planned fiscal consolidation – the Conservative Party favouring earlier cuts than the Government is envisaging, the latter worried as much about its election prospects as the risk of prematurely ending the nascent recovery- and its precise format.

The Government's view was clearly evident in the last Pre-Budget Report to be delivered before the General Election. For, as explained in the entry for the 7.12.09 in Table 2.2, most of the "pain" – e.g. increases in national insurance contributions and a capping of public sector pay settlements – only kicks in during fiscal year 2011/12, with a government spending increase of £31 billion confirmed for 2010/11. Moreover, no attempt had been made to explain where the public spending axe would eventually fall (the budgets for health, schools and the police are to be ring-fenced). As for the forecast of the impact of the planned measures on the nation's finances, public net borrowing is forecast to rise by only £3 billion (to £178 billion) in 2009/10, compared with the latest forecasts, falling to £82 billion by 2014/15. Meanwhile, public sector net debt is forecast to rise from the current 44 per cent of GDP to 78 per cent by 2014, breaking through the £1 trillion mark around Summer 2011. As in previous Pre-Budgets/Budgets, these figures are likely to prove unachievable because of the wildly over-optimistic forecasts for medium-term
growth and public sector efficiency savings. With respect to the latter, a further £5 billion of savings have been written into the books; while growth of around 3.5 per cent in both 2011 and 2012 is factored in, following expected growth of between 1 per cent and 1.5 per cent in 2010 (see HM Treasury, 2009j, p.147, Table A3). Although the longest-ever post-war recession did indeed end in the last quarter of 2009, when GDP was provisionally estimated to have grown at a meagre 0.1 per cent – taking the peak-to-trough fall to 6 per cent – there are reasons for believing a strong rebound is highly unlikely and certainly not imminent. This is because of the impact of the January increase in VAT (back to 17.5 per cent), which undoubtedly led many to move planned expenditure forward into December 2009, the intensification in the squeeze on real incomes (particularly for public sector workers), the further "deleveraging" likely to be undertaken by both consumers and the banks (hence continuing to constrict the supply of credit) and the impact of the eventual withdrawal of the extraordinary monetary, fiscal and financial stimuli (which will come sooner rather than later if the Conservatives are elected next Spring). Anaemic growth, at best, is surely all that can be hoped for in the short- to medium- term, with the prospect of a double-dip recession being a distinct possibility, despite the considerable real depreciation of sterling in recent months and strong growth elsewhere in the World, particularly in Asia (although China's rate of growth is likely to be adversely affected by the recent clamp down on bank lending). If this prognosis proves correct – the stall in EU recovery is not helping - medium-term growth of 3.5 per cent per annum looks fanciful.
2.5 Summary and Conclusions on the Main Domestic Developments

Given the vulnerability of its economy – the size of the local property bubble, the scale of consumer indebtedness and the scale of the contribution of the "City" and the financial services sector more generally to economic prosperity (i.e. employment and invisible export earnings) – and tax revenues – the UK was always going to be one of the industrialised nations most badly affected by the financial Tsunami that lapped the world in the wake of the sub-prime crisis originating in the US (IMF, 2009e). And the Government's failure to better balance the books in the good times – a legacy of the Prime Minister's stint as Chancellor – left the public finances seriously exposed to the worsening economic and financial climate. But there were some "silver linings": past fiscal rectitude had kept debt to GDP ratios at relatively-low levels by international standards (i.e. below 40 per cent), providing some additional room for fiscal stimuli should they prove necessary; and, ironically, a relatively-small manufacturing base protected us from the worst effects of the collapse in global trade. These benefits, however, were dwarfed by the weaknesses which soon became apparent in the UK banking system, centred on the existence of: widespread funding gaps, which meant excessive reliance on wholesale funding; a large "shadow" banking system; flawed executive/trader remuneration policies; weak corporate governance; and reckless business strategies, especially with respect to growth (organically or through acquisition) and proprietary trading. These problems were compounded by: poor external oversight, largely as a result of political/industry capture of the FSA which resulted in "light touch" regulation; an inadequate regulatory framework, especially with respect to failure resolution and deposit protection; and untested crisis management arrangements, including the Tripartite arrangements.
The main institutional casualties of the financial Tsunami were Northern Rock (nationalised in February 2008), the Alliance and Leicester (acquired by Banco Santander in July 2008), the Bradford and Bingley (nationalised in June 2008 with its branches being sold to Banco Santander), HBOS (acquired by Lloyds TSB in September 2008 and recapitalised by the Government in October 2008), RBS (recapitalised by the Government in October 2008, whose stake increased to 70 per cent on the subsequent conversion of preference shares to equity) and Lloyds TSB (which enjoyed state recapitalisation of £5.5 billion in October 2008 which, together with the recapitalisation of HBOS, gave the Government a 43.5 per cent stake in the combined entity). Moreover, once the details of the Asset Protection Scheme were finally agreed – commitments in principle were given by RBS/Lloyds Banking Group in February/March 2009 respectively – the Government's economic interest in RBS increased even further – to 84 per cent – although Lloyds Banking Group managed to escape from the clutches of the Scheme.

As for the policy mix adopted for restoring financial stability, the Government can rightly claim to have set in place what ultimately became the IMF's standard prescription, comprising:

- loose monetary policy (policy rates were cut to 0.5 per cent prior to the introduction of 'quantitative easing' under the Bank of England's 'Asset Purchase Facility');
- loose fiscal policy (the budget deficit and debt levels were allowed to increase substantially in the short to medium term);
- a massive infusion (eventually) of emergency liquidity through, for example, the auction of term money and the swapping of Treasury bills for illiquid assets under the 'Special Lending Facility';
• a variety of stabilisation measures, including, *inter alia*, the introduction of new legislation to allow for the nationalisation of failed institutions and other resolution approaches, the reform of deposit protection arrangements, the recapitalisation of sound but weak banks by the State, the brokering of "takeover-rescues", Government insurance of banks' toxic assets and Government guarantees of new debt issuance (the National Audit Office puts the scale of taxpayer support for the financial sector at around £850 billion at the peak of the crisis, with net cash outlays amounting to around £117 billion by end-2009 (National Audit Office, 2009); and

• an intensification in supervision, initially under the FSA's 'Supervisory Enhancement Programme' introduced in the wake of the Northern Rock affair. [Plans are also afoot to boost banks' liquidity buffers and revise bank capital adequacy rules by requiring bigger overall capital cushions, imposing higher capital charges against trading book exposures, focussing more on core tier one capital and introducing new requirements with respect to counter-cyclical reserving and provisioning, a back-stop leverage ratio and systemically-important institutions.]

With the benefit of hindsight, it is clear that a number of serious policy errors were made. The main ones comprise: the initial Bank of England lethargy in providing system-wide emergency liquidity support (most argue due to an obsession with moral hazard and an under-estimation of the severity and durability of the crisis); the slowness with which the Monetary Policy Committee at the Bank of England cut policy rates (the reasons put forward for it being "behind the curve" for too long are poor judgment and inadequate models by which to judge the success of policy); the Government's promotion of the
takeover-rescue of HBOS by Lloyds TSB (again, the Prime Minister's fingerprints are all over the deal); and the adoption of a "light touch" supervisory approach by the FSA, "cowed" by politicians and the banking industry alike.

So what, then, are we to make of the Tripartite authorities' plans for the future? Much discussion has focussed on so-called "exit strategies", in the UK's case from state investment in banks, accommodative monetary policy and loose fiscal policy. None have, as yet, been fully articulated, in part for political reasons given the imminence of the next General Election (no later than June 2010). It remains to be seen how soon UK Investments Limited divests itself of the Government's bank holdings, and how much, if anything, UK taxpayers eventually end up losing from such activities. As for monetary policy, there is much debate about the effectiveness, to date, of the Bank's "quantitative easing" policy, and about whether it should be scaled up or down and when. The timing of exit will again be crucial as neither the Bank nor the Government want to bring to a premature end the nascent recovery, nor do they wish to stimulate a fresh burst of above-target inflation in the medium to longer term. Similarly, the timing of the introduction of stronger fiscal consolidation, whatever its make-up, will sorely exercise the judgment of policymakers as premature action risks slowing and possibly reversing recovery while delay risks antagonising gilt investors and rating agencies. The planned introduction of a legally-binding pledge to reduce the deficit may, however, assuage the fears of the latter.

Apart from deliberating on the future course of action on the quantitative easing front, the Bank has a number of other important issues to address. How will it handle responsibility for micro-prudential supervision if, as seems likely, it regains such powers along with new powers for macro-prudential regulation? Should it campaign for a new
target measure of inflation that explicitly incorporates housing costs? Should it seek to prevent or "prick" asset price bubbles in the future rather than just clearing up the mess once bubbles have burst? Moreover, what can it do to repair the damage done to its reputation by its lethargy in reacting to the global financial crisis and its slowness in getting "ahead of the curve" on the interest rate front, and to its independence as a result of the sending of numerous letters of explanation to the Chancellor for inflation "overshoots" and of the introduction of quantitative easing (the scale of which requires the Treasury's consent because of potential public sector liability)?

For the FSA, whose future looks decidedly uncertain, a number of questions have yet to be answered, notwithstanding its belated attempt to get its act together under the stewardship of Lord Turner. Were its pre-Turner failings systemic rather than one-off, as argued in its internal post mortem on Northern Rock? Why did it bow to political/industry pressure for "light touch" regulation? And why did it not see fit to challenge the broad strategic objectives, especially for growth, of bank boards?

Likewise, the Treasury has a number of questions to answer before moving on to reform the UK's financial regulatory framework, about which there remains much controversy. Why does it believe its proposed reform of the Tripartite arrangements, given its similarity with existing arrangements, will deliver better results in the future than was the case with respect to Northern Rock? Do its proposals for deposit protection reform go far enough? Why weren't "Prompt Correction Action"-type measures explicitly incorporated within the "Special Resolution Regime" provisions of the Banking Act of February 2009? And why was the Financial Stability Committee, set up to oversee the Bank of England's performance with respect to a new statutory responsibility for
"contributing to the maintenance of financial stability within the UK", made a sub-committee of the Bank's Court, chaired by the Governor himself?

As far as the Government is concerned, and putting aside its responsibility for putting the real economy into such a vulnerable position pre-crisis and for pushing for the adoption of "light touch" supervision during the benign period of economic growth post-1977, it can rightly congratulate itself for pulling back the UK financial system "from the brink" in the Autumn of 2008 following the collapse of Lehman Brothers in the US. Its preferred policy mix of direct state recapitalisation of ailing banks, the state guarantee of new bank debt issuance, and a massive temporary infusion of emergency liquidity support – later complemented by the state insurance of banks' toxic assets – within a comprehensive, industry-wide bailout programme became widely accepted as "best practice". Similarly, its response on the fiscal front proved eminently sensible, despite reservations in many quarters. Unfortunately for it, however, it is unlikely to remain in power long enough to see if its gamble, using taxpayers' money, paid off.

Finally, with an eye firmly on the future, the Conservative Party, the most likely winners of the next General Election, have a number of serious issues on which to ponder. The first relates to the future conduct of fiscal policy where, as alluded to earlier, both the timing and design of fiscal consolidation will be crucial to the future development of the real economy, with concomitant implications for the current and future generations of UK taxpayers. And secondly, their proposed reform of UK financial regulation, although possessing some merits, does risk seriously de-stabilising the supervisory process. For, although it largely accepts the blueprint for reform outlined in the Turner Report, as does the current Government under its White Paper, its proposals for reshaping the architectural
landscape would see massive upheaval without the guarantee of improved results. And, even if the transition to the new framework could be managed smoothly, the costs, pecuniary and otherwise, would prove substantial. A more evolutionary approach, rather than revolutionary, might be advisable although, whatever the outcome, the current opposition party is right to emphasise the need for a new focus on competition policy, given the consolidation that has taken place in the UK financial services sector in recent years, a process exacerbated by the Government’s chosen mechanisms for handling institutional failure.
3. MAIN INTERNATIONAL DEVELOPMENTS

3.1  Recent G20 Action

As one of the main fora driving the global reform and recovery process, the G20's actions are critical to restoration of health to the global economy and hence merit close attention. In 2009, summits were held in both London and Pittsburg and a summary of the respective communiqués is provided below.

The first communiqué, issued on 2 April 2009 following the London summit, comprised commitments to tackle the global economic downturn through delivery of a $1.1 trillion support package, including support for lower income countries and a boost to IMF resources, and to tighten financial regulation with a view to strengthening the international financial system (G20, 2009c).

With respect to the $1.1 trillion support package, unfortunately little new money/pledges were involved. The $500 billion 'boost' to the IMF's resources, for example, which can be used to assist countries struggling during the crisis (through a more flexible 'New Arrangement to Borrow') had already been promised by the likes of Japan ($100 billion) and the EU (€75 billion), with the IMF starting off with around $250 billion in the kitty. No new commitments were forthcoming. Of the proposed $250 billion increase in SDRs, these will be allocated in line with voting shares at the IMF, meaning that 44 per cent will go to the G7 countries, with only $80 billion accruing to middle income and poor countries combined. On trade finance, the G20 hoped that up to $250 billion would be provided to finance or guarantee trade over the next two years, although less than $25 billion was committed to financing new trade in 2009. In contrast, much of
the $100 billion committed to assisting the poorest nations through the funding of the multilateral development banks did represent "new money" (in the form of increased resources and borrowing from financial markets), although some was brought forward from future budgets.

As for the reform of financial regulation, a new clampdown on tax havens was promised, along with the regulation of systemically-important hedge funds and rating agencies, increased capital requirements for banks, curbs on bankers' pay and the creation of a new 'Financial Stability Board' (the re-named 'Financial Stability Forum') to monitor global financial stability and promote medium-term reform, alongside the IMF. All G20 members would have a seat on the new Board.

In advance of the Pittsburg summit, a meeting of the G20 finance ministers and central bank governors was held in London during the 4th and 5th September 2009. Broad agreement was reached on the following, with the Pittsburg summit being charged with delivering the detail: the need to further strengthen the financial system; the need to develop, together with the IMF and the FSB, co-operation and co-ordinated exit policies with respect to the extraordinary fiscal, monetary and financial support provided during the crisis once recovery is firmly secured; a re-affirmation of the commitment to fight all forms of protectionism; the need to secure an orderly rebalancing of global demand and to promote the efficient functioning of global markets; and the need to do more to strengthen the IFIs (G20, 2009a).

Finally, with regard to the Pittsburg summit, a communiqué was issued on the 25 September (G20, 2009b). Having reviewed the progress made since the London summit
and the apparent success of their joint efforts to stabilise the global economy and repair financial systems, the G20 leaders pledged (G20, 2009d) to avoid a premature withdrawal of stimulatory action whilst designing appropriate exit strategies for implementation once firm recovery is secured. Commitments were then given to the taking of additional steps to: (i) ensure strong, sustainable and balanced growth; (ii) build a stronger international financial system; (iii) reduce development imbalances; and (iv) modernise the architecture for international economic co-operation. The means for delivering these promises are explored in more detail immediately below.

With respect to delivering a framework for strong, sustainable and balanced growth, the G20 members agreed to adopt a set of "core values" (see G20, 2009b, the Annex) while signing up to the following shared policy commitments: to implement responsible fiscal policies, attentive to short-term flexibility considerations and longer-run sustainability requirements; to strengthen financial supervision to prevent the re-emergence in the financial system of excess credit growth and excess leverage and to undertake macro-prudential and regulatory policies to help prevent credit and asset price cycles from becoming forces of destabilisation; to promote more balanced current accounts and support open trade and investment to advance global prosperity and growth sustainability, while actively rejecting protectionist measures; to undertake monetary policies consistent with price stability in the context of market-oriented exchange rates that reflect underlying economic fundamentals; to undertake structured reforms to increase potential growth rates and, where needed, to improve social safety nets; and to promote balanced and sustainable economic development in order to narrow development imbalances and reduce poverty. Although, of course, each member bears primary responsibility for the sound management of its economy, the G20 has a responsibility to
the wider community with respect to assuring the overall health of the global economy and, to this end, will engage in regular consultations, seek to strengthen co-operation on macroeconomic policies, exchange experiences on structural policies and assess countries' policies on a continuing basis. Moreover, to assist in the development of the mutual assessment process, Finance Ministers are called upon, with the assistance of the IMF, to: develop a forward-looking assessment of G20 economic development to help analyse whether patterns of demand and supply, credit, debt, and resources growth are supportive of strong, sustainable and balanced growth; assess the implications and consistency of fiscal and monetary policies, credit growth and asset markets, foreign exchange developments, commodities and energy prices, and current account imbalances; and report regularly to both the G20 and IMF on global economic developments, key risks, and concerns with respect to patterns of growth and suggested G20 policy adjustments, individually and collectively. It remains to be seen how this 'brave new world' functions in reality!

As for the promised strengthening of the international financial regulatory system, a range of measures are promised on a number of fronts (for more detail see Section 2.2 of this paper). With respect to building high quality capital and mitigating pro-cyclicality, all major G20 financial centres have committed to the adoption of the Basel II Capital Framework by 2011 and all members have committed to developing, by end-2010 for implementation by end-2012, internationally-agreed rules to improve the quality and quantity of bank capital, discourage excessive leverage and mitigate pro-cyclicality; these measures will complement strengthened liquidity risk requirements and forward-looking provisioning. In connection with the reform of compensation practices to support financial stability, members highlight avoiding multi-year guaranteed bonuses and requiring a
substantial portion of bonuses to be deferred, tied to performance, subject to appropriate clawback and paid in the form of stock or stock-like instruments rather than cash. Members are duly asked to implement the FSB’s ‘sound compensation practice’ standards immediately, and the FSB is asked to monitor implementation of its standards and, if necessary, propose additional measures by March 2010. As for improving over-the-counter (OTC) derivatives markets, this can be achieved by forcing most standardised contracts to be traded on exchanges or electronic trading platforms and cleared through central counterparties by end-2012 at the latest, according to members’ demands. Members are also asked to address cross-border resolutions and systemically-important institutions through, for example, the development of internationally-consistent, firm-specific contingency and resolution plans – the FSB is asked to propose measures relating to more intensive supervision and specific additional capital, liquidity and other prudential requirements by end-October 2010 – and the establishment of crisis management groups for major cross-border firms and a legal framework for crisis intervention as well as improving information-sharing in times of stress. And finally, international accounting bodies are asked to redouble their efforts to achieve a single set of high quality, global accounting standards by June 2011; while the group re-affirms its commitment to fighting "non-co-operative jurisdictions" (NCJs), with a view to ensuring that countries are able to fully enforce their laws to protect their tax bases – this will require enhanced transparency and increased exchanges of information with tax havens – and that the incidence of money laundering and terrorist financing is minimised.

Finally, in connection with the reform of the global financial and development architecture, the G20 calls for reform to the mandates, missions and governance of both the IMF and the Multilateral Development Banks. With respect to the former, the G20
calls on the IMF to play a greater role in promoting global financial stability and rebalancing growth. While applauding the creation of the innovative 'Flexible Credit Line', the group wants the Fund to strengthen its capacity to help its members cope with financial volatility, reducing the economic disruption from sudden swings in capital flows and the perceived need for excessive reserve accumulation. It also wants it to engage more fully in surveillance operations, for example through the analysis of the risks facing the global economy and the international financial system, and through monitoring of countries' policy frameworks and their collective implications for financial stability and the level and pattern of global growth. And, on the governance front, the G20 calls for a shift, of at least 5 per cent, in quota share to dynamic emerging markets and developing countries, while protecting the voting share of the poorest in the IMF. Deliberations on this issue should be part of the IMF's quota review (to be completed by end-2011), and should complement discussions on the appropriate size of any increase in IMF quotas, the size and composition of the Executive Board (the UK government is fearful of losing its seat), ways of enhancing the Board's effectiveness, and the Fund Governors' involvement in the strategic oversight of the IMF.

As for the Multilateral Development Banks, the World Bank, working together with regional development banks and other international organisations, is called upon to strengthen: its focus on food security through enhancements in agricultural productivity and access to technology, and improving access to food, in close co-operation with relevant specialised agencies; its focus on human development and security in the poorest and most challenging environments; support for private-sector led growth and infrastructure to enhance opportunities for the poorest, and raise social and economic inclusion, and economic growth; and contributions to financing the transition to a green
economy through investment in sustainable, clean energy generation and use, energy efficiency and climate resilience. The G20 has committed to ensuring these organisations will have sufficient resources to deliver on these four fronts but also calls on the institutions to strengthen their co-ordination, when appropriate, with other bilateral and multilateral institutions, in order to enhance their effectiveness. Finally, with regard to corporate governance, the G20 wants to see agreements being reached by Spring 2010 that will deliver a significant increase (i.e. of at least 3 per cent) in the voting power accorded developing and transition countries at the World Bank, additional to the 1.46 per cent previously agreed, while protecting the voting power of the smallest poor countries. It remains to be seen if this 'wish list' is granted!
3.2 US Regulatory Reform

Following deliberations on the Treasury's financial reform "blueprint" of March 2009 (US Treasury, 2009b), the US Government's White Paper on Financial Regulatory Reform was published in June 2009 (US Treasury, 2009a). Its proposals were designed to satisfy five main objectives: (i) to promote robust supervision and regulation of financial firms; (ii) to establish comprehensive regulation of financial markets; (iii) to protect consumers and investors from financial abuse; (iv) to provide the Government with the tools it needs to manage financial crises; and (v) to raise international regulatory standards and improve co-operation (the assignment of policy proposals to policy objectives is summarised in Table 3.2).

The principles underlying the proposals to promote robust supervision and regulation of financial firms comprise the following:

(i) all financial institutions critical to market functioning should be subject to strong oversight;

(ii) no financial firm that poses a significant risk for the financial system should be unregulated or weakly regulated;

(iii) there should be clear accountability in financial oversight and supervision;

(iv) similar financial institutions should face the same supervisory and regulatory standards, with no gaps/loopholes or opportunities for arbitrage; and

(v) to compel the largest and most inter-connected financial firms to internalise the costs they could impose on society in the event of failure.

Specifically, the proposals are designed to address a number of regulatory/supervisory "failings" evident during the crisis. Firstly, the regulation and supervision of bank capital
was patently inadequate, with capital requirements against trading book assets, high-risk
loans and off-balance-sheet commitments being set too low, while counter-cyclical
requirements were non-existent. Secondly, bank liquidity buffers also proved woefully
inadequate, as did the complementary "stress testing". Thirdly, there was a complete lack
of "macro-prudential" (as opposed to "micro-prudential") regulation and supervision.
Fourthly, supervisory responsibility was fragmented. Fifthly, there was inconsistency in
regulation and supervision, partly because of the fragmentation of supervisory
responsibility. Sixthly, loopholes in the legal definition of a "bank" created further
opportunities for regulatory arbitrage. Seventhly, inadequate oversight of money market
mutual funds rendered them vulnerable to investor runs. And, eighthly, the failure to cover
all important institutions (e.g. hedge funds and other private pools of capital) further
rendered the financial system vulnerable to systemic risk. While flaws one to three and
eight were common to the UK regulatory and supervisory framework – see Section 2.2 –
the others were due to the idiosyncrasies of the US system (see Hall, 1999a).

With respect to the objective of establishing comprehensive regulation of financial
markets, again the proposals were designed to address a number of problems that
manifested themselves during the recent financial crisis. Specifically, instead of reducing
systemic risk, promoting efficiency and contributing to a better allocation of resources,
financial innovation (such as securitisation and the use of credit derivatives) in fact
concentrated risk in opaque and complex ways due, for example, to a lack of transparency,
the failure of credit ratings to accurately reflect the risk of rated products, a decline in
underwriting standards and poor risk management. Moreover, the market infrastructure
(i.e. payment, clearing and settlement systems) failed to cope with the pace of financial
innovation, while supervision failed to address the issues posed by financial innovation.
Accordingly, proposals have been formulated to strengthen the regulation and supervision of securitisation markets, create comprehensive regulation of all OTC derivatives (including CDS), harmonise the regulation of futures and securities by the CTFC and the SEC, strengthen the oversight of systemically-important payment, clearing and settlement systems (and related activities) and strengthen the settlement capabilities and liquidity resources of systemically-important payment, clearing and settlement systems. Again, most of this reform agenda is common to that of the UK and other EU countries, although distinctive institutional features warrant differential treatment.

Given the abuse witnessed during the recent crisis, there is also a clear need to enhance protection for consumers and investors. The administration's solution is to create a new Consumer Financial Protection Agency (CFPA), with a broad remit to protect consumers, while strengthening investor protection primarily through an expansion in the power and authorities of the SEC.

With respect to enhancing financial crisis management, the Treasury recommends the creation of a new resolution regime for BHCs (including Tier 1 FHCs), to be modelled on the existing regime for insured depository institutions operated under the FDIA, for use when financial stability is threatened. And, following an amendment to Section 13(3) of the Federal Reserve Act, the Fed would be required to secure the prior written approval of the Secretary of the Treasury before activating its emergency lending facilities. The latter move is designed to enhance accountability in the use of crisis tools while the former is designed to allow for the efficient and effective resolution of large, inter-connected bank holding companies (or other non-bank financial firms) at times of stress at least cost to the taxpayer and in a manner which minimises systemic risk; the two current options –
obtaining emergency funding from the Government (as in the case of AIG) or filing for bankruptcy (as in the case of Lehman Brothers) – are both deemed untenable.

The search for new and improved resolution mechanisms for large, inter-connected organisations resonates with UK/EU moves in this area – see Section 2.2 – although the lack of emphasis accorded the use of "living wills" is perhaps a notable difference in the proposed ways forward. Moreover, once again, the detailed US proposals reflect its distinctive institutional arrangements which, for the moment at least, EU policymakers are reluctant to import across the Atlantic (e.g. in relation to the possible establishment of a new 'Deposit Protection Agency' in the UK, as argued for in Section 2.2).

Finally, as regards international financial regulation, the proposals promulgated under this heading are designed to address shortcomings evident in the recent crisis with respect to, inter alia: the regulation of capital standards; the oversight of global financial markets; the supervision of internationally-active financial firms; crisis prevention and management; liquidity risk management; macro-prudential regulation; compensation packages; and the oversight of credit rating agencies. Given these are common concerns with overseas policymakers, unsurprisingly the proposed reforms are designed to be consistent with G20 and other global initiatives.

So much then for the nature of the reform package but what will it mean for US financial sector architecture if it is implemented? First of all, it will mean an extension in the Fed's mandate beyond BHCs and state-chartered member banks to embrace all systemically-important financial institutions (i.e. Tier 1 FHCs). In this way it would become the systemic risk regulator for the exercise of macro-prudential powers. It would
also assume responsibility for overseeing the payment, clearing and settlement systems. Secondly, the FDIC’s roles and responsibilities would remain the same, as would those of the CFTC, the SEC (it has already lost responsibility for supervising investment bank holding companies, of which there are currently none in operation, but would see its registration role extended) and the Federal Housing Finance Agency (FHFA). Thirdly, the OTS would disappear (not unsurprisingly, given its failings with respect to AIG, IndyMac and Washington Mutual). Fourthly, a new National Bank Supervisor, housed within the Treasury and with responsibility for federally-chartered depository institutions, would replace the OCC. Fifthly, a new Office for National Insurance, again housed within the Treasury, would be created to promote national co-ordination of insurance sector regulation and supervision, currently the preserve of the states. Sixthly, a new Consumer Financial Protection Agency would be created to protect consumers across the financial spectrum from unfair, deceptive and abusive practices. And finally, a new 'Financial Services Oversight Council' of financial regulators (comprising the Secretary of the Treasury – as Chairman – the Chairman of the Board of Governors of the Federal Reserve System, the Director of the National Bank Supervisor, the Director of the CFPA, the Chairman of the SEC, the Chairman of the CTFC, the Chairman of the FDIC and the Director of the FHFA) would be created to identify emerging systemic risks and improve inter-agency co-operation.

Given the Conservative Party borrowed some of their ideas from the US Treasury’s reform plan – e.g. with respect to giving the central bank the new macro-prudential powers and creating a separate ‘conduct of business’ regulator (see Section 2.2) – there are undoubted parallels between their financial reform blueprint and that of the US administration. This does not, however, mean that the parallels will persist even if the
Conservatives form the next UK administration. This is because there is currently heated debate in Congress over the shape and substance of the optimal reform package. Many oppose extension of the Fed’s powers and responsibilities because of revealed failings in the run up to and during the crisis (e.g. in allowing asset bubbles to grow and in failing to get to grips with Citigroup and other BHCs) and the potential damage that might be done to its political independence (more responsibilities are likely to lead to more political interference) and economic credibility (already damaged by its handling of Bank of America’s takeover of Merrill Lynch) and the conduct of monetary policy (see Section 2.2). Moreover, as ever, fierce lobbying by regulatory agencies, eager to preserve turf, might yet see the administration’s plans, which elevate the status of the Treasury while emasculating that of the OCC (and the OTS), fall by the wayside. Many also fail to understand the lenient treatment accorded the SEC given its failure to prevent the Bernard Madoff fraud, despite repeated warnings of wrong-doing, and its supervisory failings with respect to investment bank holding companies and broker-dealers. It remains to be seen what Congressional horse-trading finally delivers.\textsuperscript{lxxi}
3.3 Other US Developments

3.3.1 US Fiscal Policy

Like governments in the UK and elsewhere, the US administration adopted a fiscal stimulus package early in 2009 in order to stave off the threat of depression. A $787 billion stimulus package, spread over two years, was duly signed into law on 17 February 2009. It was designed, in part, to create or save 3.5 million jobs – the unemployment rate at that time stood at 7.6 per cent – and included a provision limiting the bonuses paid to top executives of government-assisted banks to a third of total compensation.

Just over a week later, the US President unveiled his first budget, outlining plans for the ensuing 10 years. Among other things, the proposals meant Congress would be asking for an additional $750 billion (at an estimated budgetary net cost, after recouping some of the outlays, of $250 billion) to help clear up the financial system, while the budget deficit for the current year was forecast to quadruple to $1.75 trillion, equivalent to 12.3 per cent of GDP. A four-year plan to reduce the size of the deficit to 3 per cent of GDP by 2013 was also revealed. Such action meant the US budget deficit, as a share of GDP, would be on a par with that of the UK and, in August 2009, the White House revised upwards by $2 trillion, to $9 trillion, its February 2009 forecast for the US budget deficit in 10 years time. The Congressional Budget Office's March 2009 forecast was similarly revised sharply upwards, by $2.7 trillion to $7.14 trillion, for the same period, based upon no change in government policy. If the Government's planned policy changes were factored in, the latter's forecast spirals above the $10 trillion mark. As for the pound sterling, fears concerning the country's twin deficits weighed heavily on the dollar in the foreign currency markets.
3.3.2 *US Financial Policy*

The US administration's latest plans for cleaning up the financial system and restarting credit markets were revealed in February 2009. A four-point plan embraced the following: (i) recapitalisation of needy financial institutions following stress tests, using funds allocated under the TARP (around $350 billion remained available), with those receiving funds facing restrictions on dividend payments, share buy-backs and cash-financed acquisitions; (ii) spending up to $1 trillion trying to unfreeze credit markets using an expanded 'TALF' and a new lending initiative to kick-start the financing of student, auto and credit card loans, commercial mortgages and some residential mortgages; (iii) spending up to $1 trillion, to be raised from the Fed, the Treasury, the FDIC and private investors, to remove toxic assets from banks (details to be finalised); and (iv) spending up to $50 billion (to be provided by the Treasury and the Fed from existing TARP balances) to support the housing market and help limit foreclosure.

At the end of the month the US Government then agreed to a partial nationalisation of Citigroup, the third bailout of the Group in four months. Under the deal, the Government would acquire a controlling 36 per cent in the Group on conversion of $25 billion of its existing $45 billion of preferred stock into common stock and most (but not the Chief Executive) would be forced from office.

March 2009 saw a frenzy of activity. The $1 trillion expansion in the TALF began, with the Fed lending money to investors, such as hedge funds, to encourage them to buy asset-backed securities; the US Fed announced a new $300 billion programme of 'quantitative easing', under which it would buy government bonds over the next six
months; and the detailed $1 trillion plan to remove toxic assets from US banks was unveiled.

With respect to the last-mentioned initiative, the authorities' plans involved the creation of two separate schemes. Under the so-called *legacy securities plan*, the Government would authorise up to five investment managers to raise equity to buy toxic assets (i.e. MBS and ABS issued prior to 2009 with a rating at origination of at least triple-A). Each private dollar raised would be matched by a dollar of equity from a "public-private investment programme" (PPIP) – which would receive between $75 billion and $100 billion of residual TARP funding and comprise additional private capital taking its size up to $500 billion, with the potential to expand to $1 trillion – and complemented by additional Treasury loans at least matching the scale of the private equity raised. Meanwhile, under the *legacy loans plan*, designed to remove troubled loans from banks' balance sheets, a market place would be created where banks can offer pools of loans at auction. "Authorised" investors would pre-qualify for matched investment funding from the PPIP, the sum of the equity involved being eligible for leverage of up to 600 per cent through loans guaranteed by the FDIC. If the banks are happy with the price established at the auction then the sales will proceed, with private fund managers managing the loans until the final sales are made. In this way, "market" prices can be established; and no compensation restrictions will be applied to institutions taking part in the partnerships.

The main problem with the schemes was the uncertainty over the likely scale of toxic asset sales that would result. The banks will not off-load their toxic assets at what they perceive to be below "fair" (i.e. reserve) prices (sales at a discount to carrying value – book value less impairments already taken – would force banks to make writedowns equal
to the size of the discounts, thereby depleting capital and raising the spectre of additional governmental capital injections into the banks); while potential private investors may be wary of Congress's reaction if they reap too large a profit, given the favourable terms available.

The results of the US Government's stress tests, promised back in February, of its 19 largest banks, were revealed at the beginning of May. As expected, Bank of America had the biggest capital deficiency, of $33.9 billion. Others needing extra capital were Citigroup ($5.5 billion, after recent capital-raising efforts), Wells Fargo ($13.7 billion), GMAC ($11.5 billion), Morgan Stanley ($1.8 billion), PNC Financial Services ($0.6 billion), Regions Financial ($2.5 billion), Sun Trust ($2.2 billion), Fifth Third Bancorp ($1.1 billion) and Keycorp ($1.8 billion). Those banks deemed to have sufficient capital to withstand the anticipated economic shocks of the next two years comprised JP Morgan, Goldman Sachs, Metlife, Bank of NY Mellon, Capital One, American Express, US Bancorp, State Street and BB&T. Those needing extra capital were given until 9 November 2009 to plug the shortfall or face conversion of the Government's current holdings of preferred shares into equity, thereby boosting the Government's stakes in the banks and diluting existing shareholders.

The final main development, which began in June 2009, was the bank repayment of TARP money as a result of the dramatic improvement in trading conditions, particularly with respect to investment banking operations because of the subsidies and reduced competition resulting from the authorities' crisis-related remedial action. This change in most larger banks' fortunes (there were still 416 banks on the FDIC's "at risk" list at end-June 2009, rising to 702 by end-2009), as reflected in their second quarter earnings,
allowed some to escape from the state-imposed restrictions relating to pay, hiring and other operational aspects through a combined $68 billion repayment. The beneficiaries numbered 10 financial groups in total, including JP Morgan, Morgan Stanley, American Express and Goldman Sachs but notably not Citigroup or Bank of America, the last two-mentioned still owing a combined total of $90 billion to the Treasury. The beneficiaries also continue to enjoy access to the temporary liquidity guarantee programmes and can buy back, at "fair market value", the warrants taken by the Government on its provision of TARP funding in October 2008 [Morgan Stanley, in August 2009, was the first to announce such action, with the Treasury selling 88.4 million warrants held in JP Morgan, by auction, for $936 million in December 2009].
4. CONCLUDING COMMENTS

Although the final costs – in terms of permanent losses in output, reduced productive potential, private wealth destruction, lost jobs, number of bankruptcies and taxpayer losses arising from state bailouts – have yet to be counted, few can be in any doubt that the "sub-prime" crisis will prove to be one of the most calamitous events of recent financial history, if not of all time. From its humble beginnings in the US housing market in the Spring of 2007, the crisis soon spread like a virus around the global economy, leaving economic devastation in its wake. Household names in the finance industry went into liquidation, were temporarily nationalised, or otherwise were put on life-support as a precursor to a full-scale, state-financed bailout of large swathes of the banking, financial and even industrial sectors in many parts of the world. And, in some countries, the scale of the damage was so large as to trigger recourse to the IMF (e.g. Pakistan, Ukraine), with some industrialised nations (including Ireland, Iceland, Greece and Spain) also being laid low. While the sovereign ratings of others, including the US and the UK, remain under threat.

As for the causes of the crisis, a consensus has emerged from the various *post mortem* conducted, and few of the *dramatis personae* emerge with much credit. From the politicians, Board members and shareholders who failed to prevent the "excesses", to the traders and underwriters who planted the seeds of destruction, to the risk managers and supervisors who failed to exercise appropriate oversight, to the central bankers who failed to react quickly enough to the emerging crisis, to the regulators who failed to deliver appropriate financial infrastructure, regulatory frameworks and crisis resolution arrangements, to the ratings agencies' performance with respect to "structured" products, a sorry tale of incompetence emerges. Indeed, such is the scale and breadth of revealed
"failure" that laissez-faire capitalism, itself, has been called into question, with questions being asked about the alleged benefits of a market-based economy, and of orthodox economic policies in the light of the new roles foist upon the state, the clear absence of market discipline and the resurgence of Keynesian economics. Moreover, world events shattered the complacency of politicians, regulators and market participants alike as markets shut, institutions collapsed in domino-style fashion and deposit runs occurred, highlighting the extreme fragility and interconnectedness of the modern day financial world.

So much for the past, though; what about the future? Given the consensus on the identity of the major causes of the crisis, it isn't surprising that there is a high level of agreement on how to prevent a repetition of a similar style of crisis in the future, although this may be of limited benefit given financial crises rarely replicate themselves precisely through time. Nevertheless, there are sufficient common features – the emergence of asset price bubbles, especially in property, a dash for growth, relaxation of lending standards during a boom, etc., etc. – to warrant more permanent remedies to these problems; and clear areas of additional "weaknesses" were highlighted by the crisis. Accordingly, the focus is very much on improving micro-prudential regulation, in line with the recommendations of Lord Turner and the Basel Committee, for example (where the emphasis is on increased capital buffers and a new liquidity buffer), and combining this with a new focus on macro-prudential regulation (with one aim being to reduce procyclicality in financial systems), again as championed by Lord Turner. Away from regulatory reform, there is also widespread agreement on the need to improve financial infrastructure, particularly via the extension of central clearing and improved counterparty risk management and the enhancement of payments infrastructures. Moreover, there is a
clear need to improve crisis resolution arrangements to limit the extent of economic disruption following the failure of a financial institution (deposit insurance arrangements, "living wills" and bankruptcy procedures are relevant to this debate). Above all else, there is also a need to rein back "moral hazard", if only to reduce the likely incidence and scale of future financial crises. This requires a solution to the "Too-Big- (or "Too-Important" or "Too-Interconnected") To-Fail" dilemma and to the problem of how to restore market discipline more generally. The former debate has raised the issue of how beneficial the scale of a financial institution's or system's operations are to the real economy and how one might choose to limit it (e.g. through direct restrictions on size, perhaps through the imposition of a maximum leverage ratio, or through indirect measures, such as a tax on size or capital charge for systemic importance or enhanced competition) should that be deemed desirable. And, with respect to the latter problem, attention has been devoted towards ensuring unsecured creditors are credibly uninsured, for example through the use of "contingent capital", whereby debt instruments convert to equity once a pre-defined trigger is activated.

While the nature of the reform agenda is thus largely apparent, there are some worrying signs that unilateralism will undermine attempts to co-ordinate the policy response at the international level in order to deliver a "level playing field", thereby minimising opportunities for "regulatory arbitrage" and preventing potentially destabilising shifts in business location. Unilateralism is evident, for example, in both the UK, where the FSA has already moved to introduce new liquidity requirements in advance of agreement being reached within the Basel Committee and the EU and, with the French authorities, to introduce a one-off "supertax" on bank bonuses, and in the US. With respect to the latter country, President Obama has recently proposed new limitations on bank size,
activity-based restrictions (evoking memories of Glass Steagall) and a levy on large financial institutions, ostensibly to recoup the costs of Government-financed bailouts. While such action has certainly sharpened minds concerning the most appropriate reforms to be adopted, it does fly in the face of action being taken at the Basel Committee and the Financial Stability Board to resolve the issues in an internationally-agreed fashion (although, of course, some scope for "national discretion" would remain). The relative merits of a Tobin-style tax on financial transactions *vis-à-vis* an insurance levy on financial institutions to build up a fund for use in future financial crises, for example, are still being debated, yet the US appears already to have decided against the former in favour of the latter, if the proposed new levy is anything go to by.

In conclusion, although more contrition for past sins would be welcome, policymakers can congratulate themselves for having stabilised the world economy through co-ordinated action to loosen both monetary and fiscal policy, offer extraordinary support to domestic financial systems and prevent a slide into protectionism. Economic recovery in most regions, however, remains fragile, not least in the UK; while financial systems remain vulnerable to further shocks. Accordingly, it is imperative that the nature and speed of the exit policies adopted with respect to monetary, fiscal and stabilisation policy are not allowed to threaten the nascent recovery nor destabilise financial markets (*see* IMF, 2009f, Chapter 3). This is no mean task. On the timing front, for example, governments have to walk a tightrope between placating rating agencies, fearful of the impact of mounting sovereign debt burdens, and avoiding killing off economic recovery when considering the timing of their planned fiscal consolidation. Similarly, central banks, in the face of rising inflationary pressures, have to decide when, and by how much, to raise interest rates in the light of over-stretched consumer and business balance sheets and fragile bank balance
sheets. Decisions, too, about when to unwind their own debt mountains, arising from quantitative easing, have to reconcile the risks for financial stability, as rising bond yields threaten to further undermine sentiment in global bond markets where investors are already unnerved by burgeoning sovereign debts and the spectre of ratings downgrades, with the need to contain inflationary pressures. And, eventually, the extraordinary levels of liquidity support provided to the financial system will have to be withdrawn, potentially threatening financial sector recovery and market stability. Such deliberations, as well as decisions concerning the timing of the state's divestment of bank shareholdings and the role of the central bank in a revamped regulatory and supervisory architecture, will sorely tax policymakers for some time to come. The desire to prevent a return to "business as usual" in the financial world must also be weighed against the need to preserve the genuine wealth creation and growth-enhancing roles of the banking and financial systems. Populist reactions could otherwise prove very costly in the long run, to the detriment of all concerned.
APPENDICES
APPENDIX 2.1 : A BRIEF SUMMARY OF THE BANKING ACT 2009*

♦ The centrepiece is a permanent 'special resolution regime' (SRR) which provides the Authorities with a range of tools to deal with banks in financial difficulties. It builds on and refines the temporary tools introduced by the Banking (Special Provisions) Act 2008, which was used to bring Northern Rock plc into temporary public ownership in February 2008, and to resolve Bradford and Bingley plc in September 2008 and the UK subsidiaries of two Icelandic banks in 2008.

♦ Other measures contained in the Act relate to: improvement to the legal framework surrounding the operation of the Financial Services Compensation Scheme; enhancement of the operation of the regulatory frameworks preventing firms from failing; consumer protection; strengthening of the Bank of England; and new powers for the Treasury to lay regulations to deal with Investment Bank insolvency.

♦ With respect to the SRR, provisions relate to stabilisation options (of which there are three), bank insolvency procedures and bank administration procedures. Each of the three stabilisation options is achieved through the exercise of one or more of the 'stabilisation powers' – the transfer of shares or the transfer of property.

- The objectives of the SRR are as follows:
  - to protect and enhance the stability of the financial systems of the UK (including the continuity of banking services);
  - to protect and enhance public confidence in the stability of the banking systems of the UK;
  - to protect depositors;
  - to protect public funds; and
  - to avoid interfering with property rights in contravention of a Convention right (within the meaning of the Human Rights Act 1980).

  The Authorities must have regard to these objectives when using, or considering using, their SRR powers, which are also covered by a Treasury 'Code of Practice'.
  A 'Banking Liaison Panel' will also advise the Treasury on the likely impact of the SRR on banks, their customers and financial markets.

- Exercise of the Stabilisation Powers
  - A stabilisation power may only be exercised if the FSA is satisfied that the following conditions are met:
    - that the bank is failing, or is likely to fail, to satisfy the 'threshold conditions' (within the meaning of section 41(1) of the Financial Services and Markets Act 2000, which relates to permission to carry on regulated activities); and
    - that, having regard to timing and other relevant circumstances, it is not reasonably likely that (ignoring the stabilisation powers) action will be taken by or in respect of the bank that will enable the bank to satisfy the threshold conditions.
Before deciding whether the second condition is met, the FSA must consult with both the Bank of England and the Treasury.

- The **Bank of England** may exercise a stabilisation power *in respect of a bank transfer to a private sector purchaser or a bridge bank* only if it is satisfied that it is necessary to secure the public interest (i.e. in relation to financial system stability, public confidence in the stability of the banking system and depositor protection).

  Before determining whether this condition is met, and if so how to react, the Bank must consult with the FSA and the Treasury.

  Alternatively, where the Treasury notify the Bank that they have provided financial assistance in respect of a bank for the purpose of resolving or reducing a serious threat to the stability of the UK financial systems, the Bank may again exercise a stabilisation power only if it is satisfied that the Treasury have recommended such action in order to protect the public interest and that, in the Bank's opinion, this is an appropriate way to provide that protection.

- *In respect of a bank transfer to temporary public ownership*, the **Treasury** may only exercise a stabilisation power if it is satisfied that one of the following conditions is met:
  - that the exercise of the power is necessary to resolve or reduce a serious threat to UK financial system stability; or
  - that the exercise of the power is necessary to protect the public interest, where the Treasury have provided financial assistance in respect of the bank for the purpose of resolving or reducing a serious threat to UK financial system stability.

  Before determining whether either condition is met, the Treasury must consult with the FSA and the Bank of England.

[N.B. The above arrangements confirm that it is the FSA, sometimes following consultation with both the Bank and the Treasury, that actually 'triggers' the use of a stabilisation power under the SRR, although it is the Bank/Treasury which then assumes operational responsibility for the exercise of such powers, following consultation with the other Authorities.]

- **The Stabilisation Options**
  - The three stabilisation options comprise:
    - selling all or part of the bank's business to a commercial purchaser;
    - transferring all or part of the bank's business to a company which is wholly-owned by the Bank (a "bridge bank"); and
    - taking the bank into temporary public ownership.

- **Bank Insolvency Arrangements**

  The main features of the bank insolvency arrangements are as follows:
  - a bank enters the process by court order;
  - the order appoints a bank liquidator;
  - the bank liquidator aims to arrange for the bank's eligible depositors to have their accounts transferred or to receive their eligible compensation from the FSCS; and
  - the bank liquidator then winds up the bank.
The Bank Insolvency Order

- Application for such an order may be made to the court by the Bank of England, the FSA or the Secretary of State on the following grounds:
  (A) that the bank is unable, or likely to become unable, to pay its debts;
  (B) that the winding up of the bank would be in the public interest; and
  (C) that the winding up of the bank would be fair.

- The Bank of England may apply for a bank insolvency order only if:
  - the FSA has informed the Bank that it is satisfied that the general conditions for the exercise of a stabilisation power are met; and
  - the Bank is satisfied that the bank has eligible depositors and that Ground (A) or (C) applies.

- The FSA may apply for a bank insolvency order only if:
  - the Bank consents; and
  - the FSA is satisfied that the general conditions for the exercise of a stabilisation order are met, that the bank has eligible depositors and that Ground (A) or (C) applies.

- Finally, the Secretary of State may apply for a bank insolvency order only if satisfied that the bank has eligible depositors and that Ground (B) applies.

The Bank Insolvency Process

- A bank liquidator has two objectives:
  - to work with the FSCS so as to ensure that, as soon as is reasonably practicable, each eligible depositor has the relevant account transferred to another financial institution, or receives payment from (or on behalf of) the FSCS; and
  - to wind up the affairs of the bank, so as to achieve the best result for the bank's creditors as a whole.

  The first objective takes precedence over the second, although the bank liquidator is obliged to begin working towards both objectives immediately upon appointment.

- Following a bank insolvency order, a liquidation committee must be established, for the purpose of ensuring that the bank liquidator properly exercises the functions prescribed in the Act.

  This committee shall consist of three individuals, one nominated by each of the Bank, the FSA and the FSCS.

Bank Administration Arrangements

- The main features of the bank administration arrangements are that:
  - it is used where part of the business of a bank is sold to a commercial purchaser or to a bridge bank in accordance with the relevant provision of the Act;
  - the court appoints a bank administrator on the application of the Bank;
  - the bank administrator is able and required to ensure that the non-sold or non-transferred part of the bank (the 'residual bank') provides services or facilities required to enable the commercial purchaser or the transferee (the 'bridge bank') to operate effectively; and
- in other respects, the process is the same as for normal administration under the Insolvency Act 1986, subject to specified modifications.

- A bank administrator has two objectives:
  - to provide support to the commercial purchaser or bridge bank; and
  - to engage in "normal" administration (i.e. to rescue the bank as a going concern or achieve a better result for the residual bank's creditors as a whole than would be likely if the residual bank were wound up without first being in bank administration).

The first objective takes priority over the second objective although, upon appointment, a bank administrator is obliged to begin working towards securing both objectives immediately.

- An application for a bank administration order may be made to the court by the Bank of England, wherein a person to be appointed as the bank administrator must be nominated and the bank be given due notice of the application.

The grounds for said application are:
  - that the Bank has made or intends to make a property transfer instrument in respect of the bank in accordance with the relevant sections of the Act relating to such transfers to a commercial purchaser or a bridge bank; and
  - that the Bank is satisfied that the residual bank is either unable to pay its debts or is likely to become unable to pay its debts as a result of the property transfer instrument which the Bank intends to make.

*Which received the Royal Assent on 12.2.09 and took effect on 21.2.09.
Following a review of the causes of the current global banking crisis, Lord Turner identifies the changes in regulation and supervisory approach needed to create a more stable and effective banking system which the FSA has already implemented or plans to introduce and/or which it is proposing in international fora.

The former set of recommended initiatives comprise the following:

**Capital adequacy, accounting and liquidity**

1. The quality and quantity of overall capital in the global banking system should be increased, resulting in minimum regulatory requirements significantly above existing Basel rules. The transition to future rules should be carefully phased given the importance of maintaining bank lending in the current macroeconomic climate.
2. Capital required against trading book activities should be increased significantly (e.g. several times) and a fundamental review of the market risk capital regime (e.g. reliance on VAR measures for regulatory purposes) should be launched.
3. Regulators should take immediate action to ensure that the implementation of the current Basel II capital regime does not create unnecessary procyclicality; this can be achieved by using 'through the cycle' rather than 'point in time' measures of probabilities of default.
4. A counter-cyclical capital adequacy regime should be introduced, with capital buffers which increase in economic upswings and decrease in recessions.
5. Published accounts should also include buffers which anticipate potential future losses, through, for instance, the creation of an 'Economic Cycle Reserve'.
6. A maximum gross leverage ratio should be introduced as a backstop discipline against excessive growth in absolute balance sheet size.
7. Liquidity regulation and supervision should be recognised as of equal importance to capital regulation.
   - More intense and dedicated supervision of individual banks' liquidity positions should be introduced, including the use of stress tests defined by regulators and covering system-wide risks.
   - Introduction of a 'core funding ratio' to ensure sustainable funding of balance sheet growth should be considered.

**Institutional and geographic coverage of regulation**

8. Regulatory and supervisory coverage should follow the principle of economic substance not legal form.
9. Authorities should have the power to gather information on all significant unregulated financial institutions (e.g. hedge funds) to allow assessment of overall system-wide risks. Regulators should have the power to extend prudential regulation of capital and liquidity or impose other restrictions if any institution or group of institutions develops bank-like features that threaten financial stability and/or otherwise become systemically significant.
10. Offshore financial centres should be covered by global agreements on regulatory standards.

**Deposit insurance**

11. Retail deposit insurance should be sufficiently generous to ensure that the vast majority of retail depositors are protected against the impact of bank failure (note: already implemented in the UK).
12. Clear communication should be put in place to ensure that retail depositors understand the extent of deposit insurance cover.

**UK bank resolution**

13. A resolution regime which facilitates the orderly wind down of failed banks should be in place (already done via the Banking Act 2009 – see Appendix 1).

**Credit rating agencies**

14. Credit rating agencies should be subject to registration and supervision to ensure good governance and management of conflicts of interest and to ensure that credit ratings are only applied to securities for which a consistent rating is possible.
15. Rating agencies and regulators should ensure that communication to investors about the appropriate use of ratings makes clear that they are designed to carry inference for credit risk, not liquidity or market price.
16. There should be a fundamental review of the use of structured finance ratings in the Basel II framework.

**Remuneration**

17. Remuneration policies should be designed to avoid incentives for undue risk taking; risk management considerations should be closely integrated into remuneration decisions. This should be achieved through the development and enforcement of UK and global codes.

**Credit Default Swap (CDS) market infrastructure**

18. Clearing and central counterparty systems should be developed to cover the standardised contracts which account for the majority of CDS trading.

**Macro-prudential analysis**

19. Both the Bank of England and the FSA should be extensively and collaboratively involved in macro-prudential analysis and the identification of policy measures. Measures such as counter-cyclical capital and liquidity requirements should be used to offset these risks.
20. Institutions such as the IMF must have the resources and robust independence to do high quality macro-prudential analysis and if necessary to challenge conventional intellectual wisdoms and national policies.
FSA supervisory approach

21. The FSA should complete the implementation of its Supervisory Enhancement Program (SEP) which entails a major shift in its supervisory approach with:
   • Increase in resources devoted to high impact firms and in particular to large complex banks.
   • Focus on business models, strategies, risks and outcomes, rather than primarily on systems and processes.
   • Focus on technical skills as well as probity of approved persons.
   • Increased analysis of sectors and comparative analysis of firm performance.
   • Investment in specialist prudential skills.
   • More intensive information requirements on key risks (e.g. liquidity).
   • A focus on remuneration policies.

22. The SEP changes should be further reinforced by:
   • Development of capabilities in macro-prudential analysis.
   • A major intensification of the role the FSA plays in bank balance sheet analysis and in the oversight of accounting judgements.

Firm risk management and governance

23. The Walker Review should consider in particular:
   • Whether changes in governance structure are required to increase the independence of risk management functions.
   • The skill level and time commitment required for non-executive directors of large complex banks to perform effective oversight of risks and provide challenge to executive strategies.

Utility banking versus investment banking

24. New capital and liquidity requirements should be designed to constrain commercial banks' role in risky proprietary trading activities. A more formal and complete legal distinction of 'narrow banking' from market making activities is not feasible.

Global cross-border banks

25. International co-ordination of bank supervision should be enhanced by:
   • The establishment and effective operation of colleges of supervisors for the largest complex and cross-border financial institutions.
   • The pre-emptive development of crisis co-ordination mechanisms and contingency plans between supervisors, central banks and finance ministries.

26. The FSA should be prepared more actively to use its powers to require strongly capitalised local subsidiaries, local liquidity and limits to firm activity, if needed to complement improved international co-ordination.

European cross-border banks

27. A new European institution should be created which will be an independent authority with regulatory powers, a standard setter and overseer in the area of supervision, and will be significantly involved in macro-prudential analysis. This body should replace
the Lamfalussy Committees. Supervision of individual firms should continue to be performed at national level.

28. The untenable present arrangements in relation to cross-border branch pass-porting rights should be changed through some combination of:
   - Increased national powers to require subsidiarisation or to limit retail deposit-taking.
   - Reforms to European deposit insurance rules which ensure the existence of pre-funded resources to support deposits in the event of a bank failure.

♦ Another set of possible policy initiatives deserving of further debate are then identified. These relate to the following open questions:

29. Should the UK introduce product regulation of mortgage market Loan-to-Value (LTV) or Loan-to-Income (LTI)?
30. Should financial regulators be willing to impose restrictions on the design or use of wholesale market products (e.g. CDS)?
31. Does effective macro-prudential policy require the use of tools other than the variation of counter-cyclical capital and liquidity requirements e.g.
   - Through the cycle variation of LTV or LTI ratios?
   - Regulation of collateral margins ('haircuts') in derivatives contracts and secured financing transactions?
32. Should decisions on for instance short selling recognise the dangers of market irrationality as well as market abuse?

♦ The final chapter (Chapter 4) summaries the recommendations, distinguishes those which can be implemented by the FSA acting alone and those where international agreement is needed, and discusses the appropriate pace and process of implementation.

Source: FSA, 2009a

*Additional information on FSA thinking is provided in FSA, 2009b.
APPENDIX 2.3: RECOMMENDATIONS OF THE WALKER REVIEW OF CORPORATE GOVERNANCE OF UK FINANCIAL INSTITUTIONS

Board size, composition and qualification

Recommendation 1
To ensure that NEDs have the knowledge and understanding of the business to enable them to contribute effectively, a BOFI board should provide thematic business awareness sessions on a regular basis and each NED should be provided with a substantive personalised approach to induction, training and development to be reviewed annually with the chairman. Appropriate provision should be made similarly for executive board members in business areas other than those for which they have direct responsibility.

Recommendation 2
A BOFI board should provide for dedicated support for NEDs on any matter relevant to the business on which they require advice separate from or additional to that available in the normal board process.

Recommendation 3
The overall time commitment of NEDs as a group on a FTSE 100-listed bank or life assurance company board should be greater than has been normal in the past. How this is achieved in particular board situations will depend on the composition of the NED group on the board. For several NEDs, a minimum expected time commitment of 30 to 36 days in a major bank board should be clearly indicated in letters of appointment and will in some cases limit the capacity of an individual NED to retain or assume board responsibilities elsewhere. For any prospective director where so substantial a time commitment is not envisaged or practicable, the letter of appointment should specify the time commitment agreed between the individual and the board. The terms of letters of appointment should be available to shareholders on request.

Recommendation 4
The FSA's ongoing supervisory process should give closer attention to both the overall balance of the board in relation to the risk strategy of the business, taking into account the experience, behavioural and other qualities of individual directors and their access to fully adequate induction and development programmes. Such programmes should be designed to assure a sufficient continuing level of financial industry awareness so that NEDs are equipped to engage proactively in BOFI board deliberation, above all on risk strategy.

Recommendation 5
The FSA's interview process for NEDs proposed for FTSE 100-listed bank and life assurance company boards should involve questioning and assessment by one or more (retired or otherwise non-conflicted) senior advisers with relevant industry experience at or close to board level of a similarly large and complex entity who might be engaged by the FSA for the purpose, possibly on a part-time panel basis.
**Functioning of the board and evaluation of performance**

**Recommendation 6**  
As part of their role as members of the unitary board of a BOFI, NEDs should be ready, able and encouraged to challenge and test proposals on strategy put forward by the executive. They should satisfy themselves that board discussion and decision-taking on risk matters is based on accurate and appropriately comprehensive information and draws, as far as they believe it to be relevant or necessary, on external analysis and input.

**Recommendation 7**  
The chairman of a major bank should be expected to commit a substantial proportion of his or her time, probably around two-thirds, to the business of the entity, with clear understanding from the outset that, in the event of need, the bank chairmanship role would have priority over any other business time commitment. Depending on the balance and nature of their business, the required time commitment should be proportionately less for the chairman of a less complex or smaller bank, insurance or fund management entity.

**Recommendation 8**  
The chairman of a BOFI board should bring a combination of relevant financial industry experience and a track record of successful leadership capability in a significant board position. Where this desirable combination is only incompletely achievable at the selection phase, and provided that there is an adequate balance of relevant financial industry experience among other board members, the board should give particular weight to convincing leadership experience since financial industry experience without established leadership skills is unlikely to suffice. An appropriately intensive induction and continuing business awareness programme should be provided for the chairman to ensure that he or she is kept well informed and abreast of significant new developments in the business.

**Recommendation 9**  
The chairman is responsible for leadership of the board, ensuring its effectiveness in all aspects of its role and setting its agenda so that fully adequate time is available for substantive discussion on strategic issues. The chairman should facilitate, encourage and expect the informed and critical contribution of the directors in particular in discussion and decision-taking on matters of risk and strategy and should promote effective communication between executive and non-executive directors. The chairman is responsible for ensuring that the directors receive all information that is relevant to the discharge of their obligations in accurate, timely and clear form.

**Recommendation 10**  
The chairman of a BOFI board should be proposed for election on an annual basis. The board should keep under review the possibility of transitioning to annual election of all board members.

**Recommendation 11**  
The role of the senior independent director (SID) should be to provide a sounding board for the chairman, for the evaluation of the chairman and to serve as a trusted intermediary for the NEDs as and when necessary. The SID should be accessible to shareholders in the event that communication with the chairman becomes difficult or inappropriate.
**Recommendation 12**
The board should undertake a formal and rigorous evaluation of its performance, and that of committees of the board, with external facilitation of the process every second or third year. The evaluation statement should either be included as a dedicated section of the chairman's statement or as a separate section of the annual report, signed by the chairman. Where an external facilitator is used, this should be indicated in the statement, together with their name and a clear indication of any other business relationship with the company and that the board is satisfied that any potential conflict given such other business relationship has been appropriately managed.

**Recommendation 13**
The evaluation statement on board performance and governance should confirm that a rigorous evaluation process has been undertaken and describe the process for identifying the skills and experience required to address and challenge adequately key risks and decisions that confront, or may confront, the board. The statement should provide such meaningful, high-level information as the board considers necessary to assist shareholders' understanding of the main features of the process, including an indication of the extent to which issues raised in the course of the evaluation have been addressed. It should also provide an indication of the nature and extent of communication with major shareholders and confirmation that the board were fully apprised of views indicated by shareholders in the course of such dialogue.

**The role of institutional shareholders: communication and engagement**

**Recommendation 14**
Boards should ensure that they are made aware of any material cumulative changes in the share register as soon as possible, understand as far as possible the reasons for such changes and satisfy themselves that they have taken steps, if any are required, to respond. Where material cumulative changes take place over a short period, the FSA should be promptly informed.

**Recommendation 15**
Deleted.

**Recommendation 16**
The remit of the FRC should be explicitly extended to cover the development and encouragement of adherence to principles of best practice in stewardship by institutional investors and fund managers. This new role should be clarified by separating the content of the present Combined Code, which might be described as the Corporate Governance Code, from what might appropriately be described as the Stewardship Code.

**Recommendation 17**
The Code on the Responsibilities of Institutional Investors, prepared by the Institutional Shareholders' Committee, should be ratified by the FRC and become the Stewardship Code. By virtue of the independence and authority of the FRC, this transition to sponsorship by the FRC should give materially greater weight to the Stewardship Code. Its status should be akin to that of the Combined Code as a statement of best practice, with observance on a similar "comply or explain" basis.
Recommendation 18
The FRC should oversee a review of the Stewardship Code on a regular basis, in close consultation with institutional shareholders, fund managers and other interested parties, to ensure its continuing fitness for purpose in the light of experience and make proposals for any appropriate adaptation.

Recommendation 18B
All fund managers that indicate commitment to engagement should participate in a survey to monitor adherence to the Stewardship Code. Arrangements should be put in place under the guidance of the FRC for appropriately independent oversight of this monitoring process which should publish an engagement survey on an annual basis.

Recommendation 19
Fund managers and other institutions authorised by the FSA to undertake investment business should signify on their websites or in another accessible form whether they commit to the Stewardship Code. Disclosure to such commitment should be accompanied by an indication whether their mandates from life assurance, pension fund and other major clients normally include provisions in support of engagement activity and of their engagement policies on discharge of the responsibilities set out in the Stewardship Code. Where a fund manager or institutional investor is not ready to commit and to report in this sense, it should provide, similarly on the website, a clear explanation of the reasons for the position it is taking.

Recommendation 20
The FSA should require institutions that are authorised to manage assets for others to disclose clearly on their websites or in other accessible form the nature of their commitment to the Stewardship Code or their alternative business model.

Recommendation 20B
In view of the importance of facilitating enhanced engagement between shareholders and investee companies, the FSA, in consultation with the FRC and Takeover Panel, should keep under review the adequacy of the what is in effect "safe harbour" interpretation and guidance that has been provided as a means of minimising regulatory impediments to such engagement.

Recommendation 21
Institutional investors and fund managers should actively seek opportunities for collective engagement where this has the potential to enhance their ownership influence in promoting sustainable improvement in the performance of their investee companies. Initiative should be taken by the FRC and major UK fund managers and institutional investors to invite potentially interested major foreign institutional investors, such as sovereign wealth funds, public sector pension funds and endowments, to commit to the Stewardship Code and its provisions on collective engagement.

Recommendation 22
Voting powers should be exercised, fund managers and other institutional investors should disclose their voting record, and their policies in respect of voting should be described in statements on their websites or in other publicly accessible form.
Governance of risk

Recommendation 23
The board of a FTSE 100-listed bank or life insurance company should establish a board risk committee separately from the audit committee. The board risk committee should have responsibility for oversight and advice to the board on the current risk exposures of the entity and future risk strategy, including strategy for capital and liquidity management, and the embedding and maintenance throughout the entity of a supportive culture in relation to the management of risk alongside established prescriptive rules and procedures. In preparing advice to the board on its overall risk appetite, tolerance and strategy, the board risk committee should ensure that account has been taken of the current and prospective macroeconomic and financial environment drawing on financial stability assessments such as those published by the Bank of England, the FSA and other authoritative sources that may be relevant for the risk policies of the firm.

Recommendation 24
In support of board-level risk governance, a BOFI board should be served by a CRO who should participate in the risk management and oversight process at the highest level on an enterprise-wide basis and have a status of total independence from individual business units. Alongside an internal reporting line to the CEO or FD, the CRO should report to the board risk committee, with direct access to the chairman of the committee in the event of need. The tenure and independence of the CRO should be underpinned by a provision that removal from office would require the prior agreement of the board. The remuneration of the CRO should be subject to approval by the chairman or chairman of the board remuneration committee.

Recommendation 25
The board risk committee should be attentive to the potential added value from seeking external input to its work as a means of taking full account of relevant experience elsewhere and in challenging its analysis and assessment.

Recommendation 26
In respect of a proposed strategic transaction involving acquisition or disposal, it should as a matter of good practice be for the board risk committee in advising the board to ensure that a due diligence appraisal of the proposition is undertaken, focussing in particular on risk aspects and implications for the risk appetite and tolerance of the entity, drawing on external advice where appropriate and available, before the board takes a decision whether to proceed.

Recommendation 27
The board risk committee (or board) risk report should be included as a separate report within the annual report and accounts. The report should describe thematically the strategy of the entity in a risk management context, including information on the key exposures inherent in the strategy, the associated risk appetite and tolerance and how the actual risk appetite is assessed over time covering both banking and trading book exposures and the effectiveness of the risk management process over such exposures. The report should also provide at least high-level information on the scope and outcome of the stress-testing programme. An indication should be given of the membership of the committee, of the frequency of its meetings, whether external advice was taken and, if so, its source.
Remuneration

**Recommendation 28**
The remuneration committee should have sufficient understanding of the company's approach to pay and employment conditions to ensure that it is adopting a coherent approach to remuneration in respect of all employees. The terms of reference of the remuneration committee should accordingly include responsibility for setting the overarching principles and parameters of remuneration policy on a firm-wide basis.

**Recommendation 29**
The terms of reference of the remuneration committee should be extended to oversight of remuneration policy and outcomes in respect of all "high end" employees.

**Recommendation 30**
In relation to "high end" employees, the remuneration committee report should confirm that the committee is satisfied with the way in which performance objectives and risk adjustments are reflected in the compensation structures for this group and explain the principles underlying the performance objectives, risk adjustments and the related compensation structure if these differ from those for executive board members.

**Recommendation 31**
For FTSE 100-listed banks and comparable unlisted entities such as the largest building societies, the remuneration committee report for the 2010 year of account and thereafter should disclose in bands the number of "high end" employees, including executive board members, whose total expected remuneration in respect of the reported year is in a range of £1 million to £2.5 million, in a range of £2.5 million to £5 million and in £5 million bands thereafter and, within each band, the main elements of salary, cash bonus, deferred shares, performance-related long-term awards and pension contribution. Such disclosures should be accompanied by an indication to the extent possible of the areas of business activity to which these higher bands of remuneration relate.

**Recommendation 32**
FSA-authorised banks that are UK-domiciled subsidiaries of non-resident entities should disclose for the 2010 year of account and thereafter details of total remuneration bands (including remuneration received outside the UK) and the principal elements within such remuneration for their "high end" employees on a comparable basis and timescale to that required for UK-listed banks.

**Recommendation 33**
Deferral of incentive payments should provide the primary risk adjustment mechanism to align rewards with sustainable performance for executive board members and "high end" executives in a BOFI included within the scope of the FSA Remuneration Code. Incentives should be balanced so that at least one-half of variable remuneration offered in respect of a financial year is in the form of a long-term incentive scheme with vesting subject to a performance condition with half of the award vesting after not less than three years and of the remainder after five years. Short-term bonus awards should be paid over a three-year period with not more than one-third in the first year. Clawback should be used as the means to reclaim amount in circumstances of misstatement and misconduct. This recommended structure should be incorporated in the FSA Remuneration Code review process next year and the remuneration committee report for 2010 and thereafter should
indicate on a "comply or explain" basis the conformity of an entity's "high end" remuneration arrangements with this recommended structure.

**Recommendation 34**
Executive board members and "high end" executives should be expected to maintain a shareholding or retain a portion of vested awards in an amount in line with their total compensation on a historic or expected basis, to be built up over a period at the discretion of the remuneration committee. Vesting of stock for this group should not normally be accelerated on cessation of employment other than on compassionate grounds.

**Recommendation 35**
The remuneration committee should seek advice from the board risk committee on specific risk adjustments to be applied to performance objectives set in the context of incentive packages; in the event of any difference of view, appropriate risk adjustments should be decided by the chairman and NEDs on the board.

**Recommendation 36**
If the non-binding resolution of a remuneration committee report attracts less than 75 per cent of the total votes cast, the chairman of the committee should stand for re-election in the following year irrespective of his or her normal appointment term.

**Recommendation 37**
The remuneration committee report should state whether any executive board member or "high end" employee has the right or opportunity to receive enhanced pension benefits, whether while in continued employment or on termination, resignation, retirement or in the wake of any other event such as a change of control, beyond those already disclosed in the directors' remuneration report and whether the committee has exercised its discretion during the year to enhance pension benefits either generally or for any member of this group.

**Recommendation 38/39**
The remuneration consultants should put in place a formal constitution for the professional group that has now been formed, with provision: for independent oversight and review of the remuneration consultants code; that this code and an indication of those committed to it should be lodged on the FRC website; and that all remuneration committees should use the code as the basis for determining the contractual terms of engagement of their advisers; and that the remuneration committee report should indicate the source of consultancy advice and whether the consultant has any other advisory engagement with the company.

*Source: HM Treasury, 2009d*
**APPENDIX 2.4 : A SUMMARY OF THE MAIN PROPOSALS OF THE GOVERNMENT'S WHITE PAPER ON FINANCIAL REFORM**

<table>
<thead>
<tr>
<th>AREA OF CONCERN</th>
<th>PROPOSED REFORMS</th>
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<tr>
<td>A. The Governance, Co-ordination and Regulatory Framework of UK Financial Institutions</td>
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<tr>
<td>(i) Formalising and strengthening the arrangements for institutional co-operation</td>
<td>The creation of a new statutory committee – the <em>Council for Financial Stability</em> (CFS) – comprising the Treasury, the Bank of England and the FSA and chaired by the Chancellor of the Exchequer. This Council will replace the current 'Standing Committee'.</td>
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<tr>
<td>(ii) Strengthening the objectives of the FSA</td>
<td>Giving the FSA an explicit <em>financial stability objective</em> to add to its existing objectives, as set out in the FSMA.</td>
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| (iii) Strengthening the FSA’s prudential regulation and supervision of banks | The Government endorses Lord Turner's calls for, *inter alia*:  
- increases in the quality and quantity of capital;  
- the introduction of a maximum leverage ratio to complement risk-based capital requirements (to include off-balance-sheet items);  
- a strengthening of liquidity regulation (as set out in FSA, 2008d); and  
- an enhancement of the FSA's SEP. |
| (iv) Enhancing the FSA's regulatory powers | Amendment of the FSA’s rule-making, 'permission' and intervention powers to allow it to operate in fulfilment of any of its objectives (i.e. including that relating to financial stability).  
Strengthening the FSA's powers to take action in relation to authorised firms and individuals found guilty of misconduct.  
Establishing stand-alone (i.e. independent of market abuse) powers for the FSA to take emergency action to place restrictions on short selling and to require disclosure of short selling.  
Examining the need to extend the FSA's information-gathering powers. |
| (v) Strengthening the framework for compensation | Introducing an element of *pre-funding* into the deposit-taking sub-scheme of the FSCS.  
Bringing forward proposals regarding the governance and accountability of the FSCS, while carrying out a similar review of the Financial Ombudsman Service (FOS). |
<table>
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<tr>
<th>B. Dealing with systemically-significant institutions</th>
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<tr>
<td>(i) To reduce their risk of failing</td>
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<tr>
<td>Strengthening <em>market discipline</em> by using the work of the Walker Review and the FSA’s Code of Practice to provide guidance on the standards of discipline in corporate governance and remuneration respectively. The FSA will also be urged to establish and maintain dialogue on governance issues with non-executive members of boards. Enhancing <em>prudential regulation and supervision</em> by the FSA through: stricter regulation and supervision of capital and liquidity adequacy, as applied to all authorised institutions; and the imposition of additional capital requirements on systemically-significant institutions, the scale to be dependent on the size and complexity of the firm.</td>
</tr>
<tr>
<td>(ii) To reduce the impact of their failure</td>
</tr>
<tr>
<td>Strengthening <em>market infrastructure</em> (e.g. with respect to CDSs). Enhancing <em>failure resolution</em> mechanisms through: the introduction of a new insolvency regime for investment banks, to be provided for in secondary legislation early in 2010, if necessary; and forcing banks to draw up internal failure resolution plans to allow for their speedy resolution if necessary.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>C. Managing systemic risk more broadly</th>
</tr>
</thead>
<tbody>
<tr>
<td>(i) Managing systemic risk across markets and institutions</td>
</tr>
<tr>
<td>Enhancing transparency by improving <em>accounting standards</em> (the Government strongly supports the recommendations of the FSF in this area – which are due to be implemented by end-2009 – and agrees that the FSA should engage with firms and auditors to ensure more consistent approaches to the valuation of financial instruments across firms). Improving the liquidity, transparency and robustness of <em>wholesale markets</em>, and in particular securitisation and over-the-counter (OTC) derivatives markets, through increased standardisation of products, strengthened wholesale market structures, and increasing the amount of due diligence undertaken by investors. Securing a greater <em>regulatory focus</em> on systemic risk through enhanced monitoring and supervision and creating a responsive and dynamic regulatory boundary.</td>
</tr>
<tr>
<td>(ii) Managing systemic risk over the cycle</td>
</tr>
<tr>
<td>The Government endorses the use of the following:</td>
</tr>
<tr>
<td>• a <em>maximum leverage ratio</em> (to complement risk-based capital requirements);</td>
</tr>
<tr>
<td>• measures, developed by the Basel Committee and the ISAB, to reduce the pro-cyclicality of prudential and accounting standards;</td>
</tr>
<tr>
<td>• building <em>counter-cyclical capital buffers</em> in good times;</td>
</tr>
<tr>
<td>• measures designed to improve access to funding markets in downturns or crises (forcing debt for equity conversion in the event of a systemic crisis is one</td>
</tr>
<tr>
<td>D. The international regulatory and supervisory framework</td>
</tr>
</tbody>
</table>

| Strengthening regulation and supervision in Europe | The Government believes the following measures are necessary to further enhance the regulatory and supervisory framework in the EU: • a reduction in the number of national discretions allowable under EU legislation; • a strengthening of the rules and safeguards for cross-border branching within the EEA; • stronger enforcement of EU rules; • the provision of additional resources to the current Level Three committees prior to the establishment of the new European Supervisory Authorities; and • in the longer-term, the creation of a single rule-making body to improve the quality of regulation. At the domestic level, the Government will give the FSA a new statutory duty to promote sound international regulation and supervision. |

Source: HM Treasury (2009f)
APPENDIX 2.5 : A SUMMARY OF THE MAIN PROPOSALS OF THE CONSERVATIVE PARTY'S WHITE PAPER ON FINANCIAL REFORM

Changes to the regulatory architecture

- The FSA and the Tripartite system will be abolished, with the Bank of England being given the authority and powers necessary to ensure financial stability.

- The Bank of England will be made responsible for macro-prudential regulation.

- A new Financial Policy Committee will be created within the Bank, working alongside the Monetary Policy Committee, to monitor systemic risks, operate new macro-prudential regulatory tools and execute the special resolution regime for failing banks. The Committee will include the Governor and existing Deputy Governor for Financial Stability in order to ensure close co-ordination between monetary and financial policy.

- The Bank of England to be made responsible for the micro-prudential regulation of all banks, building societies and other significant institutions, including insurance companies.

- A new Financial Regulation Division of the Bank will be created to carry out the micro-prudential role, headed by a new Deputy Governor for Financial Regulation. The work of the Division will be overseen by the Financial Policy Committee to ensure close co-ordination between macro-prudential and micro-prudential regulation. The Deputy Governor for Financial Regulation will also be a member of the Financial Policy Committee.

- A new Consumer Protection Agency (CPA) will be created, inheriting the FSA's responsibilities for consumer protection.

- The regulation of consumer credit will be transferred from the Office of Fair Trading to the CPA.

- A single senior Treasury minister will be given responsibility for European financial regulation.

Changes to regulatory policy

(i) On the micro-prudential front, the following changes to existing policy are proposed:

- Additional capital and liquidity requirements to be imposed to reflect an institution's size and complexity;

- "much higher" capital requirements to be imposed on high-risk activities, such as large-scale proprietary trading;
• capital requirements to be used to crack down on risky bonus structures;

• financial institutions to be forced to prepare "living wills" to assist with their orderly wind down in the face of insolvency; and

• the introduction of a "backstop" leverage ratio to constrain bank lending.

(ii) On the macro-prudential front, the following new policies are proposed:

• the introduction of counter-cyclical capital requirements; and

• greater central counterparty clearing of over-the-counter securities.

Source: Conservative Party, 2009
APPENDIX 2.6: A COMPARISON OF THE REFORM PROPOSALS

<table>
<thead>
<tr>
<th>Current System</th>
<th>FSA</th>
<th>Treasury</th>
<th>Bank of England</th>
<th>Conservative Party</th>
<th>Hall</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>A. Regulatory Architecture</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>6. Consumer protection</td>
<td>FSA</td>
<td>FSA</td>
<td>FSA</td>
<td>FSA</td>
<td>New 'Consumer Protection Agency' (CPA)</td>
</tr>
<tr>
<td>7. Consumer credit regulation</td>
<td>OFT</td>
<td>OFT</td>
<td>OFT</td>
<td>OFT?</td>
<td>CPA</td>
</tr>
<tr>
<td>8. Deposit protection</td>
<td>FSA (runs the FSCS)</td>
<td>FSA</td>
<td>FSA</td>
<td>FSA?</td>
<td>CPA or possibly the Bank of England</td>
</tr>
<tr>
<td></td>
<td>FSA</td>
<td>Treasury</td>
<td>Bank of England</td>
<td>Conservative Party</td>
<td></td>
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<tr>
<td>------------------------</td>
<td>-----</td>
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<td>-----------------</td>
<td>--------------------</td>
<td></td>
</tr>
<tr>
<td><strong>B. Regulatory Policy</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(I) Micro-prudential regulation</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1. Higher quality and quantity of bank capital</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td></td>
</tr>
<tr>
<td>2. Higher trading book capital requirements</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td></td>
</tr>
<tr>
<td>3. Additional capital requirements to reflect size and complexity</td>
<td>✓</td>
<td>✓</td>
<td>✓(?)</td>
<td>✓</td>
<td></td>
</tr>
<tr>
<td>4. Additional capital requirements to penalise risky bonus structures</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td></td>
</tr>
<tr>
<td>5. Introduction of a maximum &quot;backstop&quot; gross leverage ratio</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td></td>
</tr>
<tr>
<td>6. Greater regulatory focus on liquidity</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td></td>
</tr>
<tr>
<td>7. Institutions to be forced to draft &quot;living wills&quot;</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td></td>
</tr>
<tr>
<td>8. Deposit protection scheme to be pre-funded</td>
<td>Maybe</td>
<td>✓</td>
<td>✓</td>
<td>Maybe</td>
<td></td>
</tr>
<tr>
<td>9. Deposit insurance &quot;premia&quot; to be risk-related</td>
<td>?</td>
<td>?</td>
<td>✓</td>
<td>?</td>
<td></td>
</tr>
<tr>
<td><strong>(II) Macro-prudential regulation</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1. The introduction of counter-cyclical capital and liquidity requirements</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td></td>
</tr>
<tr>
<td>2. The introduction of counter-cyclical accounting measures (e.g. to reduce the pro-cyclicality of fair value accounting)</td>
<td>✓</td>
<td>✓</td>
<td>?</td>
<td>?</td>
<td></td>
</tr>
<tr>
<td>(III) Other safeguards</td>
<td>FSA</td>
<td>Treasury</td>
<td>Bank of England</td>
<td>Conservative Party</td>
<td></td>
</tr>
<tr>
<td>--------------------------------------------------------------------------------------</td>
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<td>----------</td>
<td>----------------</td>
<td>-------------------</td>
<td></td>
</tr>
<tr>
<td>1. Greater regulation and tighter monitoring of credit rating agencies</td>
<td>√</td>
<td>√</td>
<td>√</td>
<td>√</td>
<td></td>
</tr>
<tr>
<td>2. Greater use of central counter-party clearing for standardised derivative contracts (incl. CDSs)</td>
<td>√</td>
<td>√</td>
<td>√</td>
<td>√</td>
<td></td>
</tr>
<tr>
<td>3. Improved accounting standards (e.g. in relation to the valuation of financial instruments)</td>
<td>√</td>
<td>√</td>
<td>√</td>
<td>√</td>
<td></td>
</tr>
<tr>
<td>4. The regulatory perimeter should be extended to include all systemically-important firms (incl. hedge funds) according to the principle of economic substance not legal form</td>
<td>√</td>
<td>√</td>
<td>?</td>
<td>?</td>
<td></td>
</tr>
<tr>
<td>5. Offshore financial centres to be covered by global agreements on regulatory standards</td>
<td>√</td>
<td>√</td>
<td>?</td>
<td>?</td>
<td></td>
</tr>
<tr>
<td>6. Remuneration policies to be subject to internationally-agreed Codes</td>
<td>√</td>
<td>√</td>
<td>√</td>
<td>√</td>
<td></td>
</tr>
<tr>
<td>7. Stronger corporate governance arrangements enforced through Codes</td>
<td>√</td>
<td>√</td>
<td>√</td>
<td>√</td>
<td></td>
</tr>
<tr>
<td>8. Enhancing failure resolution mechanisms through, for example, the introduction of a new insolvency regime for investment banks</td>
<td>?</td>
<td>√</td>
<td>?</td>
<td>√</td>
<td></td>
</tr>
<tr>
<td></td>
<td>FSA</td>
<td>Treasury</td>
<td>Bank of England</td>
<td></td>
<td></td>
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<tr>
<td>---</td>
<td>-----</td>
<td>----------</td>
<td>-----------------</td>
<td></td>
<td></td>
</tr>
<tr>
<td>9. Enhanced international co-ordination of supervision of cross-border banks through, for example, the establishment of colleges of supervisors, the pre-emptive development of crisis co-ordination mechanisms and contingency plans, and the harmonisation of failure resolution regimes</td>
<td>✓</td>
<td>✓</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>10. Increased powers for home supervisors (e.g. to be able to require local subsidiarisation) under the EU Single Market for financial services</td>
<td>✓</td>
<td>✓</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>11. Extending market discipline through, for example, using the work of the Walker Review and the FSA's Code of Practice to provide guidelines on the standards of discipline in corporate governance and remuneration respectively. [Regulatory-enforced debt for equity swaps under failure resolution mechanisms might also be employed; and principles governing the nature of public intervention need to be looked at again to minimise moral hazard.]</td>
<td>✓</td>
<td>✓</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Footnotes:
2. A '?' denotes the absence of a clear statement on the policy/principle concerned.
3. The Governor has also raised the possibility of introducing more formal structural solutions.
TABLES
TABLE 2.1: BROKERED TAKEOVER-RESCUES

<table>
<thead>
<tr>
<th>Ailing UK Institutions</th>
<th>Rescuer</th>
<th>Need for Rescue</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. The Alliance and Leicester</td>
<td>Banco Santander (July 2008)</td>
<td>Crash in profits due to exposure to UK housing market (as a former building society); excessive exposure to wholesale funding markets; falling share price</td>
</tr>
<tr>
<td>2. Halifax Bank of Scotland (HBOS)</td>
<td>Lloyds TSB (September 2008)</td>
<td>Crash in profits due to exposure to UK property market (Halifax was a former building society); excessive exposure to wholesale funding markets; precipitous fall in share price in wake of collapse of Lehman Brothers</td>
</tr>
<tr>
<td>3. Cheshire and Derbyshire Building Societies</td>
<td>Nationwide Building Society (planned mergers announced in September 2008)</td>
<td>To preserve confidence in the building society movement as both societies were expected to report pre-tax losses for the first half of 2008</td>
</tr>
<tr>
<td>4. Barnsley Building Society</td>
<td>Yorkshire Building Society (planned merger announced in October 2008)</td>
<td>To end the uncertainty associated with the Barnsley's £10 million exposure to Icelandic banks</td>
</tr>
<tr>
<td>5. Scarborough Building Society</td>
<td>Skipton Building Society (planned merger announced in November 2008)</td>
<td>To restore regional stability in the building society movement given Scarborough's precarious financial situation</td>
</tr>
<tr>
<td>6. Dunfermline Building Society</td>
<td>Nationwide Building Society (March 2009)</td>
<td>Dunfermline had incurred heavy losses on commercial and real estate activities, sub-prime lending and investments in mortgage-backed securities</td>
</tr>
</tbody>
</table>
TABLE 2.2 : MAJOR UK DEVELOPMENTS

2.2.09 Moody's downgrades Barclays credit rating two notches to "Aa3" from "Aa1" citing fears of "significant further writedowns on the bank's credit market exposures".

3.2.09 Bank of England reveals that £185 billion of assistance has been provided to UK banks through the 'Special Liquidity Scheme' by end-January 2009. With £287 billion of mostly mortgage-backed securities and covered bonds having been taken on by the Bank at a 6 per cent discount to face value, the total of support provided (through the loan of Treasury bills) suggests the Bank applied an average 'haircut' to current market values of around 23.6 per cent. The average fees paid by the banks to access the scheme were 115 basis points.

3.2.09 UK Government announces plans for a White Paper reforming UK banking supervision to be published around the time of the Spring Budget.

5.2.09 Bank of England's Monetary Policy Committee cuts its policy rate to a 315-year low of 1 per cent amid concerns that the inflation target will be undershot in the medium term.

5.2.09 According to the Halifax's house price index, average UK house prices rose by 1.9 per cent in January 2009, the first rise since February 2008.

6.2.09 Bank of England confirms that, from 13 February 2009, it will start to purchase from banks commercial paper issued by any company (including its finance subsidiaries) that makes "a material contribution to economic activity in the UK" under its new "Asset Purchase Facility".

8.2.09 Chancellor announces a review of governance in the UK banking sector – covering risk management, remuneration policy, the functioning of Boards and the role of institutional investors – is to be carried out by Sir David Walker as the row over bank bonuses escalates following news that the Government will not act to prevent up to £1 billion of bonuses being paid by RBS (70 per cent owned by the State) and that over £640 million of bonuses have been paid to executives of Barclays over the past 18 months without mention in the company accounts.

9.2.09 Despite making £8 billion of writedowns - £5.4 billion after allowing for accounting-induced balance sheet adjustments – Barclays reveals a £6.08 billion pre-tax profit for 2008, down by only 14 per cent on the 2007 figure. The figure, however, was boosted by one-off gains, most noticeably the £2.3 billion boost from the purchase of the US assets of Lehman Brothers, bought below book value.
11.2.09 Sir James Crosby, Deputy Chairman of the FSA and adviser to the Government, resigns over allegations that he ignored warnings about HBOS's rapid growth whilst he was running the bank. At the same time, the FSA announces that it had long-standing concerns about HBOS's risk management. The issue raises questions about the Prime Minister's judgment in appointing someone to be a senior regulator and adviser to the Government on how to clear up the financial mess the country is in who, it is now alleged, was in part responsible for the creation of this mess.

11.2.09 As the release of the latest unemployment figures for the last three months of 2008 reveal that unemployment has risen to 1.97 million, taking the unemployment rate to 6.3 per cent, the highest level since 1998, the Bank of England warns of a 'deep recession', likely to last much longer than previously envisaged.

13.2.09 Shares in Lloyds Banking Group crash by 35 per cent after the bank announces that HBOS, the bank it acquired in January 2009, will run up losses of over £10 billion for 2008, double most analysts' forecasts, largely due to £7 billion of provisions against corporate loans. The collapsing share price raises the spectre of majority share-ownership by the state, as is the case with RBS, as additional state support will undoubtedly prove necessary. The collapse in confidence in the newly-created bank also calls into question, once again, the wisdom of the "shot-gun" wedding brokered by the authorities last year at short notice and without full due diligence being conducted. It looks like HBOS will hobble Lloyds TSB, hitherto one of the UK's most successful and conservative banks, for many years to come; whilst the collapsing share price left taxpayers nursing a near £27 billion loss on their bank investments at the close of business on 13 February 2009.

16.2.09 Shares in Lloyds Banking Group fall by another 8 per cent following a ratings downgrade by Moody's of its long term debt – from 'Aaa' to 'Aa3' – on concerns about HBOS's exposures to commercial property and alt-A mortgages, which risk damaging the group's profitability and capital adequacy.

17.2.09 Latest inflation figures reveal that the annualised CPI fell from 3.1 per cent to 3 per cent in January 2009, whilst the RPI rose by only 0.1 per cent.

17.2.09 After governmental intervention, RBS cut its cash bonus for 2008 to £175 million compared with a figure of £2.5 billion in 2007 and also pays £160 million to non-managerial staff. This amount is supposed to represent the 'absolute legal minimum' the firm is obliged to pay. However, the amount of deferred awards – to be paid to those deemed to be essential to the bank's recovery and at serious risk of leaving in subordinated bonds rather than shares over a three-year period starting from 2010, with a performance-related claw back provision – has not been revealed, although it is thought to be in the region of £600 million.
19.2.09 Latest government borrowing figures reveal that public sector net borrowing in January 2009 was £3.3 billion, the worst January figure since 1996/97, because of falling tax receipts. This took the borrowing figure in the first ten months of 2008/09 to £79.3 billion, an amount well in excess of the £77.6 billion figure forecast for the whole of 2008/09 in the pre-Budget report of November 2008. [The IFS expects full year borrowing to be £87 billion.] The 'overshoot' foreshadows further deferred tax increases and cuts in public expenditure in the next Budget.

19.2.09 The Office for National Statistics warns that public sector net debt will soon rise to 150 per cent of GDP (up from 36 per cent in September 2007) as a result of the Government assuming control of the general corporate policy of the Lloyds Banking Group, RBS, Northern Rock and Bradford and Bingley. This means that these companies' liabilities, net of liquid assets, have to be added to the national debt figures. This will expand the figure by between £1 trillion and £1.5 trillion (i.e. between 70 and 100 per cent of GDP), taking the headlines figure to around £2 trillion. Although this is not a true reflection of taxpayers' likely future liabilities from banking losses – private estimates range from £120 billion to £200 billion – the figures still suggest the UK will run an underlying public debt figure of around 80 per cent of GDP, twice that applicable under the Government's previous "sustainable investment role".

20.2.09 Latest figures reveal that the number of repossessions in 2008 stood at 40,000 compared with 25,900 in 2007. This represented 0.34 per cent of all outstanding mortgages, the highest proportion since 1996, at the tail end of the last housing crash. The Council of Mortgage Lenders is forecasting a figure of 75,000 repossessions for 2009.

21.2.09 The Banking Act 2009 came into effect, implementing a permanent 'Special Resolution Regime' and enhancing consumer protection, amongst other things.

23.2.09 Government confirms that Northern Rock is to be used to resuscitate the UK's sluggish housing market. The bank is now expected to increase mortgage lending by up to £14 billion over the next two years, around £5 billion of new lending occurring in 2009 and between £3 billion and £9 billion occurring from 2010 onwards. The new lending will be financed partly from deposits and repayments on the existing loan book and partly through an increase in the government loan to Northern Rock and by lengthening the repayment schedule [around two-thirds of the £27 billion loan from the Bank of England has already been repaid]. As announced in August 2008, the Government is to strengthen Northern Rock's capital base by up to £3 billion. The bank will also be restructured to separate out the existing loan book ("bad bank" – borrowers in mortgage arrears of more than three months stood at 2.92 per cent of the loan book at the end of 2008, up from 1.87 per cent at end-September 2008; whilst losses in 2008 amounted to £1.4 billion) from the new activities ("good bank").
25.2.09 The new Chairman of the FSA, Lord Turner, in his "grilling" before the Treasury Committee, blames the Government for pushing the previous "light touch" regulatory regime in order to promote London as a financial centre. The result, he maintained, was an unwillingness by the FSA to be intrusive by, for example, challenging banks' business models. A clear case of "political/regulatory capture" if ever there was one!

26.2.09 FSA publishes a draft 'Code of Practice' on financial firms' remuneration policies, aimed at ensuring firms have policies which are consistent with sound risk management, and which do not expose them to excessive risk.

26.2.09 HM Treasury unveils the details of its "Asset Protection Scheme" under which banks can secure 'catastrophe insurance' on their toxic assets in return for a fee, acceptance of legally-binding commitments to increase lending to creditworthy homeowners and businesses, and a promise to adopt a remuneration policy that is consistent with the FSA's new Code of Practice on remuneration policies.

Under the Scheme, eligible participants (i.e. UK authorised deposit-takers with more than £25 billion of eligible assets, e.g. corporate and leveraged loans, commercial and residential property loans, and structured credit assets such as RMBS and CDOs) can secure Treasury protection on 90 per cent of the credit losses which exceed a negotiated "first loss" amount. The fee, designed to ensure appropriate protection for taxpayers and to allow the latter to share in any upside returns, can be paid through the issuance of appropriate capital instruments (e.g. non-voting common stock) or in cash. The Scheme will last for at least five years and its duration will reflect the tenor of the protected assets. The protected portfolio of assets must be ring-fenced and managed separately.

As the 'guinea pig' for the Scheme, the Treasury also announced RBS's participation on the following (provisional) basis: in return for securing the protection of £325 billion (out of a total of £2.2 trillion) of assets, the bank will pay (in addition to foregoing current and future tax credits on losses) a participation fee of £6.5 billion to the Treasury in the form of non-voting equity (designed to minimise the State's voting status in the bank); the bank will bear a first loss of £19.5 billion, and commit to lend £25 billion in 2009 - £9 billion in the form of mortgage lending and £16 billion in the form of business lending – and 2010; and, as part of the Government's commitment to financial stability, the Treasury will also make a further injection of capital (again, in the form of convertible non-voting but dividend-paying shares) of £13 billion, with RBS having the option to subscribe for an additional £6 billion. [If the full £25.5 billion of capital is injected, the State's economic interest in the bank would rise from 84 per cent to around 95 per cent, although its voting stake would be capped at 75 per cent.] As far as the impact of the Scheme on RBS's capital position is concerned, the issuance of £19.5 billion of non-voting "B" shares to the Government will boost its Core Tier 1 ratio, whilst £6 billion of the first loss portion that is retained by RBS will have to be deducted from capital, although the risk-weighted assets of the protected portfolio will be significantly reduced – from £578 billion to £434 billion. The net impact will be to increase the bank's lending capacity and its Core Tier 1 ratio from 7 per cent to 12.4 per cent.
26.2.09 RBS unveils a net loss of £24.1 billion for 2008, the biggest corporate loss in UK history. This was largely due to £6.9 billion of bad debt impairments, credit market losses of £7.8 billion, and a further £16.1 billion of goodwill markdowns on past acquisitions, including ABN Amro. The bank's recovery plan involves slashing group-wide costs by £2.5 billion, which will involve an estimated 20,000 job losses, a retreat to domestic markets (Asian assets, in particular, will be disposed of), and a restructuring of its investment banking operations (radical surgery will be applied to its loss-making global banking and markets division).

Despite the revelation of such massive losses, it is also confirmed that the former chief executive of the bank, Sir Fred Goodwin, is walking away with a £16 million pension pot that will pay out, from today, an annual pension of £693,000 to the 50-year-old ex-banker, until his demise. Given the Government's assurance last October, when the bank was first bailed out, that controls on executive remuneration would be rigorously applied, and its subsequent denunciation of "rewards for failure", the Government is left with "egg on its face" because of its inability to prevent such a clear breach of its stated principles. This is not to say, however, that the Government can adopt the moral high ground on the issue given the scale of its own self-awarded "gold plated" parliamentary pensions.

26.2.09 In an appearance before the Treasury Committee, the Governor of the Bank of England, like the FSA's Chairman the day before, implicates the Government in the failure of the regulatory system because of its previous insistence on 'light touch' regulation of the financial services sector.

27.2.09 Lloyds TSB reveals a pre-tax profit for 2008 of £807 million, down by 80 per cent compared with a year earlier. At the same time, its recent acquisition, HBOS, reveals a pre-tax loss of £10.8 billion – down from a profit of £5.5 billion in 2007 – in part due to £3.6 billion of writedowns on structured credit products and £6.8 billion of losses on its corporate loan book. Despite starting the marriage with a £10 billion loss, the Directors, at least in public, remain convinced of the long-term value of the tie-up (assuming the group is still around to enjoy it!).

2.3.09 The HSBC reveals a $9.3 billion pre-tax profit for 2008 – down by 62 per cent on 2007 – despite writing off $10.5 billion in goodwill on its US consumer finance operation (Household, a Chicago-based consumer finance business, was bought in 2002 for $14.7 billion and currently operates under the name of the HSBC Finance Corporation). Apart from announcing a dramatic scaling-back of its US consumer finance operations, the bank stuns the City with the confirmation that it is to make a £12.5 billion rights issue – the largest ever in the UK – to help it compete with taxpayer-supported institutions in the future (rather than to shore up the balance sheet against future problems in its existing balance sheet). It also announces a dividend cut. The market reaction was a near 20 per cent fall in the bank's share price, dragging down other bank share prices and the overall market – the FTSE 100 fell by over 5 per cent to end at a six-year low.
2.3.09 The Government announces that a new unit in the Treasury, to be run as a private limited company, is to be set up to lend, at market rates, billions of pounds to private finance initiative projects currently starved of private funding.

3.3.09 The Treasury confirms that, if necessary, it is prepared to fully-fund urgently-required PFI projects, in effect rendering them purely publicly-financed projects. Up to £2 billion of funding is envisaged for 2009 alone.

3.3.09 Northern Rock reports a loss of £1.4 billion for 2008 amid rising arrears – now representing 2.92 per cent of its loan book against 0.45 per cent at the end of 2007 – and repossessions, up from 2,215 at end-2007 to 3,620 at end-2008, representing roughly a tenth of all UK house repossessions. The publicly-owned lender also admitted that around one-third of its borrowers were facing a situation of negative equity at the moment, with average house prices set to fall yet further.

5.3.09 Monetary Policy Committee of the Bank of England cuts its policy rate by 50 basis points to a new record low of 0.5 per cent and announces that "quantitative easing" will begin next week when the Bank will start to purchase – initially, £2 billion of gilts through a reverse auction – up to £75 billion of gilts of between 5 and 25 year maturities. Another £75 billion of purchases of gilts and corporate securities – bringing the totals to £100 billion and £50 billion respectively – may follow. To the extent that the sellers are non-banks, the money supply will be directly increased, whereas bank sales would, at least initially, simply raise banks' capacity to lend through an increase in the banks' cash reserves at the central bank. The aim is to get nominal spending in the economy rising at around 5 per cent per annum.

7.3.09 The Government announces the provisional terms of Lloyds Banking Group's access to the asset protection scheme. Using the deal with RBS as a template, some £260 billion (out of a balance sheet of £1.1 trillion) of toxic assets – 83 per cent coming from HBOS portfolios – are to be insured, with the bank shouldering a 'first loss' after existing impairments of £25 billion and 10 per cent of the residual. In exchange for securing insurance on 90 per cent of the residual £235 billion, the bank will pay a 'fee' of £15.6 billion in the form of dividend-paying but non-voting "B" shares, convertible into common stock at a price of 115p. compared with the current market price of 42p. (thereby resulting in less dilution for current shareholders compared with the RBS deal). The bank has also committed to increased lending of £14 billion (£3 billion in mortgages and £11 billion in business loans) over the next 12 months, with the same again the following year. The bank is also to convert its £4 billion of preference shares, awarded to the Government in last October's bailout, into equity, thereby giving the Government a controlling (voting) stake of up to 65 per cent (the bank had fought hard to keep this below 50 per cent), its economic stake rising to 77 per cent on payment of the fee. The deal, due to be ratified by the Summer, will result in the bank's Core Tier 1 ratio rising from 6.4 per cent to 14.5 per cent. Compared with RBS, which paid a fee of nearly 4 per cent, Lloyds' fee is higher (at 6 per cent) by virtue of the fact that it is securing a bigger reduction in risk-weighted assets.
- £194 billion compared with RBS's £144 billion – thereby securing more capital benefit in the form of the boost given to its Core Tier 1 ratio. Despite ceding majority control of the bank to the Government, the Chairman and Chief Executive are likely to survive in their current positions, at least for now and despite likely wails of anguish from existing shareholders, given the support they enjoy from Number 10, where the initial deal to prevent HBOS from failing was hatched. However, they have had to agree to review the bank's existing remuneration policy and implement a policy consistent with the FSA's latest 'Code of Practice on Remuneration Policies'.

10.3.09 Industrial production in the UK is revealed to have fallen by 11.4 per cent in the year to January 2009, the worst performance since January 1981. Forecasts now believe the economy will contract by around 3 per cent in 2009 against the Government's forecast of 1 per cent.

11.3.09 Bank of England reveals that over £10.5 billion of offers for sale of gilts were received in the first of its "reverse auctions" of gilts - £2 billion of a planned £75 billion in the next three months – mainly from banks. Gilt yields duly fell by around 50 basis points, as intended, with the hope that corporate borrowing costs will similarly fall in due course.

11.3.09 Government reveals the detailed criteria for the £2.3 billion support package for the automobile industry announced in January 2009 relating to government guarantees for loans to back low carbon research and development. A £27 million government grant for Jaguar Land Rover to support a £400 million project to develop a new, greener Land Rover vehicle was also announced, as part of the business investment scheme.

17.3.09 Mirroring the debate on Congress over the administration's failure to prevent massive bonus payments to employees of the state-assisted insurance giant AIG, the Treasury and Civil Service Committee grill Lord Myners over his failure to prevent Sir Fred Goodwin, the former Chief Executive of RBS, from benefitting from failure via the bank's discretionary decision to double the size of his pension pot (to over £16 million) by allowing him to retire at 50 rather than 60 and, it is now revealed, to be allowed to take a lump sum of £2.7 million on retirement, tax on which was picked up by the bank (i.e. the taxpayer). Lord Myners, charged with ensuring that there were "no rewards for failure" when the bank was rescued last October, admitted that he waived through the deal without asking any questions about the size of the pension settlement or Sir Fred's contractual entitlement. He added, however, that negotiating the pension settlement was a Board responsibility, and that the Board had not told him the full facts. Lord Myners is now of the view that Sir Fred should have been sacked, thereby minimising his pension entitlement.

17.3.09 Latest FSA figures reveal that, despite falling interest rates, the number of mortgage borrowers in arrears at the end of 2008 stood at 377,000 – 3.4 per cent of the total – a rise of 10 per cent in the final quarter of 2008 and up by 31 per cent on the corresponding figure a year earlier.
18.3.09 The FSA publishes the review undertaken by its Chairman, Lord Turner, on its response to the global banking crisis (the 'Turner Review').

18.3.09 The latest IMF forecast for the UK is that GDP will fall by 3.8 per cent in 2009 and by 0.2 per cent in 2010, with the UK being the only large economy expected still to be in decline that year.

18.3.09 Latest figures reveal that unemployment in the UK, according to the Labour Force Survey count, climbed above 2 million in February 2009 to raise the unemployment rate to 6.5 per cent of the labour force, the highest level since Labour took office. Meanwhile the number of people claiming job-seeker's allowance jumped by 138,400 in February, the biggest monthly jump since 1971.

19.3.09 National Audit Office publishes a damning report on the Government's handling of the Northern Rock affair, criticising the Treasury's inaction in putting in place mechanisms to deal with struggling financial institutions (it was aware of the problems in 2004), its failure to prevent the bank from making a further £800 million of risky mortgage loans (i.e. with loan-to-valuations of 125 per cent) after it received State support, and the scale of expenditure on outside advisers (over £78 million).

19.3.09 Latest figures from the Office for National Statistics reveal that the public sector current budget was in deficit by £1.8 billion in February 2009 compared with a surplus of £4.6 billion a year earlier. This takes the budget deficit to £43.8 billion in the financial year to date, with the IMF forecasting that, by 2010, this will represent around 11 per cent of GDP, compared with a forecast of 8.9 per cent for the US and 6.3 per cent for the PPP GDP-weighted average of the G20. The ONS figures also reveal that public sector net debt at end-February 2009 was £717.3 billion, equivalent to 49 per cent of GDP, when the effects of the financial bailout are included.

20.3.09 The Alliance and Leicester, taken over by Banco Santander in 2008, reveals a pre-tax loss of £1.29 billion for 2008, compared with a £399 million profit for 2007. The loss is in line with Santander's expectations at the time of its acquisition.

24.3.09 Latest inflation figures reveal that, whilst the RPI fell to a 49-year low of zero in February 2009 the CPI actually increased, to 3.2 per cent, triggering yet another letter from the Governor of the Bank of England to the Chancellor explaining another missed target. The main reason for the divergence in the two inflation indicators is that, unlike the CPI, the RPI measure includes mortgage interest payments which have fallen, for many, following rapid interest rate decreases delivered by the Monetary Policy Committee of the Bank of England. It also includes energy costs, which have fallen recently. In contrast, increased food prices and the pass-through of the effects of sterling's depreciation served to increase the CPI.
24.3.09 Latest figures from the British Bankers' Association reveal that new mortgage lending rose by 16 per cent in February 2009 to a seasonally-adjusted 28,179, the highest level since April 2008. Whilst this provides some evidence that the residential property market may be stabilising, the figure is still some 31 per cent lower than the figure for the previous year; and mortgage approvals remain barely above the record lows recorded last Autumn.

24.3.09 The Governor of the Bank of England cautions against a further large-scale stimulus package, in an appearance before the Treasury Committee, whilst the European Commission demands that the UK's budget deficit be brought back below 3 per cent of GDP by 2013-14. Neither comments are likely to go down too well in No.10 Downing Street!

25.3.09 In a possible sign of things to come, as investors fret over the state of the public finances in the UK, the Government failed – for the first time in seven years and only for the fourth time since auctions began in 1986 – to sell the full amount of gilts put up for sale (£1.75 billion worth). Whilst the shortfall in demand may have resulted, in part, from the maturity of the gilts offered – 40 years as opposed to the 5 to 25 year maturities of those which the Bank of England is willing to purchase under its 'quantitative easing' programme – the fear is that further failed gilt auctions may materialise in the future as investors undertake a fundamental re-appraisal of the risks involved in investing in UK gilts.

    Meanwhile, as part of its 'quantitative easing', the Bank of England embarked upon its first purchase of corporate debt – up to £50 billion will be spent in this way – following on from its gilts purchases last week. It is to be hoped that such purchases have a more lasting impact on yields than the earlier gilt operations, where the expected fall in yields proved unexpectedly short-lived.

27.3.09 According to the Land Registry, house prices in England and Wales fell by a further 2 per cent in February 2009, taking the annualised rate of decline to 16.5 per cent.

27.3.09 Latest figures from the Office for National Statistics reveal that the household savings ratio rose from 1.7 per cent in the third quarter of 2008 to 4.8 per cent in the final quarter in the face of job insecurity and the need to address over-indebtedness.

27.3.09 Barclays Bank reveals that the "severe" stress tests carried out by the FSA had revealed that it did not need additional capital to cope with further deterioration in credit and financial conditions and the real economy. This reduces the chance of the bank seeking to access the Asset Protection Scheme.

30.3.09 Barclays Bank declares it does not need to participate in the Asset Protection Scheme, thereby avoiding governmental interference in remuneration and lending policies.
30.3.09 The Nationwide Building Society takes over the branches, deposits (£2.4 billion) and sound assets of the Dunfermline Building Society, Scotland's largest society, after the latter discloses the likelihood of losses of £26 million for 2008 following ill-fated ventures into the commercial property market, the mortgage-backed securities market and sub-prime mortgage lending. The UK Government, meanwhile, assumes responsibility for over £900 million worth of toxic loans/assets, paying the Nationwide £1.6 billion because of its assumption of all of the Dunfermline's liabilities yet only part of its assets (£68.5 million to cover the integration and running costs, is also included). The Government expects to retrieve most of its 'investment' from the wind-down of the assets acquired and, eventually, from the banks through the deposit sub-scheme of the FSCS. Although the Dunfermline will lose its independence it will retain its name.

30.3.09 Bank of England figures reveal that mortgage approvals jumped from 31,791 in January 2009 to 37,937 in February 2009, the biggest rise since 2006 and the highest level since May 2008. Meanwhile, the figures for M4 reveal that lending to non-financial companies grew at an annualised rate of over 5 per cent over the three months to February 2009, the fastest growth since June 2008. Both figures hint that the bottom of the recession may be approaching.

31.3.09 In a letter to the Treasury Select Committee, the former Chairman of RBS, Sir Tom McKillop, refutes Lord Myners' earlier suggestion that the RBS Board had used an "elaborate ruse" to increase Sir Fred Goodwin's pension by allowing him to retire early. Although such a decision may have been discretionary, Sir Tom argues that Lord Myners was fully informed of the scale of Sir Fred's pension and, at no stage, suggested Sir Fred be sacked. The letter further undermines credibility in the Government's long-stated intention of not "rewarding failure".

2.4.09 Latest Bank of England quarterly survey of credit conditions reveals that, despite several improvement in the availability of credit, this has been accompanied by a tightening of lending criteria.

3.4.09 Halifax house price index reveals a further fall of 1.9 per cent during the month of March.

7.4.09 The Government's stake in RBS rises to 70 per cent after investors snub the latest placing and open offer of shares.

9.4.09 Barclays Bank announces the sale of iShares to CVC Capital Partners, the private equity group, for $4.2 billion, thereby reducing the bank's need for a governmental injection of additional capital.

9.4.09 The Monetary Policy Committee of the Bank of England leaves its policy rate at 0.5 per cent, as it waits to see the impact of its 'quantitative easing' policy. Of the original £75 billion, £26 billion has already been spent on buying up assets – mostly gilts – although yields have not fallen by as much as intended, and a two-tier market in corporate debt has emerged as only the
yields on high-quality bonds, the focus of the Bank's attention to date, have fallen.

15.4.09 Moody's downgrades a number of UK building societies, including the largest, the Nationwide, after stress-testing how they would perform against a base case scenario of a 40 per cent fall in house prices from the peak of the boom and a further deterioration in commercial loan portfolios.

21.4.09 Latest UK inflation figures reveal that the RPI fell by 0.4 per cent in the year to March 2009 although the CPI rose by 2.9 per cent, still well above the inflation target of 2 per cent. The former's move into deflation territory was largely due to the dramatic recent fall in mortgage interest payments which followed the cuts in official interest rates.

21.4.09 Bank of England figures reveal that businesses are still being starved of credit with the flow of net funding – new loans less repayments – to businesses close to zero in February 2009. Gross mortgage lending also fell to its lowest level since March 2001.

21.4.09 It is revealed that, since its announcement in December 2008, UK mortgage providers responsible for less than half of the market have to date signed up to the Government's flagship "homeowners mortgage support" scheme (which allows borrowers to defer all of their capital repayments and up to 70 per cent of interest payments for up to two years if they have lost their job, and lenders receive a government guarantee against default). Unsurprisingly, it is the nationalised banks which have been forced to join.

21.4.09 The IMF's latest Global Financial Stability Report suggests losses of around £135 billion (equivalent to 9.1 per cent of GDP) will result from the UK Government's various financial stabilisation schemes (e.g. direct bank support, guarantees and emergency liquidity provision), with UK banks being expected to face another $200 billion of loan losses over the next two years requiring the raising of an additional $125 billion plus of capital if the ratio of tangible common equity to tangible assets is to return to its pre-crisis level of around 4 per cent.

22.4.09 Latest UK unemployment figures reveal a 177,000 rise in the first three months of 2009, taking the figure to 2.1 million – 6.7 per cent of the labour force – the highest figure since Labour came to power in May 1997.

22.4.09 Chancellor unveils a budget that provides fiscal easing, equivalent to about 0.5 per cent of GDP, in 2009/10 followed by a tightening of 0.8 per cent of GDP per year until 2013/14. The immediate stimulus reflects the support provided for industry, the housing market (including a new scheme to guarantee mortgage-backed securities) and the unemployed. The planned fiscal tightening for the medium to long term is reflected in the forecast for public spending which, as a proportion of GDP, is expected to fall from 48 per cent in 2009/10 to 39 per cent by 2017/18. Annual growth in real public sector current spending is being cut from its current level of 1.2 percent to 0.7 per cent by 2011; and capital expenditure, in cash terms, is being halved from
£44 billion this year to £22 billion in 2013/14, with public sector net investment falling to 1¼ per cent of GDP by 2013/14. Whilst such plans imply significant cuts in future public expenditure, even deeper cuts (and/or greater tax rises) have been postponed by, once again, adopting wildly-optimistic growth targets for the economy. For, although finally falling into line with independent forecasters with respect to the forecast for 2009 – the UK economy is now expected to contract by between 3¼ per cent and 3¾ per cent (although this has since been thrown into doubt following the release of figures showing that the UK economy contracted by 1.9 per cent in the first three months of 2009), compared with a figure of 3.7 per cent as an average of independent forecasters and the IMF’s latest forecast of a 4.1 per cent contraction – forecasts for 2010 and beyond are way out of line with independent forecasters. In 2010, for example, the Government expects growth to resume at a rate of between 1 per cent and 1½ per cent, only slightly less than forecast in the Pre-Budget Review last November. In contrast, the average of independent forecasts stands at a meagre 0.3 per cent; whilst the IMF believes the UK economy will actually contract by 0.4 per cent. More worrying is the size of the bounce expected in 2011 – growth of between 3¼ per cent and 3¾ per cent is anticipated compared with an average independent forecast of 1.9 per cent. And beyond 2011, trend growth of 2.75 per cent per annum is assumed. More realistic growth assumptions (as well as more conservative estimates for public sector efficiency savings and the costs of financial stabilisation policies) would see the already worryingly high public sector borrowing and debt figures spiral even higher. On the Government’s own estimates, Public Sector Net Borrowing is now expected to be £175 billion in 2009/10, equivalent to 12.4 per cent of GDP, £173 billion in 2010/11 (11.9 per cent), falling to £97 billion (5.5 per cent) in 2013/14. The budget is not expected to return to balance until 2017/18, two years later than forecast only last November. Meanwhile, public sector net debt is forecast to increase, as a share of GDP, from 59 per cent to 79 per cent in 2013/14 (after allowing for potential losses on financial stabilisation initiatives already undertaken – estimated at £50 billion, or 3½ per cent of GDP, compared with an IMF estimate of £135 billion, equivalent to over 9 per cent of GDP (IMF, 2009b, pp.44/45)).

The foreign exchange market’s immediate reaction to this news was not encouraging for sterling – it fell by 1.1 per cent against the dollar on the day, and by 1.3 per cent against the euro. And the figures concerning the public finances, necessitating gross gilt issuance of £220 billion in 2009/10 compared with £146.5 billion for 2008/09, triggered a two-day sell-off of gilts, taking yields back above their levels prior to the announcement of the Bank of England’s ‘quantitative easing’ policy. An expansion in the latter programme plus additional bank purchases in compliance with new liquidity adequacy rules may be required to soak up the additional gilt sales if undesirable increases in long-term yields or, indeed, further failed gilt auctions, are to be avoided in the future.

24.4.09 Latest GDP figures for the UK reveal that output fell by 1.9 per cent in the first quarter of 2009, its largest contraction for 30 years. Coming so soon after the Budget, the figure immediately calls into question the Government’s
economic forecasts for growth, borrowing and debt in the short to medium term.

27.4.09 Latest figures from the British Bankers' Association reveal that mortgage approvals for house purchases fell by 7 per cent in March 2009, the first fall since November 2008, dashing hopes of an early recovery in the UK housing market.

30.4.09 Latest figures for the Nationwide Building Society house price index reveal that UK house prices fell by 0.4 per cent in April 2009, providing further evidence that the housing market may not recover as soon as some had predicted (the index rose by 0.9 per cent in March 2009).

1.5.09 Figures from the Insolvency Services reveal that personal insolvencies rose to a record 29,774 in England and Wales in the first quarter of 2009, up 19 per cent on the figure of a year earlier.

4.5.09 EU Commission forecasts that the UK economy will contract by 3.8 per cent in 2009 but grow by 0.1 per cent in 2010. Whilst not as bad as recent IMF forecasts, the figures are worse than those outlined by the UK Government in its recent budget.

6.5.09 House of Commons Treasury Committee, in a report on the recent budget, joins the chorus of voices berating the Government for its optimistic growth forecasts.

6.5.09 According to the Halifax price index, UK house prices fell by a further 1.7 per cent in April 2009, on average.

7.5.09 Monetary Policy Committee of the Bank of England leaves its policy rate at 0.5 per cent but commits to spending a further £50 billion under its "quantitative easing" policy. [Of the original £75 billion of planned purchases, to date £51 billion has been spent on gilts, about £1 billion on corporate bonds and £4 billion on short-term commercial paper.]

7.5.09 Barclays Bank reveals a first-quarter pre-tax profit of £1.37 billion, up 15 per cent on last year's figure, although bad debt charges rose by 79 per cent to £2.3 billion.

7.5.09 Lloyds Banking Group announces it expects provisions for problem corporate loans – mainly inherited from HBOS – to rise by over 50 per cent (to around £14 billion) in 2009, raising the prospect of UK taxpayers picking up the tab on the bank's bad loans, according to the terms of the 'Asset Protection Scheme', sooner than expected.

8.5.09 RBS reveals a first quarter loss of £857 million, largely due to impairments of £4.9 billion and warns of a difficult year ahead.
11.5.09  HM Treasury publishes proposals for reforming insolvency procedures for investment banks in the wake of the problems revealed by the collapse of Lehman Brothers.

12.5.09  UK unemployment figures reveal a surge in the unemployment rate to 7.1 per cent at the end of March as the unemployment total rises by 244,000 in the first quarter of 2009 taking the total to 2.22 million (the highest figure since 1996).

17.5.09  Sir Victor Blank, Chairman of Lloyds Banking Group, announces that he is to retire early (i.e. before June 2010) in the face of a potential shareholder revolt at next month's annual meeting and a lack of public support from UK Financial Investments, the guardian of taxpayers' stake in the bank. The announcement follows widespread criticism of the bank's senior executives for agreeing to a "takeover-rescue" of HBOS without performing sufficient due diligence, action which has cost shareholders dear as the share price has plunged following the revelation of the scale of HBOS's bad debts.

19.5.09  Latest UK inflation figures reveal that the CPI fell to 2.3 per cent in April 2009 (3.8 percent if the one-off impact of the cut in VAT to 15 per cent is removed), with the RPI recording a figure of minus 1.2 per cent.

20.5.09  Following on Article IV Consultation, the IMF concludes that the UK Government did well to contain the financial crisis and avert a systemic breakdown. However, it goes on to argue that the UK economy remains susceptible to potential shocks because of the sharp increase in public sector borrowing and contingent government liabilities and continued financial fragility. Accordingly, the IMF suggests the Government should continue to encourage banks to expand their capital bases, through further public support where necessary, and strengthen their commitment to medium-term fiscal consolidation. The latter requires putting public debt on a firmly downward path faster than envisaged in the 2009 budget and reducing budget deficits more aggressively where unexpected growth allows.

21.5.09  Echoing the above-mentioned IMF report, Standard and Poor's lowers its medium-term outlook for UK debt from "stable" to "negative" on concerns that net government debt might shortly approach 100 percent of national income and stay there. Loss of its triple-A rating for medium-term debt would make life difficult for the Government as it tries to sell record amounts of gilts to fund its burgeoning budget deficits at "reasonable" rates of interest.

22.5.09  Publication of latest economic statistics reveal mixed signals about the UK economy. In the first quarter of 2009, inventories fell by £6 billion (2 per cent of GDP), the biggest drop since records began in 1955. While this is potentially bullish for the economy – future demand will increasingly have to be met from new production - figures for household spending reveal a fall (the biggest since 1980) of 1.2 per cent in the first quarter largely due to a fall in employees' wages and benefits.
27.5.09 Nationwide Building Society reports pre-tax profits of £212 million for the year to 4 April 2009, down from £686 million a year earlier. The decline is due to rising impairment losses on loans and advances (£394 million), a squeeze in net interest margins and a substantial contribution (£241 million) to the Financial Services Compensation Fund to cover payouts made to depositors of collapsed banks.

1.6.09 The House of Lords' Economic Affairs Committee recommends that the new Financial Stability Committee of the Bank of England be given executive responsibility for macro-prudential supervision.

2.6.09 Latest figures from the Bank of England reveal that lending to non-financial companies and households fell in April for the first time since records began in 1997, duly contracting by 0.1 per cent and taking the annual rate of growth in lending to the non-financial sector to a record low of 2.6 per cent. These figures suggest that the £125 billion programme of quantitative easing has, as yet, had little effect on broad money and credit, in part because nearly half of those selling gilts to the Bank of England were foreigners.

4.6.09 According to the Halifax's house price index, UK house prices rose by 2.6 per cent in May 2009, their fastest monthly rise in seven years, suggesting the market may be stabilising.

8.6.09 Bank of England announces that it plans to extend its asset purchase facility to commercial paper backed by assets such as trade receivables, equipment leases and short-term credit to consumers. The market size of such operations is estimated to be a few billion pounds. To date, under the £125 billion quantitative easing programme, £77 billion has been spent on government bond purchases, £2.2 billion on corporate bond purchases and £70 million on commercial paper purchases.

8.6.09 Lloyds Banking Group announces that it is to repay £2.6 billion to the Treasury following strong support for its open offer and placing aimed at repaying the Government's £4 billion holding of preference shares. [The take-up of the heavily discounted shares – at 38.43p. compared with a closing market price of 61.1p. – by non-governmental investors was 76.3 per cent, and the preference shares are to be redeemed at 101 per cent of their face value.] The repayment of government funding, the first of its kind by a big bank in the current global crisis, is designed to remove the funding burden associated with the preference shares and to allow for the restoration of dividend payments.

9.6.09 Bank of England asks insurance companies to consider swapping their holdings of subordinated bank debt either for equity or, at a discount, senior unsecured debt in an effort to help shore up the UK financial system.

10.6.09 Treasury announces that it is looking at new ways to allow building societies to raise capital without shedding their mutual status.
12.6.09 The West Bromwich Building Society announces that it has struck a deal with its debt holders to exchange £182.5 million of subordinated debt for a new instrument named "profit-participating deferred shares" (PPDS). The new (perpetual) instrument will be treated by the FSA as core equity Tier 1 capital, taking the institution's ratio from 6.8 per cent to 11.6 per cent and removing the need for a rescue or government bailout. Continued independence, however, comes at a price. The Society has agreed to pay, on a discretionary basis, up to 25 per cent of its future consolidated post-tax profits (it made a £39.3 million loss in the year to end-March 2009) as a dividend to the holders (mainly UK insurers) of the PPDS.

16.6.09 UK Government uses a bank syndication, for first time since 2005, to sell up to £5 billion of 25-year bonds.

16.6.09 The latest CPI figures for May 2009 reveal that inflation remained above target at 2.2 per cent – down from 2.3 per cent in April 2009.

17.6.09 The latest unemployment figures for the UK reveal that in the three months to April, unemployment rose by 232,000 to 2.26 million, representing 7.2 per cent of the workforce. The quarterly rise, however, was less than in the previous quarter, suggesting the worst of the recession may be over.

17.6.09 Governor of the Bank of England, in his Mansion House speech, calls for the Bank to be given greater powers to allow it to deliver on the financial stability front. This echoes earlier calls for it to be given the "trigger" – the FSA currently has it under the new Banking Act – for the activation of the 'special resolution regime'.

18.6.09 Sir Fred Goodwin, former Chief Executive of RBS, finally agrees to give back more than a third of his £16.6 million pension pot.

24.6.09 Echoing earlier calls by the IMF and the European Commission, Mervyn King, the Governor of the Bank of England, calls on the UK Government, in an appearance before the Treasury Select Committee, to do more and sooner to bring down the budget deficit (contingent upon the state of the economy).

25.6.09 FSA announces that, within three years, product providers would be banned from offering commission to secure sales, and advisers would be banned from recommending products that automatically paid commissions. The move is an attempt to limit the mis-selling of financial products, a scourge of the industry in recent times.

29.6.09 Latest Bank of England figures reveal that, during May 2009, net lending secured on homes did not grow at all, the worst performance since records began in 1993, whilst lending to private non-financial businesses fell by 0.1 per cent.

30.6.09 Revised GDP figures reveal that UK output slumped by 2.4 per cent in the first three months of 2009 compared with the earlier estimate of 1.9 per cent. This represents the worst performance for 50 years.
1.7.09  Stephen Hester, the new Chief Executive of RBS, agrees to defer part of his controversial £9.6 million pay package for an extra two years following pressure from institutional investors. Many regard his remuneration as obscene given the RBS is 70 per cent owned by UK taxpayers, and the latest agreement entitles him to bonuses of £3.4 million, after five years, if RBS shares reach 70p. (compared with a current price of 39.41p.).

2.7.09  Latest Bank of England figures reveal that, in the three months to June 2009, secured lending to UK households rose for the first time since the third quarter of 2007, whilst corporate credit availability rose for the second quarter in a row, albeit from a very low level.

8.7.09  Government publishes its White Paper on reforming UK financial regulation.

14.7.09  UK CPI inflation is revealed to have fallen below target, at an annualised rate of 1.8 per cent, during June 2009 for the first time in nearly two years. This was largely due to falling prices for food, drink, clothing and footwear. Meanwhile, RPI inflation is recorded at minus 1.6 per cent for the same period, largely due to lower mortgage payments and house prices and falls in energy costs.

15.7.09  Latest figures reveal that UK unemployment in the three months to May rose by 281,000 to 2.38 million, the largest quarterly increase since records began in 1971. This takes the unemployment rate to 7.6 percent.

16.7.09  Sir David Walker publishes his review of financial sector corporate governance arrangements.

16.7.09  In its annual assessment of the UK economy, the IMF repeats its earlier call for the UK Government to set out more concrete and rapid plans to cut the forecast £175 billion budget deficit once economic recovery has been established, while calling on the Bank of England to do more to stimulate capital markets by increasing its purchases of private sector assets under its quantitative easing programme.

19.7.09  The Conservative Party outlines its plans for financial reform should it be returned to office including, inter alia, the return of prudential supervision to the Bank of England, the granting of new macro-prudential powers to the Bank of England, to be overseen by a new financial policy committee containing some outside experts, and the scrapping of the FSA as we know it – with the agency being turned into a Consumer Protection Agency.

20.7.09  The National Audit Office qualifies the Treasury's accounts (four other public bodies were similarly affected, including three other government departments) for the first time in the Department's history because officials exceeded parliamentary spending limits by setting aside £25 billion for potential losses from the bailout of toxic bank assets.
24.7.09 FSA unveils new rules – to take effect in 2011 – for the Financial Services Compensation Scheme whereby customers of failed financial institutions will received compensation within a maximum of 20 days of the institutional failure, with a target of 7 days. Customers will no longer see their loans used to offset their claims in determining compensation limits. Moreover, banks operating under different brand names will have to warn customers that the *de jure* limit of protection of £50,000 applies to the total level of deposits held within the group and not a per brand basis.

24.7.09 The latest GDP figures reveal that the economy contracted by 0.8 per cent in the second quarter, taking the decline to 5.6 per cent in the year to June 2009, double the amount expected by most analysts and calling into question the Government's official growth forecasts for 2009, with knock-on effects for the budget deficit and public debt forecasts. The figures also bode ill for future unemployment, with service sector output declining by 0.6 per cent in the quarter.

27.7.09 The Chancellor threatens the banking industry with a competition probe if they fail to increase the supply of affordable loans to businesses, as they promised in the industry bailout packages of October 2008 and January 2009. The banks, in turn, argue that higher margins and fees reflect higher long-term funding costs incurred by the banks and rising credit risk, while market/regulatory demands that banks hold more capital have constrained the industry's ability to lend. Reduced demand for credit from creditworthy borrowers also helps to explain the recent anaemic growth in bank credit to the non-bank private sector. In response, the Government ordered ministers to hold a series of one-to-one meetings with bank chiefs during August 2009 to determine whether loan rates for small- and medium-sized firms have risen excessively.

27.7.09 Sir Win Bischoff is confirmed as the next Chairman of Lloyds Banking Group, despite some opposition from institutional investors concerned at his age (67) and that he was tainted by his stint as Chairman at the crisis-ridden Citigroup.

28.7.09 John Kingman, the Chief Executive of UK Financial Instruments, the body responsible for managing the state's stakes in UK banks, announces that he is to step down after just eight months in the job to pursue a career in the private sector, while the Government also reveals that the ailing chairman of UKFI, Mr Moreno, is to be replaced shortly by Sir David Cook. The announcements unsettled the City, concerned at the uncertainty generated for the successful management, and eventual sale, of the Government's stakes.

30.7.09 According to the Nationwide house price index, average UK house prices rose by 1.3 per cent in July 2009, following rises in the two previous months (of 1.3 per cent and 1 per cent), suggesting the UK residential property market may be stabilising.
The first half results for HSBC and Barclays, two of the UK-incorporated banks which forsook state handouts, reveal that healthy profits were made by both. Barclays, for example, reported pre-tax profits of £2.984 billion, an increase of 8 per cent on a year earlier. This, however, was largely due to an improved performance by its investment banking unit, Barclays Capital, which recorded a 100 per cent increase in pre-tax profits of over £1 billion, which helped to offset pre-tax losses on its UK retail banking and commercial banking operations. Bad debts across the group almost doubled to £4.6 billion. Meanwhile, the HSBC reported half-yearly pre-tax profits of $5.02 billion, but these were down by 51 per cent on the previous year, and were buoyed by a 34 per cent increase in pre-tax profits earned by its ‘Global Banking and Markets’ division which took earnings to a record $6.3 billion. Again, however, impairment charges and other provisions, of $13.93 billion, up by 39 per cent on the first half of 2008, indicated the difficulties faced by the group on the retail and commercial banking front. And it remains to be seen if investment banking earnings, boosted by reduced competition, increased spreads and cheap government funding, continue to offset losses on the retail/commercial fronts.

Northern Rock announces half year pre-tax losses of £725 million, up from £585 million a year earlier, while also revealing that nearly 40 per cent of its borrowers are in negative equity and that it still owes the Bank of England £10.9 billion, up from £8.95 billion at the end of 2008. Its arrears (over three months) at almost 4 per cent, were also revealed to be way above the industry average of around 2.4 per cent, contradicting earlier government assertions about the strength of the mortgage book. Meanwhile, the Government’s plans to split the bank into a "good" bank and a "bad" bank and to sell off the former are on hold pending a European Commission review. The FSA, however, is allowing the bank to operate in breach of regulatory capital requirements although it is restricting the bank’s new mortgage writing to £4 billion this year, £1 billion short of the bank’s original target.

The latest Bank of England figures reveal that bank lending to businesses dropped by a record £14.7 billion in the three months to June 2009, with manufacturing, construction and retail being the worst hit. The figures give the lie to claims that the banks are honouring the lending commitments given in the last two industry-wide bailouts.

Standard Chartered announces a 10 per cent increase in operating profit to £1.67 billion but, at the same time, launches a £1 billion cash call to fund the purchase of subsidiaries from the ailing RBS.

Lloyds Banking Group posts a half-yearly pre-tax loss of £4 billion following an impairment charge of £13.4 billion, £9.7 billion of which related to HBOS’s corporate loan book. The market was cheered, however, by the bank’s claim that impairments had now peaked, although concerns remain about retail lending, as unemployment continues to rise, and its mortgage book (despite a fall in repossessions). Also, the bank’s loans to deposits ratio, of 176 per cent, is one of the highest in the industry, reflecting its continued heavy reliance on wholesale funding (the bank wants to reduce the ratio to
Moreover, uncertainty surrounding the final terms of the asset protection scheme and those aspects of the bank's business plan which require approval from the European Commission under state aid rules suggest that investors should remain cautious for some time yet.

5.8.09 According to the latest figures for the Halifax house price index, average house prices in the UK rose by 1.1 per cent in July 2009, with prices in the three months to July 0.8 per cent higher than in the previous three months.

6.8.09 The Monetary Policy Committee of the Bank of England votes to keep interest rates on hold but to expand the scale of its quantitative easing programme by £50 billion to £175 billion. The decision was taken because, the recession appears to be deeper than previously thought and because, despite some evidence that credit conditions are easing, lending to businesses had fallen in the last month and the spreads on bank loans remained relatively high.

7.8.09 RBS reports a half-year pre-tax profit of £15 million (equivalent to a net loss of £1 billion) following impairment charges of £7.521 billion (up from £1.48 billion last year) which reflected continuing problems in its retail and corporate banking units. Rapid recovery in the second half of 2009 is not anticipated Some headway, however, has been made in shrinking its balance sheet, now down to £1.6 billion from £2.2 billion, and in cutting its loans to deposits ratio, now down to 144 per cent each from 152 per cent. Investment banking operations contributed some £5.1 billion to operating profits but this is not seen as being sustainable.

7.8.09 Barclays and HSBC both report healthy half-year profits – of £2.98 billion and $5.02 billion respectively – as strong investment bank earnings more than offset weaker profits and rising bad debts (impairment charges of £4.56 billion and $13.93 billion respectively, hit the banks), although both banks suggested the rate of loans falling into arrears was slowing.

12.8.09 UK unemployment is revealed to have surged by 220,000 in the three months to June 2009 taking the unemployment rate to 7.8 per cent, the highest level since 1996. Meanwhile, the Bank of England, in its latest Inflation Report, warns that the recession this year has been deeper than expected and that recovery will be "slow and protracted", although renewed growth is expected in the next few quarters.

23.8.09 FSA publishes its remuneration code of practice which will apply to large banks, building societies and broker-dealers from January 2010. The principles-based code is designed to ensure that boards "focus more closely on ensuring that the total amount distributed by a firm is consistent with good risk management and sustainability" and that "individual compensation packages provide the right incentives".
14.8.09 Repossessions in the second quarter of 2009 are revealed to have fallen by 10 per cent on the first quarter, to 11,400. This was due to low mortgage rates and lenders' support of borrowers. Rising property prices and interest rates, however, may trigger an upward rebound in the future.

14.8.09 Bradford and Bingley reports a pre-tax loss of £160 million for the first half of 2009. It also reveals that it has shrunk its loan book by £1.5 billion, to £40.3 billion, since end-2008, but it expects to take many more years (unless asset sales are made) to run it off.

18.8.09 Latest UK inflation figures reveal that the CPI fell to 1.8 per cent in July 2009, a smaller fall than anticipated, whilst the RPI rose to –1.4 per cent.

21.8.09 Chelsea Building Society reports a first-half year loss of £26 million following a £41 million charge taken against mortgage fraud. This follows the £29 million loss made in 2008.

23.8.09 Despite the recent upturn in the UK equity market, the UK Government is revealed still to be sitting on a £3.3 billion loss on its direct investments (via Lloyds Banking Group and RBS) in the UK banking sector, with potentially massive liabilities also being faced under the terms of the Asset Protection Scheme (the final details of which have still yet to be confirmed with the banks concerned).

26.8.09 In an interview published in Prospect magazine, Lord Turner, Chairman of the FSA, warns of the dangers of UK financial service regulators acting as a cheer-leader for the City on the international stage and argues the case for the imposition of a new, internationally-agreed, "Tobin-style" tax on financial transactions should higher capital requirements fail to curb excessive profits and pay in a bloated financial sector. Unsurprisingly, publication of the article prompted the Treasury to deny that any such taxes were under consideration, while the vested interests in the City, backed by the Mayor of London, voiced outrage at the mere raising of the issues. The truth, however, is that the financial services industry believes it has weathered the storm, albeit with enormous support from the taxpayer and at great cost to the real economy, and that it can return to "business as usual", with politicians lacking the will to fundamentally refashion the industry and prevent the recurrence of the "excesses", notably on the remuneration front, so evident pre-2007.

28.8.09 Revised GDP figures reveal that the UK economy shrank by 0.7 per cent in the second quarter of 2009, marginally less than the provisional estimate of 0.8 per cent.

3.9.09 Latest OECD forecasts see an upwards revision to G7 GDP for 2009 – from a decline of 4.1 per cent forecast last June to a decline of 3.7 per cent – but a downwards revision for UK GDP, from a contraction of 4.3 per cent to a contraction of 4.7 per cent. Despite marginal upwards revisions to UK growth forecasts for the third and final quarters, the UK is alone amongst G7 nations in experiencing no quarterly growth in 2009.
8.9.09 Publication of the latest figures for UK industrial production reveals that it rose by 0.5 per cent in July 2009, with manufacturing output rising by 0.9 per cent. The Office for National Statistics, however, advised caution, warning that monthly growth rates are particularly volatile at the moment.

15.9.09 Publication of the latest inflation figures reveals that the CPI fell from 1.8 per cent to 1.6 per cent, at an annualised rate, during August 2009. The RPI was –1.3 per cent.

16.9.09 Latest UK unemployment figures reveal that unemployment leapt by 210,000 in the three months to July 2009 taking the total to a 15-year high of 2.47 million, equivalent to 7.9 per cent of the workforce.

18.9.09 Latest government borrowing figures reveal that, in August 2009, the Government borrowed a record £16.1 billion for the month, providing further evidence that the budget forecast of £175 billion for fiscal year 2009/10 will most likely be overshot.

18.9.09 The Chancellor announces the Government’s intention to introduce legislation to provide the FSA with the power to ensure bank bonuses do not encourage excessive risk-taking or short-termism, along the lines of the FSA’s proposals. Mindful of the fact that the bill will not become law until next Spring, after the next bonus paying season, the Chancellor calls on banks to adopt the proposed reforms – as agreed at the G20 Pittsburg summit – now, in advance of the legislation. It remains to be seen if such exhortation falls on deaf ears and whether the legislation incorporates the more demanding measures included in Sir David Walker's review of corporate governance.

30.9.09 The Chancellor announces that the top five UK-incorporated banks – Barclays, HSBC, Standard Chartered, RBS and Lloyds Banking Group – have agreed to apply the rules agreed at the Pittsburg summit to the 2009 bonus round. It still remains to be seen, however, how overseas banks react to the deal, with the US Fed apparently looking for wriggle room within the wording of the summit communiqué.

2.10.09 According to the Nationwide Building Society house price index, UK house prices rose in September 2009 for the fifth month in a row. The rise of 0.9 per cent took the third quarter rise to 3.8 per cent compared with the second quarter, the fastest three-month increase since 2004. Compared to the October 2007 peak, however, house prices are still down by 13.5 per cent.

5.10.09 FSA unveils its new liquidity rules for banks, to be introduced once the recession is over.

6.10.09 Shadow Chancellor, George Osborn, unveils some of the measures the Conservative Party will adopt should they form the next government to reduce the soaring budget deficit. As well as retaining, at least for now, the 50p. tax rate for top earners announced by the Government earlier this year,
to take effect next year, he announced the following additional measures: a pay freeze, starting in 2011, for public sector workers earning more than £18,000 a year; an increase in the age at which people can receive the state pension to 66 by 2016 for men and by 2020 for women (the dates have yet to be confirmed); a reduction in tax credits for families with annual income of more than £50,000; a cap, of £50,000 a year, on public sector pensions; £3 billion a year cost savings from the operations of Whitehall and quangos by the end of the next Parliament; the scrapping of "baby bonds" for the middle-classes; and delaying the introduction of the £1 million threshold for the payment of inheritance tax until the end of the first Parliament.

In all, the measures are designed to cut £7 billion a year from the budget deficit by 2015, rising to £13 billion a year once the new pensionable age kicks in.

13.10.09 Latest UK inflation figures reveal that the CPI fell to 1.1 per cent in September 2009, with the RPI falling to −1.4 per cent.

14.10.09 Latest UK unemployment figures reveal an unexpected fall in unemployment in the three months to August 2009 to 2.469 million, suggesting unemployment peaked at 8.2 per cent in June 2009.

19.10.09 FSA unveils its proposals for regulation of the mortgage market in the wake of the problems identified in the run-up to the property crash. The FSA is proposing, inter alia: imposing affordability tests for all mortgages and making lenders ultimately responsible for assessing a consumer's ability to pay; banning 'self-certification' mortgages through required verification of borrowers' income; banning the sale of products which contain certain 'toxic combinations' of characteristics that put borrowers at risk; banning arrears charges when a borrower is already repaying and ensuring firms do not profit from people in arrears; requiring all mortgage advisers to be personally accountable to the FSA; and calling for the FSA's scope to be extended to cover buy-to-let and all lending secured on a home.

23.10.09 Latest UK GDP figures reveal that output fell by 0.4 per cent in the third quarter, the sixth in a row, taking the fall to 5.9 per cent since the Spring of 2008. This is the longest recession experienced by the UK economy since records began over 50 years ago, and means the UK is likely to be the last G7 nation to emerge from the recent worldwide recession.

28.10.09 EU Competition Commissioner clears the Government's planned restructuring of Northern Rock which will see the bank split into a "good" bank and a "bad" bank by the end of this year, with the former sold off to the private sector in the second half of 2010.

3.11.09 HM Treasury unveils restructuring plans for RBS and Lloyds Banking Group in the light of the banks' desire to limit their involvement in the Government's Asset Protection and EU demands for disposals as a result of the competitive impact of the earlier Government bailouts of the banks.

With respect to the Asset Protection Scheme, Lloyds Banking Group will no longer participate, paying an exit fee of £2.5 billion for the implicit state
protection provided to date. Instead, it will raise £21 billion of new private sector capital, £13.5 billion to come from a rights issue and £7.5 billion from swapping existing debt for "contingent" capital (i.e. which converts into equity when the bank's Core Tier 1 capital ratio falls below a critical level). The Government will subscribe £5.7 billion (net of an underwriting fee) to new shares under the rights issue to preserve its stake in the bank at 43.4 per cent. RBS, meanwhile, will remain in the APS, but subject to revised terms, which will see, inter alia, the bank accepting a larger "first loss" than originally envisaged (i.e. £60 billion rather than £42 billion), a smaller pool of insured assets (down from £325 billion to £282 billion) being put into the Scheme and the bank accepting a revised fee structure. The Government's economic interest in the bank will be confirmed at 84.4 per cent following a £25.5 billion capital injection, although its voting interest will be capped at 75 per cent (currently, 70.3 per cent). In addition, to protect against a worst-case-scenario, the Government will provide a contingent capital commitment of up to £8 billion, which would raise its economic interest to 87 per cent, in return for an additional fee; and the bank has agreed to pay a minimum exit fee of £2.5 billion when it leaves the Scheme. The net effect of all these changes is expected to reduce risks to the taxpayer (although up-front exposure has been increased by some £38 billion – but only by around £13 billion in 2009/10 compared to the last Budget's forecast – contingent exposures have been dramatically reduced (by over £300 billion); while both banks will remain subject to the lending commitments agreed to earlier in the year and be subject to restrictions on bonus payments, amongst other things.

Finally, with respect to the restructuring agreed with the EU Competition Commissioner, divestment totalling around 10 per cent of the retail banking market, will have to be undertaken by the banks within four years, with the purchasers being confined to small or new players in the market (Virgin and Tesco's are rumoured to be interested).

5.11.09 Despite acknowledging signs that a pick-up in economic activity may be imminent, the Monetary Policy Committee of the Bank of England decides to increase the scale of quantitative easing by £25 billion to £200 billion (13 per cent of GDP) because of lingering concerns that the recovery would be slow and protracted because of continuing problems with bank lending and further required deleveraging by firms and households.

6.11.09 RBS unveils a third quarter pre-tax loss of £2.2 billion (equivalent to a net loss of £1.5 billion) following impairment losses of £3.5 billion. The bank, however, claims impairments have "plateaued". Meanwhile, the quarter-on-quarter Core Tier 1 capital ratio fell from 6.4 per cent to 5.5 per cent, although the capital boost provided earlier in the week by the Government raises this to a pro-forma ratio of 11.1 per cent.

10.11.09 HSBC announces that third quarter profits will be "significantly ahead" of last year.
Barclays announces third quarter pre-tax profits of £1.6 billion (despite a one third fall in investment banking revenues), virtually unchanged since the second quarter, and resumes paying a dividend for the first time in a year. Its Core Tier 1 capital ratio now stands at 8.9 per cent.

UK unemployment rose by 30,000 in the three months to September, the lowest rise in 16 months, taking the headline count to 2.46 million, equivalent to 7.8 per cent of the labour force. Male and long-term unemployment continued to rise, however, and youth unemployment reached a record high of 19.8 per cent.

Latest UK inflation figures reveal that annualised inflation rose during October 2009 from 1.1 per cent in September to 1.5 per cent for the CPI, and fell, from –1.4 per cent to –0.8 per cent, for the RPI.

Two finance-related bills are included in the Queen's Speech. The first is the Financial Services Bill, which incorporates the Government's plans for reforming UK financial regulation, including provisions giving more power to the FSA to crack down on risk-creating bank bonuses and on financial crime. The second bill, the Fiscal Responsibility Bill, will enshrine in law the Government's plans to halve the budget deficit by 2014 and to balance the books by 2018. Lacking legal sanctions, however, it is not clear what purpose is served by the proposed legislation, unless holders of public sector debt believe that the measures will actually increase the likelihood of the promises being delivered.

Publication of the latest public borrowing figures reveals that the Government borrowed a further £11.4 billion in October 2009, the worst monthly figure since records began in 1993, taking aggregate borrowing in the first seven months of fiscal 2009/10 to £86.9 billion and suggesting the official forecast of £175 billion for the whole of fiscal 2009 will be breached. At the same time, the OECD released a report forecasting a UK budget deficit of 13.3 per cent of GDP for 2010, the worst figure of any major economy. Accordingly, it calls for "more ambitious fiscal consolidation" once recovery takes hold in order to strengthen the recovery.

The CBI backs the Conservative Party's plans for an early reduction in the budget deficit, despite the risks of choking off the nascent recovery, as it brands the Government's latest plans for restoring health to the public sector's balance sheet as too timid. It also rejects the Government's Fiscal Responsibility Bill in favour of the Conservative's proposal to establish an external monitoring body.

The Nationwide, Britain's largest building society, reports underlying half-year pre-tax profits of £117 million, 64 per cent down on the same period the previous year. The poor performance is put down to low interest rates, intense competition, particularly for retail savings, and a four-fold jump in loan loss provisions to £317 million.
In an appearance before the House of Commons' Treasury Committee, the Governor of the Bank of England reveals that £62 billion of secret loans were made to the Royal Bank of Scotland (£37 billion) and HBOS (£25 billion) in the Autumn of 2008 following the collapse of Lehman Brothers and the uncertainty this created in the World's financial markets. Backed by a £100 billion of collateral and paying a penal rate, the loans were fully repaid in January 2009. Given the Treasury's indemnification of the Bank against loss, this increased the taxpayers' exposure to the financial system yet again, but we were not made aware of it for some 13 months. Whilst there may have been merit in prematurely activating the recently-secured covert lending provisions, it is difficult to see how keeping Parliament and the general public in the dark for so long about such a major funding initiative can be justified. Moreover, Lloyds shareholders will be livid that the true state of HBOS was hidden from them before they were asked to rescue the near-bankrupt bank, a decision that resulted in the former bank becoming part-nationalised. A simpler solution, but one politically distasteful, would have been to nationalise HBOS, rather than infect a hitherto well-run British bank. Whether other UK-incorporated banks have secured similar covert loans remains unclear.

The UK GDP third-quarter fall is revised downwards to 0.3 per cent from 0.4 per cent, confounding the optimists who were anticipating a much larger revision.

RBS signs the final agreement to enter the Government's Asset Protection Scheme, under which £240 billion of its most toxic assets will be insured. The bank will formally enter the scheme once its shareholders vote in favour at a meeting to be held next month.

Yorkshire Building Society and Chelsea Building Society announce they are to merge to form the second largest building society in the UK. The announcement follows the revelation that Yorkshire Building Society made a £22 million pre-tax loss for the first half of 2009 following the Chelsea's earlier announcement of a £26 million loss for the same period largely due to massive mortgage fraud. The enlarged group will take a £200 million hit to its balance sheet as a result of a fair-value assessment of Chelsea's assets.

National Audit Office publishes a report justifying the Treasury's decision to support the UK banking sector, to the tune of up to £850 billion, given the potential economic and social consequences of large-scale bank collapses. However, it criticises the scale of fees paid by the Treasury to outside advisers, at over £150 million, the failure to force the banks in receipt of taxpayer support to deliver on their promises with respect to lending to consumers and businesses, and the failure of the authorities to notify Parliament of the covert support operations carried out by the Bank of England in the Autumn of 2008 sooner than they did.
7.12.09  The 'Asset Protection Agency' is launched to oversee the management of the £240 billion (some £40 billion of the £280 billion originally agreed on has already expired) of RBS's risky assets insured under the Asset Protection Scheme.

9.12.09  Chancellor unveils his latest Pre-Budget Report. The main measures embrace:

- a further 0.5 per cent increase in national insurance contributions for all those earning over £20,000 a year from April 2011, taking the total increase to 1 per cent (the increase is needed, in part, to offset increased public sector expenditure, for example on schools, of around £15 billion in 2011 and 2012 compared with previous plans);
- a capping of all public sector pay settlements at 1 per cent from 2011 for a period of two years;
- a one-off 50 per cent levy on discretionary bank bonuses of over £25,000 paid before April 2010 (payable by the firm);
- a ring-fencing of the budgets for health, schools and the police (but no details provided of how other departments will fare in the next few years where savage cuts – of up to 15 per cent per year for a three-year period – are anticipated);
- a confirmation of government spending plans for 2010/11, with a rise of £31 billion, with government spending growth due to fall to 0.8 per cent of GDP in 2011/12;
- £5 billion of additional 'efficiency' savings;
- a 2.5 per cent increase in the basic state pension from April 2010, when child benefit and some disability allowances increase by 1.5 per cent;
- a freezing of personal allowances and income tax allowances from April 2010 (when the new 50 per cent tax rate kicks in for those earning over £150,000), with the higher rate tax threshold frozen also from April 2012; and
- confirmation of the return of the rate of VAT to 17.5 per cent (from 15 per cent) on 1 January, 2010.

The estimated impact of the budget measures on the public finances is as follows:

- public net borrowing is forecast to rise by £3 billion, to £178 billion (equivalent to 12.6 per cent of GDP), in 2009/10, falling to £82 billion (4.4 per cent of GDP) by 2014/15; and
- public sector net debt is set to rise from the current 44 per cent of GDP to 78 per cent of GDP by 2014/15, breaking through the £1 trillion mark around Summer 2011.

The market's reaction to the Pre-Budget was unfavourable, with most viewing it as a highly political exercise (not unsurprising given the proximity of the next General Election). In particular, there was widespread concern that not enough had been done in the near-term to tackle the twin problems of the budget deficit and public debt – most of the pain only kicks in in 2011 – and no attempt had been made to identify where the public spending axe would eventually fall. Moreover, as in previous Pre-Budget Reports/Budgets, the growth forecasts are likely to prove wildly over-optimistic, particularly in the medium-term – growth of between 1 per cent and 1.5 per cent is forecast for
2010, following an expected contraction in GDP of 4.75 per cent for 2009 (forecast to be only 3.5 per cent in the last Budget), followed by two years growth at an unlikely 3.5 per cent per year – thereby undermining the Chancellor's forecasts for future public debt and budget deficit levels. And the £5 billion of "additional efficiency savings" in the public accounts are likely to prove as elusive as ever. Unsurprisingly, a substantial sell-off of gilts the day after the Pre-Budget statement caused gilt yields to rise significantly, perhaps heralding the main problem likely to face whatever Administration secures the political reins next Spring – the cost to the country of financing the public debt mountain.

11.12.09 FSA introduces "reverse stress testing" whereby institutions are required to imagine their failure and then work backwards to determine which risks and vulnerabilities are likely to have caused their hypothetical failure.

16.12.09 HM Treasury publishes a consultative document concerning proposals aimed at ensuring an orderly wind-down of ailing investment banks in the future.

17.12.09 Unemployment in the UK is revealed to have risen by only 21,000, to 2.49 million, in the three months to October 2009, keeping the unemployment rate at 7.9 per cent.

29.12.09 FTSE 100 retrieves its pre-Lehman Brothers crash level as it closes at over 5,437.
<table>
<thead>
<tr>
<th>Recipient Banks</th>
<th>Nature of Capital Infusion</th>
<th>Resultant Government Stake in the Bank (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. RBS</td>
<td>£15 billion in new equity; £5 billion in five-year preference shares paying 12 per cent per annum</td>
<td>58</td>
</tr>
<tr>
<td>2. HBOS</td>
<td>£8.5 billion in new equity; £3 billion in preference shares</td>
<td>43.5*</td>
</tr>
<tr>
<td>3. Lloyds TSB</td>
<td>£4.5 billion in new equity; £1 billion in preference shares</td>
<td></td>
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Notes: *The combined entity was named the Lloyds Banking Group
### TABLE 2.4: IMPLEMENTATION OF THE BANKS' "ASSET PROTECTION SCHEME" OF JANUARY 2009: PROVISIONAL AGREEMENT

<table>
<thead>
<tr>
<th>Recipient Bank</th>
<th>Size of Portfolio Protected (£bn.)</th>
<th>Nature of Insurance Secured</th>
<th>Fee Paid (% of insured portfolio)</th>
<th>Potential Resultant Government Stake (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>First Loss (£bn.) (borne by the bank)</td>
<td>% borne by the bank after the &quot;first loss&quot;</td>
<td>% borne by the Government after the &quot;first loss&quot;</td>
<td></td>
</tr>
</tbody>
</table>
| 1. RBS                 | 325 (of a total balance sheet of approx. £2.2 trillion) | 19.5 (+ 22.7 of historic losses) | 10 | 90 | 4 (comprising the "payment" of £6.5 bn. to the Treasury in the form of non-voting equity and agreement to forego current and future tax credits on losses) | 84
| 2. Lloyds Banking Group | 260 (of a total balance sheet of approx. £1.1 trillion) | 25 | 10 | 90 | 6² (comprising the "payment" of £15.6 bn. to the Treasury in the form of non-voting, dividend-paying equity) | 77

**Notes:**

1. This represents the Government's potential economic interest in the bank following the Treasury's conversion of its preference shares in the bank to common equity (which occurred on 7 April 2009 thereby raising the Government's stake to 70 per cent) and the bank's acceptance of a £13 billion capital infusion via the issuance of non-voting, dividend-paying "B" shares to the Treasury. This will rise to around 95 per cent if the bank exercises its option to subscribe to an additional £6 billion of such funding, although the state's voting stake is likely to be capped at 75 per cent.

2. The fee is higher than that paid by RBS (as a proportion of protected assets) because a bigger reduction in risk-weighted assets is secured, thereby delivering a bigger boost to capital ratios.

3. This reflects the Government's potential economic interest in the bank following payment of the fee and conversion of the Government's existing preference shares to common equity (which would raise the Government's stake from 43.5 per cent to 65 per cent).
US Government announces measures to restrict executive compensation and perks for those working for firms that receive state support, although the "rules" will not be applied retrospectively. For those working for firms receiving "exceptional assistance", pay will be capped at $500,000 a year and any shares received as bonuses would only vest after government funding has been fully repaid. For those who work for firms receiving general financial assistance, such as funding under the TARP, the same rules will apply but they can be waived if remuneration details are fully disclosed and shareholders vote to allow the payments. Tougher rules on transparency regarding perks and "golden parachute" payments will also be introduced.

Another 500,000 jobs are lost in the US economy in January 2009 raising the unemployment rate that month to 7.6 per cent, its highest level since 1992.

US Senate passes the $838 billion fiscal stimulus bill. Congress now has to reconcile the Senate bill with the $819 billion House of Representatives' version passed last month.

US Government unveils plans to spend up to $2 trillion to clean up the financial system and restart the credit markets. The plans embrace the following:
(i) the recapitalisation of needy financial institutions, following stress tests, using funds allocated under the TARP ($350 billion or so remains available) – those receiving funds will face restrictions on dividend payments, share buy-backs and cash – financed acquisitions;
(ii) spending up to $1 trillion trying to unfreeze credit markets using an expanded 'TALF' (term asset-backed securities loan facility) and a new lending initiative to kick-start the financing of student, auto and credit card loans, commercial mortgages and some residential mortgages;
(iii) spending up to $1 trillion, to be raised from the Fed, the Treasury, the FDIC and private investors, to remove toxic assets from banks (details to be finalised); and
(iv) spending up to $50 billion (to be provided by the Treasury and the Fed from existing TARP balances) to support the housing market and help limit foreclosure.

The lack of an insurance scheme (as introduced recently in the UK) to limit banks' potential losses on existing toxic assets, the dependence of the plans for removing the banks' toxic assets on private sector investors, and the lack of detail led to a sell-off on Wall Street following the announcement.

UBS unveils a near SFr20 billion loss for 2008, the biggest loss in Swiss corporate history, following a fourth quarter loss of SFr8.1 billion.
11.2.09 France becomes the first leading economy to impose industry-wide restrictions on future bonus payments to bankers, traders and fund managers in order to try and avoid excessive risk-taking. From April, bonuses will be paid over several years and linked to the long-term profitability of their employers.

11.2.09 Irish Government announces that it is to invest €3.5 billion into both the Allied Irish Bank and the Bank of Ireland to help them absorb losses from the local property market. The recapitalisation will involve the Government in taking preference shares paying a coupon of 8 per cent, the preference shares being counted as core tier one capital for regulatory purposes. The Government will also take share warrants, exercisable after five years, to purchase up to 25 per cent of the ordinary shares of each bank.

13.2.09 Figures reveal that Eurozone GDP fell by 1.5 per cent in the fourth quarter of 2008, led by a sharp deterioration in the German economy which experienced a contraction of 2.1 per cent. The data suggests the Eurozone is experiencing its worst recession in over 50 years.

13.2.09 US Senate passes the Government's $787 billion fiscal package following the earlier backing by the House of Representatives. The package, designed in part to create or save 3.5 million jobs and including a provision limiting bonuses paid to top executives of government-assisted banks to a third of total compensation, is expected to be signed into law next week.

16.2.09 Latest GDP figures for Japan reveal that, in the final quarter of 2008, the economy contracted by 3.3 per cent, or by 12.7 percent at an annualised rate. This is the worst economic decline experienced by the country since the oil-related crisis of 1974 and is largely due to collapsing export sales and subdued domestic consumption.

17.2.09 President Obama signs into law the $787 billion US stimulus package which will be spread over two years.

18.2.09 US Government unveils proposals for $75 billion in subsidies to encourage lenders to reduce mortgage rates for between three and four million borrowers at risk of losing their homes. The Government is also to push for a change in bankruptcy law to allow judges to force lenders to reduce mortgage rates for bankrupt homeowners. And finally, up to $200 billion of fresh Federal capital is to be injected into Fannie Mae and Freddie Mac to allow them to refinance between four and five million of additional mortgages.

19.2.09 Bank of Japan announces that it will speed up to ¥1 trillion buying corporate bonds rated A and higher from next month and also extend its programmes to buy commercial paper and provide unlimited collateral-backed loans to financial institutions.

20.2.09 Shares in Citigroup and Bank of America crash further – taking their weekly falls to 44 per cent and 34 per cent respectively – on fears of nationalisation following next week's stress tests.
24.02.09 According to the Case-Shiller index, house prices in big US cities fell by 18.5 per cent in the year to December 2008, the biggest fall since the index was first compiled 21 years ago. Continuing house price declines are, of course, bad news for the holders of sub-prime-related securities and financial markets more generally.

25.02.09 A European Commission taskforce, chaired by Jacques de Larosiere, rejects the idea of creating a pan-EU regulator in favour of more 'pragmatic, sensible co-operation' between EU regulators. It did, however, recommend the establishment of a new body, the European Systemic Risk Council, under the auspices of the ECB, to develop policy and provide risk warnings to EU supervisors; and the creation of another body – a 'European System of Financial Supervisors' – to co-ordinate the decentralised network of supervisors monitoring individual institutions and markets.

26.02.09 US President unveils his first budget, outlining plans for 10 years ahead. Among other things, the budget proposals suggest Congress will ask for an additional $750 billion (at an estimated budgetary net cost, after recouping some of the outlays, of $250 billion) to help clean up the financial system, whilst the budget deficit for the current year is forecast to quadruple to $1.75 trillion, equivalent to 12.3 per cent of GDP. A four-year plan to reduce the size of the budget deficit to 3 per cent of GDP by 2013 is also revealed.

27.02.09 Revised GDP figures reveal that the US economy shrank by 6.2 per cent, at an annualised rate, in the fourth quarter of 2008, the steepest fall since 1982.

27.02.09 US Government agrees to a partial nationalisation of Citigroup, the third bailout of the group in four months. Under the deal, the Government will acquire a controlling 36 per cent stake in the group on conversion of $25 billion of its existing $45 billion worth of preferred stock into common stock at a price of $3.25 per share, a 30 per cent premium to the bank's closing price. Other preferred shareholders will also convert up to $27.5 billion of their holdings at the same price, resulting in a huge dilution (to 26 per cent) for the bank's common shareholders. Unsurprisingly, the bank's shares finished the day down by 39 per cent. The forthcoming stress test of the bank may yet see the bank return to the Government for additional funding; whilst the latest agreement has resulted in most of the board (but not the Chief Executive) being forced from office.

2.03.09 AIG reveals a fourth-quarter loss for 2008 of $61.7 billion – the largest quarterly loss in US corporate history – taking its total net loss in 2008 to nearly $100 billion. The losses spark a new government rescue: in return for controlling stakes in AIG's Asian operations and its global life insurance business, plus $8.5 billion worth of bonds backed by cash flow from its US life insurance unit, the Government agrees to forget most or all of the $38 billion lent to AIG, reduce the interest rate on future Fed loans and provide a $30 billion standby credit line to cover further losses. Unsurprisingly, the market was unnerved by the news, the Dow Jones Industrial Average falling below the 7000 level for the first time in 12 years.
3.3.09 The Fed and the US Treasury launch the $1 trillion 'term asset-backed securities loan facility' ('TALF'), with the first loans – to be made on 25 March 2009 – aimed at boosting the availability of credit for auto loans, credit cards and student loans. Under the scheme, which will be extended to include commercial and residential mortgage-backed securities, the Fed will lend money to investors, such as hedge funds, to encourage them to buy asset-backed securities in the wake of the continuing paralysis in the once $4.5 trillion asset-backed securities market.

3.3.09 In testimony before the Senate Budget Committee, Mr Bernanke, Chairman of the Federal Reserve, contends that burgeoning fiscal deficits are a necessary evil if depression is to be avoided. He argues, however, that policymakers must also address the medium-term fiscal solvency of the US Government, withdrawing the temporary parts of the fiscal stimulus as the economy recovers. He also cautions, however, against raising public debt levels above 60 per cent of GDP.

5.3.09 ECB cuts its policy rate by 50 basis points to 1.5 per cent, the lowest rate since the euro was created in 1999.

6.3.09 US unemployment rate in February 2009 rises to 8.1 per cent, the highest level since 1983, as the US economy sheds 651,000 jobs in February.

12.3.09 Bernard Madoff pleads guilty to a $65 billion ponzi-style fraud and is jailed, facing spending the rest of his life in incarceration (his maximum term is 150 years!).

12.3.09 Basel Committee announces plans to stiffen bank capital requirements through: counter-cyclical capital requirements; increasing the quality and quantity of required capital; introducing a maximum gearing ratio; and improving the risk coverage of the capital framework.

16.3.09 US administration reveals that $165 million have been paid out in bonuses to AIG employees, despite the firm receiving over $160 billion in public funds to prevent its collapse. Amidst anger in Congress, the administration announces that it will explore all avenues to claw back the bonuses; whilst the Treasury says it will revamp the terms of the latest $30 billion of state assistance to the firm to recoup the cost of the bonuses (a 90 per cent tax on the bonus payments was subsequently revealed).

18.3.09 US Fed announces plans to buy up to $300 billion of US government debt over the next six months in order to reduce long-term (i.e. up to 10 years) yields, boost the money supply, and to improve conditions in private credit markets, as well as more than doubling (to $1.250 billion) its purchases of securities issued by Fannie Mae and Freddie Mac in an attempt to bring down mortgage rates and generally support the housing market. Once these measures are implemented, along with the $1 trillion scheme to finance credit markets, the Fed's balance sheet will swell to around $4 trillion, nearly a third of the size of the US economy.
US Treasury unveils details of its $1 trillion plan to remove toxic assets from US banks. The plan involves the operation of two schemes. Under the "legacy securities plan", the Government will authorise up to five investment managers to raise equity to buy toxic securities (i.e. MBS and ABS issued prior to 2009 with at least a triple-A rating at origination). Each private dollar raised will be matched by a dollar of equity from a "public-private investment programme" (PPIP) – which will receive between $75 billion and $100 billion of residual TARP funding and comprise additional private capital taking its size up to $500 billion, with the potential to expand to $1 trillion – and complemented by additional Treasury loans at least matching the scale of the private equity raised. The Fed is also to expand TALF to allow it, for the first time, to make loans to refinance existing, as opposed to new, toxic securities of the type described above. Meanwhile, under the "legacy loans plan", designed to remove troubled loans from banks' balance sheets, a marketplace will be created where banks can offer pools of loans at auction. Authorised investors will pre-qualify for matched investment funding from the PPIP, the sum of the equity involved being eligible for leverage of up to 600 per cent through loans guaranteed by the FDIC. If the banks are happy with the price established at the auction then the sales will proceed, with private fund managers managing the loans until the final sales are made. In this way, "market" prices can be established; and no compensation restrictions on institutions taking part in the partnerships will be applied.

The market's initial reaction was highly favourable with stock markets soaring and major private investors vowing to take part in the programme, given the favourable terms available – the public sector loans will be provided at subsidised rates, and potential upside profits, even after the repayment of State assistance, dwarf limited (i.e. to the size of the initial equity state) downside risk. It remains to be seen, however, what the scale of actual sales proves to be – the banks will not off-load their toxic assets at what they perceive to be below "fair" (i.e. reserve) prices (sales at a discount to carrying value – book value less impairments already taken – would force banks to make writedowns equal to the size of the discounts, thereby depleting capital and raising the spectre of additional governmental capital injections into the banks); while potential private investors may be wary of Congress's reaction if they reap too large a profit. Moreover, it should be appreciated that the scale of the current programme will only make a small dent in the banks' stock of toxic assets, leaving them heavily exposed to further deterioration in their portfolios. Further re-capitalisation of the banks, inevitably involving the use of additional State funds, will still be required.

US Fed begins the first of its purchases – up to $300 billion will be spent over the next three months – of old Treasury securities from dealers, focussing on those with maturities of seven years (to help lower the cost of mortgage payments for homeowners, whose average term for fixed-rate mortgages is about seven years).

Revised GDP figures show that the US economy shrank by 6.3 per cent at an annualised rate in the fourth quarter of 2008 (compared with the previous estimate of 6.2 percent), its fastest rate of contraction since 1982.
29.3.09 German Government injects an additional €60 million of equity capital into Hypo Real Estate following the bank’s revelation of a net loss of €5.5 billion for 2008, causing it to breach a minimum regulatory capital ratio. The stake, to be held in Soffin, the Government’s special financial sector bailout fund, is likely to be a precursor to full governmental control, the state’s current stake amounting to just 8.7 per cent.

31.3.09 According to the Case-Shiller index, house prices in the US’s 20 largest cities dropped by a further 2.8 per cent in January 2009, taking the annualised fall to 19 per cent, the largest since the index began in 2000. The figure suggests the bottom of the US housing market is some way off yet.

31.3.09 OECD forecasts that the GDP of its 30-member group will fall by 4.3 per cent during 2009 following a 13.2 per cent fall in World trade. Those countries which depend heavily on exports will fare especially badly, with the Japanese economy forecast to contract by 6.6 per cent and Germany by 5.3 per cent. The UK, meanwhile, is forecast to contract by 3.7 per cent compared with a US contraction of 4.4 per cent. In 2010, the policy-induced recovery is expected to reduce the contraction in OECD GDP to only 0.1 per cent.

2.4.09 The final communiqué issued by the G20 Summit held in London hails its success in securing a pledge to deliver a $1.1 trillion package of measures to tackle the global downturn, including support for lower income countries and a boost to IMF resources, and agreement on tightening financial regulation. Conspicuous by its absence, however, was any new commitment by governments to a further fiscal stimulus, an agreed plan for removing toxic assets from banks’ balance sheets or plans to reduce global economic imbalances.

With respect to the $1.1 trillion support package, unfortunately little new money/pledges are involved. The $500 billion "boost" to the IMF’s resources, for example, which can be used to assist countries struggling in the current climate (the UK?), had already been promised by the likes of Japan ($100 billion) and the EU (€75 billion), with the IMF starting off with around $250 billion in the kitty. No new commitments were forthcoming. Of the proposed $250 billion increase in SDRs, these will be allocated in line with voting shares of the IMF, meaning that 44 per cent will go to the G7 countries, with only $80 billion accruing to middle-income and poor countries combined. On trade finance, the G20 hopes that up to $250 billion will be provided to finance or guarantee trade over the next two years, although less than $25 billion has been committed to financing new trade this year. In contrast, much of the $100 billion committed to aiding the poorest nations through the funding of the multilateral development banks does represent "new money" (in the form of increased resources and borrowing from financial markets), although some has been brought forward from future budgets.

As for reform of financial regulation, a new clampdown on "tax havens" – with the OECD providing a 'blacklist' which the G20 will "take note of" – is promised, along with the regulation of systemically-important hedge funds and rating agencies, increased capital requirements for banks, curbs on bankers' pay and the creation of a new 'Financial Stability Board' (the re-
named 'Financial Stability Forum') to monitor global financial stability and promote medium-term reform, alongside the IMF. All G20 members would have a seat on the new Board.

Whatever one thinks of the 'spinning' of the size of the alleged support package, the markets clearly welcomed the degree of consensus reached on a number of important issues at the Summit, duly delivering three per cent plus increase in indices around the World, although these gains had typically been halved by the end of the following day as the euphoria dissipated, and a more considered assessment of the package prevailed.

2.4.09 ECB cuts its policy rate by 25 basis points to 1.25 per cent and hints of "quantitative easing"-type measures to come.

3.4.09 US unemployment rate hits 8.5 per cent, the highest level since 1983.

7.4.09 Irish Government introduces an emergency budget comprising, *inter alia*, a 4 per cent levy of gross income for those earning more than €75,000. The budget follows last week's downgrading of Ireland's sovereign debt rating by Standard and Poor's, and includes a forecast of an 8 per cent decline in GDP for 2009. The Government also announced the creation of a national asset management agency to take over an estimated €80 billion to €90 billion of bad loans from local banks.

13.4.09 Goldman Sachs reports first quarter net earning of $1.8 billion as elements of the US banking industry return to profitability.

15.4.09 UBS unveils an estimated loss of SFr 2 billion for the first quarter of 2009 following estimated losses of SFr 3.9 billion on illiquid positions and credit losses.

17.4.09 Citigroup and General Electric report better-than-expected first quarter results for 2009. Citigroup's net income for the first quarter was $1.6 billion, the first profit for six quarters, although it required one-off gains to offset $5.4 billion in credit-related writedowns. Meanwhile, operating profit at General Electric fell by 35 per cent to $2.8 billion.

17.4.09 Moody's puts Ireland's triple-A debt rating on review for possible downgrade.

20.4.09 Bank of America reports better-than-expected first quarter earnings of $4.2 billion but its share price falls by over 20 per cent on warnings of deteriorating credit quality and rising provisions for additional credit losses.

21.4.09 The IMF forecasts, in its latest Global Financial Stability Report, that global losses of $4,100 billion will be incurred by 2010 by financial institutions worldwide as a result of the sub-prime crisis, the credit crunch and global recession. Banks are expected to shoulder two-thirds of these losses, necessitating further recapitalisation.
Japanese Government announces that it suffered its first trade deficit for nearly 30 years in the year to March 2009, posting a deficit of ¥725.3 billion. This reflected the sharp rise in commodity prices early in the year and a severe contraction in exports due to the global economic decline.

The IMF, in its latest World Economic Outlook, forecasts that world output will fall by 1.3 per cent in 2009 and grow by just 1.9 per cent in 2010. Describing the current downturn as "the deepest global recession since the Great Depression", the IMF calls on governments to sustain or even increase fiscal stimuli whilst increasing efforts to revive financial sectors.

Bucking the trend of improved first quarter bank results, Morgan Stanley reveals a loss of $578 million.

Members of the European Parliament agree to introduce a new registration and supervisory system for credit rating agencies, to take effect in 2010.

Latest figures reveal that US GDP fell by 6.1 per cent at an annualised rate during the first three months of 2009, whilst the German Government reduces its growth forecast for 2009 to minus 6 per cent.

Chrysler, the US carmaker, files for bankruptcy protection after hedge funds block an out-of-court restructuring of its $6.0 billion of debt.

IMF announces a $17.1 billion two-year standby loan for Romania to cushion the effects of a sharp drop in capital inflows resulting from the current global financial crisis.

European Parliament approves a package of measures designed to toughen bank capital adequacy requirements and prevent a repeat of the current financial crisis. The measures embrace, *inter alia*: forcing institutions to retain at least 5 per cent of the securitised products that they originate (to give them a direct interest in assessing the products' riskiness); a tightening of the definition of core capital; limiting the amount of short-term exposure banks can have with respect to each other; tighter caps on banks' large exposures; requiring colleges of supervisors to be established for cross-border financial institutions; and bringing forward legislative proposals to make the markets for non-exchange-traded derivative products more transparent and less risky through the introduction of centralised clearing. National governments have until October 2010 to implement the legislation, which will take effect at end-2010.

The results of the US Government's "stress tests" of its 19 largest banks are revealed. As expected, Bank of America had the biggest capital deficiency, of $33.9 billion. Others needing extra capital are Citigroup ($5.5 billion, after recent capital-raising efforts), Wells Fargo ($13.7 billion), GMAC ($11.5 billion), Morgan Stanley ($1.8 billion), PNC Financial Services ($0.6 billion), Regions Financial ($2.5 billion), Sun Trust ($2.2 billion), Fifth Third Bancorp ($1.1 billion) and Keycorp ($1.8 billion). Those banks deemed to have sufficient capital to withstand the economic shocks of the next two
years comprised JP Morgan, Goldman Sachs, Metlife, Bank of NY Mellon, Capital One, American Express, US Bancorp, State Street and BB&T. Those needing extra capital have to plug the shortfall by 9 November 2009, or else face converting the Government’s current holdings of preferred share into common equity, thereby boosting the Government’s stakes and diluting existing shareholders.

7.5.09 ECB cuts its main policy rate by 25 basis points to 1 per cent and announces plans to buy €60 billion of covered bonds (triple-A rated bank debt backed by mortgage or public debt).

8.5.09 Fannie Mae reveals a seventh consecutive quarterly loss of $23.2 billion, necessitating a further $19 billion of assistance from the US Treasury.

8.5.09 US unemployment figures reveal that, in April 2009, unemployment climbed to 8.9 per cent, following a further loss of 539,000 jobs that month. This fall, however, was less than in the previous month – revised to 699,000 – suggesting that the rate of economic decline in the US economy may be slowing.

12.5.09 Bank of America raises $7.3 billion by selling close to 6 per cent of its holdings in China Construction Bank to a mainly mainland consortium.

15.5.09 Eurozone GDP is revealed to have shrunk by 2.5 per cent in the first quarter of 2009, dragged down by a slump in output in Germany of 3.8 per cent. The figures confirm, once again, that the current recession in continental Europe is the worst since the Second World War.

20.5.09 Japanese Government announces that GDP fell by 4 per cent (15.2 per cent at an annualised rate) in the first quarter of 2009 following a revision – from 3.2 per cent to 3.8 per cent – in the figures for the last quarter of 2008.

26.5.09 The latest figures for the Case-Shiller index reveal that house prices in the largest 20 cities in the US fell by 2.2 per cent in March 2009, a steeper fall than in the previous month.

27.5.09 FDIC reveals that there are now 305 banks on its ‘problem list’ (out of a total of around 8,300).

29.5.09 Revised Commerce Department figures reveal that US GDP declined by an annualised rate of 5.7 per cent in the first quarter of 2009, compared with last month’s estimate of 6.1 per cent. This represents an improvement on the 6.3 per cent contraction recorded in the last quarter of 2008.

29.5.09 Industrial production in Japan is shown to have rebounded in April 2009, rising by 5.2 per cent on a month-by-month basis. This suggests the Japanese economy may be emerging from recession.
29.5.09 Irish Government agrees to inject up to €4 billion of capital into the nationalised Anglo Irish Bank after the bank reports pre-tax losses of €4 billion for the six month period to 31 March 2009, with provisions against bad loans rising to €4.1 billion.

1.6.09 General Motors files for Chapter 11 bankruptcy protection in New York, making it the largest industrial bankruptcy in history. A court-supervised restructuring is expected to deliver a "leaner and fitter" car manufacturer somewhere down the road, with the US Government taking a 60 per cent stake following its assumption of a 55 per cent stake in a restructured Chrysler.

5.6.09 Latest US unemployment figures reveal that 345,000 more jobs were lost last month taking the unemployment rate to 9.4 per cent, its highest level for 26 years. The monthly loss, however, was much less than expected and the lowest amount since September 2008 raising hopes that the recession may be bottoming out.

8.6.09 In its latest Article IV assessment of the euro area, the IMF warns that more must be done by governments to shore up their banking systems if economic recovery is not to be retarded.

8.6.09 Standard & Poor's cuts Ireland's long-term credit rating to double A from double A plus, with a negative outlook, citing concerns about the fiscal costs of governmental support of the Irish banking system.

9.6.09 Ten financial groups, including JP Morgan Chase, Morgan Stanley, American Express and Goldman Sachs, are allowed to repay a combined total of $68 billion of TARP money in order to shed the associated restrictions on pay and hiring. Conspicuously, Citigroup and Bank of America are not within the group of 10, and still owe a combined $90 billion to the Treasury. The Government, however, still owns warrants giving it the right to buy shares in the banks that received TARP funding in October 2008, although banks have the option of buying back the warrants at "fair market value". And the temporary liquidity guarantee programme remains open to the banks, in effect subsidising their activities.

10.6.09 ECB lends €3 billion to the Swedish central bank in a bid to avert a Baltic financial crisis. The money will be used to bolster the bank's foreign reserves, increasing its firepower to help Swedish private sector banks (which dominate the region's financial sector, especially in Latvia) if necessary.

12.6.09 The Hartford Financial Services Group becomes the first US life assurer to take public funds as it accepts up to $3.4 billion of TARP funding.

15.6.09 In its annual report on the US economy, the IMF warns about the fiscal situation and the need for a bailout exit strategy. It forecast that between 2009 and 2011, federal deficits will average around 9 per cent of GDP whilst debt will soar to 75 per cent of GDP, putting further upward pressure on long-term yields. Domestic concerns about deterioration in the commercial real estate
market, foreclosures and further house price declines were also alluded to. The IMF further argues that big tax increases or spending cuts – equivalent to 3.5 per cent of GDP – will possibly be needed over the next decade if the Government is to meet its debt targets.

15.6.09 ECB predicts, in its latest twice-yearly financial stability review, that Eurozone banks face a further $283 billion of loan losses in 2009/10 due to the economic recession, with total crisis-related writedowns amounting to $649 billion.

15.6.09 Moody's downgrades 30 Spanish banks and cajas (unlisted regional savings banks) citing the worsening quality of their loans, largely due to the local property collapse, and the struggling Spanish economy. The budget deficit, for example, is due to reach 10 per cent of GDP in 2010.

17.6.09 US Government unveils plans for reform of US financial regulation that would see, *inter alia*: the Fed assuming a role of "systemic regulator", whereby it would oversee all financial companies that could pose a threat to the system and have powers to constrain risk-taking to moderate credit growth and asset prices; all financial companies holding more capital; hedge funds being required to register with the SEC, which will retain oversight of mutual funds; the OTS and the OCC being merged to form a new National Bank Supervisor; the creation of a new Consumer Financial Protection Agency to ensure the safe selling of mortgages, credit cards and other retail products through the oversight of mortgage brokers, debt collectors, credit counsellors and mortgage modification specialists; the creation of a new Financial Services Oversight Council to oversee the Fed's performance as a systemic risk regulator; and an extension of FDIC powers to enable it to wind-down systematically-important financial institutions.

19.6.09 EU leaders approve plans to overhaul financial regulation which will involve, *inter alia*, the creation of a 'European Systemic Risk Board' and a 'European System of Financial Supervisors'. The former body, set up to assess general risks to the system, will include the 27 EU central bank governors and would operate with the logistical and analytical support of the ECB. The Chairman is likely to be the ECB's president, as the ECB has been given the power to nominate the Chairman; and the Board will have the power to make "recommendations" but not to implement policy directly. The second body, to comprise three pan-European watchdogs which will oversee banking, securities and insurance, will not have the power to dictate governments' use of taxpayers' money (e.g. to bailout ailing firms) but will have 'binding and proportionate' decision-making powers relating to EU financial rules and binding arbitration power over disagreeing national regulators.

24.6.09 ECB injects, via auction, €442 billion of one-year money at its main policy rate of 1 per cent in a major stimulus effort.

25.6.09 US Commerce Department revises the first quarter contraction in GDP to 5.5 per cent from 6.1 per cent.
25.6.09 AIG announces agreement on a $25 billion debt for equity swap with the Federal Reserve. Under the deal, the Fed will receive $16 billion in preferred equity in American International Assurance, AIG's Asian arm, and $9 billion in preferred shares of American Life Assurance Company, an international life assurer. In return, AIG's debt to the Fed will be cut from $40 billion to $15 billion, and its loan facility will be cut from $60 billion to $35 billion ($40 billion has been used to date).

29.6.09 Bernard Madoff is sentenced to 150 years in prison, the maximum possible, for running a $65 billion Ponzi-style fraud.

29.6.09 BIS calls for sweeping reforms to the regulation of financial instruments, markets and institutions in its latest Annual Report.

30.6.09 Latest inflation data reveal that Eurozone CPI inflation fell by 0.1 per cent in June 2009 compared with a year earlier, the first negative figure recorded since records began.

2.7.09 Latest US unemployment figures reveal an unexpectedly-high jump in the unemployment rate in June 2009, from 9.4 per cent to 9.5 per cent, its highest level for 25 years. Separately, Eurozone unemployment surged to a 10-year high of 9.5 per cent in May 2009.

8.7.09 IMF raises its growth forecasts for the world economy as it predicts a weak economic recovery. Its growth forecast for the world economy is raised to 2.5 per cent for 2010, up from 1.9 per cent last April, largely due to stronger than anticipated growth in China, India, Japan, US and the EU. Its growth forecast for 2009 is for minus 1.4 per cent.

14.7.09 Goldman Sachs reports record second quarter earnings of $3.44 billion, up 65 per cent from the three months to end-May 2008, presaging the payment of further "obscene" bonuses.

16.7.09 JP Morgan announces sector quarter earnings of $2.7 billion, an increase of 36 per cent on the previous year, following strong investment banking earnings (of $2.2 billion). Losses, however, on prime and sub-prime mortgages and on credit cards rose substantially with credit costs amounting to $9.7 billion.

16.7.09 CIT, the embattled US small-business lender, which became a bank holding company in December 2008, teeters on the edge of bankruptcy after the authorities refuse to bail it out.

16.7.09 The Fed announces that it will lend money to hedge funds and other investors to buy CMBS that have a triple-A rating, the first time the Fed has acted to support the market for securities issued before the crisis erupted.
17.7.09 Second quarter profits are reported by both Citigroup and Bank of America but only after making large, one-off business sales. Citigroup, now 34 per cent owned by the Government, reported a $4.3 billion profit compared with a loss of $2.5 billion a year earlier, but this was heavily dependent on the partial sale (for $6.7 billion) of Smith Barney, its brokerage arm, to Morgan Stanley. Without the sale, the group would have reported another large quarterly loss, the sixth in succession. The main damage was caused by rising losses on the group's credit card, mortgage lending and other retail lending businesses, with credit costs amounting to $12.4 billion. Meanwhile, Bank of America reported earnings of $3.2 billion, despite incurring credit costs of $16.4 billion, but again this was largely due to a $5.3 billion one-off gain from the sale of its stake in China Construction Bank and a $3.8 billion gain from the sale of its share of a merchants payment company to a joint venture. Without these gains, the bank – which still has $45 billion of loans to repay to the government – would have reported a quarterly loss.

20.7.09 CIT's board approves a two-year, $3 billion rescue package involving a group of lenders to avoid bankruptcy.

21.7.09 The Chairman of the Fed outlines his 'exit strategy' from its accommodative stance for when the time comes (i.e. when sustained recovery is in place) to reverse the stance of policy.

22.7.09 Morgan Stanley reports a second quarter loss of $159 million, in part due to a $700 million write-down on its commercial property assets and dividend payments of $850 million to the government on its TARP funding. Meanwhile, Wells Fargo announces a record second quarter net income of $3.17 billion, up from $3.05 billion in the first quarter, despite a 45 per cent rise in non-performing assets and a 69 per cent increase in problem loans linked to commercial lending activity.

23.7.09 The EU issues guidelines for the restructuring of banks which received emergency support from national governments and which require approval under EU state aid rules.

27.7.09 Latest figures for US house sales reveal that sales jumped by 11 per cent in June 2009 due to falling prices, low mortgage rates and government incentives. The figures provide further evidence that the US residential housing market may be stabilising.

28.7.09 Average US house prices are revealed to have shown their first monthly rise, of 0.5 per cent, in three years in May 2009, confirming the view that the US residential property market may be stabilising. The latest rise recorded by the Case-Shiller index, however, still leaves prices 17.1 per cent lower than a year earlier.
30.7.09 According to a study by the New York attorney-general, Citigroup and Merrill Lynch, which together lost over $55 billion in 2008 and had to be bailed out by the US Government, paid bonuses of $1 million or more to over 1,400 employees during the last year (profitable banks, such as JP Morgan Chase and Goldman Sachs, paid over 1,600 and 950 million dollar - plus bonuses respectively).

31.7.09 Latest GDP figures for the US economy reveal that the rate of contraction in the economy is slowing, with the economy shrinking by only 1 per cent in the second quarter of 2009, at an annualised rate, compared with a revised 6.4 per cent for the first quarter.

31.7.09 Latest inflation figures for the Eurozone reveal that CPI inflation was minus 0.6 percent in July 2009, at an annualised rate, compared with a figure of 0.1 per cent for June 2009, stoking fears of deflation.

4.8.09 UBS announces a half-year pre-tax loss of £1.66 billion compared with a £8.9 billion shortfall a year earlier.

6.8.09 ECB holds its policy rate at 1 per cent.

6.8.09 Morgan Stanley announces plans to spend $950 million buying back warrants, at a significant discount to their estimated value, it gave the US Government as part of a $10 billion capital injection [the warrants gave the Government the right to buy shares at a fixed price for 10 years].

7.8.09 Latest US unemployment figures for the US reveal that, although job losses rose by 247,000 in July 2009, the unemployment rate fell from 9.5 per cent in June to 9.4 per cent in July, suggesting the recession is bottoming out.

13.8.09 Latest Eurozone GDP figures reveal that the Eurozone as a whole contracted by only 0.1 per cent in the second quarter of 2009 helped by positive growth, of 0.3 per cent, in both France and Germany, which occurred despite continued de-stocking. Recovery in these countries is in stark contrast to the 0.8 per cent contraction experienced by the UK.

14.8.09 Latest figures reveal that US industrial production rose by 0.5 per cent in July 2009.

17.8.09 The latest GDP figures for Japan reveal that the economy grew by 0.9 per cent in the three months to June 2009, largely due to a rise in net exports and the large fiscal stimulus. This growth follows four quarterly contractions.

25.8.09 The White House revises upwards by $2 trillion – to $9 trillion – its February 2009 forecast for the US budget deficit in 10 years' time. The Congressional Budget Office's March 2009 forecast was similarly revised sharply upwards – by $2.7 trillion to $7.14 trillion – for the same period, based upon no change in Government policy. If the Government's planned policy changes are factored in, the latter forecast spirals above the $10 trillion mark.
25.8.09 Ben Bernanke is given a second term as the Chairman of the Federal Reserve.

25.8.09 The latest data for the Case-Shiller house price index reveal that US house prices rose for a second consecutive month in July 2009, suggesting the US residential housing market has stabilised, with concomitant benefits for wider financial stability.

25.8.09 The French president announces strict new rules on banking pay and its disclosure, with banks which fail to comply being denied government mandates. The new rules include, inter alia: deferring a portion of cash bonuses for three years; banning all guaranteed bonuses beyond one year; paying a minimum of one third of bonuses in shares; and forcing banks to adopt strict long-term performance criteria in the assessment process used to determine bonus payments. He will also push G20 countries to agree to impose limits on bonus payments which he recognises he cannot do unilaterally without damaging France’s national interests.

27.8.09 The FDIC reveals that, at end-June 2009, despite the improved fortunes of many of the larger banks, the number of banks at risk of failure was at a 15-year high – 416 – while the fund protecting depositors stood at its lowest level since 1993, at just $10.4 billion. The aggregate balance sheet of the so-called “problem banks” amounted to $300 billion.

5.9.09 Following a meeting of the G20 finance ministers and central bank governors in London, the Group issued a communiqué setting out the broad areas of agreement reached (details will be thrashed out at the G20 leaders’ summit to be held in Pittsburgh on the 24/25 September 2009). The agreements reached covered, inter alia: the need to further strengthen the financial system (see below); the need to develop co-operation and co-ordinate exit policies with respect to the extraordinary fiscal, monetary and financial support provided during the crisis once recovery is firmly secured; a reaffirmation of the commitment to fight all forms of protectionism; and the need to do more to strengthen the IFIs. With respect to the further strengthening of the financial system, the Group agreed on the need for the following:

- greater disclosure and transparency of the level and structure of remuneration for those whose actions have a material impact on risk taking;
- global standards on pay structures (including on deferral, effective clawback, guaranteed bonuses and the relationship between fixed and variable remuneration) to ensure compensation packages are aligned with long-term value creation and financial stability (the FSB is called on to develop specific proposals in time for the Pittsburg summit and to explore possible approaches for limiting total variable remuneration in relation to risk and long-term performance);
- stronger regulation and oversight for systemically-important firms;
- stronger prudential regulation of other financial institutions;
- a co-ordinated approach to tackling non-co-operative jurisdictions;
- consistent and co-ordinated implementation of agreed international standards; and
- convergence towards a single set of independent accounting standards.
The European Commission proposes draft legislation to create a new 'European Systemic Risk Board', comprising the Governors of the central banks together with representatives from the Commission, the ECB and the new EU supervisory bodies of the 27-country EU bloc, as well as the creation of three pan-EU supervisory bodies to augment the day-to-day supervision of banking, insurance and securities by national authorities. Decisions taken by these bodies, however, will not be allowed to impinge upon states' finances. The former body will look for systemic risks and advise on how to handle them, while the latter, the 'European System of Financial Supervisors', will focus on individual institutions. The Commission hopes the new rules, which have to be ratified by Member States, will come into force some time in 2010.

The final communiqué issued by the G20 Group of Nations after the Pittsburgh Summit included a number of agreements designed to strengthen the international financial regulatory system. With respect to capital adequacy, the G20 nations committed to the following: developing, by end-2010, internationally-agreed rules (alongside those relating to liquidity requirements) to improve the quantity and quality of bank capital to introduce counter-cyclical capital buffers, and to discourage excessive leverage, with a view to implementing them by end-2012; and adopting the Basel II Capital Framework by 2011. As far as the reform of compensation packages is concerned, the G20 nations agreed to the following: banning multi-year guaranteed bonuses; requiring a significant proportion (i.e. of between 40 and 60 per cent and possibly higher for senior bankers) of variable compensation to be deferred (for up to three years), tied to performance, subject to appropriate clawback in the event of future poor performance, and to be vested in the form of stock or stock-like instruments, as long as these create incentives aligned with long-term value creation and the time horizon of risk; making firms' compensation policies and structures transparent through disclosure requirements; limiting variable compensation as a percentage of total net revenues when it is consistent with the maintenance of a sound capital base (dividend payments and share buybacks may also be restricted); and providing supervisors with the ability to modify compensation structures in the case of firms that fail or require extraordinary public intervention. Firms are asked to implement these sound compensation practices immediately; and the FSB is tasked to monitor the implementation of FSB standards and propose additional measures as required by March 2010.

Publication of the latest US unemployment figures reveals a sharp jump in the number of people out of work of 263,000 in September 2009, taking the unemployment rate to a 26-year high of 9.8 per cent. The figures cause some to question the sustainability of the apparent recent recovery.

JP Morgan Chase announces third quarter post-tax profits of $3.6 billion, with investment banking operations (especially fixed-income and trading activities) accounting for more than half of group profits. The investment bank also benefited from a $400 million write-up on its leveraged loans and mortgage-backed securities. In contrast, the bank's credit card unit lost $700 million.
15.10.09 Goldman Sachs and Citigroup both announce their third quarter results. The former reported near-record earnings of $3.2 billion, but down from $3.4 billion in the previous quarter, boosted by surging profits in bond and currency trading. This led the bank to set aside a further $5.4 billion for compensation and benefits, bringing the nine-month total to $16.7 million, reigniting the debate over the size of bonuses likely to be paid out for 2009 activities when, in large part, the bank's success is down to reduced competition, extraordinarily low funding costs and state guarantees, explicit or implicit. By way of contrast, Citigroup, in which the Government has a 34 per cent stake, report a post-tax loss, although this becomes a $101 million post-tax profit once the impact of the recent conversion of preference shares owned by the Government and other investors is stripped out. In large part, the loss was down to $8 billion of credit losses, although its investment banking business failed to perform as well as its competitors, with a loss of $535 million being recorded on 'principal transactions'.

16.10.09 Bank of America posts a $1 billion loss for the third quarter having set aside a reserve of $11.17 billion to cover credit losses and incurred $15.7 billion of expenses and restructuring charges.

19.10.09 DSB Bank, a small Dutch lender, becomes the first Western European bank to be allowed to fail since the onset of the financial crisis, following a run on its deposits and the failure to find a White Knight.

21.10.09 Morgan Stanley reports a third quarter post-tax profit of $575 million, its first for a year, helped by good performance in the areas of equity and debt underwriting in particular.

27.10.09 According to the Case-Shiller index, US house prices rose by a seasonably-adjusted 1 per cent in August 2009, their third consecutive month-on-month gain.

28.10.09 Latest US GDP figures reveal that the US economy emerged from the recession in the third quarter after its longest period of contraction (four quarters) since the Great Depression, posting an annualised growth of 3.5 per cent.

3.11.09 UBS unveils a third quarter loss of SFr 564 million following further defections from its private banking business.

6.11.09 Latest US unemployment figures reveal a further rise, to 10.2 percent, in the headline rate for October 2009.

6.11.09 United Commercial Bank, a San Francisco-based lender focussed on the Chinese-American market, is seized by the FDIC and sold to East West Bank, another Californian lender. The failure of the bank is expected to lead to a loss of some $300 million of TARP money, previously injected by way of equity capital to help keep the bank afloat, and to cost the FDIC's insurance fund around $1.4 billion. This represents the fourth biggest US bank failure of 2009.
7.11.09 In its latest communiqué, following a meeting of Finance Ministers and Central Bank Governors in Scotland, the G20 confirms that countries will continue to provide support for the economy until recovery is secured. It also committed to developing further strategies for managing the withdrawal from the extraordinary macroeconomic and financial support measures adopted over the last two years or so and, to this end, welcomes the work being undertaken by the IMF and FSB to develop the principles for such exit strategies. Moreover, the IMF is called on to deliver, at its next meeting, a review of options on how the financial sector could contribute to paying for burdens associated with government intervention to repair the banking system (Gordon Brown's belated conversion to the idea of imposing a Tobin-style tax got short thrift from most delegates, particularly the Americans).

13.11.09 Latest figures for Eurozone GDP show that the region emerged from the recession in the third quarter of 2009 posting 0.4 per cent growth on the previous quarter following a five-quarter contraction.

19.11.09 It is revealed that the Dutch state is to inject a further €4.4 billion in capital into ABN Amro and Fortis Bank Nederland, both previously nationalised, to keep their merger on track.

25.11.09 The Dubai authorities shock the world by asking for a six months debt standstill from the creditors of Dubai World, the Government's flagship holding company, which has debts of $22 billion. The news triggered sharp falls in stock markets in the US and Asia.

2.11.09 Bank of America announces that it is to pay back some $45 billion of TARP funding from the Treasury, partly funded from new capital raising.

4.12.09 Latest US unemployment figures reveal that the unemployment rate in November fell to 10 per cent from 10.2 per cent the previous month.

8.12.09 Fitch downgrades Greek sovereign debt to 'BBB+' and puts it on a negative outlook over fears of its deteriorating finances.

9.12.09 Standard & Poor's revises its outlook for Spanish sovereign debt from "stable" to "negative" amid concerns at the Government's failure to tackle the rising budget deficit.

9.12.09 Japan revises sharply downwards its estimate for economic growth during the three-month period July to September 2009 from an annualised rate of 4.8 per cent to 1.2 per cent.

9.12.09 US Treasury announces that it is to extend the $700 billion TARP to October 2010, paving the way for the residue to be deployed as part of a new stimulus programme. [The Treasury expects to recover all but $42 billion of the $364 billion in TARP funding extended in 2009, with most banks having already repaid their borrowings.]
10.12.09 France announces that it will follow the UK's lead and levy a one-off 50 per cent tax on 2009 bonuses above €27,000 (£24,000).

10.12.09 Goldman Sachs announces plans to force its top 30 executives – the members of its Management Committee – to take their 2009 bonuses in the form of stock (rather than cash) which must be held for at least five years. Investors are also to be given a non-binding advisory vote on its compensation principles and bonuses for top executives at its annual meetings [$17 billion of the bank's 2009 net earnings have already been set aside for compensation and related benefits]. The decision was widely applauded as it forces the management to focus on long-term wealth maximisation, temporarily boosts the bank's capital base and provides shareholders with an added incentive to monitor the bank's risk-taking and compensation policy as their own interests are diluted.

11.12.09 US Treasury sells by auction its 88.4 million warrants held in JP Morgan – they were received when $25 billion was injected into the bank – for $936 million, adding to the $118 billion already received in TARP repayments.

14.12.09 Abu Dhabi provides $10 billion of funding to fellow emirate Dubai to avoid a slide into default of the Dubai government-owned property developer, Nakheel. Markets in the region reacted positively to the news although doubts remain about Dubai World's debt restructuring plans.

14.12.09 Citigroup announces plans to repay $20 billion of TARP funding with the proceeds of an $17 billion to $19.6 billion capital-raising exercise. Under the deal, the US Treasury will sell up to $5 billion of the bank's shares, reducing its stake in the bank from 34 per cent to less than 30 per cent. The rest of the stake will be sold within 12 months. The bank will also terminate its insurance agreement with the FDIC under which some $250 billion of toxic assets were insured, thereby releasing the bank from restrictions on executive pay. [The latter initiative will see the bank cancelling $1.8 billion of preferred securities held by the FDIC, leaving the regulator with a $5.4 billion preferred investment in the lender.]

16.12.09 ECB makes its final offer of 12 months' liquidity as it moves closer to weaning banks off its emergency liquidity support.

17.12.09 Basel Committee publishes a further post-crisis consultation document setting out its proposals for, *inter alia*, narrowing the range of instruments acceptable as regulatory capital, restricting the payment of dividends or bonuses if capital falls below a minimum threshold, and for the introduction of a global leverage ratio, a new liquidity regime and counter-cyclical capital buffers.
### TABLE 3.2: THE US TREASURY’S REFORM PROPOSALS OF JUNE 2009

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<th>OBJECTIVE</th>
<th>RELEVANT PROPOSALS</th>
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<td>1. Promote Robust Supervision and Regulation of Financial Firms</td>
<td><strong>1.A Create a Financial Services Oversight Council</strong>&lt;br&gt;1. We propose the creation of a Financial Services Oversight Council to facilitate information sharing and coordination, identify emerging risks, advise the Federal Reserve on the identification of firms whose failure could pose a threat to financial stability due to their combination of size, leverage, and interconnectedness (thereafter referred to as a Tier 1 FHC), and provide a forum for resolving jurisdictional disputes between regulators.&lt;br&gt;a. The membership of the Council should include (i) the Secretary of the Treasury, who shall serve as the Chairman; (ii) the Chairman of the Board of Governors of the Federal Reserve System; (iii) the Director of the National Bank Supervisor; (iv) the Director of the Consumer Financial Protection Agency; (v) the Chairman of the SEC; (vi) the Chairman of the CFTC; (vii) the Chairman of the FDIC; and (viii) the Director of the Federal Housing Finance Agency (FHFA).&lt;br&gt;b. The Council should be supported by a permanent, full-time expert staff at Treasury. The staff should be responsible for providing the Council with the information and resources it needs to fulfil its responsibilities.&lt;br&gt;2. Our legislation will propose to give the Council the authority to gather information from any financial firm and the responsibility for referring emerging risks to the attention of regulators with the authority to respond.</td>
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<td><strong>1.B Implement Heightened Consolidated Supervision and Regulation of All Large Interconnected Financial Firms</strong>&lt;br&gt;1. Any financial firm whose combination of size, leverage and interconnectedness could pose a threat to financial stability if it failed (Tier 1 FHC) should be subject to robust consolidated supervision and regulation, regardless of whether the firm owns an insured depository institution.&lt;br&gt;2. The Federal Reserve Board should have the authority and accountability for consolidated supervision and regulation of Tier 1 FHCs.&lt;br&gt;3. Our legislation will propose criteria that the Federal Reserve must consider in identifying Tier 1 FHCs.&lt;br&gt;4. The prudential standards for Tier 1 FHCs – including capital, liquidity and risk management standards – should be stricter and more conservative than those applicable to other financial firms to account for the greater risks that their potential failure would impose on the financial system.&lt;br&gt;5. Consolidated supervision of a Tier 1 FHC should extend to the parent company and to all of its subsidiaries – regulated and unregulated, U.S. and foreign. Functionally regulated and depository institution subsidiaries of a Tier 1 FHC should continue to be supervised and regulated primarily by their functional or bank regulator, as the case may be. The constraints that the Gramm-Leach-Bliley Act (GLB Act) introduced on the Federal Reserve’s ability to require reports from, examine, or impose higher prudential requirements or more stringent activity restrictions on the functionally-regulated or depository institution subsidiaries of FHCs should removed.&lt;br&gt;6. Consolidated supervision of a Tier 1 FHC should be macroprudential in focus. That is, it should consider risk to the system as a whole.&lt;br&gt;7. The Federal Reserve, in consultation with Treasury and external...</td>
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experts, should propose recommendations by October 1, 2009 to better align its structure and governance with its authorities and responsibilities.

1.C Strengthen Capital and Other Prudential Standards for All Banks and BHCs

1. Treasury will lead a working group, with participation by federal financial regulatory agencies and outside experts, that will conduct a fundamental reassessment of existing regulatory capital requirements for banks and BHCs, including new Tier I FHCs. The working group will issue a report with its conclusions by December 31, 2009.

2. Treasury will lead a working group, with participation by federal financial regulatory agencies and outside experts, that will conduct a fundamental reassessment of the supervision of banks and BHCs. The working group will issue a report with its conclusions by October 1, 2009.

3. Federal regulators should issue standards and guidelines to better align executive compensation practices of financial firms with long-term shareholder value and to prevent compensation practices from providing incentives that could threaten the safety and soundness of supervised institutions. In addition, we will support legislation requiring all public companies to hold non-binding shareholder resolutions on the compensation packages of senior executive officers, as well as new requirements to make compensation committees more independent.

4. Capital and management requirements for FHC status should not be limited to the subsidiary depository institution. All FHCs should be required to meet the capital and management requirements on a consolidated basis as well.

5. The accounting standard setters (the FASB, the IASB, and the SEC) should review accounting standards to determine how financial firms should be required to employ more forward-looking loan loss provisioning practices that incorporate a broader range of available credit information. Fair value accounting rules also should be reviewed with the goal of identifying changes that could provide users of financial reports with both fair value information and greater transparency regarding the cash flows management expects to receive by holding investments.

6. Firewalls between banks and their affiliates should be strengthened to protect the federal safety net that supports banks and to better prevent spread of the subsidy inherent in the federal safety net to bank affiliates.

1.D Close Loopholes in Bank Regulation

1. We propose the creation of a new federal government agency, the National Bank Supervisor (NBS), to conduct prudential supervision and regulation of all federally chartered institutions, and all federal branches and agencies of foreign banks.

2. We propose to eliminate the federal thrift charter, but to preserve its interstate branching rules and apply them to state and national banks.

3. All companies that control an insured depository institution, however organized, should be subject to robust consolidated supervision and regulation at the federal level by the Federal Reserve and should be subject to the nonbanking activity restrictions of the BHC Act. The policy of separating banking from commerce should be re-affirmed and strengthened. We must close loopholes in the BHC Act for thrift holding companies, industrial loan companies, credit card banks, trust companies, and grandfathered "nonbank" banks.
| 1.E | Eliminate the SEC’s Programs for Consolidated Supervision  
The SEC has ended its Consolidated Supervised Entity Program, under which it had been the holding company supervisor for companies such as Lehman Brothers and Bear Stearns. We propose also eliminating the SEC’s Supervised Investment Bank Holding Company program. Investment banking firms that seek consolidated supervision by a U.S. regulator should be subject to supervision and regulation by the Federal Reserve. |
| 1.F | Require Hedge Funds and Other Private Pools of Capital to Register  
All advisors to hedge funds (and other private pools of capital, including private equity funds and venture capital funds) whose assets under management exceed some modest threshold should be required to register with the SEC under the Investment Advisers Act. The advisers should be required to report information on the funds they manage that is sufficient to assess whether any fund poses a threat to financial stability. |
| 1.G | Reduce the Susceptibility of Money Market Mutual Funds (MMFs) to Runs  
The SEC should move forward with its plans to strengthen the regulatory framework around MMFs to reduce the credit and liquidity risk profile of individual MMFs and to make the MMF industry as a whole less susceptible to runs. The President’s Working Group on Financial Markets should prepare a report assessing whether more fundamental changes are necessary to further reduce the MMF industry’s susceptibility to runs, such as eliminating the ability of a MMF to use a stable net asset value or requiring MMFs to obtain access to reliable emergency liquidity facilities from private sources. |
| 1.H | Enhance Oversight of the Insurance Sector  
Our legislation will propose the establishment of the Office of National Insurance within Treasury to gather information, develop expertise, negotiate international agreements, and coordinate policy in the insurance sector. Treasury will support proposals to modernize and improve our system of insurance regulation in accordance with six principles outlined in the body of the report. |
| 1.I | Determine the Future Role of the Government Sponsored Enterprises (GSEs)  
Treasury and the Department of Housing and Urban Development, in consultation with other government agencies, will engage in a wide-ranging initiative to develop recommendations on the future of Fannie Mae and Freddie Mac, and the Federal Home Loan Bank system. We need to maintain the continued stability and strength of the GSEs during these difficult financial times. We will report to the Congress and the American public at the time of the President’s 2011 Budget release. |

| 2. Establish Comprehensive Regulation of Financial Markets |

| 2.A | Strengthen Supervision and Regulation of Securitization Markets  
1. Federal banking agencies should promulgate regulations that require originators or sponsors to retain an economic interest in a material portion of the credit risk of securitised exposures.  
2. Regulators should promulgate additional regulations to align compensation of market participants with longer term performance of the underlying loans. |
3. The SEC should continue its efforts to increase the transparency and standardization of securitisation markets and be given clear authority to require robust reporting by issuers of asset backed securities (ABS).

4. The SEC should continue its efforts to strengthen the regulation of credit rating agencies, including measures to promote robust policies and procedures that manage and disclose conflicts of interest, differentiate between structured and other products, and otherwise strengthen the integrity of the ratings process.

5. Regulators should reduce their use of credit ratings in regulations and supervisory practices, wherever possible.

2.B Create Comprehensive Regulation of all OTC Derivatives, including Credit Default Swaps (CDS)
All OTC derivatives markets, including CDS markets, should be subject to comprehensive regulation that addresses relevant public policy objectives: (1) preventing activities in those markets from posing risk to the financial system; (2) promoting the efficiency and transparency of those markets; (3) preventing market manipulation, fraud, and other market abuses; and (4) ensuring that OTC derivatives are not marketed inappropriately to unsophisticated parties.

2.C Harmonize Futures and Securities Regulation
The CFTC and the SEC should make recommendations to Congress for changes to statutes and regulations that would harmonize regulation of futures and securities.

2.D Strengthen Oversight of Systemically-Important Payment, Clearing and Settlement Systems and Related Activities
We propose that the Federal Reserve have the responsibility and authority to conduct oversight of systemically-important payment, clearing and settlement systems, and activities of financial firms.

2.E Strengthen Settlement Capabilities and Liquidity Resources of Systemically-Important Payment, Clearing, and Settlement Systems
We propose that the Federal Reserve have authority to provide systemically-important payment, and settlement systems access to Reserve Bank accounts, financial services and the discount window.

3. Protect Consumers and Investors from Financial Abuse

3.A Create a New Consumer Financial Protection Agency (CFPA)
1. We propose to create a single primary federal consumer protection supervisor to protect consumers of credit, savings, payment, and other consumer financial products and services, and to regulate providers of such products and services.
2. The CFPA should have broad jurisdiction to protect consumers of consumer financial products and services such as credit, savings, and payment products.
3. The CFPA should be an independent agency with stable, robust funding.
4. The CFPA should have sole rule-making authority for consumer financial protection statutes, as well as the ability to fill gaps through rule-making.
5. The CFPA should have supervisory and enforcement authority and jurisdiction over all persons covered by the statutes that it implements, including both insured depositories and the range of other firms not previously subject to comprehensive federal supervision, and it should work with the Department of Justice to enforce the statutes under its jurisdiction in federal court.
6. The CFPA should pursue measures to promote effective regulation, including conducting periodic reviews of regulations, an outside advisory council, and coordination with the Council.
7. The CFPA's strong rules would serve as a floor, not a ceiling. The states should have the ability to adopt and enforce stricter laws for institutions of all types, regardless of charter, and to enforce federal law concurrently with respect to institutions of all types, also regardless of charter.

8. The CFPA should coordinate enforcement of efforts with the states.

9. The CFPA should have a wide variety of tools to enable it to perform its functions effectively.

10. The Federal Trade Commissions should also be given better tools and additional resources to protect consumers.

3.B Reform Consumer Protection

1. Transparency. We propose a new proactive approach to disclosure. The CFPA will be authorized to require that all disclosures and other communications with consumers be reasonable: balanced in their presentation of benefits, and clear and conspicuous in their identification of costs, penalties, and risks.

2. Simplicity. We propose that the regulator be authorized to define standards for "plain vanilla" products that are simpler and have straightforward pricing. The CFPA should be authorized to require all providers and intermediaries to offer these products prominently, alongside whatever other lawful products they choose to offer.

3. Fairness. Where efforts to improve transparency and simplicity prove inadequate to prevent unfair treatment and abuse, we propose that the CFPA be authorized to place tailored restrictions on product terms and provider practices, if the benefits outweigh the costs. Moreover, we propose to authorize the Agency to impose appropriate duties of care on financial intermediaries.

4. Access. The Agency should enforce fair lending laws and the Community Reinvestment Act and otherwise seek to ensure that underserved consumers and communities have access to prudent financial services, lending and investment.

3.C Strengthen Investor Protection

1. The SEC should be given expanded authority to promote transparency in investor disclosures.

2. The SEC should be given new tools to increase fairness for investors by establishing a fiduciary duty for broker-dealers offering investment advice and harmonizing the regulation of investment advisers and broker-dealers.

3. Financial firms and public companies should be accountable to their clients and investors by expanding protections for whistleblowers, expanding sanctions available for enforcement, and requiring non-binding shareholder votes on executive pay plans.

4. Under the leadership of the Financial Services Oversight Council, we propose the establishment of a Financial Consumer Coordinating Council with a broad membership of federal and state consumer protection agencies, and a permanent role for the SEC's Investor Advisory Committee.

5. Promote retirement security for all Americans by strengthening employment-based and private retirement plans and encouraging adequate savings.

4. Provide the Government with the Tools it Needs to Manage Financial Crises

4.A Create a Resolution Regime for Failing BHCs, including Tier 1 FHCs

We recommend the creation of a resolution regime to avoid the disorderly resolution of failing BHCs, including Tier 1 FHCs, if a disorderly resolution would have serious adverse effects on the financial system or the economy. The regime would supplement (rather than replace) and be modelled on the existing resolution regime for insured depository institutions under the Federal Deposit Insurance
| 5. Raise International Regulatory Standards and Improve International Cooperation | 5.A **Strengthen the International Capital Framework**  
We recommend that the Basel Committee on Banking Supervision (BCBS) continue to modify and improve Basel II by refining the risk weights applicable to the trading book and securitised products, introducing a supplemental leverage ratio, and improving the definition of capital by the end of 2009. We also urge the BCBS to complete an in-depth review of the Basel II framework to mitigate its procyclical effects. |
|---|---|
| | 5.B **Improve the Oversight of Global Financial Markets**  
We urge national authorities to promote the standardization and improved oversight of credit derivative and other OTC derivative markets, in particular through the use of central counterparties, along the lines of the G-20 commitment, and to advance these goals through international coordination and cooperation. |
| | 5.C **Enhance Supervision of Internationally-Active Financial Firms**  
We recommend that the Financial Stability Board (FSB) and national authorities implement G-20 commitments to strengthen arrangements for international cooperation on supervision of global financial firms through establishment and continued operational development of supervisory colleges. |
| | 5.D **Reform Crisis Prevention and Management Authorities and Procedures**  
We recommend that the BCBS expedite its work to improve cross-border resolution of global financial firms and develop recommendations by the end of 2009. We further urge national authorities to improve information-sharing arrangements and implement the FSB principles for cross-border crisis management. |
| | 5.E **Strengthen the Financial Stability Board**  
We recommend that the FSB complete its restructuring and institutionalize its new mandate to promote global financial stability by September 2009. |
| | 5.F **Strengthen Prudential Regulations**  
We recommend that the BCBS take steps to improve liquidity risk management standards for financial firms and that the FSB work with the Bank for International Settlements (BIS) and standard setters to develop macroprudential tools. |
| | 5.G **Expand the Scope of Regulation**  
1. Determine the appropriate Tier 1 FHC definition and application of requirements for foreign financial firms.  
2. We urge national authorities to implement by the end of 2009 the G-20 commitment to require hedge funds or their managers to register and disclose appropriate information necessary to assess the systemic risk they pose individually or collectively. |
| | 5.H **Introduce Better Compensation Practices**  
In line with G-20 commitments, we urge each national authority to put guidelines in place to align compensation with long-term shareholder |
value and to promote compensation structures which do not provide incentives for excessive risk taking. We recommend that the BCBS expediently integrate the FSB principles on compensation into its risk management guidance by the end of 2009.

5.I **Promote Stronger Standards in the Prudential Regulation, Money Laundering/Terrorist Financing, and Tax Information Exchange Areas**

1. We urge the FSB to expeditiously establish and coordinate peer reviews to assess compliance and implementation of international regulatory standards, with priority attention on the international cooperation elements of prudential regulatory standards.

2. The United States will work to implement the updated International Cooperation Review Group (ICRG) peer review process and work with partners in the Financial Action Task Force (FATF) to address jurisdictions not complying with international anti-money laundering/terrorist financing (AML/CFT) standards.

5.J **Improve Accounting Standards**

1. We recommend that the accounting standard setters clarify and make consistent the application of fair value accounting standards, including the impairment of financial instruments, by the end of 2009.

2. We recommend that the accounting standard setters improve accounting standards for loan loss provisioning by the end of 2009 that would make it more forward looking, as long as the transparency of financial statements is not compromised.

3. We recommend that the accounting standard setters make substantial progress by the end of 2009 toward development of a single set of high quality global accounting standards.

5.K **Tighten Oversight of Credit Rating Agencies**

We urge national authorities to enhance their regulatory regimes to effectively oversee credit rating agencies (CRAs), consistent with international standards and the G-20 Leaders' recommendations.

Source: US Treasury, 2009a, pp.10-18
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As for the future, Northern Rock will continue to operate under the restructuring package agreed with the Banking Act of February 2009 – see below. Under the rescue operation, the Government assumed responsibility for over £900 million worth of Dunfermline's toxic loans/assets, paying the Nationwide, which took over the former's branches, deposits and sound assets, £1.6 billion to cover the shortfall in assets assumed (all liabilities were transferred). The Government hopes to retrieve its "investment" through the wind-down of the assets acquired and, eventually, through reimbursement by the banks via the deposit sub-scheme of the Financial Services Compensation Scheme.

Another part of the package involved forcing Northern Rock to slow the rate of contraction in its lending activities, in order to slow the pace of contraction in UK mortgage lending. The bank was subsequently asked to increase mortgage lending by up to £14 billion during the period 2009/10, the new lending to be financed partly from deposits and repayments on the existing loan book and partly through an increase in the government loan to Northern Rock (its capital base was expanded by £3 billion) and a lengthening of the repayment schedule relating to the Bank of England's loan (around two-thirds of the £27 billion had been repaid by February 2009).

Shortly afterwards (i.e. on 3 March 2009), Northern Rock reported a loss of £1.4 billion for 2008 amid rising arrears and re-possessions, calling into question the Government's previous assertion that the lender's loan book quality was no worse than the industry average. And this was followed, in August 2009, with the announcement of half-year pre-tax losses of £725 million, up from £585 million a year earlier. It also admitted that nearly 40 per cent of its borrowers were in negative equity, that its arrears (at 4 per cent) were well above the industry average, and that it still owed the Bank of England £10.9 billion, up from £8.9 billion at the end of 2008.

As for the future, Northern Rock will continue to operate under the restructuring package agreed with the European Commission, under its 'State Aid' rules, in October 2009 (European Commission, 2009). This involved the bank in being split into a "good" bank, which will continue the economic activities (i.e. mortgage lending and deposit-taking) of Northern Rock, and a "bad" bank, which will be responsible for running down the remaining assets (mostly, the risky mortgages made by Northern Rock in the past). Both companies – Northern Rock plc and Northern Rock (Asset Management) plc – remain in Government ownership, with the former due to be privatised at some, as yet unspecified, future date.

This section rests heavily on Hall (2009b).

Such as the inadequacy of capital buffers, particularly in the trading book, the flaws in the 'value at risk' (VaR) models banks are allowed to use to generate minimum market risk capital charges, the poor quality of certain elements of regulatory capital, the induced spawning of off-balance-sheet vehicles to accommodate the impetus given to securitisation (a form of 'regulatory capital arbitrage'), the induced pro-cyclicality in financial systems and the failure to prevent excessive growth in the absolute size of banks' balance sheets. [Note, most of these 'deficiencies' were widely foreseen – see, for example, Hall (1989 and 2004).]

The focus of regulators and the market is already on "Core Tier One" capital, which excludes allowable Tier One hybrid instruments and all Tier Two capital (see Hall, 2004, for an explanation), with minimum regulatory/market demands for this ratio commonly exceeding 7 per cent or so, compared with the current overall Basel II minimum risk-adjusted requirement of 8 per cent.

This was accomplished, to a degree, through a switch from 'point in time' to 'through the cycle' measures of probabilities of default in January 2009 (FSA, 2009c).

Although this is clearly desirable, it is not without serious practical difficulties – see Gerlach and Gruenwald, 2005.

As, for example, applies in Switzerland and the USA, in the latter case through the application of a minimum Tier One leverage ratio – of between 3 and 5 per cent of total assets – originally designed to deal with interest rate risk in the banking book.

In addition to the Basel Committee, the Financial Stability Board has also endorsed most of Lord Turner's capital adequacy-related recommendations (FSB, 2009a). This is reflected in the Board's acceptance of the need for counter-cyclical capital buffers and other measures designed to reduce procyclicality, for a supplementary maximum leverage ratio, and for a fundamental review of the market risk framework, including the use of VaR estimates as the basis for the minimum capital requirement.

These floors determine the maximum reductions in required capital, relative to Basel I, allowed under Basel II.

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**ENDNOTES**

i A collapse of West Bromwich Building Society in June 2009 was avoided by regulatory action which allowed the Society to create a new class of core equity Tier 1 capital – so-called "profit-participating deferred states" – which it swapped for subordinated debt (see the entry in Table 2.2 for the 12 June 2009 for more details).

ii This was the first occasion on which the new 'Special Resolution Regime' was activated in accordance with the Banking Act of February 2009 – see below. Under the rescue operation, the Government assumed responsibility for over £900 million worth of Dunfermline's toxic loans/assets, paying the Nationwide, which took over the former's branches, deposits and sound assets, £1.6 billion to cover the shortfall in assets assumed (all liabilities were transferred). The Government hopes to retrieve its "investment" through the wind-down of the assets acquired and, eventually, through reimbursement by the banks via the deposit sub-scheme of the Financial Services Compensation Scheme.

iii See Hall (2009b) for more details.

iv Another part of the package involved forcing Northern Rock to slow the rate of contraction in its lending activities, in order to slow the pace of contraction in UK mortgage lending. The bank was subsequently asked to increase mortgage lending by up to £14 billion during the period 2009/10, the new lending to be financed partly from deposits and repayments on the existing loan book and partly through an increase in the government loan to Northern Rock (its capital base was expanded by £3 billion) and a lengthening of the repayment schedule relating to the Bank of England's loan (around two-thirds of the £27 billion had been repaid by February 2009).

v This section rests heavily on Hall (2009c).

vi Such as the inadequacy of capital buffers, particularly in the trading book, the flaws in the 'value at risk' (VaR) models banks are allowed to use to generate minimum market risk capital charges, the poor quality of certain elements of regulatory capital, the induced spawning of off-balance-sheet vehicles to accommodate the impetus given to securitisation (a form of 'regulatory capital arbitrage'), the induced pro-cyclicality in financial systems and the failure to prevent excessive growth in the absolute size of banks' balance sheets. [Note, most of these 'deficiencies' were widely foreseen – see, for example, Hall (1989 and 2004).]

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xii These floors determine the maximum reductions in required capital, relative to Basel I, allowed under Basel II.
Available alternatives to deal with the bonus issue comprise, inter alia, the adoption of more draconian approaches to the size, speed, nature and circumstances in which bonuses can be paid – the President of France, for example, has got agreement from the major French banks to ban all guaranteed bonuses, defer a portion of cash bonuses for three years, pay a minimum of one-third of bonuses in shares and adopt strict long-term performance criteria in the assessment process used to determine bonus payments, while he is also seeking G20 agreement to cap bonus payments (which he recognises he cannot do unilaterally) – and the imposition of tougher legal requirements on bank boards to oversee the actions of senior executives. The licensing of new products by the regulator (giving the latter the opportunity to prevent the introduction of undesirable financial innovation) could be used to reduce the destabilising influence of the financial system; the beefing up of anti-trust laws to raise the degree of effective competition in financial markets could be used to reduce excess profitability in the sector; and elimination of the capital subsidy (resulting from the provision of implicit state guarantees against default) enjoyed by financial institutions could be used to restrain their growth. If banks are so flush with profits, they might also be asked to start contributing to a free-standing deposit insurance fund, paying (via higher capital requirements) for implicit "too-big-to-fail" guarantees or, where relevant, repaying taxpayer support.

The self-evident need to improve the market infrastructure surrounding the trading of credit default swaps, through the development of clearing and central counterparty systems, is not discussed in this article; while Lord Turner's views on macro-prudential analysis are covered below.

Notably with respect to the supervision of Northern Rock – see FSA, 2008b, for a painful self-examination of what went wrong.

The Treasury Committee's views on what should be done to reform corporate governance and pay in the City are contained in House of Commons (2009a).

As demonstrated in Appendix 2.2, Lord Turner also made significant calls for change in other areas. On the issue of how to constrain commercial banks' engagement in risky proprietary trading activities, he advocates the use of new capital and liquidity requirements rather than a 'structured' solution – such as the adoption of a 'narrow bank' proposal, confining guarantees and official support to simple, utility-like operators, or the introduction of a 'Glass Steagall'-type regime to physically separate commercial from specification trades but small enough not to reduce the volume of international trade – on foreign exchange transactions to reduce exchange rate volatility and enhance national monetary policy autonomy in the wake of the collapse of the Bretton Woods system of fixed exchange rates – see Tobin, 1978.

Available alternatives to deal with the bonus issue comprise, inter alia, the adoption of more draconian approaches to the size, speed, nature and circumstances in which bonuses can be paid – the President of France, for example, has got agreement from the major French banks to ban all guaranteed bonuses, defer a portion of cash bonuses for three years, pay a minimum of one-third of bonuses in shares and adopt strict long-term performance criteria in the assessment process used to determine bonus payments, while he is also seeking G20 agreement to cap bonus payments (which he recognises he cannot do unilaterally) – and the imposition of tougher legal requirements on bank boards to oversee the actions of senior executives. The licensing of new products by the regulator (giving the latter the opportunity to prevent the introduction of undesirable financial innovation) could be used to reduce the destabilising influence of the financial system; the beefing up of anti-trust laws to raise the degree of effective competition in financial markets could be used to reduce excess profitability in the sector; and elimination of the capital subsidy (resulting from the provision of implicit state guarantees against default) enjoyed by financial institutions could be used to restrain their growth. If banks are so flush with profits, they might also be asked to start contributing to a free-standing deposit insurance fund, paying (via higher capital requirements) for implicit "too-big-to-fail" guarantees or, where relevant, repaying taxpayer support.

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The operation of a 'high quality sterling liquidity stock requirement', first introduced by the Bank of England in January 1996 (Bank of England, 1996), with respect to large UK retail banks, whereby such institutions were required to survive for five days without recourse to wholesale money markets, obviously proved woefully inadequate given the combined seizure of the international wholesale money markets for a period well in excess of one year!

The FSA's detailed plans were revealed in its consultation paper of December 2008 (FSA, 2008a), which followed its discussion paper of December 2007 (FSA, 2007). The final rules are set out in FSA, 2009d.

Lord Turner's recommendations on the reform of domestic deposit insurance arrangements and the bank resolution regime, noted in Appendix 2, are overlooked in this section as they have already been implemented via the recent reforms undertaken to the Financial Services Compensation Scheme (reviewed in Hall, 2009a, although more reforms have since been announced – see FSA, 2009e) and the introduction of a 'Special Resolution Regime' under the Banking Act of February 2009 (see Appendix 2.1), respectively. Similarly, his recommendations on credit rating agencies, which typically performed badly in the run up to and during the crisis – see FSF, 2008, Section IV and FSA, 2009a, Section 2.5(i) – are omitted on the grounds that the issues are being tackled at the international level (e.g. through the introduction of a new registration and monitoring system in the EU).

Compared with the refined draft version, the final version is generally less prescriptive and comprises 1 'rule' and 8 'principles' (see the text) rather than the 1 'rule' and 10 'principles' of the former. The former's principles 8 to 10, relating to the structure of remuneration, have been replaced by a single principle – principle 8 – although the 'guidance' provided to new principle 8 (it still contains the (amended) contents of the old principles) makes it clear that guaranteed bonuses which run for more than one year and similar payments in addition to salary, are unlikely to be consistent with effective risk management. The implementation date has also been pushed back from 6 November 2009 to 1 January 2010, although those firms affected (approximately 26) were expected to supply the FSA with a remuneration policy statement by end-October 2009.
investment banking – on the grounds of the infeasibility of the latter. And, with respect to the supervision of global cross-border banks, he recommends enhancing international co-ordination through the establishment and effective operation of colleges of supervisors for the largest and most complex, and the pre-emptive development of crisis co-ordination mechanisms and contingency plans between supervisors, central banks and finance ministries. Moreover, he argues the FSA should, if necessary, be prepared to use more actively its powers to require strongly-capitalised local subsidiaries and local liquidity, and to limit firms’ activities.

Which, for example, influenced the outcome of the restructuring proposed by Northern Rock, Lloyds Banking Group and RBS and the terms on which the last two mentioned could access the ‘Asset Protection Scheme’ introduced in January 2009 (HM Treasury, 2009e) – see Section 2.1.2 above.

The Icelandic bank, as a member of the European Economic Area (and thus covered by the Single Market programme), was free to branch into the UK with the FSA having only limited powers to constrain its activities. Primary responsibility for prudential supervision lay with the home authority, and the potential for support to prevent bank failure was dependent on the resources of the Icelandic government. UK depositors were also dependent on the resources of the Icelandic deposit insurance scheme in case of bank failure. In the event, both fiscal resources and deposit insurance funds proved inadequate, the UK government, for example, having to bail out the (personal) UK depositors.

The case for a more integrated approach to EU bankruptcy and re-organisation procedures for cross-border banks might also have been considered – see García, Lastra and Nieto, 2009.

The IMF, in its review of UK regulatory developments (IMF, 2009a), welcomes the introduction of the new ‘Special Resolution Regime’ under the Banking Act of February 2009 although it cautions that its effectiveness will depend upon the timely and comprehensive information-sharing between the Tripartite Authorities. It also largely welcomes the Turner Review, which it argues represents an important contribution to the international debate on the reform of the regulatory and oversight system for financial institutions. In particular, it agrees with:

- the call for higher capital requirements within a risk-based capital framework for trading book and off-balance-sheet exposures, and for the introduction of a maximum leverage ratio as a backstop against excessive balance sheet growth;
- the proposed strengthening of liquidity provision, with a special emphasis on stress tests covering system-wide risks;
- the proposal to complement these measures with the development of new macro-prudential instruments to mitigate the amplitude of the credit cycle and reduce feedback loops between the financial sector and the real economy; and
- the idea that regulatory and supervisory coverage should follow the principle of economic substance not legal form, with regulators having expanded powers to gather information on all significant financial institutions (include hedge funds) to allow for assessment of overall system-wide risks.

Despite this general ‘seal of approval’, however, the IMF does make some recommendations for further reform. Firstly, it calls for an improvement in disclosure practices to reduce uncertainty and strengthen market discipline and public surveillance. Accordingly, it wishes to see an increased coverage and frequency (to quarterly from twice-yearly) of financial reporting on banks’ finances; and, over the medium-term, regulators are asked to consider publishing non-commercially sensitive, bank-by-bank regulatory information at quarterly intervals. Secondly, it calls on the authorities to work more closely with their international partners to strengthen cross-border financial stability arrangements. This will require accelerated efforts to establish a dedicated resolution framework for the EU’s cross-border banks – see note 28 – and to quickly implement the proposed (by the de Larosière Taskforce) radical overhaul of the EU’s regulatory and supervisory arrangements. With respect to the latter, securing adequate resources, effective decision-making mechanisms, independence of the new institutions, and an unconstrained flow of information between the various bodies will be essential for the effectiveness of the proposed new architecture.

The extent of the Government’s acceptance of Lord Turner’s reform recommendations, which is virtually complete, is set out in the White Paper at pp.58-59.

The reasons for its eschewal of this approach are outlined in Section 5 of the White Paper at pp.74-75.

In April 2009, the G20 asked the Financial Stability Board to work on producing guidelines on how to identify systemically-important institutions/markets, taking forward the analysis provided in a recent ‘Geneva Report’ (Brunnermeier et. al., p.2009). The findings are due by the end of the year, following which appropriate institutional arrangements for implementing the new framework will be agreed.

A consultative paper on developing effective resolution mechanisms for investment banks was published in May 2009 (HM Treasury, 2009g) with a further consultation paper being published in December 2009 (see HM Treasury 2009h).
Lord Turner, in an interview with the Financial Times (FT, 2009), has since backed the idea, arguing that a necessary clarification and simplification of legal structures is called for as regulators become less tolerant of regulatory and tax arbitrage.

To this end, the Government has already introduced – effective from 6 March 2008 – legislation to encourage the development of the UK covered bond market. It also supports the work of the European Securitisation Forum (ESF) in establishing standards of consistency, transparency and accessibility for investors in European RMS. Finally, it endorses the proposed change to the EU’s Capital Requirements Directive (CRD), which implements Basel II, which will restrict the purchase by EU-regulated banks of securitisations where the originator or distributor does not itself retain a net economic interest of at least 5 per cent. [The measure is designed to ensure that the ability to transfer credit risk through securitisation markets does not reduce incentives for those originating and securitisings loans to assess and monitor ongoing credit quality.]

Requirements included in the CRD, which take effect in 2011, will ensure that investor credit institutions carry out substantial due diligence with respect to securitisations.

As is planned by the Basel Committee and the International Accounting Standards Board (IASB).

To this end, the Government is seeking the imposition of tougher disclosure requirements and enhanced surveillance by the FSA – backed by a credible enforcement framework – in part, through a stiffening of the planned EU Directive on Alternative Investment Fund Managers.

The introduction of a minimum “core funding ratio”, as called for by Lord Turner, would act to reduce banks’ tendency to become increasingly-reliant on less stable sources of funding as they expand their balance sheets, thereby moderating aggregate credit availability during economic expansions.

UK banks are allowed to use “through the cycle” rather than “point in time” measures of risk when calculating their minimum capital charge under the “Internal Ratings-Based” methodologies of Basel II – see FSA, 2009c.

Such a policy also reinforces market discipline as the holders of such debt have a greater incentive to monitor the activities of the issuing bank (see Calomiris, 1999).

The Government is also looking at the possible regulation of the characteristics of financial products (e.g. the loan-to-value ratios adopted by mortgage providers) rather than the behaviour of financial institutions – the results of the FSA’s deliberations on potential regulatory reform of the mortgage market were published in October 2009 (FSA, 2009j) with a further consultation paper on the subject issued in January 2010 (FSA, 2010).

The Government, however, has made it clear that it does not believe that it needs to change the Bank of England’s Monetary Policy Committee’s remit by adding explicit macro-prudential objectives (e.g. for asset prices or credit growth) nor to amend the targeted inflation indicator (currently the CPI) to include asset prices.

The G20, until recently chaired by the UK, has been at the forefront of moves to reform the international financial system based upon the principles of strengthening transparency and accountability, enhancing sound regulation, promoting integrity in financial markets and reinforcing international co-operation. Among other things, the G20 has agreed:

- to establish a new Financial Stability Board, as a successor to the Financial Stability Forum (FSF), with a strengthened mandate and a broader membership;
- that the FSB should collaborate with the IMF to provide early warning of macroeconomic and financial risks and the actions needed to address them;
- to reshape regulatory systems so that authorities are able to identify and take account of macro-prudential risks;
- to establish supervisory colleges for cross-border firms and to implement the FSF principles for cross-border crisis management;
- to extend regulation and oversight to all systemically-important financial institutions (including hedge funds, instruments and markets);
- to confirm and implement the FSF’s new principles on pay and compensation;
- to take action, once recovery is assured, to improve the quality, quantity and international consistency of capital in the banking system and agree a global framework for promoting strong liquidity buffers in financial institutions;
- to take action against non-co-operative jurisdictions, including tax havens;
- to call on the accounting standard-setters to work with supervisors and regulators to improve standards on valuation and provisioning and achieve a single set of high-quality global accounting standards; and
- to extend regulatory oversight and registration to credit rating agencies to ensure they meet the international code of good practice.

All of these moves will serve to enhance sound domestic regulation at the global level although detailed technical work remains to be completed in several areas. [The FSB produced its first report to G20...
As for strengthening the international regulatory architecture, the FSB will be at the centre of attempts to ensure consistency and coherence in the development and application of financial regulations. It will have to oversee the enforcement of standards and scrutinise members' adherence to such standards – joint reports (with the IMF) indicating the extent of compliance were produced in September 2009. While all countries would benefit from IMF/World Bank reviews under their 'Financial Sector Assessment Program'.

At home, the Government has promised to give the FSA an explicit international duty to complement its own and the Bank of England's responsibilities in this area. This new statutory duty would require the FSA to promote sound international regulation and supervision, and would involve the FSA in representing the UK's interests in international fora, having regard to international best practice and maintaining the competitiveness of the UK financial services industry. The FSA's new financial stability objective will also require the FSA to take account of the impact of international developments on financial stability in the UK.

For example, the Government agrees with the creation of a new European Systemic Risk Board (ESRB) to assess macro-financial risks in the EU and propose policy responses, thereby complementing the activities of the IMF and FSB in this area. Its analysis could also be used to inform the international Early Warning Exercise recently launched by the IMF and FSB. It firmly believes, however, that day-to-day supervision should remain in the hands of national authorities and that decisions taken by the newly-created European Supervisory Authorities should not impinge in any way on national fiscal responsibilities.

A task which it believes the new European Supervisory Authorities should take on board. They also propose a review to consider the case for putting housing costs back into the inflation target; and, given that the Bank will be responsible for both triggering and operating the Special Resolution Regime, they will consult on the case for giving the Bank direct control over the Financial Services Compensation Scheme. Finally, they will consult on the case for establishing a single regulator to tackle financial crime.

The work of the Financial Regulation Division, which will be headed by a new Deputy Governor for Financial Regulation, will be overseen by a 'Financial Policy Committee' to ensure close co-ordination between macro-prudential and micro-prudential regulation. The Deputy Governor for Financial Regulation will also be a member of the Financial Policy Committee.

This committee will include the Governor and the existing Deputy Governor for Financial Stability, who also sits on the Monetary Policy Committee, in order to ensure close co-ordination between monetary and financial policy. It will also include independent members in order to bring external expertise to bear on the problem of maintaining financial stability.

Although not mentioned, the Conservative Party also implicitly endorses the calls for increasing the quality and quantity of capital more generally, and for improving the regulatory focus on liquidity.

The Bank will be called upon to examine the case for a more structural separation of these activities within international policy fora.

The Conservative Party also makes clear that it will work at the international level to create a resolution regime for investment banks and to design a resolution regime for international banks.

This consensus reform agenda is reconfirmed in recent publications by the BIS (2009, Section VII) and the Bank of England (2009a).

And hopefully one which will prove more challenging for firms' senior management as the perceived need to preserve the competitiveness of the City through 'light touch' regulation recedes.

A degree of disagreement still persists, however, over deposit insurance arrangements (issues concerned with 'architecture' are considered below). While many have long-argued for the introduction of a pre-funded scheme and risk-related premia (see, for example, Hall, 2001a and 2002), policies since endorsed by the Bank of England (see Tucker, 2009, and Bank of England, 2009a, pp.59-61), the Government has only recently accepted the former idea (but pre-funding won't be introduced until 2012 at the earliest) and has not commented on the latter. Recent amendments to the FSCS have, however, strengthened funding arrangements, increased deposit compensation limits and improved the legal arrangements to allow for faster compensation pay out.

The recent failure of the meeting of G20 Finance Ministers (London, September 2009 – see G20, 2009a) to support the imposition of caps on bankers' bonuses following opposition from the UK and US governments in particular (who argued against the idea on the grounds of impracticality because of its unenforceability) raises the question of how far agreed 'Codes' can deliver desirable outcomes. That change is needed to realign bankers/traders' incentives more closely with the delivery of outcomes acceptable to long-term investors and taxpayers is irrefutable; but the question of the scale of bonuses is more political. Nevertheless, for governments – particularly socialist governments – to abandon the goal...
of wealth re-distribution (which has been regressive in recent years) on the grounds of impracticality so soon after the excesses revealed during the recent crisis is rather tame. Of course, taxation policy and the other measures taken to improve regulation in the wake of the crisis (through their impact on profitability) can be used to address the issue of "equity", but why can't toughened "Codes" be enforced through the use of appropriate sanctions? If banks have "money to burn", which could otherwise be used to boost retained earnings and hence capital, why can't regulators bring forward proposals to force a pre-funding of the deposit protection scheme or a boost to capital requirements to reflect higher risk-taking or the firm's systemic importance? As was eventually proved with respect to "compliance" with Western demands by offshore tax havens (e.g. Switzerland, Cayman Islands, Liechtenstein, etc.), "where there is a will there's a way"!

In the event, the G20 Summit held in Pittsburg at the end of September 2009 (see G20, 2009b) went some way to dispelling such concerns as the nations represented at the meeting agreed to the following with respect to compensation packages: banning multi-year guaranteed bonuses, requiring a significant proportion (i.e. of between 40 and 60 per cent, and higher for senior bankers) of variable compensation to be deferred (for up to three years), tied to performance, subject to appropriate clawback in the event of future poor performance, and to be vested (at least 50 per cent) in the form of stock or stock-like instruments, as long as these create incentives aligned with long-term value creation and the time horizon of risk; making firms' compensation policies and structures transparent through disclosure requirements, limiting variable compensation as a percentage of total net revenues when it is consistent with the maintenance of a sound capital base (dividend payments and share buybacks may also be restricted); and providing supervisors with the ability to modify compensation structures in the case of firms that fail or require extraordinary public intervention. Firms are asked to implement these sound compensation practices immediately; and the FSB is tasked to monitor their implementation and, if necessary, propose additional measures by March 2010. Although the top five UK banks – Barclays, HSBC, Standard Chartered, RBS and Lloyds Banking Group – subsequently agreed to adopt the rules agreed at the Summit in the next bonus round, in advance of the Government's planned legislation (which will be informed by Sir David Walker's final report on corporate governance), it remained to be seen how overseas banks would operate in the next bonus round, not least because the US Fed was thought to be looking for some "wriggle room" in the wording of the Summit's communiqué.

In the event, and notwithstanding the different approach adopted in the US – their top 28 financial institutions are to be offered a menu of different practices from which they can choose to demonstrate that the compensation for any employee who can, collectively or individually, materially affect the firm is aligned with risk – 11 foreign banks, including JP Morgan Chase, Goldman Sachs, Citigroup, Bank of America, Morgan Stanley, which operate in London, agreed to subject employees working there to the pay reforms agreed at the Pittsburgh Summit.

For the UK Government, however, this did not go far enough. For, in the Pre-Budget Report of December 2009, the Chancellor unveiled a one-off 50 per cent "windfall" payroll tax on firms (i.e. all banks and building societies operating in the UK, including overseas operators) paying discretionary bonuses (whether in the form of cash, shares or deferred bonuses) of over £25,000 before April 2010. [After that date, the recipients would be taxed at the new higher income tax rate of 50 per cent if they earnt over £150,000 per annum.] The Treasury originally estimated that this 'supertax' would yield revenue of around £0.55 billion but it soon became clear, much to the consternation of the Government, that most firms would absorb the costs themselves, boosting bonus pools accordingly and thereby forcing shareholders to take the hit (Credit Suisse, however, was one of a few to cut bonus payments for its London-based staff, reducing them by around 35 per cent compared with original plans). Accordingly, City estimates now suggest the yield will be nearer £5 billion. Meanwhile, Barclays bank has since announced plans to defer payment of up to 100 per cent (the G20 requires only 40 to 60 per cent to be deferred) of 2009 bonuses for its senior staff; while RBS has publicly stated that it will pay what it can get away with to enable it to retain key staff.

Overseas, momentum to rein in bonus payments for 2009 has also gained momentum, aided by the French decision, one day after the UK's announcement of its supertax, to also impose a 50 per cent supertax on 2009 bonuses in excess of €27,000 (just under £25,000). And, in the US, the banking industry finally acknowledged the depth of public anger by reining back planned disbursements. For, following the administration's crackdown on the remuneration paid to the top 25 executives of those seven firms deemed to have received 'exceptional assistance' from the US Government – the cash elements of remuneration were cut by an average of 90 per cent – further action was taken voluntarily by a number of banks. JP Morgan Chase was the first to set things rolling when, in January 2010, it announced that, despite making net profits of $11.8 billion in 2009, compared with $5.6 billion in 2008, it would actually cut the amount of revenues set aside for compensation – to 33 per cent, nearly half the figure for 2008 and substantially less than the historic average of 44 per cent. And, later that month, Goldman Sachs went even further by shrinking its bonus pool for the final quarter of 2009 despite
The criticism over the Bank of England’s handling of the emergency liquidity lifeline, however, does not indicate that a central bank’s credibility can be damaged by virtue of the exercise of its lender of last resort facility. So why be afraid of opening up yourself to criticism from an additional source, i.e. banking supervision? Notwithstanding this, the Bank of England is not keen to take back responsibility for micro-prudential regulation, even though a closer integration of banking liquidity supervision and central bank liquidity operations has been shown to be required.

Industry squeals about the increased intensity and scope of current practice are testament to this.

Their proposal, with a new ‘Financial Regulation Division’ within the Bank carrying out micro-prudential regulation along with the creation of a new Consumer Protection Agency, reflects their preference for a “Twin Peaks” (Taylor, 1996) institutional structure largely because of a belief that the FSA was too focussed on consumer protection issues (i.e. enforcing conduct of business rules) to allow it to adequately discharge its supervisory functions, a situation likely to prevail in any non-Twin Peaks environment (see also G30, 2008).

Possible modes of co-operation are outlined in Section 2.6(ii) of his Review, his preference being for a reconstitution of the Financial Stability Committee, currently comprising only Bank of England officials, to include FSA officials. This body would make the final judgment as to macro-prudential conditions and take the final decisions as to appropriate policy responses.

See HM Treasury, 2009f, Section 6, para.6.60.

It is interesting to note that, in the US, the current administration has proposed to Congress, despite concerns about the potential damage that might be done to its political independence and economic credibility, and to the conduct of monetary policy, that the Federal Reserve’s regulatory mandate be extended beyond bank holding companies and state-chartered member banks to embrace all “systemically-important” (i.e. so-called ‘Tier 1 Financial Holding Companies’) financial institutions. [The Fed will also be given new authority to oversee payment, clearing and settlement systems.] In this way, the Fed will assume responsibility for systemic regulation. The Government has also proposed that a new National Bank Supervisor be set up to supervise all federally-chartered banks (in replacement of the current Office of the Comptroller of the Currency) and that a new ‘Consumer Financial Protection Agency’ be established to improve protection for consumers (US Treasury, 2009a). [For more details see Section 3.2 of this paper.]

Arguments rejected by both the House of Commons Treasury Committee (House of Commons, 2009c, p.58, paras 22 and 24) and the House of Lords Select Committee on Economic Affairs (House of Lords, 2009). Moreover, the FSA’s right to reject the Committee’s advice, so long as it explains why, further undermines the Government’s claims for improvement.

Apparently because of the Government’s belief that the Bank is already looking towards life under the Conservatives, with concomitant consequences for its actions and outlook. [Clear evidence of the lack of trust can be gleaned from the Government’s failure to consult the Bank on its reform White Paper, a fact revealed during the Governor’s evidence to a shocked Treasury Select Committee on 24 June 2009 – see House of Commons, 2009c, p.58, para.25.]

For a summary of all the main developments see Table 3.1.

The recent initiatives adopted by the BIS, FSF and Basel Committee are considered under Section 2.2 so are not discussed again here.
The need for reform of the traditional "dual" (i.e. state and federal) structure of banking regulation was, in part, due to the existence of opportunities for regulatory arbitrage which allowed unregulated state organisations and non-bank affiliates of banks and thrifts to originate thousands of risky mortgages, while AIG was allowed to build up a huge and essentially unregulated hedge fund. Accordingly, under the "blueprint" produced by the Treasury, the regulatory architecture would have been changed in the following ways: (i) there would be three primary federal regulators, one (the Fed) charged with maintaining stability across the entire financial sector, one responsible for supervising the soundness of those institutions enjoying explicit government support (the OCC would be combined with the OTS for this purpose) and one responsible for protecting consumers and investors (the SEC and the CFTC would be combined for this purpose) [in addition, the Fed would be required to supply emergency liquidity support to all deserving, systemically-important institutions when necessary]; and the FDIC would continue to resolve failing commercial banks but the Fed would be empowered to resolve failing non-banks (such as Lehman Brothers and Bear Stearns) and other systemically-important institutions (such as AIG).

Congress will also have to consider the far-reaching proposals for bank reform revealed by President Obama on 21 January 2010. For, following the imposition of a 10-year levy (the 'Financial Crisis Responsibility Fee') on the 50 largest banks and insurers designed to recover losses likely to be made on bailing out the finance industry - $90 billion is being sought via a 15 basis points levy on debt liabilities other than deposits – the President is seeking to impose further limits on bank size, to ban commercial banks from owning, investing in or sponsoring hedge funds and private equity groups, and also to ban them from engaging in proprietary trading for their own account (as opposed to satisfying customer needs).

By mid-December 2009, some $118 billion of TARP funding had been repaid when Citigroup announced its intention to repay $20 billion of TARP funding from the proceeds of a planned capital-raising exercise [see the entry in Table 3.1 for 14.12.09]. The repayment will see the Treasury's stake in the bank falling from 34 per cent to below 30 per cent. This followed Bank of America's earlier decision [see the entry in Table 3.1 for 2.12.09] to repay some $45 billion of TARP funding.

For further discussion see Bank of England (2009a), ECB (2009) and IMF (2009f).