



**Public Sector Interventions in the
Financial Crisis**
Statistical Classification Decisions

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ONS

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1. Summary

- 1.1 This article explains the decisions of the Office for National Statistics (ONS) on the National Accounts classification of the financial crisis interventions by public sector authorities between 2007 and August 2009.
- 1.2 It updates the Northern Rock article previously published in 2008 and brings together a series of similar separate articles on each intervention.
- 1.3 The classification decisions are consistent with international guidelines on National Accounts. In a number of areas the responses by public authorities were unprecedented and raised new issues of interpretation against international guidance on statistical classification, leading to the creation of international task forces to interpret the guidelines. The first conclusions from this work were published by Eurostat in July 2009.
- 1.4 There have been different types of intervention by public authorities in the UK, and these have different classification effects. The first effect is on the sector classification of the entities involved and this has brought more entities into the public sector, either through nationalisation or control. The public financial corporations sector now includes The Royal Bank of Scotland Group plc, Lloyds Banking Group plc, Northern Rock plc and Bradford and Bingley plc.
- 1.5 The biggest impact of the financial interventions on the UK's fiscal measures is on public sector net debt through the reclassification of financial corporations. The exact effect of the reclassifications has not been quantified yet but is expected to be about £1.5 trillion.
- 1.6 The second effect is through the recording of the various interventions. Some of these have an immediate impact on public sector net borrowing and public sector net debt. Others produce contingent liabilities, such as the exposure to guarantee schemes, where nothing is initially recorded but losses could potentially materialise in the future and will be recorded at that later stage.
- 1.7 The exact impact on fiscal statistical measures is sometimes difficult to precisely quantify, mainly because the entities concerned are operating in a commercial market and their data are confidential and subject to disclosure constraints, but where it is possible to provide estimates this has been done. Estimates have been provided at the end of each chapter describing each intervention and these estimates are then summarised in chapter 31, which quantifies the impact on key fiscal statistics and estimates the net costs to government of the interventions.
- 1.8 The direct impacts of the interventions on public sector net borrowing and public sector current budget are not significant because the reclassification of the financial corporations place the transactions within the public sector. This consolidation within the public sector leaves these aggregates unaffected.
- 1.9 Modelled estimates, which include imputations for the borrowing costs of government to finance the interventions, show that the net costs for central government were £4.7bn in 2008 and a further £3.3bn in the first three quarters of 2009.

- 1.10 These modelled estimates show that central government's net financial liability position for the interventions was £5.2bn at end-2008. It had fallen to £2.8bn at end-September 2009 mainly as a result of higher equity values for its shareholdings in financial services groups.
- 1.11 Government contingent liabilities are estimated at about £330bn at end-September 2009.
- 1.12 Some of the decisions recorded in this article have already been announced and implemented in the Public sector finances statistics, while the remainder will be implemented as soon as possible. Implementation in National Accounts will follow a slower timetable.

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3. The Context of National Accounts Classification Decisions

- 3.1 The National Accounts provide a framework for describing what is happening in national economies. All institutional units operating within an economy are classified to an institutional sector and all transactions between the sectors of the economy are also categorised as part of the National Accounts framework. Work on classification of entities to sectors and of economic transactions is a key input in the production of National Accounts.
- 3.2 This is particularly relevant in the area of public expenditure, revenues, borrowing and debt. This applies both domestically, and within the European Union. For example, in the European Union statistics based on the *European System of Accounts 1995* (ESA95) are used in:
- the *Maastricht Treaty* measures, particularly of government debt and deficit, where they determine the convergence criteria for monetary union for non-members, and performance against the *Stability and Growth Pact* for eurozone members; and
 - the measurement of Gross National Income, one of the main determinants of member states' contributions to the European Union's budget.
- 3.3 It is a legal requirement for European Union countries to compile specified statistical returns on the basis of ESA95. The United Kingdom National Accounts are produced by ONS on this basis. Further guidance is contained in Eurostat's *Manual on Government Deficit and Debt*.
- 3.4 In the United Kingdom, the Government has also decided to base its fiscal policy framework on the National Accounts. Fiscal policy objectives are set in terms of statistics based on National Accounts aggregates, known as the Public sector finances. This means that key public sector statistics such as the current budget and the debt to GDP ratio are dependent on National Accounts definitions and classifications. As a result classification decisions for National Accounts purposes are taken by ONS.
- 3.5 In the November 2008 *Pre-Budget Report* it was announced that "The Government will depart temporarily from the fiscal rules until the global shocks have worked their way through the economy in full" and that "while the public sector fiscal aggregates continue to be affected by interventions in the financial sector the Government will report on public sector net debt both including and excluding the impact of those interventions".

4. Basis for National Accounts Classification Decisions

- 4.1 UK National Accounts classification decisions are consistent with the principles of the international statistical manuals, the *European System of Accounts 1995* (ESA95) and the *System of National Accounts 1993* (SNA93), and supporting manuals and case law.
- 4.2 An article on the classification of Northern Rock plc was published in early 2008. The classification decisions concerning Northern Rock and the German Landesbanken cases drew international attention as part of the Government Deficit and Debt statistics supplied to the European Commission. As a result Eurostat, the statistical office of the European Communities with responsibility for the application of the National Accounts standards as set out in ESA95 and its *Manual on Government Deficit and Debt*, established a task force of experts to investigate the recording of such interventions.
- 4.3 As the financial crisis deepened more interventions occurred, and the Eurostat task force gave way to one organised by the European Committee on Monetary, Financial and Balance of Payments Statistics (CMFB).
- 4.4 CMFB has responsibility for consulting its membership on issues concerning the Excessive Deficit Procedure for Maastricht Treaty and Stability and Growth Pact purposes. CMFB has a membership of 54 institutions, consisting of the national statistical offices and central banks of the 27 EU member states. CMFB provides Eurostat with the opinion of its expert members following a consultative vote. Eurostat uses this opinion as information in forming its decision.
- 4.5 The CMFB task force was attended by most EU member states together with international organisations, such as the European Central Bank and the International Monetary Fund. The report of the CMFB task force provided some guidance and further clarification was achieved through a vote of the CMFB on generalised questions. The CMFB also undertook a specific consultation on the Bank of England's Special Liquidity Scheme.
- 4.6 The CMFB opinion was provided to Eurostat on 18 March 2009 and was published on their website¹ on 17 April 2009. Further details on the role of CMFB and its consultation process can also be found there.
- 4.7 The Eurostat decision was published on 15 July 2009 and is available on their website².
- 4.8 While the international discussions were taking place ONS was unable to announce some of the classification decisions covered in this article, since they concerned market sensitive statistics and would have been provisional and potentially subject to change once international guidance had been established. However, the public sector classification of Northern Rock plc, Bradford and Bingley plc, The Royal Bank of Scotland Group plc and Lloyds Banking Group plc were all announced prior to this article.

¹ www.cmfb.org

² www.epp.eurostat.ec.europa.eu/portal/page/portal/government_finance_statistics/methodology/decisions_for_GFS

- 4.9 As mentioned earlier the different types of intervention by public authorities in the UK have sector classification and transaction classification impacts. A general description of sector classification is given here as this is common to all cases described in later chapters. The transaction classification aspects are described in the relevant chapters.
- 4.10 The UK National Accounts classification process is documented on the ONS website³.

Sector Classification

- 4.11 Chapter 2 of ESA95 defines the institutional sectors in the National Accounting system and clarifies the difference between the public and private sectors. It concentrates on control rather than ownership. The key paragraph in ESA95 for determining control is 2.26. It is reproduced below:

Control over a corporation is defined as the ability to determine general corporate policy by choosing appropriate directors, if necessary.

A single institutional unit (another corporation, a household or a government unit) secures control over a corporation by owning more than half the voting shares or otherwise controlling more than half the shareholders' voting power. In addition, government secures control over a corporation as a result of special legislation decree or regulation which empowers the government to determine corporate policy or to appoint the directors.

- 4.12 ESA95 paragraph 2.42, which defines the split of financial corporations into the public and private sectors, carries forward the criteria used in paragraph 2.26 for subdividing non-financial corporations:

With the exception of sub-sector S.121 [the Central Bank], each sub-sector may be further subdivided into:

- a) public financial corporations;*
- b) national private financial corporations;*
- c) foreign controlled financial corporations.*

The criteria for this subdivision are the same as for non-financial corporations (see paragraphs 2.26. - 2.31.).

- 4.13 Although ESA95 paragraph 2.26 refers to corporations controlling other corporations through voting powers, SNA93 paragraph 4.70 adds more by pointing to “*other evidence that control is exercised*”. ESA95 paragraph 1.01, reproduced below, describes how ESA95 is consistent with SNA93, so where ESA95 does not provide sufficient detail it is accepted convention to refer to SNA 93.

The 1995 ESA is fully consistent with the revised world-wide guidelines on national accounting, the System of National Accounts (1993 SNA, or simply: SNA; these guidelines have been produced under the joint responsibility of the United Nations, the IMF, the Commission of the European Communities, the OECD and the World Bank). However, the ESA is focused more on the circumstances and data needs in the European Union. Like the SNA, the ESA

³ http://www.statistics.gov.uk/about/methodology_by_theme/national_accounts_classifications.asp

is harmonised with the concepts and classifications used in many other, social and economic statistics. Cases in point are statistics on employment, statistics on manufacturing and statistics on external trade. The ESA can therefore serve as the central framework of reference for the social and economic statistics of the European Union and its Member States.

- 4.14 As a result ONS National Accounts classification case law uses an assessment of a number of control indicators to form a judgement on whether there is control. This is a similar approach to business accounting, which recognises that companies can be controlled other than through the majority ownership of voting share capital. The ONS National Accounts classification approach is being reflected in the current updates of the *European System of Accounts* and the *System of National Accounts*.
- 4.15 The ONS approach to classification cases involving the public sector is to first consider whether government, or any other part of the public sector, can exercise control or influence over an entity's directors through the appointment process. It then examines the situation to see whether there are any special factors or contractual arrangements that enabled any part of the public sector to determine general corporate policy, either individually or collectively.

5. The Financial Crisis

- 5.1 The global crisis in the financial system began to surface in summer 2007 in the USA housing loans market, which was experiencing mortgage repayment defaults as a result of falling house prices and rising interest rates. The "subprime crisis" in the USA led to instability in the global money markets. Subprime refers to a riskier category of mortgage lending.
- 5.2 The US subprime mortgage assets had been sold on to others, usually through securitisation (mortgage-backed securities), and these assets had often been further sliced up into a number of other financial instruments (such as Collateralised Debt Obligations) and sold on to other investors, in some cases repeatedly so. By their nature the risks inherent in these assets lacked transparency, so any impairment of them is not easy to judge. In April 2008 the International Monetary Fund (IMF) has estimated the global losses at \$945 billion (about £500bn or €600bn), whereas actual losses and write-downs to that date were just below \$200 billion. There were concerns that this potentially threatened the solvency of a number of financial institutions around the world.
- 5.3 Banks were expected to take half of these losses, with the rest mainly borne by other financial institutions (insurance corporations, pension funds, hedge funds, money market funds) predominantly in the USA and Europe. However, it is not just financial corporations that have exposure, for example in Norway it has been reported that the local government sector has exposure through investments in USA.
- 5.4 Most of the losses the IMF estimated are expected to stem from defaults in the USA, with over half the total being write-offs of prime and sub-prime mortgages and a further quarter from losses on lending for commercial property.
- 5.5 This situation caused the short-term money markets to stop, mainly due to uncertainty about the true position of the borrowers. This caused a further problem for those financial institutions that relied on short-term borrowing to fund their activities.
- 5.6 Despite attempts by major central banks, which cut interest rates and pumped liquidity into the markets, the financial markets did not return to working normally. The markets that traded mortgage-backed securities had effectively closed, and so it was very difficult for banks to exchange these assets for cash. This made the assets "illiquid": they could not readily be sold or used as security to borrow against.
- 5.7 So there were two separate problems for financial institutions - issues of solvency for those exposed to losses; and issues of liquidity for those who have a business model that required wholesale funding from the markets. These had implications for the wider economy.
- 5.8 In Germany several banks were impacted, notably the Landesbanken owned by state government. Structured Investment Vehicles (SIVs) had been used to invest in assets that were now impaired. These SIVs were off the banks' balance sheet in their published corporate accounts. The SIVs issued short-term debt to invest in these longer term assets, and rolled over the short-term debt. When the markets stopped lending they were in trouble as they could not re-finance. In some cases the parent bank had provided a re-financing guarantee for such eventualities, and this guarantee was called. The calling of the guarantees led, in some cases, to the parent banks experiencing difficulty.

- 5.9 Northern Rock plc, which had a business model of using securitisation to fund long-term mortgages, had a liquidity problem and in September 2007 sought a special central bank lending facility to deal with its liquidity problems. After the failure to find a satisfactory private sector solution it was nationalised in February 2008.
- 5.10 In the United Kingdom, although some banks had made losses through writing down the value of impaired assets, the losses were considered sustainable. However, the uncertainty about the valuation of assets in bank balance sheets led to continued uncertainty about their financial positions. As a result they remained reluctant to lend to each other on the inter-bank market. This reluctance is evident in the interest rates charged on inter-bank lending, which rose even though the Bank of England's base rate had fallen.
- 5.11 The Bank of England judged that this situation was affecting all banks and building societies and had started to affect their willingness to lend money to individuals and businesses. It had been hoped that these problems would be resolved as markets returned to normal, but by April 2008 it was clear that there was no immediate prospect that markets in mortgage-backed securities would operate normally. The Bank of England judged that the situation would improve only by dealing with the problem of illiquid assets on banks' balance sheets in an attempt to change the willingness of banks to lend to each other and, importantly, to the wider economy.
- 5.12 In April 2008 the Bank of England announced a temporary scheme, the Special Liquidity Scheme, whereby banks and building societies could exchange illiquid assets for UK government securities (treasury bills).
- 5.13 In summer 2008 there were many cases of institutions struggling and being rescued, including Bear Stearns, Fannie Mae, Freddie Mac, Merrill Lynch and the AIG insurance corporation in USA. In September 2008 the Lehman Brothers investment bank filed for bankruptcy protection.
- 5.14 The crisis deepened when distrust in the markets increased rapidly, partly in the wake of Lehman Brothers failure. Within Europe the Netherlands, Belgium and Luxembourg governments made equity injections to rescue Fortis. The three main banks in Iceland were nationalised. The France, Belgium and Luxembourg Governments made rescue equity injections into Dexia. Increases in deposit protection schemes were announced. In the UK regulators decided that Bradford and Bingley (UK) no longer met threshold conditions to act as a deposit taker and it was nationalised.
- 5.15 From this point onwards many rescue and support packages were implemented in different countries. The UK Government announced such a package in October 2008. A common theme was the government recapitalisation of banks, usually through preference shares. The Royal Bank of Scotland Group plc, HBOS and Lloyds TSB sold preference shares to the UK government, which also underwrote ordinary share issues that had little market take-up. Also common were plans to guarantee lending and impaired assets, and to transfer impaired assets into defeasance vehicles.
- 5.16 In January 2009 the UK Government announced its second support package.
- 5.17 A list of the key events from February 2007 to August 2009 is presented in Appendix A.

6. Classification of Entities Involved

Table 6.1 shows the sector classification of entities involved in the financial crisis operations. The classification of many of these is explained in detail in later sections. This chapter provides a brief description of other entities involved and their sector classification, particularly those organisations that existed prior to the financial crisis.

Table 6.1

Entity	Classification	Date from which reclassification applies (if different from the latter of inception/1946)
Abbey National plc	Private financial corporation (monetary financial institution)	
Bank of England	Public sector (central bank)	
Bank of England Asset Purchase Facility Fund Limited (first phase)	Central government **	
Bank of England Asset Purchase Facility Fund Limited (second phase)	Public sector (central Bank) **	
Bradford and Bingley plc	Public financial corporation (monetary financial institution)	26 September 2008
Bradford and Bingley International Ltd [Isle of Man]	Rest of the world	
Capital for Enterprise Limited	Central government	
DBS Bridge Bank Limited	Public financial corporation (monetary financial institution)	April-June 2009
Debt Management Office	Central government **	
Deposits Management (Edge)	Central government **	
Deposits Management (Heritable)	Central government **	
Financial Services Authority	Public financial corporation (financial auxiliary)	
Financial Services Compensation Scheme	Central government	
Grupo Santander [Spain]	Rest of the world	
HBOS	Public financial corporation	October 2008
Heritable Bank Limited	Private financial corporation*	
HM Treasury	Central government **	
ING Direct N.V. (London branch)	Private financial corporation (monetary financial institution)	
ING Direct N.V. [Netherlands]	Rest of the world	
Kaupthing Singer & Friedlander Limited	Private financial corporation*	
Landsbanki (London branch)	Private financial corporation (monetary financial institution) until ceased activity in October 2008	
Lloyds Banking Group	Public financial corporation	Inception – January 2009

Lloyds TSB	Public financial corporation	October 2008
London Scottish Bank	Private financial corporation (monetary financial institution)	
National Liabilities Fund	Central government **	
Northern Rock	Public financial corporation (monetary financial institution)	9 October 2007
The Royal Bank of Scotland Group plc	Public financial corporation	October 2008
UK Financial Investments Ltd	Central government **	

* briefly part of public sector, although this has no impact on any important public sector or government statistics.

** Not recognised as autonomous institutional units for National Accounts purposes, their activity is recorded in the sector stated.

6.1 Bank of England

6.1.1 The Bank of England is the United Kingdom's central bank. It acts as the Government's banker, for example the Central Government Consolidated Fund, National Loans Fund and Exchange Equalisation Accounts are held at the Bank of England. In addition to its role with government it also manages the United Kingdom's official reserves. It also acts as a bank for UK banks, especially in its capacity as a lender of last resort. The Bank of England was nationalised in 1946.

6.1.2 The Bank of England is a public financial corporation, specifically classified in the central bank sub-sector within the ESA95 framework.

6.2 Debt Management Office

6.2.1 The UK Debt Management Office (DMO) carries out the Government's debt management policy. It was established on 1 April 1998 and management of the UK government securities (gilts) market transferred to it.

6.2.2 DMO is classified for National Accounts purposes within the central government sub-sector.

6.3 Financial Services Authority

6.3.1 The Financial Services Authority regulates the United Kingdom's financial services industry. It is a company limited by guarantee, given statutory powers by the *Financial Services and Markets Act 2000*. It is funded by regulatory fees and governed by a board appointed by HM Treasury.

6.3.2 As defined by ESA95 paragraph 2.58g, the Financial Services Authority is a public corporation; specifically it is classified for National Accounts purposes in the public financial auxiliaries sub-sector of financial corporations.

6.4 HM Treasury

- 6.4.1 HM Treasury is the United Kingdom's economics and finance ministry. It is responsible for formulating and implementing the Government's financial and economic policy.
- 6.4.2 HM Treasury is classified for National Accounts purposes within the central government sub-sector.

6.5 National Loans Fund

- 6.5.1 The National Loans Fund was established on 1 April 1968 to account for central government borrowing and lending separately from regular revenue, such as tax, which flows via the Consolidated Fund. It provides finance for various public sector bodies and accounts, such as the Public Works Loans Board, the Debt Management Account and the Exchange Equalisation Account, and makes loans to various public sector bodies.
- 6.5.2 The National Loans Fund is classified for National Accounts purposes within the central government sub-sector.

6.6 Tripartite Authorities

- 6.6.1 Financial stability is a shared objective of HM Treasury, the Financial Services Authority and the Bank of England and their responsibilities are set out in a Memorandum of Understanding between them. They are collectively referred to as the 'Tripartite Authorities'. This collective body is not classified as a separate institutional unit for National Accounts purposes.

7. Northern Rock

The Bank of England provided liquidity support to Northern Rock plc on 14 September 2007. This support was extended and amended on 9 October 2007.

The amended arrangements changed Northern Rock plc's relationship with the public sector.

From 9 October 2007, Northern Rock plc was reclassified from the private sector to the public sector.

From 9 October 2007 Northern Rock's UK resident securitisation vehicles are also classified in the public sector.

From August 2008 Northern Rock plc's borrowing was directly from central government.

Background

- 7.1 Northern Rock Building Society was formed in 1965 from the merger of Northern Counties Permanent Building Society (established in 1850) and Rock Building Society (established in 1865). Northern Rock Building Society then merged with a number of small local building societies and, prior to its conversion to a public limited company in 1997, was an amalgamation of 53 societies.
- 7.2 Northern Rock plc was formed in October 1997 when the Northern Rock Building Society demutualised and floated on the London Stock Exchange.
- 7.3 Its core activity was residential mortgage lending in the United Kingdom. At end-December 2006 it had £22.6bn in retail deposits and £86.1bn of loans.
- 7.4 Northern Rock plc used a funding model where it borrowed, mostly short-term, from the money markets to fund issuing mortgages. As mortgages are usually long-term assets this approach required short-term liquidity to roll-over the borrowing. The financial instability in the markets made it difficult for banks to borrow from each other in the money markets.
- 7.5 From 13 August 2007 Northern Rock plc was in contact with the Financial Services Authority concerning the difficulties it faced. Attempts to find private sector investor solutions to the liquidity problems were unsuccessful.
- 7.6 On 13 September 2007 Northern Rock plc asked the Bank of England for an emergency borrowing facility, due to the problems it had borrowing in the money market to replace its borrowing that was maturing.
- 7.7 Two collateral-backed loan facilities were granted on 14 September 2007: a repo facility backed by securities and a loan facility backed by unsecuritised mortgage

- assets. The facilities had interest rates that exceeded those used for the Bank of England's standard operations. In accordance with the Tripartite Authorities' *Memorandum of Understanding* the Chancellor of the Exchequer authorised the support.
- 7.8 The news of the support was leaked before it was officially announced and prompted a run⁴ on the bank. On 17 September 2007 government announced a guarantee arrangement for depositors, which went beyond the coverage of the Financial Services Compensation Scheme. The guarantee arrangements were clarified later and also amended several times – the detail of the amendments is not important for classification purposes.
- 7.9 As it became clearer that the markets were not returning to normal it was apparent that the 14 September 2007 support operation was insufficient. On 9 October 2007 Northern Rock plc requested, and was granted, additional facilities from the Bank of England. Two new facilities were introduced, no further borrowing under the 14 September facility was allowed after 9 October 2007. The new facilities were not subject to any specific borrowing limit, were secured against all Northern Rock plc assets, and repayable on demand. As before, the facilities had interest rates that exceeded those used for the Bank of England's standard operations. From 9 October 2007 this interest premium was rolled up into further lending in the *PIK agreement*.
- 7.10 Government indemnified the Bank of England against any losses and other liabilities that arose from the 9 October 2007 support facilities.
- 7.11 On 5 December 2007 the European Commission's State Aid investigation was published. This concluded that the 14 September 2007 measures were "taken at the BoE's own initiative" and "do not constitute State aid". The measures taken from 17 September 2007 and 9 October 2007 do "constitute State aid ... in particular no market economy investor would have granted any such measures." These contain State aid elements since they benefit only one particular operator, here Northern Rock plc.
- 7.12 A private sector solution to Northern Rock plc's problems was sought but none of the offers considered were accepted. On 22 February 2008 Northern Rock plc was taken into government ownership.
- 7.13 The *Maastricht Treaty* has provisions that restrict central bank financing of government undertakings. To comply with these, the central bank lending was repaid on 28 August 2008 and replaced with a direct loan from government.
- 7.14 A capital restructuring plan was announced in August 2008 subject to State Aid approval. This involves the replacement of up to £3bn of the government loan with government equity. At time of publication of this article this restructuring had not been completed, it was planned for later in 2009.
- 7.15 On 19 January 2009, as part of the announcement of the Government's second intervention package (see chapter 24), a change to Northern Rock plc's business strategy was announced. Hitherto it had been reducing its mortgage book in order to repay the Bank of England and government loans. The new plan was to slow the 2011 date for repayment and increase the government lending in an attempt to increase UK mortgage lending. At the time of publication of this article the plans were still subject to achieving State Aid clearance.

⁴ Depositors attempting to withdraw their cash, often evidenced by long queues outside the institution's branches.

- 7.16 In 2009 a revised business plan, involving a restructuring, was provided to the European Commission for State Aid consideration. The aim is to complete the restructuring in the second half of 2009. The plan to slow the repayment date and increase the government lending in an attempt to increase UK mortgage lending was dropped. State Aid approval was given on 28 October 2009.
- 7.17 The restructuring plan involves Northern Rock plc being split into two separate companies: a bank - Northern Rock plc - and an asset manager Northern Rock (Asset Management) plc.
- 7.18 The retail deposits, some wholesale deposits and a selection of unencumbered mortgage assets and the branch network will remain in Northern Rock plc, which will offer saving and mortgage products.
- 7.19 The balance of the mortgage assets, including the interest in the securitisation and covered bond programmes, will go into Northern Rock (Asset Management) plc. The government loan to Northern Rock plc plus the wholesale funding instruments will also be part of Northern Rock (Asset Management) plc. Northern Rock (Asset Management) plc will be wound-down over time, it will not offer any savings products or new loans.

Sector Classification Issues

Summary

- 7.20 Before September 2007, Northern Rock plc is classified as a private sector other monetary financial institution. Whilst it remains an other monetary financial institution following the events of 2007, the main sector classification question concerned whether the arrangements with the public sector result in it being classified in the private sector or public sector.
- 7.21 There are two key dates for sector classification purposes: 14 September 2007, when the initial support facility started, and 9 October 2007, when the arrangements changed. ONS investigated extensively the arrangements introduced on 14 September 2007 and judged that they do not result in public sector control of Northern Rock plc. The 9 October 2007 arrangements were judged to be sufficient to result in the reclassification of Northern Rock plc from the private sector to the public sector from that date.
- 7.22 The decision to reclassify from October 2007 was based on a judgement that the public sector has the power to control Northern Rock plc's general corporate policy through clauses in the legal documents defining the arrangements. While amounts were outstanding under the loan agreement, Northern Rock plc required permission from the Bank of England before undertaking certain activities. For example, permission was required before entering into any corporate restructuring, making substantial changes to the general nature of the business, making dividend payments, and acquiring or disposing of certain types of assets. Northern Rock plc's undertakings to the Bank of England determined the National Accounts classification.
- 7.23 The activity of the UK-resident special purpose vehicles and covered bond partnership used in Northern Rock plc's securitisation and borrowing programmes are also classified as part of the public sector.

- 7.24 From the time of nationalisation in February 2008 the situation is more straightforward as government has control of Northern Rock plc through ownership and rights to appoint directors.

Lending under the Bank of England's published framework

- 7.25 The Bank of England's 'lender of last resort' arrangements should not be confused with the Bank of England's Standing Lending Facility, which allows all participating banks to borrow overnight at a penalty rate of one percentage point above the Bank base rate.
- 7.26 The following quote describing the lender of last resort arrangements is taken from the Bank of England's website:

Financial crisis management is a key element of the Bank of England's responsibility for financial stability. The Memorandum of Understanding (MoU) on financial stability between the Bank, Financial Services Authority (FSA) and HM Treasury outlined that in a financial crisis the Bank might need to undertake support operations – commonly referred to as acting as 'Lender of Last Resort'. The aim of these official financial operations would be to limit the risk of problems in or affecting particular institutions spreading to other parts of the financial system.

The situations in which the Bank might undertake support operations are outlined in the MoU. It notes that a support operation 'is expected to happen very rarely and would normally only be undertaken in the case of a genuine threat to the stability of the financial system to avoid a serious disturbance in the UK economy'. If the Bank or the FSA identified a problem where a support operation might be necessary, they would inform or consult with each other. The Chancellor would be given the option of refusing a support operation, given that public funds might ultimately be put at risk.

- 7.27 The Bank of England's published documentation relating to its operations under the sterling money market framework are available on its website⁵. This documentation comprises:
- the Eligibility Criteria for participation in Open Market Operations, to have access to Reserve Accounts or access to the standing deposit and lending facilities;
 - the Terms and Conditions applying to participation in the Bank of England's facilities; and
 - the Operating Procedures.
- 7.28 The documentation is described as establishing standard terms and conditions for all participants in the facilities and allows for these terms and conditions to be amended where the Bank of England considers this appropriate.
- 7.29 This documentation was examined and it was judged that these standard conditions do not give the Bank of England, HM Treasury or the Financial Services Authority, either individually or collectively, the ability to control the general corporate policy of the institution receiving support under these standard arrangements. Essentially the standard terms and conditions ensure that the participant can legally enter into the conditions, has the necessary regulatory authorisations to perform the transactions,

⁵ www.bankofengland.co.uk

will pay the Bank of England's charges and reimburse all fees on demand, and inform the Bank of England in advance of any proposed major organisational and business change relating to it or material to the information provided. These requirements were not deemed to constitute control for National Accounts purposes.

Support Arrangements: 14 September 2007

- 7.30 The facilities offered to Northern Rock plc on 14 September 2007 were based on the Bank of England's 'lender of last resort' arrangements. They are presented in two documents: the Sterling Loan Agreement and the Repo Facility. Through these documents the Bank of England provided a short-term loan facility, which was secured on Northern Rock plc's mortgage loan assets and related security on properties located in the UK.
- 7.31 There were a variety of conditions and undertakings relating to the provision of the loan facility. These clauses involved, for example, the provision of information to the Bank of England, the provision of an indemnity to the Bank of England, and the definition of a number of terms. Following examination of the detailed arrangements, it was judged that the arrangements did not give the Bank of England, HM Treasury or the Financial Services Authority, either individually or collectively, the ability to control Northern Rock plc's general corporate policy. As a result Northern Rock plc remained classified in the private sector following provision of the 14 September 2007 support facility.

Support Arrangements: 9 October 2007

- 7.32 On 9 October 2007 an amended facility – the *Amendment Agreement* - was agreed between the Bank of England and Northern Rock plc.
- 7.33 Whilst the *Amendment Agreement* did not give the Bank of England, or any other part of the public sector, appointment rights over the Northern Rock plc board it did contain additional restrictions and requirements.
- 7.34 These include restrictions which require Northern Rock plc “for so long as any amount is outstanding under this Loan Agreement or any other Finance Document or the transaction contemplated hereby or thereby are otherwise in force or remain to be performed” to obtain the prior written consent of the Bank of England before:
- (i) entering into any amalgamation, demerger, merger, consolidation or corporate reconstruction other than as specified under the Stabilisation Plan⁶;
 - (ii) making any substantial change to the general nature of the business, other than that contemplated in the Stabilisation Plan;
 - (iii) acquiring a company or any interest in a company, or incorporating a company;
 - (iv) investing in or acquiring any shares, stocks, securities or other interest in a joint venture;

⁶ The Stabilisation Plan covers the Repayment Plan and the Business Plan.

- (v) entering into any transactions to dispose of any assets, other than “Permitted Disposals” already defined within the agreement;
- (vi) declaring, making or paying any dividend, charge, fee or other distribution, other than dividends paid to the parent company of a member of the Group; and
- (vii) finalising the corporate activity plan, Business Plan, and Restructuring Plan.

7.35 It was judged that these restrictions and requirements provided the public sector with the ability to control Northern Rock plc’s general corporate policy, as defined for National Accounts purposes. As a result from 9 October 2007 Northern Rock plc is classified as a Public financial corporation.

7.36 The nationalisation of Northern Rock plc on 22 February 2008 has no effect on the classification. The situation is more straightforward from then as government has control of Northern Rock plc through ownership and rights to appoint directors.

Securitisation Vehicles

7.37 Given the judgement on the sector classification of Northern Rock plc it becomes necessary to agree on the boundary of what ‘Northern Rock’ actually is for National Accounts purposes. Like many mortgage lenders Northern Rock plc has securitised some of its mortgage assets and used separate legal entities in the process. As a result the detailed arrangements surrounding the securitisations were considered in order to clarify where these entities, and their assets and liabilities, would be recorded in the National Accounts and hence whether they would be included in Public sector finances.

7.38 Because these arrangements are complex, paragraphs 7.39 to 7.42 provide a brief and simplified example of a conventional securitisation arrangement. Paragraphs 7.43 to 7.47 give an overview of National Accounts guidance on classification of securitisation. At paragraph 7.48 the article returns to classification of Northern Rock’s securitisation entities and the rationale for them.

Standard Bank Securitisation Arrangements

7.39 In a conventional securitisation a bank will legally transfer some underlying assets – typically mortgages - to a Special Purpose Vehicle (SPV, or sometimes referred to as a Special Purpose Entity (SPE)). The SPV will then be in a position to issue asset-backed securities (usually bonds) to the market and use the proceeds of the issue to settle the purchase of “the securitised assets” from the bank. Mortgages provide ideal securitisation material as the assets are backed by property and produce a steady income stream to repay the bonds. The securitisation allows the bank to bring forward these future income streams, which it can use to fund new mortgages.

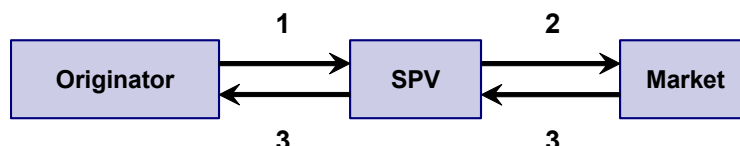
7.40 The SPVs differ from institutional units usually included the National Accounts in that they will often have no employees and little economic activity. They may have little physical presence beyond a brass plate confirming their place of registration and are often resident in a different territory from the related corporation; for UK corporations this will commonly be in tax havens like the Channel Islands. SPVs are usually structured for tax avoidance and to minimise liabilities in the event of any bankruptcy.

7.41 If the bank transfers the contractual rights to receive the income stream from the assets (even if it still administers it) then it has sold the asset. A more usual situation is that the bank retains these rights, instead undertaking to reimburse the bondholders according to "pass-through" arrangements. The bank may however retain an interest in the assets.

7.42 Diagram 1 shows the transactions involved in a simple conventional securitisation.

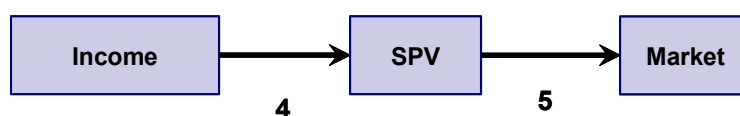
Diagram 1: Conventional securitisation where a bank is the originator

First transaction:



- 1 The originator (here a bank) sells the mortgages, or assigns the income, to the SPV.
- 2 The SPV issues bonds to the market.
- 3 The SPV receives cash from the market and passes it to the bank.

Subsequent transactions:



- 4 Payments from customers (originally to the bank) now go to the SPV.
- 5 The SPV uses these to repay bonds (both interest and principal).

National Accounts Classification Guidance on Securitisation

7.43 The international statistical manuals contain guidance on the classification of entities with some specific guidance with respect to securitisation activities. The classification of units for National Accounts need not correspond to the legal form. Excerpts from the available guidance are reproduced below.

7.44 At a basic level SNA93 provides general guidance on the definition of an institutional unit in paragraph 4.2 as:

An economic entity that is capable, in its own right, of owning assets, incurring liabilities and engaging in economic activities and in transactions with other entities.

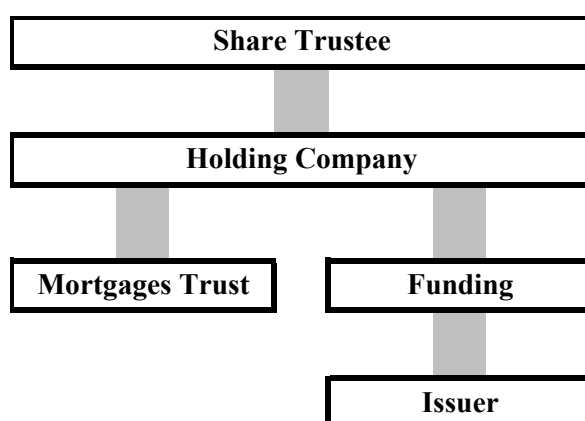
7.45 ESA95 paragraph 2.55f adds that, in defining the other financial intermediaries (excluding insurance and pension funds) sub-sector, to include "financial vehicle corporations, created to be holders of securitized assets".

7.46 Thus, if a Special Purpose Vehicle qualifies as an institutional unit within an economy, ESA95 requires classification as an other financial intermediary.

- 7.47 As a result the units involved in each stage of the securitisation of Northern Rock plc's assets were assessed to see if they met the requirements for classification as an institutional unit in National Accounts. They were then assessed against further guidance where this was relevant or helpful with the classification.

Northern Rock Securitisation

- 7.48 Consideration of this classification case required an examination of the structures and arrangements used in Northern Rock plc's borrowing programme, which involves securitisation of mortgage assets. The classification judgement here is to also classify the UK-resident special purpose vehicles used in the securitisation programme as part of the public sector. Hence, the amounts outstanding on borrowing under the securitisation programmes add to public sector net debt.
- 7.49 Northern Rock plc has a securitisation programme, similar to the standard one described earlier. It is more complicated in that it uses many SPVs but it essentially simplifies to give the same end result. It has been operating since October 1999, although the detailed mechanics have changed slightly over time. Northern Rock plc's *Annual Report and Accounts 2007* states that securitised notes accounted for 58 per cent of its funding portfolio as at end-December 2007.
- 7.50 In summary, Northern Rock plc legally transfers portfolios of its mortgages to Jersey-registered trusts, and in return has a beneficial interest in the trust property. The trusts sell mortgages to a main Special Purpose Vehicle. The residential mortgages 'vehicle' is commonly referred to in the media as Granite, although this is collective notation for a holding company and its subsidiaries. Northern Rock plc also had a securitisation programme for commercial mortgages called Dolerite, which had a similar structure – the commercial mortgage portfolio was sold between June and October 2007. Issuing subsidiaries issue loan notes (bonds). These bonds are long-term financial liabilities, typically with 20 or 40 year maturities. The bonds are issued in different tranches, with an order of seniority in case there are insufficient funds to repay them. The interest rate on each tranche reflects the risk. The bonds are issued in more than one country.
- 7.51 According to information published in Northern Rock plc's *2007 Annual Report and Accounts*, £49.6 billion of securitised mortgage assets were assigned to the trusts as at end-December 2007, of which £5.4 billion was Northern Rock plc's retained interest. The bonds outstanding at this time totalled £47.9 billion, of which £5.1 billion were held by Northern Rock plc.
- 7.52 The ownership structure of the legal entities involved in securitising Northern Rock plc's mortgages is shown in Diagram 2 below. This article, and the diagram, uses generic names for the legal entities that are used in each part of the process to simplify the situation. The Jersey-registered trusts are collectively referred to as 'Mortgages Trust' and the Special Purpose Vehicles involved in the securitisation are grouped into two main groupings and referred to as 'Funding' and 'Issuer'. The structure is different for the earlier securitisations, where both the 'Funding' and 'Issuer' roles are performed by one legal entity. Precise details of the legal entities used in each of the individual securitisations are shown in Table 1.

Diagram 2

- 7.53 'Holding Company' is legally owned by 'Share Trustee'. The latter are professional trust companies, registered in Jersey. This structure ensures that Northern Rock plc does not legally own⁷ the Special Purpose Vehicles.
- 7.54 Although 100 per cent owned by 'Share Trustee', any profits made by 'Holding Company' will go to a beneficiary, a charity. 'Holding Company' does not have any employees. The director structure for each 'Holding Company' is identical to the one described later in paragraph 7.57.
- 7.55 'Mortgages Trust' will hold the mortgages (trust property) in trust for those that have an interest in them (Northern Rock plc and 'Funding'). The trusts have always been incorporated in Jersey. They have four directors, all from Northern Rock plc's legal adviser firm.
- 7.56 The 'Funding' part of the structure, as separate from 'Issuer', was first used in 2001. Its role is to borrow from its 'Issuer' subsidiary Special Purpose Vehicle and use the proceeds to purchase mortgages from Northern Rock plc. This generic role was initially carried out, for residential mortgage securitisations, by Granite Finance Funding Limited, which was incorporated in Jersey but with a branch in England. Since 2005 Granite Finance Funding 2 Limited has been used instead, the only relevant difference in the arrangement being that it is registered in England rather than Jersey.
- 7.57 'Funding' does not have any employees. It has three directors, one of which is Northern Rock plc's Treasury Director. The other two are provided by either the 'Share Trustee' or legal advisors, and will in practice have a limited role as they may serve on the boards of over a hundred similar vehicles. As a result the Northern Rock plc director is in a minority in terms of director control of the SPVs. However, from previous cases where this model has been used, the expectation would be that the other two directors are effectively 'silent' and the minority director is effectively in control. Regardless, under law all directors have the same powers. This is particularly relevant in the current Northern Rock plc situation as the bonds become due for repayment. Here the directors' duty is to shareholders and creditors rather than Northern Rock plc. The following quote, from a prospectus, describes the situation for Granite Finance Funding Ltd:

⁷ Northern Rock plc's *Annual Report and Accounts 2007* states that "although the company has no direct or indirect ownership interest in these companies [the securitisation SPVs], they are regarded as legal subsidiaries under UK companies legislation."

"The Company, which is a special purpose company, is controlled by its board of directors. The board of directors consists of three directors. Two of the Company's three directors are provided by Mourant & Co. Capital (SPV) Limited, the principal activity of which is providing directors and corporate management services for special purpose companies. The third director of the Company is an employee of Northern Rock plc."

- 7.58 'Issuer' is the generic shorthand name for the Special Purpose Vehicles that issue the bonds. Before 2005 there was a separate legal entity for each securitisation. Since then Granite Master Issuer plc has been used. All 'Issuer' entities have had registered offices in England. 'Issuer' does not have any employees. The director structure is similar to that described earlier for 'Funding'.
- 7.59 Northern Rock plc assigns part of its mortgage assets to 'Mortgages Trust'. In return a beneficial interest in the trust property of 'Mortgages Trust' is recognised.
- 7.60 'Issuer' then issues tranches of notes (bonds) to the markets. It uses the proceeds to make an inter-company loan to 'Funding'.⁸
- 7.61 'Funding' uses the loan to purchase mortgages from 'Mortgages Trust'. 'Funding' now also has an interest in the trust property of 'Mortgages Trust'. Northern Rock plc retains a now diluted interest in the rest, but has received cash settlement for the sale of its assigned rights to mortgages in the trust property.
- 7.62 'Funding' will usually retain the proceeds from one tranche and place it in a Reserve Fund.
- 7.63 The mortgage customers make their repayments of mortgage principal and payments of interest to 'Mortgages Trust'.⁹
- 7.64 'Mortgages Trust' distributes these receipts to Northern Rock plc and 'Funding', in proportion to their interest in the trust property. At this stage Northern Rock plc will typically have retained something like a 16 per cent interest.

⁸ The sequence of events is simplified here. Many occur earlier but cash settlements are either fully or partly deferred.

⁹ Northern Rock plc administers the collection, for a fee, so the mortgage customers will in practice not notice any change to their usual arrangements.

Table 1 - Legal entities performing each of the generic roles and their Residence

Date of securitisation	Issuer	Funding	Mortgages Trust
01 October 1999	Granite Mortgages 99-1 plc	n/a	n/a
01 March 2000	Granite Mortgages 00-1 plc	n/a	n/a
25 September 2000	Granite Mortgages 00-2 plc	n/a	n/a
26 March 2001	Granite Mortgages 01-1 plc	Granite Finance Funding Limited	Jersey
28 September 2001	Granite Mortgages 01-2 plc	Granite Finance Funding Limited	Jersey
20 March 2002	Granite Mortgages 02-1 plc	Granite Finance Funding Limited	Jersey
24 June 2002	Dolerite Funding No.1 plc	n/a	Dolerite Mortgages Trustee Limited
23 September 2002	Granite Mortgages 02-2 plc	Granite Finance Funding Limited	Jersey
27 January 2003	Granite Mortgages 03-1 plc	Granite Finance Funding Limited	Jersey
21 May 2003	Granite Mortgages 03-2 plc	Granite Finance Funding Limited	Jersey
24 September 2003	Granite Mortgages 03-3 plc	Granite Finance Funding Limited	Jersey
28 January 2004	Granite Mortgages 04-1 plc	Granite Finance Funding Limited	Jersey
26 May 2004	Granite Mortgages 04-2 plc	Granite Finance Funding Limited	Jersey
22 September 2004	Granite Mortgages 04-3 plc	Granite Finance Funding Limited	Jersey
26 January 2005	Granite Master Issuer plc	Granite Finance Funding 2 Limited	UK
25 May 2005	Granite Master Issuer plc	Granite Finance Funding 2 Limited	UK
18 July 2005	Dolerite Funding No. 2 plc	n/a	Dolerite Mortgages Trustee No. 2 Limited
31 August 2005	Granite Master Issuer plc	Granite Finance Funding 2 Limited	UK
21 September 2005	Granite Master Issuer plc	Granite Finance Funding 2 Limited	UK
25 January 2006	Granite Master Issuer plc	Granite Finance Funding 2 Limited	UK
24 May 2006	Granite Master Issuer plc	Granite Finance Funding 2 Limited	UK
19 September 2006	Granite Master Issuer plc	Granite Finance Funding 2 Limited	UK
29 November 2006	Granite Master Issuer plc	Granite Finance Funding 2 Limited	UK
24 January 2007	Granite Master Issuer plc	Granite Finance Funding 2 Limited	UK
23 May 2007	Granite Master Issuer plc	Granite Finance Funding 2 Limited	UK
17 September 2007	Granite Master Issuer plc	Granite Finance Funding 2 Limited	UK

- 7.65 In early securitisations Northern Rock plc made a subordinated loan to 'Funding'. This meant that in the event of 'Funding' being wound-up and defaulting on payments to bondholders, the bondholders will have had seniority of call on these assets ahead of Northern Rock plc. In later securitisations the amounts placed in the Reserve Fund mentioned earlier are effectively achieving the same purpose. In addition there is an interest rate swap agreement between Northern Rock plc and 'Funding' that converts variable rate mortgage receipts onto a LIBOR-based equivalent. Any profits on this swap flow from 'Funding' to Northern Rock plc and any losses result in Northern Rock plc paying 'Funding' to cover the loss.
- 7.66 'Funding' uses the cash from 'Mortgages Trust' to repay principal and pay interest on the inter-company loan.
- 7.67 'Issuer' uses this receipt to repay principal and pay interest to the bondholders.

Mortgages Trust

- 7.68 At a basic level the trusts that fulfil the generic role of 'Mortgages Trust' do not appear to meet the definition of a separate institutional unit within National Accounts. This is because they exist solely to hold the mortgage portfolio; the trusts cannot incur liabilities or engage in economic activities.
- 7.69 Although not carrying the legal basis that ESA95 does, the 2000 International Monetary Fund *Monetary and Financial Statistics Manual* (MFSM) provides further definition than ESA95. MFSM gives the following description of vehicle companies:

Vehicle companies are financial entities created to be holders of securitized assets or assets that have been removed from the balance sheets of corporations or government units as part of the restructuring of these units. Many are organized as trusts or special purpose vehicles created solely to hold specific portfolios of assets or liabilities. Extensive use has been made of vehicle companies in conjunction with the securitization of assets. For example, an intermediary such as a mortgage lender could sell a portfolio of assets to a specially organized vehicle company that repackages the portfolio and sells investment interests in the portfolio to institutional or other investors. While the portfolio is usually sold irrevocably to the vehicle company, the intermediary that created the vehicle company often receives fee income for its administrative role. However, the vehicle company is the legal owner of the asset portfolio and thus may operate as a financial intermediary. If the vehicle company in the previous example sells a new financial asset (which could be a debt security, equity shares, or partnership interests) that represents an interest in the portfolio, the company is acting as a financial intermediary and—as long as a full set of accounts is available for the company—it is

deemed to be a separate institutional unit. If the vehicle company does not sell a new financial asset representing an interest in the portfolio, the company has not effectively transformed or intermediated the portfolio and thus is not deemed to be a financial intermediary. Buyers of the portfolio would be treated as direct owners of the assets, rather than as investors in a portfolio controlled by the vehicle company. In such a case, the vehicle company would be considered a trust that passively holds assets. Issuance of depository receipts or trust receipts serving only as claims on instruments held in trust does not constitute issuance of a new financial asset.

- 7.70 The key here is that, to be considered an intermediary, the Special Purpose Vehicle must sell a new financial asset - or issue a new financial liability - representing an interest in the asset portfolio. If the Special Purpose Vehicle is not recognised as an intermediary, then MFSM infers it should be considered a trust. MFSM provides further guidance on trusts:

In general, trusts will not be recognized as separate institutional units and will be consolidated within the units that control or benefit from the trusts. However, it can be difficult to determine the institutional unit into which a trust should be consolidated. Trusts may be assigned to units on the basis of the following two alternative criteria (1) Control, as exercised by the unit that established or legally administers the trust, or (2) Beneficial status, as indicated by the unit that benefits from the income or services provided by the trust.

- 7.71 It was concluded that 'Mortgages Trust' is not acting as a financial intermediary and thus should not be recognised as a separate institutional unit; as a trust it simply holds the mortgage portfolios.
- 7.72 The unit that established and legally administers the 'Mortgages Trust' is part of the Law Debenture group. It is a Jersey resident and thus is classified in the rest of the world sector for UK National Accounts.
- 7.73 However, the beneficiaries of the trust are Northern Rock plc and the 'Funding' entities. This reflects the fact that 'Funding' purchases a portion of the mortgages from the trust with Northern Rock plc retaining the interest in those mortgages that have not been sold to 'Funding'.
- 7.74 As a result it was decided that the assets of the 'Mortgages Trust' should be apportioned to the beneficiaries in accordance with their respective rights to the income streams that flow from the mortgage portfolios.

Funding and Issuer Entities

- 7.75 The National Accounts classification of the 'Funding' and 'Issuer' entities involved in the securitisation requires a decision as to whether the units meet the definition of an other financial intermediary in National Accounts.

- 7.76 To be classified as an intermediary, MFSM states:

If the vehicle company holding the assets can engage in financial intermediation, for example if it has the right and authority to issue securities backed by the assets which may be bought by third parties.

- 7.77 In addition, the MSFM states:

If the vehicle company does not sell a new financial asset representing an interest in the portfolio, the company has not effectively transformed or intermediated the portfolio and thus is not deemed to be a financial intermediary.

- 7.78 The legal entity that performed the 'Funding' role in pre-2005 residential mortgage securitisations - referred to here as Funding1 – is registered in Jersey and hence

would be part of the rest of the world sector if considered an institutional unit. The legal entity performing the 'Funding' role in residential mortgage securitisations from 2005 onwards - referred to here as Funding2 – is registered in the UK.

- 7.79 Both Funding1 and Funding 2 have the right and authority to issue securities, although neither do so in their own right. Any issuing takes place through their UK-registered issuing subsidiaries rather than directly. As a result it was decided that 'Funding' does not meet the requirement to be considered as an institutional unit.
- 7.80 The issuing SPVs, collectively referred to here as 'Issuer', issue securities backed by the income streams from the mortgage portfolios and have assets in the form of the loan to 'Funding'. Therefore, the 'Issuer' subsidiaries are classified within the other financial intermediaries sub-sector.
- 7.81 However, despite 'Funding' not meeting the criteria to be classified as an institutional unit in National Accounts, its activities still need to be recorded somewhere. The options were to combine it with: (i) its 'Share Trustee' legal owner; (ii) the charity stated as its beneficiary; (iii) its 'Issuer' subsidiaries, or (iv) Northern Rock plc as the ultimate beneficiary. It was decided to create a statistical unit by combining 'Funding' with 'Issuer'. The combined unit meets the criteria to be classified in the other financial intermediaries sub-sector.
- 7.82 However, as National Accounts and Balance of Payments statistics are based on a defined national boundary, the combined statistical unit referred to in the last paragraph actually needs to be divided into two separate units: a resident unit; and a rest of the world unit representing the activities of Funding1. This is because any economic activity occurring in Jersey needs to be recorded as outside the UK National Accounts boundary. This therefore recreates the position as if 'Funding' had been recognised as a rest of the world institutional unit.
- 7.83 So, in summary the activities of Northern Rock plc in the National Accounts are presented in three parts: the banking part in the Monetary Financial Institutions sub-sector, and the borrowing via securitisation' part, which itself is sub-divided into the UK other financial intermediaries sub-sector (for the 'Issuer' activity) and the rest of the world sector (for the 'Funding' activity).

Control of the Special Purpose Vehicles

- 7.84 The final sector classification question here is whether the other financial intermediary unit that has been constructed is deemed to be part of the public or private sector. The rest of the world part does not need to be similarly classified, although any assets or liabilities the public sector has with the rest of the world (such as through inter-company loans) will be included in public sector statistics.
- 7.85 As already detailed in this article, National Accounts focuses on control rather than ownership of an entity and there is also a requirement to recognise the economic reality of that relationship.
- 7.86 The issue of whether there is public sector control over a bank Special Purpose Vehicle was new to UK National Accounts. Previously ONS had not had to consider this since in all cases the parties involved had all been private sector or rest of the world sector. Now there was potentially a bank controlling Special Purpose Vehicles. If so, this would make the Special Purpose Vehicles part of the Public sector.

- 7.87 There is little specific National Accounts guidance in this area. As described in Section 4, an assessment of control indicators is used to determine if there is control by any party. This is a similar approach to business accounting, which recognises that companies can be controlled other than through the majority ownership of voting share capital. If we apply the UK classification case law control indicators we find that some are not applicable (because of the restricted special purpose of the vehicle) and there is nothing to obviously indicate that Northern Rock plc is controlling the entity. But with Special Purpose Vehicles that only have one asset the question is who has control of that asset.
- 7.88 The approach taken in Eurostat's *Manual on Government Deficit and Debt* towards securitisations involving government is to look at the transfer of risks and rewards. It considers that if some of the risks and rewards have been retained there has not been a true sale in economic terms. By extending these rules wider than securitisations involving government, ONS could conclude that the asset has not been transferred from Northern Rock plc. At first glance this may appear to contradict the National Accounts guidance, which is to show the asset transferring between sub-sectors of the financial corporations sector. However, this transfer only occurs at sub-sector level, for higher sector boundaries, such as the financial corporations, private and public sectors, this does not apply because intra-sector transactions are consolidated out.
- 7.89 In this instance it was decided that the statistical unit for the resident SPV is deemed to be controlled by Northern Rock plc. The judgement was influenced by the nature of the securitisation structure, which leads to the financial risks and rewards associated with the unit's assets (i.e., the 'sold' mortgages) remaining with Northern Rock plc, in particular the use of subordinated loans and a swap agreement.
- 7.90 This judgement is consistent with the business accounting judgement: the 2006 annual accounts of Granite Finance Holdings Ltd state that *"The company's ultimate controlling party is Northern Rock plc. Although Northern Rock plc does not own directly or indirectly through subsidiaries more than half the voting power, the Company is obliged to follow the policies and procedures prescribed by Northern Rock plc"*.
- 7.91 On 20 November 2008 the winding-down ("run-off") of the Northern Rock residential mortgage securitisation programme was announced. A trigger had been invoked that started the process of bondholders being repaid. This is done in a 'waterfall' approach: AAA-notes first and, when these have been fully repaid, A notes, then when they are fully repaid the next highest rated, and so on.
- 7.92 The bondholders are repaid via the repayments of principal and interest. To accelerate this, the £35bn of Granite mortgage assets could be sold and the proceeds used to repay investors. However, as Granite is restricted from selling the mortgages, they would have to be repurchased by Northern Rock plc first and then sold.
- 7.93 The securitisation was over-collateralised through Northern Rock plc putting new mortgages into the pool. Northern Rock plc changed this policy and decided not to put any new mortgages into the pool. The terms of the bonds state that if Northern Rock plc's share of the pool dropped below 8.2 per cent it triggered a breach.
- 7.94 Under the interest rate swap Northern Rock plc was receiving the rewards when this was in their favour (e.g. when the interest receivables from mortgages were higher than the interest payable on the bonds the difference was being distributed to

Northern Rock plc), but under the breached conditions the rewards on this now go to the Granite Reserve Fund to be used for repaying the bondholders.

- 7.95 Northern Rock plc was judged to hold the risks/rewards of the Granite programme, and these translate to a reported potential £3bn loss as they are lowest seniority. This is not a last tranche holding as observed in some securitisations as, apart from the September 2007 zombie securitisation¹⁰, Northern Rock plc has not entered into such arrangements. The £3bn represents Northern Rock plc's 8 per cent holding in the Mortgage Trustee pool, which is redistributable ultimately through the Reserve Fund once all bondholders have been repaid. If the Reserve Fund is fully used for payments to bondholders then this amount will be fully lost to Northern Rock plc.

Covered Bond Partnership

- 7.96 Although not used for securitisation reasons, Northern Rock plc uses another special purpose entity Northern Rock Covered Bond LLP. It assigns mortgage advances to this entity, which is on-shore, and these totalled £10.4bn at the end of December 2007. The loans are used to provide security for Northern Rock plc's issues of covered bonds. This special purpose entity is not considered to be an institutional unit for National Accounts purposes and is instead consolidated with Northern Rock plc.

Transaction Classification Issues

Government Guarantees

- 7.97 On 17 September 2007 government announced a guarantee arrangement for depositors, which went beyond the coverage of the Financial Services Compensation Scheme. The guarantee arrangements were clarified later and also amended several times. From 9 October 2007 until their repayment, government guaranteed the Bank of England for any losses that arose from the October 2007 support facilities.
- 7.98 Any potential payments under these guarantees are contingent on an event occurring (such as Northern Rock plc failing to meet the obligations covered under the guarantee to the Bank of England), and there is uncertainty about whether such events will occur or not. There is also uncertainty, if events were to happen, about the timing and the amounts that would crystallise. Contingent assets and liabilities are excluded from the National Accounts, since the accounts only cover transactions when they occur (or accrue) and the actual assets and liabilities that arise from these transactions.
- 7.99 ESA95 paragraph 5.05, reproduced below, explains that non-tradable contingent assets/liabilities are not included in the National Accounts system.

5.05 Contingent assets are contractual arrangements between institutional units, and between them and the rest of the world, which specify one or more conditions which must be fulfilled before a financial transaction takes place. Examples are guarantees of payment by third parties, letters of credit, lines of credit, underwritten note issuance facilities (NIFs) and many of the derivative instruments. In the system, a contingent asset is a financial asset in cases where the contractual arrangement itself has a market value because it is

¹⁰ In a zombie securitisation the issuance is bought up by the originator. The bonds acquired by Northern Rock plc in this securitisation were redeemed in May 2008.

tradable or can be offset on the market. Otherwise, a contingent asset is not recorded in the system.

- 7.100 The calling of a conventional government guarantee involves transferring the liability (or part of it) from the debtor to the government. The exercising of a guarantee is reflected in National Accounts by a notional capital transfer from government to the debtor, for the size of the amount called, with an offsetting notional sale of the liability from the debtor to the government in the financial account.
- 7.101 In cases where government guarantees borrowing, ONS recognises that there is an economic effect that results from the government support. Here, the guarantee allowed Northern Rock plc to borrow at a lower rate of interest than it would otherwise have obtained. The economic reality of this effect is similar to the one produced if government had directly subsidised Northern Rock plc, so that its financial position was stronger and it could borrow on more favourable terms. Hence, methodology has been introduced in the UK National Accounts whereby a subsidy on production is imputed to reflect the economic benefit that the government support brings.
- 7.102 Imputing subsidies is not an area that either ESA95 or SNA93 cover well. There are however precedents in the UK National Accounts and Eurostat recommends imputing subsidies in particular circumstances. Such imputations can often be complex and involve estimation of imprecise amounts, but they do reflect a truer position of the economic reality. The Public sector finances have included imputed subsidies for the guarantees given to London & Continental Railways, Network Rail, Railtrack plc while in administration and the London Underground PPP infrastructure companies.
- 7.103 The imputed payments from government need to be offset by an imputed receipt in order to balance the central government sub-sector accounts. This government receipt would be an imputed interest payment from Northern Rock plc to government. Northern Rock plc's gross operating surplus will also increase by the imputed subsidy, hence the financial corporation sector accounts will also be in balance. In National Accounting terms interest payments can be broken down into components. One of these is risk premium, effectively a fee charged for providing the lending. The higher the risk of default, the higher the risk premium charged, and hence the higher the interest rate. The imputed interest payment is effectively an imputed fee being charged by government for providing the support.
- 7.104 The effect of this imputation on the main fiscal indicators is neutral, but public expenditure (as measured through Total Managed Expenditure, the Government's preferred measure) and total current receipts both rise as a result of this classification.
- 7.105 There are a number of aspects to the government guarantees, which varied at different times. In general they have standard guarantee fees associated with them, and government receipts under these fees are recorded as non-market sales in the National Accounts.

Re-routing of PIK

- 7.106 Under the lending arrangements the Bank of England lent at a penal rate, which was above its base rate. From 9 October 2007, when interest was due on amounts outstanding on the loan Northern Rock plc only paid interest at the base rate, with the remainder rolled up as further lending. This 'new lending' was guaranteed by HM Treasury and had low seniority in the event that Northern Rock plc became insolvent.

It was commonly referred to as Northern Rock plc's "subordinated loan" debt to HM Treasury. In return for this aspect of the guarantee, HM Treasury were paid a "guarantee fee" equivalent to any 'penalty interest' receipts (i.e., the amounts above base rate) that were received.

- 7.107 It was decided that this transaction should be re-arranged to bring out the underlying economic relationship more clearly. The National Accounts, and hence Public sector finances, will record central government taking over the 'new lending', since they own the associated risks and rewards (e.g. if Northern Rock plc fails to pay, government loses; if it does pay, government directly receives the cash).
- 7.108 This is recorded as follows, where X represents the base rate proportion of interest on the loan and Y the penal interest amount rolled over into further lending. Firstly, the interest payable from Northern Rock plc to the Bank of England is recorded for the entire amount (X+Y), even though the cash actually paid is X, with a further loan of Y made. The further loan of Y is then shown as being transferred from the Bank of England by central government - this is balanced in National Accounts by recording it in the financial account as a withdrawal of equity from the Bank of England to central government. Thus Northern Rock plc was shown as having one loan from the Bank of England and another from central government.

Re-routing the Bank of England Lending via Government

- 7.109 Discussions took place between ONS and Eurostat in 2008 and 2009 on whether the non-PIK part of the central bank loan should also be re-arranged to show government borrowing.
- 7.110 ESA95 paragraph 1.38 explains that "some transactions are rearranged in order to bring out the underlying economic relationships more clearly" and that transactions "can be rearranged in three ways: rerouting, portioning and recognising the principal party to a transaction". These three types of rearrangement are distinct and are used in different circumstances.
- 7.111 Eurostat took a provisional view that the loan should be re-routed via government, whereby the transactions are imputed so that, firstly, central bank lends to government, and then government lends to Northern Rock plc. This has the effect that government is seen as borrowing and lending and the borrowing component would add to the general government gross liabilities debt measure used for Excessive Deficit Procedure monitoring.
- 7.112 This would have been a controversial conclusion, as it effectively produces a judgement that the economic reality of the operation is a central bank financing a government, which is illegal under Article 101 of the *1992 Maastricht Treaty on European Union*.
- 7.113 ONS decided to wait for a final conclusion before amending the recording. In the *Government deficit and debt under the Maastricht Treaty First Release* in September 2008 the effect of this alternative recording was explicitly stated: government debt as a percentage of GDP would rise from 44.2 per cent to 46.1 per cent at end-December 2007, and from 43.2 per cent to 44.9 per cent at end-March 2008; staying well within the threshold of 60 per cent for excessive debt.
- 7.114 The Bank of England loan to Northern Rock plc was £26.9bn at end-December 2007, £24.1bn at end-March 2008 and £21.0bn at end-June 2008, the last published data

before the August 2008 repayment. From August 2008 the amounts are indirectly recorded as government debt anyway, since although no borrowing is imputed for the actual loan to Northern Rock plc, government needs to borrow to fund the loan and this borrowing forms part of the debt level.

- 7.115 In April 2008 Eurostat reported the “nature of the loan that Northern Rock got from the Bank of England is under scrutiny.” In October 2008 Eurostat placed a reservation on the quality of the data reported by the United Kingdom. Later in October 2008 Eurostat acknowledged that there were still issues requiring an in-depth examination, which would be discussed within the CMFB task force.
- 7.116 The Eurostat provisional view was based on rearrangement of transactions through recognising the principal party to a transaction. ESA95 paragraph 1.41 recognises that “when a unit carries out a transaction on behalf of another unit, the transaction is recorded exclusively in the accounts of the principal”.
- 7.117 The State Aid decision published in December 2007 describes the 9 October 2007 facilities as being made at the “request of the Treasury”. This was taken by Eurostat as evidence that the lending is undertaken on behalf of government. It was eventually established to Eurostat’s satisfaction that the situation was one of joint action by HM Treasury and the Bank of England, with that action needing to be authorised by the Chancellor of the Exchequer under the *Memorandum of Understanding* for the Tripartite Authorities.
- 7.118 In April 2009 the Eurostat reservation was withdrawn.
- 7.119 The government loan to Northern Rock plc was £15.6bn at end-December 2008, £14.6bn at end-March 2009 and £14.5bn at both end-June 2009 and end-September 2009.

Nationalisation

- 7.120 When Northern Rock plc was nationalised in February 2008 nothing was initially paid to existing shareholders for the equity that transferred. Instead, an independent valuer has been appointed to determine whether any value existed. If this is determined, then the transaction will be recorded as a financial transaction in unquoted equity (ESA95 category F.512) in February 2008, with another financial transaction in other accounts receivable/payable (ESA95 category F.79) to account for the different timing of the transaction and any cash payments.

Recapitalisation

- 7.121 A capital restructuring plan was announced in August 2008 subject to State Aid approval. This involves the replacement of up to £3bn of the government loan with government equity. State Aid approval was given on 28 October 2009. At the time of publication of this article this restructuring was planned for later in 2009. The exact recording will depend on the precise details when implemented, but it is expected that this will be recorded as two financial transactions: a £3bn injection of unquoted equity, matched by a repayment of that portion of the loan. This will not impact on government deficit or public sector net borrowing, since it is a financial transaction.

Impact on Public Sector Finances

- 7.122 The exact impact of Northern Rock plc's inclusion in public sector net debt could not be stated when ONS's Northern Rock article was first published in February 2008. This was because it was not possible to collect the relevant data from Northern Rock plc in advance of this announcement and it would also have involved disclosing commercially sensitive information. It was stated that public sector net debt will increase by the amount of Northern Rock plc's relevant financial liabilities less liquid assets, excluding any intra public sector positions such as those with the Bank of England.
- 7.123 The impact from Northern Rock and related parties on public sector net debt as at end-December 2007, using information published in Northern Rock plc's *Annual Report and Accounts 2007*, was £75.8 billion. Additionally, the effect of the Bank of England's loan to Northern Rock plc, which was £26.9 billion at that time, also impacts on public sector net debt. The estimate of the total effect is therefore £102.3 billion, equivalent to 7.2 per cent of gross domestic product.
- 7.124 The impact of Northern Rock plc's reclassification on public sector current budget has not been quantified but should be immaterial over an economic cycle.
- 7.125 The 2007 government deficit and debt statistics required for European Union purposes are not affected by this decision. The 2008 general government gross debt level reflects the financing required for government to take over the loan to Northern Rock plc, which was £15.6bn at end-December 2008, and the associated interest receivable.

Impact on National Accounts

- 7.126 There will be no impact on National Accounts as a result of the sectoral reclassification of Northern Rock plc from a private other monetary financial institution to a public other monetary financial institution. This is because Northern Rock plc continues to be shown as an other monetary financial institution in National Accounts, which does not divide this sub-sector into public and private sub-divisions.

8. Financial Services Compensation Scheme

The Financial Services Compensation Scheme has been reclassified to the central government sub-sector since inception.

Any assignment of rights over a failed institution is classified as a capital tax at the time of the assignment.

Background

- 8.1 The UK's deposit protection scheme is part of a wider scheme, The Financial Services Compensation Scheme (FSCS).
- 8.2 FSCS is a company limited by guarantee. It was established under the *Financial Services & Markets Act 2000* as "the UK's compensation fund of last resort for customers of financial services firms". It became operational on 1 December 2001, replacing the Deposit Protection Board. It provides a free service to customers by paying compensation if a firm is unable, or likely to be unable, to pay claims against it covering sub-classes of financial activity: deposits; insurance policies; insurance broking; investment business; and mortgage advice and arranging.
- 8.3 FSCS covers business conducted by firms authorised by the Financial Services Authority (FSA). European firms (authorised by their home state regulator) that operate in the UK may also be covered.
- 8.4 The FSCS is accountable to the FSA and ultimately to the Treasury. FSA appoints the directors, with Treasury approval for any appointment/removal of the chairman.
- 8.5 Since 7 October 2008¹¹ the scheme protects the first £50,000 of losses on customer saving with an institution.
- 8.6 The Bradford and Bingley plc default in September 2008 was the first bank default since the FSCS started. There had previously been failures of credit unions and the FSCS website¹² describes the process of default for these as:
- "Generally, credit unions cease to trade, FSA intervenes to suspend their authorised status, and if it appears to be insolvent, depositors are referred to FSCS. Other creditors tend to be small in number and value. FSCS seeks to recover any balances of the credit union held in its bank accounts, if necessary by litigation."*
- 8.7 When the FSA determines an institution is in default, it triggers an FSCS protection. The FSCS relies on a contractual assignment of rights over the assets of a failed institution, which it takes on behalf of the customers.

¹¹ Prior to this, including at the time of the Bradford and Bingley default, the maximum amount was £35,000.

¹² www.fscs.org.uk/industry

- 8.8 Although there is an annual levy that funds its operating costs, FSCS differs from some deposit protection schemes elsewhere in Europe in that it does not have a fund to pay out when defaults occur. Any payment required following failures by banks have to be financed in the short-term until the income from the rights to the defaulter's assets crystallises. This short-term financing involves FSCS incurring interest charges, which are an operating cost of FSCS. These are recovered as part of its annual levy.
- 8.9 If the assets in a defaulting bank are insufficient, any shortfall is covered by a levy on the other members of that class of the scheme. This levy will be in proportion to the level of 'insured deposits' each member has, so the larger banks will cover most of them.
- 8.10 The regular administration costs of FSCS are funded by levies on firms authorised by the FSA. For the specific management expense costs and compensation payments, levies are allocated to contribution groups based on classes of financial activity, as described in paragraph 8.2. This means that levies are only raised against firms that are authorised to carry out the same type of business that has given rise to compensation claims.

Classification of Regular Levies

- 8.11 The regular administration levies and regular compensation calls, usually associated with claims from insurance failures, are classified as taxes on production (ESA95 category D.29). The classification of levies imposed on deposit takers to cover interest charges on FSCS borrowing will also be classified as taxes on production.
- 8.12 £0.4bn was levied on deposit takers in September 2009 in respect of the 2008/9 financial year. This is accrued to the second half of 2008/9 and balanced by an account receivable (ESA95 category AF.79) until the cash is received by the FSCS. A similar accrual takes place for 2009/10, here accrued over the entire financial year. This is estimated as £0.5bn.

Sector Classification

- 8.13 The sector classification of deposit protection schemes in Europe was discussed in the CMFB task force. It was concluded that there is sufficient variation in these schemes to make a recommendation of a harmonised generic classification inappropriate.
- 8.14 FSCS qualifies as an institutional unit for National Accounts purposes. The FSA appoints, and has the right to remove, directors to the board of FSCS. It also establishes the rules under which the Scheme operates. The appointment (and removal) of the chairman is subject to HM Treasury approval. Hence, FSCS is public sector controlled through the appointments process and is therefore itself part of the public sector.
- 8.15 National Accounts splits the public sector into market (public corporations) and non-market (general government) sub-sectors based on a test of sales as a proportion of costs. FSCS income broadly matches its expenditure, but as the income is recognised as a tax rather than a service, and hence not as sales, FSCS is non-market.

- 8.16 Non-market public sector entities are generally classified to the general government sector, and those like FSCS that have a national remit to the central government sub-sector of the general government sector. The exception to this general rule occurs in the financial sector, where some institutions, such as the FSA, are classified as public financial corporations.
- 8.17 ESA95 paragraph 2.58j, defining financial auxiliaries, includes the following:
- 2.58. In particular, the following financial corporations and quasi-corporations are classified in sub-sector S.124: ...
- j) non-profit institutions recognised as independent legal entities serving financial corporations, but not engaged in financial intermediation or auxiliary financial activities
- 8.18 So, if FSCS was judged to be serving financial corporations, then it would be classified as a financial auxiliary public corporation. It was judged that this was not the case. The scheme offers some protection to households. Although this could be seen as providing a service to financial corporations as it should enable them to attract more business due to the protection, because the scheme is compulsory there is no advantage to any particular institution from membership of it.
- 8.19 Therefore, FSCS is classified to the central government sub-sector of the public sector.
- 8.20 The sector classification of the FSCS was reviewed as part of the financial crisis classification work. It was previously classified as a public financial corporation. The levy it charged was classified as a tax on production payable to central government, which was then distributed to FSCS through an imputed current transfer (ESA95 category D.75). With FSCS now part of the central government sector, this latter imputed transaction is no longer necessary.

Classification of Irregular Levies

- 8.21 The liability on the financial sector following the default of a deposit taker is very different from the regular levies described earlier. These should be infrequent, even if many occur in a short period of financial crisis, and for larger amounts. This brings them closer to the definition of a capital tax.
- 8.22 ESA95 paragraph 4.148, reproduced below, describes irregular and infrequent taxes on the value of assets. Here the tax, if transferred to other institutions because the defaulting institution has insufficient assets, is actually based on the value of deposit liabilities rather than assets, although since assets will generally match liabilities this is interpreted as the equivalent of a tax on assets.

4.148 . Definition:

Capital taxes (D.91) consist of taxes levied at irregular and very infrequent intervals on the values of the assets or net worth owned by institutional units or on the values of assets transferred between institutional units as a result of legacies, gifts inter vivos or other transfers.

- 8.23 FSCS relies on a contractual assignment of rights over the assets of a failed institution, which it takes on behalf of the customers. These are classified as a capital tax on that institution at the time the assignment is made: the accrual recording of the tax is at the time the liability arises, which is the time of the assignment. This is matched by an 'other account payable' by them in the financial account, which is reduced when the assets are realised and the cash is paid.
- 8.24 In the event of the defaulting institution's assets being insufficient to recover costs, then FSCS levies other deposit-taking institutions for any residual amounts outstanding. If this were to occur it would be recorded, at the time it takes place, as a capital transfer from government to the institution (ESA95 category D.999), which is used to settle the other account payable outstanding, followed by a capital tax on the other financial institutions.

Capital Taxes in Fiscal Policy Indicators

- 8.25 In the definition of Public sector current budget, the statistic previously used for determination of performance against the Government's Golden Rule, capital taxes have hitherto been included alongside current revenues. This is because, from the perspective of government, capital taxes such as inheritance tax produced a regular revenue stream. From the perspective of households paying such taxes they are not a regular payment stream. As the National Accounts framework requires a consistent approach they have to be consistently allocated to either the current or capital part of the accounts and they have been allocated to the capital account. The levies on banks described here are a different form of capital tax to those that have previously been included in Public sector current budget. The Public Sector Finances (Statistics) Technical Advisory Group concluded that the capital taxes on financial institutions should be part of public sector net investment and excluded from Public sector current budget.

Compensation Payments

- 8.26 FSCS's compensation payments are recorded as capital transfers (ESA95 category D.99) in accordance with ESA95 paragraph 4.165h.

Contingent Liabilities

- 8.27 Although the FSCS should have a large contingent liability value representing its potential exposure to paying out to depositors, it similarly has a large contingent asset value reflected its ability to levy funds from the financial sector. Contingent assets and liabilities are not recorded in the National Accounts.

9. Bradford and Bingley

On 27 September 2008 Bradford and Bingley plc was declared in default by the FSA.

On this date it was reclassified from the private sector to the public sector.

Its UK resident securitisation vehicles and covered bond partnerships are also classified in the public sector.

The assignment to FSCS of the rights to £15.75bn of Bradford and Bingley plc assets is recorded as a capital tax.

Background

- 9.1 The Bradford and Bingley Building Society was formed in 1964 from the merger of Bradford Equitable Building Society and Bingley Building Society. Both of these were established in 1851, as Bradford Second Equitable Benefit Building Society and Bingley, Morton and Shipley Permanent Building Society respectively.
- 9.2 Bradford and Bingley plc was formed on 4 December 2000 when the Bradford and Bingley Building Society demutualised and floated on the London Stock Exchange.
- 9.3 Its core activity was specialist UK markets, such as buy-to-let mortgages and loans to the self-employed.
- 9.4 Like most banks it borrowed from the markets in order to lend.
- 9.5 At end-December 2007 it had £21bn in retail deposits and £40bn in loans.
- 9.6 Its initial liquidity problems from the instability in the money markets in 2007 were overcome. In April 2008 it announced to shareholders that it was "funded into 2009" and had not drawn on a £2bn funding facility. Attempted rights issues in 2008 were postponed and when one took place in August 2008 it was only 28 per cent subscribed by existing shareholders.
- 9.7 The performance of buy-to-let mortgage loans was affected by falling UK house prices, mortgage defaults and arrears. It also had some exposure to the US sub-prime crisis.
- 9.8 On 27 September 2008 the Financial Services Authority (FSA) determined that Bradford and Bingley plc did not meet the threshold conditions for operating as a deposit taker under the *Financial Services and Market Act 2000* and FSA rules. Effectively the FSA said it was in default. This triggered the Financial Services Compensation Scheme (FSCS).
- 9.9 The Tripartite Authorities acted to maintain financial stability and protect depositors. The Chancellor of the Exchequer acting on advice that financial stability was at risk

- and authorised the events that took place according to the Tripartite Authorities *Memorandum of Understanding*.
- 9.10 There was a competitive auction for the retail deposit part of the Bradford and Bingley plc business, conducted on behalf of HM Treasury.
- 9.11 On 29 September 2008 the Chancellor of the Exchequer announced that, by order of the *Banking (Special Provisions) Act 2008*, Bradford and Bingley plc was nationalised. In a second transfer the UK and Isle of Man retail deposit businesses and the branch network were transferred to Abbey National plc, a UK bank ultimately owned by Grupo Santander of Spain.
- 9.12 The transfer of the £18.6bn retail deposits business was funded by cash from HM Treasury and the Financial Services Compensation Scheme. The FSCS initially paid £14bn to Abbey National plc to enable deposits protected by the scheme to transfer. HM Treasury paid a further £4.6bn to protect UK depositors for amounts above the FSCS ceiling. Abbey National plc paid £0.6bn for the part of the business it acquired.
- 9.13 The FSCS financed its payout through a short-term loan from the Bank of England, which was guaranteed by government. This loan was replaced by a government loan in December 2008.
- 9.14 The triggering of the FSCS meant that Bradford and Bingley plc depositors would have been entitled to a compensation claim. The payments from FSCS to Abbey National plc legally constituted the payment of compensation to each claimant. A similar position is replicated for HM Treasury's amounts.
- 9.15 In return, HM Treasury and FSCS were assigned rights to Bradford and Bingley plc's assets, which they will realise through the winding down of the business.
- 9.16 Government additionally guaranteed certain wholesale deposits and borrowing by Bradford and Bingley plc.
- 9.17 Government also indemnified a working capital facility that Bradford and Bingley had with the Bank of England. This was replaced with a working capital facility from HM Treasury in December 2008.
- 9.18 In July 2009 Bradford and Bingley plc did not make £50m of interest payments due on its bonds. The payments were deferred, as permitted following amendment to the terms and conditions of those bonds made under provisions of the *Banking (Special Provisions) Act 2008*. It was expected to similarly defer a further £275m of interest payments.
- 9.19 In July 2009 the estimate of £18.6bn retail deposits was revised to about £19bn and a further £0.4bn was paid to Abbey National plc.
- 9.20 Further work on refining the proportion of deposits protected by the FSCS has updated the estimate to £15.75bn. Consistently with this, the HM Treasury amount is reduced from £4.6bn to £3.25bn.

Sector Classification Issues

Bradford and Bingley plc

- 9.21 Prior to 27 September 2008 Bradford and Bingley plc was a private sector other monetary financial institution. From that date it remains an other monetary financial institution, but is part of the public sector: a public financial corporation. Bradford and Bingley plc continued to operate as a monetary financial institution at this time and thereafter.
- 9.22 The transfer of the retail deposit business does not affect the classification, as institutions that borrow through wholesale deposits or issue of securities in order to lend are also classified as other monetary financial institutions.
- 9.23 The transfer of the retail deposits is not a defeasance structure. A financial defeasance usually occurs when government creates a 'good bank' and a 'bad bank' transferring poorly performing assets (commonly referred to as "toxic assets" or, more often but incorrectly, as "toxic debt") to the bad bank to leave the good bank viable. Here, it is purely the transfer of some assets and liabilities, with the other assets (of variable quality) being retained by the company.
- 9.24 The reclassification date reflects the powers the Government has under the *Banking (Special Provisions) Act 2008* once certain conditions are in place. These conditions were met shortly after FSA determined that Bradford & Bingley plc no longer met threshold conditions to act a deposit taker.
- 9.25 The activity of Bradford and Bingley plc's Aire Valley securitisation programme and covered bond partnerships are also classified as public sector where UK resident.
- 9.26 Bradford and Bingley plc uses a similar type of securitisation model as that described in the earlier chapter on Northern Rock, with 'Mortgages Trustee', 'Funding' and 'Issuer' entities. The 'Mortgages Trustee' role is taken by Aire Valley Trustee Limited, which is registered in Jersey. The 'Funding' role is usually performed by a master trust but there are two other 'Funding' vehicles. All are registered in England & Wales. The 'Issuer' role was performed by the vehicles shown in Table 9.1. All of these are registered in England & Wales.

Table 9.1

'Issuer' vehicle	Date of issue
Aire Valley Finance (No. 2) plc	October 2000
Aire Valley Mortgages 2004-1 plc	October 2004
Aire Valley Mortgages 2005-1 plc	April 2005
Aire Valley Mortgages 2006-1 plc	August 2006
Aire Valley Warehousing 3 Ltd	December 2006
Aire Valley Mortgages 2007-1 plc	May 2007
Aire Valley Mortgages 2007-2 plc	November 2007
Aire Valley Mortgages 2008-1 plc	July 2008

- 9.27 Based on the inactivity in the securitisation market at this time it is assumed that in the July 2008 issue at least part of the bonds were bought by Bradford and Bingley

plc in a 'zombie securitisation'¹³ for use as collateral in the Bank of England Special Liquidity Scheme.

- 9.28 An analysis of the Aire Valley structure led to the UK-resident Special Purpose Vehicles being classified as public financial corporations, specifically other financial intermediaries.

Covered Bond Partnerships

- 9.29 Although not used for securitisation reasons, Bradford and Bingley plc uses other special purpose entities: Bradford and Bingley Covered Bond LLP; Bowler Finance plc and Bradford and Bingley Warehousing No. 1 LLP. Bradford and Bingley plc assigns mortgage advances to Bradford and Bingley Covered Bond LLP, which is registered in England & Wales, although the mortgages remain the legal property of Bradford and Bingley plc. The partnership is not considered to be an institutional unit for National Accounts purposes and is instead consolidated with Bradford and Bingley plc.

Transaction Classification Issues

- 9.30 The events that occurred can be broken down into sequential steps, as described in Table 9.2. There are two separate transfers under the *Transfer Order*.

Table 9.2

Date & Time	Event
27 September 2008	FSA decision, FSCS trigger.
29 September 2008, before 08:00	Bradford and Bingley plc effectively delists before stock market opens
29 September 2008, 08:00	Transfer 1: nationalisation; Bank of England loan to FSCS.
29 September 2008	Transfer 2: transfer of UK deposits and branch network to Abbey National plc; FSCS pays Abbey National £14bn; Government pays Abbey National £4bn; shares in Isle of Man subsidiary transfer to Abbey National; government guarantees certain Bradford and Bingley liabilities.
29 September 2008	Bank of England grants working capital facility to Bradford and Bingley.
29 September 2008	Government indemnifies Bank of England for the facility.

- 9.31 On 27 September 2008 the FSCS scheme is triggered and FSCS is liable for compensation on relevant Bradford and Bingley plc deposits. In National Accounts terms FSCS has not assumed any liabilities yet, but it has a contingent liability that will crystallise soon after, when depositors become entitled to claim. Nothing is recorded at this stage.

¹³ In a zombie securitisation the issuance is bought up by the originator.

- 9.32 On 29 September 2008 an announcement is made just before the London Stock Exchange opens, such that Bradford and Bingley plc effectively delists. This would be recorded as an Other volume change, Bradford and Bingley plc's equity converting from quoted equity (ESA95 category F.511) to unquoted equity (ESA95 category F.512). However, it has been assumed that the Bradford and Bingley plc equity has no market value at this point. This valuation assumption may be subsequently revised if using information from the independent assessment being made on whether shareholders are entitled to any compensation.

First transfer

- 9.33 The first transfer under the *Transfer Order* is the nationalisation of Bradford and Bingley plc. The shares in Bradford and Bingley plc were transferred to the Treasury Solicitor (central government) as nominee of HM Treasury under Regulation 3(1) of the *Transfer Order*. This would usually be recorded as purchase of unquoted equity by central government, matched by an Other account payable (ESA95 category F.79) to reflect that no cash has moved yet. It has been assumed for now that the equity valuation is zero so there is nothing to record; this estimate will subsequently be revised if the independent assessor decides there is value at this time.
- 9.34 The Bank of England made a £14bn short-term loan to FSCS. This is recorded as a central bank financial asset and central government financial liability, in ESA95 category F.41. By December 2008 this loan had been refinanced through government borrowing and lending to FSCS, the latter step being consolidated out of the UK National Accounts since it is between two entities classified in the central government sub-sector.
- 9.35 The Bank of England loan to FSCS was indemnified by HM Treasury. The government guarantee was a contingent liability and not included in National Accounts.

Second transfer

- 9.36 The second transfer under the *Transfer Order* transferred the retail deposits business of Bradford & Bingley plc to Abbey National plc. The legal arrangement here was that HM Treasury, as owners of Bradford and Bingley plc, and Abbey National plc entered into a *Transitional Services Agreement*. Bradford and Bingley plc and Abbey National plc were to agree a 'full form agreement' in the following months.
- 9.37 As part of the transfer, FSCS assumed an obligation to pay Abbey National plc an amount equal to that which it would have had to have paid to compensate eligible depositors for the losses they would otherwise have had with Bradford and Bingley plc. This was estimated at £14bn at the time but is now estimated at £15.75bn.
- 9.38 HM Treasury assumed a liability to pay to Abbey National plc an amount equal to the non-FSCS eligible deposits transferred to Abbey National plc, less £0.6bn. This aspect is analysed separately in paragraph 9.47.

- 9.39 Consequently, FSCS paid £14bn to Abbey National plc and government paid £4.0bn. The latter represented £4.6bn to cover deposits less £0.6bn received for the value of the business.
- 9.40 The £0.6bn is for the branch assets, such as buildings and leases, intangible assets, such as the human capital, trained workforce, Bradford and Bingley brand and the value of access to the depositors as a relatively cheap borrowing source. The assets are recorded as being individually sold by Bradford and Bingley plc to Abbey National plc for the market value of assets in each category, with a capital transfer imputed to balance any difference between the price paid and market value of assets recognised in National Accounts. Importantly, the State Aid decision states that there is no reason to believe the price paid was below market price, so there is no capital transfer to impute here.
- 9.41 It is at this point that the FSCS liability crystallises. The payments by FSCS to Abbey National "constitute the payment of compensation to persons eligible to claim from the FSCS".
- 9.42 This is recorded in the following sequence:
- (a) cancellation of deposits between Bradford and Bingley plc and depositors: (i) a £15.75bn capital transfer (ESA95 category D.99) from the households sector to public financial corporations, reflecting the legal arrangements defining the mutual nature of the transaction as described in the *Transfer Order*, and (ii) the 'repayment' of the deposit liabilities by public financial corporations to households (ESA95 categories F.22 and F.29);
 - (b) the FSCS levy on Bradford and Bingley: (i) a £15.75bn capital tax (ESA95 category D.91) from public financial corporations to central government; and since no cash is paid this is balanced by an other account payable (ESA95 category F.79) by public financial corporations to central government;
 - (c) a compensation payment from government to households; (i) a £15.75bn capital transfer (ESA95 category D.99) from central government to households; (ii) which households then deposit with Abbey National plc (ESA95 categories F.22 and F.29).
- 9.43 From the perspective of the households sector all the transactions mentioned in the previous paragraph cancel out: all that has happened for them is that their deposits are with an entity that now has different ownership.
- 9.44 From the perspective of the public financial corporations sub-sector there is a tax payable matched by a capital transfer receipt in the non-financial account, which cancel out leaving no effect on net lending/borrowing, and a reduction in deposit liabilities in the financial account balanced by an account payable to settle the tax liability.
- 9.45 From the perspective of the central government sub-sector there is a tax receivable matched by a capital transfer payment in the non-financial account, which cancel out leaving no effect on net lending/borrowing, and a payment of cash (funded by the borrowing from the Bank of England) in the financial account matched by an account receivable for the tax asset.
- 9.46 From the perspective of the private sector, deposit liabilities have increased matched by a receipt of cash. From the perspective of the public sector, deposit liabilities have decreased matched by a payment of cash.

- 9.47 The Government covers compensation payments for depositors' amounts lost that are in excess of FSCS-eligible amounts. The recording here is similar to the FSCS amounts described in paragraph 9.39:
- (a) cancellation of deposits between Bradford and Bingley plc and depositors: (i) a £3.25bn capital transfer (ESA95 category D.99) from the households sector to public financial corporations; and (ii) the 'repayment' of the deposit liabilities by public financial corporations to households (ESA95 categories F.22 and F.29);
- (b) a compensation payment from government to households; (i) a £3.25bn capital transfer (ESA95 category D.99) from central government to households; (ii) which households then deposit with Abbey National plc (ESA95 categories F.22 and F.29).
- 9.48 The difference between the FSCS and government payments is that a tax is not levied on Bradford and Bingley plc to assign rights over its assets for the government amount. There is no need to do this as government already has these rights through its equity stake in Bradford and Bingley plc. A withdrawal of equity (ESA95 category F.512) or a dividend receipt (ESA95 category D.421), depending on the financial performance of Bradford and Bingley plc, will be recorded for this at the time that it occurs.
- 9.49 The £0.6bn received from the assets sales from Bradford and Bingley plc to Abbey National plc is recorded as being distributed from Bradford and Bingley plc to government, as owners, through a withdrawal of equity (ESA95 category F.512) in the financial account.
- 9.50 The Isle of Man subsidiary, Bradford and Bingley International Ltd, is not a resident unit for UK National Accounts purposes. The shares in this subsidiary are transferred to Abbey National plc. It has no transfer value to record as its deposit liabilities are matched by an offsetting inter-company loan asset.
- 9.51 Government guarantees some of Bradford and Bingley plc's wholesale borrowing as at 28 September 2008. This is not recorded in National Accounts as it is a contingent liability.

Bank of England Lending Facility

- 9.52 On 29 September 2008 the Bank of England granted a temporary working capital facility to Bradford and Bingley plc. This was recorded as central bank lending to public financial corporations when amounts were drawn.
- 9.53 At end-December 2008 £2.3bn had been withdrawn against the facility. The facility was transferred to HM Treasury before the end of 2008.
- 9.54 The government indemnified the Bank of England for any losses on the facility. This indemnity is a contingent liability and hence not recorded in National Accounts. No losses crystallised.
- 9.55 *HM Treasury Annual Report and Accounts 2008-09* shows an asset of £6bn at end-March 2009 for the facility and a further loan asset to Bradford and Bingley plc of £321m.

- 9.56 Government committed in *Budget 2009* to provide a further £5.5bn in working capital support in the financial year 2009/10.

Subsequent Transactions

- 9.57 The events described included the assignment of rights to the assets of Bradford and Bingley plc. Once the working capital facility loan has been fully repaid Bradford and Bingley plc will start paying the debt owed to government (£3.25bn) and FSCS (£15.75bn). The realisation of assets for the £3.25bn will be recorded as a mixture of dividend receipts and equity withdrawal for government, depending on the financial performance of Bradford and Bingley plc. The realisation of assets to repay the £15.75bn FSCS amounts will be recorded as reducing the tax accounts payable.
- 9.58 If the assigned assets of Bradford and Bingley plc are insufficient to settle the £15.75bn financial liability outstanding, then FSCS members will be levied to recover the amounts owed. This will be recorded as central government cancelling the amount outstanding (recorded as a capital transfer followed by a transaction in accounts payable) and then levying the FSCS members for this amount (recorded as a capital tax).

Impact on Public Sector Finances

- 9.59 This results in an impact on government deficit of £3.25bn and on general government gross debt of £18bn at the time of the initial transactions. There is no impact on public sector current budget or net borrowing. The impact on public sector net debt from the reclassification of Bradford and Bingley plc, based on information in the end-June 2008 *Bradford & Bingley Interim Financial Report* is about £25bn, plus the £18bn borrowing required to carry out the transfer of deposits.
- 9.60 In *Bradford & Bingley Annual Report and Accounts 2008* information is published that shows the £25bn has increased to about £32bn by the end of December 2008. Therefore, an estimate of the impact on public sector net debt at the time of the reclassification is about £48bn.

10. The Icelandic Crisis

Summary

- 10.1 In September/October 2008 the three largest Icelandic banks: Kaupping banki hf (also known as Kaupthing bank); Landsbanki Íslands hf and Glitnir banki hf, experienced difficulties and were unable to refinance about £35bn of debt. Their assets had grown five-fold since 2004 as they expanded operations outside of Iceland, with most of the expansion funded by borrowing. With the financial crisis affecting markets the banks were struggling to find adequate liquidity and funding. All three were nationalised by the Icelandic authorities.
- 10.2 Two UK banks, subsidiaries of Icelandic parents, plus a UK branch of an Icelandic bank were declared in default for the purposes of the UK Financial Services Compensation Scheme. For the subsidiary banks the retail deposits were transferred to ING Direct.
- 10.3 All three cases had similarities but all also had differences, so are presented separately in chapters 11-13.

Background

- 10.4 On 29 September 2008 Glitnir banki was unable to roll over its short-term debt. The Icelandic Government announced plans for a £0.5bn capital injection, which would take 75 per cent ownership.
- 10.5 As a result investors' concerns about other Icelandic banks grew. On 6 October 2008 share trading in six big Icelandic financial corporations, including the three biggest banks, was suspended.
- 10.6 On 6 October 2008 an emergency banking act was passed, which allowed the Fjármálaeftirlitið (FME), Iceland's financial services regulator, to take over commercial banks under certain conditions.
- 10.7 On 7 October 2008 the planned capital injection into Glitnir banki was cancelled. FME took control of both Glitnir banki and Landsbanki. Kaupping was given a £0.4bn loan from the Icelandic central bank.
- 10.8 On 7 October the London branch of Landsbanki froze withdrawals from its Icesave internet banking product. The UK Financial Services Authority determined that Heritable Bank Limited, a UK subsidiary of Landsbanki, no longer met its threshold conditions and was in default for the purposes of the Financial Services Compensation Scheme.
- 10.9 On 8 October 2008, the UK Financial Services Authority determined that Kaupthing Singer & Friedlander Limited, a UK subsidiary of Kaupping banki, no longer met its threshold conditions and was in default for the purposes of the Financial Services Compensation Scheme. £2.5bn of deposits with the internet banking product Kaupthing Edge were transferred to ING Direct N.V. [Netherlands], via an intermediary Bank of England company. Kaupthing Singer & Friedlander Limited was placed in administration by the court.

- 10.10 On 8 October 2008 the Financial Services Authority announced that the UK-based branch of Landsbanki was in default for the purposes of the Financial Services Compensation Scheme. The UK Government announced that the branch's eligible retail depositors using the Icesave product would receive their money in full, including those with amounts above the ceilings covered by the Tryggingarsjóður Innstæðueigenda og Fjárfesta (the Icelandic Depositors' and Investors' Guarantee Fund) and the Financial Services Compensation Scheme
- 10.11 On 9 October 2008 £0.5bn of retail deposits were transferred from Deposits Management (Heritable) Limited, a company owned by HM Treasury, to ING Direct N.V. [Netherlands]. Heritable Bank Limited was put into administration by the court. On the same day the *Landsbanki Freezing Order 2008* was passed, freezing the assets of Landsbanki in the UK.
- 10.12 On 9 October 2008 FME took control of Kaupþing banki.
- 10.13 On 9 October 2008 the domestic part of Landsbanki was segregated into a new bank, Nýi Landsbanki Íslands hf (also known as NBI). Similar operations took place for Glitnir on 15 October 2008 with the creation of Nýi Glitnir banki hf, which changed its name to Íslandsbanki in February 2009, and for Kaupþing banki on 21 October 2008 with the creation of Nýi Kaupþing banki hf.
- 10.14 On 13 October 2008 the Bank of England made a short-term loan facility (of up to £0.1bn) available to the UK branch of Landsbanki to enable it to continue its asset-backed lending in the UK. The facility was closed in November 2008.
- 10.15 On 5 June 2009 the UK Government reached agreement with the Icelandic authorities on a process to ensure the UK Government is refunded for the compensation paid out on behalf of Tryggingarsjóður Innstæðueigenda og Fjárfesta to Icesave retail depositors with the UK branch of Landsbanki, following the collapse of Landsbanki in October 2008.
- 10.16 On 28 August 2009 the Icelandic parliament (Alþingi) passed a Bill providing a state guarantee on repayment of the United Kingdom and Netherlands governments' claims on Tryggingarsjóður Innstæðueigenda og Fjárfesta for amounts they had paid out in compensation for Icesave depositors.
- 10.17 On 19 October 2009 a loan agreement was signed by the Governments of the United Kingdom, Netherlands and Iceland for the compensation that the United Kingdom and Netherlands Governments had paid out on behalf of the Tryggingarsjóður Innstæðueigenda og Fjárfesta. The agreement confirmed that the Icelandic guarantee will continue until the loan has been fully repaid. A new Bill was introduced to the Icelandic parliament on 19 October 2009.

Deposits not Protected by FSCS or Government

- 10.18 Local authorities, fire and police authorities, which are all classified as Local government for National Accounts purposes, and National Health Service Trusts, classified as central government for National Accounts purposes, had deposits with Icelandic and related banks.
- 10.19 Communities and Local Government reported that, at 31 December 2008, the deposits of English authorities were £0.9bn: 39 per cent with Landsbanki Íslands hf; 29 per cent with Heritable Bank Limited; 20 per cent with Glitnir banki hf and 12 per cent with Kaupthing Singer & Friedlander Limited. Media reports suggest the

equivalent Scottish authorities' investment was about £50m and the Welsh equivalent £66m. The UK deposits were not protected under the Financial Services Compensation Scheme.

- 10.20 In April 2009 Heritable Bank Limited's administrators reported that depositors could expect to get between 70 and 80 per cent of their deposits back. The amount is uncertain because the value of assets depends on market conditions. Any such payment is recorded as a withdrawal of deposits.
- 10.21 Any amounts that are eventually cancelled are recorded as a capital transfer from local government to the banks, matched by a financial transaction where the deposits are returned.
- 10.22 Media reports suggested that private sector institutions, particularly building societies, held an equivalent £10bn in deposits with Icelandic banks and their subsidiaries.

Impact on Public Sector Finances

- 10.23 The public sector deposits in these institutions prior to October 2008 form part of a category known as 'liquid assets' that is netted off liabilities to form public sector net debt. In October 2008, while remaining classified as deposits, they are deemed not to qualify as liquidity assets as they can no longer be realised in the short term. As a result public sector net debt increases by the amounts of public sector deposits held. This effect is excluded from the analysis of the impacts on the individual institutions and branches covered in the next three chapters.

11. Heritable

The activities of Deposits Management (Heritable) Limited, the intermediary company used in the transfer of deposits, are classified in the central government sub-sector.

Heritable Bank plc is briefly part of the public sector, although this has no material effect.

Background

- 11.1 Heritable Bank plc was a UK bank, a subsidiary of the Icelandic bank Landsbanki Íslands hf. Landsbanki acquired it in 2000.
- 11.2 On 7 October 2008 the Fjármálaeftirlitið (FME), Iceland's financial services regulator, took control of Landsbanki. On the same day Heritable Bank plc was declared in default by the Financial Services Authority for the purposes of the Financial Services Compensation Scheme (FSCS). The UK Government agreed to protect amounts above the FSCS ceiling.
- 11.3 £0.5bn of retail deposits were transferred from Heritable Bank plc to Deposits Management (Heritable) Limited, a company owned by HM Treasury. Heritable Bank plc was placed in administration.
- 11.4 On 9 October 2008 the retail deposits¹⁴ were transferred from Deposits Management (Heritable) Limited to ING Direct N.V. [Netherlands].

Sector Classification

- 11.5 The activities of Deposits Management (Heritable) Limited are classified in the central government sub-sector for National Accounts purposes.
- 11.6 Deposits Management (Heritable) Limited did not meet the criteria to be classified as a Monetary financial institution as it just had deposit liabilities. It was judged to lack the autonomy of decision in respect of its principal function necessary to be considered an autonomous institutional unit and is therefore combined with its parent body in the central government sub-sector.
- 11.7 For the period between the FSA decision and Heritable Bank plc being placed in administration, which is less than one day, it is technically part of the public sector. No transactions that occur in this time effect key fiscal aggregates, such as public sector net borrowing. Upon entering administration it returns to classification in the private sector.

¹⁴ With the exception of less than 100 accounts.

Transaction Classifications

- 11.8 The transfer, through legislation, of £0.5bn of deposit liabilities from Heritable Bank plc to Deposits Management (Heritable) Limited is recorded as debt assumption. This involves a capital transfer (ESA95 category D.99) from government to Heritable Bank plc, offset by a financial transaction in deposit liabilities, reducing Heritable Bank plc's liabilities and increasing those of central government. This recording reflects that the UK legislation used a different approach in the Bradford and Bingley plc and Icelandic cases – in the latter the institutions were not nationalised.
- 11.9 Under the legislation, depositors accept their deposits are lost, and they are thus entitled to compensation. This is recorded as if they cancel their deposits with Deposits Management (Heritable) Limited, as a £0.5bn capital transfer from households sector to central government, counter-parted by a transaction reducing deposit assets for households and deposit liabilities for central government.
- 11.10 The next step recorded is the FSCS making a call for the amount of eligible deposits covered by the scheme (£0.5bn), through assignment of rights to the assets of Heritable Bank plc. Consistent with the recording in the Bradford and Bingley plc case, this is considered a capital tax (ESA95 category D.91) on Heritable Bank plc, balanced by an account receivable (ESA95 category F.79) to reflect that no cash moves at this point.
- 11.11 Similar to the Bradford and Bingley plc case, the Government protected the depositors for amounts above the FSCS ceiling, totalling £0.05bn. Through the legislation it has a claim on Heritable Bank plc assets to recover these amounts. This is also recorded as a capital tax on Heritable Bank plc, balanced by an account receivable. This is different from the Bradford and Bingley plc case, where the claim on the defaulter was recorded as recoverable through the Government's equity stake. As Heritable Bank plc was not nationalised there is no equity stake.
- 11.12 Both the FSCS and non-FSCS compensation amounts are recorded as being paid. This is recorded as a capital transfer from central government to households for £0.5bn. Households are then recorded as depositing the proceeds with Deposits Management (Heritable) Limited.
- 11.13 The final step recorded is the transfers of deposits to ING Direct. The transfer involves the reduction of £0.5bn of central government deposits liabilities balanced by a reduction in cash assets.
- 11.14 FSCS received a £0.5bn short-term loan from the Bank of England. The FSCS borrowing from the Bank of England was refinanced by government in December 2008. A government loan to FSCS is consolidated as both are in the central government sub-sector.

Subsequent Transactions

- 11.15 Rights to future income of Heritable Bank plc, through administrators running the company and selling assets, have been assigned to government and FSCS to recover amounts owed. This will be recorded as reducing the tax accounts receivable. If Heritable Bank plc has insufficient assets to settle this financial liability then central government will cancel the amounts owed, through a capital transfer, and then levy a capital tax on other FSCS members for this amount

11.16 In August 2009 £0.1bn was received.

Impact on Public Sector Finances

11.17 There is no direct impact on public sector net borrowing, public sector current budget or general government net borrowing from the recording of the initial transactions. Both public sector net debt and general government gross debt rise by £0.5bn as a result of the borrowing required to finance the transactions. This will reduce when the rights to assets are realised.

12. Kaupthing Singer & Friedlander

The activities of Deposits Management (Edge) Limited, the intermediary company used in the transfer of deposits, are classified in the central government sub-sector.

Kaupthing Singer & Friedlander Limited is briefly part of the public sector, although this has no material effect.

Background

- 12.1 Kaupthing Singer & Friedlander Limited was a UK bank, a subsidiary of the Icelandic bank Kaupthing banki hf.
- 12.2 In 2005 Kaupthing Holdings UK Limited, a wholly-owned subsidiary of Kaupthing banki hf, acquired the UK merchant banking group Singer & Friedlander Group plc, creating Kaupthing Singer & Friedlander Limited.
- 12.3 On 8 October 2008 Kaupthing Singer & Friedlander Limited was declared in default by the Financial Services Authority for the purposes of the Financial Services Compensation Scheme (FSCS). The UK Government agreed to protect amounts above the FSCS ceiling.
- 12.4 On 8 October 2008 £2.5bn of internet retail deposits¹⁵ were transferred from Kaupthing Singer & Friedlander Limited to Deposits Management (Edge) Limited, a company owned by the Bank of England. The other 3,000 non-internet eligible retail deposit accounts did not transfer; FSCS and government compensation will be paid on these accounts.
- 12.5 On 8 October 2008 Kaupthing Singer & Friedlander Limited was placed in administration. Administrators planned to continue the rest of the business, the wholesale deposits and loan book, while seeking purchasers for it.
- 12.6 On 8 October 2008 the Deposits Management (Edge) Limited deposits were transferred to ING Direct N.V. [Netherlands].

Sector Classification

- 12.7 The activities of Deposits Management (Edge) Limited are classified in the central government sub-sector for National Accounts purposes.
- 12.8 Deposits Management (Edge) Limited is wholly-owned by the Bank of England. It does not meet the criteria to be classified as a Monetary Financial Institution as it just had deposit liabilities. It was judged to lack the autonomy of decision in respect of its principal function necessary to be considered an autonomous institutional unit and is therefore combined with the unit that controls it. To be consistent with similar cases in Europe it was decided to classify the activity of Deposits Management (Edge) Limited

¹⁵ The Kaupthing Edge product.

in the central government sub-sector, equivalent to a non-market subsidiary of a public corporation, rather than in the central bank sub-sector, although this aspect does not actually matter for the recording here.

- 12.9 For the period between the FSA decision and Kaupthing Singer & Friedlander Limited being placed in administration, which is less than one day, it is technically part of the public sector. No transactions that occur in this time effect key fiscal aggregates, such as public sector net borrowing. Upon entering administration it returns to classification in the private sector.

Transaction Classifications

- 12.10 The transfer, through legislation, of £2.5bn of deposit liabilities from Kaupthing Singer & Friedlander Limited to Deposits Management (Edge) Limited is recorded as debt assumption. This involves a capital transfer (ESA95 category D.99) from government to Kaupthing Singer & Friedlander Limited, offset by a financial transaction in deposit liabilities, reducing Kaupthing Singer & Friedlander Limited's liabilities and increasing those of central government.
- 12.11 Under the legislation, depositors accept their deposits are lost, and they are thus entitled to compensation. This is recorded as if they cancel their deposits with Deposits Management (Edge) Limited, as a £2.5bn capital transfer from households sector to central government, counter-parted by a transaction reducing deposit assets for households and deposit liabilities for central government.
- 12.12 The next step recorded is the FSCS making a call for call for the amount of eligible deposits covered by the scheme (£2bn), through assignment of rights to the assets of Kaupthing Singer & Friedlander Limited. Consistent with the recording in the Bradford and Bingley plc and Heritable Bank plc cases, this is considered a capital tax (ESA95 category D.91) on Kaupthing Singer & Friedlander Limited, balanced by an account receivable (ESA95 category F.79) to reflect that no cash moves at this point.
- 12.13 Similar to the Bradford and Bingley plc and Heritable Bank plc cases, the Government protected the depositors for amounts above the FSCS ceiling, totalling £0.5bn. Through the legislation it has a claim on Kaupthing Singer & Friedlander Limited assets to recover these amounts. As with the Heritable Bank plc case, this is recorded as a capital tax on Kaupthing Singer & Friedlander Limited, balanced by an account receivable. £0.3bn of this was paid in March 2009.
- 12.14 Both the FSCS and non-FSCS compensation amounts are recorded as being paid. This is recorded as a capital transfer from central government to households for £2.5bn. Households are then recorded as depositing the proceeds with Deposits Management (Edge) Limited.
- 12.15 The final step recorded is the transfers of deposits to ING Direct. The transfer involves the reduction of £2.5bn of central government deposits liabilities balanced by a reduction in cash assets.
- 12.16 FSCS received a £2bn short-term loan from the Bank of England. The FSCS borrowing from the Bank of England was refinanced by government in December 2008, and fully refinanced before the end of January 2009. A government loan to FSCS is consolidated as both are in the central government sub-sector.

Subsequent Transactions

- 12.17 Rights to future income of Kaupthing Singer & Friedlander Limited, through administrators running the company and selling assets, have been assigned to government and FSCS to recover amounts owed. This will be recorded as reducing the tax accounts receivable.
- 12.18 In March 2009 £59m of the government portion and £269m of the FSCS portion were paid, funded by ING Direct following a revision to the estimated size of the retail deposits transferred.
- 12.19 In July 2009 the government sector received a further £0.6bn as a result of a creditor payout by the administrators. £0.5bn of this was allocated to FSCS and £0.1bn for the government portion.
- 12.20 If Kaupthing Singer & Friedlander Limited has insufficient assets to settle its financial liability then central government will cancel the amounts owed, through a capital transfer, and then levy a capital tax on other FSCS members for this amount.

Impact on Public Sector Finances

- 12.21 There is no direct impact on public sector net borrowing, public sector current budget or general government net borrowing from the recording of the initial transactions. Both public sector net debt and general government gross debt rise by £2.5bn as a result of the borrowing required to finance the transactions. This will reduce when the rights to assets are realised.

13. Landsbanki London branch and Icesave

Landsbanki London branch is recognised as a notional UK residential unit for National Accounts purposes.

Landsbanki London is briefly part of the public sector, although this has no material effect.

Background

- 13.1 The Icelandic bank Landsbanki Íslands hf had a branch in London that was approved for deposit taking. It notably ran the Icesave internet product.
- 13.2 On 6 October 2008 an emergency banking act was passed, which allowed the Fjármálaeftirlitið (FME), Iceland's financial services regulator, to take over commercial banks under certain conditions.
- 13.3 On 7 October 2008 the FME took control of Landsbanki Íslands hf. Its London branch froze withdrawals of deposits. On 8 October the London branch was declared in default by the UK Financial Services Authority (FSA) for the purposes of the Financial Services Compensation Scheme (FSCS). On 8 October 2008 the *Landsbanki Freezing Order 2008* was passed, freezing the UK assets of Landsbanki.
- 13.4 In the event of default it was expected that Tryggingarsjóður Innstæðueigenda og Fjárfesta, Iceland's deposit protection scheme, would pay out up to €20,900 (£16,900) in compensation for losses per failed account. The FSCS would then cover any further losses on eligible deposits up to £50,000. There was controversy as to whether Iceland would honour its commitments, with allegations that its deposit protection scheme had insufficient funds and announcements made that only domestic deposits would be guaranteed. The UK Government announced that it would pay out the compensation of the Tryggingarsjóður Innstæðueigenda og Fjárfesta amounts while negotiations continued and would also compensate eligible UK Icesave customers for losses above the £50,000 FSCS ceiling.
- 13.5 The amounts to be covered are £2.3bn from Tryggingarsjóður Innstæðueigenda og Fjárfesta, £1.4bn from the FSCS and £0.8bn for government compensating the amounts above the FSCS maximum.
- 13.6 On 9 October 2008 the domestic part of Landsbanki Íslands hf was segregated into a new bank, Nýi Landsbanki Íslands hf. Landsbanki London branch remained part of Landsbanki Íslands hf (also known as old Landsbanki).
- 13.7 On 29 April 2009 the Reykjavík District Court appointed directors to wind-up Landsbanki Íslands hf.
- 13.8 On 5 June 2009 the UK Government reached agreement with the Icelandic authorities on a process to ensure the UK Government is refunded for the compensation paid out on behalf of Tryggingarsjóður Innstæðueigenda og Fjárfesta

to Icesave retail depositors with the UK branch of Landsbanki, following the collapse of Landsbanki in October 2008.

- 13.9 On 28 August 2009 the Alþingi (Althingi, Icelandic parliament) passed a Bill providing a state guarantee on repayment of the United Kingdom and Netherlands governments' claims on Tryggingarsjóður Innstæðueigenda og Fjárfesta for amounts they had paid out in compensation for Icesave depositors.
- 13.10 On 19 October 2009 a loan agreement was signing by the Governments of the United Kingdom, Netherlands and Iceland for the compensation that the United Kingdom and Netherlands Governments had paid out on behalf of the Tryggingarsjóður Innstæðueigenda og Fjárfesta. The agreement confirmed that the Icelandic guarantee will continue until the loan has been fully repaid. A new Bill was introduced to the Alþingi on 19 October 2009.

Sector Classification

- 13.11 An active UK branch of a foreign bank is classified in UK National Accounts as a notional residential unit, and is classified as an other monetary financial institution. This notional unit is referred to here as Landsbanki London.
- 13.12 Landsbanki London received a licence under *The Landsbanki Freezing Order 2008* to continue to operate its commercial finance and asset-based lending businesses.
- 13.13 As such, it was judged that Landsbanki retains control of general corporate policy and hence the UK entity remains in the private sector. Similar to the Heritable Bank plc and Kaupthing, Singer & Friedlander Limited cases, Landsbanki London is briefly in the public sector, for less than a day, and this does not impact on the main fiscal statistics in any way.

Transaction Classifications

- 13.14 Due to the UK Government's commitment to pay compensation, it was decided to record the transfer of deposits in a similar manner to the Heritable Bank plc and Kaupthing, Singer & Friedlander Limited cases, i.e., depositors accept their deposits are lost, and they are thus entitled to compensation, and cancel the FSCS-covered proportion of their deposit assets with Landsbanki London. The customers claim for compensation is judged to be an action which is a mutual cancellation. It is assumed that the best estimate is a 100 per cent claim. This is recorded as a capital transfer from the households sector to Landsbanki London for £1.4bn, with an offsetting transaction reducing the deposits.
- 13.15 The FSCS call is then made. Using the precedent of the earlier Icelandic cases, a £1.4bn capital tax is levied on Landsbanki London matched by an account receivable.
- 13.16 The central government sub-sector is then recorded as assuming responsibility for the £3bn remainder of the relevant deposits from Landsbanki London, by assuming these from the households sector through a capital transfer. This is offset by a transaction in deposit assets, so government now has a deposit asset (ESA95 category F.2) with Landsbanki. As the UK branch is no longer operating as a deposit taker, the financial liability is held by Landsbanki Íslands hf in the rest of the world sector.

- 13.17 The obligation to compensate depositors for £3bn is recorded at this time (October 2008), as a capital transfer from central government to households, offset by an account payable, which will unwind when the cash flows later.

Subsequent Transactions

- 13.18 In November 2008 FSCS, which is also organising the administration of the £2.3bn element on behalf of government, was granted a £4bn short-term loan facility from the Bank of England in order to finance the compensation payments. The FSCS borrowing from the Bank of England was refinanced by government in January 2009, when the borrowing under the facility was £3.6bn. A government loan to FSCS is consolidated as both are in the central government sub-sector.
- 13.19 When the £1.4bn FSCS compensation is recorded as a capital transfer at the time it is due to be paid, which was expected to mainly occur in November and December 2008.
- 13.20 From 29 April 2009 Landsbanki Íslands hf deposit liabilities effectively become claims on Landsbanki Íslands hf as part of the winding-up process. At this time the UK general government deposits are reclassified (using ESA95 category K.12.22 for changes in classification of assets) from deposits to long-term loans (ESA95 category AF.42). Any receipts, whether directly from the liquidators or if they are assumed by other Icelandic authorities, will be recorded as repayments of the loan.
- 13.21 The Landsbanki Resolution Committee has indicated that there will be recoveries, although these may take several years. At the time of publication of this article creditors had not received anything yet.
- 13.22 If central government receives any additional payments, for example from the sale of the remaining parts of Landsbanki London, this will reduce the Other accounts receivable for the tax liability. If the amounts are insufficient to meet the £1.4bn recorded, then the tax payable is cancelled, through a capital transfer, and a tax levied on UK banks for the amount outstanding.
- 13.23 The Bank of England granted a £0.1bn working capital loan facility to Landsbanki London for use by the factoring business, which is being run from administration. The loan was secured on assets. It was subsequently fully repaid in November 2008 and the facility withdrawn in December 2008.

Impact on Public Sector Finances

- 13.24 Apart from short-term timing effects, which mainly cancel out, there is no immediate direct impact on public sector net borrowing, public sector current budget or general government net borrowing from the recording of the initial transactions. General government gross debt rises by £4.5bn as a result of the borrowing required to finance the transactions. This will reduce if repayment is received from Iceland. Public sector net debt rises by £4.5bn as a result of the borrowing required to finance the transactions less the deposits held, which are not considered to be liquid assets.

14. London Scottish Bank

London Scottish Bank is briefly part of the public sector, although this has no material effect.

Background

- 14.1 London Scottish Bank was formed in 1935 and traced its origins to a small money-lending business at the start of the century. Its core activity was providing loans to borrowers with poor credit histories who had been refused credit elsewhere. At end-October 2007 it had £0.2bn in deposits and £0.4bn of loans.
- 14.2 On 30 November 2008, London Scottish Bank plc was declared in default by the Financial Services Authority (FSA) as it failed to meet its regulatory capital requirements. The Court put it into administration later that day. The Financial Services Compensation Scheme (FSCS) was used to compensate eligible depositors.
- 14.3 On 1 December 2008 government announced it would cover amounts above the FSCS ceiling. The total amount of London Scottish Bank plc deposits was £0.3bn at the time of its default.
- 14.4 By end March 2009 FSCS had paid out £88m in compensation and a further £12m had been paid out for the government top-up amounts.

Sector Classification

- 14.5 For the period between the FSA decision and London Scottish Bank plc being placed in administration, which is less than one day, it is technically part of the public sector. No transactions that occur in this time effect key fiscal aggregates, such as public sector net borrowing. Upon entering administration it returns to classification in the private sector.

Transaction Classifications

- 14.6 The transaction recording follows the general model used in the Bradford and Bingley plc and Icelandic cases. However, all of these cases have slight differences.
- 14.7 Following the trigger of the FSCS and government commitments to cover retail deposits for amounts in excess of the FSCS ceiling, depositors are recorded as accepting that their deposits are lost, that they are entitled to compensation and cancel their deposits with London Scottish Bank plc.
- 14.8 The cancellation of £0.3bn of deposits is recorded as a mutual cancellation capital transfer (ESA95 category D.99) from the households sector to London Scottish Bank plc in December 2008. This is used to repay deposit liabilities.

- 14.9 The FSCS call follows the earlier recording precedents and is a capital tax (ESA95 category D.91) levied on London Scottish Bank plc, a claim on the assets of the bank. This is again recorded in December 2008.
- 14.10 The FSCS and government compensation is recorded, as a capital transfer, at the time it is paid.

Impact on Public Sector Finances

- 14.11 There is no direct impact on public sector net borrowing, public sector current budget or general government net borrowing from the recording of the initial transactions. Both public sector net debt and general government gross debt rise by £0.3bn as a result of the borrowing required to finance the transactions.

15. The October 2008 Package

Background

- 15.1 In summer 2008 there were many cases observed of institutions struggling and being rescued, particularly in the USA where Bear Stearns, Fannie Mae, Freddie Mac, Merrill Lynch and the AIG insurance corporation hit problems. In September 2008 the Lehman Brothers investment bank filed for bankruptcy protection.
- 15.2 The financial crisis deepened when distrust in the markets increased rapidly, partly in the wake of Lehman Brothers failure. Within Europe the Netherlands, Belgium and Luxembourg governments made equity injections to rescue Fortis. In the UK regulators closed Bradford and Bingley (UK) as a deposit taker and it was nationalised. The three main Icelandic banks were nationalised. The governments of France, Belgium and Luxembourg made equity injections to rescue Dexia. Increases in deposit protection schemes were announced.
- 15.3 From this point onwards many rescue and support packages were implemented in different countries.
- 15.4 On 8 October 2008 the UK Government announced a support package for financial institutions. This was designed to ensure that banks had sufficient capital to go forward and to kick-start inter-bank borrowing.
- 15.5 The initial participants eligible to participate in elements of the package were the largest eight UK Monetary financial institutions: Abbey National plc, Bank of Scotland plc, Barclays Bank plc, HSBC Bank plc, Lloyds TSB Bank plc, Nationwide Building Society, The Royal Bank of Scotland plc and Standard Chartered Bank. Others would be able to apply for inclusion later.
- 15.6 The package had four aspects.

(a) Bank of England Special Liquidity Scheme Extension

- 15.7 A further £100bn of treasury bills were made available to the Bank of England for use in the Bank of England Special Liquidity Scheme. This was just an extension of the scheme, there were no new classification implications for this additional amount. The Special Liquidity Scheme is discussed in chapter 21.

(b) Credit Guarantee Scheme

- 15.8 Up to £250bn in guarantees for banks and building society lending would be granted in a scheme designed to kick-start inter-bank lending. It involved commercial terms, guaranteeing new short and medium term debt issuance to assist in refinancing maturing wholesale funding obligations. The Debt Management Office (classified as central government) runs the scheme and HM Treasury provides the guarantees. Government expects the take up to be about £250bn.

15.9 The Credit Guarantee Scheme is discussed in detail in chapter 22.

(c) Government Loans

15.10 The eight initial participants committed to increase their Tier 1 regulatory capital base¹⁶, by a total of £25bn, by the end of 2008. To enable this, a scheme was made available whereby the institutions could borrow directly from government.

15.11 As at March 2009 no loans had been provided. Although the scheme had not formally been dropped, there were no plans to make any loans.

(d) Recapitalisation Scheme

15.12 This was a scheme to inject equity into the institutions. The equity would take the form of preference shares for banks and Permanent Interest Bearing Shares (PIBS) for building societies. In addition, government would provide “assistance to ordinary share fund raising” by underwriting share issues.

15.13 The recapitalisation scheme was designed to enable the institutions concerned to increase their regulatory capital bases, either through direct government injections or through government assistance. Where government provided the capital injection it negotiated restrictions on the entities through terms and conditions, such as on dividend policy, executive pay and commitments to support lending to small businesses and home buyers.

15.14 The Recapitalisation Scheme is discussed in detail in chapter 16.

Modifications

15.15 In October 2008 many countries announced rescue packages. The European Commission judged these according to State Aid rules. The UK package was then modified to bring it into line with others, with the Credit Guarantee and Recapitalisation Schemes being modified first in December 2008 and then in January 2009.

Use of the Package

15.16 The Royal Bank of Scotland Group plc, HBOS plc and Lloyds TSB Group plc all announced their intention to use the recapitalisation scheme subject to shareholder approval. All three were recapitalised in late 2008 or early 2009.

15.17 The Bank of England Special Liquidity Scheme and the Credit Guarantee Scheme were used extensively.

¹⁶ See *Basel II: International Convergence of Capital Measurement and Capital Standards: A Revised Framework* (November 2005) at www.bis.org/publ/bcbs118.htm

16. Recapitalisation Scheme

Royal Bank of Scotland, HBOS and Lloyds TSB are reclassified to the public sector from 13 October 2008 as a result of the agreements signed to participate in the recapitalisation scheme.

The capital injections into these institutions are partitioned into financial and non-financial transactions.

The activities of UK Financial Investments Ltd, the company used to manage government shareholdings, are classified in the central government sub-sector.

Background

- 16.1 On 8 October 2008 the UK Government announced a support package for financial institutions. One aspect of this package was the recapitalisation scheme.
- 16.2 In December 2008 the scheme was modified following the European Commission's communication *Commission adopts guidance on bank recapitalisation in current financial crisis to boost credit flows to real economy*¹⁷ and to bring it into line with schemes in other European Union member states.
- 16.3 This scheme was designed to strengthen the balance sheets of the institutions with regard to the regulatory Tier 1 capital requirement. This would be achieved either through direct government injections or through government assistance.
- 16.4 Any direct government capital injections take the form of preference shares for banks and Permanent Interest Bearing Shares (PIBS) for building societies. In addition, government offered to provide "assistance to ordinary share fund raising" by underwriting ordinary share issues.
- 16.5 The government injection was designed with the intention of being a temporary measure, with the Government stating that its "intention, over time, is to dispose of all the investments it is making as part of this scheme in an orderly way."
- 16.6 Where government participated in capital injections it negotiated terms and conditions in return "that appropriately reflect the financial commitment made by the taxpayer, including in relation to dividend policy, remuneration, lending policy and wider public policy issues." The government rights covered dividend policy, executive pay and commitments to support lending to small businesses and home buyers.
- 16.7 The Government statement of 13 October 2008 described these rights as follows:

¹⁷ See http://ec.europa.eu/comm/competition/state_aid/legislation/specific_rules.html under "Financial sector: application of State aid rules to measures taken in the context of the current global financial crisis".

“As part of its investment, the Government has agreed with the banks supported by the recapitalisation scheme a range of commitments covering:

maintaining, over the next three years, the availability and active marketing of competitively-priced lending to homeowners and to small businesses at 2007 levels;

support for schemes to help people struggling with mortgage payments to stay in their homes, and to support the expansion of financial capability initiatives;

remuneration of senior executives - both for 2008 (when the Government expects no cash bonuses to be paid to board members) and for remuneration policy going forward (where incentive schemes will be reviewed and linked to long-term value creation, taking account of risk; and restricting the potential for "rewards for failure").”

- 16.8 In addition the Government agreed with boards the appointment of new non-executive directors, although these appointment rights were for a minority of the directors.
- 16.9 A special company, UK Financial Investments Ltd was set up for the purpose of holding the Government's equity, as well as taking over HM Treasury's equity ownership of Northern Rock plc and Bradford and Bingley plc.
- 16.10 On 13 October 2008 it was announced that The Royal Bank of Scotland Group plc, Lloyds TSB Group plc and HBOS plc would be the first participants in the recapitalisation scheme. Their involvement was subject to shareholder approval, plus for the latter two shareholder approval of the merger between Lloyds TSB Group plc and HBOS plc.
- 16.11 The capital injection in preference shares announced totalled £9bn, with a further £28bn of assistance in underwriting ordinary share issuance.
- 16.12 The Royal Bank of Scotland Group plc raised £20bn. £5bn of preference shares were issued to government with a coupon of 12 per cent. A rights offer of £15bn of ordinary shares at a fixed price of 65.5p per share, underwritten by HM Treasury, closed on 26 November 2008. The market price was below the offer price and government purchased nearly all the shares, which represented over 50 per cent of The Royal Bank of Scotland Group plc's share capital.
- 16.13 HBOS plc raised £11.5bn. £3bn of preference shares were issued to government with a coupon of 12 per cent. These were converted into Lloyds Banking Group plc preference shares once the merger with Lloyds TSB Group plc was completed. A rights offer of £8.5bn of ordinary shares at a fixed price of 113.6p per share, underwritten by HM Treasury, closed on 9 January 2009. The market price was below the offer price and government purchased nearly all the shares.
- 16.14 Lloyds TSB Group plc raised £5.5bn. £1bn of preference shares were issued to government with a coupon of 12 per cent. A rights offer of £4.5bn of ordinary shares at a fixed price 173.3p per share, underwritten by HM Treasury, closed on 9 January 2009. The market price was below the offer price and government purchased nearly all the shares.

Classification of UK Financial Investments

- 16.15 UK Financial Investments Ltd is a wholly-owned company set up by government to manage its shareholdings in financial institutions subscribing to recapitalisation scheme. In due course, it is expected to also manage the government shareholdings in Northern Rock plc and Bradford and Bingley plc.
- 16.16 If recognised as a separate institutional unit, UK Financial Investments Ltd would be public sector through government ownership. As it does not have any sales, it would fail the ESA95 market test, as defined in ESA95 paragraph 3.32. A public sector non-market unit with a national remit is classified in the central government sub-sector.
- 16.17 Whether UK Financial Investments Ltd qualifies as a separate institutional unit is questionable. ESA95 paragraph 2.12, defining an institutional unit, is reproduced below:

2.12. Definition: The institutional unit is an elementary economic decision-making centre characterised by uniformity of behaviour and decision-making autonomy in the exercise of its principal function. A resident unit is regarded as constituting an institutional unit if it has decision-making autonomy in respect of its principal function and either keeps a complete set of accounts or it would be possible and meaningful, from both an economic and legal viewpoint, to compile a complete set of accounts if they were required.

In order to be said to have autonomy of decision in respect of its principal function, a unit must:

- a) be entitled to own goods or assets in its own right; it will therefore be able to exchange the ownership of goods or assets in transactions with other institutional units;
- b) be able to take economic decisions and engage in economic activities for which it is itself held to be directly responsible and accountable at law;
- c) be able to incur liabilities on its own behalf, to take on other obligations or further commitments and to enter into contracts.

In order to be said to keep a complete set of accounts, a unit must keep accounting records covering all its economic and financial transactions carried out during the accounting period, as well as a balance sheet of assets and liabilities.

- 16.18 For UK Financial Investments Ltd the principal activity is the management of the shareholdings. The ownership of shares is on behalf of government rather than in its own right and its ability to engage in economic activities is restricted to activity pre-determined by government. Theoretically it has the freedom to incur liabilities on its own behalf but it has agreed not to borrow.
- 16.19 It was judged that UK Financial Investments Ltd did not meet the requirement to be regarded as a separate institutional unit and in such cases the entity is combined with the unit that controls it, in this case central government.

Control through Government Rights

- 16.20 The participants in the recapitalisation scheme signed agreements with government, which were effective from 13 October 2008.
- 16.21 These included the restrictions on executive pay and dividends and requirements for lending. There are further potential rights connected with the preference shares, which only start after they have been issued.
- 16.22 Although the Government's obligations were conditional on shareholder approval, the obligations agreed by the relevant institutions were not conditional and were binding from 13 October 2008.
- 16.23 While the preference shares are in issue the relevant institutions undertook not to declare or pay any ordinary share dividend or distribution.
- 16.24 The agreements included clauses stipulating no director bonuses for 2008, including voluntary relinquishment of contractual agreements, and restrictions on bonuses in respect of 2009.
- 16.25 The commitments on lending policy covered the period through to the end of 2011.
- 16.26 The restrictions imposed by the agreements were judged to give government the ability to control the general corporate policy of the relevant institutions from 13 October 2008.
- 16.27 Subsequently to the recapitalisation scheme The Royal Bank of Scotland Group plc and Lloyds Banking Group plc agreed to enter into the Asset Protection Scheme (see chapter 27). Participation in this scheme will also be subject to conditions, including a verifiable commitment agreed between the participant and government to "support lending to creditworthy borrowers in a commercial manner".

Classification of preference shares

- 16.28 The classification of preference shares, and their income, is an important aspect of this case. Participating preference shares are classified as quoted or unquoted shares (ESA95 categories F.511 and F.512) dependent on whether they are listed on a stock market. Non-participating preference shares are classified as securities other than shares (ESA95 category F.3). The preference shares issued here are classified as securities other than shares.
- 16.29 Permanent Interest Bearing Shares (PIBS) similarly are fixed-interest securities, although a floating rate variant is possible and has been used. They are issued by building societies and can be quoted on stock markets. PIBS have lower seniority than depositors in the event of a building society failure. No PIBS have been used in government recapitalisations and the classification of them can not be judged without examining the details.

Classification of Capital Injections

- 16.30 When new ordinary share equity is issued and there is a quoted stock market price for the equity, the financial transaction in quoted shares (ESA95 category F.511) is

recorded at the prevailing market price at time of issuance. If the market price is less than the price actually paid then any difference is recorded as a capital transfer.

- 16.31 Where the capital injections is in the form of preference shares the international discussions in the task forces focussed on the possible application of rules on capital injections into public corporations in the *Manual on Government Deficit and Debt*, the relevant chapter of the manual being part of an updating process at the same time as the task force discussions. The manual's chapter on capital injections refers to injections into public corporations and the relevance is to those that are public corporations through ownership rather than control, since it is the ultimate ownership of any losses that have occurred that is important for a capital injection. At the time of the issuance of the UK preference shares under the recapitalisation scheme none of the relevant UK institutions were owned by general government, the only shareholding by the general government sector would have been small amounts, if any, of portfolio investment.
- 16.32 The appropriateness of extending the *Manual on Government Deficit and Debt* guidance to capital injections made to private sector owned institutions was discussed in the task force meetings. A key aspect was the guidance concerning losses over several years, whereas the situation in the financial crisis concerned previously profitable institutions that had suffered, at most, exceptional losses in the year of the injection or the year prior to it. The definition of 'loss' was another issue, as the chapter was originally designed to deal with cases of government covering persistent operating losses by public corporations through capital injections, whereas the losses observed in the financial crisis are mainly driven by the holding losses on impaired assets.
- 16.33 The CMFB consultation (see chapter 4) contained a question on whether, in the case of an exceptional loss made by a financial institution, a government capital injection in unquoted equity should be recorded as a capital transfer for the amounts up to the loss.
- 16.34 The CMFB opinion describes the result as a very large majority considering that capital transfers should not be recorded where there is an exceptional loss and that a capital transfer should only be recorded if the expected rate of return on the injection is deemed insufficient under European Union State Aid rules.
- 16.35 The recapitalisations that were being observed in Europe formed three main types: (i) those verging on insolvency; (ii) those fundamentally sound but exposed to distrust in financial markets; and (iii) to encourage lending to businesses in the economy. The latter type would be evidenced by commitments to lend. To avoid distortions of competition the European Commission's principles on State Aid for financial crisis interventions distinguish between fundamentally sound and distressed banks. It does this by establishing principles for the pricing of capital injections into banks based on the base rates set by central banks to which a risk premium is added to reflect the risk profile of the beneficiary bank, the type of capital used and the safeguards accompanying the recapitalisation. Riskier banks therefore pay a higher return to government.
- 16.36 The EU State Aid rules should therefore rule out any possibility of capital transfers being recorded on the basis of an insufficient expected rate of return.

- 16.37 However, the general applicability of the CMFB opinion to the United Kingdom recapitalisation scheme was not straightforward since the preference shares do not come under the definition of unquoted equity used in the consultation. The eventual Eurostat guidance was that, during the period of the financial crisis, any recapitalisation in the form of preference shares is recorded as a financial transaction if the European Union State Aid rules on rates of return are complied with, and partitioned into financial and non-financial transactions when they are not complied with.
- 16.38 So, the United Kingdom recapitalisations using preference shares are classified as financial transactions.

17. The Royal Bank of Scotland

The Royal Bank of Scotland Group plc is reclassified to the public sector from 13 October 2008 as a result of the agreements signed to participate in the recapitalisation scheme.

The capital injections into The Royal Bank of Scotland Group plc in December 2008 and April 2009 are partitioned into a financial and a non-financial transaction.

Partnerships UK is also reclassified to the public sector from 13 October 2008.

Background

- 17.1 The Royal Bank of Scotland was founded by royal charter in 1727.
- 17.2 In March 2000 The Royal Bank of Scotland Group plc acquired National Westminster Bank plc to become the second largest banking group in the UK.
- 17.3 The group includes The Royal Bank of Scotland plc, National Westminster Bank plc, Citizens Financial Group Inc [USA], Coutts & Co, Greenwich Capital Markets Inc [USA], RBS Insurance Group Limited and Ulster Bank Limited. In October 2007 it acquired a 38 per cent stake in ABN AMRO Bank N V [Netherlands] as part of a consortium with Fortis Bank Nederland (Holding) N.V. [Netherlands] and Banco Santander S.A. (Spain).
- 17.4 The Royal Bank of Scotland Group plc is the holding company of a financial services group. It includes the Churchill, Direct Line and Privilege insurance businesses.
- 17.5 According to *RBS Group Annual Report and Accounts 2007* at end-December 2007 it had £1.9tn of assets and £1.8tn of liabilities.
- 17.6 On 13 October 2008 The Royal Bank of Scotland Group plc announced it would take part in the recapitalisation scheme (see chapter 16) as part of the October 2008 support package (see chapter 15).
- 17.7 On 1 December 2008 government purchased £5bn of preference shares. It also underwrote an ordinary share issue. The market price was below the offer price and in December 2008 government purchased nearly all the shares, which represented 57.9 per cent ownership of The Royal Bank of Scotland Group plc's share capital.
- 17.8 According to *RBS Group Annual Report and Accounts 2008* the group made an accounting loss in 2008 of £24.1bn. This was influenced by £16.2bn of write-downs of impaired assets, including a £7.7bn write-down of goodwill related to the acquisition of ABN AMRO.
- 17.9 On 19 January 2009, as part of the Government's second support package (see chapter 24) it was announced that the preference shares would be converted into ordinary shares. This would be achieved by a rights issue of ordinary shares,

- underwritten by government, with the proceeds used to redeem the preference shares. In return The Royal Bank of Scotland Group plc took on some further lending commitments.
- 17.10 The rights issue closed on 6 April 2009 and resulted in government as underwriters purchasing £5.3bn of the £5.4bn of shares offered (99.3 per cent). This took government's share ownership in The Royal Bank of Scotland Group plc to 70.3 per cent. The preference shares were redeemed on 15 April 2009. The block on dividend payments on ordinary shares was lifted at that time.
- 17.11 On 26 February 2009 The Royal Bank of Scotland Group plc announced it was planning a further £13bn recapitalisation by government, subject to shareholder approval.
- 17.12 The expectation was that the recapitalisation would take place through issuance of unlisted ordinary B shares with preferential rights in respect of dividends. The nominal and issue value were set at 50p per share. Government would also commit to subscribe for an additional £6bn of ordinary B shares at The Royal Bank of Scotland Group plc's option.
- 17.13 Also on 26 February 2009, The Royal Bank of Scotland Group plc announced it intended to participate in the Asset Protection Scheme (see chapter 27) and would place assets in the scheme with a nominal value of £325bn and a market value of £302bn.
- 17.14 The intention was that The Royal Bank of Scotland Group plc would bear a first loss amount of up to £42.2bn. Any second loss amounts would be borne 90 per cent by government ten per cent by The Royal Bank of Scotland Group plc. The scheme would apply to losses incurred on the assets on or after 1 January 2009.
- 17.15 As part of the February 2009 agreement a further £6.5bn of ordinary B shares would be issued to government as the fee for The Royal Bank of Scotland Group plc taking part in the Asset Protection Scheme.
- 17.16 On 3 November 2009 the Government confirmed that The Royal Bank of Scotland Group plc would be participating in the Asset Protection Scheme, but under different terms to that originally specified.
- 17.17 The revised terms included a reduction to the number of assets placed in the scheme. The nominal value of assets, at end-2008, to be included was reduced from £325bn to £282bn. The first loss amount, which The Royal Bank of Scotland Group plc covers in its entirety, was increased to £60bn. Any 'second loss' amounts beyond this would continue to be borne 90 per cent by government and 10 per cent by The Royal Bank of Scotland Group plc.
- 17.18 The fee for using the Asset Protection Scheme would no longer be paid in shares or upfront, instead there would be an annual fee of £0.7bn for the first three years and £0.5bn a year beyond that for the remaining life of the scheme.
- 17.19 There would also be an exit fee, which will be the larger of either £2.5bn or ten per cent of any 'regulatory capital relief' received while in the scheme. In either case the exit fee will be net of any annual fees already paid.
- 17.20 It was also announced on 3 November 2009 that Government would make a capital injection into The Royal Bank of Scotland Group plc of £25.5bn, which includes the

£19bn announced in February 2009 (see paragraph 17.12). The capital injection is to be made through ordinary B shares, so that the Government's stake in ordinary A shares remains below 75 per cent.

- 17.21 In addition Government made a commitment to provide, if needed in a worst-case scenario, up to £8bn in capital. This could be drawn down in up to two tranches if The Royal Bank of Scotland Group plc's Core Tier 1 capital ratio fell below five per cent. In return for this commitment The Royal Bank of Scotland Group plc will pay a fee of four per cent per year.
- 17.22 On 3 November 2009 it was announced that The Royal Bank of Scotland Group plc had agreed to a number of commitments, including on charges and bonuses and increasing lending.
- 17.23 As part of the State Aid requirements The Royal Bank of Scotland Group plc will sell parts of its business over the next four years.

Sector Classification

- 17.24 The Royal Bank of Scotland Group plc is a financial holding company. For National Accounts purposes it is classified as an other financial intermediary. Its UK-resident subsidiaries are classified in the appropriate financial sub-sectors.
- 17.25 From 13 October 2008 The Royal Bank of Scotland Group plc was reclassified as a public financial corporation as a result of the government rights agreed in return for participating in the recapitalisation scheme (see paragraphs 16.20 to 16.26).
- 17.26 Its UK-resident securitisation vehicles are also classified as public financial corporations.

ABN AMRO

- 17.27 ABN AMRO Bank N. V. [Netherlands] was created as the result of the 1990-91 merger between Amsterdam-Rotterdam (AMRO) Bank and ABN, whose history dated back to the founding of the Nederlandsche Handel-Maatschappij in 1824. Between 1991 and 2007, ABN AMRO Bank N. V. was one of the largest banks in Europe.
- 17.28 In October 2007 The Royal Bank of Scotland Group plc acquired a stake in ABN AMRO Bank N. V., as part of a consortium with Fortis Bank Nederland (Holding) N.V. [Netherlands] and Banco Santander S. A. (Spain).
- 17.29 The acquisition of ABN AMRO Bank N. V. was made by RFS Holdings B. V. (Netherlands), which owns 99 per cent of it. RFS Holdings B. V. was jointly owned by The Royal Bank of Scotland Group plc (with a 38 per cent stake), Fortis N. V., Fortis S. A./N. V. and Banco Santander S. A. On 3 October 2008, the Netherlands' Government announced it had nationalised Fortis Bank Nederland (Holding) N. V. and thus replaced Fortis as the ultimate shareholder of this stake in RFS Holdings B. V.
- 17.30 RFS Holdings B. V. is deemed to be controlled by The Royal Bank of Scotland Group plc, through the latter's control of the board. ABN AMRO Bank N.V. is thus also deemed to be controlled by the UK public sector, although as it is non-resident it is not an institutional unit in the UK National Accounts or public sector. The equity value of ABN AMRO Bank N. V. should appear in the equity (AF.5) category in the UK public financial corporations' balance sheet.

- 17.31 The aggregate of ABN AMRO Bank N. V.'s gross operating surplus/deficit, net property income and net current transfers receivable, whether positive or negative, is recorded as Reinvested earnings on direct foreign investment (ESA95 category D.43) in proportion to ownership of it. This has an impact on public sector net borrowing. Any holding losses on financial assets are excluded from Reinvested earnings on direct foreign investment.
- 17.32 As ABN AMRO Bank N. V. is considered UK public sector controlled its UK resident branch is therefore part of the UK public sector. This control will cease when the merger of Fortis and ABN AMRO is completed and ABN AMRO Bank N. V. transfers from RFS Holdings B. V.

Partnerships UK

- 17.33 Partnerships UK was formed in 2000 from a unit of HM Treasury. It supports the delivery of public sector infrastructure renewal through partnerships between the public and private sector, such as the Private Finance Initiative.
- 17.34 Partnerships UK was itself established as a public private partnership, being 49 per cent owned by central government and 51 per cent by the private sector.
- 17.35 The private sector shareholding included stakes held by The Royal Bank of Scotland plc, a subsidiary of The Royal Bank of Scotland Group plc, and Bank of Scotland Corporate (Uberior Infrastructure Investments (No 3) Limited), a subsidiary of HBOS plc. These amounted to 6.1 and 8.8 per cent of the share capital respectively.
- 17.36 From 13 October 2008 The Royal Bank of Scotland plc and HBOS plc are classified in the public sector. This brings the aggregate public sector ownership of Partnerships UK to over fifty per cent and results in its reclassification to the public sector from 13 October 2008.
- 17.37 The unlisted equity value of Partnership UK, based on its net assets, was £18m at end-March 2009. HM Treasury held Partnership UK £16m of loan stock at end-March 2009.

Local Partnerships

- 17.38 Local Partnerships was created on 18 August 2009. It replaced 4ps as the delivery arm of local government public private partnership projects.
- 17.39 Local Partnerships is a joint venture between the Local Government Association (classified as local government) and Partnerships UK. Local Partnerships is hence classified as public sector.

Tesco Personal Finance

- 17.40 Tesco Personal Finance was a joint venture between Tesco plc and The Royal Bank of Scotland Group plc. In December 2008 Tesco plc acquired The Royal Bank of Scotland Group plc's 50 per cent stake for a reported £0.95bn. In October 2009 it was renamed Tesco Bank.
- 17.41 Tesco Personal Finance is classified as private sector throughout the period that The Royal Bank of Scotland Group plc is classified to the public sector.

Transaction Classification

- 17.42 The preference shares issued by The Royal Bank of Scotland Group plc to government in December 2008 are classified as securities other than shares (ESA95 category F.332). They are not partitioned into non-financial and financial transactions as the expected rate of return, at 12 per cent, is not subject to any State Aid difficulties.
- 17.43 The December 2008 issue of ordinary shares is partitioned into non-financial and financial transactions. As explained in paragraph 16.30, when new ordinary share equity is issued and there is an existing quoted stock market price for the equity, the financial transaction in quoted shares (ESA95 category F.511) is recorded at the prevailing market price at time of issuance. If the market price is less than the price actually paid then any difference is recorded as a capital transfer
- 17.44 The offer price for the shares was 65.5 pence and the prevailing market price was 54.7 pence. This produced a capital transfer from central government to public corporations of £2.5bn and a financial transaction of £12.5bn. Government received £0.2bn in underwriting fees, which are recorded as other non-market output (ESA95 category P.13) and netted off government final consumption expenditure (ESA95 category P.3).
- 17.45 For the April 2009 issue of ordinary shares, the offer price for the shares was 31.75 pence and the prevailing market price when the offer closed was 30.2 pence. This produced a capital transfer from central government to public corporations of £0.3bn and a financial transaction of £5.1bn. Government received £0.1bn in underwriting fees
- 17.46 The redemption of the holding, and outstanding interest accrued thereon, of preference shares is recorded as a financial transaction. The redemption price used differed from the valuation used for National Accounts, resulting in a capital transfer receipt for government of £0.1bn.
- 17.47 On 26 February 2009, The Royal Bank of Scotland Group plc announced it was planning a further £13bn recapitalisation by government, subject to shareholder approval. The recapitalisation would take place through issuance of unlisted ordinary B shares, which have preferential rights in respect of dividends. The nominal and issue value will be 50p per share.
- 17.48 On any winding-up of the company the rights to the ordinary B shares rank *pari passu* (equal step) with other ordinary shares (e.g., 1 ordinary B share equals 1 ordinary share). There is an option to convert the ordinary B shares into ordinary shares provided that government owns less than 75 per cent of the resulting shares.
- 17.49 Although the ordinary B shares have a different dividend profile to the ordinary shares, as there is unlikely to be any dividend payments in the short-term the ordinary share market price on day of issuance of the ordinary B shares is considered to be an adequate proxy for the market value of the ordinary B shares. This market value will determine whether the transaction is partitioned into non-financial and financial transactions.
- 17.50 The National Accounts classification of the ordinary B shares will be as unquoted shares (ESA95 category F.512).

Impact on Public Sector Finances

- 17.51 The biggest impact of the reclassification of The Royal Bank of Scotland Group plc is on public sector net debt. So far no data have been specifically collected to estimate the effect, but an indicative analysis suggests that the combined addition of The Royal Bank of Scotland Group plc, HBOS plc and Lloyds TSB Group plc will be in the range between £1tn and £1.5tn. As a percentage of Gross Domestic Product, this is roughly equivalent to between 70 per cent and 100 per cent.
- 17.52 Apart from secondary effects, public sector current budget and public sector net borrowing are unaffected by the recapitalisation. They will be affected by the profitability of The Royal Bank of Scotland Group plc while it is in the public sector.
- 17.53 General government deficit increased by £2.3bn in 2008 as a result of the capital transfer imputed for the recapitalisation and the underwriting fees. Public sector net debt is unchanged. General government gross debt increases by £19.8bn, mainly reflecting the financing required for the recapitalisation.
- 17.54 General government deficit increased by £0.1bn in 2009 from the net effects of the capital transfer imputed for the second ordinary share issue, associated underwriting fees and preference share redemption. The effect on public sector net debt and general government gross debt is negligible to the nearest £0.1bn, reflecting the proceeds of the ordinary share issuance being used to redeem the preference shares.
- 17.55 Until such time as the recapitalisation announced in November 2009 goes ahead it is not possible to determine whether the transaction will be partitioned into non-financial and financial transactions and hence whether there will be any impact on general government deficit.

18. Lloyds TSB

Lloyds TSB Group plc was reclassified to the public sector from 13 October 2008 as a result of the agreements signed to participate in the recapitalisation scheme.

The capital injection into Lloyds TSB Group plc in January 2009 is partitioned into a financial and a non-financial transaction.

Background

- 18.1 The private bank of Taylors & Lloyds was founded in 1765, later becoming Lloyds Bank.
- 18.2 In 1995 Lloyds Bank and TSB Group plc merged to form Lloyds TSB Group plc.
- 18.3 Lloyds TSB Group plc was the holding company of a financial services group, which included Lloyds TSB Bank plc, Scottish Widows plc and the Cheltenham & Gloucester brand.
- 18.4 According to *Lloyds TSB Annual Report and Accounts 2007* at end-December 2007 the group had £353bn of assets and liabilities.
- 18.5 On 13 October 2008 Lloyds TSB Group plc announced it would take part in the recapitalisation scheme (see chapter 16) as part of the October 2008 support package (see chapter 15), subject to a successful merger with HBOS plc.
- 18.6 On 19 November 2008 Lloyds TSB Group plc shareholders voted in favour of the merger and involvement in the recapitalisation scheme.
- 18.7 On 13 January 2009 government purchased £1bn of preference shares. It also underwrote a £4.5bn ordinary share issue. The market price was below the offer price and government purchased nearly all the shares, which represented about 27 per cent ownership of Lloyds TSB Group plc's share capital.
- 18.8 Lloyds TSB Group plc was renamed Lloyds Banking Group plc on 19 January 2009, following the acquisition of HBOS plc.
- 18.9 According to *Lloyds TSB Annual Report and Accounts 2008* the group made an accounting profit in 2008.

Sector Classification

- 18.10 Lloyds TSB Group plc is a financial holding company. For National Accounts purposes it is classified as an other financial intermediary. Its UK-resident subsidiaries are classified in the appropriate financial sub-sectors.

- 18.11 From 13 October 2008 Lloyds TSB Group plc was reclassified as a public financial corporation as a result of the government rights agreed in return for participating in the recapitalisation scheme (see paragraphs 16.20 to 16.26).
- 18.12 Its UK-resident securitisation vehicles are also classified as public financial corporations.

Transaction Classification

- 18.13 The preference shares issued by Lloyds TSB Group plc to government in January 2009 are classified as Securities other than shares (ESA95 category F.332). They are not partitioned into non-financial and financial transactions as the expected rate of return, at 12 per cent, is not subject to any State Aid difficulties.
- 18.14 The January 2009 issue of ordinary shares is partitioned into non-financial and financial transactions. As explained in paragraph 16.30, when new ordinary share equity is issued and there is an existing quoted stock market price for the equity, the financial transaction in quoted shares (ESA95 category F.511) is recorded at the prevailing market price at time of issuance. If the market price is less than the price actually paid then any difference is recorded as a capital transfer
- 18.15 This produced a capital transfer from central government to public corporations of £1.0bn and a financial transaction of £3.4bn.
- 18.16 Government received £0.1bn in underwriting fees, which are recorded as Other non-market output (ESA95 category P.13) and netted off government final consumption expenditure (ESA95 category P.3).

Impact on Public Sector Finances

- 18.17 The biggest impact of the reclassification of Lloyds TSB Group plc is on public sector net debt. So far no data have been specifically collected to estimate the effect, but an indicative analysis suggests that the combined addition of The Royal Bank of Scotland Group plc, HBOS plc and Lloyds TSB Group plc will be in the range between £1tn and £1.5tn. As a percentage of Gross Domestic Product, this is roughly equivalent to between 70 per cent and 100 per cent.
- 18.18 Apart from secondary effects, public sector current budget and public sector net borrowing are unaffected by the recapitalisation. They will be affected by the profitability of Lloyds TSB Group plc while it is in the public sector.
- 18.19 General government deficit increased by £0.9bn in 2009 as a net result from the capital transfers imputed for the recapitalisation and the underwriting fees. Public sector net debt is unchanged. General government gross debt increases by £5.4bn, mainly reflecting the financing required for the recapitalisation.

19. HBOS

HBOS plc is reclassified to the public sector from 13 October 2008 as a result of the agreements signed to participate in the recapitalisation scheme.

The capital injection into HBOS plc in January 2009 is partitioned into a financial and a non-financial transaction.

Background

- 19.1 HBOS plc was created in 2001 through the merger of Halifax plc and the Bank of Scotland plc.
- 19.2 The Bank of Scotland was founded by an Act of the Scots Parliament in 1625, making it Scotland's first bank.
- 19.3 Halifax Permanent Benefit Building Society was founded in 1852. After merger with the Halifax Equitable Building Society in 1928 the Halifax Building Society was established. Halifax Building Society converted to a public limited company and floated on the London Stock Exchange in 1997.
- 19.4 HBOS plc was the holding company of the HBOS group, which had three main subsidiaries: Bank of Scotland plc; HBOS Insurance & Investment Group Limited and Halifax Share Dealing Limited. The group also included the Clerical Medical life assurance company.
- 19.5 According to *HBOS plc Annual Report and Accounts 2007* at end-December 2007 it had £667bn of assets and £645bn of liabilities.
- 19.6 On 13 October 2008 HBOS plc announced it would take part in the recapitalisation scheme (see chapter 16) as part of the October 2008 support package (see chapter 15), subject to a successful merger with Lloyds TSB Group plc.
- 19.7 On 12 December 2008 HBOS plc shareholders voted in favour of the merger.
- 19.8 On 13 January 2009 government purchased £3bn of HBOS plc preference shares. It also underwrote an £8.5bn ordinary share issue. The market price was below the offer price and government purchased nearly all the shares, which represented about 67 per cent ownership of HBOS plc's share capital.
- 19.9 HBOS plc delisted from the London Stock Exchange on 14 January 2009.
- 19.10 HBOS plc was acquired by Lloyds TSB Group plc on 19 January 2009. Lloyds TSB Group plc was renamed Lloyds Banking Group plc.
- 19.11 According to *HBOS plc Annual Report and Accounts 2008* the group made an accounting loss in 2008.

Sector Classification

- 19.12 HBOS plc was a financial holding company. For National Accounts purposes it was classified as an other financial intermediary. Its UK-resident subsidiaries were classified in the appropriate financial sub-sectors.
- 19.13 From 13 October 2008 HBOS plc was reclassified as a public financial corporation as a result of the government rights agreed in return for participating in the recapitalisation scheme (see paragraphs 16.20 to 16.26).
- 19.14 Its UK-resident securitisation vehicles are also classified as public financial corporations.

Transaction Classification

- 19.15 The preference shares issued by HBOS plc to government in January 2009 are classified as Securities other than shares (ESA95 category F.332). They are not partitioned into non-financial and financial transactions as the expected rate of return, at 12 per cent, is not subject to any State Aid difficulties.
- 19.16 The January 2009 issue of ordinary shares is partitioned into non-financial and financial transactions. As explained in paragraph 16.30, when new ordinary share equity is issued and there is an existing quoted stock market price for the equity, the financial transaction in quoted shares (ESA95 category F.511) is recorded at the prevailing market price at time of issuance. If the market price is less than the price actually paid then any difference is recorded as a capital transfer
- 19.17 This produced a capital transfer from central government to public corporations of £2.6bn and a financial transaction of £5.9bn.
- 19.18 Government received £0.1bn in underwriting fees, which are recorded as Other non-market output (ESA95 category P.13) and netted off government final consumption expenditure (ESA95 category P.3).

Impact on Public Sector Finances

- 19.19 The biggest impact of the reclassification of HBOS plc is on public sector net debt. So far no data have been specifically collected to estimate the effect, but an indicative analysis suggests that the combined addition of The Royal Bank of Scotland Group plc, HBOS plc and Lloyds TSB Group plc will be in the range between £1tn and £1.5tn. As a percentage of Gross Domestic Product, this is roughly equivalent to between 70 per cent and 100 per cent.
- 19.20 Apart from secondary effects, public sector current budget and public sector net borrowing are unaffected by the recapitalisation. They will be affected by the profitability of HBOS plc while it is in the public sector.
- 19.21 General government deficit increased by £2.5bn in 2009 from the net effects of the capital transfer imputed for the recapitalisation and the underwriting fees. Public sector net debt is unchanged. General government gross debt increases by £11.4bn, mainly reflecting the financing required for the recapitalisation.

20. Lloyds Banking Group

Lloyds Banking Group plc is classified to the public sector from its creation on 19 January 2009.

Background

- 20.1 Lloyds Banking Group plc was created on 19 January 2009, following Lloyds TSB Group plc's acquisition of HBOS plc.
- 20.2 The government shareholding ownership of Lloyds Banking Group plc was 43.5 per cent.
- 20.3 In March 2009, as part of the Government's second support package (see chapter 25) it was announced that Lloyds Banking Group plc intended to place assets in the Asset Protection Scheme (see chapter 28) and that the £4bn of preference shares would be converted into ordinary shares. In return Lloyds Banking Group plc took on some further lending commitments.
- 20.4 The conversion was achieved by a rights issue to existing ordinary shareholders, underwritten by government, with the proceeds used to redeem the preference shares.
- 20.5 The rights issue closed on 5 June 2009 and was 86.9 per cent subscribed, including government acquiring £1.7bn of shares in line with its shareholding. The remaining shares were sold to the market on 9 June 2009. Government did not purchase any shares in its role as underwriter. The preference shares were redeemed in two tranches, on 8 and 11 June 2009 respectively.
- 20.6 On 7 March 2009, Lloyds Banking Group plc announced its intention to participate in the Asset Protection Scheme (see chapter 28). It would place assets in the scheme with a nominal value of £260bn and a market value of £250bn. Lloyds Banking Group plc would bear a first loss amount on these assets of up to £35.2bn. Any second loss amounts would be borne 90 per cent by government ten per cent by Lloyds Banking Group plc.
- 20.7 The scheme was to apply to losses incurred on specific assets and exposure on Lloyds Banking Group plc's balance sheet as at end-2008. 83 per cent of the value of assets to be included in the scheme related to former HBOS plc assets and 17 per cent to former Lloyds TSB Group plc assets.
- 20.8 The intention was that £15.6bn of ordinary B shares would be issued to government as a fee for Lloyds Banking Group plc taking part in the Asset Protection Scheme.

- 20.9 As part of the agreement announced in March 2009, Lloyds Banking Group plc committed to lend £14bn in the year to 1 March 2010 (£11bn commercial and £3bn residential mortgage) and a further £14bn the following year.
- 20.10 On 18 September 2009 Lloyds Banking Group plc issued a press release stating it was in discussions with government on possible changes to the commercial terms on which it could enter the scheme. The release also stated that it was looking at possible alternatives to the scheme and was “in discussions with HM Treasury, UK Financial Investments and the Financial Services Authority in this regard.”
- 20.11 In October 2009 it was announced that the Halifax Estate Agencies Limited subsidiary was being sold to LSL Property Services plc for a nominal amount.
- 20.12 On 3 November 2009 the Government announced that, as a result of improved market conditions, Lloyds Banking Group plc would not participate in the Asset Protection Scheme. It would instead raise additional capital.
- 20.13 On 3 November 2009 Lloyds Banking Group plc announced a plan to raise £21bn, through a £13.5bn share issue and a £7.5bn conversion of existing debt into ‘contingent capital’. The Government would invest £5.9bn by taking up its share allocation of the rights issue. Government would receive a £0.1bn fee for its commitment to support the share issue. The Government’s shareholding would thus remain at 43 per cent.
- 20.14 It was also agreed that Lloyds Banking Group plc would make a £2.5bn payment to government, reflecting the implicit protection provided during the time it was expected to enter the Asset Protection Scheme.
- 20.15 On 3 November 2009 it was announced that The Royal Bank of Scotland Group plc had agreed to a number of commitments, including confirming an existing commitment on increasing lending and commitments on personal current account charges and the payment of bonuses.
- 20.16 As part of the State Aid requirements Lloyds Banking Group plc will sell parts of its business over the next four years.

Sector Classification

- 20.17 Lloyds Banking Group plc is a financial holding company. For National Accounts purposes it is classified as an other financial intermediary. Its UK-resident subsidiaries are classified in the appropriate sub-sectors.
- 20.18 From its creation on 19 January 2009 Lloyds Banking Group plc was reclassified as a public financial corporation as a result of the government rights agreed in return for participation in the Lloyds TSB Group plc and HBOS plc recapitalisation schemes (see paragraphs 16.20 to 16.27).
- 20.19 Its UK-resident securitisation vehicles are also classified as public financial corporations.
- 20.20 The redemption of the preference shares in June 2009 removed government’s rights over dividend policy, although the Board had already announced their intention not to pay a dividend on ordinary shares in 2009.

20.21 The other rights remain in place and the classification of Lloyds Banking Group plc in the public sector remains unchanged as a result of the redemption. The classification judgement was based on the totality of government rights and will be reassessed when the rights fall away over time.

Transaction Classifications

20.22 For the June 2009 issue of ordinary shares, the entire transaction is recorded as a financial transaction. This is because the prevailing market price when the offer closed was above the offer price and the shareholdings were not diluted by the issue¹⁸. Government received £0.1bn in underwriting fees and a capital transfer receipt on the redemption of the preference shares.

Impact on Public Sector Finances

20.23 The June acquisition of ordinary shares and redemption of the preference shares has no initial impact on public sector current budget or public sector net borrowing as the transactions are intra public sector. General government net borrowing is reduced by £0.2bn as a result of the fees earned and the interest receivable accrued on the preference shares, although this is offset by the interest payable on the financing required for the January 2009 recapitalisations.

20.24 General government gross debt reduces by £2.1bn, the difference between the preference share redemption receipt, accrued interest receivable and fees, and the costs of acquiring new ordinary shares. Public sector net debt is unchanged.

¹⁸ The shares not subscribed for were sold and the resulting premium above offer price distributed to those shareholders.

21. Bank of England Special Liquidity Scheme

The Bank of England provided treasury bills to participating banks and building societies from April 2008.

Following a lengthy international consultation on the appropriate recording, the treasury bills supplied by government to the Bank of England are not recorded as a liability of government.

The exchange of government securities for the assets of participants is considered as stock-lending and not recorded in the National Accounts.

Background

- 21.1 On 21 April 2008 the Bank of England announced a temporary scheme whereby banks and building societies¹⁹ could exchange illiquid assets for UK government treasury bills. The banks could then use the treasury bills as security when borrowing. The scheme started immediately, was open for applications and drawdowns until 31 January 2009²⁰, and then runs for three years afterwards.
- 21.2 Mervyn King, Governor of the Bank of England, explained the purpose of the scheme by saying that "The Bank of England's Special Liquidity Scheme is designed to improve the liquidity position of the banking system and raise confidence in financial markets while ensuring that the risk of losses on the loans they have made remains with the banks."
- 21.3 The scheme was ring-fenced from and independent of the Bank of England's regular money market operations.
- 21.4 When announced, eligibility to the scheme was open to the 149 banks and building societies that were eligible to sign-up to the Bank of England's Standing Facility, part of their sterling money market operations
- 21.5 The scheme is indemnified by the UK Government (HM Treasury) due to its scale relative to the central bank's balance sheet.
- 21.6 To participate in the scheme, banks and building societies have to pay a fee.

¹⁹ "Participating banks" is used throughout this chapter as short-hand for "participating banks and building societies".

²⁰ The initial application period was planned for six months, but this was later extended.

- 21.7 The Bank of England has a statutory requirement to publish its balance sheet every week but the scheme does not show up on this. The avoidance of disclosure was designed to protect the stability of the financial system; if banks needed to approach the Bank of England they wanted to do so in privacy. They had concerns about being stigmatised as the “next Northern Rock” and it was considered that standard Bank of England facilities were not being used because of the potential adverse effects of market and media speculation. One reason that the scheme was designed as a “collateral exchange” was to avoid statutory disclosure requirements.
- 21.8 The Special Liquidity Scheme is similar to one that operates in the USA, where top-rated mortgage securities are exchanged for Treasury securities, although the USA scheme has a much shorter maturity of one month. Another difference is that, whereas the USA scheme has auctions on a particular day each month, the UK scheme was not auction based and allowed participants to draw down on the scheme on any day before 31 January 2009. Therefore, a situation like Bear Stearns in USA, which apparently had collateral it could have exchanged at the next auction but was brought down by rumours 2-3 days before that date, could be avoided.
- 21.9 In September 2008 it was indicated that take-up of the Special Liquidity Scheme was over £100bn. In the October 2008 support package it was announced that a further £100bn of treasury bills would be made available to the Bank of England for the scheme.
- 21.10 On 3 February 2009, the Bank of England announced that, as of 30 January 2009, £185bn of treasury bills had been lent under the scheme against assets with an aggregate nominal value of £287bn (market value of £242bn). In total, 32 banks and building societies had participated in the scheme.

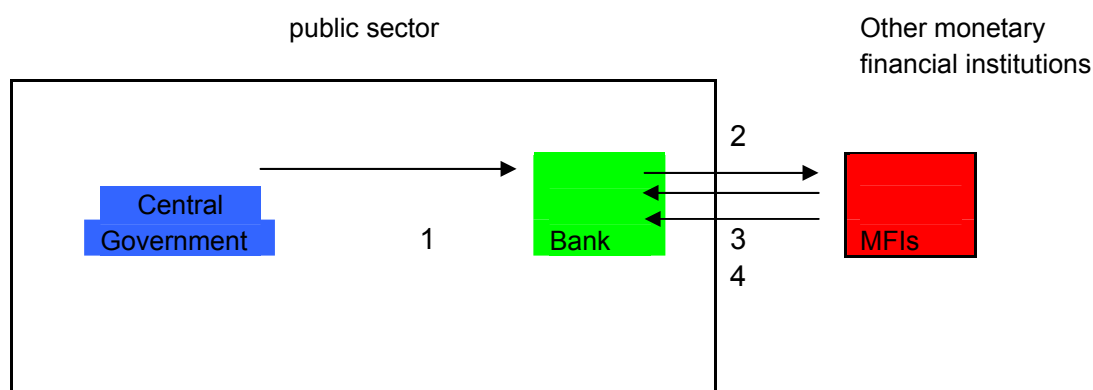
Overview of the Scheme

- 21.11 The scheme can be divided into three main stages. In the first, the government issues the treasury bills and then lends them to the Bank of England. In the second stage the central bank²¹ exchanges them with participating banks' assets, charging a fee for doing so. In the third stage the participating banks are now the legal owner of sufficient quality assets to use them as collateral to borrow against in the markets, the intention being to allow these markets to return to action.
- 21.12 The National Loans Fund (classified as part of the central government sub-sector) issues treasury bills specifically for the scheme. The treasury bills have a nine-month maturity. The Debt Management Office (also classified as part of central government) purchases the treasury bills from the National Loans Fund. The Debt Management Office supplies the central bank with the necessary treasury bills for the scheme when required.
- 21.13 In the compilation of the UK National Accounts and public sector finances any transactions within a sub-sector are consolidated. Therefore the transactions between the National Loans Fund and Debt Management Office consolidate out of the central government sub-sector accounts.

²¹ The Bank of England is generally referred to as the central bank in this chapter in order to avoid confusion with ‘participating banks’.

21.14 Although the issuance will be at market rates, the treasury bills are not issued directly to the market. The Debt Management Office loans them to the central bank in a stock-lending arrangement.

Chart 21.1 – The first two stages of the scheme



- 1 Government issues securities, lends them to central bank.
- 2 MFIs receive government securities from central bank
- 3 Central bank receives assets from MFIs
- 4 MFIs pay fees to central bank

21.15 Stock-lending is the temporary transfer of securities with agreement for their return at a pre-agreed time.

21.16 The Debt Management Office receives a fee from the central bank for this stock lending.

21.17 The treasury bills are fungible (exchangeable or substitutable) with 6-month, 3-month and 1-month treasury bills, issued through the Debt Management Office's regular sales of treasury bills, at the appropriate time of remaining maturity.

21.18 Although legal ownership of the bills passes to the central bank under the stock-lending transaction, apart from the fee there are no cash transactions. Thus the Debt Management Office retains the cash 'interest'²² that would usually accrue to the holder on redemption. In such circumstances the economic ownership, decided through assessing risks and rewards, is judged to remain with the Debt Management Office.

21.19 Once a participating bank has entered into an asset exchange with the central bank, it is free to use the borrowed treasury bills as collateral in a repo (repurchase agreement) or to sell them outright.

21.20 If it does sell them outright, it is still obliged to return treasury bills to the central bank, so will need to buy an equivalent amount of treasury bills from the market (or issuer) before the exchanges are reversed.

²² The difference between the redemption (par) value and the issue price is considered as the interest accrued on a treasury bill.

- 21.21 The treasury bills will be exchanged by the central bank for participating banks' assets. Legal ownership of both the treasury bills and participating banks' assets transfer. Economic ownership would again usually be judged to remain with the original asset holders in such circumstances.
- 21.22 The asset exchanges between the participating banks and central bank will be for a term of one year or the maturity of the collateralised asset, whichever is shorter. Participating banks will be able, at the discretion of the central bank, to renew the exchange each year while the scheme is still in operation. After that, the scheme will close. So, should the markets recover sufficiently that the scheme is no longer necessary, the central bank can effectively stop it.
- 21.23 The scheme only includes assets (e.g. securities, and underlying loans that can be converted into securities) that were on the banks' commercial balance sheets at the end of 2007. The scheme cannot be used to finance new lending.
- 21.24 The eligible assets are "a range of high-quality assets, including AAA-rated securities backed by UK and European residential mortgages."
- 21.25 In detail, the following types of asset are allowed:
- (i) UK and European Economic Area (EEA) AAA-rated covered bonds. The underlying asset must either be mortgages or public sector debt. Can include those issued by the entity, or its group.
 - (ii) UK and EEA AAA-rate 'residential mortgage' asset-backed securities. Underlying assets must not be synthetic (e.g. must be actual mortgages, not derivatives). Can include those originated by the entity, or its group.
 - (iii) UK, USA and EEA AAA-rate 'credit card receivables' asset-backed securities. Underlying assets must not be synthetic (e.g. must be actual credit card debt, not derivatives). Can include those originated by the entity, or its group.
 - (iv) government securities issued by G10 countries rated Aa3 or higher, excluding any of these that are already eligible in the central bank's normal Open Market Operations.
 - (v) AAA-rated securities issued by G10 government agencies explicitly guaranteed by national governments.
 - (vi) AAA-rated conventional debt issued by USA government sponsored enterprises (Freddie Mac, Fannie Mae and Federal Home Loans).
 - (vii) From October 2008 the list was extended to include bank debt guaranteed as part of the Credit Guarantee Scheme (see chapter 23).
- 21.26 Securities may be denominated in sterling, euro, US dollar, Australian dollar, Canadian dollar, Swedish krona, Swiss franc or (for government securities only) Japanese yen.
- 21.27 The credit rating required must be provided by two or more of the rating agencies Standard & Poors, Moody's and Fitch.
- 21.28 During the life of the scheme, a participating bank may substitute one type of eligible asset for another.

- 21.29 Subject to maintaining the minimum participation level, a participant may (fully or partially) terminate an exchange before the contractual end date provided they return the equivalent amount of government securities.
- 21.30 The market value of both the treasury bills and collateralised securities will be valued by the central bank, using observed market prices where available.
- 21.31 If an independent market price is unavailable, the central bank uses its own calculated price. In practice an observable market price should exist for nearly all the securities included in the scheme. The one exception is where a bank takes its own assets (such as mortgage or credit card assets), securitises them through its usual securitisation vehicles and then buys the resulting bonds so they can be used in the scheme in a zombie securitisation²³. As this issue of bonds is exclusively for use in creating collateral for the scheme, it does not have a market value.
- 21.32 The value of the underlying assets will be marked to market on a daily basis and differences will be corrected for via a margin account. The margin payments are not in cash, they involve the participating banks adding more collateral if required, and are known as 'margin securities'. If the market moves so that participating banks have too much collateral they may withdraw margin securities but not the original collateral.
- 21.33 However, when the market moves in this way the central bank does not have to provide additional treasury bills. So the revaluation corrections are very one-sided, in favour of the central bank, and thus not like a margin payment on a conventional swap arrangement.
- 21.34 The central bank may call a default if the participating bank fails to supply margin securities on the day they are requested.
- 21.35 Participating banks will pay a fee to the central bank for the financial services provided. The fee provides a cushion to absorb any losses in the event of default, given any fluctuations in the value of collateral. This fee should not be confused with the "haircut" (see paragraphs 21.40 and 21.41).
- 21.36 During the lifetime of an asset exchange under the scheme, participating banks will be charged a fee based on the 3-month London interbank offered rate (LIBOR). The fee will be the spread between 3-month LIBOR and the 3-month general collateral gilt repo rate (GCGRR), as observed by the central bank, subject to a 'floor' (e.g. minimum) of 20 basis points. The central bank has the power to vary this fee.
- 21.37 The GCGRR is the equivalent to a fee for borrowing government securities using cash borrowed in the unsecured inter-bank market as collateral.
- 21.38 If LIBOR increases, the fee increases. However, if the inter-bank borrowing markets recover there is still the minimum fee.
- 21.39 The spread will be fixed at the day of the exchange and re-fixed at three monthly intervals. The fee is payable every three months and at termination.
- 21.40 In financial jargon a haircut is a commonly used term for the difference between the value used and the market price of collateral assets.

²³ In a zombie securitisation the issuance is bought up by the originator.

- 21.41 The haircut here is the percentage discount applied to the values of the assets being exchanged under the scheme. The central bank also effectively has to pay for a haircut on the government securities it 'exchanges', but only one haircut is calculated, for the net position.
- 21.42 There are no cash payments for the haircut.
- 21.43 The haircut is designed to ensure that in the event of a default by a participating bank, the realisable value of the collateral should be sufficient to cover the amount due from them.
- 21.44 Participating banks will generally need to provide the central bank with assets totalling significantly greater value than the government securities they have received. If the credit ratings on banks' assets pledged as security are downgraded then, subject to central bank discretion, the banks would need to replace them with alternative highly-rated assets, or return some of the treasury bills.
- 21.45 If a participating bank could not provide alternative assets, had already repo'd or sold the borrowed treasury bills and could not get back the originals or replacements, it would be in default to the central bank. The central bank would keep the collateralised assets, and purchase new treasury bills from the Debt Management Office to replace those it needs to return. In this scenario the participating bank would probably have liquidity problems so would either need to resolve those (e.g. by a rights issue, through a central bank emergency loan, or administration).
- 21.46 Under the terms of the asset exchange, the cash interest earned on the collateral will be received by the central bank as its legal owner. However, the central bank will immediately pass the interest through to the participating banks. Similarly, the scheme details state that any interest on the government securities will be receivable by the participating banks, which would pass it through to the central bank. However, the interest on treasury bills is rolled up into the redemption payment and they are always returned before the redemption date, so no cash will flow from central government and hence there is no interest to be returned.

Sector Classification

- 21.47 There are no significant controls/rights over participants imposed by the Bank of England, so the sector classification of participating banks is not affected.

Transaction Classifications

Classification as a Central Bank or Central Government Scheme

- 21.48 The participating banks retain responsibility for any losses on their collateralised assets, and the haircut is set at a level so the central bank should not suffer losses. However, given its scale relative to the central bank's balance sheet, the scheme is indemnified by the UK Government (HM Treasury). A fee is not charged for the indemnity.

- 21.49 The scheme is designed to avoid the public sector taking on the risk of potential losses. The scheme is only exposed to potential loss if a participating bank defaulted and the realisable value of its collateral became less than the value of the government securities it had been loaned.
- 21.50 The indemnity covers loss on the overall scheme, not losses on individual participating banks.
- 21.51 One of the key classification questions here was whether to record the scheme's transactions, if appropriate, as central government or central bank. ESA95 paragraph 1.38 explains that "some transactions are rearranged in order to bring out the underlying economic relationships more clearly" and that transactions "can be rearranged in three ways: rerouting, portioning and recognising the principal party to a transaction". Principal party recording requires a transaction to be carried out on behalf of another unit and also funded by that unit. It could be argued that central government is funding the scheme through the provision of its treasury bills alongside the indemnity. So, the crucial aspect for classification is the judgement on whether the transactions are carrying out the transactions on behalf of government.
- 21.52 Information that ONS received stated that the scheme was a Bank of England one, not UK central government.
- 21.53 Following discussion in the task forces, the background document to the CMFB consultation gave guidance that "In the specific case of Central Bank liquidity operations, these operations would generally fall within the Central Bank's existing remit to preserve financial stability, and should therefore not be re-routed through government."
- 21.54 Therefore, it was decided not to re-arrange the transactions as government transactions performed by an agent.
- 21.55 The Eurostat decision published on 15 July 2009 states that "General liquidity operations carried out by national central banks are to be recorded in the accounts of the central banks" rather than re-routed through the general government sector. However, from the description of the relevant 'exchange of assets' schemes it is inferred that Eurostat does not recognise the Bank of England Special Liquidity Scheme as a general liquidity operation.
- 21.56 The Eurostat decision covers the situation where public corporations undertake transactions to support financial markets or individual financial institutions. The decision here is reproduced below.
- Transactions conducted by public corporations are to be considered as undertaken by general government as a principal party if there is written or irrefutable evidence that government has issued an instruction to the public corporation to carry out the transactions for public policy purposes. In all other cases the transactions are recorded as undertaken by the public corporation concerned.
- 21.57 As there is no evidence that government instructed the central bank here and the information ONS has received states this is not the case, any appropriate transactions for the scheme would be recorded as central bank transactions rather than government transactions.

Whether to Impute Transactions or Record Nothing

- 21.58 The second main issue was whether to record anything, apart from the fees, for the scheme. The classification question here was whether (and if so, how) to record any imputed transactions between central government and central bank, and associated balance sheet positions, or to consider the activities similar to conventional stock-lending, where nothing is recorded. This was the subject of a specific EU-wide consultation conducted by the Committee on Monetary, Financial and Balance of Payments Statistics (CMFB).
- 21.59 Although the eventual decision by Eurostat was to record nothing it is instructive to explain the discussion and process that led to the decision.
- 21.60 A conventional issue of short-term (up to 1 year) maturity government securities would be recorded in the financial account in the ESA95 F.331 transaction category; as a government liability and an asset of the holder. The accounts would be balanced by a transaction in cash (ESA95 category F.2). A UK treasury bill typically has a face value (the nominal value) for the redemption price, but the issue price will be at a discount to it. The difference between the issue price and redemption price is recorded as interest in National Accounts, and accrued over the life of the bill. The market price of the treasury bills adjusts according to the interest accrual.
- 21.61 The issue of the treasury bills by the National Loans Fund and purchase by the Debt Management Office is, by convention, consolidated out of the UK National Accounts since both parties are in the central government sub-sector. Therefore, the treasury bills do not appear as an asset or liability on the National Accounts central government balance sheet at time of issue, since they are both assets and liabilities of central government entities and are consolidated out of the balance sheet.
- 21.62 ESA95 paragraph 5.64a states that AF.332 long-term securities “[lent or subject to repurchase does not change balance sheet and remains classified in AF.332.](#)” This is included in the description of the AF.332 category because these are the types of securities usually associated with such an exchange but as other types of assets can be used the guidance can be extended to also cover AF.331 short-term securities.
- 21.63 While the classification category of the government securities will indisputably remain as AF.331 if recognised, the guidance suggests that the asset holding of the securities does not change to the central bank sub-sector’s balance sheet. There was a counter-argument that the situation here is different from a conventional stock-lending or repo transaction as described in ESA95.
- 21.64 Eurostat’s *Manual on Government Deficit and Debt*, Part V Section 3 states:

[On the contrary, securities lending without a flow in cash \(generally without collateral and for very short maturity\) should not be treated as a repurchase agreement. This case is not specified in ESA95 \(or SNA\). It is in fact a kind of “loan in materials” that is not recognised as a financial instrument. ESA 5.69 specifies that there is a loan “...when creditors lend funds to debtors” No transaction should affect the financial accounts \(stocks and flows\).](#)

[Generally, in the accounting system of the contracting parties there is no effect on the balance sheet but possibly an entry in the “off-balance sheet” in order to record the forward reverse transaction. But in some countries, portfolios reflect directly the transaction. Two cases should be distinguished.](#)

Where the distinction between securities lending with cash and without cash is available, it would be better classifying the latter transaction under “other accounts receivable/payable” and not under deposits or loans.

- 21.65 However, 'very short maturity' is not defined - the convention in National Accounts for 'short' is less than one year, so it is probably reasonable for 'very short' to be interpreted as less than one month or even less. In stock-lending transactions such as repurchase agreements (repos) the maturity can be as short as overnight or the following day, whereas the maturity here is nearly a year. It is possible that the situation described in the manual is only referring to the overnight or following day type of transaction. Conversely, the generality does not rule out longer periods of maturity.
- 21.66 Similarly, another difference from the general situation described is that stock-lending usually takes place using assets issued by another entity. While from an institutional unit viewpoint this does occur here, from a National Accounts sectoral viewpoint it is not the case: the transaction between the two central government units is consolidated out of the accounts. This leads to central government lending its own “assets”, created specifically for this purpose, but which are not recorded in its balance sheet. So, while the manual does not rule out such a situation, it is open to interpretation whether this type of stock-lending is that envisaged by the manual or not. Conversely, the stock-lending of own assets could still be viewed as “lending of materials”.
- 21.67 As an alternative to recording nothing, an imputed issue of government securities and imputed acquisition by the central bank could have been recorded.
- 21.68 For purposes of recording general government gross debt for the Excessive Deficit Procedure there would be an increase in government debt from this option, which would not occur in the 'recording nothing' option. Similarly, under the imputed option, at the end of the scheme the return of the treasury bills to government would lead to a consequent fall in government debt.
- 21.69 For the counterpart to the imputed transaction there were a number of sub-options. These were discussed in Eurostat's *Accounting Consequences for Government of the Recent Financial Crisis' Task Force*, which supported the recommendation that the capital transfer option was inappropriate here and thus reduced the sub-options to:
- i. an F.41 short-term loan (reversed at the time the security is redeemed);
 - ii. an F.512 injection of equity into the central bank (with a withdrawal of equity when the government security is returned).
- 21.70 In both these sub-options the value of the initial transaction is lower than the redemption transaction. This reflects the interest accrual on the government security. In the first sub-option the interest accrual balances between the two imputed transactions. In the second it is explained by a revaluation of equity.
- 21.71 In the Eurostat task force it was noted that the lending of securities for the amounts involved here, without anything in exchange, would only occur between a parent and a subsidiary, thus this is more like equity than a loan.

- 21.72 Another argument in favour of equity concerns the economic reality unveiled by the alternative scheme design. This involved central government increasing the asset base of the central bank by injecting equity, which would have been used to purchase the government securities.
- 21.73 Following discussion in the later *CMFB Task Force on the Accounting Consequences for Government of the Financial Turmoil* Eurostat decided to use the equity sub-option as the counterpart to any imputed issue of treasury bills.
- 21.74 In the Eurostat task force it was questioned whether the Rechtsträger-finanzierung (Austrian railways) case set a precedent. This involved the Austrian government issuing debt to the market (in its own name) and then allocated the funds to the public corporation, which made arrangements with government to repay the government borrowing.
- 21.75 The Austrians originally recorded this as public corporation borrowing on the basis that the public corporation was the principal party, but this recording was later rejected. The Austrian case is however very different to the Special Liquidity Scheme: for the Special Liquidity Scheme government is not issuing to the market - instead issuing to another central government unit - and it is the securities themselves rather than the proceeds which are lent. The precedent quoted is that “when government borrows directly on the market (in its own name) and reallocates the funds to public corporations” this is regarded as government debt. However, this is a different scenario. The similarity argued is that in both cases there is debt issued by government that can be traded on a market.
- 21.76 In September 2008 ONS requested Eurostat’s opinion on the Special Liquidity Scheme.
- 21.77 The Special Liquidity Scheme was the subject of a dedicated CMFB consultation. The consultation posed two questions, the first of which was “How should the provision of securities by the UK government to the central bank under the Special Liquidity Scheme be recorded?” The two options were: to record nothing (i.e., stock-lending with no cash) or impute an issue of government securities.
- 21.78 The voting in a CMFB consultation is not published, but the CMFB opinion presented to Eurostat reported that there was “no clear majority view in favour of either option”.
- 21.79 Where no clear majority view emerges from a CMFB opinion, Eurostat decides on the recording. Eurostat decided not to make a decision on this prior to the April 2009 Excessive Deficit Procedure notifications, instead deciding that further time was necessary to make a decision based on a fully developed analysis.
- 21.80 As a result, ONS decided not to implement any decision on the Bank of England Special Liquidity Scheme until the Eurostat decision had been made.
- 21.81 In April 2009 Eurostat placed a reservation on the quality of the data reported by the United Kingdom while it “considered the appropriate treatment of these bills, and whether or not they should be statistically included as part of United Kingdom government debt.”

21.82 On 15 July 2009 Eurostat announced its guidance on ‘exchange of assets’ schemes as part of its decision on *The statistical recording of public interventions to support financial institutions and financial markets during the financial crisis* (referred to hereafter as the *Eurostat decision*). This presented two options, the first where no government debt was recorded and the second where the securities are deemed to have economically transferred and government debt is recorded:

“The government securities exchanged in temporary liquidity schemes, where the securities will return to government at a pre-determined date in a short period of time (and the risk of loss is expected to be small), are recorded as a securities lending transaction (i.e. they remain under the economic ownership of government and do not form part of government consolidated gross debt). This holds for both schemes directly between the government and financial institutions, and for schemes conducted via the National Central Banks.

Where the liquidity scheme is of indeterminate or not short duration and/or where the risk of loss is not expected to be small, the government securities concerned will either be considered as not remaining under the economic ownership of government (schemes operated via central banks) or recorded as back-to-back repurchase agreements (schemes operated directly by government). In both cases, government consolidated gross debt would be higher by the value of the securities concerned.”

21.83 The Bank of England Special Liquidity Scheme is a temporary liquidity scheme with a duration of more than one year, where the securities exchanged return at a pre-determined date (just prior to their maturity), with a short maturity on each exchange and a small expected loss. By convention in National Accounts ‘short’ refers to one year or less and it was widely used in the discussions in this context as the existing guidance refers to very short maturity – see paragraph 21.65. Taking these factors into account, the relevant aspects of the *Eurostat decision* reduce to:

“The government securities ... where the securities will return to government at a pre-determined date in a short period of time ... are recorded as a securities lending transaction (i.e. they remain under the economic ownership of government and do not form part of government consolidated gross debt) ...

Where the liquidity scheme is of ... not short duration ... the government securities concerned will ... be considered as not remaining under the economic ownership of government ... government consolidated gross debt would be higher by the value of the securities concerned.”

21.84 However, for the Bank of England Special Liquidity Scheme both of these options hold. Therefore the *Eurostat decision*, made following a CMFB consultation on a specific subject, failed to provide adequately clear guidance on that subject despite its claims to deal with the issue.

21.85 This situation arises because the two options are not constructed consistently. The first option concentrates on the period of the exchange of assets, the second option concentrates on the duration of the scheme. These are two distinct variables that are not mutually exclusive, so the *Eurostat decision* can produce results where the criteria for both options are met.

- 21.86 The *Eurostat decision* was accompanied by a “more detailed technical note for statisticians”. This document provides an alternative wording for the second case, which if followed produces a different result for the Special Liquidity Scheme:

Where the liquidity scheme is not temporary or the risk for government is not considered to be small, the treatment of the government securities issued varies depending on the type of operation involved:

a) when the operation is conducted via an intermediary (for example, the central bank), so that government securities are provided to the intermediary, the government securities concerned should be considered as having changed economic ownership ...

b) when the operation is directly between government and the financial institutions covered by the scheme ...

- 21.87 The description here is less detailed than that given in the *Eurostat decision*. Applying the rules described in this note, rather than the decision, produced a consistent result: that no government debt should be recorded for the treasury bills used in the scheme.

- 21.88 The analysis in the technical note referred to a *Manual on Government Deficit and Debt* quote (reproduced in paragraph 21.111 of this article) on the length of the asset exchange being a “very short maturity” and commented that a characteristic of operations in the financial crisis are that they have longer periods of asset exchange. It then described the issue as length of the operation, seemingly confusing the length of the scheme/operation with the aspect of length of the exchanges.

- 21.89 Following a further meeting of the Eurostat Task Force in August 2009, Eurostat reissued its *Guidance Note* accompanying the *Eurostat decision* to clarify aspects that were unclear. This included the following additional interpretation:

The term “short duration” is used in the Eurostat Decision for schemes in a different sense from its existing use in financial accounts statistics (where the borderline between short and long term financial instruments, for example the maturity of securities, is one year). It is used in the Eurostat Decision to reinforce the idea of a temporary scheme, where the initial issuance of the stock of government securities involved takes place only during the period of the financial crisis, rather than to denote a particular length of time. That the stock of government securities may later be effectively rolled over (either directly or through the use of replacement securities) and this rollover may occur outside the period of the financial crisis is not important. However, if the scheme allows new exchanges to occur, or increases to the level of assets exchanged, outside the period of the financial crisis then the government securities used are included in government debt.

- 21.90 The updated *Guidance Note* cleared up the ambiguity. Although the *Eurostat decision* has not been modified, the two options presented in it (see paragraph 21.82) have been clarified through the *Guidance Note* to be interpreted as:

“The government securities exchanged in temporary liquidity schemes, where the securities will return to government at a pre-determined date in a short period of time (and the risk of loss is expected to be small), are recorded as a securities lending transaction (i.e. they remain under the economic ownership of government and do not form part of government consolidated gross debt).

Where the window of initial exchange in a liquidity scheme is of a period more than that the financial crisis and/or where the risk of loss to government is not expected to be small, the government securities concerned will either be considered as not remaining under the economic ownership of government (schemes operated via central banks) ... government consolidated gross debt would be higher by the value of the securities concerned.”

- 21.91 The second option does not therefore apply to the Special Liquidity Scheme. The classification of the Special Liquidity Scheme is therefore as a securities lending transaction and the government securities used are not counted towards general government gross debt.
- 21.92 The final Eurostat position was surprising, as in previous discussions they had consistently argued in favour of recording government debt. The minutes of the 2009 EDP dialogue visit to the United Kingdom record that “The Special Liquidity Scheme (SLS) was also discussed. The opinion of the Bank of England (BoE) was that nothing at all should be recorded in the accounts of government. The opinion of Eurostat was, on the contrary, that the securities issued should be recorded as government debt. ONS was of opinion that SLS is not a standard security lending operation, but did not have yet a formal position on the recording. The ECB supported the opinion of the BoE.”
- 21.93 This shift in the Eurostat position can perhaps be attributed to the design of two subsequent liquidity schemes, in Greece and Cyprus, and plans for similar schemes elsewhere in the European Union.
- 21.94 In October 2008, the government of Greece announced their package of measures in response to the financial crisis. This included a temporary liquidity scheme where government will issue up to €8bn of specific purpose securities (with maturity 2 to 5 years) and lend them to banks against collateral, with guarantee-type fees and haircuts. The banks could use the government securities as collateral for borrowing from the European Central Bank and eurozone central banks.
- 21.95 In May 2009, the government of Cyprus announced a temporary scheme where it would issue €1bn of special short-term securities, with maturity December 2009. The banks could use the government securities as collateral for liquidity with the European Central Bank. Cyprus also issued €1.4bn of government bonds to its banks in December 2008.
- 21.96 In both these schemes government lends the securities directly, rather than via a central bank. Given the recording suggested in the CMFB opinion for exchange of assets between direct parties, it would perhaps have been inconsistent for a different recording to be adopted for a similar type of case in a different Member State that involves the central bank as an intermediary.

The Exchange between Central Bank and Participating Banks

- 21.97 The other main classification issue for the Special Liquidity Scheme was whether to record anything for the second stage of the scheme, where the Bank of England exchanges the treasury bills for the assets of participating banks.

21.98 ESA95 paragraphs 5.02-5.04 provide general information on financial transactions.

5.02. Considering the definition of a transaction (see paragraph 1.33), a financial transaction is an interaction between institutional units ... by mutual agreement, involving a simultaneous creation or liquidation of a financial asset and the counterpart liability, or a change in ownership of a financial asset, or an assumption of a liability.

5.03. Financial assets are economic assets, comprising means of payment, financial claims and economic assets which are close to financial claims in nature.

5.04. Means of payment consist of monetary gold, special drawing rights, currency and transferable deposits.

Financial claims entitle their owners, the creditors, to receive a payment or series of payments without any counter-performance from other institutional units, the debtors, who have incurred the counterpart liabilities.

Examples of economic assets which are close to financial claims in nature are shares and other equity and partly contingent assets. The institutional unit issuing such a financial asset is considered to have incurred a counterpart liability.

21.99 Although there is a legal transfer of ownership of the underlying assets, for a sale of assets to be recorded in National Accounts there needs to be an exchange of economic ownership.

21.100 The participating banks are still responsible for any losses on their securities used in the scheme. Additionally, although the interest earned on the collateralised assets will be received by the central bank, it will pass it through to the participating banks immediately. Both of these factors indicate that it is not really an exchange of assets as recognised in National Accounts. As the economic reality is not one of ownership transfer, we should not record two simultaneous straightforward financial transactions for acquisition of the assets.

21.101 Three other possibilities for National Accounts recording were considered for the exchange. Eurostat's *Accounting Consequences for Government of the Recent Financial Crisis* Task Force supported the recommendation that recording as a swap was inappropriate and reduced to the following two options: recording as back-to-back lending, or not recording anything.

21.102 Repurchase agreements (repos) are financial arrangements whereby a seller "sells" securities (typically government bills and bonds, or corporate bonds or shares) that it owns to another (the buyer, usually a bank). The 'sale' is made under a commitment to 'repurchase' the same (or similar) securities at a fixed price on a specified future date, or a date subject to the discretion of the buyer. Repos are usually very short-term, such as overnight or one day maturity.

21.103 The difference between the sum at which the asset is 'sold' and 'repurchased' is called the repo rate. It is effectively an interest rate. In a repo of reasonable maturity the cash interest is usually paid at the end, although it can be paid throughout. In National Accounts interest is accrued.

- 21.104 A repo differs marginally from a collateralised loan. In a collateralised loan the borrower places the collateral assets under a lien (right to take a property if an obligation is not fulfilled) to the lender. Physical possession of the collateral assets is with the lender during the period of the loan. When it is fully settled, the borrower gets ownership of the collateral assets back. If the borrower fails to clear the loan, the lender can dispose of the collateral assets to recover what they are due. If the disposal provides amounts that are insufficient to meet what was due, the lender has the legal right to recover the balance from the borrower.
- 21.105 For a repo, if the borrower defaults on repurchasing the securities, then the lender (also known as the repo buyer) can liquidate these assets. If the value of the securities has impaired, they stand to make a loss and can't recover this from the borrower. If there is a default and the market value of the assets has risen, they will make a profit. Thus, a repo carries more risk for the bank than a collateral loan does. Normally, repos are over-collateralised to reduce the amount of risk involved.
- 21.106 In most repos the securities do not actually change legal ownership and the buyer does not have the right to sell them onto a third party.
- 21.107 Each leg of the Special Liquidity Scheme could be viewed as involving two separate financial transactions: the sale and repurchase of the underlying asset. The economic nature is similar to both a collateralised loan and repo in that the 'lender' party appears to provide advances, secured on assets as collateral, and agrees a fixed price return at the time of the repurchase. The advances and return are not observed because they are offset by a similar transaction going in the opposite direction. In the Special Liquidity Scheme the securities do change legal ownership and the participating banks do have the right to sell them onto a third party, as long as they return similar securities at the time of redemption. In assessing the risk if there is a default, the scheme is more like a repo than a collateralised loan.
- 21.108 In National Accounts the underlying asset in a repo is deemed not to have been sold, and the economic reality recorded is that of a loan²⁴ in the financial account. The value of the loan can be seen to be the 'adjusted market value' of the securities, where the adjustment represents the risk factor present in the repo rate.
- 21.109 One factor considered here was the distinction between economic and legal ownership. A repo, or collateralised loan, involves the transfer of underlying assets that are legally owned. National Accounts uses the concept of economic ownership rather than legal ownership, so it is questionable whether there can be a repo or loan of assets where the seller does not economically own the assets and hence they are not part of the entity's National Accounts balance sheet (or possibly here not actually recorded in the National Accounts at all). The European Central Bank guidance on stock-lending states "[securities lent out under securities lending operations should remain on the original owners balance sheet](#)". Here, if an economic sale is not imputed for the first stage they would not be on the Bank of England's balance sheet in advance of the stock lending, and hence could not remain there.

²⁴ In the particular case, relevant here, of a monetary financial institution is the seller it is recorded in the F.29 other deposits category instead of the F.41 loans category.

21.110 If the alternative classification as a repo were judged appropriate, two repos would be recorded. Both parties to the repo are Monetary financial institutions (one in the central bank sub-sector, the other in the 'other' sub-sector of Monetary financial institutions) and both report loans are short-term.

Table 21.2

<u>Underlying asset</u>	<u>Central bank</u>	<u>Other MFI</u>
Government security	asset	liability
Banks' assets	liability	asset

21.111 The *Manual on Government Deficit and Debt* Part V Section 3 includes:

- 2) The difference between the selling price and the repurchasing price should be recorded as interest, on an accrual basis, and included in property income.
- 4) The treatment specified in ESA95 for repos is applicable only in the case the original seller of the asset has an unquestionable commitment to repurchase it under conditions agreed at inception.
- 6) In the case an economic agent resells an asset "acquired" under a repo arrangement, a negative entry is recorded in his balance sheet.
- 7) Only securities lending with cash may be treated in a similar way to repos.

Where there is an effective flow of cash, it is clear, from an economic point of view, that the case is very similar to a repurchase agreement transaction. There is no definitive change of ownership and there is a firm commitment concerning the reverse transaction on securities. Thus, the transaction should be recorded in loans or deposits, according to the general rules mentioned above.

On the contrary, securities lending without a flow in cash (generally without collateral and for very short maturity) should not be treated as a repurchase agreement. This case is not specified in ESA95 (or SNA). It is in fact a kind of "loan in materials" that is not recognised as a financial instrument. ESA 5.69 specifies that there is a loan "...when creditors lend funds to debtors". No transaction should affect the financial accounts (stocks and flows).

Where the distinction [between securities lending with cash and without cash] is not available, the treatment would depend on the estimated share (through specific information) of each kind of transaction within the global figures. It may be assumed that only a minority of these transactions is cash-free. Thus, in absence of reliable data, a "repo-like" treatment could be applied for the whole.

21.112 Similarly, the European Central Bank guidance notes to the regulation ECB/2001/13 on the MFI balance sheet statistics states (paragraph 110-112)

Securities lending without cash collateral

110. Securities lending without cash collateral involves one party lending securities to another party with a firm commitment to the return of the same (or similar) securities on a specified future date. Contrary to repo-like operations ... there is no exchange of cash collateral - either the collateral takes the form of other assets or there is no collateral at all.

111. For the purposes of euro area money and banking statistics, securities lending operations without cash collateral should not give rise to any entries on the balance sheet (i.e. should be treated as off balance sheet operations). To maintain consistency with the treatment of repo-type operations, securities lent out under securities lending operations should remain on the original owners balance sheet (and are not to be transferred to the balance sheet of the temporary acquirer) where there is a firm commitment to reverse the operation Furthermore, as cash (representing repayable collateral) has not been passed from the temporary acquirer to the original owner, no entries are to be made under 'deposits' or 'loans'.

112. If the temporary acquirer sells the securities outright, this sale should be recorded as a transaction in securities and entered in the portfolio of the temporary acquirer as a negative position in securities.

- 21.113 Although repos are usually very short-term, such as overnight or one day maturity, there is no requirement that they should be, and there are many examples of repos with maturity longer than a calendar quarter. ESA95 recognises the existence of repos with longer maturity than those of the exchanges proposed in this scheme.
- 21.114 The alternative to repo-type recording is to record no transactions (apart from the arrangement fees, which are part of gross operating surplus in the Generation of Income account). This option uses the interpretation that this is stock-lending with no cash collateral. The *Manual on Government Deficit and Debt* states “On the contrary, securities lending without a flow in cash (generally without collateral and for very short maturity) should not be treated as a repurchase agreement”.
- 21.115 While neither of the general conditions - being without collateral or for a very short maturity – apply here, there is nothing to suggest situations different from the general case should be included or excluded.
- 21.116 Part V, Section 3, 3g of the *Manual on Government Deficit and Debt* (see paragraph 21.64 of this article) actually states that this situation should be classified under ‘other accounts receivable/payable’ (AF.79) rather than as the recording of nothing. This is inconsistent with the European Central Bank guidance and the Eurostat Task Force judged it to be a mistake that needed to be corrected as part of the manual’s update process.
- 21.117 Although these are transactions where both legs can be viewed as ‘securities lending without cash collateral’, this is only because the collateral used is ‘swapped’. It could also be viewed as imputed securities lending with cash collateral, since the net cash position is zero.
- 21.118 To illustrate this key aspect further Table 21.3 shows entity A exchanges with entity B the financial instrument described in each row for the financial instrument described in the column.

Table 21.3

A/B	Cash exchanged	Security exchanged	Nothing exchanged
For cash	F.2 cash	F.4 repo	F.4 loan
For securities	F.4 repo	***	Nothing (stock-lending)
For nothing	F.4 loan	Nothing (stock-lending)	Nothing to record.

21.119 It is the security versus security entry we are trying to determine. This can be viewed as either the sum of the two green-shaded entries (security lending with cash) or the sum of the two yellow-shaded entries (security lending without cash). The net cash position is identical in both these scenarios, but the gross asset/liability position will be very different from the net asset/liability position.

21.120 The conventional interpretation here is to take the sum of the yellow entries. The European Central Bank regulation states that in the case of “Lending of securities without cash collateral or against securities collateral (exchange of assets), neither the lending/borrowing of the securities nor the possible posting of securities collateral gives rise to entry for any of the counterparties”. However, this case possibly questions this interpretation.

21.121 In the ‘record nothing’ option there is a further complication in that banks have performed ‘zombie securitisations’ to create securities for exchange in the scheme, e.g. where the issuance is bought up by the originator. Such issues are not recognised as ‘true sales’ in the National Accounts, therefore the resulting securities are not recognised as assets. For these securities the ESA95 paragraph 5.64a point (see paragraph 21.59) about whether the stock-lending rules allow this situation is relevant.

21.122 In September 2008 ONS requested Eurostat’s opinion on the Special Liquidity Scheme.

21.123 The Special Liquidity Scheme was the subject of a dedicated CMFB consultation. The consultation posed two questions, the second of which was: “How should the exchange of assets between the UK central bank and banks participating in the Special Liquidity Scheme be recorded?” The two options were as back-to-back repos or to record nothing (i.e., as stock-lending with no cash).

21.124 The voting in a CMFB consultation is not published, but the CMFB opinion records that, based on a large majority, “the exchange of assets between the UK Central Bank and banks participating in the Special Liquidity Scheme should be recorded as stock-lending with no cash”.

21.125 Eurostat accepted the CMFB opinion.

Impact on Public Sector Finances

21.126 There is only a minimal impact on public sector fiscal statistics from the Special Liquidity Scheme. The public sector benefits from the net fees receivable from stock lending, which impact on public sector current budget, public sector net borrowing and general government deficit.

21.127 The *Bank of England Annual Report 2009* shows, for the period from the start of the scheme to 28 February 2009, a £573m post-tax profit in relation to the Special Liquidity Scheme and a payment of £54m in fees to the Debt Management Office for borrowing treasury bills. The fees are retained by the Bank of England during the period of the scheme.

21.128 If Eurostat had decided the securities used should impact on general government gross debt, then transactions in treasury bills between government and the central bank would have been imputed. The impact on general government gross debt would have been £185bn (equivalent to 12.8 per cent of 2008 Gross Domestic Product) using the position reported at 30 January 2009. There would have been no impact on government deficit as the imputed interest accrued on the treasury bills would have been offset by an imputed dividend receipt by government from the Bank of England. There would have been no impact on public sector net debt as the transactions and positions are intra public sector and hence consolidate.

22. Discount Window Facility

The Bank of England made government securities available to participating banks and building societies from October 2008.

The facility has different recording, depending on whether the 30-day or 364-day exchange maturities are used.

For the 30-day exchange the government securities supplied by government to the Bank of England for use in the Discount Window Facility are recorded as a liability of government.

For the 364-day exchange the government securities supplied by government to the Bank of England for use in the Discount Window Facility are not recorded as a liability of government

The exchange of government securities for the assets of participants is considered as stock-lending and not recorded in the National Accounts.

Background

- 22.1 In October 2008 the Bank of England introduced its Discount Window Facility scheme to provide liquidity insurance to the banking system. This scheme has some similarities with the Special Liquidity Scheme (see chapter 21).
- 22.2 Banks and building societies are able to request an exchange of assets, including illiquid assets, for UK government securities (gilts) in a collateral exchange.
- 22.3 Unlike the Special Liquidity Scheme, the Discount Window Facility is designed to be a regular part of the Bank of England's regular sterling money market operations. Other differences are that the Discount Window Facility is not indemnified or guaranteed by the UK Government, it uses a different maturity of exchange and a longer-maturity underlying financial instrument.
- 22.4 The maturity of the exchange was set at 30 days. This compares to the 12-month maturity for exchanges in the Special Liquidity Scheme and the ability of participants to enter transactions in the Special Liquidity Scheme for up to three years.
- 22.5 However, the Bank of England announced on 19 January 2009 that, from 2 February 2009, an alternative maturity of 364 days was also being made available as a temporary measure.
- 22.6 The recording of the Discount Window Facility differs depending on which exchange maturity is used, so the transaction classification section of this chapter discusses each case separately.
- 22.7 To participate in the Discount Window Facility, banks and building societies have to pay a fee.
- 22.8 As at 30 June 2009 the Bank of England had not disclosed any use of the Discount Window Facility.

Overview of the Facility

- 22.9 The facility can be divided into three main stages. In the first, the government issues the government securities and then lends them to the Bank of England. In the second stage the central bank²⁵ exchanges them with participating banks' assets, charging a fee for doing so. In the third stage the participating banks are now the legal owner of the government securities and can use them for specified purposes.
- 22.10 On 22 October 2008, the National Loans Fund (classified as part of the central government sub-sector) issued £50bn of government securities specifically for the scheme²⁶. The maturity on the government securities varied, with redemption dates ranging from 2009 to 2055. The Debt Management Office (also classified as part of central government) purchases the government securities from the National Loans Fund. The Debt Management Office supplies the central bank with the necessary securities for the scheme on request when they are required²⁷.
- 22.11 In the compilation of the UK National Accounts and public sector finances any transactions within a sub-sector are consolidated. Therefore the transactions between the National Loans Fund and Debt Management Office consolidate out of the central government sub-sector accounts.
- 22.12 The government securities are not issued directly to the market, although the issuance will be at market rates. The Debt Management Office loans them to the central bank on request in a stock-lending arrangement.
- 22.13 Stock-lending is the temporary transfer of securities with agreement for their return at a pre-agreed time. As the Discount Window Facility was designed to make financing available in stressed conditions, the maturity of the exchange was originally set at 30 days. This compares to the 12-month maturity for exchanges in the Special Liquidity Scheme and the ability of participants to enter transactions in the Special Liquidity Scheme for up to three years.
- 22.14 The Bank of England announced on 19 January 2009 that, from 2 February 2009, an alternative maturity of 364 days was also being made available on a temporary basis.
- 22.15 The Debt Management Office receives a fee from the central bank for this stock lending.
- 22.16 Although legal ownership of the government securities passes to the central bank under the stock-lending transaction, apart from the fee there are no cash transactions and the Debt Management Office retains the cash 'interest' that would usually accrue to the government security holder. In such circumstances the economic ownership, decided through assessing risks and rewards, is judged to remain with the Debt Management Office.
- 22.17 The government securities will be exchanged by the central bank for participating banks' assets. Legal ownership of both the government securities and participating

²⁵ The Bank of England is generally referred to as the central bank in this chapter in order to avoid confusion with participating banks.

²⁶ See paragraph 6.13 of www.dmo.gov.uk/docs/remit/remit0910.pdf

²⁷ See www.dmo.gov.uk/documentview.aspx?docName=/gilts/press/sa211008.pdf

banks' assets will transfer. However, economic ownership would again usually be judged as remaining with the original asset holders in such circumstances.

22.18 Once a participating bank has entered into an asset exchange with the central bank, it can use the government securities freely in market transactions.

22.19 There is a contingency to use cash instead of government securities.

Sector classification

22.20 There are no significant controls/rights over participants imposed by the Bank of England, so the sector classification of participating banks is not affected.

Transaction classifications

22.21 In discussions with Eurostat it was acknowledged that the CMFB consultation on the Bank of England Special Liquidity Scheme may provide a precedent for the statistical treatment of the Discount Window Facility. However, the resulting recording decision did not follow the eventual Special Liquidity Scheme decision.

Classification as a central bank or central government scheme

22.22 Following discussion in the task forces, the background document to the Committee on Monetary, Financial and Balance of Payments Statistics (CMFB) consultation gave guidance that "In the specific case of central bank liquidity operations, these operations would generally fall within the central bank's existing remit to preserve financial stability, and should therefore not be re-routed through government."

22.23 However, the *Eurostat decision* of 15 July 2009 covers generic schemes involving exchange of government securities, so the Discount Window Facility is covered by it. Thus any relevant transactions in government securities would be recorded as a government liability and a central bank asset.

Whether to impute transactions or record nothing

22.24 The second main issue was whether to record anything in National Accounts, apart from the fees, for the scheme. The classification question here was whether (and if so, how) to record any imputed transactions between central government and central bank or to consider the activities similar to conventional stock-lending, where nothing is recorded.

22.25 A conventional issue of government securities would be recorded in the financial account in the ESA95 F.332 transaction category; as a government liability and an asset of the holder. The accounts would be balanced by a transaction in cash (ESA95 category F.2).

22.26 The issue of the government securities by the National Loans Fund and purchase by the Debt Management Office is, by convention, consolidated out of the UK National Accounts since both parties are in the central government sub-sector. Therefore, the government securities do not appear as an asset or liability on the National Accounts

central government balance sheet at time of issue, since they are both assets and liabilities of central government entities and are consolidated out of the balance sheet.

22.27 ESA95 paragraph 5.64a states that AF.332 securities “lent or subject to repurchase does not change balance sheet and remains classified in AF.332.” The guidance suggests that the asset holding of the securities does not change to the central bank sub-sector’s balance sheet. There is a counter-argument that the situation here is different from a conventional stock-lending or repo transaction as described in ESA95.

22.28 Eurostat's *Manual on Government Deficit and Debt*, Part V Section 3 states:

On the contrary, securities lending without a flow in cash (generally without collateral and for very short maturity) should not be treated as a repurchase agreement. This case is not specified in ESA95 (or SNA). It is in fact a kind of “loan in materials” that is not recognised as a financial instrument. ESA 5.69 specifies that there is a loan “...when creditors lend funds to debtors”. No transaction should affect the financial accounts (stocks and flows).

Generally, in the accounting system of the contracting parties there is no effect on the balance sheet but possibly an entry in the “off-balance sheet” in order to record the forward reverse transaction. But in some countries, portfolios reflect directly the transaction. Two cases should be distinguished.

Where the distinction between securities lending with cash and without cash is available, it would be better classifying the latter transaction under “other accounts receivable/payable” and not under deposits or loans.

22.29 However, 'very short maturity' is not defined - the convention in National Accounts for 'short' is less than one year, so it is probably reasonable for 'very short' to be interpreted as less than one month or even less. In stock-lending transactions such as repurchase agreements (repos) the maturity can be as short as overnight or the following day. The maturity here depends on which maturity exchange is being used, either 30 or 364 days. It is possible that the situation described in the manual is only referring to the overnight or following day type of transaction. Conversely, the generality does not rule out longer periods of maturity.

22.30 Similarly, another difference from the general situation described is that stock-lending usually takes place using assets issued by another entity. While from an institutional unit viewpoint this does occur here, from a National Accounts sectoral viewpoint it is not the case: the transaction between the two central government units is consolidated out of the accounts. This leads to central government lending its own “assets”, created specifically for this purpose, but which are not recorded in its balance sheet. So, while the manual does not rule out such a situation, it is open to interpretation whether this type of stock-lending is that envisaged by the manual or not. Conversely, the stock-lending of own assets could still be viewed as “lending of materials”.

22.31 In the international discussions on recording of liquidity schemes two options were considered: recording nothing; or an imputed issue of government securities and imputed acquisition by the central bank.

- 22.32 For purposes of recording general government gross debt for the Excessive Deficit Procedure there would be an increase in government debt from the second option but not from the first. Similarly, under the imputed debt option, at the end of the scheme the return of the government securities to government would lead to a consequent fall in government debt.
- 22.33 The 2009 CMFB consultation on the Special Liquidity Scheme asked “How should the provision of securities by the UK government to the central bank under the Special Liquidity Scheme be recorded?” The CMFB opinion presented to Eurostat reported that there was “no clear majority view in favour of either option”.
- 22.34 On 15 July 2009 Eurostat announced its guidance on recording ‘exchange of assets’ schemes as part of its decision on *The statistical recording of public interventions to support financial institutions and financial markets during the financial crisis* (hereafter referred to as the *Eurostat decision*). This presented two options, the first where no government debt was recorded and the second where the securities are deemed to have economically transferred and government debt is recorded:

“The government securities exchanged in temporary liquidity schemes, where the securities will return to government at a pre-determined date in a short period of time (and the risk of loss is expected to be small), are recorded as a securities lending transaction (i.e. they remain under the economic ownership of government and do not form part of government consolidated gross debt). This holds for both schemes directly between the government and financial institutions, and for schemes conducted via the National Central Banks.

Where the liquidity scheme is of indeterminate or not short duration and/or where the risk of loss is not expected to be small, the government securities concerned will either be considered as not remaining under the economic ownership of government (schemes operated via central banks) or recorded as back-to-back repurchase agreements (schemes operated directly by government). In both cases, government consolidated gross debt would be higher by the value of the securities concerned.”

- 22.35 In September 2009 Eurostat reissued its *Guidance Note* on the *Eurostat decision*. This provided the following interpretation for use in the second option:

The term “short duration” is used in the Eurostat Decision for schemes in a different sense from its existing use in financial accounts statistics (where the borderline between short and long term financial instruments, for example the maturity of securities, is one year). It is used in the Eurostat Decision to reinforce the idea of a temporary scheme, where the initial issuance of the stock of government securities involved takes place only during the period of the financial crisis, rather than to denote a particular length of time. That the stock of government securities may later be effectively rolled over (either directly or through the use of replacement securities) and this rollover may occur outside the period of the financial crisis is not important. However, if the scheme allows new exchanges to occur, or increases to the level of assets exchanged, outside the period of the financial crisis then the government securities used are included in government debt.

Classification of Discount Window Facility 364-day maturity exchanges

- 22.36 Although the *Eurostat decision* mentions the length and temporary nature of the liquidity schemes as important criteria rather than the maturity of the asset

exchanges, there is a different classification for the Discount Window Facility depending on whether the 30-day or 364-day exchanges are used.

- 22.37 The rationale for this is that the *Eurostat decision* applies exclusively to schemes where the activities that take place do so only within “the context of the financial crisis”.
- 22.38 The Discount Window Facility’s 364-day exchange is a temporary measure designed to be used in a timescale consistent with the financial crisis. Therefore, according to the *Eurostat decision* the government securities exchanged are recorded as securities lending transactions, i.e., they remain under government’s economic ownership, no transactions are recorded and there is no impact on general government gross debt.

Classification of Discount Window Facility 30-day maturity exchanges

- 22.39 The Discount Window Facility 30-day exchanges are part of a permanent scheme, so it fits Eurostat’s second option as presented in paragraph 22.34. The classification recording is thus as a transfer of economic ownership of the government securities.
- 22.40 The decision to record the government securities used in the Discount Window Facility 30-day exchanges but not for the Special Liquidity Scheme is at first glance surprising, since the Discount Window Facility generally operates to a much shorter maturity of exchange than the Special Liquidity Scheme and there is no risk to government as it operates without a government guarantee.
- 22.41 However, the *Eurostat decision* mentions the length and temporary nature of the liquidity schemes as important criteria rather than the maturity of the asset exchanges. The rationale for this is that the *Eurostat decision* applies exclusively to schemes where the activities taking place do so only within “the context of the financial crisis”. The inference of this position is that special rules have been created for the period of the financial crisis that would not necessarily apply outside to schemes that operate outside it.
- 22.42 The interest accruing on any government securities used should be imputed as a receivable for the central bank for the period they are using the securities. This is balanced in the accounts by an imputed dividend, paid by central bank to government, for the same amounts, so has no impact on general government net borrowing.

Impact on Public Sector Finances

- 22.43 There will only be a minimal impact on public sector fiscal statistics from the Discount Window Facility, as any transactions imputed for the 30-day exchanges are within the public sector (between government and central bank). The public sector will benefit from any net fees receivable from stock lending, which impact on public sector current budget, public sector net borrowing and general government deficit.
- 22.44 General government debt is increased by the size of the government securities being lent to the central bank for use in 30-day exchanges. Government expenditure and revenue both increase by the size of the interest accrual on the government securities.

22.45 The Bank of England publish data on average daily usage of the Discount Window Facility (£m) in their *Monetary and Financial Statistics* publication – see table D2.2.3 at www.bankofengland.co.uk/statistics/ms/current/index.htm. The data are published with a time lag, appearing only after the completion of any exchanges. For the period between 20 October 2008 and 30 June 2009, no usage of the Discount Window Facility is disclosed.

23. Credit Guarantee Scheme

Over £100bn of bank and building society borrowing has been guaranteed by government through the Credit Guarantee Scheme.

This is a government contingent liability. Nothing is recorded unless a guarantee is called.

Background

- 23.1 On 8 October 2008 the UK Government announced a support package for financial institutions (see chapter 15). One aspect of this package was the Credit Guarantee Scheme.
- 23.2 The scheme involved government granting up to £250bn in guarantees for bank and building society borrowing, with the intention to kick-start markets needed for inter-bank lending. The scheme was initially restricted to the eight main institutions: Abbey National plc; Bank of Scotland plc; Barclays Bank plc; HSBC Bank plc; Lloyds TSB Bank plc; Nationwide Building Society; The Royal Bank of Scotland plc and Standard Chartered Bank; see paragraph 15.5.
- 23.3 Since then, the following institutions had received an Institution Certificate pursuant to the scheme (as of 20 July 2009) and had either issued guaranteed liabilities or intend to do so: Close Brothers Finance plc; Clydesdale Bank plc; Investec Bank plc; Rothschilds Continuation Finance plc; Standard Life Bank plc; Tesco Personal Finance plc; Yorkshire Building Society.
- 23.4 Since 13 October 2008, the following institutions had received an Institution Certificate pursuant to the scheme (as of 20 July 2009) but had not issued guaranteed liabilities nor indicated intention to do so yet: Bath Investment & Building Society; Beverley Building Society; Britannia Building Society; Buckinghamshire Building Society; Cambridge Building Society; Chelsea Building Society; Chesham Building Society; Chorley Building Society; Co-operative Bank plc; Coventry Building Society; Cumberland Building Society; Darlington Building Society; Dudley Building Society; Ecology Building Society; Furness Building Society; Hanley Economic Building Society; Hinckley and Rugby Building Society; Ipswich Building Society; Kent Reliance Building Society; Leeds Building Society; Leek United Building Society; The Loughborough Building Society; Manchester Building Society; The Mansfield Building Society; Market Harborough Building Society; Melton Mowbray Building Society; Monmouthshire Building Society; National Counties Building Society; Newbury Building Society; Newcastle Building Society; Norwich and Peterborough Building Society; Nottingham Building Society; Penrith Building Society; Principality Building Society; Progressive Building Society; Saffron Building Society; Skipton Building Society; Stroud and Swindon Building Society; Sumitomo Mitsui Banking Corporation Europe Limited; Teachers Building Society.

- 23.5 The guarantees were for new short term and medium term debt issuance to assist with the refinancing of maturing wholesale funding obligations. The eligible instruments covered by the scheme were Certificates of Deposit, Commercial Paper and unsecured senior bonds and notes; issued in a six-month drawdown period from 13 October 2008. The guaranteed debt could be rolled over, with the guarantees ceasing on 13 April 2012. Complex instruments were excluded from the scheme. The term of the instruments was restricted to a maximum of three years and their currency denominated restricted to sterling, US dollars or euro.
- 23.6 The guarantees were issued on commercial terms, including an element based on the participants' Credit Default Swap spread.
- 23.7 The Debt Management Office (classified as central government) was appointed to run the scheme and HM Treasury provided the guarantees.
- 23.8 On 15 December 2008 modifications to the scheme were announced, to adapt the package to bring it into line with other European Union Member States' plans. This included retrospectively reducing the fee, as the minimum limits set by the European Commission for government fees in interventions were relaxed.
- 23.9 The instruments issued could now additionally be denominated in Japanese yen, Australian dollars, Canadian dollars and Swiss francs.
- 23.10 The December 2008 modifications received European Commission State Aid approval on 23 December 2008.
- 23.11 Further changes to the scheme were announced on 19 January 2009. The closure of the scheme's drawdown window period was to be extended from 9 April 2009 to 31 December 2009, subject to State Aid approval. During the drawdown window eligible institutions can issue new guaranteed debt. After the closure of the window they can continue rolling over the guaranteed debt: all of it until 13 April 2012 and up to one third of the total until the final maturity date, which remained unchanged at 9 April 2014.
- 23.12 The January 2009 modifications received European Commission State Aid approval on 15 April 2009 to extend the drawdown period to 13 October 2009. On 13 October 2009 further State Aid approval was granted to extend the scheme to 31 December 2009.
- 23.13 *HM Treasury Annual Report and Accounts 2008-09* states that by the end of December 2008 "approximately £100 billion of guaranteed bank debt had been issued under the scheme". In July 2009 HM Treasury confirmed that guaranteed issuance under had "now reached over half of the £250 billion total".
- 23.14 Table 23.1 is collated from information published by the Debt Management Office. It shows the amounts of publicly issued liabilities (to 19 May 2009) that have been guaranteed under the scheme. These will be bonds, rather than the commercial paper and certificates of deposits that the majority of the guarantees will cover. Issues have been denominated in sterling, euro and US dollars.

Table 23.1 – Guarantees of publicly issued liabilities under the Credit Guarantee Scheme (£bn), covering issues to 19 May 2009

Institution \ Date	End-2008	End-March 2009	End-June 2009
Royal Bank of Scotland	6.4	9.9	13.7
Lloyds TSB Bank	3.2	6.7	8.4
Barclays Bank	2.7	7.4	7.0
Bank of Scotland	5.4	5.4	5.2
Nationwide Building Society	1.5	1.5	1.5
Clydesdale Bank	0.75	0.75	0.75
Yorkshire Building Society	-	0.75	0.75
Standard Life Bank	-	0.5	0.5
Tesco Personal Finance	-	0.2	0.2
Total	20.0	33.1	38.1

23.15 Government takes on exposure to the effects of exchange rates when the financial institutions issue guaranteed securities that are denominated in foreign currency. This exposure is managed through financial derivative contracts (forwards) entered into at the inception of each individual guarantee. At end-March 2009 the total foreign currency issues were £0.1bn.

Sector Classification

23.16 The *Supplemental Deed* to the scheme does not appear to impose rights over participants beyond requirement for information and some consultation, so the sector classification of participating banks and building societies is not affected.

Transaction Classifications

23.17 ESA95 paragraph 5.05 explains that guarantees are contingent assets/liabilities that are not recorded in the National Accounts. If any amounts crystallise they are recorded as capital transfers payable from government.

23.18 The Eurostat decision of 15 July 2009 on *The statistical recording of public interventions to support financial institutions and financial markets during the financial crisis* states that:

“Guarantees are contingent instruments with no direct impact on government accounts when they are granted, unless there is written or other irrefutable evidence that they will be called.

In all cases, calls on government guarantees relating to the financial turmoil, whether met by cash payment or assumption of debt, are to be recorded as expenditure of government (capital transfers).”

23.19 The guarantee fees receivable are accrued over the period to which they relate, and recorded as other non-market output (ESA95 category P.13). These amounts are subtracted from government final consumption expenditure (ESA95 category P.3). In financial year 2008/9 the fees receivable were £0.5bn. The fee is payable every quarter, and is paid a quarter in arrears or on maturity, whichever is earlier.

Impact on Public Sector Finances

- 23.20 The fees receivable from private sector participants increase public sector current budget and reduce general government and public sector net borrowing. Contingent assets and liabilities have no impact on public sector net debt or general government gross debt.
- 23.21 Any calls on guarantees will decrease public sector current budget and increase general government and public sector net borrowing at the time the calls are made.

24. Guarantees on Business Loans

Two guarantee schemes and an investment fund were announced.

The guarantees offered in the schemes are contingent liabilities, so are not recorded when granted.

Calls on the guarantees are recorded as capital transfers when they occur.

Background

- 24.1 On 14 January 2009 the Government announced plans to guarantee bank loans to small to medium sized enterprises, in return for fees. The plans were made up of three separate schemes.
- 24.2 The first was the £10bn Working Capital Scheme, where government would guarantee half of £20bn of short-term bank loans to businesses that had turnover below £500m per annum. The guarantee was for half of the portfolio of loans that each participating bank had, rather than on individual loans.
- 24.3 The Working Capital Scheme started on 30 April 2009, when government announced that the first £1bn tranche of guarantees had been completed. The coverage of the scheme was extended on 1 May 2009 to include up to £5bn of top-up trade credit insurance to businesses that had had their cover reduced, while maintaining the maximum cover under the scheme at £10bn.
- 24.4 Government has set aside £225m to cover expected calls on the guarantees through loan defaults.
- 24.5 The second scheme announced was the £1bn Enterprise Finance Guarantee Scheme. In this scheme government will guarantee 75 per cent of individual bank loans, of maximum amount £1m with maturity up to end-March 2020, to businesses that had turnover below £25m per annum. The guarantees will be issued up to end-March 2010. The guarantee is again granted to the financial institution rather than the business.
- 24.6 In the event of default, the financial institution must first seek recovery from the business or its administrator or liquidator. Then it can claim from government. Batches of claims will be made quarterly. The fee charged by government is 2 per cent per annum on the loan balance outstanding, discounted to 1.5 per cent until end-March 2010.
- 24.7 Government has set aside £100m to cover expected calls on the guarantees through loan defaults.

- 24.8 According to the *Department for Business, Enterprise and Regulatory Reform Annual Report and Accounts 2008-09* £346m of loans had been offered by end-June 2009, which if accepted makes the government's guarantee exposure £260m, and a provision of £21m made.
- 24.9 Capital for Enterprise Limited administers the scheme for government. It became economically active in April 2008 and is classified as central government.
- 24.10 The third scheme was the Capital for Enterprise Fund, where government is setting up a £75m fund for enterprises with high levels of debt that can no longer borrow from traditional sources. Government is providing £50m and Barclays, HSBC, Lloyds TSB and Royal Bank of Scotland collectively another £25m. The fund is a debt for equity swap vehicle.
- 24.11 According to the *Department for Business, Enterprise and Regulatory Reform Annual Report and Accounts 2008-09* £8m of equity offers had been accepted by end-June 2009, so the public sector proportion of this would be £7m.

Transaction Classification

- 24.12 The first two schemes have similarities with the Small Firms Loan Guarantee Scheme, which the Enterprise Finance Guarantee Scheme effectively replaces. In the Small Firms Loan Guarantee Scheme government made a guarantee to the lender covering 75 per cent of individual loan amounts, for which the borrower pays government a two per cent annual fee²⁸ on the outstanding balance of the loan. The government exposure to the scheme at end-March 2009 was £464m.
- 24.13 Paragraph 5.05 of the *1995 European System of Accounts (ESA95)* explains that guarantees are contingent liabilities unless they are traded or marked to market. The two guarantee schemes introduced and the Small Firms Loan Guarantee Scheme do not meet this exception, so are contingent liabilities and not recorded in the government balance sheet.
- 24.14 When calls are made on the guarantees, the amounts called are recorded as capital transfers from government to the guaranteed party. This is recorded at the time that payments are due to be made. Any recoveries made are netted off the transfers.
- 24.15 The Capital for Enterprise Fund is not an institutional unit for National Accounts purposes. Any amounts deposited with the fund and not used are recorded as being directly invested in the financial instrument where they are invested in the short-term. When amounts are drawn down for equity investment by the fund managers this is recorded as a direct equity investment in proportion to the amounts each party invests. If the value of equity assumed by the fund is equivalent to the debt assumed (market price for securities, nominal value for loans), then is recorded as two financial transactions. If there is a difference in the values then a capital transfer is also recorded.

Potential Future Recording

- 24.16 The *European System of Accounts* is in the process of being updated, with the expectation that ESA10 will be implemented by European Union Member States by 2014. This update will lead to a different recording in the future for the guarantee

²⁸ This has been discounted to 1.5 per cent until 31 March 2010.

schemes, so it is explained here. ESA10 will be based on the *2008 System of National Accounts* (SNA08).

24.17 SNA08 recognises three types of guarantees on loans:

- (i) those provided by means of a financial derivative, such as a credit default swap. This type is actively traded and conform to the ESA95 exception;
- (ii) standardised loan guarantees, such as those used for export credit. These are guarantees issued in large numbers, usually for individually small amounts. These will be recorded similarly to non-life insurance, with premia and claims, and an entry in the balance sheet showing provisions for claims;
- (iii) one-off guarantees, such as those on loans or securities where the risk can't be measured with any degree of accuracy. These are considered as contingent liabilities unless granted by government to corporations where there is a very high likelihood of default, in which case they are recorded as in (ii).

24.18 The second and third types of guarantee differ due to standardised loan guarantees often being repeated transactions with similar features and a pooling of risks, which enables a probability-based estimate of losses. One-off guarantees are individual and it is thus more difficult for a reliable estimate to be made.

24.19 For standardised loan guarantees the fees are accrued over the period the guarantee covers. A financial liability – Provisions for calls under standardised loan guarantees (ESA10 category AF.66) is recorded in the balance sheet and represents the present value of expected calls less any amounts recoverable.

24.20 Under SNA08 the Working Capital Scheme, Enterprise Finance Guarantee Scheme and the Small Firms Loan Guarantee Scheme would be considered as Standardised loan guarantee schemes. If the unit conducting the activity qualifies as an autonomous institutional unit, and the fees charged cover the calls and its costs, it will be considered as a financial corporation. Capital for Enterprise Limited, a non-departmental public body, administers the Small Firms Loan Guarantee Scheme on behalf of government, so it is possible that this entity would be reclassified, from central government to a public financial corporation, under the new guidance if ESA10 fully reflects SNA08.

Impact on Public Sector Finances

24.21 The fees receivable from private sector participants increase public sector current budget and reduce general government and public sector net borrowing. Contingent assets and liabilities have no impact on public sector net debt or general government gross debt.

24.22 Any calls on guarantees will decrease public sector current budget and increase general government and public sector net borrowing at the time the calls are made.

25. The January 2009 Package

New measures announced

- 25.1 On 19 January 2009 the UK Government announced its second financial intervention package.
- 25.2 The package involved three new measures and modifications to four existing interventions “designed to reinforce the stability of the financial system”.
- 25.3 The three new measures announced were the Asset Protection Scheme, the Bank of England Asset Purchase Facility and a facility to guarantee asset-backed securities.

Asset Protection Scheme

- 25.4 The scheme allows banks to protect assets with uncertain values. A “first loss” amount is agreed and then government guarantees a high proportion of losses beyond that amount. A fee is paid, either through a capital instrument or in cash. Participants are subject to conditions, such as agreements on new lending. The scheme is expected to last at least 5 years. The assets typically remain on the commercial accounting balance sheets of the banks and are managed by them.
- 25.5 The Asset Protection Scheme is discussed in chapter 28.

Bank of England Asset Purchase Facility

- 25.6 In this scheme the Bank of England, through a special vehicle, purchases assets from banks in order to increase the availability of corporate credit by reducing the illiquidity of underlying assets. The funding for the facility comes from the issue of government securities. The facility also provided a separate strand for asset purchases for monetary policy purposes should the Monetary Policy Committee decide it would be a useful tool for meeting its inflation target.
- 25.7 The Bank of England Asset Purchase Facility is discussed in chapter 27.

Facility to Guarantee Asset-Backed Securities

- 25.8 A scheme to guarantee banks’ and building societies’ asset-backed securities was announced. The plan was that this would commence in April 2009, subject to State Aid approval. The detail was still being worked on at the time of the announcement.
- 25.9 The scheme to guarantee asset-backed securities is discussed in chapter 26.

Modifications to Existing Measures

- 25.10 The modifications to existing measures concerned the Credit Guarantee Scheme, Bank of England Discount Window Facility, Northern Rock plc and The Royal Bank of Scotland Group plc’s involvement in the recapitalisation scheme.

Credit Guarantee Scheme

- 25.11 The drawdown window for the Credit Guarantee Scheme was extended to end-December 2009, subject to State Aid approval.
- 25.12 The Credit Guarantee Scheme is discussed in detail in chapter 23.

Bank of England Discount Window Facility

- 25.13 An alternative longer maturity of exchange was available for the Bank of England's Discount Window Facility.
- 25.14 The Discount Window Facility is discussed in detail in chapter 22.

Northern Rock plc

- 25.15 A modification of Northern Rock plc's business plan was announced. This involved the cessation of the strategy to reduce Northern Rock plc's mortgage assets in order to repay the government loan. This was replaced with a plan to slow repayments and increase Northern Rock plc's mortgage lending, subject to State Aid approval.
- 25.16 Northern Rock plc is discussed in detail in chapter 7.

Recapitalisation Scheme

- 25.17 The Government's preference shares in Royal Bank of Scotland Group plc would be redeemed, using the proceeds of a government-underwritten ordinary share rights issue.
- 25.18 The Recapitalisation Scheme is discussed in detail in chapter 16 and the Royal Bank of Scotland Group plc in chapter 17.

26. Facility for Asset Backed Securities

Government guarantees residential mortgage backed securities.

The guarantees offered in the scheme are contingent liabilities, so are not recorded when granted.

Background

- 26.1 On 19 January 2009 a scheme to guarantee banks' and building societies' asset-backed securities was announced as part of the UK Government's second financial intervention package (see chapter 25).
- 26.2 Following State Aid approval the scheme was launched on 24 April 2009 and is capped at £50bn. The scheme is administered by the Debt Management Office. As at end-August 2009 the scheme had not been used.
- 26.3 The assets eligible for the scheme are UK residential property mortgage-backed securities, which have received a AAA credit-rating from at least two rating agencies without the guarantee. There are further restrictions on the quality of the portfolio of mortgage loans backing the securities.
- 26.4 These securities are usually issued by a Special Purpose Vehicle (SPV), which is separate from the institution that has granted the underlying mortgages. See Chapter 7 on Northern Rock plc for a description of securitisation operations.
- 26.5 The guarantees apply to eligible securities issued during a six month period from the commencement of the scheme, subject to extension at the discretion of HM Treasury. The guarantees will have a maximum term of either up to three years or up to five years. Up to one-third of the amounts guaranteed may be the latter maximum term.
- 26.6 The eligible institutions are those eligible for the Credit Guarantee Scheme (see chapter 23). Those taking part in the scheme are referred to here as the 'participants'.
- 26.7 The guarantee fee payable to government is based on the Credit Default Swap spread of the participant.
- 26.8 The scheme involves two types of guarantee being provided by government: the Credit Guarantee and the Liquidity Guarantee. The securities may have either of these types of guarantee but not both.

Credit Guarantee

- 26.9 The Credit Guarantee is an unconditional and irrevocable guarantee by government to cover the shortfall of payments of principal or interest due, if the participant is unable to do so.

26.10 In the event that the Credit Guarantee is called, government is entitled to be indemnified for amounts it pays out. This involves an unsecured counter-indemnity from the participant and a secured (over the relevant mortgage pool) counter-indemnity from the issuer. This right of recourse to the mortgage originator will mean a financial claim rather than immediate payment.

Liquidity Guarantee

26.11 The Liquidity Guarantee applies where the issuer of the securities fails to exercise a “call right” in accordance with the terms of the security’s documentation; or fails to purchase the securities from the security holders in accordance with the terms.

26.12 The participant is required to undertake to the issuer that it will provide the funds needed to meet the call or the purchase obligation. If it fails to provide the funds then government, as guarantor, will purchase the securities from the holder at the relevant price. This price is the principal outstanding, adjusted for interest accrued but unpaid and any losses on the portfolio of mortgage assets which are allocable to the securities.

26.13 In the event that the Liquidity Guarantee is called, government is entitled to be indemnified for amounts it pays out. This involves an unsecured counter-indemnity from the participant. Government, as the new holder of the securities will have all the rights of a holder and may sell them or require the participant to purchase them.

Transaction Classification

26.14 Securitisation is a complex area for statistical recording. There have been CMFB consultations on specific securitisations and a general consultation to create rules for those involving government, but the text for this is still not published.

26.15 The main difficulty here involves the artificial nature of the SPV. The fundamental question becomes one of whether the SPV and/or bondholders are at risk. While the set up is usually such that the risks appear to be passed from the originator, the use of techniques to reduce the risk to bondholders makes this more questionable. So the question becomes one of whether there is a true sale, and amongst the indicators used for this is the existence of guarantees. A government guarantee of a securitisation where government is the originator is viewed as not being a true sale and instead recorded as government borrowing. The guidance covers the case of a government guarantee of a securitisation where a non-government unit is the originator and there are flows from government, but the situation where there are no flows from government is not covered.

26.16 It is worth noting that not all the securitisation may be guaranteed, as securitisations often involve the issue of different tranches of bonds. Here it is just the senior AAA-rated tranche of bonds that will be guaranteed. However, the lack of activity on the securitisation markets (apart from originators buying up the bonds for use in the Special Liquidity Scheme) perhaps suggests that the guaranteed part may be the entire transaction to be recorded, if the expectation is that the less senior non-guaranteed bonds are bought by the originator.

- 26.17 The involvement of the originator in the 'right of recourse' suggests that the 'sale' to the SPV is not a true sale, as some of the risks are retained by the originator. In such a case National Accounts guidance (based on the *Manual on Government Deficit & Debt* [MGDD]) is that the SPV is classified as part of the originator, and thus to record the borrowing as from the originator.
- 26.18 The main classification question then becomes whether this borrowing should be re-routed via government.
- 26.19 As a basic rule the MGDD sees guarantees given by Government as contingent liabilities. There is a departure from this general rule when there is strong evidence the guarantee would be called.
- 26.20 ESA95 paragraph 5.05, reproduced below, describes contingent assets and liabilities.
- [5.05. Contingent assets are contractual arrangements between institutional units, and between them and the rest of the world, which specify one or more conditions which must be fulfilled before a financial transaction takes place. Examples are guarantees of payment by third parties, letters of credit, lines of credit, underwritten note issuance facilities \(NIFs\) and many of the derivative instruments. In the system, a contingent asset is a financial asset in cases where the contractual arrangement itself has a market value because it is tradable or can be offset on the market. Otherwise, a contingent asset is not recorded in the system.](#)
- 26.21 A contingent asset is a financial asset in cases where the contractual arrangement has a market value because it is tradable or can be offset on the market. The guarantee here is a contingent asset of the originator/SPV and a contingent liability of government.
- 26.22 For the Credit Guarantee any call of the guarantee is recorded as debt assumption (e.g. government taking over that proportion of the debt), but they will also have a financial asset in return (the recourse to the originator). For the debt assumption a capital transfer is recorded from government, with government taking over the portion of the liabilities through a financial transaction. For the claim, a capital transfer is recorded to government (equal to the market value of the claim), with government taking over the assets through a financial transaction. In assessing the market value of the claim the financial position of the corporation is analysed and if it is judged the corporation is unlikely to repay, for example if it is a persistent loss-maker, then the market value of the claim is set to zero.
- 26.23 For the Liquidity Guarantee, the call of the guarantee amounts to a purchase of an asset. This acquisition is priced at the value of the amounts owed, so may be higher than the market value of the securities, particularly as the guarantee is being called because of a default. Any difference between the market value and the acquisition price is recorded as a capital transfer (ESA95 category D.99) from government to the previous security holder and the acquisition is recorded at the market value.
- 26.24 The guarantees are recognised as contingent liabilities and not recorded in the National Accounts balance sheets.

Impact on Public Sector Finances

- 26.25 The fees receivable from private sector participants increase public sector current budget and reduce general government and public sector net borrowing. Contingent assets and liabilities have no impact on public sector net debt or general government gross debt.
- 26.26 Any capital transfers recorded as a result of calls on guarantees will decrease public sector current budget and increase general government and public sector net borrowing at the time the calls are made.

27. Bank of England Asset Purchase Facility

The Bank of England Asset Purchase facility used a Bank of England subsidiary to purchase corporate assets and government securities.

The subsidiary is not recognised as an institutional unit. In the first phase of purchases it is considered to be acting on behalf of government, in the second phase it is acting on behalf of the central bank.

Background

- 27.1 On 19 January 2009 the UK Government announced the Bank of England Asset Purchase Facility as part of its second financial intervention package (see chapter 25).
- 27.2 The scheme uses a Bank of England subsidiary, Bank of England Asset Purchase Fund Facility Limited (BEAPFF), to purchase assets. BEAPFF was granted a government indemnity due to its potential size. There is no indemnity fee.
- 27.3 This intervention is best described by separately considering its two phases: government-backed purchases and monetary policy based purchases.

Government-Backed Purchases

- 27.4 The intention was that BEAPFF would acquire up to £50bn of “high quality” private sector assets. It was created to increase the availability of corporate credit by reducing the illiquidity of underlying assets.
- 27.5 In this phase of the programme the asset purchases were financed by the Debt Management Office (classified as central government), which lent to the Bank of England. The Bank of England then on-lent to BEAPFF.
- 27.6 The Debt Management Office was to finance its loan through issuing treasury bills to the market and using cash from its existing debt management operations.
- 27.7 The list of eligible assets, authorised by HM Treasury, included corporate bonds, commercial paper, syndicated loans, paper issued under the Credit Guarantee Scheme (see chapter 23), and a limited range of asset backed securities created in 'viable securitisation structures'.
- 27.8 Asset purchases started in February 2009 with commercial paper issued by private sector corporations. Commercial paper generally has a three-month maturity. The purchase programme only lasted for about two weeks before this phase was suspended and the second phase of the programme implemented instead. The net purchases settled of commercial paper totalled £1.0bn, no other type of asset was purchased. The commercial paper holdings then ran down over time.

- 27.9 The Debt Management Office position with the Bank of England at end-March 2009 was £1.0bn. By end-June 2009 this had been repaid.
- 27.10 The Debt Management Office used cash from its existing debt operations to finance BEAPFF, no specific issuance of treasury bills was needed.

Monetary Policy Based Purchases

- 27.11 The second phase of the programme was designed to provide a framework for the Monetary Policy Committee to use asset purchases for monetary policy purposes.
- 27.12 On 5 March 2009 the Monetary Policy Committee announced its intention to start undertaking purchases.
- 27.13 This phase involved central bank funded purchases of private sector assets and of government securities from the secondary market. Up to £75bn was initially set aside for purchases, with authorisation for a further £75bn if necessary. Of this £150bn up to £50bn was intended for purchases of private sector assets. In August 2009 the Monetary Policy Committee voted to extend the ceiling on the facility to £175bn and this was authorised by the Chancellor of the Exchequer.
- 27.14 The Monetary Policy Committee votes each month on the amount of asset purchases it judges necessary to meet its inflation target. Using BEAPFF the Monetary Policy Committee is able to ease monetary policy further by injecting money into the economy. It does this through the purchase of assets with central bank money. The process has been referred to as 'quantitative easing'. For more information see <http://www.bankofengland.co.uk/monetarypolicy/assetpurchases.htm>
- 27.15 The central bank financing of this phase is achieved by crediting new issuance of money to the depository reserves that banks hold with the Bank of England.

Sector Classification

- 27.16 BEAPFF was incorporated as an entity legally owned by the Bank of England on 30 January 2009.
- 27.17 ESA95 paragraph 2.12, reproduced below, defines the requirements for a legal entity to be considered as an institutional unit for National Accounts purposes. These include the requirement that units must incur liabilities on their own behalf.

2.12. Definition: The institutional unit is an elementary economic decision making centre characterized by uniformity of behaviour and decision-making autonomy in the exercise of its principal function. A resident unit is regarded as constituting an institutional unit if it has decision-making autonomy in respect of its principal function and either keeps a complete set of accounts or it would be possible and meaningful, from both an economic and legal viewpoint, to compile a complete set of accounts if they were required.

In order to be said to have autonomy of decision in respect of its principal function, a unit must:

- (a) be entitled to own goods or assets in its own right; it will therefore be able to exchange the ownership of goods or assets in transactions with other institutional units;

- (b) be able to take economic decisions and engage in economic activities for which it is itself held to be directly responsible and accountable at law;
- (c) be able to incur liabilities on its own behalf, to take on other obligations or further commitments and to enter into contracts.

- 27.18 BEAPFF is considered not to qualify as an institutional unit, since the government indemnity results in BEAPFF effectively not taking liabilities on its own behalf. This argument was also used in the CMFB Task Force discussions to suggest that the French Société de Financement de l'Économie Française vehicle did not qualify as an institutional unit.
- 27.19 ESA95 paragraph 2.13c instructs that entities that do not qualify as institutional units are consolidated with the units that control them. Again, this is best discussed by separately considering the two phases: government-backed purchases and monetary policy based purchases.

Government-Backed Purchases

- 27.20 In this phase of the scheme BEAPFF can be viewed as effectively being consolidated with central government, since it is judged to be working as an agent of government.
- 27.21 The Tripartite authorisation of BEAPFF, its announcement as part of a government package with a government indemnity, and the subsequent instructions within a letter from the Chancellor of the Exchequer to the Governor of the Bank of England are all indicators that BEAPFF is working as an agent of government.
- 27.22 Strictly speaking there is no sector classification of BEAPFF in this phase. The classification is actually based on the principle of principal party recording, which has an identical effect to consolidating the entity with government. Principal party recording is described in ESA95 paragraph 1.41, although it requires supplementary information from SNA93 paragraphs 3.31 to 3.33 to give the complete context. These paragraphs are reproduced below.

Recognizing the principal party to a transaction

1.41. When a unit carries out a transaction on behalf of another unit, the transaction is recorded exclusively in the accounts of the principal. As a rule, one should not go beyond this principle and try, for instance, to allocate taxes or subsidies to ultimate payers or ultimate beneficiaries under the adoption of assumptions.

3.31 When a unit carries out a transaction on behalf of another unit, the transaction is recorded exclusively in the accounts of the principal. Some service output may be recognized with the intermediary. As a rule one should not go beyond this principle and try, for instance, to allocate taxes or subsidies to ultimate payers or ultimate beneficiaries under the adoption of assumptions.

3.32 For example, purchases a commercial agent makes under the orders of, and at the expense of, another party are directly attributed to the latter. The accounts of the agent only show the fee charged to the principal for intermediation services rendered.

3.33 A second example is the collection of taxes and the payment of subsidies, social benefits, etc., by one government unit on behalf of another. A central government may, for example, serve as an intermediary for local governments in collecting taxes. Then, if the central government lacks discretion about the amount of collection or distribution of the relevant monies, the transactions are recorded directly in the accounts of the local government. In general, tax revenues will be allocated directly to the non-collecting government when (a) it has full or partial authority over the setting of the tax, or (b) it receives automatically under the provisions of tax law a given percentage of the tax collected or arising in its territory.

- 27.23 SNA93 paragraph 3.32 describes "purchases a commercial agent makes **under the orders of**, and **at the expense of**, another party are directly attributed to the latter".
- 27.24 In terms of '**under the orders of**', the Government authorised the Bank of England to make the purchases and specified the types of assets. Although both parties are working together and authorisation would be required under the *Memorandum of Understanding* that the Tripartite Authorities operate under, the language of the authorisation suggests the Government is giving orders and thus the activity is undertaken on behalf of government. The Bank is "asked to set up and operate this facility".
- 27.25 In terms of '**at the expense of**', the fund is economically funded by government, through explicit and intended use of a deposit financed by and placed by government with the Bank of England, together with the cover of a government indemnity.
- 27.26 Therefore, even if BEAPFF was recognised as an autonomous institutional unit, its transactions would be rearranged to show the activity performed by government as the principal party.
- 27.27 Although financial statements are a different accounting discipline, used for a different purpose, it is worth noting that the Bank of England did not consolidate BEAPFF into its published financial statements in the *Bank of England Annual Report 2009* because "it has no economic interest in its activities."

Monetary Policy Based Purchases

- 27.28 The Monetary Policy Committee is not an institutional unit for the purposes of National Accounts. Its activities are included in the central bank sub-sector.
- 27.29 In this second phase BEAPFF is effectively consolidated with the central bank, since the activity is not funded by government and is conducted at the request of the central bank rather than government. This creates a split treatment, BEAPFF being effectively consolidated with government for the first phase and with the central bank for the second phase.

27.30 The 'government as principal party' recording used for the first phase is not appropriate here. To qualify for principal party recording the second party must be judged to both be acting 'on behalf of' and 'at the expense of' the principal party. Although the use of the facility for monetary policy based purposes required government approval, necessitating the Governor of the Bank of England having to write to the Chancellor of the Exchequer requesting consent, the purchases are for monetary policy reasons rather than on behalf of government.

27.31 Table 27.1 shows the judgements made in assessing whether government is the principal party in the four classification areas where it was considered.

Table 27.1 Assessment of appropriateness of government as principal party recording for UK cases

Case	'On behalf of'	'At expense of'	Principal party recording
Central bank lending to Northern Rock plc	No	No	No
Bank of England Special Liquidity Scheme	No	Yes – funded by use of government securities	No
Asset Purchase Facility: government-backed purchases	Yes – detailed authorisation in letter from Chancellor	Yes – funded by cash provided by DMO	Yes
Asset Purchase Facility: monetary policy based purchases	No	No	No

Transaction Classification

27.32 For the government-backed purchase phase only two transactions are shown, consistent with the principal party type of recording. The first is government issuing treasury bills, or reducing its stock of currency, to fund the acquisitions. The second is government purchasing the commercial paper. The transactions where government deposits the funds with the central bank, which then on-lends it back to government (BEAPFF), are ignored.

27.33 For the monetary policy purchase phase, this is best described in two steps. The first step is central bank purchasing the assets from a bank, either corporate bonds or government securities (recorded in ESA95 category F.3: securities other than shares), matched by a movement in currency (ESA95 category F.21). In the second step the bank deposits the currency with the central bank (the transactions in deposits and cash are both in ESA95 category F.2). The two transactions in currency cancel out.

27.34 If the banks then remove the currency from their deposit accounts, the deposit liabilities are replaced with currency liabilities and thus the central bank liability position is unchanged.

27.35 The government indemnity is a contingent liability, so is not recorded in National Accounts. In any case, for the government-backed purchase phase it would be irrelevant as the liability is from one part of central government to another so would consolidate out.

Impact on Public Sector Finances

Government-backed Purchases

- 27.36 All the transactions involved are financial, so there is no impact on public sector current budget, public sector net borrowing or general government net borrowing from them. There is a very minor effect on these measures due to income from net interest receivable, as government pays interest on the debt raised to fund the purchases and receives interest on the commercial paper.
- 27.37 There is no direct effect on public sector net debt. The issuance of debt to fund the purchases is a public sector liability, but the commercial paper acquired is classified as a liquid asset due to its short-term nature. In the calculation of public sector net debt liquid assets are netted off selected financial liabilities. There is however an impact on general government gross debt, since as this is a gross measure only the liabilities are recorded.

Monetary Policy Based Purchases

- 27.38 Again all the transactions involved are financial, so there is no impact on public sector current budget, public sector net borrowing or general government net borrowing. There is a secondary effect that impacts on the public sector measures due to interest payable and receivable. This is particularly relevant for the interest payable on government securities, which is now a consolidated transaction within the public sector since the central bank has acquired the securities.
- 27.39 For public sector net debt there is an increase in liabilities but also an increase in assets held by the Bank of England. By convention the commercial paper held is considered as a liquid asset due to its short-term maturity and hence netted off the liabilities when calculating public sector net debt. The corporate bonds are classified as illiquid. However, there is an additional contribution here to public sector net debt as the assets are recorded at nominal value and the liabilities incurred in purchasing them reflect the market price paid.
- 27.40 So, for corporate bond purchases public sector net debt conceptually increases by the market price paid for them. For purchases of government securities public sector net debt will increase through the replacement of the nominal value of the government securities (which are no longer recorded as the liability and the asset holders are both in the public sector so they consolidate) with the deposit liabilities that reflect the market value of the government securities purchased. For purchases of commercial paper public sector net debt will increase by the difference between the borrowing to fund the purchases and the nominal value of the commercial paper.
- 27.41 The impact on public sector net debt at end-March 2009 was £2.9bn. At end-September 2009 it was £17.0bn.
- 27.42 Table 27.2 shows estimates of the outstanding stock at end-March 2009, end-June 2009 and 27 August 2009. The estimates are derived from information in Table D2.3 of the Bank of England's *Monetary and Financial Statistics*, available at www.bankofengland.co.uk/statistics/ms/current/index.htm. The total stood at £162.2bn on 8 October 2009

Table 27.2 – Stocks of assets (market values) purchased by BEAPFF (£bn)

Period	Commercial paper	<i>of which DMO-funded</i>	<i>of which Bank of England funded</i>	Corporate bonds	Government securities	Total
End-March 2009	2.0	1.0	1.0	0.1	19.0	21.1
End-June 2009	1.9	0	1.9	0.8	102.9	105.6
27 August 2009	1.6	0	1.6	0.9	135.0	137.5

28. Asset Protection Scheme

The Royal Bank of Scotland Group plc will participate in the Asset Protection Scheme.

Its assets to be placed in the scheme total £282bn at nominal value, with maximum government guarantee exposure of £200bn.

Government guarantees a proportion of the losses on these assets above a certain level.

The guarantees offered in the schemes are contingent liabilities, so are not recorded when granted.

Any calls on the guarantees will be recorded as capital transfers when they occur.

Background

- 28.1 On 19 January 2009 the UK Government announced the Asset Protection Scheme as part of its second financial intervention package (see chapter 25). Further details on the scheme were published on 26 February 2009.
- 28.2 The Asset Protection Agency will run the Asset Protection Scheme on behalf of HM Treasury.
- 28.3 The scheme is a variant on the idea of a defeasance structure. In a defeasance structure government sets up an institution (sometimes called a bad bank) to buy up impaired assets (sometimes called toxic assets) or assets of uncertain value. These assets are often held to maturity, or until there is a recovery, and at that stage the profits/losses on the operation become visible.
- 28.4 The Asset Protection Scheme was designed to protect financial institutions against exposure to exceptional future losses on certain portfolios of assets, as part of attempts to restore confidence to financial markets, support financial stability and encourage lending needed for the economy.
- 28.5 Participating banks would first have to agree a "first loss" amount, which the banks would have to cover. Government then guarantees about 90 per cent of the losses beyond that with the banks exposed to the residual loss as an incentive to keep losses to a minimum.
- 28.6 A fee is paid by the banks for the guarantee, either in cash or through a capital instrument. Participants are subject to conditions, such as agreements on new lending. There is no date on the duration of the scheme but it is expected to last at least 5 years. The assets typically remain on the commercial accounting balance sheets of the banks and are managed by them. Disposals of these assets are then subject to Government approval. Under certain circumstances government may take ownership and/or management of the assets.

- 28.7 The scheme was, in the first instance, open to all United Kingdom incorporated authorised deposit-takers, including subsidiaries of foreign institutions, with more than £25bn of eligible assets.
- 28.8 Participation in the scheme will be subject to conditions, including a verifiable commitment agreed between the participant and government to “support lending to creditworthy borrowers in a commercial manner”.
- 28.9 The portfolios of eligible assets were expected to include: commercial and residential property loans most affected by current economic conditions; structured credit assets, including certain asset-backed securities; certain other corporate and leveraged loans; and any closely related hedges, in each case, held by the participant or an affiliate as at end-December 2008. In practice the eligible assets were determined on a case-by-case basis.
- 28.10 The duration of the scheme was expected to be at least five years.
- 28.11 The scheme was open to applications until end-March 2009. It was due to start in late in 2009 due to the need for State Aid approval, shareholder approval and detailed assessments of the assets involved.
- 28.12 On 26 February 2009, The Royal Bank of Scotland Group plc announced it intended to participate in the Asset Protection Scheme. On 7 March 2009, Lloyds Banking Group plc announced it intended to participate. Barclays plc considered participating in the scheme but announced on 30 March 2009 that it was not going to do so.
- 28.13 The Royal Bank of Scotland Group plc announced it would place assets in the scheme with a nominal value of £325bn and a market value of £302bn. The first loss amount, which The Royal Bank of Scotland Group plc would cover itself in its entirety, was set at £42.2bn. Any ‘second loss’ amounts beyond this would be borne 90 per cent by government and 10 per cent by The Royal Bank of Scotland Group plc. This applies to losses incurred on the assets on or after 1 January 2009. The participation fee was £6.5bn, which would be paid through issuing new ordinary B shares to government.
- 28.14 Lloyds Banking Group plc announced it would place assets in the scheme with a nominal value of £260bn and a market value of £250bn. The first loss amount, which Lloyds Banking Group plc would cover itself in its entirety, was set at £35.2bn. Any ‘second loss’ amounts beyond this would be borne 90 per cent by government and 10 per cent by Lloyds Banking Group plc. This applies to losses incurred on the assets and exposure on Lloyds Banking Group plc’s balance sheet as at end-2008. The participation fee was £15.6bn, which would be paid through issuing new ordinary B shares to government.
- 28.15 In *HM Treasury Annual Report and Accounts 2008-09* the scale of expected losses on the Asset Protection Scheme was estimated at £25bn.
- 28.16 On 3 November 2009 the Government announced that Lloyds Banking Group plc would not participate in the Asset Protection Scheme and confirmed that The Royal Bank of Scotland Group plc would participate but under revised terms. Those terms remain subject to final approval, including State Aid approval by the European Commission.
- 28.17 The revised terms for The Royal Bank of Scotland Group plc include a reduction to the number of assets placed in the scheme. The nominal value of assets, at end-

2008, to be included in the scheme reduced from £325bn to £282bn. The first loss amount, which The Royal Bank of Scotland Group plc would cover in its entirety, was increased to £60bn. Any 'second loss' amounts beyond this would continue to be borne 90 per cent by government and 10 per cent by The Royal Bank of Scotland Group plc.

- 28.18 The plan for the participation fee to be paid through issuing new ordinary B shares to government was scrapped and replaced with an annual fee of £0.7bn for the first three years, followed by £0.5bn for the remainder of the life of the scheme. There would also be an exit fee, which will be the largest of either £2.5bn or ten per cent of any 'regulatory capital relief' received while in the scheme. In either case the exit fee will be net of any annual fees already paid.

Sector Classification

- 28.19 Any additional controls on participants as conditions for entry to the scheme would be a factor in determining their sector classification. However, the two participants intending to use the scheme were already classified as public sector so any additional controls gained through the scheme are not relevant.
- 28.20 The Asset Protection Agency is classified to the public sector, in the central government sub-sector.

Transaction Classification

- 28.21 There are two main options for classifying this type of schemes: as a guarantee scheme or a defeasance structure.
- 28.22 With a guarantee scheme the assets remain on the banks' balance sheet and the government guarantee is a contingent liability. If losses result and calls are made, then capital transfers are recorded from government at the time the payments are due.
- 28.23 In a government defeasance structure the assets are considered as economically owned by government. The movement of the assets to a defeasance vehicle is usually matched by a purchase price, which depending on the market valuation (if available) of the assets may result in a capital transfer being imputed. If the assets are loans the market valuation is substituted by their nominal value, with any that are determined as irrecoverable cancelled prior to the transaction being recorded.
- 28.24 Although the borderline between these two cases is not described in the Eurostat classification decision of August 2009, discussions with Eurostat favoured the recording of the Asset Protection Scheme as a guarantee scheme rather than one where economic ownership of the assets has transferred. In some cases, such as the model used for ING's assets in the Netherlands, government is party to sharing gains as well as losses and there is a stronger case for the defeasance option.
- 28.25 Payments by government on losses under the scheme will be recorded as capital transfers from government to the recipients. The exact time of recording had not been decided at the time this article was published.

Impact on Public Sector Finances

- 28.26 The fees have no impact on public sector current budget or public sector net borrowing since they flow within the public sector. They reduce general government net borrowing. Contingent assets and liabilities have no impact on public sector net debt or general government gross debt.
- 28.27 Any capital transfers recorded as a result of settlement of the guaranteed losses will increase general government and public sector net borrowing at the time the calls are made.

29. Homeowners Mortgage Support Scheme

Government provided guarantees on deferred mortgage interest payments in particular circumstances.

The guarantees are classified as contingent liabilities.

Any calls on the guarantees are recorded as capital transfers.

Background

- 29.1 On 3 December 2008 the UK Government announced plans for a scheme designed to reduce property repossessions arising from mortgage payment difficulties.
- 29.2 Following discussions with mortgage lenders the Homeowners Mortgage Support scheme was launched on 21 April 2009.
- 29.3 The scheme is designed to help mortgage payers who have a fall in income leading to difficulty maintaining their interest payments on mortgages up to £400,000. In those circumstances, their home would be at risk: the mortgage loan could default, the mortgage provider possess it and sell it.
- 29.4 The scheme allows the mortgage payers to defer up to 70 per cent of the interest payments due into new debt for a maximum of two years, by which time it is hoped they will be able to resume payments at the full amount.
- 29.5 If they can not, the government is guaranteeing the mortgage providers for the amounts deferred. Government charges fees for the guarantees.
- 29.6 A £0.5bn contingent liability has been declared to Parliament in respect of this scheme.
- 29.7 The following six entities took part at the time of launch: Lloyds Banking Group; Northern Rock; The Royal Bank of Scotland; Bradford and Bingley; National Australia Bank Group (which includes Clydesdale Bank and Yorkshire Bank) and Cumberland Building Society. The first four are all classified as public sector. GE Money and Standard Life bank subsequently joined the scheme. At the time this article was finalised Bank of Ireland (which includes the Bristol & West plc mortgage arm), GMAC, Kensington and the Post Office planned to participate in the future.
- 29.8 The Council of Mortgage Lending stated that it "does not expect that the guarantee will be triggered in many cases, as the scheme is aimed at borrowers who expect to be able to resolve their difficulties and resume full mortgage payments within a year or two."

Transaction Classification

- 29.9 Paragraph 5.05 of the *1995 European System of Accounts* (ESA95) explains that guarantees are contingent liabilities, unless they are traded or marked to market, and are thus not recorded in the government balance sheet.
- 29.10 If calls are made on the guarantees, the amounts called are recorded as capital transfers from government to the guaranteed party. This is recorded at the time that payments are due to be made.
- 29.11 If there is a call on the guarantee, government assumes the debt from the households sector. This is recorded as a capital transfer (ESA95 category D.99) from government to households and is matched by government assuming the part of the loan that the guarantee relates to (a financial transaction in ESA95 category F.42, long-term loans). Government is then shown repaying the loan to the mortgage provider in the other monetary financial institutions sub-sector (a financial transaction in ESA95 category F.42, long-term loans), matched by the payment of cash (a financial transaction in ESA95 category F.21, currency).

Impact on Public Sector Finances

- 29.12 There is only a minimal impact on public sector fiscal statistics from the Homeowners Mortgage Support scheme. Government benefits in the first two years of the scheme from the guarantee fees, which impact on public sector current budget, public sector net borrowing and general government deficit.
- 29.13 Any calls on the guarantees are recorded as government expenditure, which decreases public sector current budget and increases public sector net borrowing and general government deficit, at the time of the calls.
- 29.14 At the time of publication of this article there is no information in the public domain on the take-up of the scheme.

30. Dunfermline Building Society

On 28 March 2009 the FSA determined that Dunfermline Building Society was likely to fail to meet its threshold conditions.

On this date it was reclassified from the private Sector to the public Sector.

The social housing loan portfolio was transferred to DBS Bridge Bank Limited, which is classified in the public sector.

The portfolio was sold in July 2009.

The residual part of Dunfermline Building Society, now in an administration procedure, is classified as public sector.

Background

- 30.1 The Dunfermline Building Society was established in 1869. It was Scotland's largest building society. A building society is a mutual organisation owned by its members: broadly, those customers with certain deposits and mortgages.
- 30.2 Its main activities were retail saving deposits and mortgage lending.
- 30.3 At end-December 2007 it had £3.2bn of financial assets and £3.3bn of financial liabilities.
- 30.4 Dunfermline Building Society had a number of commercial and residential mortgages that had impaired. They required a significant write-down to the previous carrying value in its audited financial statements for 2008. Principally as a result of this write-down, Dunfermline Building Society was expected to record a loss of £26m in its income statement for 2008. As building societies do not have shareholders it is more difficult for them to recapitalise than it is for banks.
- 30.5 Speculation over the 2008 results caused a loss of confidence in Dunfermline Building Society, leading to the withdrawal of some deposits.
- 30.6 On 28 March 2009, the Financial Services Authority determined that Dunfermline Building Society was likely to fail to meet its threshold conditions and that, having regard to timing and other relevant circumstances, it was not reasonably likely that actions could be taken to enable Dunfermline Building Society to satisfy these conditions. This determination triggered the special resolution regime under the *Banking Act 2009*.
- 30.7 The *Banking Act 2009* received Royal Assent in February 2009. The centrepiece of it is a new, permanent process, the *Special Resolution Regime*, which provides the Tripartite Authorities with a range of tools to deal with banks and building societies that are failing. It replaced the temporary and expiring legislation, the *Banking (Special Provisions) Act 2008*, which was used to deal with Northern Rock plc in February 2008, Bradford and Bingley plc in September 2008, and Heritable Bank plc and Kaupthing, Singer & Friedlander Limited in October 2008.

- 30.8 The Bank of England considered whether to exercise any of the stabilisation powers under the *Banking Act 2009*. It concluded, following consultation with the other Tripartite Authorities and an evaluation of the possible resolution options, that Dunfermline Building Society should not be placed in the *Banking Act 2009*'s bank insolvency procedure and that a purchaser should be sought for some or all of its assets and liabilities. A competitive auction was held.
- 30.9 The bulk of Dunfermline Building Society's business, including its retail and wholesale deposits, residential mortgages, headquarters and branch network, was transferred to Nationwide Building Society on 30 March 2009 by way of a property transfer instrument made under the *Banking Act 2009*.
- 30.10 This transfer included a payment of £1.5bn to Nationwide Building Society representing the difference between the value of the assets and the liabilities transferred.
- 30.11 On 30 March 2009 Dunfermline Building Society's £0.5bn social housing lending assets, and associated deposits, were transferred to a company wholly-owned by the Bank of England, which was subsequently renamed DBS Bridge Bank Limited. The intention was to permit the Bank of England to support the social housing portfolio, consistent with the objectives of the special resolution regime, and to provide more time to secure a permanent solution, e.g. by way of a sale of the business.
- 30.12 The remainder of Dunfermline Building Society was placed into the Building Society Special Administration Procedure on 30 March 2009, using *The Building Societies (Insolvency and Special Administration) Order 2009*. The business included £0.65bn of commercial property loans, £0.25bn of acquired residential mortgages (principally from Lehman and GMAC), plus subordinated debt and certain treasury assets and derivatives relating to swaps entered into for hedging purposes. Dunfermline Building Society in building society special administration is referred to hereafter as DBSiA.
- 30.13 Under the *Dunfermline Building Society Property Transfer Instrument 2009*, HM Treasury acquired rights as a creditor in the winding up of DBSiA by its special administrators. The rights were for an amount equal to the payment made by HM Treasury, including the amounts relevant for the FSCS.
- 30.14 On 1 July 2009 the assets and liabilities of DBS Bridge Bank Limited were sold to Nationwide Building Society following a competitive auction.

Sector Classification

- 30.15 On 29 March 2009 Dunfermline Building Society is reclassified as a public financial corporation. It retains its sub-sector classification as an other monetary financial institution.
- 30.16 From April to June 2009 DBS Bridge Bank Limited is classified to the public sector as a public financial corporation, specifically an other monetary financial institution.
- 30.17 When the transfer of assets and liabilities to Nationwide Building Society takes place in March 2009 Dunfermline Building Society is part of the public financial corporation sector. The remainder of Dunfermline Building Society, now in building society special administration, continues to be classified in the public sector as a public financial corporation, specifically an other monetary financial institution.

30.18 A building society special administration order effectively passes control to the special administrators. When a private sector corporation enters administration its classification is usually unaffected. Here, the property transfer instrument relinquished the members' rights and hence transferred economic ownership away from the members. The main creditor of DBSiA is HM Treasury and hence they are judged to be the effective economic owners.

Transaction Classification

March 2009 Transfers to Nationwide Building Society

30.19 The transfer of the £2.3bn retail deposits business was funded, in part, by cash from within government. The Financial Services Compensation Scheme (FSCS) will eventually contribute to the costs of the transfer. The value of net liabilities transferred was £1.5bn, with the cash payment being £1.6bn. The remaining £0.1bn is recorded as a capital transfer from government to Nationwide Building Society in March 2009.

30.20 The National Accounts recording of the transfer of funds is similar to that used in the Bradford and Bingley plc and Icelandic cases. As FSCS is classified to central government there is no need to split amounts into FSCS-covered and non-FSCS amounts.

30.21 Firstly, a £2.3bn capital tax is recorded as being levied on Dunfermline Building Society, of which £0.8bn is recorded as being settled using the proceeds of assets transferred to Nationwide Building Society. The other £1.5bn is recorded as an Other account receivable asset (ESA95 category F.79) for government. This will be reduced when the assets of DBSiA are realised.

30.22 The transactions are recorded in the following sequence:

(a) cancellation of deposits between Dunfermline Building Society and depositors: (i) a £2.3bn capital transfer (ESA95 category D.99) from the households sector to public financial corporations and (ii) the 'repayment' of the deposit liabilities by public financial corporations to households (ESA95 categories F.22 and F.29);

(b) a £2.3bn capital tax (ESA95 category D.91) from public financial corporations (Dunfermline Building Society) to central government, balanced by an other account payable (ESA95 category F.79) by public financial corporations to central government.

(c) a compensation payment from government to households; (i) a £2.3bn capital transfer (ESA95 category D.99) from central government to households; (ii) which households then deposit with Nationwide Building Society (ESA95 categories F.22 and F.29). £1.6bn of cash is transferred from government to Nationwide Building Society and the remainder is temporarily recorded as an other account payable;

(d) the transfer sale of other assets/liabilities from DBSiA to Nationwide Building Society. These are recorded as first being sold/assumed by government from Dunfermline Building Society, as transactions in the underlying assets and liabilities, as partial settlement of the other account payable mentioned at (b). The actual repayment recorded is equivalent to the value of the net assets sold, £0.8bn;

(e) the assets/liabilities assumed at (d) are then transferred by government to Nationwide Building Society. The £0.1bn difference between the net assets transferred, including the settlement of the temporary other account payable mentioned in (c), is recorded as a capital transfer (ESA95 category D.99).

- 30.23 From the perspective of the households sector all the transactions mentioned in the previous paragraph cancel out: all that has happened is that their deposits are with a different entity.
- 30.24 From the perspective of the public financial corporations sub-sector there is a tax payable largely matched by a capital transfer receipt in the non-financial account, leaving a £0.1bn effect on net borrowing. In effect the public financial corporations sub-sector is being charged for the premium paid to Nationwide Building Society.
- 30.25 From the perspective of the central government sub-sector there is a tax receivable matched by a capital transfer payment in the non-financial account, which cancel out leaving no effect on net lending/borrowing, and a payment of cash in the financial account matched by a receivable for the tax asset.
- 30.26 From the perspective of the private sector, deposit liabilities, mortgage assets and other assets and liabilities have increased matched by a receipt of cash. There is a £0.1bn increase in net lending reflecting the premium paid to Nationwide Building Society.

Transfer of Social Housing Portfolio to DBS Bridge Bank Limited

- 30.27 The separation of the social housing loans and related deposits from the other activities of DBSiA, and transfer of them to DBS Bridge Bank Limited, does not give rise to any transactions. This is because both DBSiA and DBS Bridge Bank Limited are in the same sub-sector of the public sector.
- 30.28 The economic owner of DBS Bridge Bank Limited is considered to be the central government sub-sector rather than the Bank of England, which is the legal owner. This is because the net proceeds on disposal will go to DBSiA and the main ultimate creditor is therefore central government.

Bank of England Lending Facility

- 30.29 The Bank of England granted a short-term £190m facility to DBS Bridge Bank Ltd and a £10m facility to DBSiA. This is recorded as central bank lending to public financial corporations when amounts are drawn on it. Government provides a guarantee to cover any losses the Bank of England makes on these facilities. The government guarantee is considered a contingent liability.

Transfer of the Business of DBS Bridge Bank Limited to Nationwide Building Society

- 30.30 The transfer of £0.5bn of loans and the related deposits from DBS Bridge Bank Limited to Nationwide Building Society is recorded as a transaction in the financial assets transferred. The £0.1bn difference between the price paid by Nationwide Building Society and the value recorded for the net assets in the National Accounts is recorded as a capital transfer (ESA95 category D.99).

Subsequent Transactions

30.31 If the assets of DBSiA are insufficient to settle the financial liability recorded for the FSCS amounts (see paragraph 30.19), then FSCS members will be levied to recover the amounts owed. This will be recorded as central government cancelling the capital tax amount outstanding (recorded as a capital transfer followed by a transaction in accounts payable) and then levying the FSCS members for this amount (recorded as a capital tax).

Impact on Public Sector Finances

30.32 The first transfer to Nationwide Building Society results in an impact on public sector net borrowing of £0.1bn, reflecting the premium on the price paid for assets/liabilities transferred over their market price. Public sector current budget and general government deficit are unaffected. The second transfer to Nationwide Building Society, also results in an impact on public sector net borrowing of £0.1bn, reflecting the premium.

30.33 The impact on public sector net debt and general government gross debt from the transfer of Dunfermline Building Society assets and liabilities to Nationwide Building Society is £1.6bn. This amount will reduce when assets are realised – the sale of the business of DBS Bridge Bank Limited in July 2009 reduced it by £0.4bn. The impact of the public sector classification of DBS Bridge Bank Limited on public sector net debt is de minimis. The impact of the public sector classification of DBSiA on public sector net debt is about £50.

31. Effects of Interventions on Fiscal Statistics

The biggest impact of the financial interventions on the UK's fiscal measures is on public sector net debt through the reclassification of financial corporations.

The exact effect of the reclassifications on public sector net debt has not been quantified yet but is expected to be about £1.5 trillion.

The direct impacts of the interventions on public sector net borrowing and public sector current budget are not significant because the reclassification of the financial corporations leads to many transactions being within the public sector and hence not affecting these aggregates.

Modelled estimates, which include imputations for the borrowing costs of government, to finance the interventions, show that the net costs for central government were £4.7bn in 2008 and a further £3.3bn in the first three quarters of 2009.

These modelled estimates show that central government's net debt position for the interventions was £5.2bn at end-2008. It had fallen to £2.8bn at end-September 2009 mainly as a result of higher equity values for its shareholdings in financial services groups

Government contingent liabilities are estimated at about £330bn at end-September 2009.

Approximate Effects on Fiscal Statistics of Public Sector Interventions

- 31.1 This chapter estimates the direct effects of the interventions on the United Kingdom's public sector finance statistics and the European Union's general government statistics for the Excessive Deficit Procedure. It brings together in one place all the information in the sections in each chapter on 'impact on public sector finances'.
- 31.2 The tables in this chapter only show the public sector interventions as described in the earlier chapters of this article. It is important to emphasise what is excluded, so that the data are not misrepresented. The tables exclude support measures for non-financial institutions, such as the car scrappage scheme; effects of general economic support measures, such as the change in rates of Value Added Tax, changes in Financial Services Compensation Scheme levies, policies on social benefits, the costs of public sector staff resource, legal fees, and any modelling of the consequences for the economy if the interventions had not taken place, such as the beneficial effects on the economy and the impact on future tax revenue, benefit payments etc.

31.3 The estimates reflect the impact of the whole intervention at the time it takes place, not just the effect of reclassifying an entity. For example the effect of reclassifying Northern Rock plc as an entity on public sector net debt in 2007 was £75.4bn but the financing of the Bank of England's lending to Northern Rock plc added another £26.9bn. The public sector net debt figure quoted for the Northern Rock intervention is thus £102.3bn.

Transaction Measures

- 31.4 Table 31.1 shows estimates of the direct impact of the interventions on the two main UK fiscal transaction measures (public sector current budget and public sector net borrowing) and the European Union fiscal measure of general government net borrowing.
- 31.5 The measures reflect, where appropriate, impacts on revenue arising from guarantee fees, interest receivable on loans and preference shares, and production and capital tax receivables. The associated impacts on expenditure arise from the interest payable on directly observable financing from loans, capital transfers and imputed subsidies of the effect of guarantees on borrowing.
- 31.6 Directly observable financing refers to where there is identifiable borrowing to fund an intervention. For example, in the Bradford and Bingley plc case the Financial Services Compensation Scheme received a loan from the Bank of England. This loan is recorded as a government liability and the interest payable on the loan is included in general government net borrowing²⁹. When government borrows from the market, indistinguishable from its general policy borrowing requirement, to finance an intervention the associated interest payable is not covered in this table. This effect is modelled in later tables in this chapter.
- 31.7 The operating performance of financial institutions classified to the public sector will also have an impact on the public sector measures. These are excluded from the tables, although this exclusion should not distort the results shown. In many cases the large commercial accounting losses reported arise from the writing down of asset values, which will generally not impact on these measures. This is explained further in paragraphs 31.55 to 31.71.
- 31.8 A positive value in Table 31.1 represents an increase in the measure, e.g. public sector current budget rises due to net revenue, or for the net borrowing measures more net borrowing is required.
- 31.9 Most interventions do not impact on the public sector fiscal statistics because they take place between government and public financial corporations and hence the transactions are within the public sector and consolidate out of public sector measures.

²⁹ It does not impact on the public sector measures since the interest is payable between public sector entities.

Table 31.1 - Transaction Measures (£bn)

	Date	PSCB	PSNB	GGNB
Northern Rock	2008	0	0	-0.1
Bradford and Bingley	2008	0	0	3.4
Royal Bank of Scotland	2008	0	0	2.3
Lloyds TSB	2009	0	0	0.9
HBOS	2009	0	0	2.5
Special Liquidity Scheme	2008	0.5	-0.5	0
Credit Guarantee Scheme	2008/9	0.5	-0.5	-0.5
Royal Bank of Scotland	2009	0	0	0.1
Lloyds Banking Group	2009	0	0	-0.2

Key

PSCB = Public sector current budget

PSNB = Public sector net borrowing

GGNB = General government net borrowing

- 31.10 Table 31.1 shows that there is little impact on general government net borrowing from the interventions. That said, the increase shown in general government net borrowing for 2008 is still relatively high compared with that of other European Union countries, being roughly double that of the rest of the European Union combined. The only other European Union country to record a high impact is Germany.
- 31.11 Although the consequences for the public sector finances of the economic recession that developed during the financial crisis is evident in the increased amounts of public sector borrowing, one general question asked is why the financial crisis does not have a larger impact on these measures.
- 31.12 There are four main reasons for this:
- (a) the figures quoted in the media are often the maximum exposure of an intervention rather than actual amounts used or the expected losses;
 - (b) the interventions are often in the form of guarantees, which are contingent liabilities that may or may not crystallise into losses in the future;
 - (c) in the interventions where government provided cash to financial corporations these are mainly financial transactions, for example government acquiring financial assets such as shares in recapitalisations or making loans, whereas current budget and net borrowing are measures of non-financial transactions;
 - (d) the real impact for governments will be on how these financial assets revalue over time, i.e., whether there are holding profits or losses, and whether the contingent liabilities crystallise into losses.
- 31.13 The eventual performance of financial assets such as shares and securities is shown in the financial balance sheet, although there are secondary effects that will impact on the non-financial account, such as interest payable on the borrowing needed to

acquire them and decreases/increases in borrowing as a result of the profits/losses at the time of their disposal.

- 31.14 In assessing the full picture it is important therefore to concentrate on the full suite of accounts, including revaluation accounts and balance sheets, and also on information that is outside the national accounts system, such as contingent assets and liabilities.
- 31.15 In explaining the Eurostat decisions on recording interventions made during the financial crisis, Walter Radermacher, Director-General of Eurostat, was quoted in the *Financial Times* as saying “We will give information about contingent liabilities or implicit debt that has not yet materialised into actual debt. As with rainfall, we will be giving information about the clouds on the horizon. As soon as the rain starts raining, we will record it.”
- 31.16 In this analogy the clouds are the balance sheet of assets plus contingent liabilities and the rain is the resulting transactions that will be recorded if the clouds produce rainfall.

Debt Measures

- 31.17 Table 31.2 shows estimates of the direct impact of the measures on the UK fiscal debt measure of public sector net debt and the European Union fiscal debt measure of general government gross debt.
- 31.18 In Table 31.2 the impact on debt data shown for a given year generally refers to the time when the intervention occurred unless stated otherwise. The debt impacts reflect the government borrowing required to finance the intervention but not the interest accruing on that financing.

Table 31.2 - Debt measures (£bn)

	Date	PSND	GGGD
Northern Rock	2007	102.3	0
Northern Rock	End-2008	0	15.7
Bradford and Bingley	2008	48.0	18.0
Icelandic deposits	2008	1.0	0.0
Heritable	2008	0.5	0.5
Kaupthing Singer & Friedlander	2008	2.5	2.5
Landsbanki London	2008	4.5	4.5
London Scottish	2008	0.3	0.3
Royal Bank of Scotland	2008	}	19.8
Lloyds TSB	2009	} 1000-1500	5.4
HBOS	2009	}	11.4
Lloyds Banking Group	2009	0	-2.1
Dunfermline Building Society	2009	1.3	1.2

Key

PSND = Public sector net debt

GGGD = General government gross debt

- 31.19 The biggest impact of the financial interventions on any fiscal measures is on public sector net debt through the reclassification of financial corporations. The impact on debt measures is much larger than that on the transaction measures.

- 31.20 For public sector net debt this mainly reflects the reclassification of financial corporations into the public sector. While Northern Rock plc added over £100bn to public sector net debt, and Bradford and Bingley plc over £40bn, the reclassifications of Royal Bank of Scotland Group plc and the entities making up Lloyds Banking Group plc are on a much larger scale. When they were reclassified ONS announced that the impact on public sector net debt was between £1tn and £1.5tn. At the time of publication of this article the work to quantify this impact and implement it in the public sector finances was still ongoing.
- 31.21 In 2008 the impact on United Kingdom general government debt is about 25 per cent of the European Union total. The United Kingdom ranks second, behind the Netherlands. These two and Germany cover over 70 per cent of the European Union total.
- 31.22 The impact on general government gross debt is much lower than that on public sector net debt, as it just includes the increased liabilities that government takes on as part of the interventions.
- 31.23 The general government debt measure is a gross liability measure, assets are not netted off. The liabilities included are deposits, securities other than shares³⁰ and loans. The coverage of public sector net debt is also mainly liabilities, although 'liquid assets' are netted off it. It is important to recognise here that while the interventions have resulted in increased financial liabilities, they have also resulted in increases to government assets that are not reflected in these measures of debt.
- 31.24 In such circumstances a more representative measure is public sector net worth, which records the value of assets, both financial and non-financial, and nets off the value of liabilities. However, this measure is also not without problems in times of financial crisis due to two aspects concerning the valuation of assets: (i) the valuation of loans is at nominal value and hence over-records the real value of non-performing loans that have not been cancelled; (ii) it is difficult to record a market value for some securities, such as those resulting from securitisation and the collateralised debt obligations formed from the bundling of them to form new securities, when the financial markets that trade them are not functioning normally.
- 31.25 In *Budget 2008*, the Government restated its fiscal policy objectives and explained these would be implemented through two strict fiscal rules. The second of these rules is the Sustainable Investment Rule. The performance against this rule is measured using public sector net debt. *Budget 2008* states³¹ "*public sector net debt as a proportion of GDP will be held over the economic cycle at a stable and prudent level. Other things being equal, net debt will be maintained below 40 per cent of GDP over the economic cycle.*"
- 31.26 In paragraphs 2.43 and 2.44³² of *Budget 2008*, the Government set out its intention to exclude Northern Rock when measuring its performance against the Sustainable Investment Rule. These paragraphs are reproduced below:

"2.43 The Government will report on PSND both including and excluding Northern Rock in any future Budgets and Pre-Budget Reports in which the company remains classified as a public corporation. As set out in Box 2.6, the sustainable investment rule ensures sound public finances and fairness by

³⁰ Excluding financial derivatives.

³¹ Paragraph 2.33, page 23.

³² Page 29.

protecting future generations from bearing the costs of debt incurred by this generation. Northern Rock is temporarily in public ownership and its liabilities are fully backed by other financial assets held by the company, and therefore its impact on PSND does not reflect future calls on the taxpayer. For the purpose of measuring performance against the sustainable investment rule, the Government will use a measure of PSND excluding Northern Rock's assets and liabilities."

"2.44 The 'Code for fiscal stability' provides for such circumstances. While Northern Rock remains in temporary public ownership, operating at arms length from Government, the Treasury will provide financing to the company and continue to provide guarantee arrangements where appropriate. It will continue to record a contingent liability for these arrangements. Any economic profit or loss will be included within both measures of PSND (and thus within the sustainable investment rule) when that profit or loss crystallises for central government."

31.27 In *Pre-Budget Report 2008* the Government temporarily suspended its fiscal rules and introduced a new temporary operating rule:

"To set policies to improve the cyclically-adjusted current budget each year, once the economy emerges from the downturn, so it reaches balance and debt is falling as a percentage of GDP once the global shocks have worked their way through the economy in full".

31.28 The coverage of the measure of public sector net debt excluding Northern Rock was expanded so that it included all financial sector interventions.

31.29 In the monthly *Public sector finances statistical bulletin* public sector net debt is now shown on both these bases, although the measure that includes the financial interventions does not yet include the reclassification of The Royal Bank of Scotland Group plc and Lloyds Banking Group plc.

31.30 In *Budget 2009* the Government announced its intention to report its fiscal aggregates on three different bases: (i) consistent with national accounts classification; (ii) excluding financial sector interventions; and (iii) a provisions type of approach where movements in expected losses are included immediately. The extract from *Budget 2009* explaining this is reproduced below:

To ensure transparency in reporting on the impact of financial sector interventions on the public finances, the Government will publish information on three different bases:

- *including financial sector interventions on a National Accounts basis:* These measures reflect the treatment of financial sector interventions as determined by the national accounts, including temporary and exceptional effects from, for example, the inclusion of the balance sheets and operations of banks classified to the public sector;
- *excluding liabilities and unrealised losses from financial sector interventions:* These measures remove the temporary effects of financial sector interventions on the fiscal aggregates. As losses are realised for central government, and so can be reliably included in the fiscal projections, they will score in these measures; and
- *including unrealised losses on financial sector interventions:* These measures include the anticipated future loss stemming from the Government's financial sector interventions, and so are better measures of the sustainability of the medium-term fiscal position than those on the other two measurement bases. They remove the temporary effects of financial sector interventions on the fiscal aggregates.

Modelling the Costs of the Interventions

- 31.31 Although Table 31.1 shows minimal primary effect on public sector current budget or public sector net borrowing from the interventions, it does not reflect secondary effects. For example the borrowing required to support the financial institutions requires servicing and this is excluded from Tables 31.1 and 31.2. The income and expenditure of institutional units now classified in the public sector will have a minor effect on the measures in Table 31.1.
- 31.32 Similarly, the measures in Table 31.1 exclude the effect of the increase in the Bank of England's profits. For their financial year (1 March 2008 to 28 February 2009) the *Bank of England Annual Report 2009* shows a profit for the banking department of £1.0bn, compared to £0.2bn in the previous year. This translates into increased tax receipts (£162m compared to £36m) for government and an increase in dividends receivable (from £81m in 2008 to £417m in 2009).
- 31.33 Table 31.4 shows an analysis of the effects of the interventions on general government net borrowing including modelled estimates of the impact on government's general financing programme from the interventions, and from fees receivable. The impact on government debt is modelled through assuming an implied government borrowing rate on the financing required.
- 31.34 A similar version of this table was reported to the European Commission as part of the September 2009 Excessive Deficit Procedure. Eurostat gave guidance on how to calculate the implied interest rate, but this guidance reflected the practical constraints on European Union Member States to report something in a very short period of time. The recommended method included the effect of interest payable on debt raised in earlier periods, when interest rates were relatively higher, and thus was not representative of the rate government borrowed at during the financial crisis. A different method has been used to estimate an implied interest rate, which is described in the following paragraphs.
- 31.35 To estimate an implied government borrowing rate it is first necessary to examine how government borrows. Table 31.3 shows how the central government contribution to general government gross debt, at nominal values, at end-March 2009 is formed. The definition of general government gross debt used is consistent with that used for the Excessive Deficit Procedure.

Table 31.3 - Components of Central Government Debt at Nominal Value

Type of liability	Level (£bn)	Percentage of total
National savings	97.5	12.6
DMO repos	24.3	3.1
Other deposits	10.3	1.3
Currency	3.9	0.5
Loans from MFIs	14.3	1.8
Finance leases	4.7	0.6
Treasury bills	43.4	5.6
Conventional gilts	426.0	54.6
Index-linked gilts	154.0	19.8
Other bonds	1.4	0.2
Total	779.7	100

- 31.36 Table 31.3 shows that 55 per cent of the debt liability is from conventional gilt issuance, 20 per cent from index-linked gilts, 13 per cent from national savings products and 6 per cent from treasury bill issuance.
- 31.37 An analysis of changes in debt in the period of the financial crisis shows that these four are the categories that government consistently uses for borrowing purposes. The liabilities for Debt Management Office repos have also grown, but these are generally used as a short-term form of funding, which is eventually replaced by the more conventional means. They have thus been excluded from the method for calculating an implied interest rate.
- 31.38 The method used to derive implied interest rates uses data for these four main categories and is based on readily available information on interest rates on these instruments. It uses information on the interest rates for each conventional and index-linked gilt issued; discounts on one-month and three-month treasury bills as a proxy for all treasury bills issuance; and the premium bond rate and two product rates as proxies for fixed and variable rate national savings products. Taken together, 93 per cent of the debt level is covered by the method, but as explained earlier it covers virtually all of any new borrowing undertaken by government.
- 31.39 The interest rates used are weighted together, using transactions in each category in each period, to produce an overall average implied interest rate for each calendar quarter. The relevant quarterly interest rate is then allocated to the borrowing required in each quarter.
- 31.40 The imputed interest payable on this borrowing in each quarter is then added to the outstanding liability and the next period calculated.
- 31.41 The Eurostat supplementary table, on which Table 31.4 is based, covers just government interventions. Strictly speaking interventions such as the initial lending to Northern Rock plc and the Bank of England Special Liquidity Scheme could be excluded as they are central bank interventions and hence outside the scope. However, as the interventions involve government, usually through guarantees, they have been included to present a full picture.

Table 31.4 – Government Non-Financial Account: Impact of Interventions (£bn)

	2007	2008	2009q1-q3
Revenue			
Fees	0.0	0.5	1.6
Interest	0.2	0.9	0.8
Capital tax	0.0	20.5	2.3
FSCS levy	0.0	0.2	0.5
Total	0.2	22.1	5.2
Expenditure			
Actual interest	0.0	0.2	0.0
Imputed interest	0.0	0.2	2.0
Capital injections	0.0	2.5	3.8
Imputed subsidy	0.2	0.5	0.2
Other capital transfers	0.0	23.5	2.6
Total	0.2	26.8	8.5
Net borrowing	-0.0	4.7	3.3

- 31.42 Table 31.4 shows the impact on general government net borrowing, e.g. the amount by which expenditure exceeds revenue, of the interventions in 2007, 2008 and the first three quarters of 2009. To produce the latter requires more estimation than the earlier periods.
- 31.43 The table shows how the interest imputed on the government borrowing is growing over time.
- 31.44 The largest revenue entry is for the capital taxes on Bradford and Bingley plc and the UK subsidiaries of Icelandic institutions, which are mainly matched in the expenditure part of the account by the capital transfers recorded when government pays compensation for the deposits lost.
- 31.45 The capital injections row records the parts of the acquisitions of shares from The Royal Bank of Scotland Group plc and Lloyds Banking Group plc and its predecessors that are recorded as capital transfers.

Table 31.5 – Government Financial Account: Impact of Interventions (£bn)

Transactions in	2007	2008	2009q1-q3
Financial assets			
Deposits	0.0	3.0	0.0
Preference shares	0.0	5.1	-5.0
Loans	0.0	17.8	5.6
Equity	0.0	11.9	16.2
Accounts receivable	0.0	20.7	1.3
Total	0.0	58.4	18.2
Financial liabilities			
Imputed borrowing	0.0	62.7	21.8
Accounts payable	0.0	0.4	-0.4
Total	0.0	63.1	21.4
Total net financial transactions	0.0	-4.7	-3.3

31.46 Table 31.5 shows how the balance from the non-financial account, net lending – the negative of net borrowing, is financed in the financial account. This is where the imputed borrowing that finances the interventions is shown, as an increase in financial liabilities.

31.47 The accounts receivable entry reflects the capital tax due that has not been collected yet. The 2008 loans asset is mainly government taking over the loan to Northern Rock plc. The equity and preference shares entries are mainly the recapitalisation of The Royal Bank of Scotland Group plc and Lloyds Banking Group plc and its predecessors.

Table 31.6 – Government Financial Balance Sheet: Impact of Interventions (£bn)

	End-2007	End-2008	End-2009q3
Financial assets			
Deposits	0.0	3.0	0.0
Preference shares	0.0	5.1	0.0
Loans	0.0	17.9	26.4
Equity	0.0	11.3	33.2
Accounts receivable	0.0	20.7	22.1
Total	0.0	57.9	81.8
Financial liabilities			
Imputed borrowing	0.0	62.7	84.6
Accounts payable	0.0	0.4	0.0
Total	0.0	63.1	84.6
Total net financial Assets	0.0	-5.2	-2.8

- 31.48 Table 31.6 shows the impact of the interventions on the government financial balance sheet.
- 31.49 This includes the end-2008 position of £63.1bn of borrowing to finance the interventions, plus the interest payable on this financing. During 2008 this had partly been financed by borrowing from the Bank of England but by end-2008 these amounts had been replaced by the government's general borrowing programme. By end-September 2009 this had grown to an estimated £84.6bn.
- 31.50 Table 31.6 shows how this increase in financial liabilities has been partly matched by increases in financial assets. The net liability position of £5.2bn at end-2008 has reduced to £2.8bn at end-September 2009 mainly through the unrealised holding gains made on the value of the ordinary shares that government owns.
- 31.51 There are three main types of assets that contribute to the financial asset position. Loans are shown at their nominal value and their eventual repayment or otherwise will depend on the performance of the entities that government has lent to (mainly Northern Rock plc, Bradford and Bingley plc and the claim on Landsbanki Íslands hf). The equity value is at market price for the ordinary shares held in The Royal Bank of Scotland Group plc and Lloyds Banking Group plc. The latest equity values estimated for Northern Rock plc and Bradford and Bingley plc are zero, in line with the values shown in their latest published annual reports. The accounts receivable asset is the amounts owed on the capital tax levied on Bradford and Bingley plc and other institutions declared in default. If the defaulters are unable to meet their liability a levy will be imposed on other deposit takers, so this asset should not be affected by the subsequent performance of defaulters and the returns received from administrators.

Table 31.7 – Government Contingent Liabilities Arising from Interventions (£bn)

Contingent liabilities	End-2007	End-2008	End-2009q3
Guarantees	40	115	143
Securities used in temporary liquidity schemes	0	185	185
Total	40	300	328

- 31.52 The financial liabilities shown in Table 31.6 exclude contingent liabilities. These are shown in Table 31.7. Those under guarantees refer to the maximum exposure of guarantees granted to Northern Rock plc, those under the Credit Guarantee Scheme and on the Bank of England Asset Purchase Facility. For the latter this is shown net of the government securities purchased by the facility.
- 31.53 The estimate shown for securities used in temporary liquidity schemes is, in the absence of other information, the 30 January 2009 value published by the Bank of England for treasury bills lent under the Special Liquidity Scheme.
- 31.54 Some of the contingent liabilities may crystallise into losses at a later stage. It is at that stage when the impact of the crystallisation is reflected in the government balance sheet.

Writing-off, Writing-Down and Cancellation of Loans and Securities

- 31.55 The operating performance of financial institutions classified to the public sector will also have an impact on the public sector measures. These are excluded from Table 31.1, although the omission should not distort the results shown.
- 31.56 In many cases the large commercial accounting losses reported arise from the writing down of asset values, which will generally not impact on these measures. The net wealth of financial corporations is gained through profits from providing services and net property income receivable, mainly interest (both of which are recorded in the non-financial account), from profits made on acquiring and selling financial assets (recorded in the financial account) and from revaluation of assets (recorded in the revaluation accounts).
- 31.57 It is a feature of the financial crisis that large accounting losses have been reported due to the 'write-down' of asset values. In the early phase of the crisis this centred on the value of securities, particularly those with performance affected by exposure to the USA sub-prime mortgage market. In the latter part of the financial crisis these have centred on the performance of loans.
- 31.58 This correction of asset values can be divided into three types: write-downs; write-offs and cancellations. The following paragraphs explain how these are recorded in National Accounts. Unlike in commercial accounting provisions set aside for expected losses, and changes in provisions, are not recorded in National Accounts.
- 31.59 Securities and loans are explained separately due to differences in their recording. Securities are recorded in balance sheets at their market value, loans are recorded at their nominal value³³.

Cancellations

- 31.60 Cancellations are defined as the mutual cancellation of a debt, with both parties involved accepting it will not be repaid. This is recorded in National Accounts as a capital transfer from the asset holder (creditor) to the party that owes the debt (debtor), followed by the imputed repayment of the debt.
- 31.61 In cases such as secured loans the cancellation of the loan leads to the asset holder taking the secured property, for example in a mortgage loan that has defaulted the bank will take the house and then sell it in an attempt to recover its losses. In such circumstances the size of the capital transfer is reduced by an amount equal to the market value of the house at that time, and the bank is then shown purchasing the house from the debtor for the market value amount.

Write-offs

- 31.62 Write-offs are similar to cancellations, but here only the asset holder recognises that it is not going to get paid so it is a unilateral write-off. The asset holder has given up on collecting the debt, even if they do not acknowledge this to the debtor.

³³ This is adjusted for any interest accrued on the loan that has not been paid.

- 31.63 A write-off is due to bankruptcy, or similar factors that persuade the asset holder that the asset can no longer be collected, is not recorded as a financial transaction. Instead it is recorded in the other flow accounts (ESA95 category K.10 for other volume changes). The different treatment from cancellations reflects that transactions recorded in the National Accounts system must be mutual.
- 31.64 A unilateral decision by the debtor not to pay, known as debt repudiation, is not recognised in the National Accounts system.

Write-downs

- 31.65 A write-down occurs when an entity re-values an asset in its accounts. They are different from a write-off in that they have given up on collecting the debt, even if they don't acknowledge this to the liability holder.
- 31.66 In a dysfunctional or dormant market, such as the observed during the financial crisis for the securitisation and collateralised debt obligation markets, this write-down may provide an adequate estimate of the market value of the securities.
- 31.67 In such cases the writing-down of the asset is not recorded as a financial transaction. It is instead recorded in the other flow accounts (ESA95 category K.11 for nominal holding losses), as with any change to market values.
- 31.68 There may be asymmetries in the values recorded in the book-keeping balance sheets of the asset and liability holders. ESA95 solves this by guiding that write-offs by the asset holder are carried through into the balance sheet of the liability side.
- 31.69 The situation for loans is different to securities because the National Accounts system records them at their nominal value in the balance sheet. Therefore write-downs have no impact on the value of the loans recorded in the balance sheet³⁴ since at this stage it is possible the value may return. ESA95 uses write-downs in a slightly different context to here, using it for partial write-offs where the value of the part written down won't return.
- 31.70 So, in summary debt cancellations are recorded in the non-financial and financial accounts and change the value of amounts outstanding. Changes to assets that are recorded in the balance sheet at market value through write-offs and write-downs, are reflected in the financial balance sheet. Changes to the valuation of assets recorded in the balance sheet at nominal values, such as non-performing loans, are not recorded in the balance sheet.
- 31.71 As such, the National Accounts balance sheet may overstate the true value of financial corporations' assets.

³⁴ Early drafts of the next version of ESA show a slight modification in that the balance sheet will have a memorandum item showing the market value of non-performing loans.

32. Further Information

The classification decisions described in this article are consistent with international statistical guidelines on National Accounts. Further information on ONS classifications and the NACC can be found on the National Statistics website. If you have any questions on statistical classification, please contact psa@ons.gov.uk.

33. Abbreviations used in this Article

BEAPFF	Bank of England Asset Purchase Funding Facility Limited
bn	Billion (1,000,000,000)
CMFB	European Committee on Monetary Financial and Balance of Payments
DBS	Dunfermline Building Society
DBSiA	Dunfermline Building Society in building society special administration
DMO	UK Debt Management Office
ECB	European Central Bank
ESA	European System of Accounts
ESA95	<i>European System of Accounts 1995</i>
FSA	Financial Services Authority
FSCS	Financial Services Compensation Scheme
FME	Fjármálaeftirlitið, Iceland's financial services regulator
GAAP	Generally Accepted Accounting Practice
GCGRR	General collateral gilt repo rate
GDP	Gross Domestic Product
HM	Her Majesty's
IMF	International Monetary Fund
IFRS	International Financial Reporting Standards
LIBOR	London Inter-bank Overnight Rate
Ltd	Limited
MGDD	<i>Manual on Government Deficit and Debt</i>
MFSM	<i>Monetary and Financial Statistics Manual</i>
m	million (1,000,000)
MoU	Memorandum of Understanding
NACC	National Accounts Classification Committee
NIFs	Note Issuance Facilities
OECD	Organisation for Economic Co-operation and Development
ONS	The Office for National Statistics
plc	Public Limited Company
PIBS	Permanent Interest Bearing Shares
PPP	Public Private Partnership
PSCB	Public sector current budget
PSND	Public sector net debt
PSNI	Public sector net investment
Repo	Repurchase
SFEF	French Société de Financement de l'Économie Française
SIVs	Structured Investment Vehicle
SNA	System of National Accounts
SNA93	<i>System of National Accounts 1993</i>
SPE	Special Purpose Entity
SPV	Special Purpose Vehicle
Tr	Trillion (1,000,000,000,000)
UK	United Kingdom

Appendix A: Key Events from 2007 to August 2009

February 2007	HSBC (UK) reports losses in USA from mortgage lending.
February 2007	Mortgage lender Kensington (UK) puts itself up for sale due to inability to gain long-term funds, driven by subprime problems in USA and competition from Northern Rock in UK market.
March 2007	Biggest USA house builder (DR Horton) reports huge losses from subprime fall out.
March 2007	Shares suspended in New Century Financial, one of USA's biggest subprime mortgage lenders.
March 2007	Accredited Home Lenders, another USA subprime lender, agrees to sell its subprime loan book at heavy loss.
April 2007	New Century Financial (USA) files for bankruptcy protection.
May 2007	UBS (Switzerland) closes its hedge fund DRCM (USA), reintegrating it within the company.
May 2007	General Motors finance unit (USA) reports losses.
May 2007	Kensington bought by Investec (South Africa).
June 2007	Bear Stearns (USA) reports losses bailing out two of its hedge funds exposed to subprime.
July 2007	Risk shield set up for IKB (Germany).
August 2007	American Home Mortgage (USA) files for bankruptcy protection.
9 August 2007	BNP Paribas (France) suspends three investment funds worth €2bn; short-term money markets freeze.
9 August 2007	European Central Bank pumps €95bn into eurozone banking system (e.g. making loans available to banks); Federal Reserve (USA) and Bank of Japan take similar steps.
10 August 2007	ECB provides further €61bn.
13 August 2007	Goldman Sachs (USA), with others, bails out its hedge fund. ECB provides another €48bn. USA and Japan central banks also repeat their loans.
17 August 2007	Federal Reserve (USA) cuts its lending rate (discount rate) to banks by 0.5 percentage point.
August 2007	Sachsen Landesbank (Germany) receives credit facility, prior to creation of super SIV for its impaired assets and sale to state-owned Landesbank Baden-Württemberg. Problems arose from its exposure to USA subprime through an Irish-based SPV.
September 2007	IKB Industriebank (Germany) reports losses.
September 2007	ECB makes fresh injection into money markets.
September 2007	Northern Rock (UK) takes emergency loan from Bank of England. Run on the bank (depositors withdrawing deposits) leads to announcement of government guarantee of deposits.
September 2007	Federal Reserve cuts interest rates by 0.5 percentage points.
September 2007	Bank of England reverses stance following Northern Rock difficulties and offers £10bn into markets, but relatively high interest rate offered lead to no takers in first auction.
October 2007	UBS (Switzerland), Citigroup (USA), Merrill Lynch (USA), Nomura (Japan) and Deutsche Bank (Germany) reveal substantial losses or write-downs.
October 2007	IKB (Germany) investment vehicle defaults.

November 2007	Credit Suisse (Switzerland), Citigroup (USA), BNP Paribas (France), Morgan Stanley (USA), Wachovia (USA), Bank of America (USA), Barclays (UK), HSBC, FNMC 'Freddie Mac' (USA) report substantial write-downs/losses.
November 2007	JP Morgan Chase, Citigroup and Bank of America agree \$75bn fund to buy impaired assets.
November 2007	Second rescue package for IKB (Germany).
December 2007	Royal Bank of Scotland (UK), UBS (Switzerland), Morgan Stanley (USA) report losses/write-downs.
December 2007	US interest rates cut for third time.
December 2007	Five central banks (ECB, Federal Reserve, Bank of England, Switzerland, Canada) agree global plan to inject \$110bn; ECB goes beyond this and makes available \$500bn (€350bn).
December 2007	Citigroup shuts seven SIVs and brings their \$49bn debts back onto its balance sheet.
January 2008	Substantial write-downs revealed by Bear Stearns (USA), Citigroup (USA), JP Morgan Chase (USA), Merrill Lynch (USA), West Landesbank (Germany) and Fortis (Belgium).
January 2008	Capital injection into West LB (Germany) agreed.
January 2008	Bank of America (USA) buys Countrywide, the largest mortgage provider in USA.
January 2008	US interest rates cut to 3 per cent by end of month.
January 2008	Société Générale reports trading losses.
February 2008	Substantial losses/write-downs reported by GMAC (USA), Deutsche Bank (Germany), UBS (Switzerland) and Commerzbank (Germany).
February 2008	IKB (Germany) fails its regulatory requirement. German government instructs KfW to rescue it.
March 2008	Substantial losses/write-downs reported by HSBC (UK), Crédit Agricole (France),
March 2008	Peloton Partners hedge fund (UK) collapses.
March 2008	The group of five central banks jointly announce a further \$200bn lending.
March 2008	Carlyle Capital hedge fund (listed in Netherlands) fails.
March 2008	JP Morgan Chase (USA) provides emergency funds to Bear Stearns (USA), using liquidity provided by Federal Reserve. Exact structure not known, but as JP Morgan Chase states no risk to shareholders looks like its central bank lending via an intermediary. JP Morgan Chase then acquires Bear Stearns using Federal Reserve loans.
March 2008	Further interest rate cut by Federal Reserve.
April 2008	Substantial losses/write-downs reported by Deutsche Bank (Germany), UBS (Switzerland), Merrill Lynch (USA), Citigroup (USA), Royal Bank of Scotland (UK).
April 2008	Bank of England (UK) Special Liquidity Scheme starts.
May 2008	Substantial losses/write-downs reported by HSBC (UK).
May 2008	UBS (Switzerland) launches rights issue.
June 2008	Barclays (UK) announces rights issue, Qatar government invests through its investment arm.
2 nd quarter 2008	Eurozone GDP contracts.
July 2008	Mortgage lender IndyMac (USA) collapses.
July 2008	American authorities step in to support Fannie Mae (USA) and Freddie Mac (USA).
July 2008	HBoS rights issue not supported, so underwriters cover 92% of it.
July 2008	Roskilde bank (Denmark) receives a central bank liquidity facility with government guarantee.

August 2008	Central bank rescue of Roskilde (Denmark).
August 2008	IKB (Germany) sold to Lone Star (USA).
September 2008	Fannie Mae (USA) and Freddie Mac (USA) rescued by US government.
September 2008	Nationwide building society (UK) takes over two small UK building societies.
September 2008	Lehmann (USA) fails to find buyer and files for bankruptcy protection.
September 2008	Merrill Lynch (USA) taken over by Bank of America (USA).
September 2008	Federal Reserve rescues AIG (USA) insurance corporation in equity injection.
September 2008	Lloyds TSB (UK) to take over HBoS (UK) subject to shareholder approval.
September 2008	Regulators shut Washington Mutual (USA) – taken over by JP Morgan (USA).
September 2008	Netherlands, Belgium and Luxembourg governments make rescue equity injection into Fortis.
September 2008	Regulators close Bradford and Bingley (UK) as a deposit taker. It is nationalised.
September 2008	Glitnir bank (Iceland) to be nationalised.
September 2008	Wachovia (USA) bought by Citigroup (USA).
September 2008	France, Belgium and Luxembourg governments make rescue equity injection into Dexia.
September 2008	Irish Government announces it will guarantee all deposits for 2 years
3 rd quarter 2008	Eurozone, USA and UK GDP contracts.
October 2008	Defeasance package for bad debt passed in USA. Plans to purchase preference shares in banks announced.
October 2008	Rescue of Hypo Real Estate (Germany) announced.
October 2008	BNP Paribas (France) buys majority stake in Fortis Belgium & Luxembourg operations.
October 2008	Denmark sets up a fund to take over distressed banks.
October 2008	Iceland's financial regulator takes over its three largest banks: Glitnir, Landsbanki and Kaupþing.
October 2008	G7 and European Union pledge action to tackle financial crisis, followed by announcements of national rescue plans.
October 2008	UK Government announces rescue package. RBS, Lloyds TSB and HBoS will issue preference shares to government, which will also underwrite an ordinary share issue.
October 2008	Six central banks (ECB, Federal Reserve, Bank of England, Switzerland, Canada, Sweden) make emergency interest rate cut on same day.
October 2008	South Korea and Sweden announce rescue packages.
October 2008	Netherlands makes equity injections into ING and Aegon.
October 2008	Equity injections into Ethias Insurance and KBC (Belgium).
October 2008	In Austria Erste Bank is recapitalised and Kommunalkredit nationalised.
October 2008	IMF approves loan to Hungary.
October 2008	France announces plans to recapitalise Crédit Agricole, BNP Paribas, Société Générale, Crédit Mutuel, Caisse d'Épargne and Banque Populaire by the end of 2008 via its SPPE vehicle.
November 2008	IMF approves loans to Ukraine, Iceland and Pakistan.
November 2008	Hipoteku Un Zemes Banka (Latvia) public sector bank acquires majority stake in Parex Banka (Latvia).
November 2008	Regulators shut Carnegie Bank (Sweden), which is then nationalised.
November 2008	USA abandons defeasance plan. Rescue plan for Citigroup.
November 2008	European Commission and China announce economic stimulus packages.
November 2008	Equity injection into Commerzbank (Germany).

November 2008	Netherlands makes equity injections into SNS Reaal.
November 2008	Portugal nationalised BPN
December 2008	Further interest rate cuts in Europe, USA and Japan.
December 2008	Rescue of Bayern Landsbank (Germany)
December 2008	USA Government announces rescue of GMAC.
January 2009	UK Government announces plan to guarantee loans to small/medium enterprises.
January 2009	Further interest rate cuts in Europe.
January 2009	Anglo Irish Bank (Ireland) nationalised.
January 2009	Equity injection and guarantees given to Bank of America (USA).
January 2009	UK Government announces second rescue plan.
January 2009	Equity injection into Commerzbank (Germany).
January 2009	National Bank, Alpha Bank and EFG Eurobank (Greece) gain shareholder approval for government recapitalisation.
January 2009	Netherlands government agrees deal to guarantee ING assets
February 2009	Sweden announces plans to recapitalise banks.
February 2009	Ireland announces plans to recapitalise Bank of Ireland and Allied Irish Banks.
February 2009	Deal to privatise Carnegie Bank (Sweden).
February 2009	Losses announced for RBS and HBOS (UK).
March 2009	HSBC (UK) announces plans for rights issue.
March 2009	IMF agrees a loan to Romania.
March 2009	Bank of England starts monetary policy asset purchases (quantitative easing)
March 2009	Dunfermline Building Society (UK) defaults.
April 2009	German rescue fund SoFFin attempts to buy existing equity in Hypo Real Estate
April 2009	UK Government purchases ordinary shares as RBS redeems preference shares
June 2009	Lloyds Banking Group (UK) rights issue and redemption of preference shares