REVIEW OF THE BANK OF ENGLAND'S PROVISION OF EMERGENCY LIQUIDITY ASSISTANCE IN 2008–09

Report by Ian Plenderleith

Presented to the Court of the Bank of England

October 2012

Introduction

1. This Review examines the actions of the Bank of England at the height of the financial crisis, around the collapse of Lehman Brothers, to provide emergency liquidity assistance (ELA) to HBOS and Royal Bank of Scotland in 2008–09. It is one of three reviews commissioned by the Court of Governors of the Bank on 21 May 2012.

2. The terms of reference for the Review (set out in full in Appendix 1) specify that its purpose is to learn lessons to inform the way the Bank conducts ELA operations for individual financial institutions. Specifically, the Review is charged with examining:

   - The basis of the decisions to provide ELA to each firm concerned;
   - The governance arrangements within the Bank for making those decisions;
   - The structure and terms of each ELA operation;
   - The effects of those operations on the institutions concerned and on overall financial stability;
   - The capability of the Bank to plan, implement and manage those operations.

3. Overall, the Review is charged with examining how the Bank discharged its responsibilities as lender of last resort in a crisis and making recommendations for the conduct of any such operations in the future.

4. The Review addresses this remit by examining each aspect of the Bank's ELA operations in 2008–09 in turn. At each stage, an assessment is made of the effectiveness of the Bank's actions in the circumstances of the time; and, looking forward, recommendations are made at various points on issues the Bank may need to consider for the conduct of any future ELA operations. For ease of reference, the 28 recommendations are listed at the end of the main body of the Review.

5. Chapter 1 provides details of the main features of the ELA extended to HBOS and RBS and, as relevant background, a summary of the other principal measures taken by the Bank and the Government in 2008 to address the crisis and of significant subsequent changes made in response to the crisis in the statutory and regulatory framework and in the Bank's framework for liquidity insurance. Appendix 3 describes these changes in more detail, and Appendix 2 provides details of the course of the financial crisis that gave rise to the need for ELA.

6. The next two chapters (Chapters 2 and 3) look at the run-up to the need to provide ELA and examine the Bank's state of readiness ahead of the need crystallising in October 2008.

7. Four chapters (Chapters 4–7) then examine successively the basis on which the decision to extend ELA was taken, the terms on which ELA was extended, the governance and decision-making process surrounding the ELA operation, and issues relating to disclosure.

8. Chapter 8 offers an assessment of the effectiveness of the operations. A concluding chapter (Chapter 9) looks forward and examines the future role that ELA might need to play, as part of the Bank's wider lender of last resort function, and how that function might be exercised.

9. No review of the Bank's ELA operations in 2008–09 could be conducted without taking full account of the immediately previous occasion on which the Bank had to extend ELA, to Northern Rock in 2007. The terms of reference for this Review provide for it "to build on the lessons learned in relation to the ELA provided to Northern Rock in 2007, as set out in the Treasury Committee's report, *The run on the Rock*." The lessons the Bank learned from its experience of that episode are examined at relevant points throughout this Review and are drawn together in Appendix 4, which addresses each of the relevant conclusions and recommendations in the Treasury Committee's report.

10. In conducting this Review, I have had full and unrestricted access to the Bank's records, which has greatly facilitated my work. The Review has also benefited from interviews with many of the main participants in the events of 2008–09 (both inside the Bank and outside), as well as with a number of those within the Bank who would be involved in an ELA operation today, and I greatly appreciate the time they have made available to provide clarification and to respond to questions. A list of those interviewed is in Appendix 6.

11. I have also had immensely valued assistance from the indefatigable Support Unit provided by the Bank. Particular appreciation is owed to Antonia Brown and Gareth Ramsay for the unfailing support, input, challenge and insight they have provided at all stages of the Review.

Ian Plenderleith

18 October 2012

Contents

Executive Summary

Emergency liquidity assistance extended to HBOS and Royal Bank of Scotland

1. In October 2008, as the financial crisis intensified rapidly following the failure of Lehman Brothers the previous month, HBOS and the Royal Bank of Scotland (RBS) received emergency liquidity assistance (ELA) from the Bank of England (the Bank) on a large scale, amounting at its intraday peak to £61.5 billion:

   - HBOS first received ELA on 1 October 2008 and at peak on 13 November had drawn £25.4 billion. HBOS made final repayment of the facility on 16 January 2009;

   - RBS first received ELA on 7 October 2008, initially in dollars, but subsequently from 10 October also in sterling. Its use of the dollar facility peaked at $25 billion on 10 October, and of the sterling facility at £29.4 billion on 27 October. RBS made final repayment of ELA on 16 December 2008.

2. The sterling ELA took the form of collateral swaps, under which the Bank lent the two banks UK Treasury bills (T-bills) against unsecuritised mortgage and loan assets. The structure was similar in form to the Special Liquidity Scheme (SLS), under which the Bank had been providing liquidity against an extended range of collateral on a market-wide basis since April 2008. The Bank charged a fee of 200 basis points on amounts drawn. The Bank received an indemnity from HM Treasury (HMT) for any additional amounts drawn after 13 October. Before that indemnity was put in place, the full £51.1 billion of the Bank's exposure at that date was not indemnified. Even after the indemnity was in place, the Bank remained unindemnified for £50.9 billion of its peak intraday exposure of £61.5 billion on 17 October. The ELA operation was conducted covertly; it was publicly disclosed on 24 November 2009, just over a year after it was initiated.

Background to the ELA operation

3. ELA took place against the backdrop of the global financial crisis, which had precipitated the failure of Northern Rock in September 2007 and had intensified significantly after the failure of Lehman Brothers on 15 September 2008. Shortly after the commencement of the ELA, the UK Government announced, on 8 October 2008, a package of support measures for the financial system, including a recapitalisation scheme for banks. As a result of Government recapitalisation received under that scheme, RBS and Lloyds Banking Group (the result of HBOS's merger with Lloyds TSB, which was completed on 19 January 2009) were brought into partial public ownership, where they remain today.

4. Since the crisis, there have been significant changes in the statutory and regulatory framework and in the Bank's framework for providing liquidity insurance; further changes in the statutory framework are envisaged in the Financial Services Bill currently before Parliament. Notably:

- The Banking Act 2009 gave the Bank a statutory objective in relation to financial stability and established the Special Resolution Regime (SRR) to provide a permanent framework for distressed banks to be resolved without disturbance to financial stability;
- The regulatory framework has been intensified, with higher capital and liquidity requirements for banks;
- The Bank has introduced, in addition to a variety of market-wide liquidity insurance facilities, the Discount Window Facility (DWF), to provide bilateral liquidity assistance to banks in the event of stress;
- The Prudential Regulation Authority (PRA) is to be established as a subsidiary of the Bank, with responsibility for microprudential regulation;
- The Financial Policy Committee (FPC) is to be established in statute to monitor systemic risk and initiate policy actions in that area.

5. These changes will have particular implications for any ELA operations undertaken by the Bank in future. They are therefore outlined in Chapter 1 of the Review. More detail on these changes is provided in Appendix 3. Appendix 2 outlines the course of the unfolding crisis that gave rise to them.

The run-up to ELA

6. By the time ELA was needed to support HBOS and RBS in October 2008, the strains that were destabilising the financial system had been evident for over a year; and the Bank had already had experience of extending ELA to Northern Rock the previous year. Against this background, the Review examines in Chapters 2 and 3 the Bank's state of readiness to provide ELA to HBOS and RBS ahead of the need crystallising in October 2008. Chapter 2 examines how far the Bank was able to scan the horizon to identify risks to financial stability in the run-up to October 2008. Chapter 3 examines the practical preparations the Bank had made in planning for the provision of ELA.

Horizon scanning

7. The evidence reviewed in Chapter 2 indicates that in both its public output (in the Financial Stability Report and in speeches) and in analyses it provided for discussions with the Financial Services Authority (FSA) and HMT, the Bank was able in varying degrees to identify and highlight the principal areas where impending financial stresses were threatening systemic stability in the run-up to October 2008. But, at least until the failure of Northern Rock, there was greater focus on risks at the systemic level, as distinct from threats to individual banks; and even in 2008 there was arguably too little attention directed to the consequences of low-probability (tail) risks (such as the failure of a large, complex financial institution) which, in the form of the failure of Lehman Brothers, were what actually precipitated the intensification of the crisis in October 2008.

8. In relation to the specific vulnerabilities of the two banks to which the Bank eventually extended ELA, the Bank was able to identify in advance, and to monitor, the increasing liquidity strains that HBOS was experiencing during 2008. There was significantly less close focus on the liquidity position of RBS, but its funding problems did not in fact crystallise until a late stage, after the failure of Lehman Brothers.

9. In relation to both banks, however, and indeed to the process of monitoring the risks to individual banks in general, the Bank's ability to identify impending threats in concrete terms was made more difficult by an underlap that had developed in the regulatory structure. Initially at any rate, the Bank was dependant on the FSA for liquidity data on individual banks; but the data available to the FSA were not forward-looking and lacked the granular detail the Bank required for an operational response like ELA. Equally, while the Bank could identify the threat that vulnerabilities in individual banks posed to wider systemic stability, the FSA was less closely focused on the deteriorating systemic picture. Under the pressure of events, this underlap was progressively bridged during the course of 2008, but it hampered how far in advance the Bank could get a clear view of the strains building up on individual banks.

10. Since the funding difficulties being experienced by HBOS were identified at an early stage, well in advance of its need for ELA crystallising in October 2008, the Review suggests that, where there is advance awareness of such strains, the Bank might consider acting pre-emptively to provide bilateral liquidity support before the need becomes immediate.

11. Since 2008, there has been a significant enhancement of the authorities' ability to scan the horizon for impending financial stresses. The liquid assets buffer that banks are now required to hold should itself provide early warning of stresses, if a bank needed to utilise the buffer. Liquidity data available to the FSA, and the flow of that data to the Bank, have improved significantly; and the establishment of the PRA within the Bank should enhance that process. Within the Bank, there are four distinct areas contributing jointly to monitoring and identifying financial stresses—market intelligence, risk management, the Special Resolution Unit and the Bank's financial stability function. The establishment of the FPC should also provide a greatly enhanced structure for identifying and addressing systemic threats at an early stage.

12. Overall, this material strengthening of the apparatus for monitoring and assessing risks to financial stability should make the Bank not only better able than in 2008 to identify impending financial stresses, but also able to do so further in advance of the risks crystallising, particularly if the risks emerge through stress on an individual bank. The inevitable result, however, is that there is now a formidable amount of raw data and information being collected and analysed within the Bank. The Review notes that it will be important that the Bank continues to develop and monitor processes to enable sufficient and intelligent filtering of this information, such that senior staff within the Bank receive timely notification of key developments, without being overwhelmed with data and analysis.

13. The Review also highlights the importance of the Bank maintaining this strengthened capacity to scan the horizon for impending financial stresses even when financial conditions

return to relative calm and the immediate need for the functions that have been built up within the Bank as a response to the crisis is less intense.

14. More widely, the Review notes that in future, systemic threats might arise from, or primarily affect, non-banks, and recommends that the Bank be able to identify impending systemic shocks emanating from, or impacting on, non-bank financial institutions.

Planning for ELA

15. The Bank's planning for providing ELA is reviewed in Chapter 3. A number of events in the run-up to the need to extend ELA in October 2008 helped to build up the Bank's capacity to handle ELA operations. Relevant staff had recent experience of ELA lending from the support provided for Northern Rock the previous year. More substantially, operation of the SLS since April 2008 had helped the Bank to develop its capacity to conduct collateral swaps, value collateral and apply haircuts. There was also specific planning for such operations after the initial period of lending to Northern Rock. Recognising the need for decisions to be taken at speed, the Court of Directors of the Bank (Court) had established a Transactions Committee (TransCo) to facilitate consultation of Court, and the Bank's Executive had set up a Resolution Committee (ResCo) to address operational decisions.

16. Overall, therefore, the Bank had acquired sufficient experience, and expertise, from its support operation for Northern Rock and from its operation of the SLS, to be able to respond rapidly and effectively when the need to extend ELA to HBOS and RBS arose. Nonetheless, some features of the operation had to be put together at the last minute, which heightened the Bank's exposure to operational risk.

17. For any possible need to extend ELA in the future, the operation of the Discount Window Facility (DWF) is likely to provide and sustain a level of operational readiness that was not available in 2008; it is likely that any future ELA would be implemented using similar mechanisms and legal documents to those used in the DWF. Pre-positioning of collateral in the DWF will be helpful to the Bank's ability to extend ELA to existing counterparties in future if need arises.

18. For ELA in foreign currency, the Bank may need to utilise swap lines in place with overseas central banks, which are due to be renewed in 2013. The Review recommends that these swap lines be maintained, but also suggests that the Bank continues to consider alternative sources for funding ELA in foreign currency (such as market swaps, use of the Bank's own foreign exchange reserves, or use of the Government's foreign exchange reserves) in case the central bank swap lines are for some reason not available for that purpose.

19. Contingency planning to provide ELA has been strengthened at the operational level by the establishment of the ELA Implementation Committee, which has put in place an ELA governance and control framework. Since some shocks are by their nature inherently unforeseeable, the Review recommends that the Bank needs to maintain its capacity to manage the consequences of unforeseen, as well as foreseeable, events, and notes that detailed contingency planning to implement ELA may help with this. The Review also

recommends that the Bank should consider what expertise it needs to have in-house for crisis scenarios if it is unlikely to be able to call on external expertise, either because an operation needs to be implemented at short notice, or because the Bank has concerns about secrecy. In terms of the need for external expertise, the Review notes that the Bank's normal legal advisers may not be available to be used in a situation where they already represent the bank to which ELA is being extended (as happened in the case of Northern Rock). The Bank is aware of this possibility and should continue to make contingency plans for engaging alternative legal advisers if needed.

20. Overall, against any possible future need to provide ELA to *banks*, the Bank has built on its experience of 2008 and is as fully prepared as could reasonably be expected. The Bank's planning has understandably focused thus far most closely on the banking sector. But it is as likely that in future a systemic threat will arise outside the banking sector. Against that possibility, and given that a number of the improvements in readiness resulting from changes to the Bank's liquidity provision and resolution planning frameworks (for example, through the DWF and SRR) are not available to non-bank institutions, the Bank may need the capacity to extend ELA to systemically important non-banks. This issue is examined in more detail in Chapter 9.

The ELA decision

21. The decision to extend ELA is examined in Chapter 4. The judgement as to whether or not to activate ELA in 2008 needed to address three core criteria—that the potential failure of the banks in need of support should be judged to be a threat to systemic stability; that the banks receiving support should in a broad sense be solvent; and that there should be a feasible exit strategy from the ELA—that is, the ELA should be a temporary bridge to a stable state in which the ELA could be repaid to the Bank.

22. In regard to the first criterion, there can be little doubt that in 2008 the failure of either HBOS or RBS would have had severe and damaging systemic consequences.

23. The second criterion of solvency is never easy to assess because difficulties in funding can quickly transmute into impairment of solvency. But for both banks in 2008 there was a concrete path to future solvency on which the Bank could base its decision to extend ELA. In the case of HBOS, the path to future solvency at the point ELA was extended appeared to be the merger with Lloyds TSB that had been announced on 18 September 2008. In the case of RBS, by the time ELA was extended, the Government's plan to recapitalise the banking sector was well advanced, and indeed was announced on 8 October, the day after ELA was first extended to RBS.

24. In relation to the third criterion, there were two clear exit routes that provided an adequate prospect for the Bank that its ELA would indeed prove temporary. The first was the proposed merger of HBOS with Lloyds TSB, together with the recapitalisation of both those banks and RBS. The second was the use by HBOS and RBS of the Government's Credit Guarantee Scheme (CGS) that was announced on 8 October at the same time as the recapitalisation plan.

25. On this basis, the three criteria can be judged to have been met. The criteria of forward-looking solvency and a path to exit could only be met through Government recapitalisation, but it was essentially the purpose of the ELA to provide a bridge to that unavoidable outcome.

26. The Review considers whether there were alternatives to ELA available to the Bank—for example, a support operation by other banks similar to the 'lifeboat' for the secondary banks in 1973–75; lending from a consortium of banks guaranteed by the Bank, as was done in the small banks crisis in the early-1990s; sale of either bank to another bank; or greater use of the SLS. None of these options is regarded as having been feasible as an alternative to ELA in the circumstances of the crisis in 2008.

27. For any decision to extend ELA in the future, there is now a more structured framework in place for assessing in a considered and coherent manner whether the criteria are met for ELA to be an appropriate response in a situation where a bank comes under strain: the process for conducting systemic impact assessments has been strengthened; the framework within the Bank for assessing solvency and viability of banks has been developed; and the SRR tools provide more options for the authorities to manage the process of returning a bank to a stable state or of resolving it in an orderly manner.

28. However, the Review notes that it will be important to ensure that the more structured framework now in place can be made to work effectively in practice, so that the Bank can marshal information internally in an efficient manner and, in conjunction with HMT, reach and implement decisions on whether or not to extend ELA without delay.

Terms of the ELA

29. The terms on which the Bank extended ELA are reviewed in detail in Chapter 5, which examines in turn the amount of ELA advanced, the structure of the operation, the maturity of the assistance given, the collateral taken and the haircuts applied, the fee charged, the conditions and monitoring, and the indemnity provided by HMT.

30. In general, the terms on which ELA is extended need to be guided by two principles:

- The need to minimise moral hazard—principally by means of the fee charged and the degree to which the management and shareholders of a bank receiving ELA suffer reputational and financial loss;
- The need to control the risks to the central bank's balance sheet—principally by the terms set for taking and valuing collateral.

31. The terms of the ELA extended to HBOS and RBS addressed both these principles appropriately and were well designed and worked satisfactorily. But the Review notes that:

- In relation to collateral taken, the task of managing and realising collateral, if the need ever arose, would be a formidable administrative challenge. The Bank has contingency plans in place, but it will be important to have a fully developed plan to manage this process;

- In applying haircuts, the Bank may need the capacity to be able to value and determine appropriate haircuts for collateral beyond that taken in the operations within its published framework and may need to give more detailed consideration to how it would do so. The Bank will need to ensure that its risk management function continues to develop in response to the evolving balance sheets of banks;
- In extending US dollar ELA to RBS, the Bank received no return in the first three of the four repos undertaken with RBS;
- The Bank should consider what monitoring of banks in receipt of ELA might be necessary in future.

32. The Review also suggests that, for the future, since ELA operations require authorisation by the Chancellor, it would in principle be logical for the Bank to seek an indemnity from HMT for the full amount from the outset. There may be practical or logistical reasons for the Bank to carry the risk on its balance sheet, without indemnity, for an initial period, as was the case in 2008. But in general, covering ELA with an indemnity from HMT would seem consistent with the allocation of responsibilities between the authorities.

Governance and decision-making

33. The Bank's governance and decision-making processes for its ELA operations in 2008 are examined in Chapter 6.

34. The requirements for external governance of the Bank's ELA operations in 2008 were set out in the Tripartite Memorandum of Understanding (MoU) signed in 1997 and updated in 2006. The Governor sought, and received, authorisation for the 2008 operations from the Chancellor. The arrangements for authorisation under the Tripartite MoU thus operated as envisaged.

35. The governance responsibility for the risk the Bank incurs in ELA operations lies with the Court of Directors of the Bank (Court). The decision to extend ELA is not a matter reserved to Court—appropriately so, as the decision is ultimately the responsibility of the Chancellor, as set out in the Tripartite MoU. The role of Court is to scrutinise the Bank's decision-making process and the conduct and terms of its ELA operations, particularly in regard to the Bank's exposure to risk.

36. The Governor is, however, obliged to consult Court, and did so through Transactions Committee (TransCo). The most important role for Court arguably flowed from its responsibility for the risk management policies adopted by the Bank. At peak, the Bank was not indemnified for £51.1 billion of lending to HBOS and RBS. In aggregate, over the life of the facilities, the Bank was indemnified for only 12% of its exposure. This ELA lending, and the Bank's contemporaneous lending through its Extended Collateral Long-Term Repo facility, both represented quantum leaps in the scale of unindemnified risk to which the

Bank's balance sheet was exposed; lending under the two facilities together constituted amongst the biggest risks to the Bank's balance sheet in its history. The Review suggests that, for the future, in view of the scale of risk to which the Bank's balance sheet may be exposed, a more structured process of reporting by the Executive might assist the relevant Court committee in discharging its oversight responsibilities—for example, a daily teleconference and weekly monitoring reports, covering in particular the risk management policies being put in place by the Bank to manage the increased exposure.

37. The Review also recommends that the Bank's formal statement setting out the responsibilities of Court, *Governance of the Bank Including Matters Reserved to Court*, be reviewed to specify more clearly and precisely Court's role as regards the Bank's balance sheet and its financial risk exposure.

38. TransCo's terms of reference provided for it to report the outcome of its meetings to the full Court as soon as possible or at such other time as it determined, in consultation with the Governor. Because of the need to maintain secrecy, the Governor and TransCo chose to delay reporting the action taken in respect of HBOS and RBS to the rest of Court. The ELA was reported to the Bank's external auditors in February 2009 and, in May 2009, to Court's Audit Committee in order to allow it to agree the Annual Report. As a result of the Banking Act 2009, there was considerable change in the membership of Court at the end of May 2009. Court as a whole was not notified until the ELA was publicly disclosed in November 2009. In the circumstances of the time, given the need for secrecy and given that a number of members of Court had potential conflicts of interest as a result of positions on the boards of other financial institutions, the delay was reasonable and was consistent with the oversight responsibility delegated to TransCo by Court.

39. Since the passage of the Banking Act 2009, the functions of TransCo in relation to ELA have passed to the Financial Stability Committee of Court, which also has a wider remit in relation to the Bank's financial stability objective. Under the Financial Services Bill currently before Parliament, the responsibilities of the Financial Stability Committee relating to system-wide financial stability, but not those relating to individual institutions, will pass to the new Financial Policy Committee (FPC). For the purpose of consultation on ELA, Court will again have the option of setting up a non-statutory committee. The Review recommends that any committee constituted for this purpose should have substantial representation of non-conflicted Non-Executive Directors.

40. Internally, the establishment of Resolution Committee (ResCo) in July 2008 helped to provide a coherent and streamlined internal decision-making process in relation to individual banks. Although HBOS and RBS had been receiving a considerable degree of sterling liquidity from the Bank's market-wide facilities, which were operated by the Bank's Markets Directorate, when the two banks began to receive sterling ELA the responsibility for managing ELA operations lay with the Banking Services Directorate. The Review notes that there might have been potential for miscommunication as a result of this dispersion of responsibilities. In the event, there is no evidence that this dispersion created any practical problems in 2008, but the Review suggests that for the future it might be logical to manage any ELA from the

Markets Directorate, in order to minimise the scope for confusion. Equally, other management structures would be possible and it is recommended that the Bank reviews whether the present dispersion of responsibilities remains appropriate in light of the significant extension in recent years of its framework for liquidity insurance.

41. The Review notes that in 2008 there was only partial separation of front, middle and back office functions. For the future, the Bank intends to ensure that separation is in place, which the Review suggests would be an appropriate step to strengthen risk management safeguards.

42. The Review also notes that there is some crossover of responsibilities in the reporting lines of the Markets Directorate and the Banking Services Directorate. A number of the market-wide facilities managed by the Markets Directorate, which reports to the Deputy Governor for Monetary Policy, are conducted primarily for financial stability purposes, for which the Deputy Governor for Financial Stability is responsible. For the future, the Review suggests that a more structured approach of each Directorate reporting to the relevant Deputy Governor for the latter's area of responsibility could be considered. The structure of responsibilities might appropriately be addressed when the third Deputy Governor, responsible for the Prudential Regulation Authority (PRA), joins the Bank.

43. Overall, in 2008 the process for decision-making within the Bank in the severe stress of exceptional events worked well in enabling the Bank to respond rapidly and effectively to an extreme financial crisis. It should also be noted that proper care was taken to keep records and provide an audit trail.

44. The Review considers the question of whether all members of the Monetary Policy Committee (MPC), some of whom were not aware of the Bank's ELA operations at the time, should have been briefed on them, as a development possibly relevant to the MPC's decisions on setting interest rates. This issue raises conflicting considerations, but in the circumstances it is understandable that the full MPC was not briefed on them.

45. For the future, the Review suggests that consideration will need to be given to what role the new FPC will appropriately play in relation to any provision of ELA. The Review suggests that, although the FPC will not be involved in operational decisions to extend ELA in individual cases, it may have a role in establishing the framework within which any future ELA decisions would be made and in developing any wider response that might be needed to the systemic threat that gave rise to the need for ELA.

Disclosure

46. The decision to keep ELA operations covert until they were disclosed in November 2009 is examined in Chapter 7.

47. On the face of it, it is remarkable that operations on the scale and intensity of the ELA extended in 2008 could be kept covert. That this was possible, however, owed a great deal to the background of extreme market disturbance at the time—notably, the use banks

generally had been making of the SLS since April, and the widespread dysfunction of markets. Both of these factors served as camouflage for the ELA operation and for the specific problems of the two banks receiving ELA.

48. There were a number of possible practical constraints that might have jeopardised the covert nature of the operations—relating to publication of the weekly Bank Return; disclosure requirements for the Bank's Annual Report; the need to register any charge over assets; the requirement for HMT to report a contingent liability, such as the indemnity given to the Bank, to Parliament; European Union State Aid rules; the European Central Bank's rules on monetary financing; and any disclosure obligations the banks receiving ELA might have had. In the event, the Bank was able to address these constraints.

49. In light of the extreme fragility of the markets at the time, and in view of the considerable disturbance that had been caused by the revelation of the lending to Northern Rock the previous year, it was right to endeavour to keep the ELA operations in 2008 covert.

50. Steps have been taken to alleviate some of the constraints the Bank faced in 2008, including removing the requirement for the Bank to publish the weekly Bank Return. The Review recommends that the Bank should indeed cease to publish this Return at an appropriate time. The Review also notes the importance of resolving remaining uncertainties in some areas of the legal and regulatory framework for disclosure so that, to the extent possible, the standard requirements for disclosure do not, in a crisis, counterproductively compromise the wider public interest in maintaining financial stability.

51. Even with the changes made, however, for any future ELA operations it may not be possible to maintain the level of secrecy that was achieved in 2008: for example, it may well not be the case that any future ELA would be undertaken against the background of an extended period of market disturbance and of similarly structured facilities like the SLS, both of which helped to mask the ELA in 2008.

52. The Review suggests that it would be helpful, in terms of enabling ELA to be undertaken covertly, if there were fuller implementation of the regulatory rule requiring banks periodically to realise a proportion of their liquid assets through repo or outright sale in the market, such that banks undertook this periodic realisation on sufficient scale to provide a degree of cover for any ELA support extended by the Bank.

53. The ELA operations were disclosed by a Bank announcement in November 2009, nearly 14 months after they had been initiated. There were a number of occasions during this period when disclosure might have been possible. But in the fragile circumstances of 2009, it was reasonable for the Bank to wait until it was confident that the risks to disclosure had been reduced. The muted market reaction to the announcement supported the Bank's judgement.

54. Although the case for disclosure was considered in the Bank at intervals in 2009, there was no regular mechanism for reviewing the point at which it might be appropriate to disclose. Such a procedure has now been put in place between HMT and the Bank, for instances where ELA has been indemnified by HMT. The Review suggests that it would be appropriate

for a similar process to be followed within the Bank in relation to any ELA that is not indemnified.

Effectiveness of the ELA operations

55. The terms of reference for this Review require it to examine the effects of the Bank's ELA operations on the institutions concerned and on overall financial stability. That assessment is provided in Chapter 8.

56. It is impossible to distinguish the specific contribution ELA may have made to stabilising the two banks, and the financial system as a whole, from the impact of the wider range of stabilisation measures taken by the Bank and the Government over the period of the crisis. Halting the contagion and averting the threat of total collapse required a battery of Government measures, in the context of which the ELA support provided by the Bank was an essential, but necessarily temporary, element. The Bank's ELA operations did not in any sense resolve the financial crisis. Nor could they have done so, on their own. But they were an essential plank in the structure of official support that was able in the end to return the financial system to a degree of stability.

57. In the necessarily narrow terms of what it aimed to achieve, the ELA extended by the Bank can be judged to have achieved its purpose effectively. Had ELA not been extended, it is very probable that HBOS would have been forced to cease business within days, and RBS similarly when its sources of dollar funding dried up. In terms of the broader stability of the financial system, there can be little doubt that the failure of either bank would have precipitated a widespread further diminution of confidence in other, less stressed, banks. In systemic terms, therefore, the ELA served to contain the spread of contagion in a period of high risk of systemic collapse. The operation can be viewed as a classical exercise of the central bank's lender of last resort function.

58. The way the ELA was structured also addressed the two important principles of controlling the risks to the Bank's balance sheet and to public funds, and of minimising moral hazard. The degree of oversight to which the banks receiving ELA were subjected, the financial loss incurred by their shareholders and the reputational damage both banks and their senior management suffered also served to minimise moral hazard.

59. It should also be recognised that the effectiveness of the Bank's operations through this exceptionally challenging phase of the crisis owed a great deal to the professional competence, technical expertise and dedication of the Bank's staff as a whole and their capacity to operate to high standards under pressure over an extended period.

ELA in the future and the Bank's lender of last resort function

60. The future role that ELA might need to play, and how it might be conducted, is examined in Chapter 9.

61. The nature of the Bank's lender of last resort (LoLR) function has been fundamentally transformed since 2008. In terms of providing liquidity support, a large part of what in the

past was termed ELA has now been institutionalised in facilities within the Bank's published framework, notably the Discount Window Facility (DWF). In circumstances in which the Bank does not consider ELA to be the appropriate response, the authorities now have the means, through the Special Resolution Regime (SRR), to resolve a bank in an orderly manner. So there is now a much reduced space in which ELA might need to be contemplated.

62. Nonetheless, such situations could arise. One set of circumstances would be if a bank needing liquidity could not for some reason utilise the DWF. Another would be if ELA was needed to give time for one of the SRR tools to be put in place. A further case would be if a non-bank financial institution posed a systemic threat. The Bank now has for the most part the capacity to provide ELA to *banks* outside the DWF, if the need should arise. But the Review suggests that it will be important for the Bank to have the capacity, if necessary, to extend ELA to non-banks if strains on one or more were to precipitate a threat to systemic stability. Analogous considerations will arise in respect of banks outside the ring-fence proposed by the Independent Commission on Banking and the Government's White Paper on Banking Reform.

63. More widely, the Bank, like any central bank, may need to take the lead in crisis management if the financial system is destabilised by sudden and unforeseen shocks that may take many forms—not necessarily involving the provision of ELA. The Review recommends that at some stage the Bank should set out the principles under which it would now contemplate activating its LoLR function in the widest sense.

64. The Bank's role in crisis management, and in particular in providing ELA, will—once the Financial Services Bill is passed—be governed by a new (currently draft) MoU on Crisis Management. This provides that, "where the Bank is able to manage a financial crisis without public funds being put at risk, it will have autonomy in exercising its responsibilities in line with the relevant statutory provisions."[1] There is practical advantage in a central bank having room for manoeuvre in responding to a financial crisis. But how far it can do so is constrained by the degree of risk exposure it is able to take.

65. The risk management policies adopted by the Bank are the responsibility of its Court of Directors (Court). In exercising this responsibility, Court has necessarily to have regard to the size of the Bank's capital. Given that the Bank's capital already has to cover the significantly increased potential scale of risk exposure it incurs through the expanded range of liquidity insurance facilities it operates, the Review suggests that some increase in the size of the Bank's capital may be appropriate, to enable the Bank to play an effective role in a financial crisis, where this can be done without public funds being put at risk, as envisaged in the draft Crisis Management MoU.

[1] HM Treasury, *A new approach to financial regulation: securing stability, protecting consumers*, Cm 8268, January 2012, Annex E - Memorandum of Understanding on financial crisis management, p.110

Chapter 1: Background

Emergency liquidity assistance extended to HBOS and RBS

66. In the period after the failure of Lehman Brothers on 15 September 2008, the financial crisis, which had been building since the summer of 2007, intensified rapidly. Vulnerable financial institutions came under increasing pressure, with many struggling to raise sufficient liquidity in the market. Against this background, two banks, HBOS and Royal Bank of Scotland (RBS), were forced to request liquidity support from the Bank of England (the Bank) and as a result received emergency liquidity assistance (ELA) on a large scale.

67. HBOS first received ELA on 1 October 2008. The ELA facility was structured as a collateral swap under which the Bank lent HBOS UK Treasury bills (T-bills) against unsecuritised mortgage assets. This was a structure similar to that used in the market-wide Special Liquidity Scheme (SLS) which the Bank had been operating since April 2008. The Bank charged a fee of 200 basis points on the market value of the T-bills lent for the duration of the facility. HBOS's use of the ELA facility peaked in terms of the market value of T-bills lent at £25.4 billion on 13 November 2008. HBOS made final repayment of the facility on 16 January 2009.

68. There were two elements to the ELA extended to RBS. The first element was a bilateral US dollar repo facility under which the Bank lent RBS US dollars in exchange for UK T-bills. This was distinct from, but the same in form as, the market-wide US Dollar Repo Operations which the Bank was already operating and in which RBS also participated. The second element of the ELA was a collateral swap facility under which the Bank lent T-bills to RBS against unsecuritised mortgage and loan assets (in an equivalent operation to that undertaken for HBOS).

69. RBS first used the US dollar ELA facility on 7 October 2008 and made final repayment of this facility on 17 October 2008. RBS was charged the highest price bid in that day's auction for dollars in the market-wide US Dollar Repo Operations for any amounts drawn under this facility. The maximum amount lent under this facility was $25 billion, which was outstanding from 10 October to 17 October.

70. RBS first used the sterling ELA facility on 10 October 2008. It made final repayment on 16 December 2008. RBS's use of this facility in terms of the market value of T-bills lent peaked at £29.4 billion on 27 October 2008. As with HBOS, RBS was also charged a fee of 200 basis points on the market value of the T-bills lent.

71. From 14 October 2008, HMT provided an indemnity to the Bank for any amounts above the amount drawn under these facilities at close of business on 13 October 2008. The HBOS facility was therefore indemnified above £23.1 billion and the RBS sterling facility was indemnified above £13.5 billion. The US dollar ELA facility was not indemnified. This meant that, at peak on 13 October, £51.1 billion of the Bank's exposure to these two banks was not indemnified. Once the US dollar facility was repaid on 17 October, £36.5 billion remained unindemnified.

72. The ELA facilities to both banks were provided covertly and their existence was not publicly disclosed until 24 November 2009, when the Bank published details of the facilities.

73. The ELA extended by the Bank to HBOS and RBS occurred against the backdrop of the global financial crisis. Because the action the Bank took in providing that ELA needs to be seen in the context of the continuing crisis running back to the summer of 2007, Appendix 2 gives a short summary of the principal events of the financial crisis.

Wider Bank and Government measures in 2008 to address the crisis

74. The ELA extended to HBOS and RBS was part of a series of measures taken by both the Bank and the Government to address the deepening financial crisis during 2008. The measures that are most significant in terms of understanding the context of the ELA were the Bank's SLS (initiated in April 2008), its US Dollar Repo Operations (from September 2008) and the Government's package of support measures for the financial system announced in October 2008.

75. On 21 April 2008, the Bank announced the launch of the SLS to allow banks temporarily to swap their high quality, but currently illiquid, mortgage-backed and other securities for UK T-bills (more detail on the SLS is given in Box 1). Peak usage of the scheme was £185 billion at the point that the drawdown window closed in January 2009. On 18 September 2008, in response to elevated levels of stress in the US dollar funding market following the failure of Lehman Brothers, the Bank, along with a number of other central banks, introduced US Dollar Repo Operations to lend dollars direct to UK banks (more detail on these operations is given in Box 2).

76. On 8 October 2008, HMT announced a package of support measures for the UK financial system. This included the provision of capital to UK banks and the Credit Guarantee Scheme (CGS), which provided Government guarantees for new short/medium-term senior unsecured debt issuance (more detail on the CGS is given in Box 3).

77. As a consequence of the recapitalisation scheme announced on 8 October, on 13 October HMT acquired shares in both HBOS and Lloyds TSB. After the merger of those two banks on 19 January 2009, HMT held 43% of the share capital of the merged entity, Lloyds Banking Group. The Government's ownership of Lloyds Banking Group stood at 40% at end-March 2012. Recapitalisation of RBS occurred in a series of transactions which eventually led to Government ownership of 83% of RBS. The Government's ownership of RBS now stands at 82%.

Box 1: the Special Liquidity Scheme

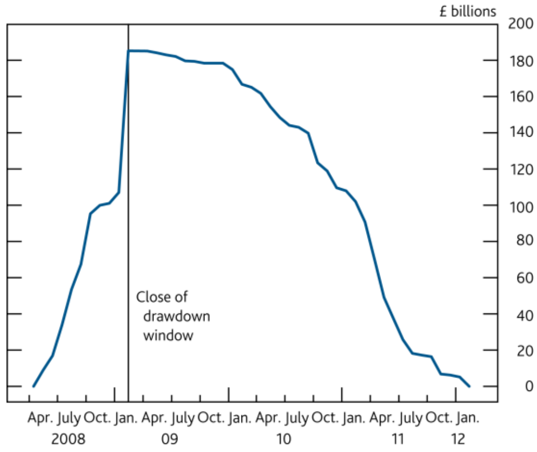
The Special Liquidity Scheme (SLS) was launched on 21 April 2008. It was designed to help improve the liquidity position of the UK banking system, following the closure of some asset-backed security markets. The SLS operated as a collateral swap, allowing banks, for a fee, to swap high-quality mortgage-backed and other securities for 9-month UK Treasury bills (T-bills) for a term of up to three years. Because the SLS was designed to help banks finance 'legacy' assets, only loans extended before 31 December 2007 were allowed to be securitised for use in the scheme.

Banks were allowed to enter in to collateral swaps with the Bank during the specified 'drawdown window'. At the time of the launch of the scheme that window was set to last six months, until 21 October 2008. On 17 September, after the failure of Lehman Brothers, the Bank announced that the drawdown window would be extended until 30 January 2009.

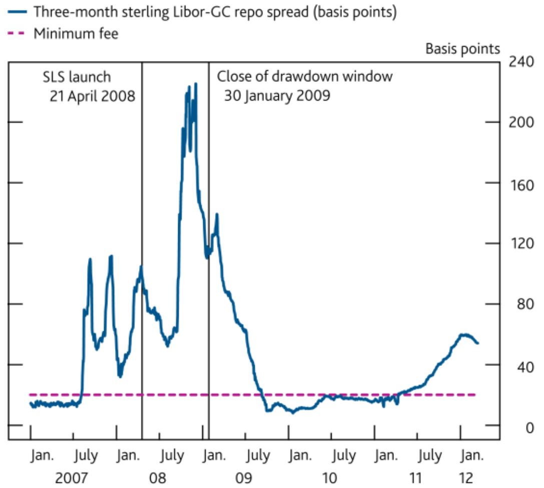
At its peak, when the drawdown window closed at the end of January 2009, £185 billion of T-bills had been borrowed by 32 banks under the scheme, against securities with a nominal value of £287 billion. The last of the swaps under the SLS expired at the end of January 2012. Because of the size of the scheme relative to the Bank's balance sheet, the Bank was indemnified by HM Treasury for any net losses. In the event, no such losses were incurred.

The fee charged for participation in the scheme was based on the spread between three-month sterling Libor and the three-month sterling general collateral (GC) gilt repo rate, with a minimum fee of 20 basis points. The Bank charged higher fees for higher levels of usage relative to the size of each bank's balance sheet. The fee for each SLS swap was set on the date of the drawdown and subsequently reset every three months thereafter.

Face value of Treasury bills borrowed in the SLS†



Sterling three-month Libor GC spread†



†Charts reproduced from 'The Bank of England's Special Liquidity Scheme', *Bank of England Quarterly Bulletin 2012 Q1*, Vol. 52, No. 1, March 2012

Box 2: US Dollar Repo Operations

On 18 September 2008, shortly after the failure of Lehman Brothers, the Bank of Canada, the Bank of England, the European Central Bank, the Bank of Japan and the Swiss National Bank announced coordinated measures designed to address elevated pressures in US dollar funding markets.

The Bank announced market-wide US Dollar Repo Operations. Under these operations the Bank provided US dollar funding to UK banks by repo against eligible collateral. These operations were facilitated by a reciprocal swap agreement with the Federal Reserve, which provided the Bank with the US dollar funding to provide to the market.

The US Dollar Repo Operations initially provided a fixed amount of dollars overnight against collateral routinely eligible in the Bank's short-term repo Open Market Operations (OMOs) and Standing Facilities, along with conventional US Treasury securities. The operations were undertaken on a variable-rate auction basis, with funds being allocated in descending order of the rate bid (with banks paying the rate they had bid), but with no bank being allowed more than 20% of the total allocation of dollars. From 26 September, the Bank also offered a fixed amount of dollars on the same terms but for periods of one week. From 3 October, eligible collateral for the one-week US Dollar Repo Operations was widened to the Bank's 'wider collateral pool'. This included, for example, G10 government bonds and securities issued by government-guaranteed agencies, as well as AAA-rated asset-backed securities and covered bonds and, from 8 October, debt guaranteed under the Government's Credit Guarantee Scheme.

From 15 October, while the overnight variable-rate auctions continued, the one-week operations became fixed rate (at the OIS rate plus 100 basis points) and for an unlimited amount, with settlement two days after the operation was conducted, e.g. 17 October for the first unlimited size operation. On 21 October, the Bank announced it would also conduct fixed-rate, unlimited amount US Dollar Repo Operations for one- and three-month maturities. The last variable-rate overnight auction operation was held on 7 November 2008, after which all operations were at a fixed rate, for unlimited amounts and for longer than overnight maturities.

The final US Dollar Repo Operation was conducted on 27 January 2010. However in response to the re-emergence of strains in US dollar short-term funding markets in Europe, the swap line with the Federal Reserve was re-established in May 2010 and the Bank recommenced weekly fixed-rate unlimited operations. From 12 October 2011 these were supplemented by monthly fixed-rate unlimited operations offering dollars for terms of three months. In November 2011, the Bank put in place bilateral liquidity swap arrangements with the Bank of Canada, the European Central Bank, the Bank of Japan, and the Swiss National Bank in order that liquidity can be provided in those currencies if necessary. To date, these facilities have not been used.

Box 3: the Credit Guarantee Scheme

The Government announced the Credit Guarantee Scheme (CGS) on 8 October 2008 as one element of its package of measures, along with bank recapitalisation, aimed at improving stability within the financial system.

The scheme was open to UK banks, as long as they had put in place plans to raise what the Government considered to be an appropriate amount and form of Tier 1 capital within a specified timeframe. Under the scheme, the Government guaranteed, for a fee, specified short- and medium-term debt instruments issued during the period from 13 October 2008 to 28 February 2010. The term of the instruments guaranteed under the scheme could be no longer than three years. Guaranteed debt maturing after the issuance window could be rolled over, so that it was still guaranteed, as long as it matured before the guarantee expired. The original guarantee expiry date was 13 April 2012, but this was later extended to 13 April 2014.

The fee on guaranteed issues under the scheme was 50 basis points per annum plus the bank's median five-year Credit Default Swap spread during the 12 months to 7 October 2008. The amount each bank was able to issue under the CGS was determined by its Eligible Liabilities (a measure of short-term sterling deposits). The maximum amount issued under the scheme was around £135 billion.

The following banks issued debt under the scheme: Bank of Scotland (part of HBOS and then the Lloyds Banking Group); Barclays; Clydesdale; Coventry Building Society; Investec; Lloyds TSB; Nationwide Building Society; Rothschilds Continuation Finance; Skipton Building Society; Standard Life; Tesco Personal Finance; The Royal Bank of Scotland; West Bromwich Building Society; and Yorkshire Building Society.

78. A further major step in restoring financial stability was the announcement of the Asset Protection Scheme (APS) in January 2009. The APS provided Government insurance against future credit losses on defined pools of assets (more detail on the APS is provided in Box 4). RBS and Lloyds Banking Group agreed in principle to participate in the APS in February and March 2009 respectively. On 3 November 2009, it was announced that RBS had formally signed up for the APS and that Lloyds Banking Group had decided not to participate in the scheme, but to embark on an alternative strategy for capital raising. Following these two decisions, the Bank judged that it was no longer necessary for the ELA extended to HBOS and RBS to remain covert and disclosure was made on 24 November 2009.

Box 4: the Asset Protection Scheme

The Asset Protection Scheme (APS), announced in January 2009, was designed to allow the Government to provide participating banks with what was effectively insurance against future credit losses on defined portfolios of assets in exchange for a fee.

RBS and Lloyds Banking Group agreed in principle to participate in the APS in February and March 2009 respectively. These initial agreements gave both banks implicit protection from that point. In November 2009, it was announced that Lloyds Banking Group would not be participating in the scheme; it was charged a fee of £2.5 billion for the implicit protection it had received since March, as a result of its initial agreement in principle to participate.

RBS was therefore the sole participant in the scheme. Under the scheme RBS paid an annual fee in return for which the Government insured the value of certain of RBS's assets. If those assets fell in value, RBS would bear the first £60 billion of losses, after which losses would be shared between the Government and RBS in a ratio of 9:1.

RBS paid fees of £700 million per year for the first three years of the scheme and then £500 million each year thereafter. In order to leave the APS RBS had to pay £2.5 billion, less any amount already paid in fees. RBS left the scheme on 18 October 2012, the date by which it had paid £2.5 billion in fees (that is, the earliest date consistent with the minimum contractual fee), without having made a claim under the scheme. RBS insured a pool of £282 billion worth of assets (value as at 31 December 2008) under the scheme.

Changes in the statutory and regulatory framework, and in the Bank's operational framework since 2008

79. Since ELA was extended to HBOS and RBS in October 2008, there have been a number of changes to the statutory and regulatory framework and to the Bank's operational framework for liquidity insurance. The changes that are most relevant to any future provision of ELA are outlined here. A more comprehensive outline of the changes since 2008 is given in Appendix 3.

80. Even before the financial crisis, it was recognised that normal insolvency procedures were not well suited to banks[2]. The crisis, and in particular the run on Northern Rock, underlined the problems presented by the lack of an appropriate framework for resolving banks facing failure. As a result, Parliament passed temporary emergency legislation in February 2008, the Banking (Special Provisions) Act 2008, which gave HMT powers to facilitate the orderly

[2] Throughout the Review 'banks' is used as a short-hand to refer to regulated deposit taking institutions, including, for example, building societies. Deposit taking institutions that are required under the Bank of England Act to report their 'Eligible Liabilities' can apply to become participants in any of the operations within the Bank's published framework.

resolution of a failing bank in order to maintain financial stability or protect the public interest.

81. The Banking Act 2009, which came into force on 21 February 2009, superseded the Banking (Special Provisions) Act 2008, the provisions of which were temporary and lapsed on 20 February 2009. The Banking Act 2009 made a number of statutory changes, including giving the Bank a statutory objective to "contribute to protecting and enhancing the stability of the financial systems of the United Kingdom".[3]

82. One of the main purposes of the Banking Act 2009 was to establish the Special Resolution Regime (SRR) to give the UK a permanent framework for resolving distressed banks. The SRR includes three stabilisation tools: transfer of all or some of an institution to a private sector purchaser; transfer of all or part of the business of an institution to a bridge bank (both exercisable by the Bank, as resolution authority); and placing an institution into temporary public ownership (exercisable by HMT). The SRR also provides the authorities with the ability to apply to place an institution into the bank insolvency procedure to facilitate the rapid pay-out of depositors covered by the Financial Services Compensation Scheme. The statutory objectives of the SRR (which have to be balanced as appropriate in each case) are, in summary, to protect UK financial stability, to protect the banking systems of the UK, to protect depositors, to protect public funds and to avoid interference with property rights.

83. Alongside changes to the statutory framework, there have been significant changes to the international and national regulatory framework. New international regulations proposed under Basel III will require banks to hold much higher levels of capital. A global minimum liquidity standard will also be established. In advance of these changes, the FSA has considerably adjusted its regulatory stance by increasing the intensity of its supervision and by setting higher capital and liquidity requirements for UK banks.

84. Similarly, the Bank has adapted considerably its published framework for providing liquidity insurance since the beginning of the crisis.[4] It has done this by extending the range of facilities for providing liquidity, both on a market-wide basis, for example through the introduction of Indexed Long-Term Repo operations and the Extended Collateral Term Repo operations (for more detail on these facilities see Appendix 3), and on a bilateral basis through the Discount Window Facility (DWF). The most significant change in terms of any future ELA is the introduction of the DWF. The DWF is designed to provide liquidity to banks in the event of stress and enables banks to borrow UK Government securities, or in certain circumstances cash, against a wide range of collateral including, since April 2011, portfolios of unsecuritised loans (more detail on the DWF is provided in Box 5).

[3] Banking Act 2009 (c.1), Section 238, (1), 2A (1), UK financial stability, p.122

[4] The accompanying review by Bill Winters, *Review of the Bank of England's framework for providing liquidity to the banking system*, examines the structure and terms of the facilities within the Bank's published money market framework, how that framework has operated since 2008 and the operation of the Special Liquidity Scheme.

Box 5: the Discount Window Facility

In October 2008 the Bank separated its bilateral Standing Facilities into Operational Standing Facilities (OSFs) and a Discount Window Facility (DWF). The OSFs, which largely replicate the form and purpose of the previous Standing Facilities, are designed to support monetary policy by ensuring that short-term market interest rates do not deviate too far from Bank Rate, but also to provide liquidity insurance to banks experiencing unexpected (frictional) payment shocks which may arise due to technical problems in banks' own systems or in the market-wide payments and settlements infrastructure.

The DWF is a permanent bilateral liquidity insurance facility which offers liquidity insurance for idiosyncratic as well as system-wide shocks. The DWF allows banks to borrow, for a fee, gilts (or in some circumstances, at the Bank's discretion, cash) against a range of potentially less liquid eligible collateral.

DWF drawings are intended to be for a maximum of 30 days, though they can be rolled over at the Bank's discretion, and for an additional fee can be for a maximum term of 364 days. Drawings can be terminated at any point. Collateral eligible in the DWF is divided into four levels: Level A – the most liquid 'narrow set'; Level B – the 'wider set' of high-quality collateral that normally trades in liquid markets; Level C – high-quality but illiquid collateral; and Level D – the least liquid, own-name securities or pools of loans where a borrowing bank itself originated, or has some other close financial link to, the assets comprising the collateral. Since April 2011, eligible collateral has included portfolios of unsecuritised loans. The population of eligible collateral is expected to be developed over time.

The fee charged varies on the basis of the type of collateral used and the size of the drawing relative to the size of the borrower, and may be varied at the Bank's discretion.

Banks are encouraged to pre-position eligible collateral in the DWF to ensure they can draw rapidly if needed. As at end-March 2012, over £265 billion had been pre-positioned in the DWF.

Future changes to the statutory framework

85. The Financial Services Bill currently in Parliament proposes three main institutional changes to the regulatory structure. First it will establish the Financial Policy Committee (FPC) which will have responsibility for macroprudential regulation. Second, it will establish the Prudential Regulation Authority (PRA) as a subsidiary of the Bank. The PRA will have responsibility for microprudential regulation of deposit-takers, insurance companies and some investment firms. Third, it will establish the Financial Conduct Authority (FCA). The FCA will be responsible for conduct of business issues and the prudential supervision of all firms

not covered by the PRA. The PRA and FCA will replace the current Financial Services Authority (FSA).

86. The proposed legislation will have particular implications for any ELA operations undertaken by the Bank in future. Such operations are currently governed by the Tripartite Memorandum of Understanding (MoU) established in 1997 and revised in 2006, examined in more detail in Chapter 6. Under the proposed legislation in the Financial Services Bill, ELA operations will be governed by a new (currently draft) MoU on Crisis Management. This MoU is examined further in Chapter 9.

Chapter 2: Horizon scanning

87. The need for the Bank to extend ELA to HBOS and RBS in October 2008 arose against the background of significant disturbances in the financial system. This chapter addresses the following questions:

- How effectively was the Bank able to identify impending financial stresses in the run-up to October 2008?
- How aware was the Bank of the particular vulnerabilities of the two banks to which it eventually extended ELA?
- How well equipped is the Bank now to identify impending financial stresses?

88. Chapter 3 will examine in more detail the specific question of the Bank's level of preparedness and planning to undertake ELA.

How effectively was the Bank able to identify impending financial stresses in the run-up to October 2008?

89. The Bank's second core purpose, as defined at the onset of the financial crisis, was to detect and reduce threats to the financial system as a whole.[5] Prior to the financial crisis, there was debate within the Bank as to how well equipped the Bank was to discharge this core purpose. Whilst it had the analytical capability to identify and assess macro-systemic threats to financial stability, it had no statutory responsibility in this area and no formal powers to act, other than to communicate its concerns. It could do so in private in the Tripartite, and in public through the Bank's biannual Financial Stability Report (FSR)—which sets out the Bank's assessment of the outlook for the stability and resilience of the financial sector—and through speeches made by members of the Bank Executive. Moreover, the focus of the Bank's work on financial stress was necessarily on systemic developments; the formal flow of information on individual banks ran to the FSA.

90. In a letter from Sir David Lees, current Chairman of the Bank's Court of Directors (Court), to Andrew Tyrie MP, Chairman of the House of Commons Treasury Committee in April 2011, Sir David noted that it was evident from Court minutes from the period from June 2007 to May 2009 that with respect to the Bank's financial stability function, "Court was both conscious of and frustrated by the limitations imposed by the Bank's formal responsibilities and powers."[6]

91. It was not until the passage of the Banking Act in February 2009 that the Bank received a formal statutory objective "to contribute to protecting and enhancing the stability of the financial systems of the United Kingdom".[7] Even at this point, the Bank was not given

[5] Bank of England, *Annual Report 2007*, May 2007, p.1

[6] Sir David Lees, Chairman of the Court of Directors of the Bank of England, letter to Andrew Tyrie MP, Chairman of the House of Commons Treasury Committee, 26 April 2011, http://www.parliament.uk/documents/commons-committees/treasury/CorrespondencewithCourtfinal.pdf

[7] Banking Act 2009 (c.1), Section 238, (1), 2A (1), UK financial stability, p.122

specific tools to address concerns it may have had about threats to financial stability. The powers proposed for the Financial Policy Committee (FPC) in the Financial Services Bill are designed to address that shortcoming.

92. Despite these limitations, examination of the Bank's public output demonstrates that it was monitoring and highlighting many of the main systemic risks that subsequently crystallised during the financial crisis. For example, the June 2004 FSR discussed the possibility that the search for yield might be reflecting misperception of risk; the December 2005 FSR noted that the proliferation of structured products had the potential to become a source of vulnerability if investors were under-pricing risk or underestimating the possibility of new channels of contagion from these products; in November 2005 the then Deputy Governor, Sir Andrew Large, underlined in a speech the need for liquidity cushions as protection against the intricacies of structured products; and in a speech in May 2006 Paul Tucker, then Executive Director for Markets, noted that there was particular uncertainty about the liquidity of structured products under stressed conditions.[8] Similarly, several FSRs flagged potential risks associated with funding structures used by banks, especially in periods of stress.[9]

93. However, although some risks that subsequently materialised were identified before the crisis, they were identified by the Bank as being low-probability. This meant that the impact they might have if they did crystallise received arguably too little attention. For example, the July 2006 FSR assessed the probability of severe stress occurring in a large complex financial institution (LCFI) in the medium term as being "remote" and with a likelihood "close to zero". The April 2007 FSR judged that the probability of this risk crystallising was broadly unchanged (from the July 2006 FSR) and assessed that its expected impact on major UK banks' balance sheets had increased only slightly. Even in October 2007, the FSR assessed the probability and impact of LCFI distress as having increased only slightly (from the April 2007 FSR).[10] The Bank has subsequently acknowledged that it could have done more to broadcast the risks it did perceive.[11]

---

[8] *Bank of England Financial Stability Review*, Issue No. 16, June 2004, p.11; *Bank of England Financial Stability Review*, Issue No. 19, December 2005, p.30; Sir Andrew Large, 'Financial stability: managing liquidity risk in a global system', speech given to the City of London Central Banking and Regulatory Conference, London, 28 November 2005; Paul Tucker, 'Uncertainty, the implementation of monetary policy and the management of risk', speech given to the Association of Corporate Treasurers, Newport, 19 May 2006

[9] See, for example, *Bank of England Financial Stability Report*, Issue No. 20, July 2006; *Bank of England Financial Stability Review*, Issue No. 19, December 2005; *Bank of England Financial Stability Review*, Issue No. 18, June 2005

[10] *Bank of England Financial Stability Report*, Issue No. 20, July 2006, Box 6 – systemic stress testing, pp.45–49; *Bank of England Financial Stability Report*, Issue No. 21, April 2007, p.38; *Bank of England Financial Stability Report*, Issue No. 22, October 2007, p.15

[11] Sir Mervyn King noted in the '2012 BBC Today Programme Lecture', London, 2 May 2012, that: "Our power was limited to that of publishing reports and preaching sermons. And we did preach sermons about the risks. But we didn't imagine the scale of the disaster that would occur when the risks crystallised. With the benefit of hindsight, we should have shouted from the rooftops that a system had been built in which banks were too important to fail, that banks had grown too quickly and borrowed too much, and that so-called 'light-touch' regulation hadn't prevented any of this. And in the crisis, we tried, but should have tried harder, to persuade everyone of the need to recapitalise the banks sooner and by more."

94. In addition to its public output, the Bank was also sharing analysis within the Tripartite that highlighted its assessment of particular systemic risks. For example, and as noted in the FSA's report into the failure of RBS, the Bank provided an assessment to the Tripartite Standing Committee on Financial Stability in October 2006 which noted the significant increase in UK banks' reliance on wholesale funding sources and considered the major UK banks' wholesale funding vulnerability.[12]

95. Although high-level monitoring of systemic risks was clearly taking place well before the failure of Northern Rock in autumn 2007, the Bank was not focused to any degree on individual banks. This reflects the fact that, under the Tripartite arrangements, monitoring of individual institutions was the responsibility of the FSA. However, the failure of Northern Rock, and the need for the Bank to provide ELA to support it, led to a progressive increase in the Bank's monitoring of, and engagement with, individual banks. In its contribution to the Chancellor's review into Northern Rock in December 2007 the Bank noted that it was "striking that a new approach has emerged since September in which the Bank has been more closely engaged with individual firms."[13] This change in approach was intended not only to support the Bank's ability to deal with individual institutions in crisis, but also to support its ability to assess overall systemic vulnerability.

96. One class of information that is likely to be particularly important in order for the Bank to be able to identify impending financial stresses is timely and relevant data on the liquidity sources and needs of individual institutions. Before the crisis, data on individual banks' liquidity provided by the FSA to the Bank were not ideal for horizon scanning: these data were not forward-looking and lacked the immediacy and granular detail needed to form judgements on the liquidity position and funding needs of individual banks under stress. As the Bank noted in its submission to the Chancellor's review on Northern Rock, "It has become apparent that the data normally collected by the FSA on liquidity fall short of what is needed either for early warning of vulnerabilities or for crisis management."[14] The FSA's report into the failure of RBS also acknowledged that, "Insofar as the FSA was monitoring liquidity risks for firms such as RBS, it was through the Sterling Stock Regime (SSR), the quantitative requirements of which were inadequate fully to capture sterling wholesale funding risks, and which did not at all capture risks of funding in US$ or other non-sterling currencies."[15] This was particularly important in the case of RBS where its initial need for ELA was the result of inability to secure sufficient US dollar funding in the market.

97. Overall, the Bank was able in varying degrees to identify and highlight the principal areas where impending financial stresses were threatening systemic stability in the run-up to October 2008. But, at least until the failure of Northern Rock, there was greater focus on

[12] Financial Services Authority, *The failure of the Royal Bank of Scotland: Financial Services Authority Board Report*, December 2011, p.96
[13] Bank of England, 'Tripartite lessons from Northern Rock: Bank of England input to the Chancellor's review', December 2007, p.4, http://www.parliament.uk/documents/commons-committees/treasury/CorrespondencewithCourtfinal.pdf
[14] *Ibid.*, p.3
[15] Financial Services Authority, *The failure of the Royal Bank of Scotland: Financial Services Authority Board Report*, December 2011, p.45

risks at the systemic level, as distinct from threats to individual banks; and even in 2008 there was arguably too little attention directed to the consequences of low-probability (tail) risks (such as the failure of an LCFI) which, in the form of the failure of Lehman Brothers, were what actually precipitated the intensification of the crisis in October 2008.

How aware was the Bank of the particular vulnerabilities of the two banks to which it eventually extended ELA?

The case of HBOS

98. As noted above, the run on Northern Rock marked a step-change in the level of the Bank's engagement with individual banks and it is clear that the Bank, and indeed the other members of the Tripartite, were fully aware of the vulnerabilities of HBOS prior to its need for ELA in October 2008. By September 2007 the Bank was receiving what it felt were more appropriate data from the FSA, at any rate on banks identified as more vulnerable, including daily liquidity reports from the FSA on HBOS (as well as on Alliance & Leicester and Bradford & Bingley).

99. Work undertaken within the Bank in November 2007 identified a number of key risks that meant that HBOS was likely to be particularly vulnerable to a change in market sentiment. These included: the risk of reputational contagion from association with other mortgage banks, given that HBOS was the UK's largest mortgage bank; HBOS's reliance on wholesale funding at around 50% of total funding, and within that its reliance on securitisation as a source of funding; and its commercial property exposures. At that stage, HBOS was nonetheless viewed as being somewhat less vulnerable than Alliance & Leicester and Bradford & Bingley because of its more diversified business model.

100. The increased focus on individual banks and improved data flow from the FSA was not just confined to HBOS, Alliance & Leicester and Bradford & Bingley. From September 2007, the Bank began to receive liquidity information on other major UK banks from the FSA at least weekly. The individual banks' data lacked in several respects the detail the Bank would have liked, but it was used by the Bank to try to determine which banks would be most affected by a crystallisation of the possible key risks to the UK banking sector. Iterations of this work were shared with the Tripartite Standing Committee in October and November 2007.

101. From late-2007, the Tripartite authorities began contingency planning to map out possible options for resolving HBOS should the key risks facing it crystallise. There was heightened monitoring of HBOS from March 2008 after the emergency sale of Bear Stearns on 16 March and after an unfounded market rumour that HBOS was receiving emergency assistance from the Bank caused a sharp fall in HBOS's share price on 19 March. At this stage the Bank was considering in detail the consequences of HBOS, like Northern Rock the previous September, being unable to fund itself in the markets.

102. By mid-April 2008, although still work in progress, a comprehensive contingency plan had been prepared by the FSA, in conjunction with HMT and the Bank. This contingency planning explicitly recognised the possibility of the Bank needing to undertake some form of ELA in

the event of wholesale markets beginning to close to HBOS. Although by May the immediate threat to HBOS appeared to have receded somewhat, in part because it was able to utilise the SLS launched in April, the Bank continued through the summer closely to monitor HBOS's liquidity strains on a daily basis as HBOS endeavoured to scale back assets and increase deposits in order to reduce its reliance on wholesale funding. In the event, wholesale funding became increasingly difficult as the maturity of funding available to HBOS shortened, progressively increasing the 'snowball' of funding that had to be rolled at shorter maturities. With the failure of Lehman Brothers on 15 September, HBOS's position rapidly became untenable. When it finally needed to seek ELA from the Bank on 1 October, the approach did not come as a surprise and the Bank was able to respond rapidly.

103. When HBOS asked for liquidity support from the Bank on 1 October, its need for liquidity was urgent. This raises the question of whether, given that the vulnerability of HBOS's liquidity position had been evident for some time, the Bank might have intervened pre-emptively to stabilise HBOS before the need to do so became urgent. Contingency planning from April 2008 did in fact consider the possibility of providing gilts to HBOS through a collateral swap and phasing this in before its need for liquidity became urgent. The launch of the SLS on 21 April rendered this type of bilateral facility less necessary given that the SLS effectively provided the same facility on a market-wide basis.

104. A related question, given the launch of the SLS in April and the knowledge of HBOS's vulnerability to deterioration in funding markets, is whether the Bank and the FSA could have been more active in encouraging HBOS to increase the pace of securitising their mortgages for use in the SLS. There was enough time between April and October for HBOS to have securitised more of their mortgage loans. In the event, greater use of the SLS may not have been a feasible option, but faster securitisation would have subsequently made it easier for the Bank to provide ELA against securitised loans.

105. **For the future, in situations where the Bank is aware of a bank experiencing escalating liquidity strains, the Bank could consider whether it might act pre-emptively to provide bilateral liquidity support before the need definitively crystallises.** The Bank has moved in the direction of pre-emptive action in its market-wide liquidity facilities, for example with the Extended Collateral Term Repo operations, a contingency liquidity facility which the Bank can activate at actual or prospective points of market-wide stress. A similarly pre-emptive approach to extending ELA, if the need arose, could have the advantage of avoiding in some degree the inevitable risks of lending only at the extreme moment when a bank can no longer access market funding. Such assistance, in present circumstances, would most likely be provided through the Discount Window Facility (DWF). But use of the DWF currently lies at the option of individual banks, whereas pre-emptive action would be at the initiative of the Bank.

106. Such action would be facilitated by the extent to which banks have, with the Bank's encouragement, taken steps to pre-position eligible collateral at the Discount Window; and the possibility of such pre-emptive action might itself encourage greater pre-positioning.

107. There is a danger, of course, that pre-emptive action of this kind by the Bank, if it failed to remain covert, could precipitate the wider crisis that the Bank and the bank in question were seeking to forestall. This risk would be smaller to the extent that use of the DWF could be de-stigmatised.[16]

The case of RBS

108. In the case of RBS, it is less clear that the degree of that bank's vulnerability was appreciated significantly in advance of October 2008. There was clearly a general concern around RBS's capital position, pressure on which increased as a result of the acquisition of ABN Amro, which was announced in April 2007 and concluded in October 2007. RBS's relatively low level of capital was recognised in the Bank in October 2007 and RBS was added to the FSA's Watchlist (for firms it considers to have particular risks that require additional monitoring) for capital risk in December 2007.[17] This concern led to the FSA requiring RBS to raise additional capital, which it did in a rights issue announced in April 2008.

109. Work undertaken by the Bank in September 2007, examining UK banking sector vulnerabilities generally, also identified RBS's vulnerability to a closure of wholesale funding markets. In September 2007, the RMBS and CMBS wholesale funding markets had been closed to UK banks since August, and the covered bond market had only recently reopened. Additionally, other funding markets, for example, the secured and unsecured interbank funding markets, had become severely dislocated. While a number of banks were identified as being at risk if wholesale funding markets closed, it was judged that RBS might be particularly vulnerable due to its dependence on rolling over a large proportion of its wholesale funding overnight in euros and US dollars. But RBS was assessed, along with a number of other large UK banks, as being much less vulnerable to a change in investor sentiment than HBOS was in March 2008. In short, it seems that there was a general consensus with the FSA's assessment prior to October 2008 that, "RBS's liquidity position was not an immediate risk."[18]

110. There were reasonable grounds for the judgement that the challenges RBS faced with respect to its liquidity position were less acute than those faced by HBOS. While both banks were reliant on wholesale funding—HBOS's proportion of wholesale funding was around 50% of total funding in March 2008, RBS's peaked at around 40% in October 2008—HBOS operated a model that was much more similar to that of Northern Rock. HBOS was a significant mortgage bank and was much more reliant on the securitisation market—a market that had been closed since summer 2007. In contrast, RBS was a full-service bank, with less concentration than HBOS on mortgage lending. Some evidence that the market shared the assessment of authorities in relation to these two banks is given by their relative Credit Default Swap (CDS) and equity performance (see Charts 1 and 2 below). Although both

[16] The issue of stigma and the DWF is discussed in the accompanying review by Bill Winters, *Review of the Bank of England's framework for providing liquidity to the banking system*.
[17] Financial Services Authority, *The failure of the Royal Bank of Scotland: Financial Services Authority Board Report*, December 2011, p.86
[18] *Ibid.*, p.189

banks showed deterioration in these indicators over the period from the beginning of 2008, and particularly from March onwards, the deterioration of HBOS was more marked and occurred earlier.

Chart 1: CDS spreads for HBOS and RBS, 2 January 2008–31 December 2008

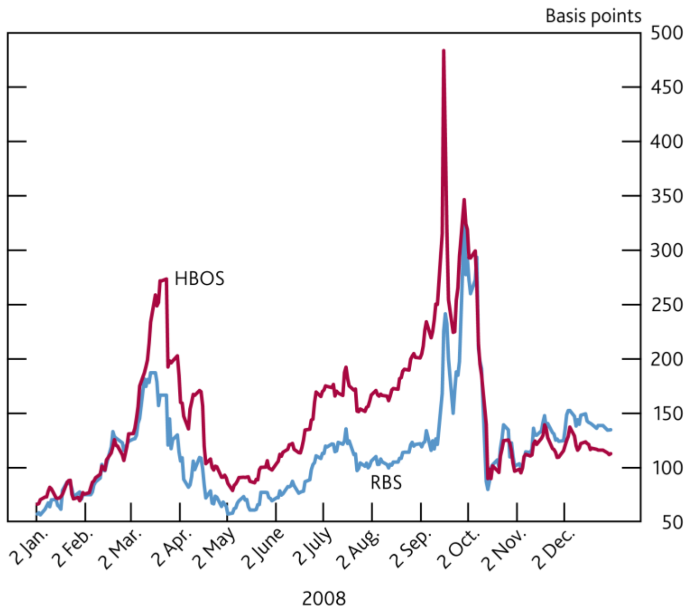
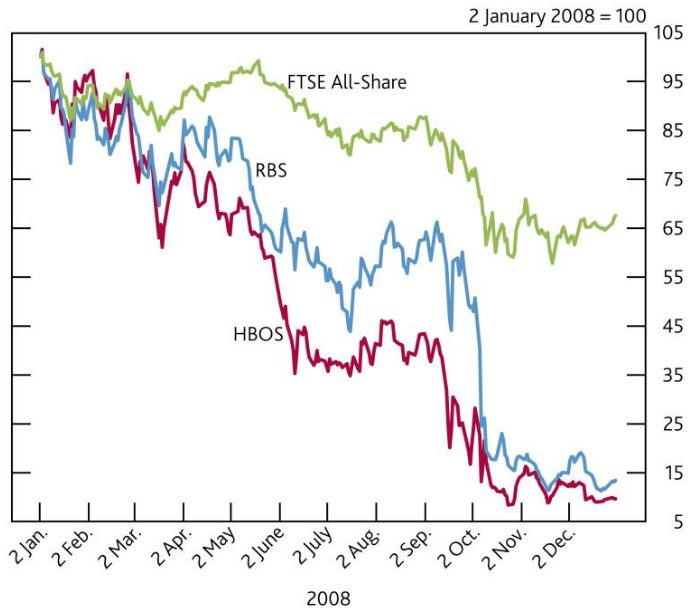


Chart 2: Equity prices for HBOS and RBS, 2 January 2008–31 December 2008



111. Not unreasonably, the focus of attention amongst the authorities in the period after August/September 2007 was on the major mortgage lenders—HBOS, Bradford & Bingley and Alliance & Leicester—which, as Hector Sants noted in a Treasury Committee hearing, "were

clearly the most at-risk institutions."[19] It is possible that, to some degree, the extent of the focus on these banks in this period may have been at the expense of looking more closely at other banks and how they might be affected by a more wide-reaching seizing-up of the wholesale funding markets.

112. The funding problems experienced by RBS became acute after the failure of Lehman Brothers on 15 September 2008. It is clear that that was a trigger event that undermined market confidence even in the largest financial institutions and, in the immediate aftermath, increased the market's perception of risks in lending to such counterparties. The freezing of the dollar funding market which prompted the Bank and a number of other central banks to launch coordinated measures to address pressure in US dollar funding markets, and subsequently led RBS to seek bilateral assistance with dollar and then other funding, was a direct result of the failure of Lehman Brothers. It was possible to see that RBS was vulnerable to a wholesale funding freeze, and indeed this was identified by the Bank a considerable time before October 2008, but it is not clear that it was possible to foresee such a widespread freeze actually occurring in the absence of the failure of Lehman Brothers.

113. Overall, it is clear that, in relation to HBOS, the Bank was able to identify in advance, and to monitor, the increasing liquidity strains that that bank was experiencing during 2008. There was significantly less close focus on the liquidity position of RBS, but its funding problems did not in fact crystallise until a late stage, after the failure of Lehman Brothers.

114. In relation to both banks, however, and indeed to the process of monitoring the risks to individual banks in general, the Bank's ability to identify impending threats in concrete terms was made more difficult by an underlap that had developed in the regulatory structure. Initially at any rate, the Bank was dependent on the FSA for liquidity data on individual banks; but the data available to the FSA were not forward-looking and lacked the granular detail the Bank required for an operational response like ELA. Equally, while the Bank could identify the threat that vulnerabilities in individual banks posed to wider systemic stability, the FSA was less closely focussed on the deteriorating systemic picture. Under the pressure of events, this underlap was progressively bridged during the course of 2008, but it limited how far in advance the Bank could get a clear view of the strains building up on individual banks.

How well equipped is the Bank now to identify impending financial stresses?

115. Since 2008 there has been a significant enhancement of the authorities' ability to scan the horizon for impending financial stresses. The Bank was given a statutory objective to contribute to financial stability in the Banking Act 2009; and since the beginning of the crisis a number of changes have occurred within the Bank which should improve the Bank's ability to foresee problems both at a system-wide level and, importantly, at the level of individual institutions.

---

[19] Uncorrected transcript of oral evidence taken before the House of Commons Treasury Committee, HC 1780-ii, 30 January 2012, Q143, http://www.publications.parliament.uk/pa/cm201012/cmselect/cmtreasy/uc1780-ii/uc178001.htm

116. Specifically, there are four areas where the authorities' capacity to identify emerging risks has been significantly enhanced.

117. First, in the regulatory framework, as developed both nationally and internationally, there is much greater requirement for banks to hold adequate liquid assets to cover both their normal operating needs and potential stress situations. The liquid assets that banks hold not only serve as a buffer against shocks, but also provide an early-warning system for the authorities that an individual bank may be coming under liquidity stress.

118. Second, the FSA now has much better data on the liquidity position of individual regulated institutions and much more systematic analysis is undertaken of potential risks, for example through increased use of stress testing and scenario analysis. The flow of information between the FSA and the Bank has also improved significantly and the establishment of the Prudential Regulation Authority (PRA) within the Bank should enhance this process.

119. Third, even before the establishment of the PRA, there are four streams of monitoring within the Bank at operational level which should help the Bank identify financial stresses:

i. The market intelligence available to the Bank through its market operations and through its regular dialogue with market participants has always been an essential source of information for the Bank, both for its monetary and for its financial stability functions. Since the crisis, additional resources have been devoted to this function and the capacity of the Bank to gather intelligence on individual banks through its market contacts has been enhanced;

ii. The Bank's credit assessment function within its Risk Management Division has also been considerably developed to focus on fundamental risk assessment of the Bank's counterparties. While the primary motivation of this risk management function is to protect the Bank's balance sheet, it also provides a mechanism through which individual banks can be monitored and information shared within the Bank and with the other authorities;

iii. The introduction of the Special Resolution Regime (SRR) under the Banking Act 2009 has led to the establishment of a dedicated Special Resolution Unit (SRU) within the Bank which is focused on resolution planning for individual institutions. A great deal of institution-specific monitoring is undertaken by this area of the Bank. This ensures that there is a much greater understanding within the Bank of the vulnerabilities and potential needs of individual banks;

iv. Similarly, in the Financial Stability area, there is now much enhanced focus on individual banks and their vulnerability to stress, through the Financial Institutions Division.

120. Fourth, the establishment of the Financial Policy Committee (FPC) should provide a greatly enhanced structure for identifying and addressing systemic threats at an early stage.

121. Overall, this material strengthening of the apparatus for monitoring and assessing risks to financial stability should make the Bank not only better able than in 2008 to identify

impending financial stresses, but also able to do so further in advance of the risks crystallising, particularly if the risks emerge through stress on an individual bank. This answers to one of the recommendations in the Treasury Committee's report, *The run on the Rock,* in relation to improving the ability of the authorities to identify impending bank failures (see Appendix 4). The inevitable result, however, is that there is now a formidable amount of raw data and information being collected and analysed within the Bank. **It will be important that the Bank continues to develop and monitor processes to enable sufficient and intelligent filtering of this information, such that senior staff within the Bank receive timely notification of key developments, without being overwhelmed with data and analysis.**

122. The effectiveness of these arrangements was tested earlier this year when Moody's credit ratings agency reviewed, and ultimately lowered, its ratings of a number of major UK banks. The Bank and the FSA, working together, were able to identify the degree of risk faced by individual banks that the downgrading might impact on their access to liquidity, to monitor these exposures and to plan remedial action that might be needed. In the event, no significant stress emerged, but the process of identifying the threat to financial stability worked well.

123. A number of the changes that have helped to strengthen horizon scanning, such as the SRR, the establishment of the FPC and the transfer of the PRA to the Bank, are now or will soon be embedded in the Bank by statute. There are other improvements the Bank has made, however, such as to its market intelligence and risk management functions, that have evolved out of the crisis but are not embedded in this way. Maintaining a focus on horizon scanning while a crisis is still ongoing is likely to be easier than doing so in more normal conditions. **So it will be important for the Bank to maintain its strengthened capacity to scan the horizon for impending financial stresses even when financial conditions return to relative calm. It will be a challenge not to allow the functions within the Bank that have been built up as a response to the crisis to deteriorate when the immediate need for them is less intense.**

124. Although the Bank's ability to identify risks in the banking sector is now considerably strengthened, the relevant horizon stretches well beyond the banking system. Systemic threats might in future arise from, or primarily affect, non-banks, for example, broker-dealers, insurers, fund managers, payment and settlement systems or central counterparties. **The Bank needs to be able to identify impending systemic shocks emanating from, or impacting on, non-bank financial institutions.**

125. This task may be complicated by the fact that some of the changes that have enhanced the Bank's capability to scan the horizon, as outlined above, do not apply to non-banks. For example, there is currently no equivalent to the SRR for non-bank financial institutions, although the Government has recently published a consultation on proposals to extend the resolution regime to non-banks.[20] This means that, currently at least, the work of the SRR is entirely focused on banks. Similarly, the risk management function focuses principally on the

[20] HM Treasury, *Financial sector resolution: broadening the regime*, Cm 8419, August 2012

Bank's sterling and foreign exchange counterparties, most of which are banks, although a number of broker-dealers are also counterparties and some financial infrastructure providers are routinely assessed. While the Bank is closely involved in the oversight of payment systems, for which it is the regulator, and the market intelligence function of the Bank and the work of the FPC are attuned to non-banks as well as banks, overall the Bank is likely to be less closely involved in ongoing monitoring of non-bank financial institutions. It needs to be as able to identify shocks arising from that source as from within the banking system.

Chapter 3: Planning for ELA

126. The previous chapter examined the Bank's ability to identify in advance the vulnerabilities and financial market strains that would ultimately cause HBOS and RBS to approach the Bank for emergency liquidity in October 2008. This chapter looks at the Bank's planning for this challenge and considers:

- How well prepared was the Bank to extend ELA to the two banks when they requested it?
- How well developed now is the Bank's planning for the possible need to extend ELA in the future?

How well prepared was the Bank to extend ELA to the two banks when they requested it?

127. A number of events in the run-up to the emergency lending in 2008 helped to ensure that the Bank was able to put together the ELA facilities for HBOS and RBS rapidly and effectively. In particular the recent experience of extending liquidity support to Northern Rock in September 2007 meant there was a cadre of staff within the Bank who had gained experience in designing and implementing facilities through which to carry out emergency lending. Beyond this, the development and implementation of the SLS, which was launched in April 2008, had helped the Bank to develop its ability to conduct collateral swaps, the transaction structure replicated by the ELA. The SLS had also given the Bank greater experience of valuing collateral, and meant that a number of policy and operational questions, such as on the haircuts to be applied to different types of collateral, had already been considered internally. Underpinning the specific experience given by the Northern Rock crisis and the operation of the SLS, since mid-2007 there had been an accumulation of expertise within the Bank in implementing a variety of complex operations at speed. This 'battle-readiness' was an important strength.

128. Besides this operational experience, some specific planning had occurred during and immediately following the period of lending to Northern Rock, to consider how loan facilities might be constructed in a different way to those that had been extended to Northern Rock. In particular, work had been undertaken on how the Bank could implement a liquidity facility using collateral swaps and what the advantages of such a method would be. Some of the insights from that work were incorporated in the design of the SLS and utilised again in the ELA provided in October 2008.

129. The Bank had also prepared itself to approve and implement operations at speed through the establishment of a more streamlined decision-making and governance structure. At the Executive level, Resolution Committee (ResCo) was established in July 2008 to bring key Bank officials together at short notice to address operational decisions. To facilitate consultation of the Bank's Court of Directors, Transactions Committee (TransCo) had been established as

a committee of Court in November 2007. These committees ensured that a structured process for rapid decision-making was in place when needed.

130. Although the experience accumulated by Bank staff helped to ensure that the ELA operation was implemented effectively, a significant amount of the work needed to design and implement the facilities was carried out at a late stage immediately prior to the lending itself, at a time when the same staff were also managing the consequences of the failure of Lehman Brothers and the resolutions of Bradford & Bingley and the Icelandic banks. As noted in the previous chapter, the possibility that HBOS, at any rate, might need ELA was recognised as early as April 2008. Even so, there was no pre-established framework or playbook in place to guide those implementing the emergency lending. Concrete plans to consider an ELA facility as an alternative to further SLS drawings were first initiated only in September, and preliminary work on a specific facility for HBOS was only commissioned late in that month.

131. One example of the work that needed to be done immediately prior to the lending itself was the preparation of the legal documentation necessary for the facility. The exact form of the facility was decided only shortly before it was made operational, and the particular legal structure used—which was different from that used to provide ELA to Northern Rock—was first suggested by legal advisers assisting HBOS, who also provided draft legal documentation which the Bank was then able to adapt. Similarly, there was no framework in place under which to value and decide haircuts for the ‘raw’ (that is, unsecuritised) loans that had to be taken as collateral. The Bank had developed experience within its Risk Management Division of valuing and deciding haircuts for the securitised loans that were taken as collateral in the SLS, but valuations and haircuts for the raw loans in the ELA had to be set largely by analogy with those applied to securitised loans in the SLS.

132. The US dollar ELA facility made use of the legal documentation that was already in place between RBS and the Bank for the market-wide US Dollar Repo Operations; so no additional legal preparation was required for this facility.

133. In 2008, the Bank made some use of outside legal advice in setting up the facilities. In contrast, in other areas—such as risk management and collateral valuation—it largely relied on in-house expertise. This was feasible, in part, due to the establishment and operation of the SLS. The Bank benefitted from having a greater degree of expertise in, for example, collateral valuation than would have been the case in the absence of the SLS; the Bank had already started to recruit staff with specialist knowledge as a result of the scheme. The reliance on Bank staff from non-specialist backgrounds in the event proved adequate, but it did involve staff learning new skills very rapidly at a point where there was little margin for error.

134. Overall, therefore, the Bank had acquired sufficient experience, and expertise, from its support operation for Northern Rock and from its operation of the SLS, to be able to respond rapidly and effectively when the need to extend ELA to HBOS and RBS arose. The delay a year earlier in finalising the ELA for Northern Rock in September 2007, about which the Treasury Committee expressed concern in its report, *The run on the Rock* (see Appendix 4), did not

occur in the ELA operation in 2008. Nonetheless, some features of the operation had to be put together at the last minute, which heightened the Bank's exposure to operational risk, particularly given the pressure already on staff managing other aspects of the intensifying crisis.

How well developed now is the Bank's planning for the possible need to extend ELA in the future?

135. Since 2008 a number of changes have occurred which have improved the Bank's ability to plan for, and conduct, emergency liquidity operations. These changes fall broadly into two categories: changes to the Bank's operational framework that are likely to have improved the Bank's ability to conduct ELA; and, more detailed and comprehensive contingency planning for the possibility of having to conduct ELA.

Changes to the Bank's operational framework

136. Perhaps the most significant change to the Bank's operational framework with respect to its ability to conduct ELA has been the introduction of the Discount Window Facility (DWF), a facility within the Bank's published framework in which the Bank accepts a wide range of collateral (see Box 5 in Chapter 1 for more detail on the DWF). The DWF has significantly improved the Bank's ability, both in terms of systems and staff, to evaluate and manage both securitised and unsecuritised collateral.

137. The operation of the DWF in steady state is likely to provide and sustain a level of operational readiness that was not present in 2008. The dedicated Collateral Management Team within the Risk Management Division of the Bank has built up considerable technical expertise in valuing collateral and setting haircuts; and a dedicated IT system has been put in place for managing collateral and calculating haircuts (the Collateral Monitoring and Risk Management System). It is likely that any future ELA would be implemented using similar mechanisms and legal structures to those used for the DWF. Maintaining these mechanisms and legal documentation for use in the DWF should support the Bank's ability to adapt them for use in an ELA scenario.

138. The pre-positioning of collateral within the DWF (amounting to over £265 billion at end-March 2012) will be helpful to the Bank's ability to extend ELA to existing counterparties in future if need arises. The collateral, having already been processed through the Bank's valuation and haircut procedures, could be rapidly utilised in an ELA operation outside the terms of the DWF, if necessary.

139. Further, the introduction of the SRR and the establishment of the SRU have greatly improved the Bank's resolution planning capability, which includes not just close analysis of the financial condition of individual banks, but also active planning for resolution.

140. As in the case of RBS in 2008, it is possible that the Bank may need to provide foreign currency emergency lending to a bank facing liquidity stresses. The US dollar swap line put in place in September 2008 was terminated in January 2010, but reactivated in May of that

year in light of the re-emergence of strains in the dollar funding market. In addition, the Bank agreed in November 2011 to establish temporary bilateral liquidity swap arrangements with the Bank of Canada, the European Central Bank, the Bank of Japan and the Swiss National Bank so that liquidity can be provided in any of their currencies should market conditions so warrant.

141. These foreign currency swap lines are currently due to be renewed on 1 February 2013. **It would be a sensible contingency for the Bank to maintain these swap lines in case of need.**

142. In circumstances other than those which pertained in 2008 (that is, when the dollar funding market was effectively frozen), it might be possible for the Bank to fund the provision of foreign currency ELA using other means, for example through swaps undertaken in the market, by using the Bank's foreign exchange reserves (which are held in support of its monetary policy objective), or by using the Exchange Equalisation Account (which holds the UK Government's gold and foreign exchange reserves, and is managed by the Bank). Funding from such alternative sources might be necessary if the swap lines currently in place with central banks were for some reason not available for that purpose. **The Bank should continue to explore these options to ensure that it is adequately prepared to extend foreign currency ELA if necessary.**

143. As noted in Chapter 2, the quality of data that the Bank receives in relation to banks' liquidity positions has improved since 2008. In part, this is a result of better regulatory data being collected by the FSA, but it also reflects the Bank's closer engagement with individual institutions. These improved data would not only help the Bank to determine when ELA is likely to be required, but also what quantum might be necessary.

More detailed planning for ELA

144. Alongside the development of facilities within the Bank's published framework such as the DWF and the introduction of the SRR, since 2008 considerable work has been undertaken within the Bank to improve the level of detailed planning for any future ELA. The Bank has established an ELA Implementation Committee, which meets regularly. This committee is charged with ensuring the Bank's preparedness to implement ELA from an operational and legal perspective. Such planning is important, not least because, in the absence of recent crisis experience, it may be more difficult in future to maintain the degree of battle-readiness to undertake emergency operations that was available within the Bank in 2008. Moreover, although horizon scanning, as discussed in the previous chapter, will help the Bank to foresee and prepare for some impending financial stresses, some shocks, such as the impact of rogue traders or events like 9/11, are, by their nature, inherently unforeseeable. **The Bank needs to maintain its capacity to manage the consequences of unforeseen, as well as foreseeable, events.** Detailed contingency planning may mitigate a lack of recent crisis experience and help the Bank to respond rapidly and effectively to unforeseen shocks.

145. The ELA Implementation Committee has now put in place an ELA governance and control framework, which provides high-level guidelines on governance arrangements and areas of responsibility within the Bank in the event that a decision to extend ELA is taken. The

framework has been examined as part of this Review. It provides a sensible and coherent approach to managing a crisis. In practice, and as the framework recognises, the Bank might need to deviate from the framework depending on the circumstances surrounding the particular instance of ELA. The Bank should plainly be ready to be flexible in situations where that might be required. But it is nonetheless likely to be helpful for those implementing ELA to have up-to-date operational guidance in place. Consideration has been given to the form of the legal agreements that might be needed in the event that ELA is extended and draft documents are now available if required. Again, these agreements might need to be adapted to different circumstances.

146. Given the need for secrecy in 2008 the reliance on existing staff for a variety of functions during that episode was understandable. **For the future, the Bank should consider what expertise it needs to have in-house for crisis scenarios if it is unlikely to be able to call on external expertise, either because an operation needs to be implemented at short notice or because the Bank has concerns about secrecy.**

147. One particular consideration with regard to the Bank making use of external expertise in future is that in some instances the Bank's normal external legal advisers may not be able to be used because they are already representing the counterparty to which ELA is being extended. This was the case in 2007 with Northern Rock, although did not apply to HBOS or RBS. **The Bank is aware of this possibility and should continue to make contingency plans for engaging alternative legal advisers if needed.**

148. The Treasury Committee report into the events around the failure of Northern Rock, *The run on the Rock*, highlights the importance of adequate plans being put in place for handling press and public communications in relation to support operations if they become public (see Appendix 4). So long as covert ELA lending is in operation, the Bank plainly needs to have a contingent communications plan ready in case of inadvertent premature disclosure. Such planning is now included in the Bank's ELA control and governance framework.

149. Overall, against any possible future need to provide ELA to *banks*, the Bank has built on its experience of 2008 and is as fully prepared as could reasonably be expected. But the Bank's planning has understandably focused thus far most closely on the banking sector. As noted in the previous chapter, it is as likely that in future a systemic threat will arise outside the banking sector. Against that possibility, and given that a number of the improvements in readiness resulting from changes to the Bank's liquidity provision and resolution planning frameworks (for example through the DWF and SRR) are not available to non-bank institutions, the Bank may need the capacity to extend ELA to systemically important non-banks. This issue is examined in more detail in Chapter 9.

Chapter 4: The decision to extend ELA

150. This chapter examines the basis of the decision to provide ELA to HBOS and RBS in 2008.

ELA and the Bank's role as lender of last resort

151. ELA can be regarded as a classical example of the exercise of a central bank's lender of last resort (LoLR) function. There are many ways in which a central bank may need to be ready to support the financial system in times of stress: this wider LoLR role is discussed further in Chapter 9. But liquidity assistance is perhaps the most orthodox and frequent form that LoLR operations take.

152. Credit is generally given to Walter Bagehot for being the first to apply close scrutiny to the central bank's function as LoLR, in *Lombard Street: A Description of the Money Market*, published in 1873.[21] Bagehot's main proposals with respect to the LoLR role can be paraphrased as follows: first, that the Bank should lend freely and readily in times of panic; second, that such loans should be made at a very high rate of interest; and third, that loans should be made against any good quality security.[22]

153. The modern central bank's approach to the LoLR function was set out by the then Governor, Lord George, in his Bank of England Lecture at the London School of Economics on 18 November 1993. In that speech he stated that the overriding principle of the LoLR function is that Bank of England support, "whatever form it takes, is directed to safeguarding the financial system (and therefore preventing damage to the wider economy), not the institution itself."[23] Beyond that overriding principle he set out five rules that the Bank would also apply, as follows:

> "First, we will explore every option for a commercial solution before committing our own funds. [...] Second, [...] If we do provide support, we will try to structure it so that any losses fall first on the shareholders and any benefits come first to us. And any support we provide will be on terms that are as penal as we can make them, without precipitating the collapse we are trying to avoid. Third, we aim to provide liquidity; we will not, in normal circumstances, support a bank that we know at the time to be insolvent. [...] Fourth, we look for a clear exit. [...] Fifth, we usually keep the fact that we are providing systemic support secret at the time."

154. Twenty years on from that speech, the principles underlying the provision of emergency liquidity are largely unchanged. The present Governor confirmed in 2007 that "LoLR operations remain in the armoury of all central banks" and that the rationale for lending to "an individual bank facing temporary liquidity problems, but that is otherwise regarded as

---

[21] Henry Thornton was perhaps the first to consider many of the issues relating to the LoLR function in *An Enquiry into the Nature and Effects of the Paper Credit of Great Britain*, published in 1802.
[22] Walter Bagehot, *Lombard Street: A Description of the Money Market*, 1873, VII.57–59
[23] Lord George, 'The pursuit of financial stability', LSE Bank of England Lecture, London, 18 November 1993

solvent" would be that "the failure of such a bank would lead to serious economic damage, including to the customers of the bank."[24]

The criteria for extending ELA

155. Drawing these criteria together, this Review suggests that there are three core judgments that the Bank and HMT needed to make in determining whether to extend ELA in 2008. These were: that the potential failure of the banks in need of support should be judged to be a threat to systemic stability; that the banks receiving support should in a broad sense be solvent; and that there should be a feasible exit strategy from the ELA—that is, the ELA would be a temporary bridge to a stable state in which the ELA would be repaid to the Bank. In addition, the operation needed to be structured to take account of two further principles: that the element of moral hazard should be minimised; and that the risks to the Bank's balance sheet and to public funds should be controlled. The ways in which the Bank addressed these two principles are examined in Chapters 5 and 8.

156. The Bank's LoLR role arises from its remit to protect and enhance financial stability. Therefore, if a bank can be allowed to fail without significant systemic impact, there is in principle no reason for the Bank to intervene. The Bank is not, and should not be, aiming for a world in which there is no bank failure. As the Chancellor and the Secretary of State for Business, Innovation and Skills noted in the foreword to the recent White Paper on Banking Reform, "A zero-failure financial system is not our aim, nor should it be."[25] It follows that the decision whether or not to extend ELA in any particular case, and on what terms, must remain at the discretion of the authorities—in the UK, the Bank of England acting under the framework of the Tripartite Memorandum of Understanding (MoU) with HMT and the FSA. Any pre-commitment would run the risk of reducing considerably the incentive banks have to conduct their business prudently—that is, it would give rise to moral hazard.

157. On the first of the three criteria—that there should be a threat to systemic stability—the judgement is likely to depend, in part, on the size of the bank under threat and its interconnectedness with other financial institutions. But it will also depend on the circumstances in which a request for ELA occurs. During a period of intense market stress, banks that might not otherwise be considered systemic may pose a systemic threat. In a period of calm in financial markets, even a large bank might be allowed to wind down in an orderly way without giving rise to significant contagion to other financial institutions.

158. The second criterion is that the immediate problem should be one of liquidity rather than solvency: that is, the bank to which ELA is to be provided should be fundamentally solvent in the sense that it should have adequate capital and a business model which is likely to be viable. But it is often very difficult to distinguish whether an institution is illiquid or insolvent. It is in the nature of banks that it is possible for difficulties in funding to transmute very

[24] Sir Mervyn King, 'Turmoil in financial markets: what can central banks do?', Paper submitted to the Treasury Committee, 12 September 2007

[25] HM treasury and the Department for Business, Innovation & Skills, *Banking reform: delivering stability and supporting a sustainable economy*, Cm 8356, June 2012, p.4

quickly into impairment of a bank's solvency, for example if funding for the bank becomes unsustainably expensive, or if adverse economic conditions mean that the assets of the bank may be falling in value.

159. There may also be circumstances in which a bank is solvent, in the sense of the value of its assets exceeding its liabilities or in the regulatory sense of having capital adequate to meet the threshold conditions set out by the regulator for it to continue operating, but the Bank would not wish to extend ELA because it believed that the bank in question will not continue to be solvent. In contrast, there may be circumstances in which a bank is technically insolvent, but the Bank would be willing to lend because its return to solvency was clear and imminent. Nonetheless, the general rule remains that it is not the role of a central bank to support insolvent financial institutions. The danger of doing so is again that the knowledge that this may occur could lead banks to take on excessive risk (moral hazard). There is also a much higher risk that an institution that is already insolvent will be unable to repay any lending it receives, and therefore lending to an insolvent institution is likely to lead to the Bank taking an unacceptable level of risk on its balance sheet.

160. The third criterion is that the Bank should have a clear idea of how any bank to which it lends will be able to repay the ELA. In other words, the ELA should be a temporary bridge to a stable platform. The emphasis on having a credible plan to repay relates in the first instance to the need for the Bank to protect its balance sheet. But it is also inherent in the purpose of the ELA that it is directed at giving time for a bank to resolve temporary liquidity strains: if no foreseeable end to the stress can be identified, the problem is more probably one of a lack of longer-run viability, leading to insolvency. A clear exit plan is also a protection against adverse market reaction if the ELA should become known publicly; the loss of public confidence that precipitated the run on Northern Rock was in part driven by the lack of a clear and viable exit plan to stabilise Northern Rock once its need to resort to ELA became known.

Did HBOS and RBS meet the criteria for emergency liquidity assistance?

161. In regard to the first of the three criteria set out above—that there should be a threat to systemic stability—there can be little doubt that in 2008 the failure of either HBOS or RBS would have had severe and damaging systemic consequences. At end-June 2008, RBS had total assets of £1.9 trillion and HBOS £681 billion.[26] In June 2007 RBS had a market share of around 17% of the current account market, while HBOS had a share of around 14%.[27]

162. As part of the contingency planning for HBOS, specific consideration had been given to the question of whether the failure of HBOS would precipitate systemic damage and the judgement was that it would. The severe market turmoil following the failure of Lehman Brothers served only to heighten that risk. For RBS, its size and the fact that (unlike HBOS) it was a full-service international bank equally suggested that its failure would have

[26] RBS Interim Results, 8 August 2008; HBOS plc Interim Results 2008, 31 July 2008
[27] The Office of Fair Trading, *Review of barriers to entry, expansion and exit in retail banking*, OFT 1282, November 2010, Table 3.2, p.35

precipitated widespread systemic disturbance. The judgements made in this regard in relation to both banks accorded closely with the considerations relating to systemic risk expressed in the Treasury Committee's report, *The run on the Rock* (see Appendix 4).

163. In regard to the second of the three criteria—solvency and viability—at the point at which ELA was extended HBOS and RBS were both solvent in the regulatory sense that they continued to meet threshold conditions for continuing to operate set by the FSA. But the extreme level of financial market stress and the specific problems those banks were having funding themselves in the market may have called into question their medium-term viability and therefore future solvency. Further, the deteriorating macroeconomic backdrop inevitably meant there was uncertainty about the quality of the banks' assets and therefore their future solvency.

164. Despite those uncertainties, there was for both banks a concrete path to future solvency on which the Bank could base its decision to extend ELA. In HBOS's case, the path to future solvency at the point ELA was extended appeared to be the merger with Lloyds TSB that had been announced on 18 September 2008. In the case of RBS, by the time ELA was extended, the Government's plan to recapitalise the banking sector was well advanced, and indeed was announced on 8 October, the day after ELA was first extended to RBS. The Bank had been active in pressing for a general recapitalisation of the banking sector for some time prior to this. In the event, all three of RBS, HBOS and Lloyds TSB were recapitalised significantly.

165. In regard to the third of the three criteria—the path to exit from the emergency lending—there were two clear exit routes that provided an adequate prospect for the Bank that its ELA would indeed prove temporary. The first was the proposed merger of HBOS with Lloyds TSB, together with the recapitalisation of both those banks and RBS. The second was the use by both banks of the Government's Credit Guarantee Scheme (CGS) that was announced on 8 October at the same time as the recapitalisation plan (see Box 3 in Chapter 1 for more detail on the CGS). From that date, the Bank accepted bank debt issued under the CGS as collateral in its market-wide liquidity facilities. Both banks were able to utilise the CGS to obtain liquidity from those facilities and to resume funding in the market.

166. Following recapitalisation and the introduction of the CGS, HBOS began sizeable repayments of the ELA facility on 11 December 2008 and had repaid the facility in full by 16 January 2009. Some of the mortgage collateral that had been used as security against the ELA facility was utilised to increase borrowings from the SLS. This was possible both because during the period of the ELA HBOS had time to securitise assets so that they were eligible for the SLS, and also because, once the merger with Lloyds TSB had been approved, the Bank allowed HBOS greater access to the SLS. HBOS's drawings under the SLS approximately doubled in the second half of January 2009. HBOS's improved ability to fund itself both in the market and through Bank facilities was also supported by CGS issuance. At end-December 2009, Lloyds Banking Group had issued around £50 billion of debt guaranteed under the CGS.[28]

[28] Lloyds Banking Group, *Annual Report and Accounts 2009*, p.217

167. RBS was able to repay its US dollar ELA facility on 17 October in large part because from that date the market-wide US Dollar Repo Operations were made unlimited in size (see Box 2 in Chapter 1 for more detail on these operations). As a result, RBS was able to receive the full amount of US dollar liquidity it required from the Bank in the market-wide operations and was able to repay its bilateral US dollar ELA. RBS began repayments of its sterling ELA facility on 6 November 2008 and repaid the facility in full by 16 December 2008. Again, this repayment was supported by the issuance under the CGS. As at end-December 2008, RBS had issued £32 billion of debt guaranteed under the CGS. By the end of 2009, this figure had risen to £52 billion.[29]

168. On this basis, the three criteria outlined above can be judged to have been met. The criteria of forward-looking solvency and a path to exit could only be met through Government recapitalisation, but it was essentially the purpose of the ELA to provide a bridge to that unavoidable outcome.

Were alternatives to ELA available to the authorities?

169. An assessment of the decision to extend ELA to HBOS and RBS also needs to consider what alternatives were available at the time. As Lord George noted in his 1993 speech, the Bank will generally try to seek a private sector solution if one is available. For example, in the secondary banking crisis of 1973–5 the Bank organised a consortium ('lifeboat') of the largest UK banks to provide £1.3 billion liquidity support for a number of secondary banks. The Bank contributed only a small proportion of the liquidity support provided in that operation. An alternative approach was adopted in the small banks crisis in the early-1990s, when the Bank guaranteed lending from a consortium of banks against loss if they continued to offer credit lines to some smaller banks suffering liquidity strains.[30] Such an option was briefly considered by the Bank in April 2008 in relation to HBOS, but was not regarded as likely to be workable. Given the market turmoil of late-2008, and the strained liquidity conditions all banks were experiencing, neither of these approaches to supporting banks as large as HBOS and RBS was likely to have been feasible.

170. For other, smaller banks that faced difficulties during the crisis, the authorities' first preference in 2008 was indeed to seek private sector solutions where feasible, though even then in some instances special legislative powers were needed and only partial private sector solutions were possible. In May 2008, Alliance & Leicester was acquired by Santander UK. In September 2008, HMT used the Banking (Special Provisions) Act 2008 to transfer the deposits and branches of Bradford & Bingley to Santander UK and nationalise its assets. Similarly, in October 2008, after ELA had been extended to HBOS and RBS, the Banking (Special Provisions) Act 2008 was used to transfer deposits of two subsidiaries of Icelandic banks—Heritable and Kaupthing, Singer & Friedlander—to ING Direct.

[29] Royal Bank of Scotland, *Annual Report and Accounts 2009,* p.193
[30] See Appendix 5 for further details of both of these lender of last resort operations, and a number of other such operations undertaken by the Bank since the 1970s.

171. In the case of HBOS, the possibility of a private sector solution arose in the form of the merger with Lloyds TSB. In the heightened market stress of late-2008 this proved not to be sufficient to forestall HBOS's need for additional support from the Bank. It seems unlikely that even with a longer period to organise, or in a more benign market environment, it would have been possible to find an institution with the capacity to buy RBS.

172. An alternative to providing institution-specific ELA for HBOS and RBS might have been to extend additional liquidity to these banks through the SLS. There were essentially two difficulties in doing so. First, the SLS was a market-wide facility designed to provide liquid assets (Treasury bills) in exchange for illiquid assets to the banking system as a whole for an extended term (3 years). Short-term liquidity to meet the emergency needs of two individual banks did not sit well with this purpose, particularly as the scale of liquidity support needed by the two banks would have given the Bank an excessively concentrated exposure to them under the SLS. Second, neither HBOS nor RBS had eligible collateral available in sufficient quantities to draw the quantity of liquidity that they required from the SLS. HBOS had mortgages that would be eligible if securitised, but had not had time to complete the securitisation process (as noted above, these assets were securitised over the last quarter of 2008 and subsequently used in the SLS).

173. To amend the SLS to accept a wider range of collateral, including unsecuritised loans, would have risked distorting the purpose and design of the scheme by adapting it to encompass the specific needs of two individual banks. Extending collateral eligibility in the SLS would have entailed announcing the changed criteria publicly and allowing all banks access on those criteria. In these circumstances, choosing to extend ELA on terms tailored to the specific situation of the two banks, rather than adapt the terms of the SLS, was an appropriate decision.

Is the Bank now well placed to judge whether ELA should be extended to institutions facing liquidity stresses?

174. Inevitably ELA is likely to be undertaken during acute periods of financial stress and decisions will always have to be taken rapidly and in situations where there is a considerable lack of certainty. Nonetheless it is worth asking whether the Bank is better placed now than it was in 2008 to assess whether future requests for ELA will meet the criteria set out above.

175. In the first instance, if a bank was to face a short-term liquidity shock, and the Bank was satisfied that it met the applicable criteria for access, under current arrangements the DWF would be a first port of call. It is only if access to the DWF were for some reason not available that ELA might still be required. Circumstances in which this might arise are examined further in Chapter 9.

176. Of the three core criteria outlined above, the Bank would need first to assess if the failure of a bank would have systemic implications. A process for conducting systemic impact assessments, in which impact assessments are provided separately by both the FSA and the Bank at the request of HMT, was agreed by the Tripartite authorities before the crisis, but has been developed and refined since 2008 in light of experience. This framework assesses

the likely costs, in the absence of any intervention by the authorities, of a shock to the financial system. The focus of systemic impact assessments has been sharpened since 2009 as they are now used as one tool to inform the statutory judgement about use of SRR tools under the 2009 Banking Act.

177. On the second of the three criteria, there has been considerable development of the framework within the Risk Management Division of the Bank to assess the solvency and viability of institutions that are counterparties of the Bank. This should help the Bank to reach a judgement about whether an institution requiring ELA is broadly solvent. This judgement can be supplemented with the views of the bank supervisor (currently the FSA). But the Bank will not necessarily make the same judgement about broad viability as the supervisor and so the Bank as lender will want to make its own assessment. A judgement about banks having a credible plan to repay ELA will depend on the circumstances of the borrower and the context in which they are requesting assistance. As noted above, however, credible exit and broad solvency are likely to be intertwined.

178. In the case of both systemic importance assessments and judgements about solvency, the improved data available to the Bank as compared with 2008 is likely to be an important factor in enabling the Bank to be better placed to examine these questions today than it was then. The closer working relationship with the FSA has helped this process, as will the establishment of the PRA within the Bank.

179. In terms of exit, there are now more options available to the authorities to manage the process of returning a bank to a stable state or of resolving it in an orderly manner. With a more developed ability to resolve failing banks, if a bank is assessed by the FSA as no longer satisfying the threshold conditions for authorisation and is deemed not to be likely to take action to satisfy them, it can be resolved using the SRR. The financial sector reforms being put in place to improve the ability of authorities to resolve large and complex financial institutions and reduce the problem of institutions being too big or important to fail should greatly strengthen the process of stabilising in resolution a bank experiencing distress. This underlines the importance of the continued work, through Recovery and Resolution Plans, directed at ensuring that large systemically important institutions are resolvable.

180. Overall, therefore, there is now a more structured framework in place for assessing in a considered and coherent manner whether the criteria are met for ELA to be an appropriate response in a situation where a bank comes under strain. However, no such framework will ever provide easy answers. Judgements on those criteria will depend on the circumstances of the time, and will inevitably require decisions to be taken in the face of incomplete information. **It will be important to ensure that the more structured framework now in place can be made to work effectively in practice, so that the Bank, including in future the PRA, can marshal information internally in an efficient manner and, in conjunction with HMT, reach and implement decisions on whether or not to extend ELA without delay.**

Chapter 5: Terms of the ELA

181. This Section reviews the terms on which the Bank extended ELA to HBOS and RBS. It examines whether the terms were appropriate in the circumstances and whether any changes need to be considered for possible future ELA operations.

182. The terms on which ELA is extended necessarily have to be fashioned to the particular circumstances of the crisis which gave rise to the need for ELA. But as far as possible, the terms need to be guided by two principles, as noted in the previous chapter:

i. Any instance of special assistance necessarily gives rise to increased moral hazard. The terms on which ELA is extended need to be set to minimise moral hazard—principally by means of the fee charged and the degree to which the management and shareholders of a bank receiving ELA suffer reputational and financial loss;

ii. The risks to the central bank's balance sheet (and to public funds, if the ELA is indemnified by the Government) should be controlled. This can principally be achieved by the terms set for taking and valuing collateral.

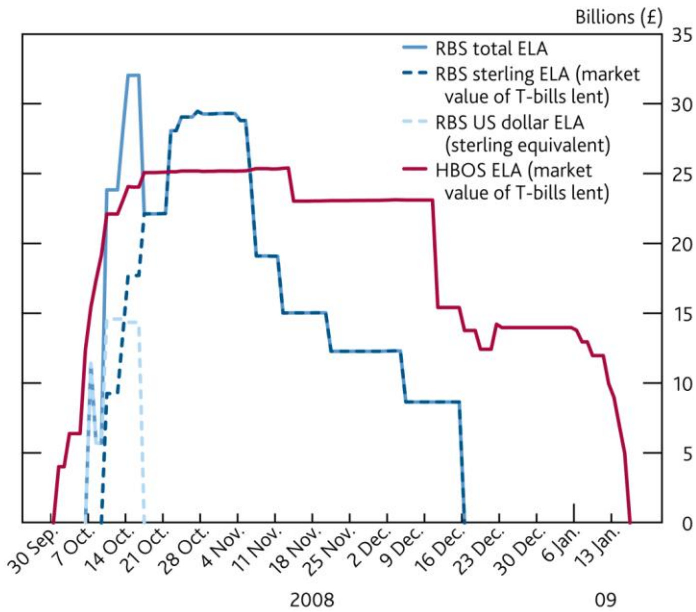
183. The terms of the ELA extended to HBOS and RBS addressed both these principles appropriately, as set out in detail in this chapter and reviewed as a whole in Chapter 8.

Amount

184. The Bank extended ELA to HBOS from 1 October 2008 to 16 January 2009. The amount extended peaked at £25.4 billion, in terms of the market value of T-bills lent, on 13 November. The Bank extended ELA to RBS from 7 October 2008 to 16 December 2008. Part of this ELA was in US dollars, which the Bank lent from 7 October to 17 October. This lending peaked at US$25 billion (around £14.5 billion) from 10 October to 17 October. The remainder of the ELA to RBS was extended in sterling T-bills which were lent from 10 October to 16 December. The market value of T-bills lent to RBS peaked at £29.4 billion on 27 October. The combined value of T-bills and dollars lent to RBS peaked intraday at £36.4 billion on 17 October.

185. The highest aggregate intraday exposure for both sterling and dollar ELA for both banks was £61.5 billion on 17 October, before RBS repaid its US dollar ELA that day. The highest aggregate overnight exposure was £56.1 billion on 14 October. The highest aggregate overnight exposure under the sterling facilities alone was £54.6 billion on 27 October 2008. The amounts of the ELA facilities are shown in Chart 3 below.

Chart 3: Total ELA provided to HBOS and RBS



186. ELA to HBOS and RBS was in addition to significant liquidity provided to both of those banks through the Bank's market-wide liquidity facilities, such as its Long-Term Repos, Extended Collateral Long-Term Repos (ELTRs), the Special Liquidity Scheme (SLS) and the US Dollar Repo Operations. Liquidity received by both banks from the Bank's market-wide liquidity facilities increased significantly after September 2008. Taken in its entirety, the total liquidity support extended to both banks was very substantially larger than the ELA support extended throughout the period in question.

187. The Governor was obliged to consult Transactions Committee (TransCo, the sub-committee of the Bank's Court of Directors set up for this purpose) before any ELA facility was agreed. This consultation first took place on 1 October, the day the facility for HBOS was put in place and first drawn. TransCo met at frequent intervals thereafter for consultation on the facility for RBS, on subsequent increases in drawings under these facilities and, on 13 October, on the decision to seek an indemnity from HMT for amounts lent after that date.

188. No pre-determined limit was set on the amount of ELA, and nor could it be. It is inherent in such an operation that the central bank may need to lend as much as the bank requesting liquidity support needs. For an ELA operation to be successful, the Bank must provide sufficient liquidity to bridge the gap between the initial liquidity shortage and a stable future state. To limit liquidity provision once ELA is underway would risk precipitating the systemic impact the Bank was trying to avoid. From the beginning of October, the Bank recognised that it would need to ensure that HBOS had sufficient liquidity each day to avoid a situation where its funding was in doubt, and to provide breathing space in which a viable funding plan through to the merger with Lloyds TSB could be devised. It was also recognised that it was not possible to rule out that the Bank might need to lend to HBOS on an unsecured basis at some point. In the case of RBS, the stated aim as expressed to TransCo was to provide

funding to bridge to the point that RBS was able to use the Government's recapitalisation scheme.

189. For both banks, the Bank was right to recognise the need for its lending to be essentially open-ended in amount. It also took steps to consult TransCo at each stage when the amount lent needed to be increased.

Structure of the ELA

190. The sterling ELA to HBOS and RBS was undertaken via a collateral swap in which the Bank took security over portfolios of unsecuritised mortgages and loans. This was done by creating trust structures for the collateral, with the Bank being granted formal beneficial interest in the trust. In return for this collateral the Bank supplied HBOS and RBS with T-bills, which were borrowed from the Debt Management Office (DMO), and had originally been created by the DMO for use in the SLS.

191. Structuring the ELA in this way had a number of advantages. Perhaps the most important of these was the structure ensured that, unless the ELA recipients defaulted, the credit risk associated with the loans provided as collateral remained with the banks themselves. The chosen structure also helped to keep the ELA covert: first, because it was a collateral swap, the ELA was off balance sheet and so was not visible in the weekly Bank return (the summary balance sheet that the Bank publishes each Thursday); second, because the collateral was placed in a trust over which the Bank was granted a beneficial interest, the Bank was not required to take a charge over the assets which would have needed to be registered publicly by the ELA recipients. The collateral swap mechanism, though not the underlying trust structure, also had the advantage of mirroring that used in the SLS, and thus following a procedure with which the participants were already familiar. The T-bills lent in the ELA could be retained by HBOS and RBS as a liquidity buffer, used in the market, or used in other Bank facilities, such as the US Dollar Repo Operations or the ELTRs. Using a collateral swap also avoided the operations having any direct monetary impact, so that no offsetting drain of liquidity through the Bank's Open Market Operations (OMOs) was required.

192. The US dollar bilateral ELA facility provided to RBS was extended on the same terms and under the same legal agreement as the market-wide US Dollar Repo Operations. These operations initially offered US dollar funds overnight on an auction basis against collateral then routinely eligible in the Bank's short-term OMOs and Standing Facilities, as well as conventional US Treasury securities, but were subsequently expanded to offer dollars for terms of one week, and then longer periods and against somewhat wider collateral. From 15 October, although US dollars continued to be offered overnight on an auction basis, the Bank began to offer an unlimited amount of dollars for longer terms at a fixed rate (see Box 2 in Chapter 1 for more detail on these operations).

193. It proved possible to assemble legal documentation very rapidly to support these transactions. As noted in Chapter 3, the trust structure mechanism was suggested by HBOS's legal advisers, who also provided the initial legal documentation for the structure, which the

Bank was then able to adapt. The Master Repurchase Agreements supporting the collateral swaps mirrored those already in place for the SLS.

194. The structure of the operation was thus well designed. It sensibly replicated the familiar structure of the SLS wherever possible and the adaptations necessary for the special nature of the ELA operation were appropriate and worked well.

Maturity

195. The sterling ELA facilities had terms of one month, but were renewable on a rolling basis. Within those agreements each swap had a maturity of 14 days under rolling sale/repurchase agreements, again on a renewable basis. The US dollar ELA was provided under the same terms as the market-wide US Dollar Repo Operations and was for terms ranging from overnight to six days, similar to the maturity of repos in the market-wide facility. Having rolling maturities for ELA is appropriate because it reflects the temporary nature of ELA, and gives regular opportunities for the necessity, scale and terms of the facility to be reviewed.

Collateral

196. The Bank took collateral in order to protect itself in the event that either of the banks to which it was lending was forced to default. As described in an article in the *Quarterly Bulletin 2010 Q2*, 'Collateral Risk Management at the Bank of England', the Bank undertakes collateral risk management through three basic tools of eligibility, valuations and haircuts. These same tools were used to manage the collateral provided by HBOS and RBS in 2008. Collateral taken in ELA is likely, by the nature of the operation, to be outside the standard set of eligible collateral, however defined—that is, collateral accepted in ELA may well be ineligible in facilities within the Bank's published framework. This was true in 2008 where unsecuritised loans were accepted in ELA when they were not eligible in any of the Bank's market-wide operations (although securitised loans of similar quality were).

197. In 2008 the Bank chose initially to take the collateral that it was most able to value accurately. In the case of HBOS, this was four pools of mortgages that were already in the process of being securitised. The aggregate nominal value of collateral provided by HBOS peaked at £66.1 billion. The Bank also made preparations to lend against a wider variety of assets, including loans relating to small and medium enterprises, commercial real estate, private finance initiatives, commercial loans, social housing and auto loans, but in the event these pools of assets were never drawn against. RBS provided four pools of mortgages, and three pools covering personal loans, SME loans and corporate loans. In aggregate the value of the collateral provided by RBS against the sterling ELA facility peaked at £65.6 billion. The collateral provided by RBS for the US dollar ELA facility was T-bills, which RBS obtained initially from the SLS and subsequently from the sterling ELA facility.

198. From the point at which the facilities were operational, the Internal Audit function within the Bank began to obtain information from the banks in order to conduct a due diligence exercise designed to verify the existence, ownership, quality and eligibility (compliance with legal agreements) of the collateral assets. The Internal Audit function subsequently produced

a report on the lessons learned from this due diligence process, including suggestions for how this process might be improved in any future instances of ELA.

199. The selection and management of collateral was appropriate in the circumstances and the due diligence process managed by the Bank's Internal Audit provided reasonable verification of the collateral provided.

Haircuts

200. The Bank did not lend an amount equal to the full value of the collateral taken. It applied a discount (haircut) in order to reduce the risk that the Bank would make a loss in the event that either HBOS or RBS defaulted and the Bank had to realise the collateral it had taken. The general principles the Bank adheres to in calculating haircuts were outlined in the *Quarterly Bulletin 2010 Q2* article on collateral risk management. The same article set out the basis on which haircuts were applied to the 2008 ELA as follows:

201. "The Bank applied a haircut to each pool of loans comprised of the following three elements [...]:

- 'AAA haircut' – to replicate the credit enhancement inherent in a typical AAA securitisation of that loan type, to bring the credit protection up to broadly the AAA level;

- 'valuation haircut' – based on the valuations of securitisations backed by similar loans, to replicate the effect of a market price (given that the loans were not tradable instruments they did not have market prices); and

- 'conventional haircuts' – applied based on the haircuts applied to equivalent securitisations in the ELTRs. For example, pools of mortgages attracted the same 12 percentage point base haircut applied to RMBS. Additional haircuts were applied for own-name risk and model-price risk, with further add-ons applied to account for any idiosyncratic risks in the loan pools, such as limited availability of data on the loans. The Bank also used stress tests to ensure the adequacy of the protection provided by the haircuts."[31]

202. The average haircuts relative to the nominal value of the loans were 48% for HBOS and 49% for RBS.[32] That is, the Bank was, on average, willing to lend both HBOS and RBS T-bills with a market value of around half of the nominal value of the collateral provided. In fact, at various points HBOS and RBS borrowed less than the Bank was willing to lend given the collateral that had been provided, and so the Bank was protected to an even greater extent than these haircuts implied.

[31] 'Collateral risk management at the Bank of England', *Bank of England Quarterly Bulletin 2010 Q2*, Vol. 50, No. 2, June 2010

[32] *Ibid.*, p.102

203. The haircuts applied by the Bank varied across different pools of collateral. For example, for pools of pre-1996 residential mortgages provided by HBOS (which would be likely to have low loan-to-value ratios), the haircut applied was 22%. For other pools, which included some buy-to-let, self-certified and sub-prime mortgages, the haircut was as much as 55%.[33] The haircuts on RBS's pools of residential mortgages ranged from 38–50%, while the haircut on a pool of personal loans was 50%, SME loans 63% and corporate loans 66%. The value of the collateral taken, the haircuts applied, and the amounts lent to HBOS and RBS are shown in the Charts 4 and 5 below.

Chart 4: Value of collateral provided by HBOS against the market value of T-bills lent

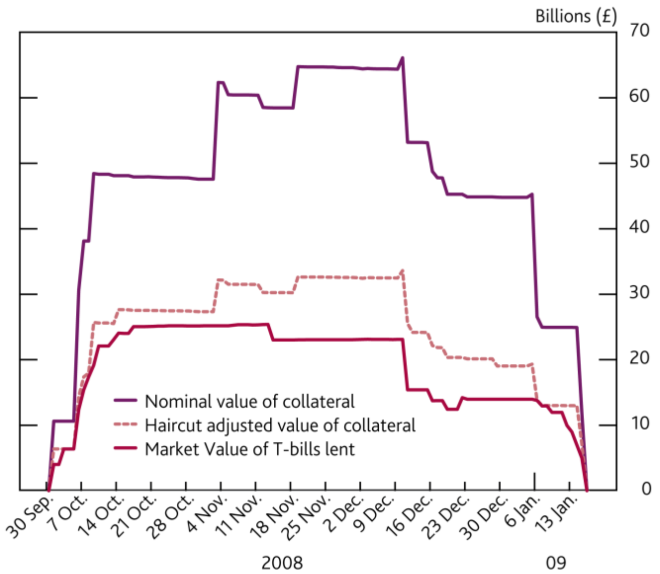
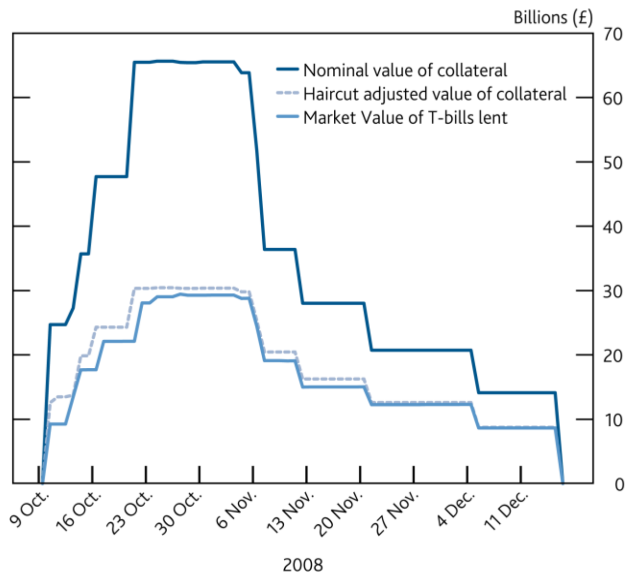


Chart 5: Value of collateral provided by RBS against the market value of T-bills lent



[33] The haircuts proposed for the pools of assets not drawn against were higher still, with the proposed haircut for commercial business loans, for example, being 72%.

204. The haircuts applied to the T-bills provided by RBS in the US dollar ELA were the same as those applied in the market-wide US Dollar Repo Operations.

205. Taking collateral and applying appropriate haircuts is a critical consideration in managing the risk to the Bank's balance sheet in extending ELA. In the context of the ELA, the approach taken to the management of collateral and haircuts appears to have been appropriate. As a comparator, the effective haircut for the SLS against the nominal value of the collateral provided was around 34%, compared with 48%–49% for the assets provided by HBOS and RBS.[34] Given the riskier nature of the assets and the more limited data available, a higher effective haircut for ELA seems appropriate.

206. Since 2008, the Bank has extended the range of facilities within its published framework to accept a wider range of collateral than was eligible in 2008. The Bank's ability to value collateral now has improved as a result of the establishment of the DWF. This expertise is maintained even when there is no use of the facilities, because banks pre-position collateral in the DWF which is valued and analysed so that haircuts can be calculated. As noted in Chapter 3, this capability is now supported by a dedicated IT system for collateral valuation and haircut calculation.

207. In the future, however, if the need for ELA arises, the Bank may need the capacity to be able to value and determine appropriate haircuts for collateral beyond that taken in the DWF or other operations. The Bank has a developed capacity for valuing collateral taken in operations within its published framework, but **it may need to give more detailed consideration to how it would accept, value and determine appropriate haircuts for collateral outside those operations.** This will be an ongoing task, as the assets held by banks that might be available to be taken as collateral by the Bank may change over time. As a consequence, **the Bank will need to ensure that its risk management function continues to develop in response to the evolving balance sheets of banks.**

208. The Bank did not have to realise collateral in 2008, as all its lending was repaid in full. But that may not be the case for any future episode of ELA, so the Bank needs to prepare for the event that a counterparty defaults and the Bank consequently needs to realise the collateral it has taken. The Bank has set up a Counterparty Default Working Party, which meets regularly to assess what action would need to be taken in the event of a counterparty default. This includes a contingency plan for administering the realisation of collateral if the need arose. The task of managing and realising collateral, particularly portfolios of raw loans, if the need ever arose in the future would be a formidable administrative challenge. **It will be important to have a fully developed plan to manage this process.**

Fee

209. The fee charged for the sterling ELA provided to RBS and HBOS was 200 basis points on the daily market value of the T-bills outstanding. In total this amounted to £176.2 million for

[34] 'Collateral risk management at the Bank of England', *Bank of England Quarterly Bulletin 2010 Q2*, Vol. 50, No. 2, June 2010, p.102

both banks. Of this, 7 basis points (£6.2 million) was paid to the DMO for the T-bills lent that were used in the operations (this was the same fee that the Bank paid for using T-bills in the SLS) and 170 basis points on the amount indemnified (£18.9 million) was paid to HMT for the indemnity provided for the additional lending from 14 October onwards. The final income retained by the Bank was therefore £151.1 million.

210. The market-wide US Dollar Repo Operations initially took the form of a variable-rate auction of a fixed amount of funds with successful bids allocated at the rate bid by the counterparty (the amount available was later made unlimited and allocated at a fixed rate). RBS was charged for the ELA dollar repos the highest rate bid in that day's market-wide auction. In total there were four ELA dollar repos with RBS (alongside a number of other repos provided through the market-wide facility). The interest for the ELA repos was passed on to the US Federal Reserve in accordance with the agreement on the swap line already in place for the market facility, except for the final repo, where the Bank retained 150 basis points of the interest charged. This meant that, apart from on the final repo, the Bank received no return for extending US dollar ELA to RBS. It would have been preferable for the 150 basis points retained by the Bank on the final repo to have been a feature also of the earlier repos.

211. The appropriate level of fee for ELA was subject to analysis in the Bank at the time of the 2008 operations. ELA was necessary because, in essence, the banks did not hold sufficient assets that were eligible for use in facilities within the Bank's published framework. The fee for ELA should therefore penalise the banks for not holding such assets, and in principle should equate to the benefit the recipient bank has gained in preceding years by not holding sufficient eligible assets to be able to access the Bank's regular facilities. In practice, the level of fee has to be dependent on the circumstances of the time. In general the fee should be high, to penalise use and so minimise moral hazard, but not so high as to accentuate the strains the ELA is seeking to alleviate. In some instances, it may be appropriate, in setting the fee, to distinguish between the circumstances of the borrowers: that is, it may be appropriate to charge a higher fee to a bank which is subject to an idiosyncratic shock as a result of poor risk management than to a bank that is subject to a systemic shock beyond its control. Fees are not designed to manage the Bank's risk (or risk to public funds, if an indemnity is in place) which should be adequately covered by collateral and haircuts. The fee should, however, be sufficient to cover the Bank's costs and those of any other institutions involved, for example the DMO and HMT.

212. To give some context for considering whether the fee charged for ELA was appropriate, the fees for a variety of Bank facilities past and present are outlined here. The fee for the Bank's Standing Facilities at the time of the ELA was 100 basis points. The fee for the SLS, which could be considered the most similar market-wide operation, was based on the spread between the 3-month sterling London Interbank Offered Rate (Libor) and the 3-month sterling general collateral gilt repo rate (the rate for borrowing against the security of UK Government bonds). During the period in which ELA was outstanding from 1 October 2008 to 16 January 2009, this spread ranged from 112 basis points to 225 basis points, and was on average 178 basis points. On top of this the Bank charged higher SLS fees for higher levels of usage relative to the size of each institution's balance sheet. This meant that in the period of

the ELA some institutions would, at times, have paid more for SLS drawings than HBOS and RBS did for ELA. However, the fee on borrowing in the SLS was reset every three months, so that, while it might have briefly been higher than the 200 basis points charged on the ELA, it would soon have been reset to a lower rate. The figures are, in any case, not directly comparable because ELA was a short-term facility while the SLS had a term of three years, and because different haircuts were applied to collateral in the ELA and SLS.

213. The fee charged in the DWF varies depending on what type of collateral is lent against and how much is being lent relative to a borrowing bank's sterling Eligible Liabilities (a measure of a bank's short-term sterling deposits). The fee can range from 50 basis points for lending against the most liquid collateral up to 10% of a bank's Eligible Liabilities, to 400 basis points for lending against the least liquid category of collateral for amounts over 30% of a bank's Eligible Liabilities. Under current DWF pricing, the ELA extended to HBOS and RBS would be likely to have been charged a fee of 200 basis points.

214. The fee for the ELA provided to HBOS and RBS is not directly comparable with the fee charged to Northern Rock for its emergency liquidity starting in 2007, which was set at 150 basis points above Bank Rate. This is because the Bank's lending to Northern Rock was in cash, for which the Bank's opportunity cost of funds was Bank Rate. The lending to HBOS and RBS was in the form of T-bills, for which the Bank paid the DMO 7 basis points.

215. On the criteria outlined above and given fees charged on other facilities, charging RBS the highest rate bid in that day's auction for the US dollar ELA, and charging 200 basis points on the market value of the T-bills lent to HBOS and RBS in the sterling ELA, seems appropriate in the circumstances.

Conditions and monitoring

216. Intensified monitoring of both HBOS and RBS, particularly in relation to their day-to-day liquidity management, was maintained from the point at which ELA was first extended. Both banks also made available appropriate information to facilitate the due diligence process managed by the Bank's Internal Audit function.

217. Following the Government recapitalisation of both banks, it was largely HMT, through UK Financial Investments (UKFI), rather than the Bank, which took primary responsibility for oversight and monitoring of HBOS and RBS after October 2008, although the Bank continued to monitor the liquidity position of both banks. In any future ELA, the Bank as both lender and the supervisory authority will need to be closely involved in monitoring the progress of the bank in returning to a more liquid position and in repaying the outstanding ELA. **The Bank should consider what monitoring might be necessary in future and how legal agreements should be structured to ensure that the banks in receipt of ELA are obliged to facilitate that monitoring.** As noted above, the Bank's Internal Audit function produced a report outlining lessons learned from the due diligence process it managed in relation to the 2008 ELA, which included suggestions for how legal documentation could be improved to facilitate the Bank's ability to oblige ELA recipients to provide appropriate data to the Bank.

Indemnity from HM Treasury

218. As noted above, HMT provided an indemnity to the Bank from 14 October to cover any exposures above the level of lending at close of business on the preceding day. Amounts lent at that date were £23.1 billion to HBOS, and £13.5 billion to RBS under the sterling ELA facility and US$25 billion (approximately £14.5 billion) under the US dollar ELA facility. This meant that at peak, on 13 October before the indemnity was put in place, the Bank was unindemnified on £51.1 billion of ELA extended to HBOS and RBS. Even after the indemnity was put in place the Bank was unindemnified for £50.9 billion of its peak intraday exposure of £61.5 billion on 17 October.

219. Since the facilities were separately indemnified, the US dollar ELA facility was effectively not indemnified because the exposure at close of business on 13 October of US$25 billion was the maximum amount drawn under that facility. Exposure to HBOS was marginally above the indemnified threshold for most of the period from 14 October to 11 December: in aggregate, over the life of the facility, the Bank was indemnified for 3% of its exposure to HBOS. Exposure to RBS under the sterling ELA facility was above the indemnified threshold between 14 October and 21 November: in aggregate, over the life of the facility, the Bank was indemnified for 29% of its sterling exposure to RBS. When both the sterling and dollar ELA facilities to RBS are considered together, the Bank was indemnified for 27% of its total exposure to RBS. Overall, across both banks and all ELA facilities, the Bank was indemnified for 12% of its exposure. As noted above, the fee payable to HMT for provision of the indemnity was 170 basis points on any exposure above the indemnified threshold, which amounted to £18.9 million in total.

220. The level of the indemnity and the remaining unindemnified amounts for the sterling ELA facilities are shown in Charts 6 and 7 below. The total amounts of indemnified and unindemnified lending across all facilities are shown in Chart 8.

221. The proximate reason for the Bank seeking an indemnity from 14 October was that the scale of ELA was rapidly increasing, to the point where the Bank (and the Transactions Committee of Court) were uncomfortable with the level of exposure to these two banks that the Bank was incurring. **For the future, since ELA operations require authorisation by the Chancellor, it would in principle be logical for the Bank to seek an indemnity from HMT for the full amount from the outset.** This would in no way lessen the need for the Bank to take collateral and apply haircuts, since it will be equally as important to control the risk to public funds (if the ELA is indemnified) as it would be to control the risks to the Bank’s balance sheet (if the ELA were not indemnified). There may be practical or logistical reasons for the Bank to carry the risk on its balance sheet, without indemnity, for an initial period, as was the case in 2008—for example, to provide time for decisions to be taken about the scale of ELA, the length of time for which it is to be extended and the appropriate exit route. But in general, covering ELA by an indemnity from HMT would seem consistent with the allocation of responsibilities between the authorities set out in both the existing Tripartite MoU and the proposed future MoU on Crisis Management.

Chart 6: Indemnity for ELA to HBOS

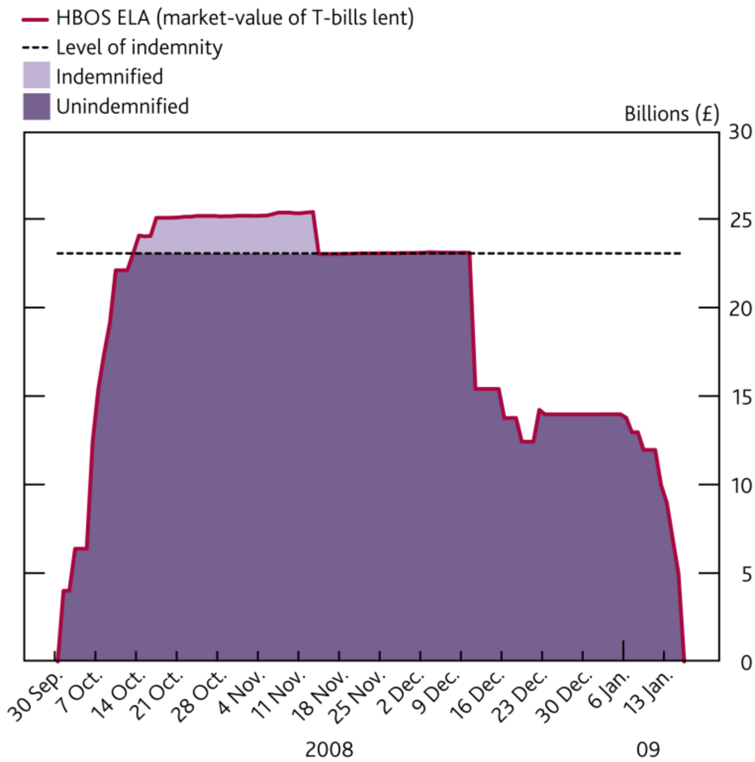


Chart 7: Indemnity for sterling ELA to RBS

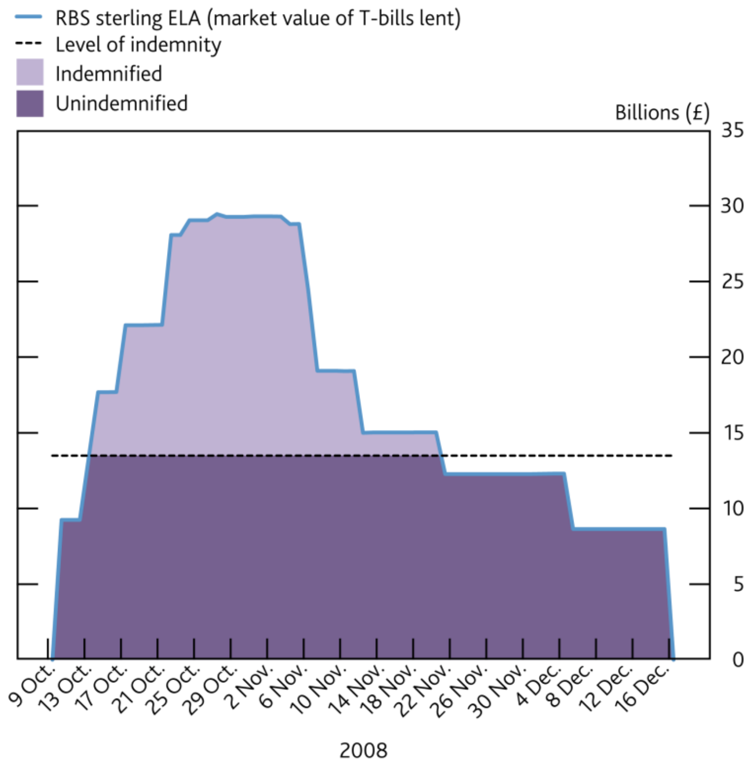
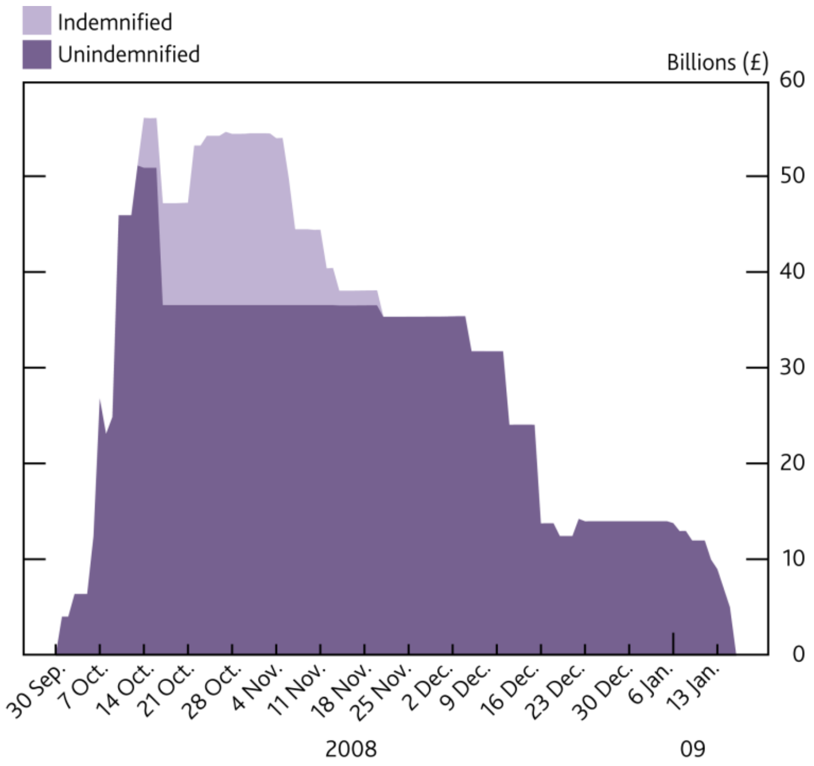


Chart 8: Total amounts of indemnified and unindemnified ELA across all ELA facilities



Chapter 6: Governance and decision-making

222. This chapter considers how effectively the Bank's governance and decision-making processes functioned when ELA was extended in 2008 and whether there is an appropriate governance and decision-making structure in place for any future ELA operations.

External governance

223. In extending ELA in 2008, the Bank was operating under the Tripartite Memorandum of Understanding (MoU) between HMT, the Bank and the FSA, initially signed in 1997 and updated in 2006. This sets out the responsibilities of, and framework for cooperation between, the Bank, HMT and the FSA in the field of financial stability. It states that in exceptional circumstances there may be a need for support operations going beyond the Bank's published framework for money market operations. The Tripartite MoU goes on to state that "ultimate responsibility for authorisation of support operations in exceptional circumstances rests with the Chancellor."[35] In 2008, the Governor sought, and received, authorisation for the ELA to HBOS and RBS and assurance from the Chancellor that he was content for the Bank to use its balance sheet to support these operations. The arrangements for authorisation of ELA set out in the Tripartite MoU thus operated as envisaged.

224. The new Crisis Management MoU proposed in the Financial Services Bill is examined in Chapter 9.

Governance by the Court

225. Under the Bank of England Act 1998, the Court of Directors of the Bank (Court) is responsible for managing the affairs of the Bank, other than the formulation of monetary policy. Following the Banking Act 2009, Court comprises the Governor, two Deputy Governors and nine Non-Executive members appointed by the Chancellor. Court delegates to the Governor the day-to-day management of the Bank, while reserving certain key decisions to itself. These decisions are publicly set out in *Governance of the Bank Including Matters Reserved to Court*. In particular, Court reserves to itself responsibility for the risk management policies adopted by the Bank.[36]

226. The decision to extend ELA is not one that is reserved to Court, but the Governor is obliged to consult Court if the need to extend ELA is envisaged. Court in 2008, prior to its membership being reduced under the Banking Act 2009, consisted of 19 members including 16 Non-Executive Directors, and as such was not a body well structured to be consulted on emergency operations. Recognising that, in November 2007 Court established a Transactions Committee (TransCo), to which it delegated the responsibility for being consulted on ELA.

---

[35] Memorandum of Understanding between HM Treasury, the Bank of England and the Financial Services Authority, October 1997, updated in March 2006, http://www.hm-treasury.gov.uk/d/fin_mou_hmt_boe_fsa.pdf

[36] Bank of England, *Governance of the Bank Including Matters Reserved to Court*, Approved at Court November 2009, Revised version to include changes agreed by Court October 2010 and November 2011, http://www.bankofengland.co.uk/about/Documents/pdfs/matters_court.pdf

TransCo comprised the Chair of the Non-Executive Directors and two other Non-Executive Directors, usually the Deputy Chair of the Non-Executive Directors and the Chair of the Audit Committee.

227. TransCo met five times in October 2008 in relation to the ELA for HBOS and RBS, including for consultation on successive increments in the scale of ELA and on the terms on which ELA was being extended. In the circumstances, with decisions being made very rapidly, it would not have been feasible for TransCo to take a substantive decision on whether or not to extend ELA. Nor would it have been appropriate for it to do so. The decision on whether to extend ELA was ultimately the responsibility of the Chancellor, as set out in the Tripartite MoU. The role of Court was to scrutinise the Bank's decision-making process and the conduct and terms of its ELA operations, particularly in regard to the Bank's exposure to risk. In this sense, the role of TransCo in relation to the decision to extend ELA could be considered as analogous to the role of Court in relation to decisions of the Monetary Policy Committee (MPC), where Court does not itself take the policy decision, but has an important role in scrutinising the process for arriving at that decision.

228. In relation to the ELA extended to HBOS and RBS, the most important role for Court arguably flowed from its responsibility for the risk management policies adopted by the Bank. The maximum amount of unindemnified ELA peaked at £51.1 billion on 13 October. Of the total intraday peak of £61.5 billion lent by the Bank on 17 October, £50.9 billion was not indemnified. In aggregate, over the life of the facilities, the Bank was indemnified for only 12% of its exposure to both banks in respect of the ELA extended. The lending was fully collateralised and was subjected to sizeable haircuts. But the ELA lending, and the Bank's contemporaneous lending through its Extended Collateral Long-Term Repo (ELTR) facility, which began in 2007 and reached a peak of £180 billion in January 2009, both represented quantum leaps in the scale of unindemnified risk to which the Bank's balance sheet was exposed; and of the two, the ELA lending, while smaller in amount and shorter in duration, was structurally riskier, being secured against lower-quality collateral and concentrated on two banks. Lending under the two facilities together constituted amongst the biggest risks to the Bank's balance sheet in its history. At its frequent meetings during October 2008, TransCo monitored the terms on which ELA was being provided and the risks to the Bank's balance sheet and was, in particular, instrumental in ensuring that, as the Bank's exposure increased, an indemnity for amounts above the £51.1 billion that remained at the Bank's risk was sought, and obtained, from HMT. **For the future, however, in view of the scale of risk to which the Bank's balance sheet may be exposed, a more structured process of reporting by the Executive might assist the relevant Court committee in discharging its oversight responsibilities—for example, a daily teleconference and weekly monitoring reports, covering in particular the risk management policies being put in place by the Bank to manage the increased exposure.**

229. **In this connection, it is recommended that the Bank's formal statement, approved by Court, setting out how Court operates, *Governance of the Bank Including Matters Reserved to Court*, be reviewed to specify more clearly and precisely Court's role as regards the Bank's balance sheet and its financial risk exposure.** At present, the main body of Matters

Reserved to Court specifies only that Court reserves to itself responsibility for "the risk management policies adopted by the Bank".[37] But an annex to the document—setting out the terms of reference of the Audit and Risk Committee—states that Court has "responsibility for approving the Bank-wide risk framework and for monitoring the overall risk profile of the Bank".[38] While these two definitions are not contradictory, the latter statement is a rather fuller description of Court's responsibilities in this important area. Even that latter definition, however, does not make clear the extent to which Court has a role in defining the Bank's risk tolerance. There may, therefore, be a case for revisiting this document to ensure that it sets out clearly, consistently and comprehensively Court's responsibilities regarding the Bank's balance sheet and its exposure to risk.

230. TransCo's terms of reference provided for the Governor to report the outcome of its meetings to the full Court as soon as possible, or at such other time as TransCo determined, in consultation with the Governor. Because of the need to maintain secrecy, the Governor and TransCo chose to delay reporting the action taken in respect of HBOS and RBS to the rest of Court. Court was informed in November 2008 that TransCo had met on a number of occasions during October, but were not told what the content of those meetings had been in the case of the meetings that related to HBOS and RBS. The ELA was reported to the Bank's external auditors in February 2009 and, in May 2009, to members of Court's Audit Committee in order to allow them to agree the Annual Report. The remainder of Court was not notified until the ELA was publicly disclosed in November 2009. Changes to the structure of Court as a result of the enactment of the 2009 Banking Act meant that there was a significant change in Court membership during 2009: the number of Non-Executive Directors on Court was reduced from 16 to nine, and as a result nine Non-Executive Directors stood down on 31 May 2009 (in addition to two Non-Executive Directors who had resigned in late-2008 and were not replaced) and four new members were appointed on 1 June 2009. In the circumstances of the time, given the need for secrecy and given that a number of members of Court had potential conflicts of interest as a result of positions on the boards of other financial institutions, the delay was reasonable and was consistent with the oversight responsibility delegated to TransCo by Court.

231. The Banking Act 2009 created a statutory committee, the Financial Stability Committee, which has certain responsibilities under the Act in relation to the Bank's financial stability objective (which was made a statutory objective in that Act). In addition to these statutory responsibilities, Court has delegated to the Financial Stability Committee the responsibility "to advise the Governor about any loan, commitment or other transaction which it is proposed that the Bank should make or enter into for the purpose of pursing the Financial Stability Objective".[39] This would include any instances of ELA, so the Financial Stability Committee has effectively superseded TransCo as the body that would be consulted in the event that ELA was undertaken now. The membership of the Financial Stability Committee

---

[37] Bank of England, *Governance of the Bank Including Matters Reserved to Court*, Approved at Court November 2009, Revised version to include changes agreed by Court October 2010 and November 2011, p.9, http://www.bankofengland.co.uk/about/Documents/pdfs/matters_court.pdf

[38] *Ibid.*, p.22

[39] *Ibid.*, p.13

comprises the Governor, two Deputy Governors, four members of Court nominated by the Chair of Court, and a Treasury observer (who may not vote). As such, the Financial Stability Committee has a greater representation of Non-Executives than TransCo did, both absolutely (TransCo was only obliged to have three Non-Executive Directors) and proportionally (TransCo had three Non-Executives of a possible 16, whereas the Financial Stability Committee has four of a possible nine; the number of Non-Executive Directors of the Bank was reduced from 16 to nine in the Banking Act 2009).

232. Under the proposals in the Financial Services Bill, currently being debated in Parliament, the Financial Stability Committee will be abolished. Some of its responsibilities in relation to the financial stability objective will pass to the new Financial Policy Committee (FPC), but these will relate to system-wide financial stability rather than individual institutions. Under the proposed arrangements, Court will again have the option to set up a non-statutory sub-committee for the purposes of consultation on ELA. It is appropriate, given the need for meetings to be called at short notice in a crisis and the need to maintain secrecy, for the requirement to consult Court about ELA to be fulfilled by a smaller group of Non-Executives. **Any sub-committee constituted for this purpose should, however, have substantial representation of non-conflicted Non-Executive Directors, as is the case in the current Financial Stability Committee.**

233. For a commercial company, operating under normal corporate governance standards, it would be expected that the board's role would extend beyond that of consultation to actually taking the ultimate decision on facilities of the nature and scale of ELA. In the case of ELA, however, approval is required from the Chancellor, under the terms of the Tripartite MoU. It is therefore appropriate, in the specific case of ELA, that Court is consulted and has responsibility, through its appointed sub-committee, for oversight of the Bank's conduct of ELA operations, rather than having responsibility for the policy decision itself.

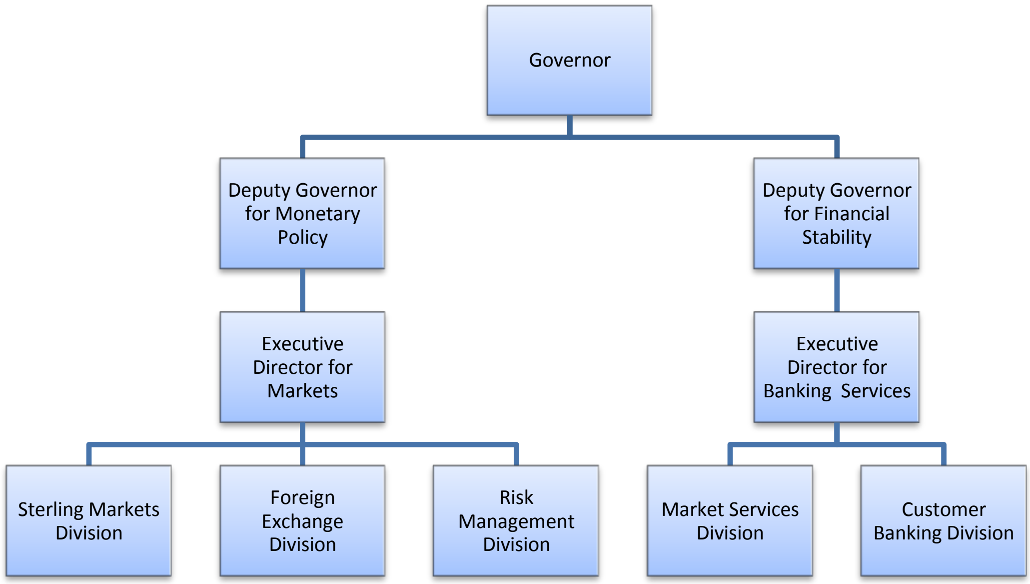
Decision-making within the Bank

234. In any emergency, decisions need to be taken quickly. Recognising this, and in response to the mounting pressures on a number of individual banks, the Bank established in July 2008 a new Resolution Committee (ResCo) comprising the Governor, the Deputy Governor for Financial Stability, and the Executive Directors for Banking Services and Markets. ResCo's initial terms of reference were to discuss issues relating to individual institutions causing concern with the objective of identifying the Bank's strategy towards that institution and agreeing specific action points. ResCo had no formal constitutional role; it was a working executive committee. But the establishment of this committee was a sensible step to enable the key members of the Executive to be brought together at short notice, and helped to provide a coherent and streamlined internal-decision making process in relation to individual banks.

235. In line with the Bank's enlarged statutory responsibilities in the 2009 Banking Act, the membership and terms of reference of ResCo were amended in March 2009. From this point, the membership of ResCo was expanded to comprise the Governor, both Deputy Governors, the Executive Directors for Banking Services, Financial Stability and Markets and the Director

of the Special Resolution Unit. The terms of reference were also expanded to reflect the Bank's new powers under the Special Resolution Regime (SRR). Under these new terms of reference ResCo is tasked with agreeing the resolution strategy in relation to individual firms that are at risk of entering the SRR, or are being resolved under the SRR. Its remit also includes identifying actions outside of the SRR to reduce immediate financial stability risks.

236. While strategic or sensitive decisions are made by the Governor, operational implementation of those decisions is delegated within the Bank. Implementation of ELA to individual banks is managed by the Banking Services Directorate. Market-wide facilities, including the SLS in 2008, are managed by the Markets Directorate. Thus in 2008, the Banking Services Directorate led on the implementation of the sterling ELA to HBOS and RBS, but the US dollar ELA to RBS was implemented by the Markets Directorate, which was already conducting the market-wide US Dollar Repo Operations. Regardless of whether an operation is ELA for an individual bank or a market-wide operation, risk management is conducted by the Risk Management Division, which sits in the Markets Directorate; and settlement of transactions occurs in the Market Services Division which sits within the Banking Services Directorate. A subset of the Bank's internal structure, highlighting the relevant Directorates (Banking Services and Markets) and the relevant Divisions within those Directorates and their reporting lines are set out in the diagram below.



237. In 2008, as noted in Chapter 5, HBOS and RBS were already receiving a considerable degree of sterling liquidity from a variety of the Bank's market-wide operations (for example, the ELTRs and the SLS), which were being implemented by the Markets Directorate. When both banks began to receive sterling ELA, the responsibility for managing ELA operations lay with the Banking Services Directorate. In the stress of the ongoing crisis, and given that the requirement of secrecy made it desirable to minimise the number of staff involved in the ELA operations, there might have been the potential for miscommunication as a result of this dispersion of responsibilities.

238. To avoid this dispersion, it might have been more logical to manage the ELA from within the Markets Directorate, although this would have added to the pressure placed upon staff within that Directorate at a time when those staff were already under significant pressure managing a number of other market-wide crisis operations. Besides avoiding a dispersion of responsibilities in mid-crisis, this might have had two other advantages. First, the Markets Directorate was already operating the SLS and the sterling ELA was structured in essentially the same way as the SLS. Second, the Markets Directorate was in any case managing the US dollar ELA, since those operations followed the same structure as the market-wide US Dollar Repo Operations.

239. In the event, there was close communication between the different areas of the Bank involved in the ELA operations and there is no evidence that the dispersion of responsibilities across two Directorates created any practical problems. **For the future, it might be logical to manage any ELA from the Markets Directorate, in order to minimise the scope for confusion. This may be worth considering particularly if, as is intended, any future ELA is likely to be similar in mechanism to the DWF, which is managed in the Markets Directorate. Equally, other management structures would be possible and it is recommended that the Bank reviews whether the present dispersion of responsibilities remains appropriate in light of the significant extension in recent years of its framework for liquidity insurance.**

240. A further organisational point for consideration arises in relation to the desirability, on risk management grounds, of separating front, middle and back office operational functions. In general, good operational practice from a risk management perspective is for initiation for a transaction to come from the front office, risk management to be undertaken within the middle office, and the transaction to be settled by the back office. In terms of the Bank's Divisions (which sit within the Directorates) that would normally imply that the Sterling Markets Division or the Foreign Exchange Division would initiate a transaction, the Risk Management Division would undertake the necessary risk management and the Market Services Division would settle the transaction. In 2008, the ELA transactions, once authorised by the Executive, were both initiated and settled by the Market Services Division. For the future, it is accepted by the Bank that ELA would be initiated by the Customer Banking Division. **Separation of front, middle and back office responsibilities at the Divisional level is an appropriate step to strengthen risk management safeguards.**

241. Whether responsibility for ELA operations is located in the Banking Services Directorate (as at present) or in the Markets Directorate, it remains the case at present that the Banking Services Directorate reports to the Deputy Governor for Financial Stability and the Markets Directorate reports to the Deputy Governor for Monetary Policy. But a number of the market-wide facilities managed by the Markets Directorate (for example, in the past the SLS and ELTRs and currently the DWF and Extended Collateral Term Repo operations) are conducted primarily for financial stability purposes. In practice, this crossover of responsibilities gave rise to no problems in 2008 and is managed by both Deputy Governors having regular meetings with the relevant Executive Directors. **For the future, the current reporting lines of the Markets and Banking Services Directorates to their respective Deputy**

Governors may leave scope for uncertainty and a more structured approach of each Directorate reporting to the relevant Deputy Governor for the latter's area of responsibility could be considered. The structure of responsibilities might appropriately be addressed when the third Deputy Governor, responsible for the PRA, joins the Bank, especially as the PRA will also have a role in decisions on some of the Bank's operations under its existing facilities (such as the DWF) as well as in decisions on any future ELA.

242. Overall, in 2008 the process for decision-making within the Bank in the severe stress of exceptional events worked well in enabling the Bank to respond rapidly and effectively to an extreme financial crisis. It should also be noted that proper care was taken to keep records and provide an audit trail.

The roles of the MPC and the FPC

243. The question has been raised as to whether all members of the Monetary Policy Committee (MPC), some of whom were not aware of the ELA extended to HBOS and RBS at the time, should have been briefed on it, as a development possibly relevant to the MPC's decisions on setting interest rates.

244. This issue raises conflicting considerations. In principle, it is plainly important that all members of the Committee have access to the same information where it is relevant to the Committee's responsibilities. Briefing in general terms on the deepening financial crisis was provided for the Committee from 2007 onwards, and this included briefing on the market-wide liquidity support provided through, for example, the SLS and the US Dollar Repo Operations. It is unclear from the MPC's minutes how far this briefing enabled all members to appreciate the extent and intensity of the crisis. It may be that knowledge that two individual banks had by October 2008 reached the point of needing ELA would have altered their view of the severity of the crisis.

245. But the MPC's first meeting (on 8 October) after the Bank began extending ELA (on 1 October) was in fact on the day that the Government announced its decision to recapitalise banks, including HBOS and RBS, if necessary, at which point the extent of the UK banking system's need for financial support, extending well beyond liquidity assistance, was public knowledge. As noted in the MPC's minutes, the Governor briefed the Committee on the Government's recapitalisation programme at its meeting that day.

246. At its meeting on 8 October, the MPC decided on a 50 basis points reduction in Bank Rate in coordination with other central banks; and it cut Bank Rate by a total of a further 400 basis points in steps at each of its next five successive meetings. It is not clear that lack of information on the specific decision to extend ELA to two individual banks had a material impact on the MPC's decisions. Given the extreme sensitivity of the ELA operations and their short-lived term, it is understandable that the full MPC was not briefed on them.

247. **For the future, consideration will need to be given to what role the new Financial Policy Committee (FPC), which will have a statutory responsibility for monitoring systemic risk and initiating policy actions in that area, would appropriately play in relation to any**

provision of ELA. The Financial Services Bill states that the FPC "may not make recommendations about the provision by the Bank of financial assistance in relation to a particular institution."[40] The FPC will therefore not be involved in operational decisions to extend ELA in individual cases. But given that, as discussed in Chapter 4, ELA would be being extended because of the potential systemic impact of a bank failure, the FPC may have a role in establishing the framework within which any future ELA decisions would be made and in developing any wider response that might be needed to the systemic threat that gave rise to the need for ELA.

[40] Financial Services Bill. Section 9N, (3)(a), Recommendations by Financial Policy Committee: Making of recommendations within the Bank, p.9

Chapter 7: Disclosure

248. The Bank decided to keep the ELA extended to HBOS and RBS in 2008 covert. This chapter examines whether that decision was appropriate; and whether it would be feasible and appropriate to maintain similar conditions of secrecy in any future ELA operations.

ELA covert operations in 2008

249. On the face of it, it is remarkable that operations of the scale and intensity of the ELA extended in 2008 could be kept covert and that the operations were not detected by the market or by the press. That this was possible, however, owed a great deal to the background of extreme market disturbance against which the ELA operations were conducted.

250. In particular, banks had been utilising the SLS since April to alleviate their funding difficulties. The sterling ELA extended to HBOS and RBS was very similar in structure to the liquidity provided under the SLS (9-month T-bills provided by the Bank on a collateral swap against illiquid assets). So provision of additional T-bills to two banks in ELA operations, and their use by those two banks in the market or in the Bank's operations, would not have been distinguishable in the market from T-bills provided in the SLS. In this sense, while the SLS was directed to a different purpose, it served as camouflage for the ELA operations.

251. More generally, the widespread dysfunction of markets in the wake of the failure of Lehman Brothers made the liquidity problems of HBOS and RBS less discernible. Any change in the pattern of their funding, from struggling to roll over market funding at increasingly short maturities before they received ELA to a more orderly process of funding after receipt of ELA, was effectively blurred, only a week after ELA was initiated, by the more far-reaching announcement on 8 October of the Government recapitalisation scheme for banks and of the Credit Guarantee Scheme (CGS), of which both banks took advantage. Again, general market disturbance provided camouflage for the specific problems of two individual banks.

Possible constraints on secrecy

252. The disturbed market background in 2008 was thus a significant factor in making it feasible for the ELA to be kept covert. This was not the case when ELA had to be extended to Northern Rock a year earlier, in September 2007, as highlighted in the Treasury Committee's report, *The run on the Rock* (see Appendix 4). In 2008 there were also a range of practical constraints to keeping an operation covert which the Bank was able in the event to address.

253. First, had the liquidity support been provided in immediate cash, as was the case in the ELA extended to Northern Rock, the assistance would have appeared in the weekly Bank Return, which was being closely scrutinised at that time. The form in which the lending was provided—collateral swaps—was off balance sheet and so did not appear in the weekly Bank Return.

254. Second, because the facilities were repaid by January 2009, there was no need for the Bank to disclose any current exposure arising from the facilities in its Annual Report for the year ending February 2009, issued in May 2009. The Bank of England Act 1998 allows the Bank to limit the disclosures it makes about lender of last resort operations to the extent that, while the financial effects of such operations must be included in financial statements in the year in which they occur, the financial statements do not have explicitly to identify the existence of such support. Because the ELA facilities were structured as collateral swaps, their existence would not have been visible on the Bank's year-end balance sheet. But if the facilities had been outstanding at the end of February 2009, the Bank would have been obliged to disclose the fair value of the collateral held against the facilities. Although this would not have needed to be identified explicitly as relating to ELA, it may have raised questions as to what the collateral was being held against.

255. Income generated from the facilities and fees paid for the indemnity had to be included in the Annual Report, but under the disclosure limitation did not need to be identified explicitly as being from the ELA. Moreover, the income and fees from the ELA were to some extent masked by the income and fees from very large market operations such as the SLS. Similarly, the 2009 Annual Report identified indemnities that were outstanding at the end of February, but this did not include the indemnity provided in respect of ELA because the operation had by then already ceased.

256. Third, the trust structure used to grant the Bank security over the assets against which T-bills were lent meant that there was no need for the ELA recipients to register a publicly-visible charge over the assets at Companies House, as had been the case with the Northern Rock ELA.

257. Fourth, if Government incurs a contingent liability, such as that incurred by the granting of the indemnity to the Bank for the ELA from 14 October, the Chancellor is obliged to notify Parliament. Notification may, however, be delayed in exceptional circumstances if the contingent liability needs to remain confidential. By convention, if these conditions pertain the Chancellor would normally notify the Chairs of the relevant Select Committee (in this case the Treasury Committee) and the Public Accounts Committee. On this occasion, in light of the imperative for the operations to be kept secret, the Chancellor elected not to notify the Chairs of these Committees. This decision was one for the Chancellor, rather than the Bank, and is reviewed in detail in the Treasury Committee's report, *Reporting contingent liabilities to Parliament*.[41]

258. Fifth, under EU regulations governing State Aid, although short-term liquidity assistance from a central bank to a financial institution does not constitute State Aid[42], the grant of an indemnity for that lending by the Government could trigger the need to notify the European

[41] House of Commons Treasury Committee, *Reporting contingent liabilities to Parliament*, Fifth Report of Session 2009–10, HC181, February 2010

[42] State Aid is defined in Article 87 of the EC Treaty as "any aid granted by a Member State or through State resources in any form whatsoever which distorts or threatens to distort competition by favouring certain undertakings or the production of certain goods."
http://ec.europa.eu/competition/legislation/treaties/ec/art87_en.html

Commission. This threshold was not reached until 14 October, when the HMT indemnity was put in place. By that time the European Commission had already been notified of the full package of measures, including the Government's bank recapitalisation scheme, which was announced on 8 October.

259. Sixth, any ELA provided by a central bank in the EU has to comply with the EU prohibition against monetary financing as defined in Article 123 (previously Article 101) of the European Treaty. In particular, ELA might be deemed to be incompatible with the monetary financing prohibition if the central bank lent to an institution that was insolvent rather than illiquid, particularly if that lending was backed by a state guarantee. Such a situation might require notification of the operation to the European Central Bank. In the case of the ELA to HBOS and RBS these conditions were judged not to apply.

260. Beyond the Bank's or HMT's obligations to disclose, special assistance of the nature received by HBOS and RBS in 2008 could also raise the question of whether the recipient banks have an obligation to disclose the assistance. For example, in 2007 when the Bank lent to Northern Rock, it was judged that it was not possible for the operation to be undertaken on a covert basis because statements Northern Rock had previously made to the market about its sources of funding meant that not disclosing the ELA would have risked misleading the public, in contravention of the Market Abuse Directive. As a consequence, the Bank decided to undertake that operation on an overt basis (which in the event suffered premature disclosure through a leak to the media). In 2008, the banks in receipt of the ELA determined that they were not obliged to disclose the existence of the ELA specifically.

Was secrecy appropriate in 2008?

261. In light of the extreme fragility of the markets at the time, and in view of the considerable disturbance that had been caused by the revelation of the lending to Northern Rock the previous year, it was right to endeavour to keep the ELA operations in 2008 covert. None of those interviewed for this Review has suggested otherwise. The decision to keep the operations covert was agreed by the Chancellor and supported internally in Court both by TransCo and subsequently by Audit Committee when they signed off the Annual Report in May 2009.

Covert ELA operations in the future

262. Whether or not any such operations in future should be conducted in similarly covert conditions is a policy decision which can only be determined in the circumstances of the time. It may be that, if an individual bank is seen to be experiencing funding problems for idiosyncratic reasons at a time when systemic stability is not in jeopardy, public disclosure of ELA provided by the Bank would be an appropriate step in re-establishing market confidence in the bank in question without precipitating wider concerns. But in conditions of more severe systemic disturbance, as in 2008, ELA is likely to be more effective if provided covertly.

263. If covert ELA operations were needed in the future, a number of changes have been made since 2008 in order overcome several of the practical constraints that might make undertaking a covert operation more difficult, notwithstanding the ability of the Bank to keep the 2008 operations covert. For example:

- Under the Banking Act 2009, the Bank is no longer required to publish the weekly Bank Return. **The Bank in fact still publishes the Return, but it should consider ceasing to do so at an appropriate time, in order to improve its ability to provide covert assistance in future if needed.** Its information content, given its abbreviated form, is minimal;
- The Banking Act 2009 also removed the obligation for any charge over assets made in favour of the Bank to be publicly registered;
- The Bank is also no longer required to reveal the fair value of collateral held at the balance sheet date in the Annual Report, as reporting of the fair value of collateral held and pledged has now been included as a disclosure limitation under the provisions of the Bank of England Act 1998. This would mean that if ELA were conducted via a collateral swap in future, the value of the collateral taken and thus the existence of the ELA would not be implicitly revealed through the Annual Report. This may also assist with maintaining confidentiality around DWF drawings;
- The Market Abuse Directive is to be replaced by a Market Abuse Regulation which will permit delay in disclosing information if that information is of systemic importance and it is in the public interest to delay disclosure. This gives regulators the power to permit a delay for a limited period in the wider public interest of maintaining the stability of the financial system.

264. There remain, however, uncertainties in some areas of the legal and regulatory framework for disclosure, principally at the EU level, that could complicate the process of keeping any future ELA covert if that were judged necessary. The UK authorities should address these issues as **it is important that they be resolved so that as far as possible the standard requirements for disclosure do not, in a crisis, counterproductively compromise the wider public interest in maintaining financial stability.**

265. Even with the changes made, for any future ELA operations it may not be possible to maintain the level of secrecy that was achieved in 2008. Aside from the risk of an unintended leak, given the number of people inevitably involved in operations as complex and far-reaching as ELA, it may well not be the case that any future ELA would be undertaken against the background of an extended period of market disturbance and of the existence of similarly structured facilities like the SLS, both of which helped to mask the ELA in 2008.

266. The regulatory rules governing banks' liquidity require "periodic realisation" of assets held in banks' liquid asset buffers—that is, a bank should periodically realise a proportion of those assets through repo or outright sale in the market.[43] This requirement has the prudential

[43] Financial Services Authority, *Prudential sourcebook for Banks, Building Societies and Investment Firms*, BIPRU 12.7.11

benefit of increasing the chances that, if a bank needed to realise liquid assets in response to funding strains, it could do so without attracting undue attention. **It would be helpful, in terms of enabling ELA to be undertaken covertly, if there were fuller implementation of these rules, such that banks undertook "periodic realisation" on sufficient scale to provide a degree of cover for any ELA support extended by the Bank**. Similar considerations apply to routinised use of the DWF.[44] Consideration might also be given to whether it is appropriate that some, particularly smaller, banks may hold their liquid asset buffers solely in the form of reserves at the Bank of England.

Timing of disclosure

267. The ELA operations in 2008 were first publicly disclosed on 24 November 2009 in a statement from the Bank to the Treasury Committee.[45] This was close to 14 months after ELA was first extended, on 1 October 2008, and 10 months after the last tranche of ELA was repaid on 16 January 2009.

268. There were a number of occasions in 2009 when disclosure might have been possible. An early occasion might have been provided by the agreement, in February and March 2009, of initial terms for RBS and Lloyds Banking Group (with which HBOS had by then merged) to participate in the Asset Protection Scheme (APS)—though Lloyds Banking Group subsequently decided not to participate. A further occasion might have been in February 2009, when the Banking Act 2009 came into effect, establishing the SRR. Another occasion might have been provided in April 2009, when the European Commission approved the CGS and the recapitalisation of banks under the EU's State Aid rules. Disclosure was a consideration for the Bank's Audit Committee at the time of agreeing the Bank's Annual Report in May 2009. The Bank reviewed the advisability of making disclosure on two occasions in September and October 2009, but judged that it could not be confident that disclosure would not have adverse consequences.

269. In the event, disclosure of the ELA facilities on 24 November 2009 was in part prompted by the intention of the National Audit Office to publish on 4 December a report on all of the Government's financial stability interventions, including the ELA and the associated indemnity. RBS's participation in the APS and the fact that Lloyds Banking Group would not be participating in the scheme were announced by the Chancellor in Parliament on 3 November 2009. The Bank judged that these steps had reduced the risks around disclosure. The disclosure announcement on 24 November was widely commented upon in the press, but had a limited impact on financial markets.

270. The appropriate time to disclose ELA operations can only be judged in the circumstances of each occasion. But there are perhaps two overriding conditions that need to be satisfied: that the bank(s) receiving temporary ELA should be seen to have found a more permanent

[44] Routinised use of the DWF is considered in detail in the accompanying review by Bill Winters, *Review of the Bank of England's framework for providing liquidity to the banking system*.

[45] Bank of England, 'Additional information provided to the Treasury Committee by the Bank of England: Statement on the Emergency Liquidity Assistance (ELA) extended to two institutions, RBS and HBOS, in the Autumn of 2008', 24 November 2009

and credible basis for future viability without ELA; and that the financial system as a whole should have stabilised sufficiently for it to be able to absorb the news without disclosure precipitating renewed loss of confidence. In the fragile circumstances of 2009, it was reasonable for the Bank to wait until it was confident that these conditions had been met. The muted market reaction to the announcement supported the Bank's judgement.

271. Although the case for disclosure was considered in the Bank at intervals in 2009, there was no regular mechanism for reviewing the point at which it might be appropriate to disclose the existence of the ELA facilities. Such a procedure has now been put in place for indemnified ELA. After the disclosure in 2009, it was agreed that in future instances of ELA where HMT indemnified the Bank, the Chancellor would provide oral briefing to the Chairs of the Treasury Committee and the Public Accounts Committee at the time of any ELA operation. After that, the Chancellor will consult with the Governor every three months about whether and when it is possible to disclose to Parliament (and therefore publicly) the existence of the ELA. Within the Bank the internal control framework for ELA sets out that prior to each quarterly meeting between the Governor and the Chancellor the ELA Implementation Committee will meet to consider the case for disclosure and put a recommendation to the Governor. **It would be appropriate for a similar process of quarterly review on the timing of disclosure to be followed within the Bank in relation to any ELA that is not indemnified.**

Chapter 8: Effectiveness of the 2008 ELA operations

> "Success is relative:
> It is what we can make of the mess we have made of things."
> T.S. Eliot: *The Family Reunion*

272. The terms of reference for this Review require it to examine the effects of the Bank's ELA operations in 2008 on the institutions concerned and on overall financial stability. This chapter provides that assessment.

273. ELA was a short-run operation, lasting four months, extended to two individual banks. It is impossible to distinguish the specific contribution ELA may have made to stabilising the two banks, and the financial system as a whole, from the impact of the wider range of stabilisation measures taken by the Bank and the Government over the period of the crisis—in particular, the market-wide liquidity provided by the Bank through the SLS and the support provided by the Government through its bank recapitalisation scheme, the CGS and the APS.

274. The damage wreaked by the financial crisis has been immense, in terms of output foregone in the wider economy, in terms of the fiscal cost of recapitalisation and in terms of dysfunction in the financial system that continues to this day. Halting the contagion and averting the threat of total collapse required a battery of Government measures, in the context of which the ELA support provided by the Bank was an essential, but necessarily temporary, element. To stabilise their business on a more permanent basis, the two banks required substantial recapitalisation by the Government; and they remain in partial public ownership four years later. The Bank's ELA operations did not in any sense resolve the financial crisis. Nor could they have done so, on their own. But they were an essential plank in the structure of official support that was able in the end to return the financial system to a degree of stability.

275. In the necessarily narrow terms of what it aimed to achieve, the ELA extended by the Bank can be judged to have achieved its purpose effectively. The operations met the three criteria reviewed in Chapter 4—that the threat should be systemic; that the banks to which liquidity support is extended should be capable of maintaining solvency and viability at least in the medium term; and that there should be an exit point in prospect for the Bank's assistance.

276. The ELA served as a bridge to enable HBOS, through its merger with Lloyds TSB, and both HBOS (in its merged form) and RBS, through Government recapitalisation, to avoid precipitate failure and stabilise their businesses. Had ELA not been extended, it is very probable that HBOS would have been forced to cease business within days, and RBS similarly when its sources of dollar funding dried up. In terms of the broader stability of the financial system, there can be little doubt that the failure of either bank would have precipitated a widespread further diminution of confidence in other, less stressed, banks. In systemic terms, therefore, the ELA served to contain the spread of contagion in a period of high risk of systemic collapse.

277. Importantly, the way the ELA was structured also addressed two further essential principles. First, the risks to the Bank's balance sheet and, after an indemnity was given by HMT, the risks to public funds, were properly controlled by the collateral the Bank took and the haircuts it applied. Second, the extent to which the Bank's actions increased moral hazard in the system as a whole was minimised—specifically by the fee charged for the ELA, and more generally by the degree of oversight to which the banks were subjected, by the financial loss incurred by their shareholders, and by the reputational damage both banks and their senior management suffered. The stigma attaching to a bank needing to resort to ELA is an important safeguard against moral hazard. The need to minimise moral hazard is highlighted by the Treasury Committee in its report, *The run on the Rock* (see Appendix 4).

278. The Bank's ELA operations in 2008 can thus be viewed as a classical exercise of the lender of last resort (LoLR) function. The Bank, working with the FSA and HMT, moved quickly to take the necessary action in a severe emergency. It conducted the operations effectively, with proper regard to controlling risks to its balance sheet and to public funds and to minimising moral hazard. The actions served their purpose in providing a bridge to a long-term route to stabilisation. The Bank was repaid in full and suffered no loss; indeed, the operation generated a return for the public sector of around £175 million. It is hard to conceive of a clearer exemplar of the LoLR function operating as intended.

279. It should also be recognised that the effectiveness of the Bank's operations through this exceptionally challenging phase of the crisis owed a great deal to the professional competence, technical expertise and dedication of the Bank's staff as a whole and their capacity to operate to high standards under pressure over an extended period.

Chapter 9: ELA in the future and the Bank's lender of last resort function

280. The nature of the Bank's lender of last resort (LoLR) function has been fundamentally transformed since 2008.

281. In terms of providing liquidity support, a large part of what in the past was termed ELA—liquidity provided ad hoc by the Bank to a bank encountering funding difficulties—has now been institutionalised in facilities within the Bank's published framework, notably the DWF. Liquidity support by the Bank that in the past might or might not have been available to a bank in need is now available on demand, provided the bank meets the conditions of the DWF.

282. Besides the facilities the Bank has established for liquidity insurance, there are also now many more options available to the Bank if it does not consider liquidity support to be the appropriate response in a particular situation. In such circumstances, the authorities now have available the means to resolve a bank in an orderly manner, through the Special Resolution Regime (SRR).

283. Between these two structures—the facilities within the Bank's published framework and the SRR—there is now a much reduced space in which ELA might need to be contemplated. Nonetheless, such situations could arise:

- A bank needing liquidity support may not have pre-positioned sufficient collateral with the DWF;
- A bank may have good collateral, but not of the type eligible for the DWF;
- There may be concerns about disclosure requirements attaching to the DWF and possible stigma that might be attached to such use;
- Temporary emergency liquidity may need to be provided while it is determined whether a bank should be placed into the SRR;
- For a bank within the SRR, temporary liquidity support may be needed to assist one of the resolution options—for example, sale to another party, establishment of a bridge bank or entry into, or exit from, temporary public ownership;
- More generally, since crises never arrive in exactly the form anticipated, it is all too likely that cases will arise where a bank's need for liquidity does not precisely fit the specific terms of the DWF. To avoid having to adapt the terms of the DWF on an ad hoc basis, the Bank might need to consider extending ELA on terms tailored to the specific needs of the individual bank;
- More widely still, a systemic threat may arise from liquidity strains affecting financial institutions outside the banking system—for example, broker-dealers, insurers, fund managers, central counterparties or payment or settlement systems.

284. Of these possible instances, the Bank now has, for the most part, the capacity to provide ELA to *banks* outside the terms of the DWF, if the need should arise, as reviewed in Chapter 3. It is also focused on possible systemic risks if strains were to emerge in central counterparties. But future shocks to systemic stability may be as likely to arise from the activities of other types of non-banks. This reflects the large-scale expansion in recent years in disintermediated financial activity, conducted not over banks' balance sheets, but in globally-linked trading markets (in money, capital, derivatives and commodities). For a central bank to be prepared to provide emergency liquidity in response to strains on banks is arguably no longer sufficient. It must also be prepared to respond to strains on non-banks that threaten financial stability.

285. The UK authorities, including the Bank, are well aware of this wider dimension, as evidenced by the Government's recent consultation on proposals to extend the SRR to non-banks. The extent to which strains on a non-bank financial institution would in fact be likely to generate systemic instability may be rather different from situations involving a bank. **But it will be important for the Bank to have the capacity, if necessary, to extend ELA to non-banks if strains on one or more were to precipitate a threat to systemic stability.**

286. Analogous considerations will arise in relation to the ring-fencing proposals set out in the report of the Independent Commission on Banking and the Government's White Paper on Banking Reform.[46] Banks outside the ring-fence, having lower capital requirements and riskier business models than banks inside, may be more likely to encounter liquidity strains from unforeseen shocks. But even though they are outside the ring-fence, it will be hard to suppose that, ipso facto, any strains they suffer will never have systemic consequences. So their operations may raise similar questions in relation to ELA as discussed above in relation to non-banks.

287. In relation to both banks and non-banks, the international dimension can further complicate the question of whether, and how, to extend ELA. If the overseas subsidiary of a UK financial institution, or the UK subsidiary of an overseas financial institution, were to encounter funding difficulties on a scale that threatened systemic stability in either country, the response by the authorities would be likely to require consultation and close cooperation between the central banks and regulatory authorities of both countries—or, indeed, action on a multilateral basis, given the increasing international spread of many financial institutions. This international dimension was not a factor in the funding crisis surrounding HBOS and RBS in 2008, but the global interconnection of financial institutions and markets will continue to pose challenges for central banks in planning and executing liquidity support operations.

288. Beyond liquidity strains as such, the Bank, like any central bank, may need to take the lead in crisis management if the financial system is destabilised by sudden and unforeseeable shocks that could take many forms. In many cases, the action needed by the Bank will not involve

[46] Independent Commission on Banking, *Final Report: Recommendations*, September 2011; HM Treasury and the Department for Business, Innovation & Skills, *Banking reform: delivering stability and supporting a sustainable economy,* Cm 8356, June 2012

ELA. Its role may be essentially logistical—organising an appropriate response by market participants and providing information and guidance—or it may need to intervene more actively, for example by facilitating payments or settlements, providing hedging cover or mounting operations to enable particular markets to continue functioning. In this last area, the Bank's operations since 2009 under its Asset Purchase Facility, designed to improve the functioning of the commercial paper and corporate bond markets, are a case in point. Such operations are sometimes characterised as the central bank acting as market-maker of last resort, but can be viewed essentially as just one of a gamut of actions a central bank may need to contemplate to address strains on the financial system.

289. In this wider sense, the LoLR function is inherent and continuously present in all the Bank's operations. In some areas, the function is long-standing, as in the Bank's OMOs. In others, it has been more recently institutionalised, through facilities within the Bank's published framework for lending against extended collateral. In other areas the LoLR function remains necessarily not pre-specified, as in the Bank's latent capacity to respond to unforeseen shocks in a variety of possible ways. ELA is one instrument available to the Bank in exercising its LoLR function, but far from the only option.

290. **Given the fundamental changes in the nature of the Bank's LoLR function since 2008, it may be appropriate at some stage for the Bank to set out the principles under which it would contemplate activating its LoLR function in the widest sense, particularly in light of the greatly enhanced regulatory and statutory frameworks within which the financial system now operates.** In doing so, it would be important to be clear that, outside the Bank's published framework, there can be no pre-commitment by the Bank to LoLR actions: 'constructive ambiguity' may have been diluted by the necessary responses to the financial crisis in the past few years, but it remains a critical element in limiting moral hazard in relation to LoLR operations outside the Bank's published framework.[47]

291. The Bank's role in crisis management, and in particular in providing ELA, will—once the Financial Services Bill is passed—for the future be governed by the (draft) MoU on Crisis Management. This MoU, which is relevant to the recommendation in the Treasury Committee's report, *The run on the Rock*, on the need for a clear leadership structure (see Appendix 4), sets out the respective responsibilities of the Bank and HMT in a crisis. It makes clear that, appropriately, "the Bank has primary operational responsibility for financial crisis management. The Chancellor and the Treasury have sole responsibility for any decision involving public funds."[48]

292. Essentially, the draft Crisis Management MoU envisages three possible approaches to managing a crisis:

---

[47] The issue of constructive ambiguity in relation to operations within the Bank's published framework is discussed in the accompanying review by Bill Winters, *Review of the Bank of England's framework for providing liquidity to the banking system*.

[48] HM Treasury, *A new approach to financial regulation: securing stability, protecting consumers*, Cm 8268, January 2012, Annex E - Memorandum of Understanding on financial crisis management, p.109

- First, the Bank has freedom to act within the terms of its published framework for offering liquidity insurance to the financial system on terms that safeguard the Bank's capital. The draft Crisis Management MoU notes that, "where the Bank is able to manage a financial crisis without public funds being put at risk, it will have autonomy in exercising its responsibilities in line with the relevant statutory provisions";
- Second, any ELA (defined as support operations outside the Bank's published frameworks) to firms at risk but judged to be solvent must be authorised by the Chancellor and HMT;
- Third, the Chancellor also has the power to direct the Bank to conduct special support operations for the financial system as a whole, or to provide ELA. Any operation conducted under such an instruction would be indemnified by HMT.

293. The first of these approaches provides appropriate scope for the Bank to respond to emerging financial stress, short of extending ELA. Indeed, the scope for such action has already been greatly extended by the expansion over the past few years in the range of facilities for liquidity insurance within the Bank's published framework. But in seeking to manage a financial crisis, the Bank will inherently face a degree of risk to its balance sheet, as it does in all its operations. There is practical advantage in a central bank having room for manoeuvre in responding to a financial crisis. But how far it can do so is constrained by the degree of risk exposure it is able to take.

294. The risk management policies adopted by the Bank are the responsibility of the Bank's Court of Directors. In exercising this responsibility, Court has necessarily to have regard to the size of the Bank's capital. The Bank's capital, at around £2 billion in terms of potential loss-bearing capacity, is not large; and the considerable expansion over the past few years of the Bank's facilities for liquidity insurance has significantly increased the potential scale of risk exposure that the Bank's capital has to cover. Operations to manage a financial crisis, even without recourse to ELA, would further strain the adequacy of the Bank's capital. **Some increase in the size of the Bank's capital may be appropriate, to enable the Bank to play an effective role in a financial crisis, where this can be done without public funds being put at risk, as envisaged in the draft Crisis Management MoU.**

Recommendations

Chapter 2: Horizon scanning

1. In situations where the Bank is aware of a bank experiencing escalating liquidity strains, the Bank could consider whether it might act pre-emptively to provide bilateral liquidity support before the need definitively crystallises. (Paragraph 105)

2. It will be important that the Bank continues to develop and monitor processes to enable sufficient and intelligent filtering of the formidable amount of raw data and information now being collected and analysed within the Bank, such that senior staff receive timely notification of key developments, without being overwhelmed with data and analysis. (Paragraph 121)

3. It will be important for the Bank to maintain its strengthened capacity to scan the horizon for impending financial stresses even when financial conditions return to relative calm. It will be a challenge not to allow the functions within the Bank that have been built up as a response to the crisis to deteriorate when the immediate need for them is less intense. (Paragraph 123)

4. The Bank needs to be able to identify impending systemic shocks emanating from, or impacting on, non-bank financial institutions. (Paragraph 124)

Chapter 3: Planning for ELA

5. The Bank's foreign currency swap lines with overseas central banks are currently due to be renewed on 1 February 2013. It would be a sensible contingency for the Bank to maintain these swap lines in case of need. (Paragraph 141)

6. The Bank should continue to explore the options of funding the provision of foreign currency ELA through swaps undertaken in the market, or by using the Bank's or Government's foreign exchange reserves, in order to ensure that it is adequately prepared to extend foreign currency ELA if swap lines with other central banks were for some reason not available for that purpose. (Paragraph 142)

7. Notwithstanding the Bank's improved ability to identify impending financial stresses, some shocks, such as the impact of rogue traders, or events like 9/11, are, by their nature, inherently unforeseeable. The Bank needs to maintain its capacity to manage the consequences of unforeseen, as well as foreseeable, events. (Paragraph 144)

8. The Bank should consider what expertise—for example in risk management and collateral valuation—it needs to have in-house for crisis scenarios if it is unlikely to be able to call on external expertise, either because an operation needs to be implemented at short notice or because the Bank has concerns about secrecy. (Paragraph 146)

9. In some instances the Bank's normal external legal advisers may not be able to be used because they are already representing the counterparty to which ELA is being extended. The

Bank is aware of this possibility and should continue to make contingency plans for engaging alternative legal advisers if needed. (Paragraph 147)

Chapter 4: The decision to extend ELA

10. It will be important to ensure that the more structured framework which is now in place for assessing whether the criteria are met for extending ELA can be made to work effectively in practice, so that the Bank, including in future the Prudential Regulation Authority, can marshal information internally in an efficient manner and, in conjunction with HMT, reach and implement decisions on whether or not to extend ELA without delay. (Paragraph 180)

Chapter 5: Terms of the ELA

11. The Bank may need to give more detailed consideration to how it would accept, value and determine appropriate haircuts for collateral outside that eligible in operations within its published framework. As a consequence, the Bank will need to ensure that its risk management function continues to develop in response to the evolving balance sheets of banks. (Paragraph 207)

12. The task of managing and realising collateral, particularly portfolios of unsecuritised loans, in the event that an ELA recipient defaulted would be a formidable administrative challenge. The Bank needs to have a fully developed plan to manage this process. (Paragraph 208)

13. In any future ELA, the Bank as both lender and the supervisory authority will need to be closely involved in monitoring the progress of the ELA recipient in returning to a more liquid position and in repaying the outstanding ELA. The Bank should consider what monitoring might be necessary in future and how legal agreements should be structured to ensure that the banks in receipt of ELA are obliged to facilitate that monitoring. (Paragraph 217)

14. Since ELA operations require authorisation by the Chancellor, it would in principle be logical for the Bank to seek an indemnity from HMT for the full amount of ELA from the outset of any operation. (Paragraph 221)

Chapter 6: Governance and decision-making

15. In view of the scale of risk to which the Bank's balance sheet may be exposed by any ELA lending, a more structured process of reporting on the progress of ELA operations by the Executive to the relevant committee of Bank's Court of Directors might assist that committee in discharging its oversight responsibilities—for example, a daily teleconference and weekly monitoring reports, covering in particular the risk management policies being put in place by the Bank to manage the increased exposure. (Paragraph 228)

16. It is recommended that the Bank's formal statement, approved by Court, setting out how Court operates, *Governance of the Bank Including Matters Reserved to Court,* be reviewed to specify more clearly and precisely Court's role as regards the Bank's balance sheet and its financial risk exposure. (Paragraph 229)

17. It is appropriate, given the need for meetings to be called at short notice in a crisis and the need to maintain secrecy, for the requirement to consult Court about ELA to be fulfilled by a smaller group of Non-Executives. Any sub-committee constituted for this purpose should, however, have substantial representation of non-conflicted Non-Executive Directors. (Paragraph 232)

18. In order to minimise the scope for confusion, it might be logical to manage any future ELA from the Markets Directorate, particularly if any future ELA is likely to be similar in mechanism to the Discount Window Facility, which is managed within that Directorate. Equally, other management structures would be possible and it is recommended that the Bank reviews whether the present dispersion of responsibilities remains appropriate in light of the significant extension in recent years of its framework for liquidity insurance. (Paragraph 239)

19. Separation at the Divisional level of the responsibility for initiation, risk management and settlement of any ELA between front, middle and back office is an appropriate step to strengthen risk management safeguards. (Paragraph 240)

20. The current reporting lines of the Markets and Banking Services Directorates to their respective Deputy Governors may leave scope for uncertainty. A more structured approach of each Directorate reporting to the relevant Deputy Governor for the latter's area of responsibility could be considered. The structure of responsibilities might appropriately be addressed when the third Deputy Governor, responsible for the Prudential Regulation Authority, joins the Bank. (Paragraph 241)

21. Consideration will need to be given to what role the new Financial Policy Committee, which will have a statutory responsibility for monitoring systemic risk and initiating policy actions in that area, would appropriately play in establishing the framework within which ELA decisions would be made. (Paragraph 247)

Chapter 7: Disclosure

22. The Bank still publishes the weekly Bank Return, despite no longer being required to, following the enactment of the Banking Act 2009. It should consider ceasing to do so at an appropriate time, in order to improve its ability to provide covert liquidity assistance in future. (Paragraph 263)

23. It is important that remaining uncertainties in some areas of the legal and regulatory framework for disclosure are resolved so that to the extent possible the standard requirements for disclosure do not, in a crisis, counterproductively compromise the wider public interest in financial stability. (Paragraph 264)

24. It would be helpful, in terms of enabling ELA to be undertaken covertly, if there were fuller implementation of the regulatory rule requiring banks periodically to realise a proportion of their liquid assets through repo or outright sale in the market, such that banks undertook

this periodic realisation on sufficient scale to provide a degree of cover for any ELA support extended by the Bank. (Paragraph 266)

25. It would be appropriate for a process of quarterly review on the timing of disclosure to be followed within the Bank in relation to any ELA that is not indemnified by HMT. (Paragraph 271)

Chapter 9: Future ELA and the Bank's lender of last resort function

26. It will be important for the Bank to have the capacity, if necessary, to extend ELA to non-banks if strains on one or more were to precipitate a threat to systemic stability. (Paragraph 285)

27. Given the fundamental changes in the nature of the Bank's lender of last resort function since 2008, it may be appropriate at some stage for the Bank to set out the principles under which it would contemplate activating this function in its widest sense, particularly in light of the greatly enhanced regulatory and statutory frameworks within which the financial system now operates. (Paragraph 290)

28. Some increase in the size of the Bank's capital may be appropriate, to enable the Bank to play an effective role in a financial crisis, where this can be done without public funds being put at risk, as envisaged in the draft Memorandum of Understanding on Crisis Management. (Paragraph 294)

Appendix 1: Terms of reference for the Review

Provision of Emergency Liquidity Assistance in 2008/9

On 21 May 2012, the Court of the Bank of England asked Ian Plenderleith to review the Bank's actions at the height of the financial crisis, around the collapse of Lehman Brothers, to provide Emergency Liquidity Assistance (ELA) to Royal Bank of Scotland and HBOS.

The purpose of this review is to learn lessons to inform the way the Bank conducts ELA operations for individual financial institutions. Such support operations will, in due course, be conducted under the new Crisis Management Memorandum of Understanding which was published in January 2012. The review will build on the lessons learned in relation to the ELA provided to Northern Rock in 2007, as set out in the Treasury Committee's report *The run on the Rock*.

Specifically, the review will examine:

- The basis of the decisions to provide Emergency Liquidity Assistance (ELA) to each firm concerned.
- The governance arrangements within the Bank for making those decisions.
- The structure and terms of each ELA operation.
- The effects of those operations on the institutions concerned and on overall financial stability.
- The capability of the Bank to plan, implement and manage those operations.

Overall, the review will examine how the Bank discharged its responsibilities as lender of last resort in a crisis and make recommendations for the conduct of any such operations in the future.

Appendix 2: The course of the financial crisis

1. The emergency liquidity assistance (ELA) extended by the Bank of England (the Bank) to HBOS and RBS occurred against the backdrop of the global financial crisis. Because the action the Bank took in providing ELA to HBOS and RBS needs to be seen in the context of the continuing crisis running back to the summer of 2007, what follows gives a summary of the principal events leading up to the ELA.

2. From the summer of 2007, the financial crisis can be regarded as evolving in three phases. The first phase ran from mid-2007 through to the provision of Bank liquidity to, and the run on, Northern Rock in September 2007. The second phase ran from then until the failure of Lehman Brothers in September 2008. That collapse precipitated the third, and most damaging, phase of the crisis.

3. The first phase of the crisis emerged from mid-2007, with evidence of some financial institutions incurring losses on exposures related to US sub-prime mortgages. In June, Bear Stearns pledged collateralised loans to one of its hedge funds, but elected not to support another. On 9 August, BNP Paribas announced that it was suspending calculation of asset values of three money market funds exposed to sub-prime mortgages, and halting redemptions. At this point, liquidity in short-term money markets became seriously constrained, precipitating more widespread market stress.

4. Central banks responded to these market conditions in a variety of ways. On 9 August, in response to the problems in money markets, the European Central Bank (ECB) injected €95 billion overnight to assist liquidity. On 17 August, the Federal Reserve approved a temporary 50 basis points reduction to its discount window borrowing rate and began to provide term financing up to 30 days, renewable by the borrower. On 13 September, the Bank announced it would widen the range on banks' reserves targets within which they would be remunerated at Bank Rate, in order to remove any impediment to banks electing to hold higher reserve balances at the Bank.

5. In the UK, the first significant casualty of the crisis was Northern Rock. The Bank announced on 14 September that it had agreed to provide emergency liquidity support to Northern Rock. Reports of this agreement to provide support had, however, leaked the previous evening and precipitated a loss of public confidence in the bank.

6. The run on Northern Rock marked the beginning of the second phase of the crisis, in which the Bank initiated further steps to ease the continuing strains in the markets. On 26 September 2007 the Bank announced a series of four special auctions to lend cash for three months against a wider range of collateral than normally accepted in Bank operations. There was no participation in these auctions, possibly because the minimum price was seen as being too high. On 18 December, the Bank introduced Extended Collateral Long-Term Repo operations (ELTRs), in which counterparties could bid for reserves for a three-month term, against either standard narrow collateral or a broader set of collateral. The size of these operations peaked at £180 billion in January 2009.

7. In February 2008—largely in response to the failure of Northern Rock—Parliament passed temporary emergency legislation, the Banking (Special Provisions) Act 2008, which gave HMT powers to facilitate the orderly resolution of a failing bank in order to maintain financial stability or protect the public interest.

8. The second phase of the crisis intensified with the purchase of Bear Stearns by JPMorgan Chase & Co on 16 March 2008. The Fed provided US$30 billion of funding to support this transaction. On 19 March, an unfounded rumour that HBOS was receiving support from the Bank resulted in its share price falling over 17% during the course of one day before recovering to close 7% lower on the day. The Bank responded to the intensified market pressure, and in particular the continued poor conditions in asset-backed securities markets, with the launch of the Special Liquidity Scheme (SLS) on 21 April 2008, which allowed banks to swap a wider range of collateral than was eligible for the Bank's ELTR operations, including high-quality mortgage-backed and other securities, for UK T-bills; liquidity provided under the SLS was available for a term of up to three years.

9. In light of pressure on its capital, particularly following its acquisition of ABN Amro and mark-to-market losses on structured products, RBS announced a £12 billion rights issue on 22 April and confirmed on 9 June that 95% of the issue had been accepted. HBOS announced a £4 billion rights issue on 29 April, but only 8% of the HBOS rights issue was taken up by private investors in July, with the remainder being left with the underwriters. Bradford & Bingley was also seeking to raise funds during this period, but with difficulty: it announced a £400 million rights issue in May, which however had to be repriced and restructured in June after a profits warning, and was then restructured again shortly afterwards when one of the underwriters withdrew its support following a ratings downgrade. In the event, only 28% of the issue was taken up, with the remainder being left with the underwriters.

10. On 13 July 2008, the US Treasury announced a rescue plan for Fannie Mae and Freddie Mac; both were taken into conservatorship on 7 September. On 14 July in the UK, it was announced that Santander UK would purchase Alliance & Leicester.

11. The third, and most damaging, phase of the crisis began on 15 September 2008, with the failure of Lehman Brothers. From this point onwards, the severity of the crisis intensified significantly.

12. The same day, Bank of America announced its purchase of Merrill Lynch. On 16 September, the US Government provided a US$85 billion emergency loan to AIG in exchange for an 80% stake in the company. On 17 September, the Bank announced that it was extending the drawdown window for the SLS, so that instead of closing on 21 October 2008 as had originally been announced, it would now close on 30 January 2009. On 18 September, Lloyds TSB and HBOS announced plans to merge. The same day, a number of central banks announced measures to address continued elevated pressures in the US dollar short-term funding market by putting in place reciprocal swap agreements with the Fed through which US dollars could be provided to the market.

13. On 25 September, JPMorgan bought part of Washington Mutual. On 29 September, the UK Government used statutory powers under the Banking (Special Provisions) Act 2008 to nationalise Bradford & Bingley and transfer its deposits and branches to Santander UK. In Europe, the Belgian, Dutch and Luxembourg Governments announced that they would invest €11.2 billion in Fortis and on 30 September the Belgian, French and Luxembourg Governments announced that they would be injecting additional capital into Dexia.

14. On 1 and 7 October, the Bank began to extend ELA to HBOS and RBS respectively. On 7 October 2008, the Icelandic Government took control of Glitnir and Landsbanki (of which the UK retail brand Icesave was a branch); and on 8 October 2008 the retail deposit businesses of two subsidiaries of other Icelandic banks were transferred to ING Direct and the remainder of the businesses were put into administration, again using powers under the Banking (Special Provisions) Act 2008.

15. On 8 October 2008, in response to these increasing pressures, a package of support measures for the UK financial system was announced by the UK authorities. It included the provision of capital to UK banks, a Government guarantee for new short/medium-term senior unsecured debt issuance—the Credit Guarantee Scheme (CGS)—and the extension and widening of a number of Bank operations, including the SLS, to accept Government-guaranteed debt issued under the CGS. A coordinated interest rate cut of 50 basis points by a number of central banks, including by the ECB, the Federal Reserve and the Bank was also announced on 8 October.

16. As a consequence of the recapitalisation scheme announced on 8 October, on 13 October HMT acquired £8.5 billion of ordinary shares and £3 billion of preference shares in HBOS and £4.5 billion of ordinary shares and £1 billion of preference shares in Lloyds TSB. After the merger of HBOS and Lloyds TSB on 19 January 2009 HMT held 43% of the share capital and £4 billion preference shares of the merged entity, Lloyds Banking Group, which were subsequently converted into new ordinary shares in March 2009. An issuance of new ordinary shares in June 2009 reduced HMT’s holding of the ordinary share capital of Lloyds Banking Group to 41%. In December 2008, HMT acquired £15 billion of ordinary shares plus £5 billion of preference shares in RBS. In January 2009, these preference shares were converted into new ordinary shares. In December 2009, the Government injected £25.5 billion of capital in the form of B shares. As a result of these measures the Government’s economic ownership of RBS now stands at around 82%.

17. The package of measures announced by the Government in October 2008, and the continued operation of a range of Bank facilities, alleviated the most immediate pressures on the UK financial system.

18. The Government announced a further stabilisation measure, the Asset Protection Scheme (APS), in January 2009. The APS was designed to insure the assets of participating banks against future losses, with the first portion of loss being borne by the bank up to a certain limit, after which the Government would take a significant proportion (90%) of any further losses. RBS and Lloyds Banking Group agreed in principle to participate in the scheme in February and March 2009 respectively. In the event, only RBS participated, and their

agreement with the Government was finalised in November 2009 and announced by the Chancellor on 3 November 2009.

19. The Banking Act 2009 was passed on 21 February 2009, replacing the Banking (Special Provisions) Act 2008 and putting in place the Special Resolution Regime for resolving failing banks in an orderly fashion.

20. On 18 November 2009, the European Commission approved the restructuring plan of Lloyds Banking Group, which had been required following the Government recapitalisation. RBS's participation in the APS and their restructuring plan were approved by the Commission on 14 December 2009.

21. On 24 November 2009, the Bank of England disclosed that it had extended ELA to HBOS and RBS in a statement to the House of Commons Treasury Committee.

Appendix 3: Changes to the statutory and regulatory framework and the Bank's framework for liquidity insurance

1. Since ELA was extended to HBOS and RBS in October 2008, there have been a number of changes to the statutory and regulatory framework and to the Bank's operational framework for liquidity provision. Further legislative changes are expected as a result of the Financial Services Bill currently before Parliament and the White Paper on Banking Reform published in June 2012. These changes are summarised in this Appendix. Ways in which they may affect the Bank's operation of ELA are examined at relevant points in the main Review.

Changes to the statutory framework since 2008

2. Even before the financial crisis, it was recognised that normal insolvency procedures were not well suited to banks. The crisis, and in particular the run on Northern Rock, underlined the problems presented by the lack of an appropriate framework for resolving banks facing failure. As a result, Parliament passed temporary emergency legislation in February 2008, the Banking (Special Provisions) Act 2008, which gave HMT powers to facilitate the orderly resolution of a failing bank in order to maintain financial stability or protect the public interest.

3. The powers under this Act were used: to take Northern Rock into temporary public ownership on 22 February 2008; to transfer the deposits and branch network of Bradford & Bingley to Santander UK and nationalise the remaining assets and liabilities on 29 September 2008; and to transfer parts of Heritable Bank and Kaupthing, Singer & Friedlander to ING Direct and place the remainder of those businesses into administration on 7 and 8 October 2008 respectively.

4. The Banking Act 2009, which came into force on 21 February 2009, superseded the Banking (Special Provisions) Act 2008, the provisions of which were temporary and lapsed on 20 February 2009. The Banking Act 2009 made a number of statutory changes, including giving the Bank a statutory objective to "contribute to protecting and enhancing the stability of the financial systems of the United Kingdom".[49]

5. One of the main purposes of the Banking Act 2009 was to establish the Special Resolution Regime (SRR) to give the UK a permanent framework for resolving distressed banks. The SRR includes three stabilisation tools: transfer of all or some of an institution to a private sector purchaser; transfer of all or part of the business of an institution to a bridge bank (both exercisable by the Bank, as resolution authority); and placing an institution into temporary public ownership (exercisable by HMT). The SRR also provides the authorities with the ability to apply to place an institution into the bank insolvency procedure to facilitate the rapid pay-out of depositors covered by the Financial Services Compensation Scheme. The statutory objectives of the SRR (which have to be balanced as appropriate in each case) are, in

[49] Banking Act 2009 (c.1), Section 238, (1), 2A (1), UK financial stability, p.122

summary, to protect UK financial stability, to protect the banking systems of the UK, to protect depositors, to protect public funds and to avoid interference with property rights.

6. SRR powers have been used twice since February 2009, once in March 2009 to resolve the Dunfermline Building Society and once in June 2011 to resolve the Southsea Mortgage and Investment Company.

Changes to the regulatory framework since 2008

7. Alongside changes to the statutory framework, there have been significant changes to both the international and national regulatory frameworks. New international regulations proposed under Basel III will require banks to hold significantly higher levels of capital. A global minimum liquidity standard will also be established. In advance of these changes, the FSA has considerably adjusted its regulatory stance by increasing the intensity of its supervision and by setting higher capital and liquidity requirements for UK banks.

8. Also in response to the crisis, the rules surrounding deposit insurance provided by the Financial Services Compensation Scheme were changed by the FSA so that 100% of amounts up to a specified limit were insured. Since 31 December 2008, amounts up to £85,000 are fully insured in the event that a bank fails.

Changes to the Bank's framework for liquidity insurance

9. Statutory and regulatory changes as a result of the crisis have been accompanied by significant changes to the Bank's framework for liquidity insurance. The main features relevant to the Bank's ELA operations are summarised here.

10. Some of these changes were temporary responses to the crisis, including Term Auctions, Extended Collateral Long-Term Repo (ELTR) operations, the Special Liquidity Scheme (SLS), and the original US Dollar Repo Operations. Others are now permanent facilities, such as the Operational Standing Facilities (OSFs), the Discount Window Facility (DWF) and the Indexed Long-Term Repo (ILTR) operations. After a short suspension in 2010, US Dollar Repo Operations have been reintroduced. More recently the Bank has activated Extended Collateral Term Repo (ECTR) operations.

11. Operations introduced in response to the crisis, but no longer occurring include:

- *Term Auctions* – On 26 September 2007, the Bank held the first of four special auctions to lend cash against a much wider range of collateral than usually taken (prior to this point the Bank had accepted only the highest quality collateral in its liquidity operations). There was, however, no take up by the market in any of the auctions;

- *ELTRs* – On 18 December 2007, the Bank held the first three-month Extended Collateral Long-Term Repo (ELTR) operation, where counterparties could bid for reserves against either collateral routinely eligible in the Bank's Open Market Operations (OMOs) or against a broader set of collateral. Over the course of autumn 2008, as liquidity in the markets for certain asset classes worsened, the Bank increased the range of wider collateral eligible in these operations to include commercial mortgage-backed securities and corporate debt (in October) and residential mortgage-backed securities and covered bonds (in December). From 8 October bank debt guaranteed under the Government's Credit Guarantee Scheme (CGS) was also eligible in this and a number of other Bank operations. The size of the ELTR operations peaked at £180 billion in January 2009. The ELTR facility was replaced by the permanent Indexed Long-Term Repo (ILTR) facility in June 2010 (see below);

- *SLS* – On 21 April 2008, the Bank announced the launch of the Special Liquidity Scheme to allow banks temporarily to swap their high quality, but currently illiquid, mortgage-backed and other securities for UK Treasury bills (T-bills). The facility was available for a wide range of assets on the balance sheets of banks at end-December 2007 and provided liquidity against these illiquid assets on a term basis (up to three years). Peak usage of the scheme was £185 billion at the point that the drawdown window closed in January 2009;

- *US Dollar Repo Operations* – On 18 September 2008, in response to elevated levels of stress in the US dollar funding market, the Bank, along with a number of other central banks, introduced US Dollar Repo Operations to lend dollars direct to UK banks. The last US Dollar Repo Operation was conducted on 27 January 2010. Although intended to be a temporary facility, it was reintroduced later in 2010 (see below).

12. Since the beginning of the crisis, the Bank has expanded the range of regularly available liquidity insurance facilities within its published framework to include:

- *OSFs* – The Operational Standing Facilities (which largely replicate the form and function of the previous Standing Facilities) allow banks to deposit reserves with or borrow reserves directly from the Bank on a bilateral basis throughout each business day. They serve two purposes: the first relates to monetary policy implementation and is to provide an arbitrage mechanism to prevent money market rates moving far away from Bank Rate; the second relates to liquidity insurance, in that the OSFs provide a means to allow banks to manage unexpected (frictional) payment shocks which may arise due to technical problems in banks' own systems or in the market-wide payments and settlements infrastructure;

- *DWF* – The Bank also introduced the Discount Window Facility (DWF), which enables banks to borrow UK Government securities against a wide range of collateral. The aim of the DWF is to provide liquidity insurance to individual banks in the event of stress. From April 2011, collateral eligible in the DWF has included portfolios of unsecuritised loans;

- *ILTR* – The ELTR facility (see above) was replaced by the permanent Indexed Long-Term Repo (ILTR) facility in June 2010. This facility is designed to enable funds to be lent against different types of collateral depending on the degree of stress in the system;

- *ECTR* – In December 2011, the Bank announced the introduction of the Extended Collateral Term Repo (ECTR) Facility, a contingency liquidity facility that the Bank can activate in response to actual or prospective market-wide stress of an exceptional nature. The ECTR facility enables the Bank to undertake operations, normally for a term of 30 days, against a much wider range of collateral than is eligible in the ILTRs. The ECTR was activated for the first time in June 2012;

- *Foreign-currency repo facilities* – Although the last operation under the original US Dollar Repo Operations was undertaken in January 2010, the facility was reactivated in May 2010, in response to the re-emergence of strains in US dollar short-term funding market in Europe. In November 2011, the Bank also set up swap lines with the Bank of Canada, the European Central Bank, the Bank of Japan, and the Swiss National Bank in order that Canadian dollar, euro, Japanese yen and Swiss franc repo facilities can be provided to banks if necessary. These swap lines, on which the foreign currency repo facilities are reliant, are due to be renewed on 1 February 2013.

13. The key feature of many of these changes to the liquidity insurance framework is that they have allowed the Bank to provide liquidity against a much wider range of collateral than was the case before the crisis. From October 2009, the Bank also widened the population of banks eligible to apply for access to its facilities to assist smaller banks in managing their liquidity. This has substantially increased the number of banks able to use the facilities outlined above.

Future changes to the statutory framework

14. The Financial Services Bill currently in Parliament will fundamentally change the UK regulatory structure once it enters into force early next year. The Bill proposes three main institutional changes. First, it will establish the Financial Policy Committee (FPC) which will have responsibility for macroprudential regulation. Second, it will establish the Prudential Regulation Authority (PRA) as a subsidiary of the Bank. The PRA will have responsibility for microprudential regulation. Third, it will establish the Financial Conduct Authority (FCA). The FCA will be responsible for conduct of business issues and the prudential supervision of all firms not covered by the PRA. The PRA and FCA will replace the current Financial Services Authority.

15. The proposed legislation will have particular implications for any ELA operations undertaken by the Bank in future. Such operations are currently governed by the Tripartite Memorandum of Understanding (MoU) between HMT, the Bank of England and the Financial Services Authority established in 1998 and revised in 2006. The Tripartite MoU is examined in Chapter 6. Under the proposed legislation, ELA operations will be governed by a new (currently draft) MoU on Crisis Management.

16. The draft Crisis Management MoU proposes that the Bank should have primary operational responsibility for crisis management, including through "the provision, when authorised by the Treasury, of Emergency Liquidity Assistance (ELA – defined as support operations outside the Bank's published frameworks) to firms that are at risk but are judged to be solvent." The Chancellor and the Treasury have sole responsibility for any decision on whether and how to use public funds, including "authorising any proposal by the Bank to provide ELA to one or

more individual firms in a support operation that goes beyond the Bank's published frameworks." In addition, under certain circumstances HMT may direct the Bank to undertake particular actions. The power of direction allows the Chancellor to direct the Bank to: "provide ELA in a support operation going beyond the Bank's published frameworks to one or more firms that are not judged by the Bank to be solvent and viable," or to, "provide ELA in a support operation going beyond the Bank's published frameworks to one or more firms on terms other than those proposed by the Bank."[50]

17. Further changes to the banking system are also proposed in the White Paper on Banking Reform published in June 2012, which aims to implement the proposals of the Independent Commission on Banking to ring-fence essential retail banking services, increase the loss-absorbency of banks and increase competition in the banking sector. These changes are likely to have implications for which banks or parts of banks are eligible for access to facilities within the Bank's published framework, and also for the range of institutions to which the Bank might contemplate providing ELA outside that framework.

18. In August 2012, HMT also published a consultation paper entitled *Financial sector resolution: broadening the regime*, which put forward proposals to extend the resolution regime to non-banks to ensure that non-bank financial firms are able to be resolved without threatening financial stability, or requiring recourse to taxpayer support.[51]

[50] HM Treasury, *A new approach to financial regulation: securing stability, protecting consumers*, Cm 8268, January 2012, Annex E - Memorandum of Understanding on financial crisis management
[51] HM Treasury, *Financial sector resolution: broadening the regime*, Cm 8419, August 2012

Appendix 4: Lessons from *The run on the Rock*

1. The terms of reference for this Review provide for it to "build on the lessons learned in relation to the ELA provided to Northern Rock in 2007, as set out in the Treasury Committee's report, *The run on the Rock*."

2. This Appendix sets out the conclusions and recommendations from the Treasury Committee's report that are most relevant to the Bank's provision of ELA, summarises how the Bank has addressed those recommendations, and indicates where they are examined in this Review.

Horizon scanning

3. *The run on the Rock* highlights the importance of the authorities being able to identify failing banks in advance of their need to seek ELA support.

> *Conclusion/recommendation 32*
>
> We do not view a bank's recourse to the Bank of England in its capacity as lender of last resort as an ideal trigger for prompt corrective action. This option is a last resort, and the relevant authorities must be able to identify a bank as failing prior to this stage. (Paragraph 194)

4. Since 2008, there has been a significant enhancement in the authorities' ability to scan the horizon for impending financial stresses and, within the Bank, a material strengthening of its apparatus for monitoring and assessing risks to financial stability. The Review examines these steps in detail in Chapter 2. It concludes that they should make the Bank not only better able than in 2008 to identify impending financial stresses, but also able to do so further in advance of the risks crystallising, particularly if the risks emerge through stresses on an individual bank. The Review notes, however, that the Bank will also need to be able to identify impending systemic shocks emanating from, or impacting on, non-bank financial institutions.

Planning for ELA

5. A further concern highlighted by *The run on the Rock* report is that there was delay in finalising the support operation for Northern Rock.

> *Conclusion/recommendation 23*
>
> In view of the role that fears of a leak of a support operation had played in the decision on Tuesday 11 September that a covert operation was not possible, the Tripartite authorities were unwise initially to accede to Northern Rock's request for the announcement of the support operation to be delayed until Monday 17 September. In the light of subsequent events, it seems evident that the Tripartite authorities and Northern Rock ought to have strained every sinew to finalise the support operation and announce it within hours rather than days of the decision to proceed with the operation. A swift announcement would have

been assisted by early preparation of such an announcement. In that context, we find it surprising that high level discussions between the Bank of England and Northern Rock about the support facility did not take place prior to 10 September. (Paragraph 145)

6. In 2008, in part as a result of the experience it had gained with providing ELA for Northern Rock in 2008, the Bank was able to respond rapidly and effectively when the need to extend ELA to HBOS and RBS arose. Nevertheless, some features of the operation had to be put together at the last minute, which heightened the Bank's operational risk. Since 2008, a number of further changes have occurred which have improved the Bank's ability to plan for, and conduct, ELA operations.

7. These steps are examined in detail in Chapter 3 of the Review. The Review concludes that, against any possible future need to provide ELA to *banks*, the Bank is as fully prepared as could reasonably be expected. But the Review suggests that the Bank may need the capacity to extend ELA to systemically important non-banks.

Communications plans for disclosure of ELA

8. *The run on the Rock* examines the management of disclosure of the ELA operation in support of Northern Rock, and in particular points up the need for planning by the authorities to handle press and public interest in the event of premature disclosure.

Conclusion/recommendation 24

In failing either to make an announcement earlier in the week or to put in place adequate plans for handling press and public interest in the support operation, the Tripartite authorities and the Board of Northern Rock ended up with the worst of both worlds. (Paragraph 148)

Conclusion/recommendation 25

We accept that the consequences of an announcement of the Bank of England's support operation for Northern Rock were unpredictable. There was a reasonable prospect that the announcement would have reassured depositors rather than having the opposite effect, particularly prior to the premature disclosure of the operation. However, after the premature disclosure of the support, and against the background of the market reaction to Barclays use of lending a fortnight earlier, it seems surprising that the issues were not urgently revisited. It is unacceptable, that the terms of the guarantee to depositors had not been agreed in advance in order to allow a timely announcement in the event of an adverse reaction to the Bank of England support facility. (Paragraph 165)

Conclusion/recommendation 26

The Tripartite authorities were conscious during the planning of the support operation that announcement of that operation might have an adverse effect. In light of this, we regard it as a serious error of judgement that the Tripartite authorities at deputies level failed to plan in advance for the announcement of a Government guarantee and failed to raise some of the issues surrounding such a guarantee with the principals prior to Sunday 16 September. We are also concerned that it did not prove possible to announce the guarantee that was decided upon that day before the markets opened the following day. The cumulative effect of these failures was to delay the guarantee until the evening of the fourth day after the run started and thus to make the run on the deposits of Northern Rock more prolonged, and more damaging to the health of the company, than might otherwise have been the case. (Paragraph 166)

Conclusion/recommendation 56

There was no sign of a communications strategy of the Tripartite authorities during the crisis of September 2007. We believe that this was a contributory cause of the run on the bank. The Tripartite authorities must learn the lessons of the failure or absence of a communications strategy between 10 and 17 September. We recommend that the Tripartite authorities revise their communications arrangements for future crises, to ensure a single, coherent and coordinated message, which was absent in the crisis in September 2007. This message needs to take into account the public's likely reaction, and be in language people can readily understand. (Paragraph 289)

9. In light of the ELA operations in 2007 and 2008, the Bank has undertaken considerable work to improve the level of detailed planning for any future ELA. An ELA governance and control framework has been put in place, which includes a contingent communications plan in case of premature disclosure. This provides communications plans for both managed and unmanaged disclosures of ELA.

10. The Review examines this framework, including the communications plan, in Chapter 3 and concludes that it provides a sensible and coherent approach to managing a crisis.

Systemic risk

11. *The run on the Rock* report endorses the authorities' view in 2007 that Northern Rock posed a systemic risk.

Conclusion/recommendation 19

The Chancellor of the Exchequer's decision in the first half of September to make a support facility available to Northern Rock should the need arise was the right one. Had he chosen not to do so, there would have been a significant risk of substantial disadvantage to Northern Rock depositors and a very real prospect of "contagion", whereby the public would lose confidence in the security of holdings across the United Kingdom banking system. In view of the weaknesses of the legal framework for handling failing banks at that time, the Tripartite authorities were right to view Northern Rock as posing a systemic risk. Had any other decision been taken, it is quite possible that the events that unfolded from mid-September onwards could have been more damaging to consumers and to the United Kingdom financial system than those that have actually taken place. (Paragraph 122)

12. A similar judgement needed to be made in October 2008 as to whether the liquidity strains being experienced by HBOS and RBS posed a systemic risk. The Review examines this judgement, and the process for reaching it, in detail in Chapter 4. It concludes that there can be little doubt that in 2008 the failure of either HBOS or RBS would have had severe and damaging consequences.

Covert ELA

13. A number of conclusions and recommendations in *The run on the Rock* relate to the decision of the Tripartite authorities that the ELA support for Northern Rock could not be kept covert.

> *Conclusion/recommendation 20*
>
> On the basis of the texts cited in the preceding paragraphs, we accept that the provisions of the Market Abuse Directive and the implementing Directive relevant to market disclosure in the case of Northern Rock in September 2007 were properly transposed into United Kingdom law. It is evident from the texts of both the Directive and of the FSA Handbook that any decision to delay disclosure, even in the case of an issuer that is in grave and imminent danger, is subject to provisos relating to the need for the issuer to be satisfied that such a delay would not be likely to mislead the markets and that the issuer is able to ensure the confidentiality of that information. The Governor of the Bank of England received legal advice through the FSA from lawyers working for the Tripartite authorities indicating that the Market Abuse Directive was a barrier to a covert operation, even if information could be kept confidential, and, as such, the Governor was justified in regarding the legal interpretation of the Market Abuse Directive shared by the Financial Services Authority and Northern Rock's legal advisers as a material factor in consideration of a covert operation, although it was not necessarily the leading factor in the final decision that a covert operation was not possible. (Paragraph 137)
>
> *Conclusion/recommendation 21*
>
> In the circumstances of Northern Rock in early September 2007, the barriers to a covert support operation were real. Any large scale support operation for Northern Rock would have become known to many market participants. In the febrile and fevered atmosphere of that period, media speculation would have followed. The leaking of news of a support operation that was intended to remain covert for a period of time would have been potentially as damaging as the premature disclosure of an overt operation. The practical risks of a leak are linked to the legal difficulties, insofar as covert support operations only appear to be permitted under the Market Abuse Directive in instances when the issuer can be assured of confidentiality. We consider later in this Report whether there are circumstances when a covert support operation should be considered in future, and what legal and other changes might be necessary to facilitate such an operation. (Paragraph 141)

Conclusion/recommendation 22

However we also find it unacceptable that the possibilities for covert action had not been properly considered much earlier. Had this issue been clarified, the authorities could have reacted with more despatch which in itself might make covert action a more realistic option. We return to the state of readiness of the authorities and "war gaming" later in this Report. (Paragraph 142)

Conclusion/recommendation 38

We recommend that the Government seek to work with the European Commission, European Central Bank and national central banks within the European Union to establish whether the Market Abuse Directive ought be amended, so as to ensure that covert support operations by a central bank are permitted in specified circumstances. (Paragraph 215)

Conclusion/recommendation 39

We further recommend that the Government review the interaction between the terms of the Market Abuse Directive and other aspects of the regulatory regime including the FSA guidelines, to ensure that they do not unnecessarily restrict areas of the discretion otherwise allowed under the Directive. (Paragraph 216)

14. *The run on the Rock* describes the obstacles to keeping the ELA extended to Northern Rock in September 2007 covert. Circumstances were very different a year later when ELA was extended to HBOS and RBS in October 2008. The ELA support to those two banks took place against the background of extended market disturbance during the course of 2008, acutely intensified by the failure of Lehman Brothers in September 2008; and both banks had since April 2008 been utilising the Special Liquidity Scheme, which was very similar in structure to the liquidity provided in the form of ELA. There was thus, in October 2008, unlike a year earlier, a backdrop of widespread dysfunction in markets and active use of market-wide Bank liquidity facilities that made it possible to keep ELA provided to the two banks covert. Moreover, from the experience of the Northern Rock episode, the authorities had a more informed understanding of the regulatory and practical constraints on covert operations.

15. The Review examines these issues, and in particular how the Bank was able in 2008 to address the practical constraints on secrecy, in Chapter 7. It concludes that it was right to endeavour to keep the ELA operations in 2008 covert. The Review also examines the further steps the Bank and other authorities have taken since 2008, including in relation to the Market Abuse Directive, to assist in keeping any future ELA operations covert, if necessary. The Review notes that, in circumstances different from those prevailing in 2008, it may well not be possible to maintain that level of secrecy.

Moral hazard

16. *The run on the Rock* report highlights the difficulty of giving appropriate focus to moral hazard concerns in the circumstances of the Northern Rock crisis.

Conclusion/recommendation 10

The Bank of England, the European Central Bank and the Federal Reserve each pursued a different course of action in response to the money market turmoil in August 2007. Only the Bank of England took no contingency measures at all during August, in order to protect against moral hazard, that is, the fear that an injection of liquidity would offer incentives for banks to take on more liquidity risk, secure in the knowledge that the Bank of England would step in to resolve future liquidity crises. The European Central Bank appeared to attach far less weight to the moral hazard argument than the Bank of England. Instead, it adopted a proactive approach in resolving what it saw as a practical problem of a faltering market resulting from banks losing confidence in each other. Although the European Central Bank injected no net additional liquidity in August, it did alter the timing and term profile of its regular operations, front-loading its credit supply towards the start of August, and draining this liquidity before the end of the maintenance period. In doing so, the European Central Bank appeared to satisfy the immediate liquidity demands of the Eurozone banking sector, whilst UK banks' sterling demands went unmet. We are unconvinced that the Bank of England's focus on moral hazard was appropriate for the circumstances in August. In our view, the lack of confidence in the money markets was a practical problem and the Bank of England should have adopted a more proactive response. (Paragraph 89)

Conclusion/recommendation 12

We cannot know whether an open market liquidity operation of the kind asked for by a number of banks in August would have prevented Northern Rock's need for emergency support from the Bank of England in September. It is most unlikely that any such lending operation in September, following the stigmatisation of Barclays which we deal with later, could have been of a sufficient scale to ensure that Northern Rock could have received the liquidity it then required. Such an operation would also have raised severe 'moral hazard' concerns, signalling to the banking sector as a whole that public sector support would be made available in the event of any bank facing distress. (Paragraph 95)

Conclusion/recommendation 14

The usual penalty rate was charged on the 3-month operation announced on 19 September. The penalty rate should not be viewed as a punishment for recalcitrant banks, but rather a reminder to banks to manage their liquidity risks in an appropriate manner. (Paragraph 98)

17. Notwithstanding concerns about moral hazard, the Bank had made clear at the time of the crisis in 2007, in the Governor's statement to the Treasury Committee on 12 September, that "LoLR operations remain in the armoury of all central banks" and that the rationale for lending to "an individual bank facing temporary liquidity problems, but that is otherwise regarded as solvent," would be that "the failure of such a bank would lead to serious economic damage, including to the customers of the bank."[52] The same dilemma was present when ELA for HBOS and RBS became necessary in 2008, and indeed is always and

[52] Sir Mervyn King, 'Turmoil in financial markets: what can central banks do?', Paper submitted to the Treasury Committee, 12 September 2007

inevitably a factor in judgements as to whether to act as lender of last resort in any particular situation. In 2008, the Bank was able to minimise the extent of moral hazard through the terms on which it provided ELA, notably through the fee it charged, but also through the degree of oversight to which the banks were subjected, the financial loss incurred by their shareholders and the reputational damage both banks and their senior management suffered.

18. The Review examines the relevant terms of the Bank's ELA in 2008 in Chapter 5 and issues relating to moral hazard in Chapter 8. It notes that, besides the fee charged, an important safeguard against moral hazard is the stigma attaching to a bank needing to resort to ELA.

Leadership structure

19. *The run on the Rock* identifies the need for a clear leadership structure for handling future financial crises.

Conclusion/recommendation 55

While we welcome the Chancellor's admission that he was ultimately in charge of the decision making process relating to Northern Rock, we are concerned that, to outside observers, the Tripartite authorities did not seem to have a clear leadership structure. We recommend that the creation of such an authoritative structure must be part of the reforms for handling future financial crises and this informs the recommendations we make in the next Chapter. (Paragraph 284)

20. The Financial Services Bill currently before Parliament provides for a new (currently draft) MoU on Crisis Management, which sets out the respective responsibilities of the Bank and HMT in a crisis. In particular this MoU makes clear that, appropriately, the Bank has primary operational responsibility for crisis management, while the Chancellor and HMT have sole responsibility for any decisions involving public funds. The Review examines the draft Crisis Management MoU, and its implications for the Bank's management of a financial crisis, in Chapter 9. It suggests that some increase in the Bank's capital may be appropriate.

Appendix 5: Past episodes of lender of last resort by the Bank of England

1. The Bank of England has in the past exercised its role as lender of last resort (LoLR) in a variety of ways, not always through itself providing ELA. The following summary outlines some of the different ways in which the Bank has exercised the LoLR function over the past 40 years, starting with the secondary banking crisis and concluding with the ELA extended to Northern Rock.

1973–74: the secondary banking crisis

2. The secondary banking crisis occurred when a significant fall in property prices in the UK threatened a large number of small ('secondary') lending banks with bankruptcy. The secondary banks had overlent to the property sector, on the basis of wholesale deposits. When property prices declined and the secondary banks came under pressure, the loss of confidence threatened to spread to other deposit institutions. The Bank took the lead in organising a 'lifeboat', which at its peak in March 1975 provided £1.3 billion of support from the Bank and the larger clearing banks to a total of 26 distressed institutions (eight of which were subsequently placed into receivership or liquidation). The Bank's share in the provision of finance and acceptance of risk was around 10%.

3. In the wake of the secondary banking crisis the Bank also provided support on its own account, outside the lifeboat, for three institutions, Slater Walker, Edward Bates & Sons and Wallace Brothers. In the case of the two former institutions this was done by the Bank eventually purchasing both banks and making them wholly owned subsidiaries, in order to facilitate the orderly sale or realisation of their assets. In the case of Wallace Brothers, the Bank provided support for the private sale of the bank to Standard Chartered.

4. A full account of this crisis is given in the official history of the Bank by Forrest Capie, The Bank of England: 1950s to 1979, Cambridge University Press, 2010, pp.524–586, and in 'The secondary banking crisis and the Bank of England's support operations', Bank of England Quarterly Bulletin, Vol. 18, No. 2, June 1978, p.230.

1984: Johnson Matthey

5. Johnson Matthey Bankers (JMB), was established in 1965 to undertake the banking and bullion business of Johnson Matthey & Co. JMB was an active London market-maker in gold bullion, but expanded its other banking business rapidly in the early-1980s (its balance sheet more than doubled between 1980 and 1984), particularly its commercial lending. A severe deterioration in asset quality led to financial difficulties, which began to crystallise in 1984. The Bank determined that, because of its role in the London gold bullion market, the collapse of JMB might have systemic implications. The Bank purchased JMB and its subsidiaries for £1 in September 1984 after it was established that it was insolvent and no private buyer could be found. At that time an agreement was put in place under which the Bank provided JMB with an indemnity of up to £150 million to meet losses in its commercial loan book, while a

number of banks and other members of the bullion market agreed to counter-indemnify the Bank for half of any such losses. Most of JMB's business was subsequently sold to Mase Westpac in 1986.

6. Fuller details of this episode are available in the Bank of England Annual Report 1985, 'Annex: The Bank of England and Johnson Matthey Bankers Limited', p.31.

Early-1990s: the small banks' crisis

7. The small banks' crisis was precipitated by the announcement of the closure of BCCI in July 1991, which rapidly led to the withdrawal of wholesale funds from small and medium-sized UK banks. In total, around 40 small UK banks came under liquidity pressure. From mid-1991, the Bank made arrangements to provide liquidity support to a few of these small banks. The Bank initially guaranteed lending from a consortium of banks against loss if they continued to offer credit lines to some smaller banks, and eventually took over the loan from the consortium two years later. National Mortgage Bank, which had received liquidity support, was purchased by the Bank for £1 in September 1994 in order to facilitate control over asset realisation.

8. This crisis is described more fully in a paper by Glenn Hoggarth and Farouk Soussa (Bank of England), 'Crisis management, lender of last resort and the changing nature of the banking industry,' in Financial Stability and Central Banks: A Global Perspective (Central Bank Governors' Symposium Series), Routledge, 2001.

1995: failure of Barings Bank

9. In February 1995, it was announced that Barings Bank was to enter administration as a result of losses incurred from fraudulent activity in its Singapore subsidiary. The Bank announced that it would stand ready to provide adequate liquidity to the UK banking system, if required; in the event no such liquidity provision was needed. In the period after the failure of Barings, the Bank provided payment services for the Barings' administrators and assisted them with hedging certain open positions when they were unable to do so in the market.

10. The failure of Barings and the Bank's response is also described more fully in Hoggarth and Soussa, 'Crisis management, lender of last resort and the changing nature of the banking industry' (see above).

2007: Northern Rock

11. By June 2007 Northern Rock's share of the UK mortgage market had grown rapidly to 19% from 11% the previous year. In the first half of 2007 Northern Rock was writing around 20% of all new UK mortgages. In large part this rapid growth was predicated on money market funding raised by securitising mortgages; over 75% of Northern Rock's funding was from wholesale markets. Following disruption to the securitisation market in summer 2007, Northern Rock increasingly struggled to renew its funding and was ultimately obliged to approach the Bank for emergency funding.

12. On 14 September 2007, Northern Rock began to receive emergency liquidity support from the Bank. The Tripartite authorities had determined that this lending could not be undertaken covertly and, as a consequence, planned to announce the support facility on the day it was initiated. Before this happened, however, on the evening of 13 September, the support was prematurely disclosed to the media. From the next morning a run began on the bank, with depositors queuing outside branches and large numbers of customers trying to withdraw money online. On 17 September at 5pm, the Chancellor announced that all Northern Rock deposits would be guaranteed in full (this guarantee was later extended to cover certain wholesale deposits as well). The initial statement on 17 September had the effect of dissipating the momentum of the run.

13. The emergency lending provided by the Bank to Northern Rock was initially made against high quality loan collateral. From 9 October 2007, additional lending was indemnified by HMT, and was secured by a fixed and floating charge over all the assets of Northern Rock. On 17 February 2008, after attempts to find a private sector buyer for Northern Rock had failed to provide a solution that the Government felt offered enough value to the taxpayer, Northern Rock was nationalised. The Bank's loan to Northern Rock, which peaked at £27 billion at the end of December 2007, was transferred to HMT on 28 August 2008.

14. On 1 January 2010, Northern Rock was split into two companies: Northern Rock Plc, which held £21 billion in deposits and £10 billion of high-quality mortgages transferred from Northern Rock, £10 billion in cash and £1.4 billion of equity injected by HMT; and Northern Rock (Asset Management) plc, which held the remaining £54 billion of Northern Rock mortgages, and liabilities including the £23 billion outstanding loan from HMT (this loan included £14.5 billion of the Bank's loan that had been transferred to HMT in August 2008 which was still outstanding, and £8.5 billion of the £10 billion of cash that had been given to Northern Rock Plc at the point of the split). On 17 November 2011, the Government announced that it would sell Northern Rock Plc to Virgin Money for an initial consideration of £747 million. The sale was completed on 1 January 2012.

15. The Northern Rock crisis is examined in detail in the House of Commons Treasury Committee's report, *The run on the Rock*, Fifth Report of Session 2007–08, HC56-I, January 2008.

Appendix 6: List of people interviewed in the course of the Review

Interviewee	Position held in October 2008
Bank of England	
Sir Mervyn King	Governor
Charlie Bean	Deputy Governor for Monetary Policy
Sir John Gieve	Deputy Governor for Financial Stability
Andrew Bailey	Executive Director for Banking Services and Chief Cashier
John Footman	Executive Director for Central Services
Nigel Jenkinson	Executive Director for Financial Stability
Warwick Jones	Finance Director
Paul Tucker	Executive Director for Markets
Dame Juliet Wheldon	Chief Legal Adviser
Paul Fisher	Head of Foreign Exchange Division, Markets Directorate
Sarah Breeden	Head of Risk Management Division, Markets Directorate & Programme Manager for Crisis Response
Mike Cross	Head of Sterling Markets Division, Markets Directorate
Alistair Wilson	Head of Market Services Division, Banking Services Directorate
Alastair Clark	Adviser to the Governor
Stephen Brown	Head of Internal Audit
Andy Haldane	*Executive Director for Financial Stability
Graham Nicholson	*Chief Legal Adviser
Chris Salmon	*Executive Director for Banking Services and Chief Cashier
Andrew Gracie	*Director of the Special Resolution Unit
Alan Sheppard	*Head of Risk Management Division, Markets Directorate
Sir John Parker	Non-Executive Director, Chairman of the Committee of Non-Executive Directors
Dame Amelia Fawcett	Non-Executive Director, Chairman of the Audit Committee
Sir Roger Carr	Non-Executive Director
Peter Jay	Non-Executive Director
Lord Myners	Non-Executive Director, from October 2008 Financial Services Secretary/City Minister
Sir David Potter	Non-Executive Director
Lady Susan Rice	Non-Executive Director
Bob Wigley	Non-Executive Director
Kate Barker	External Member of Monetary Policy Committee
David Blanchflower	External Member of Monetary Policy Committee

HM Treasury

Sir Nicholas Macpherson	Permanent Secretary
Tom Scholar	Second Permanent Secretary
Gareth Evans	Deputy Director, Treasury Legal Advisers
Ed Whiting	Senior Policy Advisor, Financial Stability Unit

Financial Services Authority

Lord Turner	Chairman
Hector Sants	Chief Executive

Debt Management Office

Robert Stheeman	Chief Executive

HBOS

Lord Stevenson	Chairman
Andy Hornby	Group Chief Executive
Mike Ellis	Finance Director
Cliff Pattenden	Treasurer

Lloyds TSB

Sir Victor Blank	Chairman
Eric Daniels	Chief Executive

Royal Bank of Scotland

John Cummins	Group Treasurer
David O'Loan	Deputy Treasurer

Freshfields Bruckhaus Deringer

Michael Raffan	Partner

Other

Willem Buiter

Tim Congdon

Charles Goodhart

*Where more relevant, current roles, rather than October 2008 roles, are specified.

Appendix 7: Glossary

APS	Asset Protection Scheme
CDS	Credit default swap
CGS	Credit Guarantee Scheme
CMBS	Commercial mortgage-backed security
Court	The Court of Directors of the Bank of England
DMO	Debt Management Office
DWF	Discount Window Facility
ECB	European Central Bank
ECTR	Extended Collateral Term Repo
ELA	Emergency liquidity assistance
ELTR	Extended Collateral Long-Term Repo
FCA	Financial Conduct Authority
FPC	Financial Policy Committee
FSA	Financial Services Authority
FSR	Financial Stability Review (until 2005); Financial Stability Report (from 2006)
HMT	Her Majesty's Treasury
ILTR	Indexed Long-Term Repo
LCFI	Large complex financial institution
Libor	London Interbank Offered Rate
LoLR	Lender of last resort
MoU	Memorandum of Understanding
MPC	Monetary Policy Committee
OIS	Overnight indexed swap
OMOs	Open Market Operations
OSFs	Operational Standing Facilities
PRA	Prudential Regulation Authority
RBS	Royal Bank of Scotland
Repo	Repurchase agreement
ResCo	Resolution Committee
RMBS	Residential mortgage-backed security
SLS	Special Liquidity Scheme
SME	Small and medium-sized enterprise
SRR	Special Resolution Regime
SRU	Special Resolution Unit
T-bills	Treasury bills
TransCo	Transactions Committee
UKFI	UK Financial Investments Ltd