

The world economy was hit by a global credit shock in mid-2007. Since then, global financial markets have suffered a sustained period of stress and instability. The intensification of the financial market stress into the worst global financial crisis for generations delivered a severe blow to an already weakened world economy, precipitating a steep and synchronised global downturn. The world economy is forecast to contract in 2009 for the first time in the post-war period.

Financial markets are critical to the well-being of all citizens and the success of all businesses in this country. They also strongly influence economic growth and development across the world. They are the core mechanism for allocating resources efficiently in an economy and a key driver of productivity, growth and opportunities. Financial instability, to the extent that it disrupts the functioning of financial markets, can therefore affect everybody.

Governments around the world have provided significant support to strengthen their financial systems. At the London Summit, G20 Leaders committed to take all necessary action to restore the flow of credit and ensure the soundness of systemically important institutions.

The Government has taken decisive action to support the stability of the financial system and wider economy. Tackling a downturn of this nature and dealing with its consequences requires a comprehensive policy response to support the economy: fiscal and monetary policy, financial sector interventions, and targeted support for individuals and businesses.

The action taken by the Government since October 2008 has been successful in preventing the collapse of the financial system and ensuring that no retail depositors in UK banks or building societies lost money. These interventions have supported the wider economy, and they are helping individuals and businesses. The Government will continue to do whatever it takes to maintain financial stability through its objectives to ensure stability and restore confidence in the financial system, protect retail depositors' money and safeguard the interests of taxpayers.

This chapter sets out the Government's response to financial market disruption in two areas. First, it describes the Government's immediate response aimed at ensuring the stability of the financial system, involving:

- targeted action for individual financial institutions; and
- a comprehensive system-wide response, including action to ensure liquidity, strengthen bank capital, guarantee certain wholesale funding, deal with impaired assets, and increase lending in the economy.

Second, it sets out the Government's view of the longer-term action required to renew financial markets for the future. This chapter introduces a forthcoming paper by the Government, covering:

- key elements of the Government's approach to the future of financial markets;
- steps already taken to achieve this approach, including the Turner Review, leading work in the G20, and the Banking Act 2009; and
- further important action, including renewing financial regulation, reducing the impact of bank failure, protecting and supporting consumers, improving efficiency and competition in capital markets, and strengthening regulators and the international regulatory framework.

THE IMPACT OF GOVERNMENT INTERVENTION

3.1 In response to the current financial market stress and instability, the Government has taken decisive and immediate steps to limit the negative effects on the economy. Key sets of measures were introduced in October 2008, and again in January 2009. These and other measures are described in detail later in the chapter.

Mechanisms 3.2 The Government's interventions have been targeted at tackling problems in individual institutions, addressing system-wide instability, and getting credit flowing through the economy once more. These interventions share the common purpose of protecting the customers of financial institutions – people and businesses – from the consequences of financial instability and restricted access to credit. In particular:

- by dealing with specific institutions such as Northern Rock and Bradford & Bingley, the Government ensured that problems at one institution did not spread through the banking system, that no retail depositor in UK banks or building societies lost money, and that borrowers were not unduly disrupted;
- by acting decisively as the global financial crisis raised system-wide risks in October 2008, to prevent the collapse of the banking system and the massive costs that would have entailed for businesses and individuals, and by comprehensively addressing the needs for liquidity, capital, and funding, the Government ensured that the banking system was in a position to support the economy through the provision of credit to creditworthy borrowers; and
- by acting to limit the risks attached to banks' existing assets, through the Asset Protection Scheme, and by agreeing quantified and legally-binding lending commitments with banks accessing Government support, the Government has enabled around £40 billion of additional lending to be made available to individuals and businesses in 2009 and 2010.

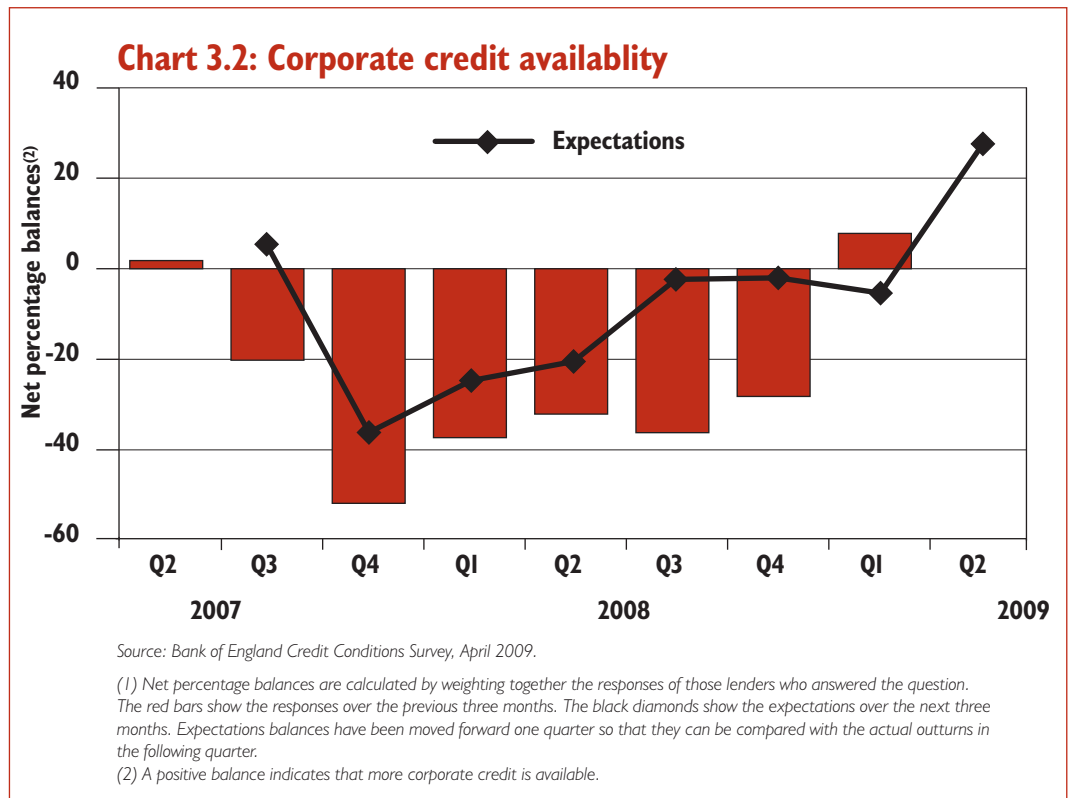
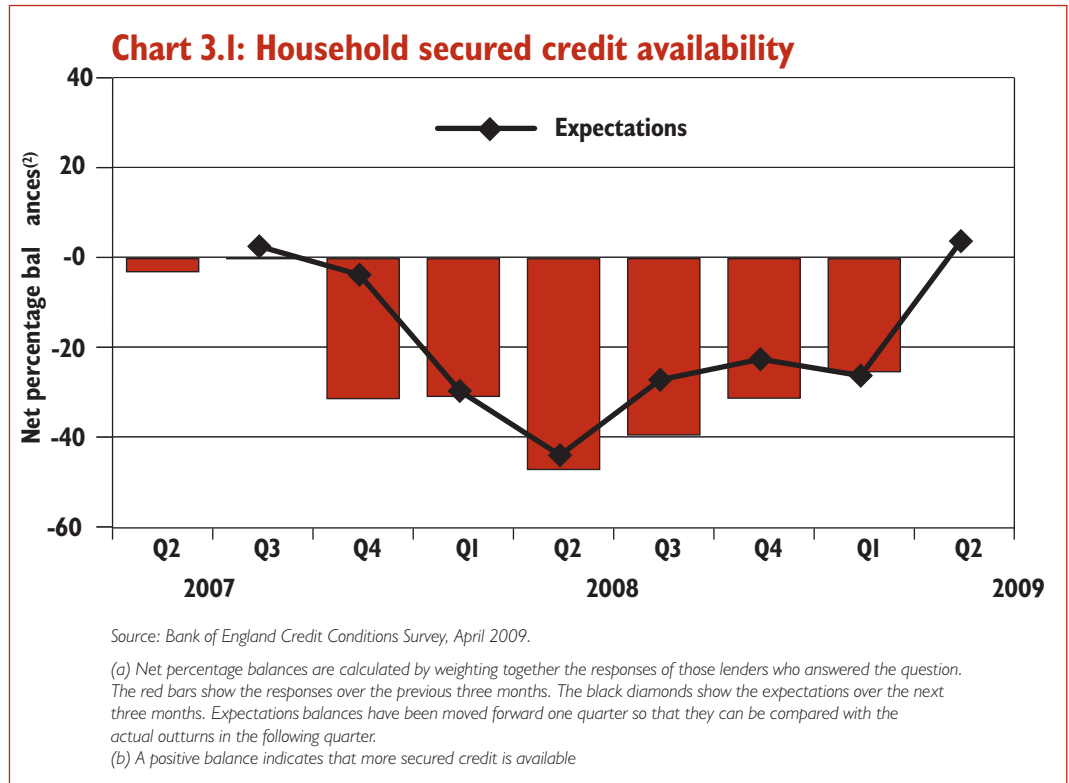
3.3 The Government's comprehensive and coherent series of interventions have therefore protected the economy from the worst costs of financial instability or bank failures, provided the resources and certainty necessary for credit growth, and agreed commitments that will get credit flowing to creditworthy borrowers, and so support economic recovery.

Supporting the economy 3.4 These actions alone are not able to ensure economic recovery. Instead they form part of the wider set of comprehensive and complementary policy actions to support the economy, as set out in Chapter 2, including:

- providing broader support for the economy by implementing a timely, targeted and temporary fiscal stimulus and allowing the automatic stabilisers to operate in full;
- sharp cuts in interest rates by the Bank of England's Monetary Policy Committee;
- authorising the use of a new monetary policy instrument by the Bank of England to ensure that the inflation target can be met;
- introducing more targeted measures to mitigate the risk of a deeper or more prolonged downturn and to provide additional support to those who need it most; and
- implementing a clear plan for sustained fiscal consolidation.

Early indications 3.5 It will take time for the effective functioning of financial markets to be fully restored, but there are already some signs that steps to increase lending and confidence are affecting the availability of credit. The Bank of England's latest *Credit Conditions Survey* and *Trends in Lending* report, drawing on data collected on behalf of the Lending Panel, to the Lending Panel suggest a slight easing in the availability of credit to companies during the first quarter of 2009, and expectations of further easing in the second quarter. The availability of credit to households continued to tighten, although it is expected to ease in the coming months. These

developments are shown in Charts 3.1 and 3.2. The latest Bank of England data show that while effective interest rates paid by households and companies have not fallen by the same amount as Bank Rate has been cut, they have declined significantly.



3.6 By taking comprehensive and complementary policy actions in a timely manner, the Government's interventions will work together to support the economy, individuals and businesses. The effect of Government intervention on the public finances is addressed in Chapter 2. In addition, the action that the Government has taken to mitigate the impact of turbulent financial markets on creditworthy businesses and individuals, is set out in Chapters 4 and 5 respectively.

DISRUPTION TO GLOBAL FINANCIAL MARKETS AND THE ECONOMIC DOWNTURN

Events since summer 2007

Global financial crisis 3.7 The world economy was hit by a succession of shocks during 2007 and 2008. The global credit shock, triggered by problems in the US subprime mortgage market in mid-2007, caused a tightening of credit conditions and institutional failures across advanced economies. The surge in global commodity prices through to mid-2008 squeezed real incomes further, pushing many advanced economies into recession.

3.8 In mid-September 2008, in the aftermath of the failure of Lehman Brothers in the US, there was an intensification of the stress in global credit markets, leading to the worst financial crisis for generations. As it became clear that the stability of not just individual institutions but the entire banking system was at risk, with potentially devastating consequences for UK households and businesses, the Government announced in October 2008 a comprehensive package both to support the stability of the banking system and to protect retail depositors (set out in more detail in the 2008 Pre-Budget Report).

Developments since November 2008

World economic downturn 3.9 From autumn 2008 the intensification of the stress in global credit markets into the worst global financial crisis for generations delivered a severe blow to an already weakened world economy, precipitating a steep and synchronised global downturn. The recession has further impacted the financial system, increasing household and company credit risk, leading to further falls in asset prices and illiquidity in several key markets. This has exposed system-wide vulnerabilities, rooted in uncertainties about the value of banks' assets, and amplified by excessive leverage, which has generated significant funding difficulties for some institutions.

3.10 These developments have affected financial institutions around the world, and resulted in interventions in many countries. Since November 2008 these have included the rescue of Bank of America and re-structuring of Citigroup in the United States; the nationalisation of Anglo-Irish Bank in Ireland; the proposed nationalisation of Hypo RE and the rescue of Commerzbank in Germany among others (see Box 3.3 for further details).

Impacts on the wider economy

Impacts on bank lending 3.11 The ability of financial institutions to provide credit necessary to support the wider economy is affected by many factors. Banks lend a multiple of their capital, so in normal times additional capital has a powerful multiplier effect on total lending. Banks fund lending through a variety of sources, including retail deposits and wholesale capital markets. Other wholesale sources are available in normal times, for example interbank markets, to fill any funding gap between loans and deposits. The presence of non-bank lenders and foreign institutions also boosts total lending capacity. Each of these sources has recently been acting to depress credit growth:

- when banks fear future losses, they try to reduce the multiple of loans to capital to provide a buffer against potential losses, so additional capital may not deliver additional lending;
- the withdrawal of wholesale funding sources has required banks to find other funding sources or to reduce new lending to a level that can be supported by retail deposits; and
- the withdrawal of some lending institutions from the UK market, with many global banks retrenching behind national borders.

3.12 The global economic downturn and associated increase in credit losses are creating costly levels of uncertainty around the value of assets held on banks' balance sheets. Both the complexity of structured products and the uncertainty around economic losses mean that banks and their investors have been unable to predict the degree of losses on these assets with any confidence. This uncertainty and lack of confidence is leading banks to hold more capital to protect themselves against worst-case scenarios. As a result, banks have not been providing sufficient credit to creditworthy borrowers for fear that they will be left without enough capital. Investors have also been reluctant to provide funds to the banks due to lack of confidence, further eroding their capacity to lend, with damaging consequences for the wider economy.

3.13 Bank of England data shows that secured lending to households increased by an average of £7¼ billion a month in 2007, which fell to £3½ billion a month in the second half of 2008 and £2¾ billion in the first two months of 2009. Lending to private non-financial companies fell from £5¾ billion a month in 2007 to an average monthly decline of £½ billion in the second half of 2008.¹

Box 3.1: Why financial markets matter

Ensuring financial stability is central to the Government's economic objectives; not for the financial sector itself but for the economy as a whole. Efficient, fair and stable markets are essential to all developed economies. Financial markets:

- allocate capital through the investment chain;
- help businesses and households to manage risk; and
- provide the payments systems and accounts for holding and transmitting funds necessary to allow trade and business to take place.

Financial instability, to the extent that it creates losses in the financial system and disrupts its ability to support the economy, can affect everybody. If a retail financial institution fails, customers can be denied access to their savings unless adequate protections are in place. If the wholesale funding markets dry up, banks can no longer finance themselves to extend loans to individuals and firms on reasonable terms so a lack of confidence in the financial system can have a very damaging effect on everyday economic activity.

¹M4 lending excluding the effects of securitisation and loan transfers, seasonally adjusted.

ENSURING FINANCIAL STABILITY: RESPONDING TO THE IMMEDIATE CHALLENGES

The UK framework **3.14** In the UK, the Financial Services Authority (FSA) is responsible, under the Financial Services and Markets Act 2000 (FSMA), for financial regulation and supervision. The FSA, the Bank of England, and the Treasury work closely together on matters relating to financial stability, as set out in a Memorandum of Understanding. Each of the authorities has separate, but complementary, roles.

3.15 The Government has strengthened and updated the framework for financial stability in the Banking Act 2009, which includes changes to the objectives and role of the Bank of England (see Box 3.7 for further details).

International arrangements **3.16** International cooperation to ensure financial stability has become increasingly important as the degree of global financial integration has risen. Much of this cooperation takes place within the European Union or through non-legislative bodies such as the International Monetary Fund (IMF), the new Financial Stability Board (FSB) or global standard-setting bodies like the International Accounting Standards Board (IASB).

3.17 Many of the actions set out below have been developed and implemented through the frameworks described above, in the UK and in some cases internationally.

Action targeted at specific institutions

3.18 Government action to deal with specific institutions has been undertaken through its consistent objectives to:

- support stability and restore confidence in the financial system;
- protect retail depositors' money; and
- safeguard the interests of taxpayers.

Northern Rock **3.19** Northern Rock was taken into temporary public ownership in February 2008 using the Banking (Special Provisions) Act 2008, after experiencing severe funding problems. A new business plan was published in March 2008. Economic conditions have changed significantly since then and as a result, on 23 February 2009, the Government announced that Northern Rock will increase mortgage lending by up to £14 billion over the next two years. The new lending will be on commercial terms, to help build a high quality mortgage book and viable bank for sale. To maximise the bank's capacity for new lending, Northern Rock will be restructured so that the back book of mortgages is managed separately to its other business. The Government will increase the loan to Northern Rock and extend the repayment schedule. The capital requirement for the revised strategy will be within the potential £3 billion of support previously announced by the Government in August 2008. These plans are subject to State Aid approval by the European Commission.

Bradford & Bingley 3.20 In September 2008, the Government again used the Banking (Special Provisions) Act 2008 to take swift action in relation to Bradford & Bingley. The retail deposits and branches of Bradford & Bingley were transferred to Abbey following a competitive sale process. To enable this transfer, the Financial Services Compensation Scheme (FSCS) paid out approximately £14 billion, funded through a loan from the Treasury, and the Treasury paid out approximately £4 billion in addition. The remainder of Bradford & Bingley's business was taken into public ownership. Now in public ownership, Bradford & Bingley has developed a business plan for the wind-down of the bank and has published the Executive Summary of this plan on its website. Since November 2008, the Treasury has approved Bradford & Bingley's business plan and has submitted a Restructuring Aid notification to the European Commission. The FSCS and the Treasury will be repaid through the proceeds of the wind-down and realisation of the assets of the remaining business of Bradford & Bingley in public ownership.

London Scottish 3.21 On 30 November 2008, the FSA determined that London Scottish Bank plc should be prevented from accepting further deposits as it no longer met the FSA's threshold conditions for authorisation, particularly in relation to its financial position. The bank was placed into administration later that evening by the Court on the application of its directors and Ernst & Young were appointed as administrator. The FSCS was triggered so that retail deposits up to the compensation limit of £50,000 were protected. The Government stepped in quickly to protect all retail depositors (including deposits above £50,000) in order to maintain consumer confidence and preserve financial stability.

Dunfermline Building Society 3.22 On 30 March 2009, action was taken to resolve Dunfermline Building Society after the FSA, in consultation with the Treasury and Bank of England, determined on 28 March 2009 that the conditions for the society to be dealt with under the special resolution regime of the Banking Act 2009 were met. Under the Act, Dunfermline's retail and wholesale deposits, branches, head office and own-originated residential mortgages were transferred to Nationwide Building Society. This followed a competitive sale process conducted by the Bank of England over the weekend of 28-29 March. Dunfermline's social housing loans and related deposits have been placed into a bridge bank, wholly owned by the Bank of England, so that the best outcome for this part of Dunfermline's business can be determined. A court order was made on 30 March 2009 to place the remainder of Dunfermline's business into a Special Administration Procedure and to appoint an administrator.

System-wide responses

3.23 As set out above, financial market conditions deteriorated significantly following the collapse of Lehman Brothers in September 2008. The problems were no longer confined to specific institutions but affected the entire system. The likelihood of the banking system collapsing, with profoundly damaging consequences for the wider economy, had increased.

Bank of England liquidity measures 3.24 At the onset of the crisis, banks became increasingly uncertain about their ability to meet potential demands quickly due to the illiquidity of financial markets. To tackle this, the Bank of England put in place a series of changes to its liquidity operations. Those changes, such as the provision of additional reserves and term auctions against a wide range of collateral, started in autumn 2007. The Special Liquidity Scheme (SLS) was introduced in April 2008. The SLS provided liquidity by allowing institutions to swap their pre-existing assets, (which had become illiquid) for Treasury bills over a three-year period, which are more easily converted into cash. In September 2008, following further deterioration in financial markets, the drawdown window was extended. In October 2008 authorities announced that at least £200 billion would be made available to banks under the scheme.

3.25 The drawdown period for the SLS closed on 30 January 2009. On 3 February, the Bank of England reported that £185 billion of Treasury bills has been taken up under the SLS in exchange for high quality private sector assets of £287 billion in nominal value terms. The illiquidity of financial markets continued as the financial crisis precipitated a global recession. The Discount Window Facility (DWF) was introduced in October 2008 as a permanent feature of the Bank of England's operations. It allows banks to swap high-quality illiquid assets for gilts (or cash under some circumstances). Initially for a period of 30 days, the DWF was extended in January 2009 to also provide a facility for up to 12 months.

Recapitalisation 3.26 As concerns shifted from banks' ability to access liquidity to the solvency of financial institutions, the Government addressed this source of extreme stress by announcing the Bank Recapitalisation Scheme in October 2008. In November and December 2008 the shareholders of the Royal Bank of Scotland (RBS), Lloyds TSB and HBOS approved their recapitalisation through the Government recapitalisation scheme and the Government subsequently invested £20 billion in RBS and £17 billion in what is now Lloyds Banking Group (created following the merger of Lloyds TSB and HBOS in January 2009). Other financial institutions announced plans to raise their capital levels without Government support. The Government, in consultation with UKFI, has since agreed to convert the RBS and Lloyds Banking Group (Lloyds) preference shares, plus accrued coupon and underwriting fees, into ordinary shares.

Credit Guarantee Scheme 3.27 The Credit Guarantee Scheme (CGS) was also announced in October 2008. The purpose of the CGS is to help restore confidence by making available to eligible institutions government guarantees of eligible debt issuance. The Treasury acts as guarantor for the use of the CGS, while the Debt Management Office handles the operational aspects of the Scheme. On 15 December 2008 an announcement was made changing the fees, lengthening the Scheme, and extending eligible currencies of issue beyond sterling, dollars and euros. On 19 January 2009, the Government announced that the drawdown window would be extended. Following approval from the European Commission the window has been extended from 9 April to 13 October 2009 and is to be extended further to 31 December 2009, subject to further approval from the Commission. Over £100 billion of debt issued by eligible institutions has been guaranteed under the Scheme.

Managing the Government's investments 3.28 The Government set up a company, UK Financial Investments Ltd (UKFI), on 3 November 2008 to manage its investments in financial institutions on a commercial basis. A Framework Agreement between the Treasury and UKFI governs the company's activities and sets out its relationship to the Treasury². UKFI has an overarching objective to protect and create value for the taxpayer as shareholder with due regard to the maintenance of financial stability and to act in a way that promotes competition. This includes:

- acting in a way that is consistent with the Treasury's stated aim that it should not be a permanent investor in UK financial institutions, maximising sustainable value for the taxpayer, taking account of risks;
- maintaining financial stability by having due regard to the impact of its value realisation decisions; and
- promoting competition in a way that is consistent with a UK financial services industry that operates to the benefit of consumers and respects the commercial decisions of the financial institutions.

²www.ukfi.gov.uk.

Developments since November 2008

Asset Protection Scheme 3.29 As conditions in financial markets deteriorated further and created a global economic recession, uncertainty around the level of credit losses banks might sustain continued. In such circumstances it becomes necessary for governments to bear some of the risk attached to banks' existing assets by providing a manageable maximum loss on these assets to restore confidence in the financial system, and ultimately to increase lending to individuals and businesses. On 19 January 2009 the Government announced its intention to offer an Asset Protection Scheme to restore confidence in the banks and get credit flowing again, by dealing with the losses associated with impaired assets.

3.30 Details of the Asset Protection Scheme were published on 26 February 2009. Under the scheme, the Government provides protection against future credit losses on certain assets in exchange for a fee. A 'first loss' (similar to the excess in insurance policies) remains with the institution. The Government protection will cover 90 per cent of the credit losses exceeding this amount, with the participating institution retaining the residual exposure. The scheme has been designed to draw a line under problems arising from impaired assets, by putting a floor to banks' exposure to losses associated with these assets. This should enable the healthier core of banks' commercial business to attract investments and deposits and make loans to creditworthy businesses and households.

3.31 RBS and Lloyds have both announced their intention to participate in the scheme, as described in Box 3.2. Implementation of the Asset Protection Scheme will be subject to further due diligence by the Treasury and its advisers, execution of legally binding documentation, satisfaction of the application criteria and asset eligibility criteria of the Scheme, and satisfaction of applicable conditions precedent to the accession of the Scheme, including regulatory, State Aid and shareholder approvals.

Box 3.2: Asset Protection Scheme agreements in principle

On 26 February 2009, RBS announced its intention to participate in the Asset Protection Scheme. RBS intends to protect £325 billion of eligible assets. Key elements of the announcement include:

- RBS will pay a fee of £6.5 billion in B shares (non-voting ordinary shares, which constitute Core Tier 1 capital). They have also agreed for a number of years not to claim certain UK tax losses and allowances.
- RBS will bear a first loss amount of £42.2 billion in relation to protected assets. Thereafter losses will be borne 90 per cent by the Treasury and 10 per cent by RBS.
- In addition, and conditional on RBS' participation in the Scheme, the Government has agreed to inject up to £19 billion more capital in the form of B shares – £13 billion on accession and £6 billion at RBS' option after the end of 2009.

On 7 March 2009, Lloyds announced its intention to participate in the Asset Protection Scheme. Lloyds intends to protect £260 billion of eligible assets. Key elements of the announcement include:

- Lloyds will pay a fee of £15.6 billion for participation in the Scheme. The fee will be satisfied through the issuance of B shares (non-voting ordinary shares, which constitute Core Tier 1 capital).
- Lloyds will bear a first loss amount of £35.2 billion in relation to protected assets. Thereafter losses will be borne 90 per cent by the Treasury and 10 per cent by Lloyds.

Both RBS and Lloyds have committed to additional lending, the details of which are set out later in this chapter.

Further work on due diligence is currently taking place to ensure that the Government has a full understanding of the risks and costs that the scheme will involve before agreements are finalised.

Asset Purchase Facility **3.32** The Asset Purchase Facility (APF) was announced on 19 January 2009. The APF is operated by the Bank of England. Initially, provision was made to purchase up to £50 billion of eligible private sector assets (commercial paper, corporate bonds, syndicated loans, paper issued under the CGS and asset-backed securities created in viable securitisation structures). As of 17 April 2009, the APF had purchased £2.4 billion of commercial paper, and £0.5 billion off corporate bonds. The Bank of England is considering whether it might extend the APF to purchase a wider range of private sector assets, consistent with the objectives of the facility. While the APF aims to improve liquidity in financial markets, it also provides a framework that the Monetary Policy Committee (MPC) of the Bank of England can use to conduct monetary policy through adjusting the supply of money. Until 5 March, purchases were financed by this issuance of Treasury bills. Following a request from the MPC, the Chancellor authorised the Bank of England to use the APF for monetary policy purposes and increased the total scale of the fund to £150 billion, up to £50 billion of which could be used for private sector asset purchases. Asset purchases since then have been financed by the issuance of central bank reserves at the Bank of England. Chapter 2 provides further information of the monetary policy framework and the Bank of England's use of the APF in its quantitative easing policy.

Asset-Backed Securities Guarantee Scheme **3.33** On 19 January 2009, the Government announced it would establish a guarantee scheme for asset-backed securities. **The Government announces that the scheme is available, at first until October 2009, for banks and building societies to use alongside the existing CGS to support their lending in the economy.** The scheme, which has been approved by the European Commission, extends the funding options open to banks and building societies under the existing CGS to residential mortgage-backed securities (RMBS).

3.34 Following discussions with the industry, the Government is announcing two types of guarantee to be attached to triple-A rated securities: a credit guarantee and a liquidity guarantee. The Debt Management Office will make guarantees available to banks and building societies wishing to access the scheme on the terms set out in the Market Notice and scheme rules.

3.35 The Government is setting high quality criteria, and encouraging high quality reporting standards, in order to help lay the foundations for stronger markets in the future. The Government welcomes the European Securitisation Forum's (ESF) recently published new reporting standards for European RMBS and will require participants in the guarantee scheme to comply with international best practice. The Government encourages the industry to bring forward standardised reporting templates for investors, and agree common definitions of terms this year.

3.36 The Government and FSA, working closely with industry, will also review the current regulatory regime for covered bonds, which was introduced one year ago. This review will consider the current regime's impact on the UK market and further steps to enhance investor confidence, and will report by the 2009 Pre-Budget Report.

Lending commitments and actions

3.37 Action to ensure the stability of the financial system is a necessary precondition for economic recovery. The Government's responses are designed to support lending in the UK economy, an important part of supporting the economy through the downturn, and benefiting individuals and businesses.

Lending commitments **3.38** Quantified and legally binding lending commitments will be agreed with banks accessing government support through the Asset Protection Scheme and the extended Credit Guarantee Scheme. Such lending commitments – on commercial terms, and subject to market demand – have already been agreed with both RBS and Lloyds. RBS will lend an additional £25

billion on commercial terms over the 12 months from March 2009 – £9 billion of mortgage lending and £16 billion of business lending. Lloyds will lend an additional £14 billion on commercial terms over the 12 months from March 2009 – £3 billion of mortgage lending and £11 billion of business lending. Similar lending commitments have been made in respect of the subsequent 12 months and will be reviewed to ensure they reflect economic circumstances at that time. A robust monitoring framework has been put in place, and the Government will report to Parliament annually on the delivery of these agreements.

3.39 As described earlier in this chapter, on 23 February 2009 the Government announced that Northern Rock will undertake new lending of about £5 billion in 2009, and £3-9 billion a year from 2010 onwards, subject to market demand.

Lending Panel 3.40 At the 2008 Pre-Budget Report, the Government announced the creation of a new Lending Panel to monitor lending to businesses and households and drive up standards of industry best practice in lending decisions. As part of this new monitoring approach, the Bank of England is publishing a monthly report – *Trends in Lending* – the first of which was published on 21 April 2009.

International actions

Global issues 3.41 Governments around the world have been working to tackle similar problems to those faced by the UK (see Box 3.3). As a result of the downturn across the world, cross-border flows are growing more slowly than domestic flows and some banks are favouring domestic lending over foreign lending. It is vital that national measures aimed at restoring lending and repairing the financial system do not encourage a retreat into domestic financial markets and end up linking deleveraging with deglobalisation.

International action 3.42 In particular, concerted action at the international level is needed to:

- boost market confidence by creating a positive contagion effect across banks;
- ensure that global banks are addressed effectively and coherently by the different national authorities in which they operate; and
- reduce negative spillovers such as distortions in competition and domestic retrenchment.

G20 framework for financial repair and recovery 3.43 In March this year, the G20 Finance Ministers and Central Bank Governors agreed a framework for financial repair and recovery, committing to taking decisive action, where needed, and to use all available tools to restore the full functioning of financial markets. In particular, they committed to underpin the flow of credit, both domestically and globally, by:

- providing liquidity support, including through government guarantees to financial institutions' liabilities;
- injecting capital into financial institutions;
- protecting savings and deposits; and
- agreeing a set of principles for a cooperative and consistent approach to programmes addressing impaired assets.

Box 3.3: Financial stability measures taken internationally

The IMF recommended in its 2009 Financial Stability Report that governments should pursue a broad three-pronged approach – liquidity provision, capital injections, and dealing with problem assets – to encourage bank balance sheet cleansing and restore the financial sector functionality and confidence necessary to sustain economic recovery. Countries have been responding to the financial crisis by adapting this mix of measures to their own national circumstances:

1. **liquidity provision:** liquidity and debt issuance guarantees have played a crucial role in helping governments and markets to manage the deleveraging process and mitigate the increased cost of funding;
2. **capital injections:** following the recapitalisation by the UK in October, many EU Member States, as well as the US, Japan, South Korea, Switzerland and others, have offered capital injections to banks (see table 3.1);

Table 3.1: Global Capital Injections

Capital Injections	Private US\$bn	Public US\$bn	Public Sector as percentage of total
Total capital	505.3	567.7	52.9
America	253.6	392.5	60.8
Europe	219.3	111.8	43.8
Asia	32.3	3.4	9.5

Source: Bloomberg 8 April 2009. Figures relate to the period from Q3 2007 to 8 April 2009 and have been rounded to one decimal place.

3. **dealing with problem assets:** as the crisis has deepened and spread, it has become clear that the key priority is to address the problem of impaired assets on banks' balance sheets, which is severely constraining banks' ability and willingness to resume lending. For example:
 - in October 2008, the Swiss government decided to transfer up to \$60 billion of illiquid securities and other assets from UBS's balance sheet to a separate entity in an attempt to eliminate uncertainty;
 - the Belgium and US governments have opted for insurance schemes to enable Dexia in Belgium and Citigroup and Bank of America in the US to rebuild investors' confidence in their capacity to withstand severe further losses; and
 - the US and Ireland have announced new systemic initiatives aimed at reducing the uncertainties created by losses in real estate asset prices. The US plans to enlist private sector investors with the help of US Treasury equity and non-recourse guaranteed debt facilities to purchase real estate-related assets from banks and other financial institutions. Ireland's programme also aims at cleaning banks' balance sheets of certain real estate-related assets, through a new asset management company, which with government funds will purchase assets from Irish banks and manage them on a commercial basis.

To ensure the effectiveness of these measures and minimise market distortions, G20 Finance Ministers and Central Bank Governors agreed on 14 March 2009 to a set of principles for a cooperative and consistent approach to programmes addressing impaired assets.

RENEWING FINANCIAL MARKETS FOR THE FUTURE

The need for renewal and reform

3.44 The recent failures of financial markets require a systematic approach to prevent such difficulties happening again. It is also important that reforms tackle the decline in trust and confidence in financial markets, among consumers and wider market participants. The changing nature of financial markets, including the consolidation of the banking sector and the significant increase in state intervention, pose further questions.

3.45 The Government will, in a document to be published before the summer, describe its approach to the future of financial markets and set out the actions necessary to achieve it. The Government will seek financial markets, in the UK and internationally, that:

- are open and competitive, meeting the needs of all constituents in society and the wider economy efficiently and fairly;
- enjoy and inspire the trust and confidence of all users, including consumers;
- are subject to stronger regulation that reduces the likelihood of damaging market and institutional failures; and
- have effective mechanisms for dealing with the failure of financial institutions when, nevertheless, they do occur.

Steps taken 3.46 The Government has already taken a number of important steps described below:

- **the Banking Act 2009** – this addressed the immediate need for a comprehensive regime for dealing with bank failures and other important aspects of financial stability and depositor protection (explained in Box 3.7 below);
- **the Turner Review of financial regulation** – in October 2008 the Chancellor asked Lord Turner, the Chairman of the FSA, to make recommendations on the changes in regulation and supervisory approach needed to create a more robust banking system for the future. The Government welcomes the Review's recommendations and the accompanying FSA Discussion Paper, published on 18 March 2009 (see Box 3.4 for more details)³;
- **progress in the G20 and other international fora** – many of the regulatory changes necessary will need international agreement. The Government is leading the debate on the future of financial markets. Leaders and Finance Ministers of the G20 met in London on 2 April 2009 and agreed a broad range of measures to strengthen the financial system (see Box 3.5). Further progress will be needed to take this forward. The UK has also contributed to progress in this area within other international fora, such as the G7 and in the EU;
- **the Walker Review of corporate governance** – the Government announced in February 2009 that Sir David Walker would conduct an independent review to cover the effectiveness of risk management at board level (including the incentives in remuneration policy to manage risk responsibly and the balance of skills, experience and independence required on the boards of UK banking institutions); the effectiveness of board practices and the performance of audit, risk, remuneration and nomination committees; the role of institutional shareholders in engaging effectively with companies and monitoring of

³The Turner Review can be found on the FSA website, www.fsa.gov.uk

boards; and whether the UK approach is consistent with international practice and how national and international best practice can be promulgated. A consultation document will be published in summer 2009 with conclusions in autumn 2009. The Government's view on remuneration practices in banks is discussed in Box 3.7 below; and

- **the Foot Review of British offshore financial centres** – the Government announced on 2 December 2008 that Michael Foot would carry out an independent review, covering the areas of financial supervision and transparency; taxation, in relation to financial stability, sustainability and future competitiveness; financial crisis management and resolution arrangements; and international cooperation. A progress report of the Foot Review, setting out its scope and issues for consultation, was published on 21 April 2009.⁴

Box 3.4: The Turner Review

The Turner Review set out 32 recommended actions to improve financial regulation and create a more robust banking system for the future. The Review makes a number of recommendations that have already been enacted in the UK, such as a resolution regime for the orderly wind down of failed banks (provided by the Banking Act 2009), or that are being tackled, such as changes to corporate governance and risk management of financial institutions being examined by the Walker Review. Key areas within which detailed recommendations are made are summarised below:

The supervisory framework: The Review acknowledges that far-reaching changes are already being made to the FSA approach to supervision. More broadly, it recommends that supervisory coverage should follow the principle of economic substance not legal form, and that regulators should have powers to extend prudential regulation or impose restrictions on institutions that create risks to financial stability. The Review recommends that the Bank of England and the FSA should collaborate on macro-prudential analysis and that international coordination of bank supervision should be enhanced through the use of supervisory colleges. It also recommends that credit rating agencies should be subject to supervision.

Prudential regulation: The Review recommends a broad range of changes to be considered, including increasing the quantity and quality of capital in the global banking system; reducing the pro-cyclicality of regulatory standards; implementing a maximum gross leverage ratio; and far-reaching changes to bank liquidity regulation.

Risk management and governance: The Review concludes that a firm's remuneration strategy should not encourage the taking of undue risk, and recommends that the role of non-executive directors at large complex financial institutions should be re-considered.

Resolution and consumer protection: The Review recommends that, at a consumer level, retail deposit insurance should be sufficiently generous to cover the vast majority of retail depositors and the extent of coverage should be clearly communicated to retail depositors.

The credit default swap market: The Review recommends that there should be increased use of central counterparties to cover the standardised contracts that account for the majority of credit default swap trading.

While many of the recommendations are for the FSA to introduce through its own rules, some others require international or EU agreement, on which the Government will work closely with the FSA and the Bank of England. Others may require legislative changes for which the Government will be responsible.

⁴The report can be found at: www.hm-treasury.gov.uk

Box 3.5: Progress made by the G20

The G20 agreed to take action to build a stronger and more globally consistent supervisory and regulatory framework for the future. Building on, and responding to, the actions set out at the Washington Summit in November 2008, the G20 agreed major reforms based on the principles of strengthening transparency and accountability, enhancing sound regulation, promoting integrity in financial markets and reinforcing international cooperation, including:

- to establish a new Financial Stability Board (FSB) with a strengthened mandate, as a successor to the Financial Stability Forum (FSF), including all G20 countries, FSF members, Spain, and the European Commission;
- that the FSB should collaborate with the IMF to provide early warning of macroeconomic and financial risks and the actions needed to address them;
- to reshape regulatory systems so that authorities are able to identify and take account of macro-prudential risks;
- to extend regulation and oversight to all systemically important financial institutions, instruments and markets. This will include systemically important hedge funds;
- to endorse and implement the FSF's new principles on pay and compensation and to support sustainable compensation schemes;
- to take action, once recovery is assured, to improve the quality, quantity, and international consistency of capital in the banking system;
- to take action against non-cooperative jurisdictions, including tax havens;
- to call on the accounting standard setters to work with supervisors and regulators to improve standards on valuation and provisioning and achieve a single set of high-quality global accounting standards; and
- to extend regulatory oversight and registration to credit rating agencies to ensure they meet the international code of good practice.

G20 Leaders instructed Finance Ministers to complete the implementation of the decisions in line with the timetable set out in the Washington Action Plan. The FSB and the IMF will work with other relevant bodies to provide a full report to Finance Ministers in Scotland in November.

Further action required 3.47

The Government will propose action covering five areas:

- **renewing financial regulation** – including legislative changes where needed to support changes recommended in the Turner Review and to deliver the G20 conclusions;
- **reducing the impact of the failure of financial firms** – including implementing actions under the Banking Act 2009 and securing action internationally to improve cross-border arrangements for dealing with failures;
- **protecting and supporting consumers** – including practical measures to boost financial capability and tighten up consumer-focused regulation;
- **improving efficiency and competition in financial markets** – including considering ways to make it easier for new entrants to join the banking market and to strengthen the diversity of market participants, as well as action to maintain the competitive position of the UK as the leading global financial centre; and

- **strengthening regulators and the international regulatory framework** – including action in the UK to ensure that the FSA has sufficient powers and internationally to improve cross-border cooperation..

Further information on these actions is set out below.

Renewing financial regulation

3.48 A key longer-term challenge for financial markets is to reform regulation. The problems in financial markets have highlighted serious failures in the global financial regulatory system. There is international consensus on the need to strengthen regulation in light of recent events, including in the G20.

Strengthening regulation **3.49** Regulation and supervision of financial markets and institutions need to be strengthened across the world, and be capable of adapting to innovative and evolving markets. In particular:

- there have been failures of market discipline to prevent deficiencies emerging in corporate governance and risk management in the institutional investment chain;
- the quantity and quality of capital, and liquidity risk management standards, have been proven to be inadequate. Bank balance sheets were excessively leveraged and there has been an over-reliance on short-term wholesale funding;
- markets have proved to be more systemic than previously understood, and in many cases have failed to deliver the infrastructure or transparency necessary to minimise systemic risks; and
- the existing regulatory system focuses on the ability of individual financial institutions to survive shocks. This has proved inadequate for protecting the wider macroeconomic system.

International action **3.50** As financial markets and institutions are global in nature, the debate on the future of financial regulation requires international negotiation and agreement. At a global level this debate is continuing through the G20, with the UK as current chair (as discussed in Box 3.5 above).

Progress in the EU **3.51** The EU has also made progress with changes to financial regulation. Most recently the de Larosière Report has made a number of recommendations for EU financial services and supervision. The Chancellor wrote to his EU colleagues on 3 March 2009 setting out the UK's position on EU financial regulation and supervision. In his letter he welcomed the report of the de Larosière group, as a good basis for further discussions. The letter set out a number of principles for EU supervision and regulation:

- prudential and conduct-of-business issues cannot be separated and need to be considered together;
- supervisory and crisis-management arrangements need to be consistent and aligned;
- EU arrangements need to fit with global practice;
- through all of this, Government's must continue to support the development of open, global markets; and
- arrangements should be independent and accountable.

3.52 In this context, the Chancellor made four proposals, to form the basis for the EU's response, which the Government will take forward in European meetings over the coming months: the need for an effective early warning system; a new independent rule-making body, which should become a regulatory authority and a forum for reviewing national supervisors; the development of rules for clearing and settlement systems to improve operational and prudential standards; and a fundamental review of the risks and safeguards around cross-border branching models, to consider issues such as home versus host responsibilities and effective cooperation between national deposit guarantee schemes.

Next steps 3.53 To deliver the changes necessary to renew financial regulation, the Government will:

- strengthen market discipline with reforms to reduce the deficiencies seen in corporate governance and lead the way in developing responsible remuneration practices. Measures are needed to strengthen responsible shareholder engagement, remuneration and risk management practices. Remuneration is discussed in more detail in box 3.6;
- strengthen the regulation of financial services firms, once the recovery is assured, by improving the quantity and quality of bank capital, tightening liquidity regulation and placing simple and effective limits to mitigate excessive leverage and increase future financial stability. The Government will support the FSA and the Bank of England in achieving these changes internationally;
- reduce the systemic risk of markets by working urgently to improve transparency. The Government strongly supports international efforts to improve transparency. The London summit agreed to call on accounting standard setters to work urgently with supervisors and regulators to improve standards on valuation and provisioning and achieve a single set of high-quality global accounting standards; and
- ensure that all systemically important institutions are subject to appropriate regulation and oversight and consider the institutional arrangements in the UK necessary to deliver a macro-prudential approach. The Government will consider further options to implement such an approach in the UK (see Box 3.11).

Box 3.6: Remuneration practices in banks

There is widespread consensus that remuneration practices in banks contributed to the market disruption. Staff in certain areas of banking were incentivised to pursue overly risky practices, which although profitable in the short term, did not take appropriate account of risk over the long term. That many of these longer term risks are difficult to quantify cannot justify them being understated by senior management. The Government is clear that the banking industry, both in the UK and globally, needs to develop sustainable long-term remuneration policies that take better account of risk.

In the UK, the FSA has published a Code of Practice on remuneration, which it intends to add to the FSA handbook; the Code is currently being consulted on and the FSA aims to have it in place for firms' 2009 remuneration review processes. In parallel, the Walker Review is looking, among other things, at strengthening remuneration practices as part of improvements to corporate governance. Neither the FSA's work nor the Walker Review are intended to dictate the quantum of remuneration, either for individuals or at the level of groups or institutions. This remains a matter for those institutions. Rather, the Walker Review will look at how boards can oversee the establishment of appropriate remuneration policies that avoid contributing to excessive risk taking and financial instability.

It is clear that to be most effective, international cooperation is needed on remuneration policies to avoid a race-to-the-bottom in terms of attracting financial services between countries. The UK has played a leading role in developing an international approach. The FSA was a key player in the preparation of the Financial Stability Forum's (FSF's) Principles for Sound Compensation Practices report that G20 Leaders agreed at the London Summit to endorse and implement. The FSF's principles state that there should be: effective governance of compensation; effective alignment of compensation with prudent risk taking; and, effective supervisory oversight and engagement by stakeholders. The FSF report stated that these principles will be implemented by firms and supported by work at the national level; as the FSA is currently doing in the UK.

Furthermore, UKFI, which is wholly owned by the Government and operates on a commercial basis, is overseeing the remuneration conditions attached to subscribing to the Government's recapitalisation fund and working with RBS and Lloyds in the context of the Asset Protection Scheme. UKFI has worked to ensure that the banks subscribing to these schemes offer incentives based on the Government's principles on remuneration, including no rewards for failure, and to protect the interest of the taxpayer as a shareholder.

Reducing the impacts of the failure of financial firms

Banking Act 2009 3.54 The Banking Act 2009 received Royal Assent on 12 February 2009 and is a major reform in reducing the impact of a bank failure. The Act builds on existing arrangements to enhance the ability of the Treasury, the FSA and the Bank of England to deal with crises in the banking system, to protect retail depositors and to maintain financial stability. Box 3.7 sets out the main features of the Act.

Box 3.7: Banking Act 2009

The Government's approach to the Act was informed by the following high-level objectives:

- strengthening the stability of the financial system;
- reducing the likelihood of individual banks facing difficulties;
- reducing the impact if, nevertheless, they do;
- ensuring effective protection for retail depositors if they were to fail; and
- strengthening the Bank of England and ensuring effective co-ordinated actions by authorities in UK and internationally.

Key features of the Act include:

Prevention: Reducing the likelihood of bank failure by strengthening the existing regulatory structures, including:

- new powers for the FSA to collect information relating to financial stability;
- a statutory financial stability role for the Bank of England;
- the creation of the new Financial Stability Committee;
- improved arrangements for the provision of liquidity assistance by the Authorities, directly addressing issues that arose over Northern Rock; and
- formal regulation of inter-bank payments systems.

Resolution: The Act's centrepiece is a permanent and proportionate special resolution regime, providing the Authorities with a range of tools to deal with banks and building societies in financial difficulties. These include:

- a power to facilitate private sector purchase;
- powers to transfer some or all of a bank to a public sector bridge bank;
- the ability to take a bank into temporary public ownership; and
- new insolvency and administration procedures for banks and building societies, and powers to introduce a new insolvency regime for investment banks.

Compensation: Measures to improve the legal framework and efficiency of the FSCS, and measures to allow for the use of the National Loans Fund to provide the FSCS with immediate liquidity; a power to pre-fund the FSCS in the future; and measures further to protect holders of banknotes issued by commercial banks in Scotland and Northern Ireland.

3.55 The Government has already commenced important parts of the Banking Act 2009, including parts 1, 2 and 3 that introduce the special resolution regime. However, the Government is bringing forward further important steps to improve arrangements for dealing with failures in the financial system. As a result:

- as indicated in the Pre-Budget Report, the Government is conducting a detailed review of the arrangements surrounding the insolvency of investment banks. To support this work, the Treasury has established an expert review group, to consider whether it would be appropriate to make changes to market or regulatory practice, or to lay secondary legislation, to address the issues that have emerged around prime brokerage; and
- the Government will also outline a programme of consultations to implement other parts of the Banking Act.

3.56 The authorities have taken decisive action to protect bank consumers should a bank fail, including the Banking Act 2009 measures to increase the efficiency of the FSCS (as outlined in Box 3.7), and increasing the deposit compensation limit to £50,000. The Government will propose measures both in the UK and through the EU to continue to increase consumer protection, including:

- consulting on proposals to allow the FSCS to operate more effectively across a wider remit;
- working with the European Commission and other Member States to ensure that the EU develops tools for early intervention and crisis management, building on the UK reforms put forward in the Banking Act 2009; and
- continuing to support reforms to strengthen deposit guarantee arrangements in the EU and to press for the introduction of guarantee schemes to cover insurance across the EEA.

Protecting and supporting consumers

3.57 The recent disruption has seriously affected consumers' trust and confidence in financial markets. These developments come in addition to longstanding problems in retail financial services markets. The Government is already acting to address some of these problems, including by improving financial capability, reducing financial exclusion and introducing straightforward stakeholder products. The FSA's retail distribution review will help to improve the quality of advice, and remove so-called commission bias from the market.

Retail Financial Services Forum

3.58 In the 2008 Pre-Budget Report, the Government announced the establishment of the Retail Financial Services Forum (RFSF), chaired by the Economic Secretary to the Treasury. The RFSF has a remit to champion retail financial consumers' interests and help restore confidence in financial services. The Government will ask the RFSF to act as a steering group for the development of some of the proposals set out below and will identify and take forward others.

3.59 In its forthcoming document, the Government will put forward measures to support:

- confident and capable consumers, able to exert competitive pressure on the industry – such as arrangements for delivering consumer education;
- high quality financial guidance – through taking steps to prepare for a national Money Guidance service, following the Thoresen Review published in March 2008 (see Chapter 5 for more details on measures to help consumers make confident, informed financial decisions);
- access for all citizens to simple, transparent, value for money products which meet their needs – including work through the RFSF and legislative changes where needed;
- appropriate levels of consumer protection – including an effective framework of mortgage and credit regulation; and
- swift redress if things do go wrong.

Improving efficiency and competition

3.60 This chapter has described the importance of the financial system to the wider economy and society. In addition, the financial sector is itself a major source of income, exports, and employment to the UK.

Banking industry structure

3.61 Financial markets have changed substantially in recent years. Consolidation has accelerated, with a move towards larger financial institutions in many countries, including the UK. These developments are, to an extent, commercial matters. But they are also of concern for public policy – given their impacts on competition, consumers, and potentially, financial stability. There have been arguments made in favour of limiting banks in terms of the type of activity they undertake or the scale and complexity they can achieve. These issues are discussed in Box 3.8.

Box 3.8: Alternative approaches to regulating the banking sector

The banking sector can be regulated in a number of ways. One such way would be to introduce 'Glass-Steagall'-type provisions in the UK to divide investment-banking activities from core activities such as deposit-taking and lending, creating a 'narrow' versus 'broad' bank divide.^a Others have suggested that it might be desirable to limit the scale and complexity of banking institutions.

The arguments in support of such approaches generally focus on the need and ability to protect the core banking system from risks to depositors, the taxpayer and wider financial stability, while arguing that implicit or explicit guarantees should not be used to facilitate other forms of speculative activity. The complexity of institutions does appear in some cases to have contributed to difficulties in managing risk and, potentially, supervision. Smaller, simpler institutions can be tackled much more effectively through resolution tools, such as the Banking Act in the UK, than more complex ones. And, of course, the failure of those larger firms is likely to be much more damaging if it does occur.

However, there are arguments against this type of divide. In the past, contagion to other parts of the system was largely seen as taking place through depositors. Events of the last 18 months have demonstrated that channels of contagion have become more varied and complex. Banks of all sizes have encountered difficulties recently and it is difficult to say that larger banks are more likely to fail than small ones or vice versa. Narrower banks, such as Northern Rock and London Scottish in the UK, have experienced difficulties as well as broad banks, such as RBS. Dividing commercial and investment banking businesses would not address counterparty risk exposures between banks, nor would it necessarily insulate pure deposit taking institutions from the failure of a large investment bank, so some of the issues raised by current market disruption would remain. It is also the case that broader and larger banks allow for stronger connections between the banking sector and capital markets, potentially benefiting market efficiency.

Resolving these tensions is a difficult judgment. However, the Government is not persuaded of the case for introducing 'Glass-Steagall'-type approaches. The most appropriate way to support banking stability is to ensure that new capital and liquidity requirements are designed to constrain activities that are inherently more risky, such as some types of proprietary trading; while ensuring that banks are structured to facilitate sensible resolution if things go wrong; and that they be prohibited from using overly complex structures that inhibit effective risk management – or face considerably higher capital requirements as a result. The Government will consider these issues more fully in its forthcoming paper.

^aGlass-Steagall laws refer to provisions within the 1933 US Banking Act that created a separation of banking activities between commercial and investment banks. These measures were withdrawn in the US in the late 1990s.

Challenges 3.62 Key challenges for the medium-term to improve efficiency and competition include:

- planning for a coordinated reduction of state involvement in specific institutions over time, and acting to reduce distortions through the G20 and EU;
- considering steps to make it easier for new entrants to the financial services market in the context of the strengthening of financial regulation and consolidation within the financial sector; and
- supporting alternative ownership and business models to provide financial services (for example see discussion of mutual societies in Box 3.9). While global markets provide real benefits to customers and the wider economy, sometimes individuals and firms will want to deal with local providers, which understand and adapt to local circumstances.

3.63 As a result the Government will:

- continue to work closely with the G20 and the EU to ensure a coordinated reduction of state involvement in the financial sector;
- consider, building on the OFT financial services strategy published in April 2009⁵, how best to encourage new entrants to the financial services markets; and
- put forward proposals to encourage a diversity of ownership structures of financial institutions, in particular encouraging mutuals.

Box 3.9: Diversity of ownership and encouraging mutuals

Throughout the world, most countries have a variety of different types of credit institutions. In the US, there are large, mostly international, banks and state-run banks and savings institutions. In the rest of Europe, many countries have a strong presence of mutually-owned or even state-owned banking institutions. In the UK, the building society sector has traditionally had a strong role in providing mortgages and saving products, alongside commercial banks. Credit unions also provide an alternative to mainstream financial providers in local communities. Maintaining a diversity of ownership and business models provides some additional resilience. Diversity also provides a source of competition and choice in the market for consumers.

The Government has a longstanding aim of enabling the mutual sector to grow and serve a wider section of the community. Together, mutual societies – building societies, friendly societies, industrial and provident societies and credit unions – across the UK have a combined membership of over 30 million and total assets of over £400 billion.

As well as providing choice in financial services provision, the mutuals sector also contributes to financial inclusion and the strengthening of local communities. As institutions, they command a relatively high degree of trust among consumers, which is all the more important in today's economic climate.

The Government has supported a number of pieces of legislation to modernise the mutuals business model and achieve a level of parity with the company form. The Government is announcing an important tax change in relation to mergers between some financial mutuals, as noted later in this chapter. The Government will put forward further proposals in its forthcoming paper to strengthen the mutual sector. This will include actions relating to the development and design of capital instruments and the potential for shared services between mutuals.

⁵www.ofc.gov.uk

Dialogue with financial and professional services **3.64** The Government remains confident in the UK's position as a leading global finance centre in the medium- to long-term. In addition to shaping the future regulatory environment, the industry and the Government are working collaboratively on independent and joint actions that will strengthen the position of the UK financial and professional services sector over the next 10-15 years. As part of this work, the Government will press ahead with the implementation of the conclusions of the Rights Issues Review.

3.65 More generally, the Government will:

- continue to work closely with industry to prioritise and respond to the challenges facing sub-sectors such as insurance and asset management;
- consider, following the report of the Financial Services Global Competitiveness group, co-chaired by Sir Win Bischoff, to be published shortly, actions required to ensure that the UK financial services sector can maximise its contribution to its clients in the long-term;
- respond to the issues highlighted by the professional services industry in a recent report to Government, as crucial to its ability to contribute to the UK's productivity over the medium- to longer-term, such as nurturing skills and ensuring effective regulation; and
- continue deepening its economic and financial dialogues with key emerging markets such as China and India, providing a strong focus on market opportunities for UK-based firms.

Taxation of asset management **3.66** Budget 2009 brings to a conclusion work on an extensive package of measures to enhance the competitiveness of the UK as a centre for asset management (see Box 3.10).

Box 3.10: Taxation of asset management in the UK

Since publication of the Investment Management Association (IMA)/KPMG report on *Taxation and the Competitiveness of UK Funds*, the Government and the asset management industry have worked closely together to identify areas where tax reform could enhance the competitiveness of the UK in this sector. Advances to date include improved trust and understanding between Government, the FSA and the industry through quarterly meetings; a new tax efficient structure for funds which invest in property; replacing the tax rules for the Qualified Investor Scheme; HMRC guidance to give greater certainty on trading and investment regarding certain financial services transactions; and extensive consultation on options for reform of stamp duty reserve tax (SDRT) Schedule 19.

Budget 2009 announces further measures which will bring a conclusion to this work:

- launching a new **Tax Elected Funds regime to enable Authorised Investment Funds (AIFs)** to market themselves more competitively; and
- legislating to **clarify whether certain transactions will be taxed as trading or investment for UK AIFs** and equivalent offshore funds.

The proposals set out in the IMA/KPMG report regarding SDRT Schedule 19 have also been considered very carefully, and the possibility of reform has been discussed at length. However, following extensive consultation and discussion with the industry **the Government has decided not to go ahead with reform of Schedule 19 at this time but to retain the current regime.**

Discussions with the broader asset management industry have highlighted other areas where tax reform can enhance UK competitiveness. Budget 2009 announces **a new tax framework for Investment Trust Companies** to enable tax-efficient investment in interest bearing assets.

Taken together this package of measures makes significant progress towards enhancing the competitiveness of the UK as a key international centre for asset management.

Islamic finance 3.67 The Government can also announce three further measures on alternative finance as part of the ongoing drive to promote the UK as a centre for Islamic finance:

- provision of **relief from stamp duty land tax (SDLT)** in respect of transactions undertaken as part of the issue of alternative finance property investment bonds;
- provision of **relief from tax on capital gains** in respect of these types of transactions; and
- **clarification of how the capital allowances regime will interact with these changes** on SDLT and tax on capital gains.

These changes aim to align tax treatment of alternative finance products with their conventional equivalents.

Taxation of mutual societies 3.68 A measure will be introduced to enable the removal of tax barriers to transfers of business between mutual societies taking place on or after 22 April 2009.

Strengthening regulators and the international regulatory framework

UK regulatory system 3.69 Recent actions taken to safeguard and strengthen the UK's banking system and wider financial stability have demonstrated the ability of the Bank of England, the FSA and the Treasury to work together in an effective and timely manner to stabilise banks and support the long-term strength of the economy. It is also important that lessons are learned from the experience of recent events. The FSA recognised weaknesses in its supervision of Northern Rock and has implemented a far-reaching supervisory enhancement programme to improve its supervision of at-risk firms. The Banking Act 2009 strengthened the Bank of England's role in financial stability and modernised its governance arrangements. Finally, new challenges have arisen, in particular for the FSCS, given its significant borrowing and potential future role in managing any pre-funded scheme.

3.70 Following on from this work, the Government will bring forward proposals regarding the governance and accountability of the FSCS and the Financial Ombudsman Service to ensure that they are best able to respond to these challenges.

Macro-prudential approach 3.71 The G20 and the Turner Review considered the importance of a macro-prudential approach. Financial regulation to date has been based largely on the premise that if individual banks are sound, then the financial system overall is sound. This, as we now know, is insufficient for financial and economic stability. While each institution may have acted in compliance with its regulations, the rapid rise in leverage, asset prices, financial interconnectedness; and consequent deterioration in credit quality across the system created fragilities which allowed shocks to be amplified through markets and across institutions to such an extent as to risk undermining the capital supporting the entire banking system. As outlined in Box 3.11 below, the Government will consider further options to deliver a macro-prudential approach effectively in the UK.

International framework 3.72 Internationally, institutional changes are also required and the Government will take a lead through:

- continuing to press for the establishment of supervisory colleges, in line with the G20 commitment to establish the remaining colleges for significant cross-border firms by June 2009, to strengthen their ability to monitor and deal with risks in individual firms;

- with the FSA and the Bank of England, setting up cross-border stability groups with those countries with which it has significant shared financial market interests, consistent with the G20 commitment to implement the FSB principles for cross border crisis management immediately; and
- reviewing the sustainability of the current business models of offshore financial jurisdictions, as discussed in the Foot Review, described earlier in this chapter.

Box 3.11: Macro-prudential approach to financial regulation

A macro-prudential approach to regulation is designed to reduce the frequency and impact of systemic financial crises. It is “macro” in the sense that it goes beyond treating each customer, institution, or market in isolation but recognises the links between them both in an economic upturn and how they might change in a downturn.

The recent financial market disruption has highlighted several possible market failures that can create systemic risk, although real time diagnosis and solutions are often far more challenging than might first appear. Examples include asset bubbles, pro-cyclical bank capital, excessive leverage, fire sales in systemically important asset markets, opaque counter-party credit risk chains and institutions, markets or products too big or interconnected to fail. While not exhaustive, this list captures some of the interactions that are at the centre of the recent financial disruption.

A macro-prudential approach needs to be designed to complement traditional institution-by-institution prudential regulation to take account of how financial institutions interact together through markets with the aim of preventing systemic crises. It is not a panacea but a necessary part of a comprehensive macroeconomic framework for stability.

Internationally, a new Financial Stability Board (FSB) has been established to take account of macro-prudential risks. The FSB’s mandate includes monitoring and advising on market developments and best practice in regulatory standards; and collaborating with the IMF on macro-prudential surveillance. G20 leaders have also agreed to reshape their regulatory systems so that they are able to identify and take account of macro-prudential risks and to extend regulation and oversight to all systemically important financial institutions, instruments and markets. Alongside this, in the EU, there is general support for establishing an EU-level macro-prudential body. This body should interact with the new wider international arrangements being discussed within the G20.

In the UK, the Government will put forward proposals on the best institutional arrangements to deliver an effective macro-prudential approach, involving the FSA, the Bank of England, and the Treasury. This will include consideration of what arrangements are necessary to identify and respond to macro-prudential risks and how this will operate within the Government’s existing macroeconomic framework. Some of the key issues to consider will be:

- how best to incorporate a macro-prudential approach into the framework consistent with the guiding principles and responsibilities described in the Memorandum of Understanding, discussed earlier in this chapter;
- ensuring that any macro-prudential approach takes advantage of synergies with the existing capabilities and expertise of the relevant authorities;
- ensuring that the different authorities’ macro-prudential responsibilities are consistent with their current objectives and responsibilities; and
- interactions between a macro-prudential approach and the wider macroeconomic framework.

Further steps

3.73 Building on issues discussed in this chapter, the Government will, before the summer, set out its approach to renewing financial markets for the long term, exploring these issues in greater detail and updating on progress on the G20 work and an outline programme for the implementation of the Banking Act 2009.