



## Update on UK Government's Banking Support Measures and the Banking Act 2009

Our client alert dated 4<sup>th</sup> February 2009, "[UK Government's Banking Support Measures](#)," reported on the comprehensive programme of legislative and financial measures introduced by the UK Government ("Govt.") to help support the UK banking industry through the ongoing global financial turmoil. This programme comprised the Banking Bill involving long-term regulatory reforms, as well as measures designed to provide more immediate financial relief which the Govt. announced on 8<sup>th</sup> October 2008 and 19<sup>th</sup> January 2009, respectively.

The Banking Bill has now received royal assent, creating the Banking Act 2009<sup>1</sup> effective from 21<sup>st</sup> February 2009, together with a series of statutory instruments to implement its provisions. In addition, the Govt. has published further details relating to the operation of the Asset Protection Scheme ("APS") and the Asset Purchase Facility ("APF") which were initially announced on 19<sup>th</sup> January 2009.

We summarise the latest developments below.

### I. The Banking Act 2009

The most fundamental changes introduced by the Banking Act 2009 are as follows:

Part 1 of the Banking Act 2009 replaces the temporary Special Resolution Regime ("SRR") provided by the Banking (Special Provisions) Act 2008 (which expired on 20<sup>th</sup> February 2009) and implements a new permanent SRR, which provides the UK's HM Treasury ("HMT"), the Bank of England (the "BOE") and the Financial Services Authority ("FSA") (together, the "Tripartite Authorities") with new tools to deal with failing banks and building societies through to an orderly resolution.

Part 2 introduces the new Bank Insolvency Procedure ("BIP"), providing for the orderly winding up of a failed or failing bank with a view to speedy compensation of depositors under the Financial Services Compensation Scheme ("FSCS").

Part 3 introduces the new Bank Administration Procedure ("BAP"), designed to ensure a smooth transition where only a part of a failing bank's business assets or liabilities have been transferred (to a private sector purchaser or bridge bank) under the SRR, prior to the winding up of the failing bank.

In addition, Part 7 authorises HMT to enact regulations to create a new "investment bank insolvency procedure" for UK investment banks which hold client assets.

<sup>1</sup> Banking Act 2009, [http://www.opsi.gov.uk/acts/acts2009/pdf/ukpga\\_20090001\\_en.pdf](http://www.opsi.gov.uk/acts/acts2009/pdf/ukpga_20090001_en.pdf). See also HMT's press notice on "New Banking Act comes into effect" (23<sup>rd</sup> February 2009), [http://www.hm-treasury.gov.uk/press\\_16\\_09.htm](http://www.hm-treasury.gov.uk/press_16_09.htm).

Certain existing legislation, such as the Financial Services and Markets Act 2000 and the Companies Act 2006, have been amended, also with effect from 21<sup>st</sup> February 2009, to ensure that BIP and BAP under the Act work in a similar way to the underlying procedures on which they have been based.<sup>2</sup>

### ***SRR and Partial Transfers***

Under SRR, the Tripartite Authorities have the power to transfer all or a part of a failing bank's property, overriding outstanding contractual or other legal rights in the process. To address the "potentially negative effects of unfettered partial transfers" highlighted by the feedback from market participants<sup>3</sup> during HMT's public consultation on SRR and expert advice from the Banking Liaison Panel ("BLP"),<sup>4</sup> two statutory instruments have been adopted under the Banking Act 2009.

#### *The Banking Act 2009 (Restriction of Partial Property Transfers) Order 2009*

The Banking Act 2009 (Restriction of Partial Property Transfers) Order 2009<sup>5</sup> lays down certain safeguards for partial property transfers under SRR for "protected" categories of transactions and arrangements, including the following:

1) "Set-off and netting"

Set-off and netting arrangements and title transfer financial collateral arrangements (e.g., English law ISDA Credit Support Annex) are "protected rights" and as such, may only be transferred in whole and may not be modified or terminated, in each case as long as they do not constitute "excluded rights" or "excluded liabilities." Excluded rights and liabilities are defined as those that relate to:

- i) retail bank deposits;
- ii) retail liabilities owed to a bank;
- iii) contractual rights unrelated to financial instruments, deposits or loans;
- iv) damages or indemnity claims relating to financial instruments, deposits or loans; and
- v) subordinated debt issued by the bank or its counterparty.

Some concerns have been raised that the definition of financial instruments may not include all derivative transactions commonly documented under master netting agreements, including spot and forward FX contracts. There is also a concern that if one transaction documented under a master netting agreement does not fall within the definition of financial instruments, the entire arrangement would not be protected under these provisions.<sup>6</sup>

<sup>2</sup> The Banking Act 2009 (Parts 2 and 3 Consequential Amendments) Order 2009, [http://www.opsi.gov.uk/si/si2009/pdf/uksi\\_20090317\\_en.pdf](http://www.opsi.gov.uk/si/si2009/pdf/uksi_20090317_en.pdf).

<sup>3</sup> HMT's consultation paper, "Special Resolution Regime: Safeguards for Partial Property Transfers" (6<sup>th</sup> November 2008), [http://www.hm-treasury.gov.uk/d/specialresolutionregime\\_061108.pdf](http://www.hm-treasury.gov.uk/d/specialresolutionregime_061108.pdf).

<sup>4</sup> The "expert liaison group" of representatives from HMT, FSA, the BOE, FSCS, and the banking industry formed by the HMT in October 2008 to advise the ministers on the secondary legislation implementing the SRR under the Banking Bill has been placed on a statutory footing as the "Banking Liaison Panel" under Section 10 of the Banking Act 2009.

<sup>5</sup> The Banking Act 2009 (Restriction of Partial Property Transfers) Order 2009, [http://www.opsi.gov.uk/si/si2009/pdf/uksi\\_20090322\\_en.pdf](http://www.opsi.gov.uk/si/si2009/pdf/uksi_20090322_en.pdf).

<sup>6</sup> See ISDA letter to HMT dated 27<sup>th</sup> February 2009 under the heading of "Banking Act 2009 – Safeguards Order – scope of netting and set-off," <http://www.isda.org/speeches/pdf/ISDA-HMT-Feb09.pdf>.

## 2) “Secured liabilities”

Secured liabilities may only be transferred together with the benefit of the related security interests, including floating charges. Similarly, property subject to security may only be transferred together with the liability that is secured by that property and the benefit of the related security interests, again including floating charges.

In addition, any partial property transfer may not make provision for the termination or modification of an arrangement if the effect of that provision is to provide that the liability is no longer secured against the property or right.

## 3) “Capital market arrangements”

Capital market arrangements may only be transferred in whole, not in part, and may not be modified or terminated, in each case unless they relate solely to deposits. Here the term capital market arrangement is used as defined in paragraph 1 of Schedule 2A<sup>7</sup> to the Insolvency Act 1986, as amended by Enterprise Act 2002, and refers to an arrangement which involves a grant of security to a trustee or other party to a capital market investment (e.g., securitisations and covered bonds).

## 4) “Financial markets”

A partial property transfer is not permitted to the extent it would modify or render unenforceable:

- i) a market contract;<sup>8</sup>
- ii) the default rules<sup>9</sup> of a recognised investment exchange or recognised clearing house and market contracts; or
- iii) the rules of a recognised investment exchange or recognised clearing house on the settlement of market contracts not dealt with under its default rules.

## 5) “Reverse property transfers”

Where under SRR either (a) the BOE has made a property transfer instrument to a bridge bank under SRR or (b) HMT has made a property transfer order to a wholly owned subsidiary of BOE or HMT or a nominee of HMT (for temporary public ownership), any subsequent reverse property transfer may not transfer back, *inter alia*, any rights and liabilities under a financial instrument.

## 6) “Termination rights”

A property transfer instrument may stipulate that Section 38(6) or (7) of the Banking Act 2009 shall apply, such that the instrument is to be disregarded in determining whether a default event provision applies, either completely or except as otherwise provided by the instrument itself.

<sup>7</sup> Enterprise Act 2002, [http://www.opsi.gov.uk/acts/acts2002/ukpga\\_20020040\\_en\\_44#sch18](http://www.opsi.gov.uk/acts/acts2002/ukpga_20020040_en_44#sch18), which amends Insolvency Act 1986, <http://www.insolvency.gov.uk/insolvencyprofessionandlegislation/legislation/uk/insolvencyact.pdf>.

<sup>8</sup> As defined in Section 155 of the Companies Act 1989, [http://www.opsi.gov.uk/si/si2009/pdf/uksi\\_20090322\\_en.pdf](http://www.opsi.gov.uk/si/si2009/pdf/uksi_20090322_en.pdf).

<sup>9</sup> As defined in Section 188 of the Companies Act 1989, [http://www.opsi.gov.uk/si/si2009/pdf/uksi\\_20090322\\_en.pdf](http://www.opsi.gov.uk/si/si2009/pdf/uksi_20090322_en.pdf).

A partial property transfer may not provide for Section 38(6) or (7) of the Banking Act 2009 (Termination rights, etc.) to apply to:

- i) a relevant financial instrument to the extent that it confers rights and liabilities (except excluded rights or excluded liabilities) which either party to the instrument is entitled to set-off or net under a set-off arrangement, netting arrangement or title transfer financial collateral arrangement; or
- ii) a set-off or netting arrangement or title transfer financial collateral arrangement to the extent that it confers a right to set-off or net rights and liabilities (except excluded rights or excluded liabilities) under a relevant financial instrument.

*The Banking Act 2009 (Third Party Compensation Arrangements for Partial Property Transfers) Regulations 2009*

The Banking Act 2009 (Third Party Compensation Arrangements for Partial Property Transfers) Regulations 2009<sup>10</sup> provide for the payment of compensation to “pre-transfer creditors” (i.e., those who were creditors of the bank before the partial property transfer was made) who are left in the residual bank, where they are made “worse off” than they would have been had the bank been liquidated. It also provides for an independent valuation mechanism to determine the appropriate level of compensation.

*Special Resolution Regime Code of Practice*

The SRR Code of Practice was published by HMT on 23<sup>rd</sup> February 2009 to provide the Tripartite Authorities with guidance on the use of the SRR stabilisation options, BIP and BAP.<sup>11</sup> Section 5(4) of the Banking Act 2009 requires that the Tripartite Authorities observe the SRR Code of Practice.

HMT will periodically update or amend the SRR Code of Practice in the light of “evolving experience,” in consultation with FSA, the BOE and FSCS, and/or with BLP, as appropriate.

***BIP***

The aim of the new BIP under Part 2 of Banking Act 2009 is the orderly winding up of a failing bank, including in particular speedy compensation payments from the FSCS to eligible depositors, or the transfer of their deposit accounts to another financial institution. The Bank Insolvency (England & Wales) Rules 2009,<sup>12</sup> effective from 25<sup>th</sup> February 2009, set out the procedures for the appointment of a bank liquidator and the operation of BIP in England and Wales. In order to avoid a “run” on the failing bank and to preserve its assets, the Rules modify the process of applying for a bank insolvency order so as to facilitate a prompt court hearing.

Similar to Rule 4.90 of the Insolvency Rules 1986, Rule 72 of the Bank Insolvency (England & Wales) Rules 2009 provide for the mandatory set-off of mutual credits and debits.

As a result of FSA’s ongoing consultation, however, FSCS may be amended to make compensation payments to eligible depositors on a “gross” basis, ignoring (i.e., without setting off) any debts owed by the eligible depositor to the failed bank. In anticipation of this possible change to FSCS, Rule 73 provides that, with regard to eligible depositors, set-off will only be applicable to any account balance(s) exceeding the compensation limit.

<sup>10</sup> The Banking Act 2009 (Third Party Compensation Arrangements for Partial Property Transfers) Regulations 2009, [http://www.opsi.gov.uk/si/si2009/pdf/uksi\\_20090319\\_en.pdf](http://www.opsi.gov.uk/si/si2009/pdf/uksi_20090319_en.pdf).

<sup>11</sup> HMT’s Special Resolution Regime: Code of Practice (23<sup>rd</sup> February 2009), [http://www.hm-treasury.gov.uk/d/bankingact2009\\_codeofpractice.pdf](http://www.hm-treasury.gov.uk/d/bankingact2009_codeofpractice.pdf).

<sup>12</sup> Bank Insolvency (England & Wales) Rules 2009, [http://www.opsi.gov.uk/si/si2009/pdf/uksi\\_20090356\\_en.pdf](http://www.opsi.gov.uk/si/si2009/pdf/uksi_20090356_en.pdf).

**BAP**

New BAP under Part 3 of the Banking Act 2009 applies where there has been a transfer of only a part of a failing bank's business under the SRR, leaving an insolvent residual entity, and is designed to ensure that essential services and facilities continue to be provided to the transferee bank to enable it to operate effectively during the period between the date of the transfer and the end of the failing bank's administration.

*Bank Administration (England and Wales) Rules 2009*

In order to implement new BAP in England and Wales, HMT introduced, with effect from 21<sup>st</sup> February 2009, the Bank Administration (England and Wales) Rules 2009,<sup>13</sup> which include provisions on the following:

- i) the application for a Bank Administration Order;
- ii) the bank administration process;
- iii) the court procedure and practice in relation to BAP; and
- iv) the application of specified provisions of the Insolvency Rules 1986.

*Banking Act 2009 (Bank Administration) (Modification for Application to Banks in Temporary Public Ownership) Regulations 2009*

The Banking Act 2009 (Bank Administration) (Modification for Application to Banks in Temporary Public Ownership) Regulations 2009,<sup>14</sup> modify Part 3 of the Banking Act 2009 (which sets out new BAP) where HMT makes a property transfer order to transfer a part of the business of a bank in temporary public ownership to a bridge bank (i.e., a company wholly owned by the BOE or HMT, or a nominee of HMT), or to a private sector purchaser.

*Banking Act 2009 (Bank Administration) (Modification for Application to Multiple Transfers) Regulations 2009*

The Banking Act 2009 (Bank Administration) (Modification for Application to Multiple Transfers) Regulations 2009<sup>15</sup> modify Part 3 of the Banking Act 2009 where more than one property transfer instrument is made by the BOE (e.g., first to a bridge bank, then onward to an end transferee).

*Bank Administration (Sharing Information) Regulations 2009*

Bank Administration (Sharing Information) Regulations 2009<sup>16</sup> mandate information sharing between a bank administrator, the BOE and a bridge bank after a partial transfer to a bridge bank, in order to help facilitate the bank administrator's performance of his functions in BAP.

<sup>13</sup> Bank Administration (England and Wales) Rules 2009, [http://www.opsi.gov.uk/si/si2009/pdf/uksi\\_20090357\\_en.pdf](http://www.opsi.gov.uk/si/si2009/pdf/uksi_20090357_en.pdf).

<sup>14</sup> Banking Act 2009 (Bank Administration) (Modification for Application to Banks in Temporary Public Ownership) Regulations 2009, [http://www.opsi.gov.uk/si/si2009/pdf/uksi\\_20090312\\_en.pdf](http://www.opsi.gov.uk/si/si2009/pdf/uksi_20090312_en.pdf).

<sup>15</sup> Banking Act 2009 (Bank Administration) (Modification for Application to Multiple Transfers) Regulations 2009, [http://www.opsi.gov.uk/si/si2009/pdf/uksi\\_20090313\\_en.pdf](http://www.opsi.gov.uk/si/si2009/pdf/uksi_20090313_en.pdf).

<sup>16</sup> Banking Administration (Sharing Information) Regulations 2009, [http://www.opsi.gov.uk/si/si2009/pdf/uksi\\_20090314\\_en.pdf](http://www.opsi.gov.uk/si/si2009/pdf/uksi_20090314_en.pdf).

## II. Details of the UK Government's Second Package of Banking Support Measures for the UK Banking Industry

### *Asset Purchase Facility ("APF")*

The Govt. initially announced the APF on 19<sup>th</sup> January 2009 as part of its second package of banking support measures. Details of the APF were subsequently outlined in an exchange of letters dated 29<sup>th</sup> January 2009 between Alistair Darling, Chancellor of the Exchequer, and Mervyn King, BOE Governor.<sup>17</sup>

Under the APF, BOE will make purchases of high quality (i.e., broadly equivalent to "investment grade") private sector assets up to £50 billion for which BOE is satisfied that there is a "viable private market demand" (or a "genuine private demand in normal conditions"), initially covering sterling-denominated commercial paper, corporate bonds and debt.

In order to implement the APF, the BOE has established a wholly owned subsidiary named the "Bank of England Asset Purchase Facility Fund Limited" (the "APF Fund"). The APF Fund will only purchase from companies which make "a material contribution to economic activity in the United Kingdom." UK-incorporated companies, including UK subsidiaries of foreign companies, which are of a sufficient size to sustain a commercial paper programme and have a genuine business in the UK will normally be regarded as meeting this requirement.

On 6<sup>th</sup> February 2009, the BOE published a market notice<sup>18</sup> setting out how it initially intends to operate its new APF. This was updated on 13<sup>th</sup> February 2009 by a further market notice concerning the purchase of commercial paper under the APF (the "Commercial Paper Facility" or "CPF")<sup>19</sup> and the publication of a standard form application to establish issuer eligibility for the secondary market purchases under the APF.

To assist eligible issuers to take advantage of the APF, on 11<sup>th</sup> February 2009, the BOE also published the following relevant documents:

- Application form and questionnaire for applicants seeking to become counterparties in the CPF;<sup>20</sup>
- Settlement procedures for counterparties participating in the APF;<sup>21</sup>
- Terms and conditions for counterparties in the APF;<sup>22</sup> and
- A set of *pro forma* documents,<sup>23</sup> consisting of:
  - i) the form of parent company guarantee to be provided in connection with the APF,
  - ii) the form of legal opinion on any guarantee provided in connection with the APF,

<sup>17</sup> Letter from the Chancellor to the Governor (29<sup>th</sup> January 2009), [http://www.hm-treasury.gov.uk/d/ck\\_letter\\_boe290109.pdf](http://www.hm-treasury.gov.uk/d/ck_letter_boe290109.pdf) and Letter from the Governor to the Chancellor (29<sup>th</sup> January 2009), <http://www.bankofengland.co.uk/markets/apfgovletter090129.pdf>. See also the BOE's news release on APF (29<sup>th</sup> January 2009), <http://www.bankofengland.co.uk/publications/news/2009/005.htm>.

<sup>18</sup> The BOE's news release on APF (6<sup>th</sup> February 2009), <http://www.bankofengland.co.uk/publications/news/2009/009.htm>; Bank of England Market Notice: Asset Purchase Facility (6<sup>th</sup> February 2009), <http://www.bankofengland.co.uk/markets/marketnotice090206.pdf>.

<sup>19</sup> Bank of England Market Notice: Asset Purchase Facility – Commercial Paper Facility (13<sup>th</sup> February 2009), <http://www.bankofengland.co.uk/markets/marketnotice090213.pdf>.

<sup>20</sup> Application form and questionnaire for applicants wishing to become counterparties in the BOE's CPF (9<sup>th</sup> February 2009), <http://www.bankofengland.co.uk/markets/apf/appform-questionnaire-cpf.doc>.

<sup>21</sup> Settlement procedures for counterparties participating in the BOE's APF (9<sup>th</sup> February 2009), <http://www.bankofengland.co.uk/markets/apf/settlementprocedures.pdf>.

<sup>22</sup> Terms and Conditions for Counterparties in the BOE's APF (11<sup>th</sup> February 2009), <http://www.bankofengland.co.uk/markets/apf/termsandconditions090211.pdf>.

<sup>23</sup> Pro forma documents for BOE's APF (16<sup>th</sup> February 2009), consisting of: (i) Guarantee provided in connection with the facility, <http://www.bankofengland.co.uk/markets/apf/proformaguarantee.doc>; (ii) Legal opinion on a guarantee provided in connection with the facility, <http://www.bankofengland.co.uk/markets/apf/proformalegalopinion.doc>; (iii) Bank of England Asset Purchase Facility/ Commercial Paper Facility – Issuer Eligibility Pro-Forma for Purchases in the Primary Market, <http://www.bankofengland.co.uk/markets/apf/issuer-eligibility-proforma-primary.xls>; and (iv) Issuer eligibility cover letter, <http://www.bankofengland.co.uk/markets/apf/issuecoverletter.doc>.

- iii) the form of issuer eligibility form for purchases in the primary market, and
- iv) the form of issuer eligibility cover letter.

The BOE will keep under review whether to expand the list of eligible assets or currencies which may be purchased by the APF Fund and whether to hedge any of the risks in the APF Fund's portfolio of assets.

#### *Commercial Paper Facility ("CPF")*

Under the CPF, the BOE, via the APF Fund, will purchase investment grade commercial paper issued by UK companies at a minimum spread over risk-free rates, both at initial issuance from dealers in primary market and after issuance from other eligible counterparties in secondary market.

Other eligibility conditions also apply as to the issuer, the features of the commercial paper, counterparty, purchase limit set by the BOE for a particular issuer (which the BOE will make available if requested but only to that issuer) and the relevant application and settlement procedures.

Non-bank financial companies qualify as eligible issuers in principle, if they can convince the BOE that they make a "significant contribution to corporate financing in the UK." On the other hand, leveraged investment vehicles are not eligible issuers under the CPF.

To be eligible, commercial paper must, among other things, (i) be denominated in sterling, (ii) have a maturity of three months if issued to the APF Fund via a dealer, or have a residual maturity of three months or less if sold to the APF Fund in the secondary market, (iii) not have non-standard features (e.g., extendability, subordination) and (iv) not be asset-backed commercial paper.

During the two weeks from the launch of the CPF on 13<sup>th</sup> February 2009 to 26<sup>th</sup> February 2009, the BOE's APF Fund reportedly purchased £820 million of commercial paper.

#### *Corporate Bond Secondary Market Scheme ("CB SMS")*

On 19<sup>th</sup> March 2009, the BOE published a market notice<sup>24</sup> and relevant documents<sup>25</sup> concerning the CB SMS to be implemented under the APF from 25<sup>th</sup> March 2009.

Under the CB SMS, the BOE will make regular small purchases, via reverse auctions, of a wide range of high credit quality sterling corporate bonds, in order to boost secondary market liquidity initially by facilitating market-making by banks and dealers. Corporate bonds issued by non-bank financial companies (excluding building societies, leveraged finance companies and companies within groups that are predominantly credit institutions or investment banks) will be eligible in principle, subject to BOE being satisfied that the issuer makes a significant contribution to corporate financing in the UK.

The eligibility criteria for eligible corporate bonds under the CB SMS include the following:

- i) conventional senior, unsubordinated debt (excluding convertible or exchangeable bonds and bonds with complex or non-standard features);

<sup>24</sup> Bank of England Market Notice: Asset Purchase Facility (19<sup>th</sup> March 2009), <http://www.bankofengland.co.uk/markets/marketnotice090319.pdf>. See also the BOE's news release "Corporate Bond Secondary Market Purchase Scheme," <http://www.bankofengland.co.uk/publications/news/2009/025.htm>.

<sup>25</sup> Bank of England Asset Purchase Facility: Bonds Eligible for the Corporate Bond Secondary Market Scheme (as at 19<sup>th</sup> March 2009), <http://www.bankofengland.co.uk/markets/apf/corp-bond-eligibilitylist.xls>; Application Form for CB SMS and/or CGS SMS, [www.bankofengland.co.uk/markets/apf/index.htm](http://www.bankofengland.co.uk/markets/apf/index.htm). See also Terms and Conditions for APF, [www.bankofengland.co.uk/markets/apf/index.htm](http://www.bankofengland.co.uk/markets/apf/index.htm).

- ii) a minimum long-term credit rating of BBB-/Baa3 from at least two of Standard and Poor's, Moody's and Fitch;
- iii) minimum issue amount of £100 million;
- iv) issued at least one month ago;
- v) minimum residual maturity of 12 months (but no perpetual debt);
- vi) cleared and settled through Euroclear and/or Clearstream; and
- vii) admitted to listing on an EU stock exchange.

#### *Credit Guarantee Scheme Secondary Market Scheme ("CGS SMS")*

BOE announced on 19<sup>th</sup> March 2009<sup>26</sup> that it will activate the CGS SMS, "contingent on a deterioration in market conditions," standing ready to purchase through reverse auctions eligible securities issued by banks under HMT's Credit Guarantee Scheme ("CGS") if it would be "beneficial to provide a backstop bid for eligible securities." Initially only sterling-denominated publicly issued CGS will be eligible.

#### *Potential Inclusion of Syndicated Loans and Certain ABS in the Future*

The BOE intends to consult more broadly on the possible extension of the APF to syndicated loans and ABS created in "viable securitisation structures."

#### *Asset Protection Scheme ("APS")*

Initially announced as part of the second package of banking support measures on 19<sup>th</sup> January 2009,<sup>27</sup> the APS enables participating banks to insure a proportion of eligible assets through HMT, helping to reduce the uncertainty regarding their value given abnormal market conditions and thereby freeing up the healthier core of their commercial business to continue lending.

On 26<sup>th</sup> February 2009, HMT published a detailed statement on its operation of the APS, including a term sheet for participants in the scheme.<sup>28</sup>

UK-incorporated authorised deposit-takers (including UK subsidiaries of foreign institutions) (and possibly their affiliates) may participate in the APS if they have more than £25 billion of "eligible assets" on their balance sheet as at 31<sup>st</sup> December 2008, to include corporate and leveraged loans, residential and commercial property loans, structured credit assets (e.g., residential or commercial mortgage-backed securities, collateralised loan obligations and collateralised debt obligations).

Under the APS, HMT will, in return for a fee, provide the participating bank with protection against future credit losses on eligible assets to the extent they exceed a "first loss amount," provided that the bank must retain a further residual exposure of 10% of the losses exceeding the "first loss amount."

<sup>26</sup> Bank of England Market Notice: Asset Purchase Facility (19<sup>th</sup> March 2009), <http://www.bankofengland.co.uk/markets/marketnotice090319.pdf>. See also Application Form for CB SMS and/or CGS SMS, [www.bankofengland.co.uk/markets/apf/index.htm](http://www.bankofengland.co.uk/markets/apf/index.htm) and Terms and Conditions for APF, [www.bankofengland.co.uk/markets/apf/index.htm](http://www.bankofengland.co.uk/markets/apf/index.htm).

<sup>27</sup> HMT's press notice 07/09 dated 19<sup>th</sup> January 2009 on "Statement on the Government's Asset protection scheme," [http://www.hm-treasury.gov.uk/press\\_07\\_09.htm](http://www.hm-treasury.gov.uk/press_07_09.htm).

<sup>28</sup> HMT's "Statement on the Government's Asset Protection Scheme" (26<sup>th</sup> February 2009), [http://www.hm-treasury.gov.uk/d/press\\_18\\_09.pdf](http://www.hm-treasury.gov.uk/d/press_18_09.pdf); See also HMT's press notice on "Asset Protection Scheme and Increased Lending" (26<sup>th</sup> February 2009), [http://www.hm-treasury.gov.uk/press\\_19\\_09.htm](http://www.hm-treasury.gov.uk/press_19_09.htm).

In order to access the APS, participating banks will be required, among other things:

- i) to pay a fee,
- ii) to give verifiable legal commitments to increase lending they provide to credit-worthy borrowers, and
- iii) to develop a sustainable long-term remuneration policy consistent with the detailed principles in the FSA's Code of Practice on Remuneration Policies, published for consultation on 26<sup>th</sup> February 2009.<sup>29</sup>

HMT will publish finalised APS rules in due course.

#### *Banks Participating in the APS to Date*

The first to tap the APS, Royal Bank of Scotland ("RBS") on 26<sup>th</sup> February 2009 announced that HMT agreed to insure £325 billion of its assets in exchange for a £6.5 billion fee (2% of the total assets insured) to be paid for in non-voting equity shares.<sup>30</sup>

RBS will be responsible for a "first loss" of 6% of the value of the assets if the loans or assets default (i.e., £19.5 billion). Beyond such "first loss," HMT will cover 90% of the remaining loss, with RBS retaining the risk on the other 10%. The insurance arrangement will last at least 5 years.

Likewise, Lloyds Banking Group ("Lloyds") announced on 7<sup>th</sup> March 2009<sup>31</sup> that £260 billion of its assets (83% of them being HBOS legacy loans) will be insured under the APS, in return for a participation fee of £15.6 billion (6% of the total assets insured), which will be paid for by issuing non-voting B shares to HMT which will be convertible at the option of HMT into ordinary shares. Lloyds will be responsible for a £25 billion (9.6% of the total assets insured) "first loss" and another 10% of any further losses.

As in RBS's agreement with HMT, Lloyds has made commitments:

- to make additional lending commitments; and
- to review and implement a remuneration policy consistent with the principles set out in the FSA's draft code of practice on remuneration policies.

In addition, Lloyds has agreed to replace the £4 billion preference shares held by HMT with new ordinary shares, which will be offered to existing shareholders on a pre-emptive basis. If existing shareholders do not purchase any of the new shares, HMT's shareholding in Lloyds will increase to 65% (from the current 43%). If HMT were to convert all the B shares into ordinary shares, its shareholding in Lloyds could even rise to 77%. However, HMT has agreed to limit any conversion such that its aggregate ordinary shareholding will not be more than 75%.

Other eligible institutions have until 31<sup>st</sup> March 2009 to apply to participate in the APS.

<sup>29</sup> FSA draft Code of practice on remuneration policies (26<sup>th</sup> February 2009),

[http://www.fsa.gov.uk/Pages/Library/Other\\_publications/Miscellaneous/2009/cop\\_remun.shtml](http://www.fsa.gov.uk/Pages/Library/Other_publications/Miscellaneous/2009/cop_remun.shtml).

<sup>30</sup> See Regulatory Announcement made by Royal Bank of Scotland, "RBS Group intended participation in HM Treasury Asset Protection Scheme and Additional Capital Raising" (26<sup>th</sup> February 2009),

<http://www.londonstockexchange.com/LSECWS/IFSPages/MarketNewsPopup.aspx?id=2099374&source=RNS> and HMT's press release "Asset protection scheme and increased lending" (26<sup>th</sup> February 2009), [http://www.hm-treasury.gov.uk/press\\_19\\_09.htm](http://www.hm-treasury.gov.uk/press_19_09.htm).

<sup>31</sup> See Regulatory Announcement made by Lloyds Banking Group, "Asset Protection Scheme" (9<sup>th</sup> March 2009),

<http://www.londonstockexchange.com/LSECWS/IFSPages/MarketNewsPopup.aspx?id=2107269&source=RNS> and HMT's press release "Asset Protection Scheme – agreement with Lloyds" (7<sup>th</sup> March 2009), [http://www.hm-treasury.gov.uk/press\\_19\\_09.htm](http://www.hm-treasury.gov.uk/press_19_09.htm).

*FSA's Assessment of the APS's Capital Implications*

On 26th February 2009, FSA published two related statements which outline its assessment of how the APS will affect the capital position of participating banks.<sup>32</sup> Although the precise capital impact will depend on such factors as the size of the first loss deduction, FSA expects that the Core Tier 1 ratio will improve, thereby making it easier for the banks participating in APS to provide new lending.

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*Because of the generality of this update, the information provided herein may not be applicable in all situations and should not be acted upon without specific legal advice based on particular situations.*

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<sup>32</sup> FSA statement on the capital implications of the APS (26<sup>th</sup> February 2009), <http://www.fsa.gov.uk/pages/Library/Communication/Statements/2009/aps.shtml>; Detailed FSA statement on the capital implications of the APS (26<sup>th</sup> February 2009), [http://www.fsa.gov.uk/pages/Library/Communication/Statements/2009/aps\\_detail.shtml](http://www.fsa.gov.uk/pages/Library/Communication/Statements/2009/aps_detail.shtml).