

Financial markets influence the lives of every individual and business in the country. They are the core mechanism by which resources are efficiently allocated in an economy and a key driver of productivity, growth and opportunities. Financial instability, to the extent that it disrupts financial markets, can therefore affect everybody.

Since July 2007, the global economy has experienced levels of financial instability not seen for generations. The causes of this instability are varied and global. They include both macroeconomic factors, such as global financial imbalances, and microeconomic factors, such as the failure of banks to manage financial risk. The trigger for the instability was the downturn in the US housing market, the 'subprime' end of which was a feature of many of the financial products that had been created in recent years. The instability grew steadily, peaking in the weeks following the collapse of Lehman Brothers, a US investment bank, in September 2008.

The Government's objectives for addressing these threats to the financial system have been consistent, and focused around the need to:

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

In September 2008, the crisis intensified and it became clear that not just individual institutions but the entire banking system was at risk of collapse. That would have had devastating consequences for UK households and businesses. The Government therefore intervened decisively to prevent systemic collapse. First, to address concerns about liquidity, at least £200 billion was made available to the Bank of England's existing Special Liquidity Scheme. Second, to address concerns about solvency, at least £50 billion was committed to a Bank Recapitalisation Fund. Third, to address concerns about funding, a credit guarantee scheme was established.

Other governments around the world have followed with similar steps and market reactions have been generally positive. However, markets remain fragile and volatile. The Government remains committed to taking action to meet its objectives.

Looking to the future, and given the global nature of this instability, the Government's international priorities include:

- **as the 2009 Chair of the G20, making rapid progress on priority issues for the future of the international financial regulatory system;**
- **ensuring that the EU learns the lessons from the crisis, in particular regarding supervision and deposit protection arrangements for banks operating across borders; and**
- **reviewing the long-term opportunities and challenges for the UK's crown dependencies and overseas territories as financial centres.**

Within the UK, the Government's immediate priorities include:

- **continuing to monitor the financial system to ensure it is able to support the wider economy, including through appropriate levels of lending to businesses and households;**
- **strengthening the Banking Bill to enhance the Authorities' ability to deal with banking group holding companies and the insolvency of investment firms; and**
- **introducing measures to facilitate the raising of equity capital.**

FINANCIAL MARKETS AND STABILITY

3.1 Since July 2007, the global financial system has endured greater instability than at any time for generations. The implications of the instability have been felt by every household and business in the country and are covered throughout this Pre-Budget Report. This chapter analyses the origins and development of the crisis and describes the UK's policy response. The chapter concludes by outlining the UK's priorities for building a stronger, more resilient and more competitive financial system for the future.

The role of financial markets

3.2 Efficient, fair and stable markets are an essential part of the financial system in all developed economies. The financial system performs a crucial role in securing the efficiency of the economy by:

- providing firms and individuals with a secure means by which to make and receive timely payments;
- monitoring the performance of borrowers on behalf of savers to ensure that funds are used appropriately and loans repaid in a timely manner;
- allowing credit-worthy borrowers to have access to funds with which to tide-over temporary income shocks, thereby avoiding costly disruptions to consumption and investment plans;
- allocating the savings of households and businesses to opportunities expected to yield the highest risk adjusted return, raising the sustainable rate of economic growth and employment; and
- allowing the diversification of risk and the distribution of remaining risks to those most willing and able to hold them.

3.3 In addition, the financial services sector itself is an important part of the UK economy. In 2007, the sector accounted for 7½ per cent of GDP, employed around 1 million people and contributed around 25 per cent of corporation tax receipts. In the first half of 2008, the UK's trade surplus in financial and insurance services combined was £21 billion, up £4½ billion on the previous year. The Government therefore remains committed to the medium- and long-term competitiveness of the financial services sector in the UK and measures aimed at achieving this are outlined in Chapter 4.

Financial instability

3.4 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. And a lack of confidence in the financial system can have a very damaging effect on everyday economic activity. It is for these reasons that ensuring financial stability is central to the Government's economic objectives; not for the financial sector itself but for the economy as a whole.

Box 3.1: The economic importance of banks

Financial systems determine the efficiency with which savings by households and firms are channelled into the most productive investment opportunities in the economy. They are the core mechanism by which resources are efficiently allocated throughout an economy and a key driver of productivity, growth and opportunities. The prosperity of developed economies is underpinned by the existence of a well functioning financial sector and a number of influential studies show that the efficiency of a country's financial system is critically important in determining its growth and dynamism.^a

The importance of banks rests on their business of making medium- and long-term loans to borrowers using the funds of depositors who may require repayment at very short notice. Banks pool customers' deposits together and act on their behalf by first assessing potential borrowers' ability to repay and then monitoring them to make sure the funds are used for the purpose agreed. Some banks rely on interbank markets to meet any additional funding requirements. By this process, banks enable households and businesses to borrow to purchase key items such as homes, or invest in new opportunities, repaying depositors with interest as loan repayments are made. This process creates an efficient allocation of finance at the centre of all modern economies.

However, the nature of this business carries inherent risk. If a large number of depositors demand immediate repayment of their savings, a bank without access to alternative funds would be forced to call in outstanding loans at short notice, causing severe disruption for borrowers and the wider economy. If the bank is judged to be solvent, central banks may provide access to funds, but at a penalty rate and secured against good quality collateral. In extreme cases, such distress at one bank can spread to other banks. Where this raises risks to the whole banking system, the potential cost in terms of bail-outs or loss of economic output and employment can be very high.

In the current global banking crisis, the inability to assess possible losses on complex assets has led to a sharp and widespread increase in the cost of funding for all banks around the world. This has led to higher borrowing costs for households and companies, pushing many advanced economies into recession. It also raised the risk of a systemic collapse, which would mean greater losses in output, employment and ultimately taxpayers' money. The Government's policy response to this challenge is described throughout this chapter.

^a See for example: Levin, R (2004): *Finance and Growth: Theory and Evidence*, NBER Working Paper

**The UK financial
stability
framework**

3.5 The core role of the banking system, and in particular the risk that bank failures pose for the wider economy, requires sector-specific regulation. In the UK, the framework to protect financial stability is enshrined in the 2006 Memorandum of Understanding (MoU) between HM Treasury, the Financial Services Authority (FSA) and the Bank of England (collectively known as 'the Authorities'). The division of responsibilities between the Authorities is based on four principles: clear accountability; transparency; avoidance of duplication; and regular information exchange.

3.6 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 engagement with non-legislative bodies such as the International Monetary Fund (IMF), the Financial Stability Forum (FSF) or global standard-setting bodies like the International Accounting Standards Board.

Learning lessons

3.7 While the Authorities have worked effectively to address the crisis (as discussed below) financial market developments since last summer have exposed shortcomings in both the domestic and international approach to financial regulation and the degree of international cooperation. Far-reaching changes are clearly needed and the Government's priorities in each area are set out at the end of this chapter.

Box 3.2: Financial stability roles and responses

HM Treasury is responsible for the overall institutional structure of financial regulation and the legislation that governs it. Financial stability measures recently introduced by HM Treasury are described later in this chapter.

The FSA is responsible for the prudential supervision of firms and markets. Financial stability measures introduced in 2008 by the FSA include:

- publishing a thorough internal review into the supervision of Northern Rock, making recommendations for improvements and setting out areas of improvement already in train;
- introducing a temporary ban on active increases in net short positions on financial shares, on the basis that in extreme market conditions the short-selling of those shares was exacerbating disorderly markets; and
- issuing a strong statement on remuneration policy, making clear the need for firms to follow policies aligned with sound risk management systems and controls. The Authorities acknowledge the positive commitments already made by financial institutions in revising their remuneration policies.

The Bank of England contributes towards the maintenance of the stability of the financial system as a whole by supplying liquidity. Financial stability measures introduced in 2008 by the Bank of England include:

- coordinating liquidity management actions with other major central banks, which has been important given the international nature of the recent episode of financial instability. Specific measures include the introduction of dollar repo operations, as well as larger, more frequent long-term repo operations against wider collateral;
- introducing the Special Liquidity Scheme (SLS). The SLS is a temporary scheme that offers banks liquidity insurance by allowing them to exchange high-quality but currently illiquid securities for liquid UK government securities; and
- establishing new permanent liquidity insurance facilities which banks can access in stressed financial circumstances (the Discount Window), and permanent long-term repo open market operations against broader classes of collateral.

THE DEVELOPMENT OF THE FINANCIAL CRISIS

3.8 The origins of the financial crisis are numerous and global. They include the macroeconomic context, where increasingly integrated financial markets at differing stages of development and persistent global imbalances contributed to low interest rates. Low interest rates encouraged financial institutions to increase their leverage and to invest in new highly complex products, which were distributed to investors around the world. With hindsight, it is now clear that there was insufficient understanding and monitoring of the resulting risks in the private sector; internally in financial institutions; and in credit rating agencies; as well as by regulators across the world.

Macroeconomic factors

3.9 Over the past 20 years, global markets have become increasingly integrated, with enormous amounts of capital flowing across borders every day and emerging economies gaining an increasing share of international trade.¹

¹ *Embracing financial globalisation*, HM Treasury, May 2008.

Drivers of low interest rates **3.10** In the aftermath of the late 1990s emerging markets' financial crisis, many emerging market governments followed fixed or managed exchange rate regimes and built up large foreign exchange reserves. This, in combination with traditionally high private saving rates and a sustained rise in commodity prices, resulted in large net foreign exchange positions in these countries. A large proportion of these were invested in developed countries' government bonds and private debt instruments, financing substantial current account deficits in developed economies (especially the US). Together, these cross-border investment flows helped to push global long-term interest rates lower.

3.11 In addition, improved domestic macroeconomic policy frameworks and increased supply of low-cost goods from the emerging markets reduced consumer price inflation and lowered longer term inflation expectations, contributing further to a low long-term interest rate environment. The result was low government bond yields and low returns on fixed-income financial assets across all advanced economies.

The search for yield **3.12** With returns on conventional fixed-income assets low, and against a stable macroeconomic environment, investors sought higher returns by taking on more risk – both in terms of the products they created and invested in, and by increasing exposure to these instruments through higher levels of borrowing. This pushed down spreads on riskier assets to historically low levels, both between countries and between corporate borrowers.

Microeconomic factors

Increasing financial complexity **3.13** Advances in information technology widened the scope for financial institutions to create new products, for example by bundling together and subsequently repackaging traditional loans such as mortgages. Whereas individual loans have different terms and are backed by specific collateral, these loans were repackaged into securities. Examples include the complex and sometimes opaque structures known as 'collateralised debt obligations' (CDOs).² These products were then offered to investors around the world to meet the demand for higher-yielding assets. It is now clear that investors were under-pricing risk, and some investors were exposing themselves to risks they had not understood. As a result, these new products became overvalued.

Increasing leverage **3.14** Banks also sought to increase returns by raising borrowing levels (referred to as 'leverage'), particularly in wholesale markets, faster than growth in their equity capital, to fund the expansion of both traditional lending and more innovative securities. While domestic and international regulation tried to address risk from growth in lending and other assets, it did not keep up with changes in how banks funded this expansion. Investors borrowed heavily in global capital markets that turned out to be more vulnerable to illiquidity than had been previously experienced. Structured investment vehicles and conduits were developed to hold assets like CDOs, increasing the degree of leverage without the requirement to hold as much regulatory capital as would have been the case if these assets had been held on the banks' own balance sheets.

3.15 The counterpart to the greater leverage and financial complexity was increased lending to businesses and households. Much of the increase in household debt fuelled rising house prices and, in turn, a greater willingness to accept more debt. Many non-financial businesses also increased their leverage, often through transactions intended to increase returns to shareholders, without fully recognising the risks.

² CDOs are securities backed by a portfolio of fixed income assets that are issued in tranches of varying seniority. As default losses accrue to the underlying portfolio they are applied to securities in reverse order of seniority.

Shortcomings in the management of risk

3.16 Market participants and internal risk management systems further contributed to the development of the crisis. Directors and shareholders, as well as debt investors in financial institutions, failed to recognise the inherent risks associated with remuneration policies that were based on bonuses rewarding short-term book profits irrespective of the longer-term implications when the financial cycle turned. Similarly, credit-rating agencies failed to provide accurate ratings for structured products and the credit-rating business model, whereby institutions paid the agencies for the ratings received, allowed the development of potential conflicts of interest. Equally, it is not clear that investors exercised their own due diligence regarding their investments, relying instead on inadequate valuations by banks and the credit-rating agencies.

3.17 Finally, regulation did not keep pace with financial innovation and market practices. It failed to focus sufficiently on the pace and nature of balance sheet expansion by many financial institutions, and the systemic consequences of liquidity and credit risk. The combination of product and technological innovation made it possible to design and trade financial instruments in such a way that the nature of the risk they contained, and where that risk was located, was difficult to determine. When concerns over the location and risk of certain assets became too large, the close integration of financial markets ensured that the withdrawal of liquidity in one area rapidly transmitted instability to other, seemingly unrelated, parts of the global financial system.

US subprime market trigger

The US housing market

3.18 Financial innovation provided prospective homeowners with access to greater sources of funding, either at attractive short-term fixed interest rates or to borrowers with weak credit histories. This was particularly true in the US, where subprime mortgages, which were often linked to low short-term fixed, or 'teaser', rates before re-setting to higher floating rates, funded an increase in demand for housing from individuals previously unable to afford a house. This increased demand for housing pushed up prices.

3.19 During 2006 there was a downturn in the US housing market after a decade long boom. As US interest rates rose and house prices fell, defaults on subprime loans increased markedly and it became clear that the structured investment products that had repackaged these loans were worth less than had been thought. As a result, financial institutions around the world have had to revalue these securities, with the Bank of England estimating that losses in the market value of assets linked to US subprime mortgages amount to \$600 billion.³ The complex nature of these assets made the recognition of the size and location of the losses difficult. This led to a sharp increase in actual (and an even sharper increase in perceived) counterparty risk, translating into mounting pressure on liquidity.

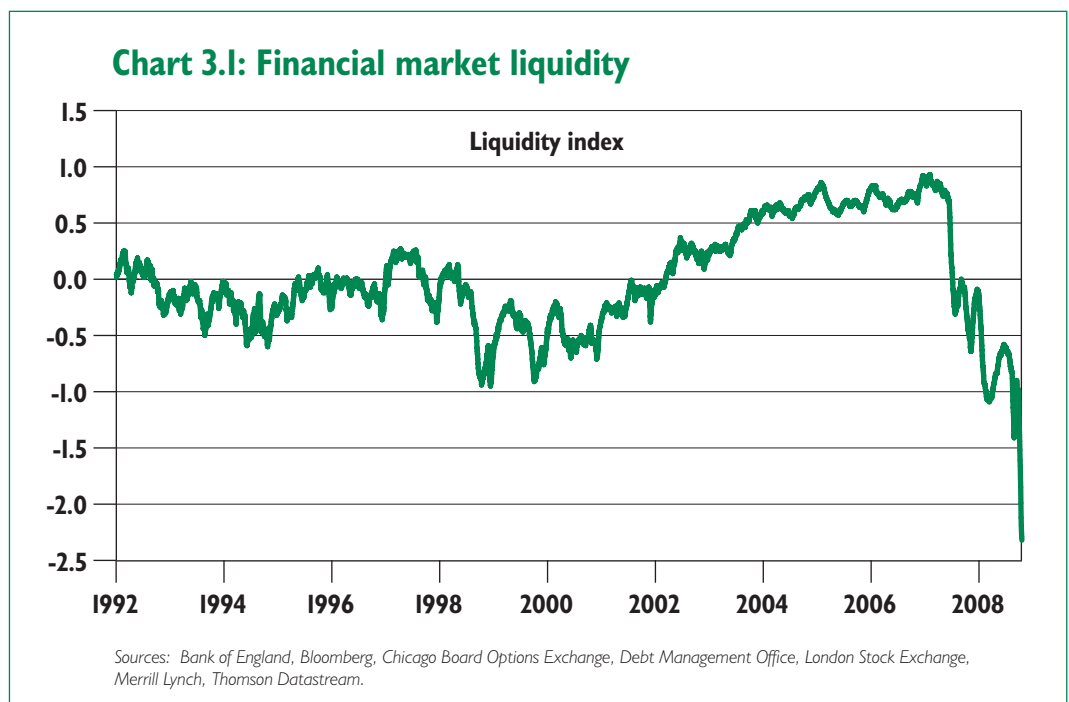
Liquidity concerns

3.20 At the onset of the crisis, banks became highly uncertain about their future funding needs and less confident about their ability to meet potential demands quickly due to the illiquidity of money markets. As a result, the demand for central bank reserves increased. Central banks responded by developing their liquidity supply operations and facilities, including the coordinated provision of US dollar liquidity by central banks in Europe.

³ *Financial Stability Report*, Bank of England (October 2008). Total mark-to-market losses on structured assets and corporate bonds were estimated to amount to \$2.8 trillion.

Impact on individual institutions **3.21** As the crisis unfolded, interbank markets came under pressure as investors became reluctant to place funds in unsecured money markets at anything other than the shortest horizon. In such troubled market conditions, even major institutions were vulnerable. A liquidity run on Bear Stearns ended with the forced sale of the investment bank to JP Morgan Chase, supported and funded by a \$29 billion Federal Reserve loan on 16 March 2008. Within the UK, concerns over liquidity became particularly acute in the market for retail mortgage backed securities (RMBS), where public issuance fell from a peak of £41 billion in the fourth quarter of 2006 to £0.4 billion in the first quarter of 2008.⁴ Northern Rock's difficulties, caused by excessive reliance on money markets, are discussed later in the chapter.

3.22 As it became apparent that funding conditions were becoming tighter, asset prices began to adjust. In particular, house prices in many countries began to fall. Lower property values implied less collateral behind secured loans, thereby increasing the risk of banks across several countries. With this development, interbank markets became even less liquid.



Solvency concerns

3.23 September 2008 marked the beginning of the most turbulent period of the current financial turmoil. US mortgage finance agencies Fannie Mae and Freddie Mac were placed into conservatorship, as doubts increased about their solvency. A few days later, the share price of Lehman Brothers fell sharply as concerns about its financial condition grew and other firms started to pull back from doing business with it. This liquidity run, and failure to find a private sector buyer, eventually forced Lehman Brothers to file for Chapter 11 bankruptcy protection on 15 September. Other US investment banks came under pressure, prompting the sale of Merrill Lynch to Bank of America, and subsequently the transformation of Morgan Stanley and Goldman Sachs into bank holding companies, allowing them similar access to the Federal Reserve's facilities as that of depository institutions.

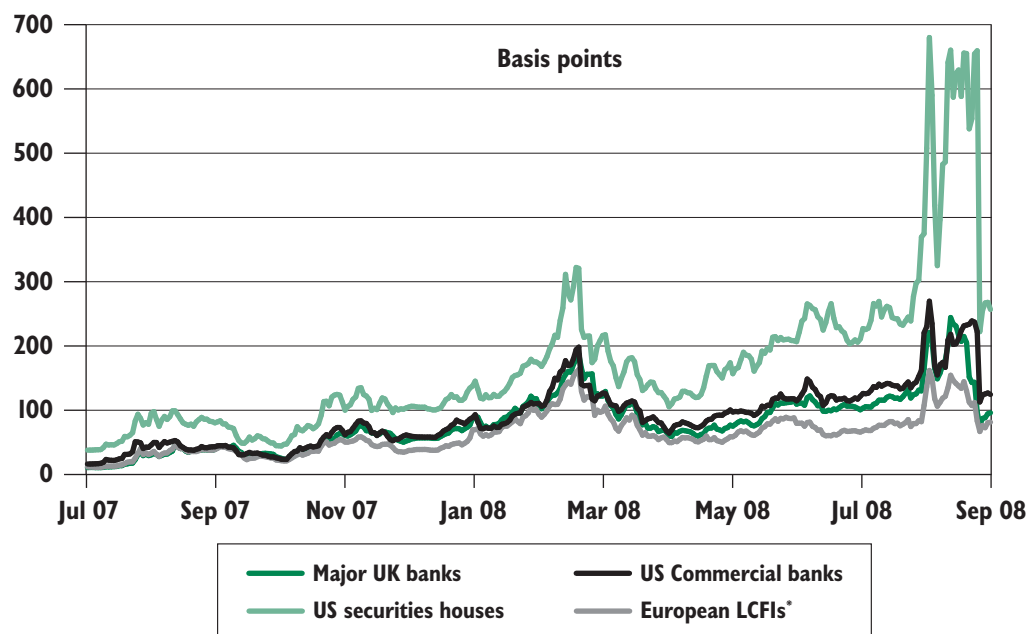
⁴ *Mortgage finance: final report and recommendations*, Sir James Crosby, HM Treasury, 2008.

3.24 In the following days, the US insurer AIG came under pressure as investors became concerned that it could not raise enough cash to meet its growing obligations. The US Federal Reserve, with the support of the US Treasury, extended to the company an \$85 billion loan, judging that the failure of AIG would present a systemic risk. This initial loan proved insufficient and further lending from the Federal Reserve and a recapitalisation by the US Treasury became necessary.

**Interbank
funding strains
intensify**

3.25 In the aftermath of Lehman Brothers' failure, institutions across Europe and the US experienced severe difficulties. The global financial system came under extreme stress as financial institutions and investors lost confidence in counterparties in general. Spreads on interbank lending reached unprecedented highs and stock markets fell 20 per cent or more in less than a month. The extreme financial volatility, and the threat it posed to the functioning of the banking system, necessitated a number of significant government interventions in the financial markets in the UK, US and across Europe.

Chart 3.2: Financial institutions' credit default swap premia



Source: Bank of England
*Large complex financial institutions

Box 3.3: Financial instability in the emerging markets

In the past two months, the financial crisis has spread to the emerging markets. Investors have moved to the relative safety of dollar assets and economic prospects have deteriorated sharply around the world. A number of countries in eastern Europe and beyond have experienced economic instability, with important implications for UK interests.

A number of countries have approached the IMF for support, which has already fast-tracked multi-billion dollar support packages for Hungary and Ukraine. It has also created a new short-term liquidity facility for those emerging markets that have sound economic policies but are experiencing difficulties accessing funding from abroad as a result of the financial crisis. The EU has played an important role in supporting European countries experiencing difficulties, particularly through its balance of payments facility.

The Government is playing an important role working with the IMF, the EU, the G7 and the G20 in responding to emerging market risks, leading calls for the international community to take action to ensure that the IMF has sufficient resources to continue to provide support to countries affected by the financial crisis. The Government welcomes the ongoing work to review the IMF's lending instruments. It is important that these instruments remain relevant to today's challenges and adequately meet their members' needs.

UK POLICY RESPONSE TO THE FINANCIAL CRISIS

Consistent objectives **3.26** Strong banks, and confidence and trust in the financial system, play an integral role in supporting jobs and prosperity across the UK. Since the onset of the instability in August 2007, the strength of institutions has been questioned and confidence diminished, requiring the Government to intervene to protect the interests of individuals, businesses and the taxpayer. Throughout this period, the Government has been clear about the objectives of these interventions, which are to:

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

3.27 The Government has also made clear that pursuing these objectives will not compromise the UK's longstanding commitment to economic and financial openness, recognising that the benefits of financial globalisation, if underpinned by the appropriate systems of global financial regulation, can be significant.⁵

And a flexible approach **3.28** The scale and impact of turbulence in financial markets has evolved since July 2007, as described in the previous section. To accommodate the changing circumstances, the Government's strategy for achieving its objectives has also evolved through two key stages:

- as individual institutions came under pressure, the Government protected financial stability through targeted actions at an institutional level, as well as supporting measures to improve liquidity in the financial system; and
- as concerns over solvency escalated and it became more likely that the global banking system as a whole would be affected, with inestimable consequences for the UK and global economy, the Government led the international response by delivering a comprehensive and decisive package that addressed the root causes of the crisis.

⁵ *Embracing financial globalisation*, HM Treasury, 2008.

Targeted actions at an institutional level

3.29 The initial manifestation of financial instability in the second half of 2007 was the rapid reduction in liquidity and equally rapid spike in perceived counterparty risk. The impact this had on banks varied according to institution-specific factors, such as an individual bank's business model and exposure to particular asset classes. While this persisted, the appropriate policy response was to deal with problems faced by institutions on an individual basis and to support actions to improve liquidity in the financial system.

Northern Rock 3.30 Northern Rock's business model was highly dependent on wholesale funding. As wholesale funding markets tightened during summer 2007, Northern Rock was left unable to fund its operations. On 17 September 2007, the Government announced guarantee arrangements in respect of all existing retail savings in, and certain existing wholesale liabilities of, Northern Rock. This was to prevent contagion from the large-scale withdrawals of deposits that followed the announcement of an emergency loan from the Bank of England. The guarantee arrangements were extended as necessary in the light of circumstances. However the bank's funding problems remained, and after exploring all options for a private sector solution (including options which included ongoing public support), the Government took Northern Rock into temporary public ownership using powers under the Banking (Special Provisions) Act, which is discussed below. In August 2008, the Government announced that it would strengthen Northern Rock's capital position by converting up to £3 billion of the Government loan into equity, and converting £400 million of preference shares into ordinary shares. Northern Rock is now pursuing a business plan aimed at creating a smaller, more viable mortgage and savings bank, repaying the Government loan and enabling release of the Government guarantee arrangements.

Box 3.4: New powers to achieve the Government's objectives

Immediately following the onset of financial instability in August 2007, the Government acknowledged that existing powers were insufficient to address a bank failure quickly and effectively. Over the autumn of 2007, the Government consulted extensively on delivering the appropriate powers while minimising unintended consequences.

In February 2008, the Government introduced the Banking (Special Provisions) Act, granting HM Treasury powers to transfer the securities or property rights and liabilities of distressed banks or building societies to the public sector, or any private sector company. The Act allowed the Government to respond effectively and expediently when Bradford & Bingley and the two Icelandic banks with UK subsidiaries encountered severe financial difficulties, which are both discussed below.

After further in-depth consultation, in October 2008 the Government introduced to Parliament the Banking Bill, which is described later in the chapter.

Bradford & Bingley 3.31 The Banking (Special Provisions) Act enabled the Government to take swift action in relation to Bradford & Bingley. The bank was heavily reliant on buy-to-let and self-certified mortgages, which were of poorer quality than prime residential mortgages and which were vulnerable to a sharp rise in the rate of arrears. As a result, it lost market confidence, causing its share price to fall sharply and making it increasingly difficult for it to access funding. On 27 September, the FSA determined that Bradford & Bingley was no longer meeting its threshold conditions to operate as a deposit-taker under the Financial Services and Markets Act 2000 and FSA rules. The FSA also declared the company to be in default for the purposes of the Financial Services Compensation Scheme (FSCS). The Government, on the advice of the FSA and the Bank of England, acted immediately. The retail deposits and branches of Bradford & Bingley were transferred to Abbey National plc following a competitive sale process. The remainder of Bradford & Bingley's business was taken into public ownership and will be wound down.

3.32 Under the Transfer Order, the FSCS has paid out approximately £14 billion to enable retail deposits held in Bradford & Bingley and covered by the FSCS to be transferred to Abbey National plc (a subsidiary of the Spanish bank Santander). This is financed through a short-term loan from the Bank of England, which will be replaced with a loan from the Government after a short period of time. HM Treasury has made a payment to Abbey National plc for retail deposit amounts not covered by the FSCS, amounting to approximately £4 billion. In return, the FSCS and the Treasury have acquired rights against Bradford & Bingley and 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.

Icelandic banks 3.33 By autumn 2008, the Icelandic financial services sector had become significantly over-leveraged, with profound implications for Iceland's economic stability. In an attempt to stabilise the country's financial system following a very serious deterioration in the principal Icelandic banks, the Icelandic authorities passed emergency legislation on 6 October 2008.

3.34 On 8 October, the Government froze the assets of Landsbanki in the UK. This was because there was great uncertainty as to whether UK creditors and depositors were receiving fair and equal treatment and whether the Icelandic authorities were complying with EEA and international law. Discriminatory and unlawful treatment would have had consequential impact on the UK economy (or part of it), including through an impact on depositor confidence. This action was taken under the Anti-terrorism, Crime and Security Act 2001. The 2001 Act includes a broad range of provisions and is not only about countering terrorism. The UK's action was not taken on the basis of the anti-terrorism provisions in the Act.

3.35 Also, during the second week of October, the UK subsidiaries of two Icelandic banks, Kaupthing, Singer & Friedlander and Heritable, were facing serious difficulties as a result of market developments and the emerging situation in Iceland. It was therefore necessary for the FSA and the Treasury, in their respective capacities, to take action to resolve the situation. Kaupthing, Singer & Friedlander and Heritable were both placed into administration following due legal process. The Treasury exercised their powers under the Banking (Special Provisions) Act to transfer the retail deposits in certain accounts in KSF and in Heritable to the Dutch bank ING.

3.36 Through these actions, the Government has protected all FSCS-eligible retail deposits of Kaupthing, Singer & Friedlander and Heritable, as well as all FSCS-eligible retail deposits in the UK branch of Landsbanki.

Consolidation of the retail banking sector 3.37 The events described above, combined with other completed or planned mergers among UK banks and building societies, have led to some consolidation of the UK banking sector. Examples of this include:

- the transfer of the deposit books of Bradford & Bingley and the two Icelandic subsidiaries to Abbey National plc and ING respectively;
- the takeover of Alliance & Leicester by the Spanish bank Santander;
- the planned merger between Lloyds TSB and HBOS, for which the Secretary of State for Business, Enterprise and Regulatory Reform issued an intervention notice allowing the decision on whether to refer the merger to the Competition Commission to be made with reference to both competition and financial stability. The Secretary of State also made a general change to competition law, adding maintenance of UK financial stability to the list of public interest considerations in the Enterprise Act 2002. On 31 October 2008, the Secretary of State, having considered a report by the Office of Fair Trading and other

submissions put to him, concluded that the merger between Lloyds TSB and HBOS was in the overall public interest; and

- the planned mergers of a number of UK building societies: Catholic and Chelsea Building Societies; Cheshire, Derbyshire and Nationwide Building Societies; Barnsley and Yorkshire Building Societies; and Scarborough and Skipton Building Societies. These transactions are all expected to be completed before the end of the year.

3.38 Consolidation of the banking sector is neither a recent nor UK specific phenomenon: in the US, for example, there were 7,000 commercial banks at the end of 2007, compared with nearly 14,500 in 1984.⁶ The Government remains committed to competition as an essential characteristic of fair and open markets. However, under certain circumstances, consolidation results in stronger and better-capitalised financial institutions, which will lead to greater financial stability; more protection for consumers; and better availability of competitive financial products.

A comprehensive and decisive UK policy response

3.39 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, irrespective of business models. The likelihood of the banking system collapsing, with profoundly damaging consequences for the wider economy, had increased.

The cost of a systemic collapse

3.40 It is difficult to estimate what the cost would be to the UK of a systemic financial collapse. Recent IMF analysis of previous banking crises suggests it would be very significant. In the six developed market crises most similar to the current crisis, the average fiscal cost was 9.4 per cent of GDP. However, there is great variance in these figures: the fiscal cost in Japan was estimated to be 24 per cent of GDP, while in Sweden some estimates suggest it was only 3.6 per cent.⁷ This spread can in part be attributed to the speed and decisiveness of the relevant government's policy response.

Specific and comprehensive measures

3.41 Therefore, after consultation with the Bank of England and the Financial Services Authority, on 8 October the Government announced measures to address the three root causes of the crisis: concerns about liquidity, capital and funding:

- first, to address concerns about liquidity, the authorities announced that at least £200 billion would be made available to banks under the Bank of England's Special Liquidity Scheme (SLS). The SLS, which was first introduced in April 2008, provides banks and building societies with short-term liquidity by allowing them to swap temporarily pre-existing, illiquid financial assets, including mortgage-backed securities, for highly liquid Treasury bills. It is designed to provide financing for legacy illiquid assets existing at the end of 2007. Each swap is for a period of one year but can be renewed for a total of up to three years at the Bank's discretion. The SLS drawdown window will be open until 30 January 2009;
- second, to address concerns about solvency, the Government established the Bank Recapitalisation Fund. This makes available new Tier 1 capital to eligible UK banks and building societies, allowing them to strengthen their resources, while maintaining their support for the wider economy. The Bank

⁶ Federal Deposit Insurance Corporation: www.fdic.gov

⁷ International Monetary Fund: www.imf.org

Recapitalisation Fund, and the role of UK Financial Investments Ltd. in managing the investments, is described below; and

- third, to address funding concerns (reflecting a lack of mutual confidence and trust between financial institutions), the Government established a credit guarantee scheme. This makes available to eligible institutions a government guarantee to refinance maturing debt. The credit guarantee is intended to unblock the interbank money market, thereby allowing banks to continue to lend to the wider economy. Since 13 October, the Debt Management Office, an Executive Agency of HM Treasury, has been operating the scheme.

Impact of the measures 3.42 This package of measures was essential. In the short term, it has stabilised the UK banking system. Over the coming months and years, it will cushion the impact on households and businesses as banks seek to rebalance their funding needs away from wholesale funding and towards customer funding. The recapitalisation measures in particular will increase banks' capacity to absorb losses on legacy assets, reducing the impact of the economic downturn on banks' lending behaviour, thereby supporting the availability of bank credit to households and companies.⁸

International responses 3.43 Given the global nature of the disruptions in financial markets, and the interconnectedness of the international financial system, it is vital for countries to coordinate their actions and to take account of the potential cross-border effects of national decisions. The communiqué of the G7 Finance Ministers and central bank governors on 10 October agreed a plan of action for coordinated interventions concerning the recapitalisation of financial institutions and the unfreezing of credit and money markets that was consistent with the UK's policy response.

3.44 In line with action taken by the UK, both the US government and the euro area governments have announced their own proposals. The US Treasury has announced the introduction of a recapitalisation programme as part of its \$700 billion financial rescue package and support the Federal Reserve's efforts to unlock lending. Euro area governments have committed to a common approach based on guaranteeing bank funding and the recapitalisation of banks as necessary; in particular, France and Germany have announced rescue packages of €860 billion, out of which up to €120 billion will be used for recapitalisation. Central banks have also coordinated injections of liquidity into the system.

⁸ Bank of England: www.bankofengland.co.uk

Box 3.5: The Bank Recapitalisation Fund and the role of UK Financial Investments Ltd

In September 2008, concerns developed about whether the major UK financial institutions had sufficient capital. Though all exceeded the FSA's regulatory capital requirements, a sudden rise in the perceived default risk following the collapse of Lehman Brothers increased the probability that these financial institutions would need suddenly to sell their assets at market prices which, due to low levels of liquidity, would be far below their economic value. This implied lower asset values and higher potential capital needs for banks. Without the immediate provision of capital, the banks would have been compelled to reduce their loan exposures to UK households and businesses in order to build up their capital reserves.

To ensure that the banks did not withdraw their support to the wider economy, the Government has made available at least £50 billion through the Bank Recapitalisation Fund. Following detailed discussions with the UK's eight largest financial institutions, the Government announced that it would underwrite the raising of £37 billion by RBS and, upon successful merger, HBOS and Lloyds. Simultaneously, other financial institutions announced plans to raise their capital levels without Government support.

Access to the Fund remains open to all UK building societies and other eligible banks that can demonstrate they meet the necessary conditions, as set out by the Chancellor to Parliament on 18 November 2008. Those institutions that do subscribe to the Government's Fund do so on the terms and conditions that appropriately reflect the financial commitment made by the taxpayer, including in relation to dividend policy, remuneration and lending to small businesses and households.

The Government's investments in financial institutions will be managed on a commercial basis by an arm's-length company, 'UK Financial Investments Ltd' (UKFI), wholly owned by the Government. UKFI's overarching objective will be 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:

- maximising sustainable value for the taxpayer, taking account of risk;
- 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.

UKFI will manage the Government's shareholdings in financial institutions: both those subscribing to the bank recapitalisation fund and Northern Rock and Bradford & Bingley, which the Government wholly owns. All these companies will continue to have their own independent Boards and management teams, determining their own commercial strategies. The governance of UKFI will be consistent with the Government's intention to manage its investments on a commercial and arm's-length basis. The Board will be accountable to the Government and, through the Chancellor, to Parliament for the delivery of its objectives.

The Government will not be a permanent investor in UK financial institutions and will, over time, seek to dispose of the investments in an orderly way through sale, redemption, buy-back or other means, in accordance with UKFI's objectives.

The market reaction **3.45** The market reaction to the Government's announcements was also generally positive. Credit default swap (CDS) premia, which measure the probability of banks defaulting on their obligations, declined as the recapitalisation was perceived to have reduced the probability of a future default. Falls in the CDS premia for most of the major UK banks have been broadly constant across CDS contracts of all maturities, suggesting that banks' prospects have been enhanced both in the near and longer term. Since the introduction of the credit guarantee scheme, LIBOR rates have also eased gradually, with the spread to Bank Rate falling to levels last seen in September.

LOOKING TO THE FUTURE

3.46 Though initial reactions to the Government's policy response have been positive, the current period of financial turbulence is not over. The Government is committed to achieving its financial stability objectives and will continue to monitor the financial system to ensure that it can continue to support the wider economy. The Government's Bank Recapitalisation Fund remains open to all UK building societies and eligible banks that can demonstrate that they meet the necessary conditions, as set out by the Chancellor to Parliament on 18 November 2008.⁹

3.47 Over the last year, the Government has taken a series of extraordinary measures to deal with the crisis and avoid a systemic collapse. These measures have been necessary to ensure that the financial system continues to support the economy as a whole. Interventions such as these inevitably have other effects on markets. So, while they have been essential, the Government will act over time to reduce and remove such distortions. This will require careful planning and international cooperation.

3.48 In addition, it is essential that finance ministries, supervisors and central banks address the supervisory, regulatory and social issues that the crisis has highlighted.

Leading the international response

Work with the EU **3.49** As a key global marketplace, the EU has an important role to play in shaping the appropriate international response. The Economic and Financial Affairs Council (ECOFIN) endorsed a programme of work in autumn 2007 on the issues raised by the market disruption, with work continuing during 2008. On 7 October 2008, common EU principles were agreed to guide public interventions at the national level to ensure a swift, appropriate and coordinated response with minimal disruption to the EU common market.

3.50 The modern economy depends on finance flowing freely across international borders, especially within the EU and European Economic Area (EEA). It is therefore crucial that the EU continually looks to improve the manner in which it legislates for cross-border financial transactions, and ensures that appropriate safeguards are in place. **The Government believes that recent events have illustrated the need to address a number of important EEA-wide issues, including:**

- **the regulatory safeguards for cross-border activity, in particular for risk assessment and monitoring; crisis prevention and mitigation; and crisis resolution.** This is especially important for branch-based activity, where the need for supervisory cooperation and coordination is even greater and

⁹ HM Treasury: www.hm-treasury.gov.uk

- **increasing the level of guaranteed deposits and the speed of resolution or pay-out in the event of a failure.** More comprehensive arrangements are also needed to protect depositors in branches of foreign banks, for example to provide for a mutual evaluation of the compensation arrangements in force in the home and host States and better cooperation between deposit guarantee schemes.

3.51 The Government has written to the European Commission asking that these issues be considered urgently.

A global response to global events

3.52 Work is also under way to deliver a coordinated international community response to strengthen the stability and resilience of the global financial markets for the future. In October 2007, G7 Finance Ministers asked the Financial Stability Forum (FSF) to analyse the underlying causes of recent market turbulence and propose appropriate recommendations, with a focus on events in the markets for structured products. The FSF presented its report, *Enhancing Market and Institutional Resilience*, to G7 Finance Ministers in April. It recommended action in five areas:

- prudential oversight of capital, liquidity and risk management;
- transparency and valuation;
- the role and uses of credit ratings;
- the authorities' responsiveness to risks; and
- arrangements for dealing with stress in the financial system.

3.53 The report was strongly endorsed by the G7 Finance Ministers, who committed to its rapid implementation. The Authorities fully support this work, and are taking steps both here in the UK and through international fora to ensure the FSF's recommendations are implemented.¹⁰ The FSF provided an update on progress to the G7 Finance Ministers' meeting in October, which explained that implementation of the priority actions is on track and that good progress is being made on the other recommendations in the FSF report.

Shaping the future of international finance

3.54 At the recent G20 Summit in Washington on 15 November, the Government pushed for action in three areas: encouraging world leaders to take concerted action to address the current causes of macroeconomic and financial instability; establishing applicable standards of financial regulation and supervision as well as improved cooperation between regulators to address cross-border issues; and reforming the global financial and economic architecture to ensure that all countries are better prepared to deal with future global economic events. More detail on the summit and next steps for the G20 work are described below.

¹⁰ *Financial stability and depositor protection: further consultation*, HM Treasury, 2008.

Box 3.6: the international summit and the UK's Chair of the G20

Leaders and finance ministers of G20 countries met in Washington on 15 November and agreed that urgent action was needed in a number of areas to tackle the financial and economic crisis. Specifically, leaders tasked Finance Ministers to take work forward in the following five areas:

- Strengthening transparency and accountability to foster enhanced openness and disclosure so that value-impaired assets cannot be hidden. Executive compensation schemes should also be reviewed to ensure that they do not encourage excessive risk-taking.
- Enhancing sound regulation ensuring that all financial institutions, markets and products are appropriately regulated, including credit rating agencies, private capital funds and hedge funds; and making regulatory regimes more effective over the economic cycle.
- Promoting integrity in financial markets by implementing measures to prevent conflicts of interest, illegal market manipulation, fraudulent activities and illicit finance risks.
- Reinforcing international cooperation to ensure global consistency of national and regional regulation through enhanced collaboration on crisis prevention, management and resolution, including through the development of international colleges of regulators and cross-border stability groups.
- Reforming the International Financial Institutions so that the IMF, in collaboration with the expanded FSF and other bodies, can better identify vulnerabilities, anticipate potential stresses, and act swiftly to play a key role in crisis response.

The UK assumes the Chair of the G20 in 2009 and will play a leading role in driving the G20 work forward, alongside the previous and next Chairs of the G20, Brazil and South Korea. In doing so, the Government will draw widely on domestic and international advice and expertise, including through a new panel. Finance Ministers will prepare immediate measures for implementation by 31 March 2009 and Leaders will meet again before 30 April to review the progress made.

Crown dependencies and overseas territories

3.55 Many crown dependencies and overseas territories are significant financial centres in their own right and the financial sector plays a vital role in their economies. The Government recognises the progress made by most offshore financial centres to improve financial regulation and transparency, and tackle financial crime. However, crown dependencies and overseas territories, like all offshore financial centres, face challenges and opportunities as the world is changing. In particular, severe financial turbulence has raised questions for all jurisdictions, while there is growing international pressure to line up standards of financial regulation and meet international norms with regards to taxation.

3.56 **The Government will shortly commission an independent review of British offshore financial centres; their role in the global economy; and their long-term business strategies. The review will not consider changes to the UK's constitutional relationship. It will work with the crown dependencies and overseas territories to identify current and future opportunities, risks and mitigation strategies, including issues such as:**

- financial supervision and transparency;
- fiscal arrangements;
- financial crisis management and resolution arrangements; and
- international cooperation.

Enhancing the UK's approach to financial stability

3.57 The Government has three clear domestic priorities. First, ensuring stability so that financial markets can resume their crucial role of supporting the wider economy. Second, achieving a sustainable banking sector that remains fair and open, offering the range and price of services that are demanded by consumers and firms. Finally, ensuring that the UK economy benefits from a successful financial services sector that is internationally competitive, value-adding and innovative, and that takes a lead in observing (and setting) global best practice in internal governance and risk management.

1) Restoring stability

FSA review of financial regulation

3.58 The FSA published in March 2008 a summary of the thorough internal review into its supervision of Northern Rock. The review identified a number of areas for improvement in the execution of supervision, which are being advanced urgently by the FSA's management, via a dedicated Supervisory Enhancement Programme.¹¹ The FSA is also currently conducting a review of its liquidity requirements for banks and building societies with a view to addressing practical shortcomings and improving standards of liquidity risk management.

3.59 A strong and effective system of outcome-focussed, principles-based regulation has a leading role to play in restoring stability and creating a framework for change. On 6 October, the Chancellor asked Lord Turner, the Chairman of the FSA, to make recommendations for reforming UK and international approaches to regulation, to ensure the future stability of the UK banking system. **The FSA's review will be published in March 2009 and will address the following issues:**

- **the FSA's supervisory approach, processes and resources** – in particular whether the changes already being implemented through the FSA's Supervisory Enhancement Programme are sufficient, given the further global developments since it was initially designed;
- **UK and international policies relating to: capital adequacy; liquidity; valuation and accounting; rating agencies and the originate and distribute model; market infrastructure in over-the-counter derivatives markets; and remuneration and incentive structures;**
- **the institutional coverage of prudential regulation** – whether recent steps to extend the appropriate accounting and regulatory coverage of near-bank and shadow bank institutions go far enough;
- **cross-border cooperation and coordination** – including international regulatory cooperation in non-crisis periods, and the scope for better international coordination during individual institutional crises; and
- **analysis and implications of macro trends in the financial system** – what actions may be required to ensure that analysis of macro financial trends feeds into adjustments to regulatory policy or supervisory focus, both at national level and internationally, including consideration of policies aimed at mitigating pro-cyclicality.

¹¹ Financial Services Authority: www.fsa.gov.uk

Box 3.7: Pro-cyclicality of the financial system

Financial systems have a tendency to be pro-cyclical, fluctuating with the economy and potentially amplifying business cycles. In a typical cycle, a development, such as a technological innovation, appears to boost returns and lower risk, setting off an expansion of credit. Market participants frequently exaggerate the impact on expected returns, resulting in the development of asset price bubbles and excessive risk taking and leverage. In these circumstances, a shock which destabilises financial markets can carry significant costs in terms of economic output.

In recent years, a number of policy options have been proposed at an international level to make accounting standards or prudential regulations more counter-cyclical. Such proposals would ensure that banks build up sufficient buffers of capital and liquidity in good times to enable them to absorb losses without triggering or amplifying an economic downturn. Options include a more active approach to provisioning, which would require banks to build up reserves against future losses, and introducing a counter-cyclical element into banks' capital requirements linked to measures of the financial cycle such as lending growth.

The Government strongly supports the technical work in train through the FSF to examine the forces that contribute to pro-cyclicality in the financial system and possible mitigating options. There are considerable challenges to designing and implementing effective counter-cyclical policies. The Authorities are working together to assess the policy options and contribute to international discussions, including through the FSA's review, referred to above.

Strengthening the legal framework **3.60** In October 2008, the Government introduced into Parliament the new Banking Bill. This Bill contains a number of significant provisions for supporting financial stability and protecting depositors, including:

- a 'special resolution regime' (SRR) to allow the Authorities to intervene when a bank gets into severe difficulties;
- the creation of a new insolvency procedure for banks, alongside changes to the legal framework for the FSCS, to facilitate faster pay out to depositors should their bank fail; and
- strengthening the role of the Bank of England, by providing it with a statutory objective for financial stability, new policy levers (such as formal oversight of payment systems and a key role in the SRR), and a new Financial Stability Committee to advise the Bank on this area.

3.61 The Bill has now completed scrutiny in committee in the House of Commons and will be introduced into the House of Lords in the new Parliamentary session. The Government is working with cross-party support to secure the passage of the Bill by 20 February 2009, when temporary powers taken under the Banking (Special Provisions) Act 2008 will expire.

Amendments to the Banking Bill **3.62** The Government intends to bring forward amendments that would make two additions to the Bill in the House of Lords, to increase the Bill's effectiveness in allowing the Authorities to deal with risks to financial stability:

- first, the Government proposes to extend HM Treasury's power to take a failing bank into temporary public ownership (where this would be in the interests of financial stability or the protection of public funds) to include banking group holding companies. This power would be used in cases where the resolution of a deposit-taker within a financial group would not by itself be sufficient to prevent a serious risk to financial stability, public funds, or both; and

- second, in response to emerging developments concerning the UK subsidiary of Lehman Brothers, which is currently under administration, the Government proposes to take a power in the Banking Bill to introduce, by secondary legislation, a new special insolvency procedure for investment firms, which hold client assets or client money.

Insolvency arrangements for investment firms **3.63** Therefore, the Government will, in the coming months, conduct a review of the insolvency arrangements for these investment firms, to inform secondary legislation to be made under the Banking Bill. The review, which will conclude by summer 2009, will consider:

- the precise definition of the firms to which the new procedure should apply;
- the treatment of unencumbered client money and client assets;
- the treatment of client money and client assets which have been posted as collateral;
- arrangements to enable a temporary continuation of brokerage activities (including the matching of unsettled trades); and
- how an insolvency procedure would work having regard to 1-3 above, and particularly, what the objectives for the new procedure should be.

3.64 This review will be conducted under the auspices of the expert liaison group, established by the Treasury in October 2008 to advise on and keep under review the Banking Bill and associated secondary legislation. The group, which includes industry practitioners, insolvency experts, legal specialists and representatives from the Authorities, will consult widely with stakeholders. Following the review, there will be a full formal consultation on draft secondary legislation, in line with the normal legislative procedure.

Facilitating equity capital raising **3.65** Efficient and orderly equity capital raising techniques are essential to enable companies to raise equity capital at the lowest cost and preserve the integrity of the market and the issuer's reputation. The Government therefore welcomes the report by the Rights Issues Review Group – a working party co-chaired by HM Treasury and the FSA. **The Government agrees with their recommendations, which make significant improvements to the duration of the rights issue process from the current 39 days it can take to 32 days, and for many issues down to 16 days. These improvements will benefit the market, companies and shareholders.**

2) Achieving a sustainable banking sector

Supporting competition **3.66** The Office of Fair Trading (OFT) is responsible for ensuring that markets are competitive and work well for consumers. It therefore has a key role to play in monitoring and tackling the potential anti-competitive effects of consolidation within the financial services sector. The OFT is already doing specific work on bad debt collection practices, irresponsible lending, and unfair terms. There are also orders in place, which can be enforced by the OFT and the Competition Commission, to promote competition in small business banking. The OFT will also look at market features which hinder competition and will promote change itself or through reference to the Competition Commission.

3.67 Alongside its normal annual plan, the OFT will set out in the new year a specific financial services plan, detailing how it will build on its strong track record of tackling abusive behaviour and consumer detriment.

Enabling an efficient mutuals sector

3.68 Financial mutuals can provide a valuable local alternative to banks over a range of financial services, and the Government is committed to enabling growth and efficiency across the sector as a whole.

3.69 The Building Societies (Funding) and Mutual Societies (Transfers) Act 2007, which received Royal Assent in 2007, is part of a wider package of measures aimed at improving efficiency. Implementing the Act will, in time, allow building societies greater flexibility in their funding strategies; enhance members' rights in the event of insolvency; and make it easier for a mutual to transfer its business to a subsidiary of another mutual. **The Government is also planning to reform the legislation governing cooperatives and credit unions. It will set out its further plans, including a response to consultation on the Act, in December 2008.**

3.70 In addition, the Treasury will undertake a review of the regulation of credit unions and industrial and provident societies in Northern Ireland, working closely with the relevant authorities in the Northern Ireland Executive. These mutuals are currently regulated by the Department for Enterprise, Trade and Industry, Northern Ireland under Northern Ireland credit union and industrial and provident society legislation. The review will take account of the importance of mutuals to the Northern Ireland financial sector, and draw on good practice in other countries.

3.71 Finally, the Government is taking steps, under the Banking Bill, to extend access to liquidity support from the Bank of England for building societies.

Box 3.8: Restoring trust in the UK financial services sector

The Government has a qualitatively different relationship with the banking sector compared with other parts of the economy. If a systemically important bank gets into difficulties, there is a good case for the Government intervening, as the past fifteen months have shown. The Government has so far committed to invest up to £37 billion into the UK banks and, through the credit guarantee scheme, is providing further support to unblock interbank lending. These developments, which would have been unthinkable until very recently, now suggest the need to review what is, in effect, the social contract between banks and citizens.

The Government believes there is need for a debate with both the banking industry and consumer groups about the elements of this relationship. Particular priorities for the Government include:

- ensuring people can obtain trusted, impartial advice to help them make informed financial decisions and develop the financial capability to plan appropriately for their future;
- providing free, accessible and impartial sources of debt advice, to help people struggling with debt;
- supporting access for all to appropriate financial products and services; and
- promoting responsible lending and borrowing (including through the third sector), to the benefit of individuals, institutions and the economy as a whole.

Many of these objectives, such as maintaining the availability of lending and supporting measures to improve financial capability, underpin the conditions required of banks subscribing to the Government's Recapitalisation Fund. Implementation of these conditions will be overseen by UKFI.

The Government already encourages discussion between the financial sector and representatives of business and retail consumers. **To encourage this debate further, the Government will set up a discussion forum with membership drawn from across the retail financial services sector and representatives of personal customers. Chaired by the Economic Secretary to the Treasury, the group will look at how banks and other financial institutions can work better in the interests of consumers and society as a whole, and what measures may be needed to restore trust in financial institutions. Membership of the group will be announced shortly.**

The Government will use the output of the group to inform its views on the role of the financial sector in society, and will set out its emerging views during 2009.

3) Retaining UK excellence in financial services

3.72 The financial services sector has been, and will remain, an important part of the UK economy, not only contributing significantly to overall economic growth, but also providing the core mechanism through which households save for the future and businesses invest in opportunities. Looking ahead, one of the Government's overarching objectives remains the promotion of efficient, fair, stable and competitive financial markets. This is complemented by the Government's continued commitment to having an active dialogue with the financial services and related industries to ensure that London, as the world's leading international financial centre, and the UK, emerge from current difficulties equipped to respond to future challenges and opportunities.

3.73 Therefore, over the coming months, the Government will be working closely with senior executives in the asset management, insurance and wholesale financial markets to examine the strategic priorities facing these sectors and identify commercial and public policy challenges to be addressed. In addition, the Government looks forward to receiving by spring 2009 practical analysis from the Financial Services Global Competitiveness Group, led by Sir Win Bischoff, of the medium- to long-term trends impacting on the competitiveness of the global financial services industry, and considerations in due course from the UK professional services sector.

Box 3.9: Medium term perspective of the financial sector

Rapid growth in the financial sector contributed significantly to overall growth in the economy over the past decade. The financial sector's share of total UK Gross Value Added rose by half from 2000 to 2007. Much of this expansion was driven by sustainable factors. For example, the demand for financial services is supported by the need to:

- provide an increasingly wealthy population with wealth management and saving services;
- finance growing innovation in the wider economy by allowing investment opportunities to translate into actual investment, so boosting productivity and competitiveness; and
- efficiently monitor borrowers to ensure that funds are used appropriately and loans repaid in a timely manner.

On the supply side, financial innovations, especially risk diversification, also stimulated growth in the sector. Supporting these developments, the UK has consistently offered a favourable environment for financial services and related industries, attracting international talents and capital, and benefiting from an evident comparative advantage in the provision of financial services.

However, as discussed earlier in this chapter, rapid growth in financial services activity was also driven by the impact of under-priced risks; inadequate procedures for managing risk; and an excessive degree of leverage. As a consequence, the financial sector is likely to contract in the short term as it adjusts to reflect the impact of the ongoing credit shock.

Nevertheless, those sustainable demand drivers at work in the recent past will still continue to operate in the years to come. Benefiting from both its prominent position as a major financial centre, and well-balanced regulatory responses to the credit shock, the UK will continue to provide a favourable environment for global financial services.

