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The United Kingdom's Credit Guarantee Scheme (U.K. GFC)

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United Kingdom: Credit Guarantee Scheme[1]

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Abstract

The September 15, 2008, bankruptcy of Lehman Brothers resulted in a collapse of wholesale funding markets that threatened the ability of UK financial institutions to continue funding themselves. By the end of the month, two leading UK banks—HBOS and Bradford & Bingley—had to be rescued, and there was a real risk that the entire financial system could collapse. Faced with the need to stabilize the system, UK regulators on October 8 introduced a package of measures that included a £250 billion Credit Guarantee Scheme (the Guarantee Scheme) aimed at providing banks with access to needed funding. Under the Guarantee Scheme, eligible institutions could pay a risk-based fee and issue debt with terms of up to three years that would be guaranteed by HM Treasury. Debt issuance under the Guarantee Scheme was initially quite significant at approximately £100 billion by the end of 2008. After its issuance window closed on February 28, 2010, the Guarantee Scheme terminated on October 26, 2012, when the final guaranteed debt matured. During the course of its existence, the Guarantee Scheme had guaranteed approximately £134 billion in debt. HM Treasury suffered no losses under the program and earned approximately £4.3 billion in fees.

Keywords: United Kingdom, short-term debt, medium-term debt, government guarantee

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[1] This case study is part of the Yale Program on Financial Stability (YPFS) selection of New Bagehot Project modules considering the responses to the global financial crisis that pertain to bank debt guarantee programs.

Cases are available from the *Journal of Financial Crises* at https://elischolar.library.yale.edu/journal-of-financial-crises/.

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UK Credit Guarantee Scheme

At a Glance

Faced with the need to stabilize the financial system following the collapse of Lehman Brothers, UK regulators on October 8, 2008, introduced a package of measures that included the Credit Guarantee Scheme (the Guarantee Scheme), the Bank Recapitalisation Fund, and an expansion of the existing Special Liquidity Scheme.

Summary of Key Terms	
Purpose: "To assist in refinancing maturing, wholesale funding obligations as they fall due"	
Announcement Date	October 8, 2008
Operational Date	October 13, 2008
Date of First Guaranteed Loan Issuance	October 27, 2008
Issuance Window Expiration Date	Originally April 9, 2009; extended until December 31, 2009, and then February 28, 2010 (with some ability to roll over guaranteed debt after this date)
Program Size	£250 billion
Usage	Approximately £134 billion in guaranteed debt issued by approximately 14 institutions
Outcomes	No defaults; £4.3 billion in fees collected
Notable Features	Buybacks of guaranteed debt initially prohibited and later subject to a fee

Under the Guarantee Scheme, participants could pay a risk-based fee and issue debt with terms of up to three years that would be guaranteed by HM Treasury. Senior unsecured debt instruments with standard market terms used to refinance liabilities maturing after the launch of the Guarantee Scheme were eligible. Eight major UK financial institutions were automatically eligible for the Guarantee Scheme based on their participation in the Bank Recapitalisation Fund, and other UK deposit-takers and building societies could apply.

HM Treasury initially anticipated that £250 billion in debt would be issued under the Guarantee Scheme, and it established this amount as the size of the program subject to subsequent adjustment. By the end of 2008, approximately £100 billion of debt had been issued pursuant to the program by 14 institutions. In March 2010, shortly after the issuance window for the Guarantee Scheme closed, outstanding issuances stood at £125 billion, down from a total of £134 billion outstanding. Over the life of the program, HM Treasury collected fees totaling £4.3 billion and wasn't required to make any guarantee payouts.

Summary Evaluation

Although the specific impact of the Guarantee Scheme is difficult to determine given that it was one component of a package of measures, the establishment of the Guarantee Scheme was followed by a significant reduction in the stress that had been roiling wholesale funding markets.

UK Credit Guarantee Scheme: United Kingdom Context	
GDP **(SAAR, Nominal GDP in LCU converted to USD)**	$3,102.8 billion in 2007 $2,948.0 billion in 2008 *Source: Bloomberg*
GDP per capita **(SAAR, Nominal GDP in LCU converted to USD)**	$50,567 in 2007 $47,287 in 2008 *Source: Bloomberg*
Sovereign credit rating (5-year senior debt)	As of Q4 2007: Fitch: AAA Moody's: Aaa S&P: AAA As of Q4 2008: Fitch: AAA Moody's: Aaa S&P: AAA *Source: Bloomberg*
Size of banking system	$4,895.3 billion in total assets in 2007 $5,299.6 billion in total assets in 2008 *Source: Bloomberg*

Size of banking system as a percentage of GDP	157.8% in 2007 179.8% in 2008 *Source: Bloomberg*
Size of banking system as a percentage of financial system	Data not available for 2007/2008 *Source: World Bank Global Financial Development Database*
5-bank concentration of banking system	76.8% of total banking assets in 2007 79.1% of total banking assets in 2008 *Source: World Bank Global Financial Development Database*
Foreign involvement in banking system	14% of total banking assets in 2007 19% of total banking assets in 2008 *Source: World Bank Global Financial Development Database*
Government ownership of banking system	Data not available for 2007 1% of banks owned by the state in 2008 *Source: Call et al. "Bank Ownership – Trends and Implications"*

Existence of deposit insurance	100% insurance on deposits up to $4,000; 90% on next $66,000 in 2007 100% insurance on deposits up to $93,000 after October 2008 *Source: World Bank Deposit Insurance Dataset, OECD*

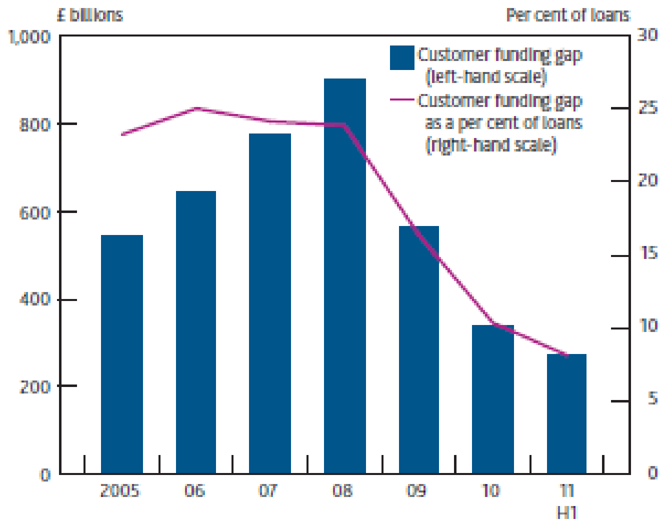
I. Overview

Background

In the years leading up to the global financial crisis of 2007–2009, the UK banking system became increasingly reliant on short-term wholesale funding as growth in customer loans far outpaced that in customer deposits. As shown in Figure 1, the extent of this customer funding gap increased from under £600 billion in 2005 to about £900 billion just three years later. The result was that many UK banks became extremely vulnerable to disruptions in wholesale funding.

Although stress in the UK banking system was evident as early as the September 2007 run on Northern Rock (in which the loss of wholesale funding required Northern Rock to seek assistance from the Bank of England, triggering the first British bank run in almost 150 years), it was not until a year later that the magnitude of the problem became fully apparent. Lehman Brothers' bankruptcy filing on September 15, 2008, resulted in a substantial spike in three-month interbank rates as indicated in Figure 2. Within a short time, the resulting deterioration of wholesale funding markets had threatened the continued existence of several of the UK's leading financial institutions. On September 17, Lloyds TSB agreed to acquire HBOS for £12 billion in a bid to rescue the country's largest mortgage lender. On September 29, the Chancellor of the Exchequer announced that the retail deposit business and branch network of Bradford & Bingley, the ninth-largest UK bank by market capitalization, had been transferred to Abbey National and its remaining business taken into public ownership following a determination by the Financial Services Authority that the bank no longer met minimum threshold conditions for operating as a depositor. These steps did little to calm the panic, however, and on October 6, the FTSE 100 fell by nearly 9% as it became apparent that the financial system faced the real risk of collapse.

Figure 1: UK Banks' Customer Funding Gap



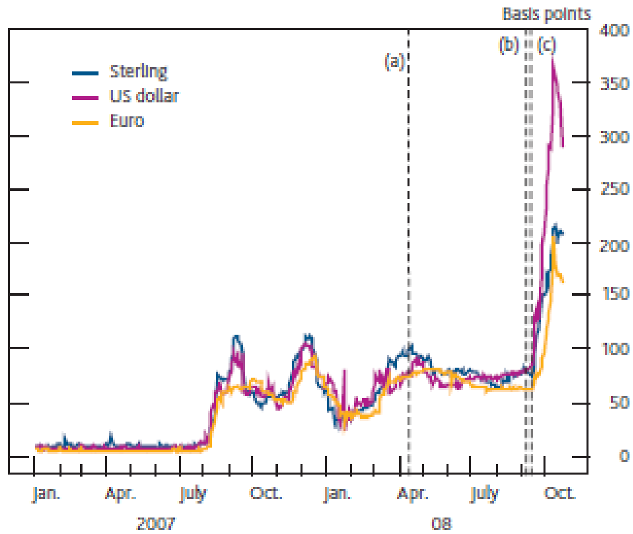
Sources: Published accounts and Bank calculations.

(a) Shows the gap between customer lending and customer funding, where customer refers to all non-bank borrowers and depositors. Repurchase agreements are excluded from loans and deposits where disclosed.

Source: Bank of England 2011, p. 17

Figure 2: Three-Month Interbank Rates

Three-month interbank rates relative to expected policy rates



Sources: Bloomberg and Bank calculations.
(a) April 2008 *Report*.
(b) Fannie Mae and Freddie Mac taken into conservatorship.
(c) Lehman Brothers Holdings files for Chapter 11 bankruptcy protection.

Source: Bank of England 2008, p. 5

Program Description

To avert this collapse, the British government announced a package of measures on October 8, 2008, designed to restore funding to banks. In addition to the Credit Guarantee Scheme (the Guarantee Scheme), this package included a £50 billion Bank Recapitalisation Fund (pursuant to which the government could inject capital into eligible institutions in return for equity) and an expansion of the existing Special Liquidity Scheme (pursuant to which banks could exchange high-quality mortgage-backed and other securities for HM Treasury bills for up to three years) to £200 billion, up from an initially projected £50 billion.

Under the Guarantee Scheme, eligible institutions could have eligible debt with terms of up to three years guaranteed by HM Treasury in exchange for a fee. The government does not appear to have established minimum maturity requirements for eligible debt. Initially, HM Treasury designated eight financial institutions, consisting of the major UK banks and largest building societies,[3] as eligible to participate in the Guarantee Scheme based on their commitment to strengthen their Tier 1 capital position via participation in the Bank Recapitalisation Fund. Other financial institutions could make a written request to HM Treasury for an "Institution Certificate" granting them eligibility. Subject to HM Treasury's discretion, to receive an Institution Certificate an institution had to be an authorized UK deposit taker (including the UK subsidiary of a foreign bank) or a UK building society. The institution further had to meet a Tier 1 capital threshold specified by HM Treasury and would have its role in the UK banking system and overall economy evaluated. Finally, the institution had to agree to submit a plan for being able to access the wholesale funding markets without benefit of the Guarantee Scheme.

Eligible institutions (whether those initially designated as such or those requesting and receiving an Institution Certificate) had the ability to apply for an "Eligibility Certificate" with respect to a given proposed issuance of debt. The application would set forth details about the proposed issuance including the type of debt, the principal amount, the currency in which denominated, an indicative interest rate or discount and the proposed issuance and maturity dates. To be eligible for the Guarantee Scheme, the debt would have to meet "Instrument Eligibility Criteria" including:

- being a senior unsecured debt instrument with standard market terms in the form of a certificate of deposit, commercial paper, a bond or a note;
- being single currency denominated in an eligible currency (originally sterling, euros, or US dollars, but later expanded to include Australian dollars, Canadian dollars, Swiss Francs, and Japanese yen);

[3] Abbey National, Barclays, HBOS, HSBC Bank, Lloyds TSB, Nationwide Building Society, Royal Bank of Scotland, and Standard Chartered.

- not containing an event of default constituted by cross-default or cross-acceleration (i.e., a default or acceleration under other outstanding debt could not automatically give rise to a default under this debt); and

- being used to refinance liabilities maturing after the commencement of the Guarantee Scheme.

As part of its application, the eligible institution also had to include an executed "Counter-Indemnity" (pursuant to which the institution agreed to be responsible for any losses suffered by HM Treasury in connection with guaranteeing the institution's debt) and an executed "Fee Letter" (pursuant to which the institution agreed to pay the fees associated with the Guarantee Scheme as described below).

The Eligibility Certificate issued upon acceptance of an application notified potential purchasers of the debt that HM Treasury would be responsible for any payments the debt-issuing institution failed to make. The terms of this obligation were set forth in a "Deed of Guarantee" made by HM Treasury in favor of all persons holding any debt guaranteed under the Guarantee Scheme. Once the Eligibility Certificate had been issued, the financial institution would have 30 days to issue the debt it covered.

Upon the earlier of the issuance of the debt or three business days after the issuance of the Eligibility Certificate, the financial institution would become responsible for paying a fee based on a per annum rate of 50 basis points (bps) plus 100% of the median five-year credit default swap (CDS) spread during the 12 months ended July 1, 2008, of the debt-issuing institution or any affiliate designated by HM Treasury. This fee would apply to the principal amount specified in the Eligibility Certificate and would last until the scheduled maturity of the debt (or for 30 days after the Eligibility Certificate was issued if no debt was ever issued). The fee was payable in the currency set forth in the Eligibility Certificate and could be increased to reflect any costs associated with payment in currencies other than sterling.

Participating institutions initially had to agree to specified limitations on balance sheet growth tied to the average growth of the UK banking sector and the growth of the UK's economy. UK authorities later eliminated these restrictions. The Guarantee Scheme also prohibited explicit use of the Scheme as part of an institution's marketing. With the prolongation of the Guarantee Scheme in April 2009, UK authorities introduced a requirement that large banks issuing guaranteed debt after April 9, 2009 agree to negotiated levels of lending to the real economy.

HM Treasury initially anticipated that £250 billion in debt would be issued under the Guarantee Scheme, and it established this amount as the size of the program subject to subsequent adjustment. HM Treasury determined the amount that individual institutions could issue pursuant to the Guarantee Scheme based on their sterling deposit liabilities. Eligible institutions had until the end of a specified issuance window (such end originally set as April 9, 2009, but later extended until December 31, 2009, and then February 28, 2010) to apply for Eligibility Certificates and make new issuances of guaranteed debt. Following the expiration of the issuance window (known in the parlance of the Guarantee Scheme as the "drawdown window"), all guaranteed debt issued pursuant to an Eligibility Certificate could be rolled over until April 13, 2012. After that date, up to £83 billion (one-third the £250 billion program size) in guaranteed debt could be rolled over until April 9, 2014.

The Guarantee Scheme originally prohibited institutions from repurchasing and retiring any debt issued. A June 2011 amendment established a Credit Guarantee Scheme Buyback Facility that enabled issuers to repurchase guaranteed debt prior to maturity subject to a break fee of 15% of the Guarantee Scheme fee that otherwise would have been payable had the guaranteed debt remained outstanding.

Outcomes

A small group of eligible institutions made significant use of the Guarantee Scheme in the first three months after its introduction. By the end of 2008, approximately £100 billion of debt had been issued pursuant to the program by 14 institutions (including Barclays Bank and Lloyds TSB). An additional 47 eligible institutions (including HSBC Bank and Standard Chartered Bank) did not issue any debt under the Guarantee Scheme. In March 2010, shortly after the issuance window for the Guarantee Scheme closed, outstanding issuances stood at £125 billion, down from a total of £134 billion outstanding as debt issued during the early days of the program matured (HM Treasury 2010). This was half of the £250 billion amount initially projected by HM Treasury.

As indicated in Figure 3, debt was issued under the Guarantee Scheme in several different currencies. The overwhelming majority of this debt had a maturity of between one and three years, with less than £2 billion being issued with a maturity less than 12 months.

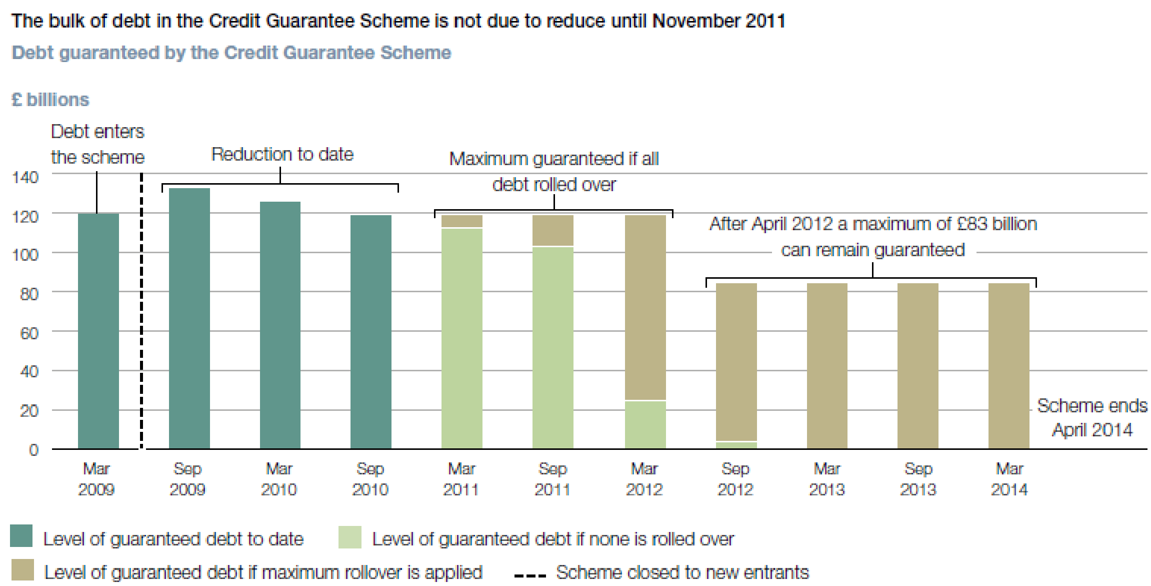
Figure 3: Credit Guarantee Scheme Issuances by Currency (as of March 24, 2010)

Sterling (£mn)	Euros (£mn)	US Dollars (£mn)	Australian Dollars (£mn)	Swiss Francs (£mn)	Japanese Yen (£mn)	Canadian Dollars (£mn)
48,763	19,747	45,522	1,952	207	8,742	–

Source: HM Treasury 2010, p. 2

As shown in Figure 4, under the Guarantee Scheme's rollover provisions as much as £83 billion of guaranteed debt could have remained outstanding as late as the program's April 2014 termination date. Participating institutions did not make use of this feature however, and by October 26, 2012, HM Treasury terminated the Guarantee Scheme after the final guarantee expired. Over the life of the program, HM Treasury collected fees totaling £4.3 billion and wasn't required to make any guarantee payouts (National Audit Office 2013).

Figure 4: Timeline of the Debt Guaranteed under the Credit Guarantee Scheme



Source: National Audit Office 2010, p. 26

II. Key Design Decisions

1. **The British government introduced the Guarantee Scheme as part of a package of stabilization measures announced on October 8, 2008, that included a recapitalization fund and the extension of a special liquidity program.**

Faced with the potential collapse of the financial system following the rescue of HBOS and Bradford & Bingley, the British government announced a package of measures on October 8, 2008, intended to "to ensure the stability of the financial system and to protect ordinary savers, depositors, businesses and borrowers" (HM Treasury 2008a). In addition to the Credit Guarantee Scheme (the Guarantee Scheme), this package included the £50 billion Bank Recapitalisation Fund (pursuant to which the government could inject capital into eligible institutions in return for equity) and an expansion of the existing Special Liquidity Scheme (pursuant to which banks could exchange high-quality mortgage-backed and other securities for HM Treasury bills for up to three years) to £200 billion, up from the £50 billion initially projected. The Bank of England declared debt guaranteed pursuant to the Guarantee Scheme eligible for all of the Bank's extended collateral operations including the Special Liquidity Scheme.

2. **The Guarantee Scheme was established pursuant to the authority of the Chancellor of the Exchequer to issue guarantees of debt.**

This authority allowed for the establishment of the Guarantee Scheme without the need for additional legislation.

3. **In accordance with State aid rules, the Guarantee Scheme required European Commission approval to be implemented.**

UK authorities notified the European Commission of the October 8 package of measures on October 11, 2008, and received approval on October 13, 2008, under a new accelerated procedure for emergency rescue measures. The European Commission found the measures to be "compatible with EU State aid rules, because they were an appropriate means to remedy a serious disturbance in the UK economy" under Article 87(3)(b)of the European Commission Treaty (EC 2008a). UK authorities subsequently notified the European Commission of modifications to the Guarantee Scheme (including an expansion of eligible currencies, a change to the formula for calculating fees, and an extension of the rollover window) on December 18, 2008, and received approval on December 23, 2008.

4. **The size of the program was initially established at £250 billion, subject to subsequent adjustment.**

The British government established the size of the Guarantee Scheme at £250 billion, reflecting HM Treasury's estimate of the amount of debt likely to be issued pursuant to the program. This total was subject to subsequent adjustment; because actual issuance proved to be far less than the £250 billion projection, no adjustment in total size was ever made.

5. **Eight major UK financial institutions were automatically eligible for the Guarantee Scheme, and other UK deposit takers and building societies could apply for eligibility.**

When the British government introduced the Guarantee Scheme as part of the October 8, 2008, package of stabilization measures, it made eight institutions, consisting of the major UK banks and the largest building societies,[4] automatically eligible for participation "in recognition of their commitment to strengthen their aggregate capital position" by a collective £25 billion in Tier 1 capital pursuant to the Bank Recapitalisation Fund that was also part of the package. This commitment occurred following "discussions convened by HM Treasury." Other UK deposit takers (including UK-incorporated subsidiaries of foreign institutions) and building societies could apply to be eligible, with eligibility contingent on a determination by HM Treasury that the applicant possessed sufficient Tier 1 capital. Applicants would also be evaluated on their roles in the UK banking system and overall economy.

[4] See footnote 3.

6. **Senior unsecured debt instruments with standard market terms used to refinance liabilities maturing after the launch of the Guarantee Scheme were eligible.**

These instruments could take the form of a certificate of deposit, commercial paper, a bond, or a note. No cross-default or cross-acceleration provisions could be included.

7. **Debt with maturities of up to three years could be issued under the Guarantee Scheme.**

The government does not appear to have established minimum maturity requirements for eligible debt.

8. **Only debt issued in sterling, euros, or US dollars was eligible for the Guarantee Scheme until the list of eligible currencies was expanded.**

This initial list of eligible currencies was ultimately expanded as part of the December 2008 modifications to include Australian dollars, Canadian dollars, Swiss Francs, and Japanese yen, with the objective of "further extending the investor base in UK banks and building societies" (HM Treasury 2008b).

9. **Individual caps on participation were to be determined by HM Treasury based on a firm's sterling deposit liabilities.**

Program documents did not provide a specific rationale for using this measure to determine individual participation caps.

10. **The fee for issuing debt pursuant to the Guarantee Scheme varied based on the soundness of the issuing bank.**

HM Treasury charged a fee (payable in the currency in which the guarantee was denominated) equal to a per annum rate of 50 bps plus 100% of the median five-year CDS spread during the 12 months ended July 1, 2008, of the debt-issuing institution or any affiliate designated by HM Treasury. This fee could be increased in HM Treasury's discretion to reflect any added cost associated with guaranteeing debt issued in currencies other than sterling.

This approach to determining fees based on institution-specific risk as measured through five-year CDS spreads was consistent with the fee framework subsequently set forth by the European Central Bank in its "Recommendations on Government Guarantees on Bank Debt" of October 20, 2008. UK authorities initially chose the 12-month period ended October 7, 2008 as the CDS reference period for the fee calculation, but in December 2008 they shifted to the July 1, 2008 end date based on a desire to lower fees to be more consistent with other countries' guarantee programs. This revised reference period had retroactive effect.

11. The repurchase of guaranteed debt was initially prohibited; it later became subject to a cancellation fee.

When introduced, the Guarantee Scheme contained a provision prohibiting eligible debt from including any right of prepayment by the issuer. On June 8, 2011, UK authorities amended the Guarantee Scheme to include a Buyback Facility pursuant to which issuers could repurchase and cancel guaranteed debt. Such repurchases would relieve the issuer of the obligation to pay any future guarantee fees on the cancelled debt, in exchange for which the issuer would pay a break fee equal to 15% of the total future guarantee fees avoided.

12. Participating institutions faced a prohibition on using the Guarantee Scheme in advertising and, initially, limitations on growth. A requirement for lending to the real economy was later added.

Institutions participating in the Guarantee Scheme initially had to limit their growth "to the higher of the average historical growth of the balance sheets in the UK banking sector during the period 1987–2007, or the annual rate of growth of UK nominal GDP in the preceding year." In December 2008, UK authorities eliminated this condition for institutions deemed "fundamentally sound."

Participants also had to refrain from "explicitly promoting [themselves] on the basis of the state guarantee" (European Commission 2008b). These restrictions were consistent with European Commission guidelines subsequently released in October 2008 on potential safeguards "to minimize…distortions and the potential abuse of the preferential situations of beneficiaries brought about by a State guarantee" and "to avoid moral hazard" (European Commission 2008c).

A set of additional conditions including compensation restrictions, lending commitments, and support for mortgage assistance programs imposed on participants in the Bank Recapitalisation Fund did not generally apply to the Guarantee Scheme but could be imposed on a case-by-case basis, particularly for institutions that made heavy use of it (European Commission 2008b).

In connection with the prolongation of the Guarantee Scheme in April 2009, UK authorities added a requirement that large banks (defined as having more than £25 billion in sterling eligible liabilities) issuing guaranteed debt after April 9, 2009 commit to a negotiated level of lending to the real economy.

13. Participating institutions had to submit a plan for ultimately being able to access the wholesale funding market without the benefit of the Guarantee Scheme.

UK authorities intended this requirement to help ensure that only those institutions that would be viable absent crisis conditions could access the Guarantee Scheme.

14. The deadline for issuance under the Guarantee Scheme was initially April 9, 2009, but was later extended to February 28, 2010.

According to UK authorities, lingering uncertainty about the credit risk of individual financial institutions continued to hinder interbank lending markets as the Guarantee Scheme approached its originally scheduled issuance deadline. This required that the Guarantee Scheme be prolonged.

15. Even after the issuance deadline, guaranteed debt could be rolled over for a certain period of time.

Following the expiration of the issuance window, all guaranteed debt issued pursuant to an Eligibility Certificate could be rolled over until April 13, 2012. After that date, up to £83 billion (one-third the £250 billion program size) in guaranteed debt could be rolled over until April 9, 2014. The purpose of these rollover provisions was "to enable participating institutions to manage better the transition from guaranteed to wholly unsupported funding" (House of Commons 2008).

III. Evaluation

Although the specific impact of the Guarantee Scheme is difficult to determine, given that it was one component of a package of measures introduced at the same time (including a significant expansion of the Special Liquidity Scheme and the creation of the Bank Recapitalisation Fund), the establishment of the Guarantee Scheme was followed by a significant reduction in the stress that had been roiling wholesale funding markets. As shown in Figure 5, less than a month after the introduction of the Guarantee Scheme CDS spreads for many leading UK financial institutions had fallen by a half to two-thirds.

Figure 5: Major UK Banks' Credit Default Swap Spreads, April 2008–October 2008

Major UK banks' CDS spreads[(a)]

Credit default swap spreads (basis points)[(b)]

	April 2008 *Report*	Prior to support package[(c)]	October 2008 *Report*
Barclays	99	196	101
HBOS	175	264	102
Lloyds TSB	73	146	80
RBS	113	291	103
HSBC	78	98	65
Nationwide	211	292	103

Sources: Thomson Datastream and Bank calculations.
(a) Data to close of business on 20 October 2008.
(b) Five-year senior credit default swaps.
(c) Last closing price before UK Government's announcement of financial support package.

Source: Bank of England 2008, p. 6

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V. Key Program Documents

Summary of Program

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