

# UK Asset Protection Scheme

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February 2009



HM TREASURY





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ISBN 978-1-84532-572-5  
PU756

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# 1

# Purpose of the Asset Protection Scheme

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## Financial market and economic context

**1.1** Financial markets influence the lives of every business and family in the country. The banking system is vital to the efficient operation of the economy: enabling payments, protecting savings, providing funds to credit-worthy borrowers, and channelling savers' funds to the most productive investment opportunities. Financial institutions are therefore a key driver of productivity, growth and opportunity.

**1.2** The world's financial markets have experienced unprecedented turbulence since summer 2007, which has intensified into the worst financial crisis for generations. The resulting withdrawal of credit has led to a world recession, which in turn is adding to fears about the value of assets that the banking system holds. Without these uncertainties resolved, banks will be constrained from lending to creditworthy people and businesses, which is essential for our economy.

**1.3** Against this backdrop of economic and financial uncertainties, governments and other authorities across the world have acted to tackle threats to financial stability and, in turn, to deal with difficulties in the real economy. The UK Government has, throughout this period, intervened to protect the interests of individuals, businesses and the taxpayer, including:

- actions to protect individual depositors and risks to financial stability arising from difficulties in specific banks, including Northern Rock and Bradford & Bingley;
- acting quickly to resolve fears about the solvency of the banking system with the establishment of a recapitalisation scheme in October 2008, followed quickly by international action to recapitalise banks; and
- to address funding concerns at the same time, establishing the Credit Guarantee Scheme in October 2008.

## The Asset Protection Scheme

**1.4** On 19 January 2009, the Government announced a comprehensive package of measures designed to reinforce the stability of the financial system following the intensification of the global economic downturn, and in turn to support the recovery of the economy by increasing the capacity of banks to lend. As part of this package, the Government announced its intention to introduce an Asset Protection Scheme, and set out some principles for its design.

**1.5** The Government's intervention in October to recapitalise major banks successfully stabilised the UK banking system, and was followed by similar interventions across the world. Adding capital to banks usually has powerful "multiplier" effects in terms of encouraging banks to lend. This is particularly the case when the economy is growing as banks search for new profitable lending opportunities. This multiplier mechanism is currently impaired by the problems in the global financial system.

**1.6** The deterioration in growth prospects around the world and rising credit losses are creating costly levels of uncertainty around the value of assets held on banks' balance sheets. Both the

complexity of structured products and the uncertainty around economic losses mean that banks and their investors are unable to predict the degree of losses on these assets with any confidence. This fear and uncertainty, and the extent to which banks are holding capital to protect themselves from worst case scenarios undermines the multiplier effect and prevents banks from providing credit to credit-worthy borrowers, with damaging consequences for economic growth.

**1.7** Doubts around the value of banks' previous investments are at the root of why banks are constrained in their lending - because banks and their investors are uncertain about the future value of these assets they have an incentive to hoard capital rather than lend to businesses and households. In such circumstances it may be necessary for governments to bear some of the risk attached to banks' existing assets by providing a manageable maximum loss on these assets. The Asset Protection Scheme works in this way, dealing with the problem of legacy assets by providing a floor on any future losses on protected assets. This allows for the cleaning up of banks' balance sheets and provides them with the confidence around the scale of future losses to rebuild their operations and to increase lending in the economy.

## **International action**

**1.8** This approach has a long history and has been used in many countries across the world. In its most direct form, this is often described as a "good bank, bad bank" strategy, where either a new vehicle, supported by public money, is created, or where insurance is used to separate the impaired assets, either outside or within the original bank. There are already several specific examples of government arrangements to assist in dealing with impaired assets at individual banks in the US, Netherlands and Switzerland. The Government has also recently announced that it proposes to restructure the operation of Northern Rock's business to provide for the separation of "good" and "bad" businesses and pursued a similar strategy in the resolution of Bradford and Bingley. Past experiences of this strategy in developed countries such as Sweden, Japan and the US have been generally positive with the final cost to the taxpayer only a small fraction of support.

**1.9** The development of the Scheme has taken into account developments internationally, including other countries' experience of schemes to deal with legacy assets. The Government strongly supports the need for coordinated international action to tackle these issues and, in addition to working closely with the European Commission and EU Member States, has today written to partners in the G20 proposing a set of key principles to discuss at the forthcoming meeting of G20 Finance Ministers on 14 March, as set out in Chapter 4.

**1.10** This document provides further information on the design of, operation and the conditions attached to the Scheme, international cooperation on impaired assets, and sets out next steps on the Asset Protection Scheme.

# 2

## Scheme Design

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**2.1** This Chapter sets out the Treasury's current thinking about the design of the Asset Protection Scheme. It follows detailed discussions with a number of financial institutions about scheme design. Aspects of the scheme design will evolve as these discussions continue and detailed contractual terms are finalised.

**2.2** Under the Scheme, in return for a fee, the Treasury will provide to each participating institution protection against credit losses incurred from 1 January 2009 on existing assets which have been placed in the Scheme. The cover extends to portfolios of defined assets to the extent that overall credit losses on these assets exceed a "first loss" amount to be borne by the institution. It is intended that the Scheme will target those asset classes that represent the cause of the uncertainty in the current economic conditions. The Treasury protection will cover 90 per cent. of the credit losses which exceed this "first loss" amount. Each participating institution will be required to retain a further residual exposure of 10 per cent. of the credit losses which exceed the "first loss" amount. This residual exposure will provide an appropriate incentive for participating institutions to endeavour to keep losses to a minimum.

**2.3** This Chapter covers particular aspects of the design of the Scheme, including:

- eligible institutions;
- eligible assets;
- assessment of "first loss" amounts and fee;
- disclosure;
- regulatory capital and accounting treatments; and
- duration.

### Eligible institutions

**2.4** As stated in the announcement of 19 January, protection under the Scheme is offered, in the first instance, to UK incorporated authorised deposit-takers (including UK subsidiaries of foreign institutions) with more than £25 billion of eligible assets. Affiliated entities of those deposit-takers will also be considered by the Treasury for protection under the Scheme.

**2.5** The Treasury will consider extending the Scheme more widely to other UK incorporated authorised deposit-takers (including UK subsidiaries of foreign institutions). Further participation in the Scheme will be at the discretion of the Treasury taking account of the advice of the Bank of England and the FSA on the basis of its judgement of how important the deposit-taker concerned is to financial market stability and the overall economy and the most effective possible use of public resources.

**2.6** The Government's recapitalisation and credit guarantee schemes continue to be available to those institutions that are eligible to participate in those schemes.

**2.7** Each applicant to any of the Government schemes (including this Scheme) is required to satisfy the Treasury that going forward:

- it is adequately capitalised and funded or has a realistic plan for accessing adequate capital and funding;
- it has a sustainable business model and delivery plan;
- its funding profile, sources and mix are broad-based and sustainable; and
- its senior management team is credible, with demonstrable ability to deliver its business model and delivery plan.

## Eligible assets

**2.8** The Scheme is intended to provide protection for those assets on an institution's balance sheet where there is the greatest degree of uncertainty about the future performance of those assets or asset classes. The following categories of assets are eligible for inclusion in the Scheme:

- corporate and leveraged loans;
- commercial and residential property loans;
- structured credit assets, including residential mortgage-backed securities (RMBS), commercial mortgage-backed securities (CMBS), collateralised loan obligations (CLO) and collateralised debt obligations (CDO);
- participations in respect of the above;

**2.9** Each asset to be included in the Scheme must:

- have been owned by the institution or an affiliate from 31 December 2008 to the date on which the institution enters the Scheme (subject to exceptions for certain permitted arrangements);
- have been included on the audited consolidated balance sheet of the institution's group from 31 December 2008 to the date on which the institution enters the Scheme; and
- be denominated in sterling, euro or US dollars, or such other currency as the Treasury may agree.

**2.10** The Treasury will continue to work with the relevant institutions to assess whether certain other classes of assets can be included in the Scheme. Inclusion of additional classes of assets within the Scheme is subject to determination by the Treasury and its advisers of any additional terms relating to their inclusion.

**2.11** Unfunded commitments to lend and revolving loan facilities may be included in the Scheme provided the commitment to fund has been in effect from 31 December 2008. Certain refinancings and rollovers of assets may be eligible for inclusion on a basis to be agreed with the Treasury.

**2.12** Participants may only include synthetic positions or long positions arising without ownership, short positions, hedges or other forms of credit mitigation with the prior consent of the Treasury.

**2.13** Similarly, participants may only include certain equity or equity-like assets and certain assets which are obligations of entities controlled by the institution with the prior consent of the Treasury.

**2.14** The Scheme covers assets owned by and on the balance sheet of an entity which became a member of the institution's group after 31 December 2008.

**2.15** Assets covered by the Scheme are required to be held by the institution or one or more of its affiliates which has been approved by the Treasury (subject to exceptions for certain permitted arrangements). Such approval will be given in light of the impact on financial market stability and the overall economy and the most effective possible use of public resources.

**2.16** The Treasury may waive any one or more of these criteria on a case-by-case basis.

**2.17** Assets proposed for inclusion in the Scheme will be subject to appropriate scrutiny and due diligence by the Treasury and its advisers. Applicants are required to give the Treasury and its advisers open access to all information required by them for this purpose.

## **Assessment of “first loss” amount and fee**

**2.18** In setting the terms under which protection will be offered, the Treasury and its advisers will take into account, amongst other considerations, their estimation of the performance of the assets of the institution to be included in the Scheme.

**2.19** Pricing of the Scheme will be structured having regard to international practice and European Commission guidance on state aid. The “first loss” and fee amount to be borne by the institution will be set with a view to capping future losses on certain portfolios of assets. Because of the traditional par value approach to the guarantee offered by HM Treasury, the first loss will include existing impairments. The institution will therefore only be exposed for the excess between current impairments and the first loss ceiling.

**2.20** To protect the interest of the taxpayer, the Scheme’s first loss will be set at a level that provides an appropriate incentive for the institution to ensure efficient management of asset performance. The fee is charged on the assets covered by the Scheme and the amount paid by participating institutions depends on the amount of assets included in the Scheme. The fee is designed to compensate the taxpayer for insuring assets, and the pricing and structure of the Scheme will also ensure that the Treasury benefits from a share of any upside returns.

**2.21** The fee can be paid in cash but will usually be satisfied by the issue of capital instruments by the institution. These instruments may include a range of alternative capital instruments, but are not expected to include ordinary voting shares. These instruments will contribute to the capital of participating institutions, further stabilizing and restoring market confidence in them. The Treasury is open to proposals of other forms of the fee, including cash.

**2.22** Participating institutions may cancel the protection under the Scheme at any time in whole or in part with the prior consent of HM Treasury. It is envisaged that a termination amount will be payable in connection with any early termination.

## **Assessment of loss under the Scheme**

**2.23** The Scheme offers protection against credit risk on the assets covered by the Scheme. For this reason, the loss suffered on an asset is determined under the Scheme by reference to the outstanding principal amount of the asset at the date on which a credit event occurs or, if lower, the amount covered under the Scheme in respect of the asset. All subsequent amounts recovered in respect of that asset will reduce the loss in respect of that institution’s asset pool, and are applied as follows:

- when the first loss amount has not been exceeded, for the account of the institution;
- when the first loss amount has been exceeded, 90% of recoveries compensate the Treasury for amounts payable or payments made under the Scheme to the institution, and the remaining 10% of recoveries compensate the institution; and

- any remaining recoveries are received by the institution.

**2.24** The credit events covered under the Scheme do not include unrealised losses resulting from changes in the market value of the assets included in the Scheme, accounting provisions or accounting write-downs by the participating institutions or the disposal of assets covered by the Scheme. Losses covered under the Scheme will be adjusted to exclude losses arising from failure by the institution to manage the asset in accordance with the asset management requirements of the Scheme. Chapter 3 includes further details on the asset management requirements of the Scheme.

**2.25** It should be noted that banks may have already taken provisions or write-downs against certain assets protected under the Scheme. If so, the institution may have already made provision against losses that may fall within the first loss amount for which it would be potentially liable under the Scheme.

## **Diligence on assets covered by the Scheme**

**2.26** The Treasury has worked closely with a number of eligible institutions to agree which assets should be covered by the Scheme. This work has been supported by a parallel process of risk assessment and due diligence to check whether or not the levels of coverage, degree of risk transfer, and overall Scheme economics are robust and compatible with the overall objectives of the Scheme.

**2.27** Following publication of this document, the due diligence will continue to broaden and deepen the detailed analysis allowing greater coverage of detailed analysis of assets covered by the Scheme. Nevertheless, significant uncertainty will remain over the value of many assets in the scheme while current market conditions persist.

**2.28** Specifically, the Treasury's objectives in relation to due diligence include:

- Being satisfied that the assets most affected by current economic conditions are brought into the Scheme;
- Being satisfied that the size and nature of the risks being passed on to the Treasury are well understood and appropriately factored into the terms of the Scheme, as agreed with the institutions; and
- Applying appropriate and justifiable criteria for inclusion of assets into the Scheme.

**2.29** In order to help deliver these objectives, the Treasury has, in coordination with the Bank of England and the Financial Services Authority, deployed experienced teams to review the participant institutions. The Treasury has appointed independent advisers from accountancy and investment banking firms to support teams from across the Tripartite Authorities in this work.

**2.30** The diligence process has considered where the areas of greatest uncertainty and risk might lie, and has targeted more detailed analysis to consider these areas – utilising a range of approaches to generate an assessment of the overall risk to public finances. This has included bottom-up scrutiny and risk assessment across the proposed asset portfolios; including assumptions drawn from rating agency models and other forecasts, assessment of the institutions' own internal risk models; all subject to cross-checking with the Tripartite Authorities' own assumptions on the impact of the Scheme on individual firms and estimated losses that participant banks might suffer.

## **Conditions**

**2.31** Participation in the Asset Protection Scheme carries with it a number of conditions:

- **Lending commitments.** Participating institutions will be required to make contractual commitments to additional lending to households and business in 2009 and 2010. The institutions will also agree to participate in a range of Government and industry initiatives to support borrowers and businesses in difficulty. These commitments will be agreed with the individual banks on a commercial basis.

Participating institutions will report to Government on a monthly basis on delivering their commitments. The Government will keep these agreements under review and report annually on their delivery.

- **Disclosure.** All participants in the Scheme are required to meet the highest international standards of public disclosure in relation to the institution's asset pool as well as its assets that are outside the Scheme. This aims to ensure that the institution's financial position is transparent and to improve comparability between institutions. The FSA and HM Treasury will consult on these standards in due course.

Subject to maintaining appropriate commercial confidentiality, the Treasury will publish and lay before Parliament the agreements which it enters into with participating institutions in relation to the operation of the Scheme.

- **Remuneration.** There must be an end to the banking sector's short-term bonus culture. The independent Walker Review of bank governance has already been established, with preliminary conclusions due by Autumn 2009, including on how all bank boards can ensure they develop sustainable remuneration policies.

Participants in the Asset Protection Scheme will be required to develop a remuneration policy consistent with the Financial Service Authority's Code of Remuneration Policy, published on 26 February for consultation. They will also have to comply with specific remuneration rules designed to ensure that assets covered by the Scheme are properly managed.

## Regulatory capital and accounting treatment of the Scheme

**2.32** The Treasury will seek to implement the Scheme in a manner which is efficient and effective for regulatory capital purposes and achieves an appropriate accounting treatment, taking into account the assets included in the Scheme. The FSA's view on the regulatory capital implication of the Scheme is reproduced at Annex D, and available on its website.<sup>1</sup>

## Duration of the Scheme

**2.33** The duration of the coverage will be not less than five years and will be consistent with the tenor of the assets. The Treasury will also report regularly to Parliament on the operation of the Scheme and the implications for the taxpayer.

## State Aid

**2.34** The Scheme requires notification to the European Commission under the EC State Aid rules and cannot be implemented until clearance is received. This is covered further in Chapter 4.

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<sup>1</sup> [www.fsa.gov.uk](http://www.fsa.gov.uk)



# 3

## Operation of the Scheme

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**3.1** The success of the Scheme, including the management of risk to taxpayers, will rely on its operation as well as its design. This Chapter sets out key elements of the operation of the Scheme, including:

- organisational arrangements and accountabilities;
- asset management arrangements;
- paying for the Scheme; and
- transitional arrangements.

### Organisation and accountabilities

**3.2** To achieve the goals of the Asset Protection Scheme, the Treasury is to enter into individual asset protection arrangements with participating financial institutions. These arrangements are to be managed for the duration of the scheme by a self-standing unit based in the Treasury but at arms' length from its day-to-day business. This will ensure that decisions are taken on a commercial basis and that any potential conflicts of interest with other aspects of the Treasury's business are mitigated, including those that might exist from the Government's shareholdings in financial institutions that are participating in the Scheme.

**3.3** This unit will be governed by a Framework Document and headed by an additional accounting officer, ensuring that Parliament has appropriate oversight of the Scheme. This Framework Document will be published shortly. The objectives of the Scheme operation will be to deliver value to and protect the taxpayer, whilst giving due consideration to the maintenance of financial stability. The Chancellor of the Exchequer will empower the unit to manage the Scheme on a day-to-day basis to achieve this. Certain interventions, including those that could have particularly significant implications for the taxpayer, will remain subject to ministerial approval.

**3.4** The primary ongoing role of this unit will be to check claims and administer fees and payments relating to assets covered by the Scheme. To achieve this, the unit will monitor and oversee the ongoing management of protected assets by participating institutions. The unit will oversee the banks' management of the assets in the Asset Protection Scheme and will also monitor their adherence to the Scheme.

**3.5** To keep administrative costs to a minimum it is anticipated that the Treasury's existing back-office infrastructure will be made use of where possible. It is expected that the Scheme will be staffed by a small number of highly-qualified individuals employed on contracts in line with best practice in the public sector.

## **Asset management requirements for Asset Protection Scheme participants**

**3.6** Assets included in the Scheme will continue to be managed by the relevant participating institution in accordance with its ordinary business practices and remain on its balance sheet. To protect taxpayers interests, participants will be subject to a number of conditions and Treasury controls over the management of protected assets. These requirements are expected to include:

- managing protected assets according to agreed principles and guidelines;
- requiring participating institutions to set up efficient operating structures to manage and report on protected assets;
- requiring participants to agree with the Treasury remuneration policies that align the interests of employees involved in managing assets backed by the scheme with those of taxpayers; and
- agreeing with participating institutions the rights that the Treasury has regarding the management of the protected assets.

### **a) Principles and guidelines for protected assets**

**3.7** The Government believes that the overarching principle to follow should be to maximise the economic value of their protected assets. This will help to mitigate potential implications for the public finances while contributing to financial stability. In addition to this overarching principle, the Government may put in place more detailed asset management guidelines for individual participants.

### **b) Governance arrangements for protected assets**

**3.8** The Board of Directors at a participating institution is responsible for compliance with the Scheme. However, to manage any potential conflicts of interest, the Government expects as far as possible that the management of protected assets will be segregated from the remainder of the institution. The precise nature of this will depend on the existing operating structures of each institution, but in outline it is expected that participants will be required to manage protected assets within an autonomous business unit under an asset management committee and dedicated protected asset senior executive team. In addition, it is expected that senior appointments to this unit will be subject to the Treasury's approval. Where the management of the protected assets cannot be segregated, it is expected that the Treasury would have to approve the alternative arrangements that are put in place.

**3.9** To enable the Government to monitor the management of protected assets effectively, participating institutions will be required to submit comprehensive and transparent financial and performance data on a regular basis. The Treasury will also have a right of access on an ad hoc basis to any relevant information relating to assets backed by the scheme.

### **c) Remuneration arrangements for managers of protected assets**

**3.10** The Government intends to agree with participating financial institutions that they will put in place sensible, sustainable remuneration policies for employees involved in managing assets covered by the scheme. It is expected that these remuneration policies will be subject to the Treasury's approval. In practice, it is likely this will mean that the compensation of relevant employees (up to and including senior executives) will be in part dependent on their success in mitigating the potential liability for the taxpayer from the assets they manage.

## **d) Treasury rights over protected assets**

**3.11** In general, it is the Government's intention that as far as is appropriate decisions regarding individual assets or groups of assets should be left with the institutions in question. This ensures that those who best understand the assets are responsible for managing them. It is expected however that certain asset transactions will be subject to the Treasury's approval. These include transactions with related parties, transactions involving assets above a threshold value and transactions adversely affecting the credit quality of assets.

**3.12** In addition, the Scheme will also provide for the Treasury to take over management of the assets – or to appoint an appropriate third party to manage these assets on the public's behalf – in certain circumstances. These could include where participants have been unable to meet with the detailed asset management requirements set out above or in instances where there could be significant implications for the public finances. In addition, the Government would expect to assess for each participating institution whether their asset management arrangements remain appropriate in the event that a participant's losses have exceeded their agreed "first loss" amount.

**3.13** The Treasury may agree with the institution to purchase assets protected by the Scheme at a later date.

**3.14** The Treasury will also consider applications by an institution to make asset sales from the covered pool consistent with maximising taxpayer value.

## **Paying for the Asset Protection Scheme**

**3.15** It is expected that participating institutions will cover the costs incurred by the Treasury in connection with the Scheme. These costs will include those relating to the Scheme's initial establishment and set-up, ongoing scheme operating costs and any other costs – such as those associated with the Treasury taking over direct management of protected assets – that may be necessary. These costs will be allocated to individual participating institutions on a pro rata basis. Participants will be expected to meet set-up costs ahead of the commencement of the scheme and to make regular payments thereafter.

## **Transitional arrangements**

**3.16** The detailed contractual terms on which financial institutions will participate in the Scheme will be agreed prior to the Scheme's commencement. During this period, it is essential that the interests of all stakeholders, including taxpayers, are taken into account by participating institutions when taking decisions relating to the assets that will be covered by the Scheme.

**3.17** To achieve this, the Government will agree with participating institutions that they will provide appropriate information, access and assistance during this "pre-accession" period. In addition participating institutions will – subject to consultation with the Treasury – start to develop the asset management strategy that they will undertake following the commencement of the Scheme and the operational and management structures that they will implement to support this.



# 4

## International cooperation

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### The case for international coordination

**4.1** The Government believes that the problems associated with impaired assets are best tackled with international co-operation, given the nature of global financial markets. This Chapter:

- Sets out the case for international co-ordination;
- Provides an update on actions in the EU; and
- Sets out actions underway internationally.

**4.2** Financial markets are global in nature. Assets originated in one country are often traded and held in many others. This brings important benefits by allowing banks to reduce their concentration of risks, but also leads to higher risks of cross-border contagion when a major dislocation occurs. Banks themselves are often major cross-border businesses, with activities across the world.

**4.3** Many countries are either taking, or expect to take, action to deal with impaired assets. The Government believes that the global nature of banks and the cross-border holdings of many assets mean that a concerted international approach will be more effective than the sum of national initiatives. In particular, international cooperation will:

- Boost market confidence by increasing the coverage of treated assets and creating positive spillover effects;
- Ensure that issues affecting cross-border banks are addressed effectively and coherently by the different national authorities in which they operate; and
- Reduce negative spillovers such as distortions in competition and domestic retrenchment to national markets.

### (a) Boosting market confidence and effects

**4.4** Concerted action will show governments' commitment to take rapid and decisive action to address the financial crisis. Increasing the proportion of assets covered globally by impaired assets measures would also reduce the risk of extreme losses and increase the positive impact on lending and the global economy. While the fiscal implications of broadening impaired asset relief measures need to be considered very carefully, the larger and deeper the coverage of assets, the stronger this positive loop between reduced uncertainty, lending and economic growth would potentially be.

**4.5** Coordinated international action has a further benefit if it helps to regularise the international interbank market. A greater number of healthy banks creates beneficial network effects shared between all banks. This, in effect, creates a positive contagion effect across banks, which would multiply the effect of the schemes on investors and public confidence.

**4.6** International cooperation on disclosure requirements could also provide an important benefit. The announcement of steadily worse losses and disclosures coming from major financial institutions has had a negative impact on confidence. To break this cycle, fuller disclosure on banks' balance sheets is necessary. An international approach would allow investors to make a reasonable judgement about banks' financial positions and inspire greater confidence that all the 'bad news' has come out while avoiding potential competitive distortions arising from different disclosure requirements. The FSA and Treasury will be publishing a joint consultation document on disclosure shortly.

### **(b) Cross-border banking**

**4.7** Global banks have branches and assets across and within many countries, raising issues about which national authorities are best placed to deal with their impaired assets, about potential inconsistencies across national jurisdictions and risks of insufficient institutional coverage to ensure effectiveness. International coordination on institutional eligibility criteria would help resolve these issues and ensure a more coherent policy.

### **(c) Reducing negative spillovers**

**4.8** As the downturn spreads across the world, for the first time, cross-border flows are growing more slowly than domestic flows and some banks are starting to favour their domestic lending over foreign lending. It is vital that national measures aimed at stimulating lending do not encourage a retreat into financial protectionism. Concerted action at the international level can also help to mitigate the pressures being faced by some emerging markets as a result of changes to capital and lending flows during the current financial crisis.

## **European Union action**

**4.9** The Government welcomes recent debates in the Council of Economic and Finance Ministers (ECOFIN) of the EU on how best to tackle the financial crisis. On 20 January ECOFIN agreed to take strong and decisive actions in order to stimulate economies, provide liquidity, strengthen the capital of financial institutions, protect savings and deposits, address regulatory deficiencies and unfreeze credit markets. This was followed on 20 February by further agreement by ECOFIN on the need for a common and coordinated approach to the issue of impaired assets in order to safeguard banking stability.<sup>1</sup>

**4.10** The European Commission, the European Central Bank and EU Member States have been working closely together on developing a framework to address impaired assets to maximize the effectiveness of asset relief measures and minimise distortions. The European Commission published on 25 February guidelines including a set of key principles for the operation of schemes to tackle impaired assets in the banking sector. The key principles include a consistent approach to valuation, retention of a portion of the risk by the banks in question, full transparency, and ongoing monitoring of implementation.

**4.11** The Government is in discussions about the Asset Protection Scheme with the European Commission. Implementation of the Scheme will depend on state aid approval from the Commission.

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<sup>1</sup> Implementation of financial rescue packages and treatment of impaired assets, ECOFIN Ministers breakfast meeting, Brussels, 10 February 2009, [www.consiliium.europa.eu](http://www.consiliium.europa.eu)

## International

**4.12** Financial markets are integrated at the global level, and many of the benefits of international coordination will come through action with partner countries in America, Asia and Africa.

**4.13** As well as discussing these issues with key partners, the Government proposes that the G20 should agree a set of principles covering action on impaired assets. The Chancellor of the Exchequer has written to partners in the G20 proposing a set of key principles to discuss at the forthcoming meeting of G20 finance ministers on 14 March, as at Annex E, and looks forward to working with G20 colleagues on these in the coming weeks.





# Scheme Term Sheet

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## Part 1. Scheme Participation

### 1. Scheme participants

- (1) UK incorporated authorised deposit-taker (including UK subsidiary of foreign institution) with more than £25 billion of assets satisfying the Asset Eligibility Criteria (as defined in paragraph 11) (the “**Bank**”); or
- (2) an affiliate of the Bank (including a holding company thereof) that has been approved by Her Majesty’s Treasury (“**HMT**”) as eligible for inclusion under the Scheme,

(the Bank or, as the case may be, such affiliate, the “**Participant**”).

HMT may consider extending the Scheme to other UK incorporated authorised deposit-takers (including UK subsidiaries of foreign institutions not covered by (1) or (2) above) based on advice of the Bank of England and the Financial Services Authority (the “**FSA**”) and based on HMT’s best judgment of how important the deposit-taker concerned is to financial market stability and the overall economy and the most effective possible use of public resources.

### 2. Application period

A Participant shall be entitled, until (and including) 31 March 2009 (or such later date as may be determined by HMT in its sole discretion), to request to participate in the Scheme.

### 3. Application Criteria; Lending Condition

In order to participate in the Scheme each Participant must satisfy HMT that it meets the criteria for eligibility for protection under the Scheme (the “**Application Criteria**”), namely that the Participant and its group:

- is adequately capitalised and funded or has a realistic plan for accessing adequate capital and funding;
- has a sustainable business model and delivery plan;
- has a broad-based and sustainable funding profile, sources and mix; and
- has a credible senior management team, with demonstrable ability to deliver its business model and delivery plan.

Each Participant’s participation in the Scheme is also conditional upon:

- (1) the relevant Participant making a verifiable commitment to advance new credit to creditworthy borrowers in a commercial manner (the “**Lending Condition**”); and
- (2) the relevant Participant giving HMT and its advisers (or, as applicable, procuring that HMT and advisers are given) open access to all information (including full disclosure of the Balance Sheet (as defined in paragraph 11)) as may be required by HMT and its

advisers to assess the probability and expected quantum of future loss in relation to the relevant assets and the satisfaction of the Application Criteria.

#### 4. Accession to the Scheme by the Participants

Each Participant wishing to participate in the Scheme is required to accede to the Scheme Rules (as defined in paragraph 6) pursuant to an accession agreement to be entered into with HMT (in a form to be agreed between that Participant and HMT) (the "**Accession Agreement**"). The Accession Agreement will specify, *inter alia*, each of the details set out in the Schedule to this term sheet in respect of that Participant. The relevant accession date with respect to a Participant shall be the "**Participant Accession Date**".

#### 5. Conditions precedent to the Participant's accession to the Scheme

To include the following in respect of each Participant:

- evidence satisfactory to HMT that the Participant and its group (i) satisfy the Application Criteria (including the delivery of its business model and delivery plan) and (ii) have committed to the applicable Lending Condition;
- executed Scheme documents, including the relevant Accession Agreement and documents relating to issue of capital instruments pursuant to the fee arrangements referred to in paragraph 23, each in a form satisfactory to HMT;
- European Commission state aid clearance in respect of the Scheme;
- other applicable regulatory approvals or waivers (including any approvals required in connection with the issue of capital instruments pursuant to the fee arrangements referred to in paragraph 23);
- all relevant opinions (which may include legal, regulatory capital, tax and accounting opinions) issued to the Participant (and disclosed to HMT) by the Participant's relevant professional advisers;
- board resolutions (including specified signatories acceptable to HMT) and requisite shareholder resolutions approving the entry into the Scheme and execution of associated documentation, including the applicable Accession Agreement and any capital instruments to be issued as part of the fee arrangements referred to in paragraph 23 (in the case of shareholder resolutions, save to the extent that a derogation from the applicable Listing Rule has been obtained from the UKLA);
- documentation for implementation, administration and monitoring compliance with the applicable Remuneration Policy (as defined in paragraph 27), as specified in the applicable Accession Agreement;
- evidence that the asset management structure required by the Asset Management Requirements (as defined in paragraph 26) has been or will be implemented as specified in the applicable Accession Agreement;
- completion of due diligence satisfactory to HMT in relation to the relevant Covered Assets (as defined in paragraph 10) and in relation to the Balance Sheet (as defined in paragraph 11); and
- such further conditions as may be specified in the relevant Accession Agreement.

#### 6. Anticipated commencement date of Scheme

The date of publication of the finalised rules of the Scheme (the "**Scheme Rules**") by HMT shall be the "**Scheme Commencement Date**".

This term sheet is not legally binding and no obligation or liability on HMT or any Participant arises except to the extent that it is expressly undertaken by such party, whether in the Scheme Rules, the relevant Accession Agreement or otherwise.

## Part 2. Scheme structure and parameters

#### 7. Availability of Scheme within Participant's group; nature of the Scheme

Subject as provided below in this paragraph 7, it is envisaged that the Scheme will comprise one protection scheme (which will be structured as a financial guarantee as defined in IAS 39 and recorded as such in the consolidated accounts of the Participant's group).

The Scheme is intended to cover assets satisfying the Asset Eligibility Criteria (as defined in paragraph 11) Owned (as defined in paragraph 11) by the Participant and one or more of its affiliates approved by HMT in light of HMT's assessment of (i) the impact on financial market stability and the overall economy and (ii) the most effective possible use of public resources (such affiliates together with the relevant Participant and any transferee of the Covered Assets referred to in paragraph 28, the "**Covered Entities**"). The Participant may enter into appropriate risk transfer arrangements with the Covered Entities.

To the extent that the Covered Assets cannot be reclassified so that they are no longer required to be fair valued, HMT may consider a request by a Participant to split the Scheme into two transactions for, respectively:

- (1) Covered Assets not being fair valued through the consolidated profit and loss account of that Participant's group (the relevant protection being structured as a financial guarantee as defined in IAS 39); and
- (2) Covered Assets being fair valued through the consolidated profit and loss account of that Participant's group (the relevant protection being structured as a derivative as defined in IAS 39).

HMT will seek to implement the Scheme in respect of each Participant in a manner which is efficient and effective for regulatory capital purposes and, in this regard, HMT intends to work closely with the relevant Participant and the FSA.

#### 8. Term

The term of the protection under the Scheme will be consistent with the tenor of the relevant Covered Assets. The Scheme will terminate on the date specified in the applicable Accession Agreement or, as the case may be, on the date of termination of that Participant's participation in the Scheme in accordance with paragraph 9 (the "**Termination Date**").

#### 9. Early termination

A Participant may terminate its participation in the Scheme at any time in whole or in part with the prior consent of HMT. It is envisaged that a termination amount will be payable in connection with any early termination in accordance with paragraph 23.

#### 10. Covered Assets; Covered Assets Pool

The following assets may be included within the Scheme:

- corporate and leveraged loans;
- commercial and residential property loans;
- structured credit assets (including residential mortgage-backed securities (RMBS), commercial mortgage-backed securities (CMBS), collateralised loan obligations (CLO) and collateralised debt obligations (CDO));
- participations in respect of the above; and
- such other assets or exposures as HMT may consent to being included in the Scheme,

in each case, provided each asset or exposure satisfies the Asset Eligibility Criteria. Assets which meet such Asset Eligibility Criteria and are included within the Scheme constitute the "**Covered Assets**".

Each asset or exposure to be included in a pool of Covered Assets (the “**Covered Assets Pool**”) must be identified upon entry into the Scheme in a schedule to the Accession Agreement (the “**Covered Assets Schedule**”). The Covered Assets Schedule may be amended as a result of the post-accession confirmation process pursuant to paragraph 25.

The Covered Assets may include unfunded commitments and revolving facilities that satisfy the Asset Eligibility Criteria provided that the commitment to fund was in effect at all times from (and including) 31 December 2008 to (and including) the date of utilisation. Certain refinancings and roll overs of assets or exposures will be eligible for inclusion on a basis to be agreed with HMT.

The Covered Assets may not include synthetic positions or long positions arising without Ownership (as defined in paragraph 11) nor do they include short positions, hedges or other credit mitigants, unless HMT specifically consents to the inclusion of such assets.

When considering whether to consent to the inclusion within the Scheme of assets or exposures which would otherwise be excluded, HMT is likely to have regard, among other things, to whether the inclusion of such assets or exposures is likely to be consistent with the Scheme’s objectives. The provisions of this term sheet may have to be amended to accommodate any such assets or exposures which are so included.

## 11. Asset Eligibility Criteria

The “**Asset Eligibility Criteria**” are that the relevant asset or exposure:

- must have been an asset or exposure:
  - (i) Owned (as defined in this paragraph 11) by the Participant, an affiliate of the Participant or any Relevant Entity (as defined in this paragraph 11) from (and including) 31 December 2008 to (and including) the Scheme Commencement Date (subject to any Permitted Arrangement, as defined in this paragraph 11),
  - (ii) Owned by a Covered Entity on the Scheme Commencement Date (subject to any Permitted Arrangement), and
  - (iii) which was included in the audited consolidated balance sheet of the Participant’s group or the audited balance sheet of a Relevant Entity (each, a “**Balance Sheet**”) from (and including) 31 December 2008 to (and including) the Scheme Commencement Date;
- must not be an equity or equity-linked asset, save that convertible and exchangeable instruments on standard terms may be included with the consent of HMT;
- must have fixed or determinable payments and a defined final maturity or an imputed maturity date;
- must not have as an obligor the Participant or a person that, directly or indirectly, is in control of, is controlled by or is under common control with the Participant (and, for this purpose, SPV issuers of asset-backed securities will not be deemed to be so affiliated solely as a result of any economic interest in such issuer); and
- must be denominated in euro, US dollars or sterling or such other currency as may be agreed by HMT,

provided that HMT may at any time waive one or more of such criteria on a case by case basis. When considering whether to waive such criteria with respect to a specific asset or exposure, HMT is likely to have regard, among other things, to whether the inclusion of such asset or exposure within the Scheme is likely to be consistent with the Scheme’s objectives. The provisions of this term sheet may have to be amended to the extent such criteria are waived.

In this paragraph 11:

**“Ownership”** of an asset means (i) legal and beneficial ownership of that asset or (ii) other significant economic exposure to that asset acceptable to HMT and **“Owned”** shall be construed accordingly.

**“Permitted Arrangement”** means a pledge or other security interest or a repo, stock loan or other title transfer arrangement in respect of an asset where:

- (i) the relevant Covered Entity (or, as the case may be, affiliate of the Participant) continues to retain sufficient economic exposure to the relevant asset, and
- (ii) such arrangement allows the relevant Covered Entity (or, as the case may be, affiliate of the Participant) to obtain Ownership of the asset (or an equivalent asset) at any time (including, for example, by substituting other eligible collateral),

provided that HMT may agree to vary the conditions referred to in (i) and/or (ii) above on a case by case basis.

**“Relevant Entity”** means an entity which became a member of a Participant’s group before the Scheme Commencement Date but which was not part of that Participant’s group as at 31 December 2008.

## 12. Quantum of Covered Assets

The amount of each Participant’s Covered Assets Pool (the **“Covered Assets Pool Amount”**) will be set out in the relevant Accession Agreement, being an amount equal to the aggregate of the outstanding principal balance (or, as the case may be, the amount of the applicable commitment) (the **“Covered Amount”**) of each Covered Asset in the relevant Covered Assets Pool as at 31 December 2008, as specified in the Covered Assets Schedule.

## 13. First loss retention by Participant

Payments will be made under the Scheme in respect of Losses (as defined in paragraph 16) on Covered Assets only to the extent that the aggregate amount of such Losses (as reduced by any Recoveries received by the Participant in accordance with paragraph 17) exceeds the sterling amount specified as the first loss amount in the Accession Agreement for that Participant (the **“First Loss Amount”**).

## 14. Loss allocation

HMT will cover 90% of the Losses arising in respect of the Covered Assets Pool which exceed the First Loss Amount applicable to that Participant. The remaining 10% of those Losses will be borne by the relevant Covered Entity (the **“Residual Amount”**).

## 15. Triggers

A Covered Asset will be treated as defaulted upon the occurrence with respect to it of any of the following (each, a **“Trigger”**):

- (1) failure to pay amounts due (whether principal, interest or otherwise), subject to grace period and provision for cure;
- (2) bankruptcy; or
- (3) such other event or circumstance (including certain restructurings) as HMT may agree shall be a Trigger in respect of a specific Covered Asset or a Covered Assets Pool (as specified in the relevant Accession Agreement).

A Trigger may have occurred in respect of a Covered Asset before the Scheme Commencement Date.

Triggers do not include (i) unrealised mark-to-market losses, (ii) accounting provisions or accounting write-downs, or (iii) disposals of Covered Assets.

## 16. Calculation of Losses on Covered Assets

Losses will be determined in respect of each Participant by reference to the following principles:

- Following the occurrence of a Trigger in respect of a Covered Asset, a loss (the “**Loss**”) will arise equal to the lesser of the outstanding principal balance of that Covered Asset as at the date on which the Trigger occurred and the Covered Amount (but excluding any interest capitalised after 31 December 2008).
- All Covered Assets in respect of which a Trigger has occurred (regardless of whether the Trigger occurs before the First Loss Amount is exceeded) will be triggered assets for the purposes of the Scheme (the “**Triggered Assets**”).
- Losses will be adjusted to exclude losses arising from a failure by the Participant to manage (or procure the management of) the Covered Assets in accordance with the Asset Management Requirements.

## 17. Allocation of Recoveries

All amounts paid or other recoveries made with respect to the Triggered Assets (whether in respect of principal or interest), net of the direct costs and expenses of any such amounts and recoveries (such net amount, the “**Recoveries**”), will be applied in respect of each quarter (each, a “**Calculation Period**”) on the following basis:

- (1) whenever the First Loss Amount is not exceeded, Recoveries will be for the account of the relevant Participant and, accordingly, will be deducted from the aggregate amount of Losses for the purpose of determining whether the First Loss Amount has been exceeded;
- (2) whenever the First Loss Amount is exceeded, Recoveries will be applied as follows:
  - (a) 90% of Recoveries will be applied in (i) firstly, discharging amounts (whether or not then due) that would otherwise have been payable by HMT under the Scheme in respect of then Triggered Assets and (ii) secondly, reimbursing HMT for payments made under the Scheme, including interest thereon (from the date of the relevant payment by HMT to the date of reimbursement) at the Reference Rate (as defined in paragraph 21); and
  - (b) 10% of Recoveries will be for the account of the relevant Participant; and
- (3) whenever Recoveries exceed the amount then required (on a 90/10 basis) to discharge the amounts referred to in paragraphs 17(2)(a)(i) and 17(2)(a)(ii) above, the whole of the excess will be for the account of the relevant Participant and, accordingly, will be deemed to reduce the aggregate amount of Losses (as reduced by any Recoveries received by the Participant in accordance with this paragraph 17) below the First Loss Amount by an amount corresponding to the excess, with the effect that subsequent Losses will be for the account of the Participant and subsequent Recoveries will be applied in accordance with paragraph 17(1) above until the First Loss Amount is once again exceeded.

## 18. Treatment of non-sterling denominated Covered Assets

HMT and the Participant will together develop a hedging strategy in respect of the Covered Assets.

Losses will be converted into sterling at the spot rate on the date of the relevant Trigger. Recoveries in respect of Triggered Assets will be converted into sterling at the spot rate on the date the relevant Recoveries are received.

## 19. Quarterly Statement

Each Participant shall provide HMT with a quarterly statement setting out the aggregate amount of all Losses and Recoveries in respect of the Triggered Assets (within a period to be agreed) after the end of each Calculation Period (a “**Quarterly Statement**”).

The form of a Quarterly Statement will be set out in the Scheme Rules.

## Part 3. Settlement of Losses

### 20. Scheme Ledger

A separate ledger account (each, a “**Scheme Ledger**”) shall be maintained by or on behalf of each Participant of the amounts payable by HMT to that Participant in respect of Losses referable to Triggered Assets. Whenever the First Loss Amount is exceeded, the balance of the relevant Scheme Ledger shall be:

- increased as of the date of the applicable Trigger by an amount equal to 90% of each Loss;
- reduced by an amount equal to 90% of each Recovery as of the date that Recovery is received in accordance with paragraph 17(2)(a)(i);
- reduced by the amount of each payment made by HMT pursuant to paragraph 21;
- increased by the interest credited pursuant to paragraph 21; and
- adjusted as otherwise required to give effect to the Scheme documentation.

If the relevant Scheme Ledger reduces to zero, subsequent Recoveries shall be applied in accordance with paragraph 17(2)(a)(ii) in reimbursing HMT for payments it has made under the Scheme (including interest thereon) and, thereafter, pursuant to paragraphs 17(3) and 17(1).

Each Scheme Ledger shall be maintained in sterling. The balance of a Scheme Ledger shall not reduce below zero.

### 21. Timing and frequency of payments in respect of Losses by HMT; Reference Rate

HMT shall settle amounts due under the Scheme in respect of Losses (as reduced by Recoveries) in accordance with timing to be specified in or pursuant to the Scheme documentation until the balance of the relevant Scheme Ledger is reduced to zero, provided that HMT may (at its sole discretion) resolve to make such payments on earlier dates. HMT shall make such payments only to the extent the balance of the relevant Scheme Ledger is more than zero. Each such payment shall reduce the balance of the relevant Scheme Ledger. HMT’s liability under the Scheme shall not exceed the balance from time to time of the relevant Scheme Ledger.

Any positive balance on the relevant Scheme Ledger shall accrue interest daily at a rate determined by HMT to correspond to HMT’s cost of funds (the “**Reference Rate**”). The Reference Rate is expected to be reset by HMT, and accrued interest is expected to be credited to the relevant Scheme Ledger, on a quarterly basis.

Each payment by HMT shall be made in sterling.

### 22. Conditions precedent to payment by HMT under the Scheme

To include the following:

- the balance of the relevant Participant’s Scheme Ledger is more than zero;
- each of the repeating representations and warranties are true, accurate and not misleading on the date of the relevant payment;
- no Event of Default has occurred and is continuing on the date of the relevant payment;
- HMT has received a duly delivered and completed Quarterly Statement; and

- delivery of such other documents as may be specified in the applicable Accession Agreement.

#### **Part 4. Fees and costs**

##### **23. Fees to be paid by each Participant**

The relevant Accession Agreement will specify the fee (and the form of such fee) payable by the relevant Participant to HMT (the “**Fee**”). The Fee will include an amount calculated to be the applicable Participant’s pro rata share of the costs incurred or to be incurred by HMT in establishing the Scheme.

Upon early termination by a Participant pursuant to paragraph 9, a termination amount will be payable as agreed by HMT and the relevant Participant at the relevant time, taking into account the Fee paid (or payable) by the relevant Participant.

##### **24. Cost of the Scheme**

Each Participant shall bear its own costs and expenses in connection with its accession to, and participation in, the Scheme.

Each Participant shall bear an appropriate proportion of the ongoing costs and expenses of administering the Scheme incurred by or on behalf of HMT (including any costs and expenses of (i) the assignment, transfer or delegation of its monitoring, administration or enforcement rights pursuant to paragraph 31, or (ii) the appointment of an independent manager by HMT pursuant to paragraph 26). HMT will invoice the relevant Participant quarterly in respect of these costs. If, following a period of consultation, the parties are unable to resolve any disagreement as to the amount of any such costs, HMT’s position will prevail.

#### **Part 5. Scheme operation**

##### **25. Post-accession confirmation process; removal of assets from Covered Assets Pool**

An updated Covered Assets Schedule must be prepared by the Participant within a specified period following the relevant Participant Accession Date reflecting any necessary adjustments to the Covered Assets Pool Amount or to the composition of the Covered Assets Pool (due to any asset not meeting the Asset Eligibility Criteria or not being within an eligible asset class (as described in paragraph 10) or any Covered Amount or other material details of any asset having been incorrectly stated).

The Scheme will not cover Losses in respect of any asset removed from the initial Covered Assets Schedule pursuant to the post-accession confirmation process.

If assets are removed from the initial Covered Assets Schedule as a result of the post-accession confirmation process, the Participant may include substitute assets in its updated Covered Assets Schedule, provided that (i) each such substitute asset satisfies the Asset Eligibility Criteria and (ii) the aggregate of the Covered Amount of each of the substitute assets as at 31 December 2008 does not exceed the aggregate of the Covered Amount of each of the removed assets as at 31 December 2008.

HMT may object to the updated Covered Assets Schedule within a specified period following the receipt thereof. In the case of any disagreement as to the final composition of the updated Covered Assets Schedule, if there is no resolution within a specified period following the relevant Participant Accession Date, the relevant Covered Assets Schedule shall be amended consistent with HMT’s position.

Following the completion of the post-accession confirmation process, substitutions of Covered Assets or additions of assets to the Covered Asset Pool are not permitted.

## 26. Management of assets

Each Participant will continue to manage, or procure that the relevant Covered Entities manage, the Covered Assets (including any Triggered Assets) in accordance with its ordinary business practices, and will in addition be required to comply with the general and asset pool specific asset management requirements prescribed by HMT and specified in the applicable Accession Agreement (the “**Asset Management Requirements**”). The Asset Management Requirements will include:

- a. reporting requirements, including for purposes of facilitating Loss quantification, to provide financial, risk and performance data in respect of the Covered Asset Pool and to monitor compliance with the Scheme (including the applicable Remuneration Policy and the applicable Asset Management Requirements), such reporting to be undertaken in a format and manner prescribed by, or agreed with, HMT;
- b. a requirement to adopt oversight and control procedures with respect to the management of the Covered Assets Pool, including notice and/or approval requirements for (i) transactions with related parties (or otherwise on terms that are not arm’s length), (ii) transactions (including disposals) affecting or involving the Covered Assets with a value in excess of, or resulting in aggregate Losses in excess of, thresholds specified in the relevant Accession Agreement or (iii) transactions which adversely affect the credit quality of a Covered Asset (the “**Restricted Transactions**”).
- c. increased reporting requirements, and oversight and control procedures for Restricted Transactions;
- d. requirements in relation to organisational structure, staffing, resourcing, systems and controls required for implementation, administration and monitoring compliance with the Scheme, the applicable Remuneration Policy and the other Asset Management Requirements, in each case, on terms no less favourable than those accorded to the group’s assets which are outside the Scheme, and including audit/verification requirements prescribed by HMT;
- e. a requirement to provide HMT and its agents access to all books, records and other relevant information within that Participant’s control and relating to that Participant’s group’s Covered Assets and its participation in the Scheme;
- f. a requirement to mitigate its Loss, including in respect of the implementation of any restructuring, compromise or other dealing in respect of a Covered Asset, realisation of security/collateral, the application of netting and set-off rights, and claiming on hedges, guarantees and/or indemnities and any other risk mitigants;
- g. negative pledge in respect of assets contained in the Covered Assets Pool (subject to any Permitted Arrangements up to the date of delivery of a Quarterly Statement in respect of the relevant asset);
- h. right for HMT to appoint an independent manager to manage or supervise the management of some or all of the Covered Assets in prescribed circumstances, including if aggregate Losses exceed the applicable threshold specified in the relevant Accession Agreement; and
- i. requirements relating to the monitoring and management of conflicts of interest and potential conflicts of interest.

## 27. Remuneration

Each Participant will be required to adopt a remuneration policy within the parameters, or which otherwise meets the requirements, specified in the relevant Accession Agreement (the “**Remuneration Policy**”). It is envisaged that the Remuneration Policy will include a performance based remuneration policy applicable to those involved in implementing, administering and

monitoring compliance with the terms of the Scheme and the applicable Asset Management Requirements.

28. Covenants of each Participant in respect of its Covered Assets To include the following (subject to any applicable materiality and/or other thresholds or remedy periods specified in the Scheme Rules or, as the case may be, the applicable Accession Agreement):

- by the first anniversary of the relevant Accession Agreement, transfer of Ownership of certain of the Covered Assets to a group company or companies agreed with HMT (or, where such transfer is not feasible or where the relevant Participant demonstrates to the satisfaction of HMT that the burden of such transfer would outweigh the benefits of such transfer, such other arrangement with respect to the relevant Covered Assets as may be agreed with HMT);
- each Covered Asset is Owned by a Covered Entity (subject to any Permitted Arrangement) and the Covered Assets are included in the Balance Sheet;
- provision of such financial and other information within the control or possession of a Covered Entity as HMT may from time to time reasonably request;
- compliance with applicable laws and compliance with and performance of its obligations under the Scheme, the relevant Accession Agreement and any other document relating to its participation in the Scheme (including compliance by each Participant and the relevant Covered Entities with the applicable Remuneration Policy, the applicable Asset Management Requirements and the best practice disclosure requirements referred to in paragraph 34);
- keep separate and appropriate books and records in relation to the Covered Assets and permit representatives of HMT access to its books and records relating to the Covered Assets;
- no credit hedging in respect of the Residual Amount without HMT's prior consent;
- give notice to HMT of (i) any Event of Default (as defined in paragraph 30) or potential Event of Default, (ii) any material litigation, investigation or proceeding affecting any Covered Entity, (iii) any other development or event that has or could reasonably be expected to have a material adverse effect on the Covered Entities or rights and remedies of HMT under the Scheme; and
- such other covenants as may be specified with respect to a Participant in the relevant Accession Agreement.

29. Representations and warranties of each Participant

To include the following (those marked with asterisk to be given by the Participant in respect of itself and each other relevant Covered Entity), subject to any applicable materiality and/or other thresholds or remedy periods specified in the Scheme Rules or, as the case may be, the applicable Accession Agreement:

- customary corporate representations (\*);
- ownership of all Covered Entities;
- power and authority to enter into the Scheme as a Participant or a Covered Entity (\*);
- no conflict (\*);
- accuracy of information provided (\*);
- financial statements, including no material change (\*);
- no guarantees, indemnities, borrowings or defaults which would be material in the context of the Scheme (\*);
- intellectual property, information technology (\*);
- insurance (\*);
- insolvency (\*);
- regulatory, competition (\*);
- litigation (\*);
- pensions (\*); and

- such other representations and warranties as may be specified with respect to a Participant in the relevant Accession Agreement.

### 30. Events of Default

The following events will constitute an event of default (each, an “**Event of Default**”) with respect to a Participant (subject to any applicable materiality and/or other thresholds or remedy periods specified in the Scheme Rules or, as the case may be, the applicable Accession Agreement):

- failure to apply Recoveries in accordance with the requirements specified in paragraph 17;
- any repeating representation or warranty is untrue, inaccurate or misleading in any respect;
- failure by the relevant member(s) of the Participant’s group to observe or perform any covenant, agreement or undertaking in relation to the Scheme (including in respect of the applicable Asset Management Requirements and the applicable Remuneration Policy);
- repudiation and rescission;
- unlawfulness or invalidity of a Participant’s obligations under Scheme; and
- such other events or circumstances as may be specified with respect to a Participant in the relevant Accession Agreement.

## Part 6. Other matters

### 31. Assignment; Transfer

HMT will be entitled to assign, transfer or otherwise delegate at any time during the term of the Scheme and on such terms as it considers appropriate:

- (1) some or all of its monitoring, administration and enforcement rights under the Scheme to a regulatory authority, government department, non-departmental government body, a body exercising functions on behalf of the Crown, a body corporate established by HMT or any third party provider; and/or
- (2) some or all of the risk associated with the protection under the Scheme, subject to parameters to be agreed at the relevant time between HMT and the Participant, and having regard to the effect of any such transfer on the regulatory capital position of the Covered Entities.

No Participant is entitled to assign, transfer or otherwise delegate any of its rights or obligations under or in connection with the Scheme without the prior written consent of HMT, except (i) as provided for in paragraph 7, and (ii) (in the case of any delegation of its obligations under or in connection with the Scheme) in respect of ordinary course of business arrangements for the relevant class of asset or intra-group arrangements.

### 32. Confidentiality

Scheme documentation will provide for suitable confidentiality provisions in relation to the disclosure of information by the Covered Entities, taking into account the applicable legal, regulatory and contractual restrictions.

HMT will enter into suitable confidentiality undertakings with each Participant with regard to confidential information provided to HMT in order to monitor, administer and enforce the terms of the Scheme. Such undertakings will provide appropriate disclosure carve-outs to enable HMT to:

- fulfil its reporting obligations, including to Parliament, Parliamentary committees and the European Commission;
- comply with legal obligations to which it is subject; and

- liaise with the other Tripartite Authorities on the implementation, administration and monitoring of the Scheme.

### 33. Announcements; publicity

Save as required by applicable law or regulations (including in connection with listing securities), no announcements will be made by any Participant, its agents or advisers in relation to the Scheme or a Participant's participation in the Scheme without the prior written consent of HMT.

HMT will publish and lay before Parliament the material documentation in relation to the Scheme (including the Scheme Rules and the Accession Agreements).

### 34. Best practice disclosure in relation to Participant's assets

- (1) Requirement to comply with the highest international standards of public disclosure in relation to the Participant's Covered Assets Pool as well as the Participant's assets which are outside the Scheme, as set out in the final form of the public disclosure requirements established by the FSA and HMT in relation to the Scheme following the end of the consultation period referred to in the FSA's consultation paper dated on or around 26 February 2009.
- (2) Requirement to provide sufficient and appropriate information on a regular basis to enable HMT and its advisers to monitor:
  - compliance with the terms of the Scheme;
  - the performance of the Covered Assets; and
  - any transaction or event that has or might have a material impact on the Scheme or the rights and remedies of HMT under the Scheme.
- (3) HMT verification requirements in relation to the public disclosure referred to in paragraph 34(1):
  - full audit/verification for annual results of the Covered Assets Pool;
  - review opinion to be provided for half-yearly results of the Covered Assets Pool; and
  - no opinion to be provided for interim management statements, in line with current practice.

### 35. Dispute resolution

Any disputes in relation to the Scheme will be determined in accordance with an agreed, expedited process and any determinations in relation to the Scheme (including in relation to Losses and/or Recoveries) will be conclusively determined by an independent third party.

### 26. Governing law

English law

## SCHEDULE

### Details to be specified in respect of a Participant in the relevant Accession Agreement

The Accession Agreement to be entered into between each Participant and HMT will include the following details in respect of that Participant:

- Covered Entities;
- Covered Assets Schedule;
- term of the protection provided to the Participant under the Scheme;
- First Loss Amount;
- Covered Assets Pool Amount (calculated in accordance with paragraph 12), denominated in sterling;
- any additional Triggers applicable to that Participant;

- the quarterly payment dates applicable to that Participant;
- details of the Fee payable by the Participant to HMT;
- the Asset Management Requirements;
- details of the Remuneration Policy to be adopted;
- any representations, warranties, covenants, events of default and/or conditions precedent specific to that Participant and any applicable materiality and/or threshold qualifications or remedy periods for specific representations, warranties and/or covenants; and
- any necessary variation to the Scheme Rules in respect of that Participant.



# B

## Next Steps

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**B.1** This Annex sets out what will happen now and over the coming months ahead of the Scheme becoming operational.

**B.2** Work will continue to ensure that the conditions set out in the term sheet, included at Annex A, are met by the participating institutions, ahead of final contracts being completed. This will include:

### Due Diligence

**B.3** Due diligence of the participating institutions assets that will be included in the Scheme and relevant balance sheet information will continue, until completed to the satisfaction of HM Treasury. This will ensure a full understanding of the nature of the assets to be included in the Scheme.

### Interim operations

**B.4** Chapter 3 sets out how the Scheme will operate once contracts have been signed. The exact terms on which financial institutions will participate in the Asset Protection Scheme, will be agreed over the next few months prior to the Scheme's commencement. During this period, it is essential that the interests of all stakeholders, including tax payers, are taken into account by participating institutions when taking decisions in relation to the assets that will be covered by the Scheme.

**B.5** To achieve this, the Government has agreed with participating institutions that they will provide appropriate information, access and assistance during this 'pre-accession' period. In addition participating institutions will be required to agree to asset management requirements. This includes principles and guidelines for the management of the assets to be included in the Scheme and they will start to develop the asset management strategy that they will undertake following the commencement of the Asset Protection Scheme and the operation management structures they will implement to support this.

### Scheme Operations

**B.6** Work will continue to put in place the resources and structures within HM Treasury to manage the Scheme in the long-term, including recruiting the necessary staff and putting in place the required controls, policies, procedures and technical infrastructure that is needed. We will also continue to work with the participating institutions to ensure they are putting in place the necessary governance procedures, as required by their involvement in the Asset Protection Scheme.

### State Aid

**B.7** Work will continue to ensure that State aid clearance in respect of the Scheme will be obtained from the European Commission.

## Disclosure

**B.8** As stated in Chapter 2, the FSA and HM Treasury are jointly launching a consultation paper shortly that will consult on the rules and regulations which all participants in the Scheme will be required to meet. Once the consultation is concluded, work will take place to set a final position on the standards of public disclosure in relation to the institution's asset pool as well as its assets that are outside the Scheme that participating institutions will be required to meet. This aims to ensure that the institution's financial status is transparent and to improve comparability between the institutions participating in the Scheme.

## Application Period and other Institutions

**B.9** In addition to this, the Scheme remains open for other institutions to request participation in the Scheme until (and including) 31 March 2009. As set out in Chapter [3] Scheme participants can include

- UK incorporated authorised deposit-takers (including subsidiary of foreign institution) with more than £25 billion of assets satisfying the Asset Eligibility Criteria; or
- An affiliate of the Bank (including a holding company thereof) that has been approved by Her Majesty's Treasury as eligible for inclusion under the Scheme.

**B.10** HMT may consider extending the Scheme to other UK incorporated authorised deposit-takers (including UK subsidiaries of foreign institutions not covered by (1) or (2) above) based on advice on the Bank of England and the Financial Services Authority and based on HMT's best judgement of how important the deposit-taker concerned is to financial market stability and the overall economy and the most effective possible use of public resources.

**B.11** HMT will take forward negotiations with any other institutions that want to and are eligible to join the Scheme.



# Statement on the Asset Protection Scheme, 19 January 2009

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## Statement on the Government's Asset protection scheme

### Overview

**C.1** As part of a comprehensive package designed to reinforce the stability of the financial system, to increase confidence and capacity to lend, and in turn to support the recovery of the economy the Government is today announcing its intention to offer protection on those assets most affected by the current economic conditions. The Asset Protection Scheme is designed to protect financial institutions against exposure to exceptional future credit losses on certain portfolios of assets. In conjunction with the steps already taken by the UK authorities and in co-ordination with their international partners, the Scheme is designed to restore confidence to financial markets, supporting financial stability and the availability of credit to creditworthy borrowers in the economy. The Government will be taking forward discussions in the coming weeks with its international partners about the establishment and co-ordination of such schemes by a number of countries. This document summarises the headline terms of how a UK scheme would be implemented.

### Introduction

**C.2** Under the Scheme, in return for a fee, the Treasury will provide to each participating institution protection against future credit losses on one or more portfolios of defined assets to the extent that credit losses exceed a "first loss" amount to be borne by the institution. It is intended that the Scheme will target those asset classes most affected by current economic conditions.

**C.3** The Treasury protection will cover the major part but not all of the credit losses which exceed this "first loss" amount. Each participating institution will be required to retain a further residual exposure, which is expected to be in the region of 10 per cent. of the credit losses which exceed the "first loss" amount. This residual exposure will provide an appropriate incentive for participating institutions to endeavour to keep losses to a minimum.

**C.4** The Treasury currently expects that the fee will usually be satisfied by the issue of capital instruments of the participating institution. These instruments are not expected to include ordinary shares, but will include a range of alternative capital instruments. The Treasury will be open to consider other forms of fee, including cash.

### Eligible Institutions

**C.5** The Treasury will, in the first instance, offer protection to UK incorporated authorised deposit-takers (including UK subsidiaries of foreign institutions) with more than £25 billion of eligible assets. Affiliated entities will also be considered by the Treasury for protection under the Scheme in the light of its assessment of the impact on financial market stability and the overall economy and the most effective possible use of public resources.

**C.6** The Treasury will subsequently consider extending the Scheme more widely to other UK incorporated authorised deposit-takers (including UK subsidiaries of foreign institutions).

Further participation in the Scheme will be at the discretion of the Treasury taking account of the advice of the Bank of England and the FSA on the basis of its best judgment of how important the deposit-taker concerned is to financial market stability and the overall economy and the most effective possible use of public resources.

**C.7** The Government's recapitalisation and credit guarantee schemes continue to be available to those institutions which are eligible to participate in those schemes. The Government remains prepared to provide capital to any eligible institution either directly or, alternatively, on a contingent basis under the recapitalisation scheme.

**C.8** Each applicant to any of the Government schemes (including the Scheme) will be required to satisfy the Treasury that:

- it is adequately capitalised and funded or has a realistic plan for accessing adequate capital and funding;
- it has a sustainable business model and delivery plan;
- its funding profile, sources and mix are clear, broad-based and sustainable; and
- its senior management team is credible, with demonstrable ability to deliver its business model and delivery plan.

## Conditions and lending commitments

**C.9** Participation in the Scheme will be subject to a number of further conditions, including a verifiable commitment agreed between the participating institution and the Treasury to support lending to creditworthy borrowers in a commercial manner.

**C.10** A number of further conditions will apply to the Scheme, including in relation to remuneration policy.

## Disclosure

**C.11** All participants in the Scheme will be required to meet the highest international standards of public disclosure in relation to their asset books.

**C.12** Subject to maintaining appropriate commercial confidentiality, the Treasury will publish and lay before Parliament the agreements which it enters into with participating institutions in relation to the operation of the Scheme.

## Eligible Assets

**C.13** The Scheme will provide protection for portfolios containing assets each of which must be eligible for the Scheme. The Treasury expects to provide protection for those assets on an institution's balance sheet where there is the greatest degree of uncertainty about the future performance of those assets. Assets may be denominated in any currency. It is intended that the following categories of assets will be eligible for the Scheme, subject to assessment by the Treasury for inclusion on a case-by-case basis:

- Portfolios of commercial and residential property loans most affected by current economic conditions;
- structured credit assets, including certain asset-backed securities;
- certain other corporate and leveraged loans;
- and any closely related hedges, in each case, held by the participating institution or an affiliate as at 31<sup>st</sup> December 2008.

**C.14** The Treasury may consider the inclusion of other asset classes in the Scheme, subject to appropriate investigation by the Treasury and its advisers and the determination of an appropriate fee.

**C.15** Assets to be included in the Scheme will be subject to appropriate investigation by the Treasury and its advisers in order to assess the probability of future loss. An applicant will be required to give the Treasury and its advisers open access to all information required for this purpose.

**C.16** The level of protection offered by the Treasury will be determined following detailed discussions with eligible institutions and their demand for the Scheme.

## **Assessment of “First Loss” Amount and Fee**

**C.17** In setting the terms under which protection will be offered, the Treasury and its advisers will take into account their estimation of the performance of the assets of the institution to be included in the Scheme. The fee, “first loss” amount to be borne by the institution and residual exposure will be set accordingly.

**C.18** It is intended that pricing of the Scheme will be structured having regard to international practice so as to provide appropriate incentives to participating institutions to meet their commitments agreed with the Treasury to support lending to creditworthy borrowers and to ensure appropriate protection for taxpayers.

**C.19** Participating institutions will be entitled to cancel the protection, subject to the agreement of the Treasury and payment of an appropriate termination fee.

## **Management of the Assets**

**C.20** Assets included in the Scheme will continue to be managed by the institution and will remain on its balance sheet but will be required to be “ring-fenced” by the institution so that actions in relation to them, including enforcement and disposal, will be subject to appropriate Treasury controls. The Scheme may also provide for the Treasury to take over ownership and/or management of the assets in certain defined circumstances.

**C.21** The Scheme will include appropriate further requirements as to the management of the assets by the institution.

**C.22** The Treasury will require open access to all information it considers necessary in connection with the Scheme and will require regular reporting by the institution to the Treasury.

## **Duration of the Scheme**

**C.23** The duration of the coverage will be determined following examination of the assets to be included in the Scheme and is expected to be not less than 5 years and to be consistent with the tenor of the assets.

## **Administration of the Scheme**

**C.24** The Scheme is expected to be administered by the Treasury or an entity to be established or designated by the Treasury.

**C.25** References in this summary to the Treasury include, where appropriate, an entity as described in paragraph 10.1.

**C.26** The cost of establishing and administering the Scheme will be borne by participating institutions.

## **Regulatory approvals**

**C.27** The Scheme is subject to applicable regulatory and state aid approvals.

## **Timing**

**C.28** It is not currently intended that there will be any further announcement relating to the details of the Scheme until the last week of February.



# FSA statement on the capital implications of the Asset Protection Scheme

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**D.1** This note complements the statement that the FSA has made today in conjunction with the Government's announcement about its Asset Protection Scheme ('the Scheme'). What follows is its assessment of the potential impact that a transaction of this nature would have on the capital position of a firm participating in the Scheme.<sup>1</sup>

## Nature of the Scheme

**D.2** The Scheme is designated in two tranches:

- a 'First Loss' tranche, whereby losses are fully retained by the participant; and
- 'Senior' tranche, whereby only a designated proportion of losses are retained by the participant ("vertical slice"). The other losses on this Senior tranche will be reimbursed by the Treasury

**D.3** The First Loss is a fixed Sterling amount, calculated by reference to the nominal (i.e. gross) value (as at 31 December 2008) of the assets covered by the Scheme.

NB: The actual attachment point of the protection may vary for each of the participants in the Scheme, but the principles for designating these tranches are the same for each participant.

**D.4** The fee payable for the scheme can be paid in cash but will usually be satisfied by the issue of capital instruments by the institution. Specifically the fee may be funded through the issuance of a capital instrument to HMT. If the cost of the scheme is amortised down over the useful life of the contract, then this will mean an up front capital injection equivalent to the full premium payable, less any amortisation of the premium for the first reporting period.

## Capital instrument

**D.5** It is intended that the capital instruments issued to meet the fee payment will be structured to qualify as 'Core Tier 1 Capital'.

## Impact on capital position

**D.6** The Scheme is expected to affect the capital position of the firm in the three following ways:

- 1 if the initial up-front premium is satisfied by the issuance of a capital instrument as described above, there will be an increase in Core Tier 1 capital; and
- 2 the RWAs of the portfolios covered by the Scheme will be significantly reduced (in some cases, to zero);
- 3 under BIPRU 9, the deduction from capital resources taken for the First Loss position, as described below, cannot be more than 8% of the underlying RWAs (plus the expected loss amounts against those assets), and the deduction from Core Tier 1 capital is therefore limited to 50% of this amount.

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<sup>1</sup> The document is available at [www.fsa.gov.uk](http://www.fsa.gov.uk).

**D.7** The exact capital impact will depend on, among other things, the size of the First Loss deduction. However, taken together, we expect that the above factors will improve participants' capital ratios.

## **Impact on capital ratios - over time**

**D.8** Any further losses on the covered portfolio would be expected to have the following effects on Core Tier 1 Capital:

- 1 losses incurred up to the First Loss threshold would erode Core Tier 1 Capital. This effect would be partially off-set as the deduction from capital resources taken for the First Loss tranche is reduced;
- 2 losses incurred after the First Loss threshold would predominantly be covered by the Scheme. Only those losses relating to the pro-rata share retained by the participant (through the vertical slice) would reduce Core Tier 1 Capital.

## **Regulatory capital calculation**

**D.9** The Scheme is intended to protect against credit losses experienced in respect of assets held in the Banking Book, although it is possible that requests for cover to be provided to assets in the Trading Book may be considered by the Treasury on a case-by-case basis. However, the FSA expects the Scheme predominantly to cover assets that are held in the Banking Book, and it discusses the capital treatment of that Scheme here.

**D.10** For assets held in the Banking Book, the Scheme has been structured to be considered as eligible unfunded credit protection under the Prudential Sourcebook for Banks, Building Societies and Investment Firms (BIPRU).

**D.11** The protection afforded by the Scheme is denominated in the currency of the underlying assets and is structured to match the full maturity of all assets included in the Scheme. There are, therefore, no currency or maturity mis-matches arising from the Scheme.

**D.12** The Scheme is intended to be extended to one member within a banking group. Where a group desires to include assets in more than one entity within the Scheme, and it has not been possible to transfer the assets to the participating entity, then the participant may use appropriate intra-group arrangements to distribute the protection within the group. The precise nature of these intra-group arrangements will necessarily depend on the circumstances of the group.

## **Vertical retained slice**

**D.13** Given that the participant remains exposed to a pro-rata exposure on the underlying assets through its exposure to the First Loss tranche and the retained vertical slice of the Senior tranche, it is possible for the vertical slice to be considered as a pro-rata exposure to the underlying assets.

## **Remaining pro-rata exposure**

**D.14** The remaining pro-rata exposure to the underlying assets should be treated as being subject to a tranching unfunded credit protection arrangement. Given the tranching nature of this protection, the capital treatment for the Scheme is determined by reference to the requirements for a 'synthetic securitisation' and, as such, capital requirements should be calculated for each of the tranches of the Scheme, and not against the underlying assets. For

participants using the Internal Ratings Based Approach, this includes the Expected Loss calculation, which is typically set to zero.

## First Loss

**D.15** the First Loss tranche is unrated and not subject to any credit protection (i.e. it is fully retained by the bank). It is therefore subject to a 1250% risk weight or, alternatively, should be deducted from capital resources. The FSA expects firms would apply the deduction in this case.

**D.16** The capital deduction amount is reduced by value adjustments (e.g. provisions for impairment) taken against the assets covered by the Scheme. At inception of the Scheme, this includes impairments already taken and, on an ongoing basis, the deduction is reduced to zero as the First Loss tranche is eroded by an equivalent amount of losses.

**D.17** Any deduction taken against the First Loss must be taken 50% from Tier 1 capital, and 50% from Tier 2 capital. When assessing capital ratios of the banks that the FSA supervises, it expects that the Tier 1 deduction be taken fully from Core Tier 1 capital.

## Senior tranche

**D.18** The Senior tranche, in which losses are reimbursed by the Treasury, is subject to the risk weight of the protection provider, which in this case would typically be 0% and therefore would attract no capital charge.

## First Loss - option for additional cover

**D.19** The participant may have the ability to request that some part of the losses in the First Loss tranche are covered by an equal cash payment from the Treasury to the participant in exchange for the issuance of further capital instruments. If structured as eligible unfunded credit protection, this part of the First Loss would be considered as covered by the Treasury in the event of losses and would be subject to the risk weight associated with the UK Government, which would typically be 0%.

## Overall cap

**D.20** The total capital held against the Scheme, including any deduction from capital, is 'capped' at 8% of the risk-weighted assets (RWAs) of the underlying assets, plus the expected loss amounts against those assets. This cap has the effect of replicating the capital requirement that would have applied had the protected assets not been placed under the Scheme.







ISBN 978-1-84532-572-5



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