Review of HM Treasury's management response to the financial crisis

March 2012

Review of HM Treasury's management response to the financial crisis

March 2012

Official versions of this document are printed on 100% recycled paper. When you have finished with it please recycle it again.

If using an electronic version of the document, please consider the environment and only print the pages which you need and recycle them when you have finished.

Any queries regarding this publication should be sent to us at: public.enquiries@hm-treasury.gov.uk.

ISBN 978-1-84532-953-2
PU1286

Contents

Foreword

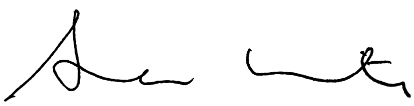
The financial crisis of 2007 to 2009 was arguably the most difficult set of economic circumstances that the Treasury has faced in its history. The crisis has had huge ramifications for the economy, the public finances and people's living standards. Its impacts are still being felt. In its response, the Department proved itself flexible and adaptable, ramping up resources right through the crisis. The commitment and dedication of staff working directly on the crisis – or covering for those who were – was highly impressive. At the same time, there are lessons to be learnt.

The Treasury, like many other institutions, did not see the crisis coming and was consequently under-resourced when it began. The Treasury responded nimbly – with a strong 'esprit de corps'. It drew in outside expertise where it did not have the skills in-house. Resources could have been brought in more quickly and greater investment should have been made in staff and project management. The Treasury put actions in place to address many of these weaknesses in a 'Strategic Review' of the Department in the autumn of 2010. The Treasury has made significant progress on financial sector contingency planning to deal with any fall-out from the Eurozone.

Looking ahead, the Treasury will need deeper expertise – 'generalists' with greater experience and some financial sector specialists – if it is to play an effective role in the new regulatory arrangements. This may necessitate a different career path for such professionals that takes them between the Treasury and outside financial institutions and regulators. It may also require stronger incentives for staff with experience to remain at the Treasury for longer. This in turn will mean tackling organisation-wide issues, most notably high turnover and low pay relative to the rest of the public sector.

I owe an enormous debt of thanks to my Review team who have worked so hard over the last five months: Robert Pollock, Anna Longman, Virginia Fenton, Mo Rahee, Rowlando Morgan, Peter Bode (Department for Work and Pensions), Sowdamini Kadambari and Sharon Wiles.

I am also extremely grateful to the people who agreed to give their views to the Review – for their frankness and for their constructive engagement – and to Jill Rutter and the Institute for Government for hosting workshops with Treasury staff. We found an enormous consensus of views amongst those we consulted, across institutions and at different levels of seniority and proximity to the crisis. Without them, we would not have had such a weighty evidence basis for – or such confidence in – our conclusions.



Sharon White

Executive summary

Background

Crises by their nature are complex, largely unexpected, out-of-the-ordinary events that demand immediate actions. Before the 2007-09 financial crisis, regulators across the international financial system championed the economic benefits of rational, self-correcting markets and the merits of financial innovation. A global consensus emerged that new modes of finance had reduced systemic risks.

The decade of steady economic growth that preceded the crisis was read by many as an endorsement of the UK's principles-based approach to financial regulation and of the Tripartite framework established in 1998 – HM Treasury (the Treasury), the Bank of England (the Bank) and the Financial Services Authority (FSA). International institutions such as the International Monetary Fund cited the UK as an example of best practice.

Within the Tripartite, the Bank had primary responsibility for financial stability, though this came to be overshadowed by a much sharper focus on monetary policy after 2003. The Tripartite's standing committee on financial stability[1] identified the absence of a legislative framework to resolve failing banks as early as 2005. Remedying this was not deemed to be a priority by the Treasury in the context of the benign financial climate. War games were played for the scenario of an individual institution failure but not for a system-wide crisis, which was judged to be highly improbable.

Prior to the crisis, bank failures had been a rare occurrence and so, by definition, the Treasury's senior management had limited personal experience of them. The financial sector had not been a high profile area of the Treasury's business for a number of years. And there was a small Treasury team working on financial stability in the immediate run-up to the crisis. The Bank had cut back its staffing on financial stability and the FSA was increasingly focused on consumer and competition issues. Working-level relationships across the Tripartite were constructive but tended to be distant amongst the Principals[2].

Assessment of the Treasury's response to the financial crisis 2007–09

The financial crisis placed extraordinary demands on the Treasury. The nature of the challenge, the scale of the workload and the immediacy of the deadlines were unprecedented. A timeline of key events is set out at Annex A.

Organisationally, the Treasury responded in a nimble and dynamic fashion. Resources were ramped up, although this could have been quicker. In hindsight, the peak in staffing in 2009 should have come earlier – in the summer of 2008. This had implications for workloads and staff well-being. The level of personal commitment shown by officials was outstanding, both those working directly on the crisis and those providing cover. Overall, the Treasury was stretched and could have been better prepared.

Once the broader implications of the collapse of Northern Rock in the autumn of 2007 became clear, the Treasury reacted quickly to establish a well resourced project team, led at Second Permanent Secretary level. The team had few staff with specific banking expertise and they were highly valued. The majority of staff had to learn on the job.

[1] The principal forum for agreeing policy and coordinating action between the Treasury, the Bank and FSA.

[2] Principals comprise the Chancellor of the Exchequer, the Governor of the Bank of England and the Chairman of the Financial Services Authority.

The Treasury rightly sought expert external legal and financial advice; this was sometimes at short notice, even overnight. The Treasury had not previously sought external advice on this scale or at this speed, and at times was not strong enough in its procurement processes or, due to the novel circumstances of the crisis, able to be clear about what specifically it was paying for.

After Northern Rock was nationalised in February 2008, part of the crisis team was kept on to work on state aid issues and the bank's business plan. The Treasury undertook contingency planning to manage the risks of a broader crisis. After the collapse of Lehman Brothers in September 2008, it was clear that a systemic crisis was now a certainty.

The Treasury, which had increased its capability steadily over the summer, quickened the pace of its recruitment. Staff working on financial stability policy and interventions increased from around 20 in September 2008 to around 45 by the end of the year. This rapid mobilisation of staff from across the Treasury in connection with bank recapitalisation issues in the autumn of 2008 was a significant achievement.

Staff working on financial stability peaked in the summer of 2009 at around 120, although the total number, including officials providing support from other Treasury teams, was closer to 200. However, there was enormous pressure on workloads and staff well-being, including for people not directly working on the crisis. More resources should have been brought in.

The Treasury drew on the experience of nationalising Northern Rock to resolve subsequent failing financial institutions, such as Bradford & Bingley, more quickly and decisively. The Treasury ramped up its capability again to set up the Asset Protection Scheme (APS) and the associated agency that would deliver it – the Asset Protection Agency (APA).

Project management skills were drawn in from elsewhere in Whitehall and a number of people from the private sector were brought in on secondment. The size of the senior team was also increased. However, there would have been significant pay-off at this point – and throughout the crisis – from more investment in staff management in terms of providing greater clarity of roles and communications.

Progress made and current capability

The Treasury has worked hard to learn lessons since the financial crisis. This Review is practical evidence of that. By late 2009, the Treasury had taken on board many of the issues flagged in a National Audit Office study of the nationalisation of Northern Rock.[3] These included improvements in knowledge and risk management, though the Review found that progress in the former needs to be consolidated.

Most recently there has been substantial progress on:

- contingency planning and mobilisation;
- establishment of links between financial stability and macroeconomic policy;
- monitoring of financial risks; and
- procurement processes for external advisers.

The Strategic Review of the Treasury in 2010 and subsequent reorganisation – the most significant in 20 years – has also driven improvements. There is more flexible and less-siloed working and better use of project management. A new business planning process means resources are more closely aligned with the Department's policy priorities. The organisational

[3] 'HM Treasury: The nationalisation of Northern Rock', National Audit Office (2009)

changes have been accompanied by serious efforts to improve the Treasury's leadership and management.

The Treasury has much greater capability in the financial sector – and on crisis management – than it had before and in the early stages of the crisis. There remain some discrete areas where improvements can be made, and it will be particularly important to retain strong capacity in key areas like European negotiations to reflect the quantity of new legislation expected from Brussels over the next few years. The greater challenge, however, is to retain the experience that has been gained despite a declining budget. Treasury staff numbers are expected to fall from a peak towards the end of the crisis in the summer of 2009 of around 1,420 to 1,000 in 2014. As a result of ongoing risks from the Eurozone crisis, the Treasury took the decision to protect resourcing for financial stability, having previously judged that it would be prudent to scale back somewhat.

Future capability: financial services and stability

The Government's proposals to reform the regulation of the financial sector will place the Bank's responsibility for financial stability on a statutory footing, and give the Bank responsibility for the Prudential Regulation Authority (PRA) and the Financial Policy Committee (FPC). The new framework makes clear that ultimate responsibility for decisions during crises that involve a risk to public funds rests with the Chancellor of the Exchequer. The Government is also embarking on major reform of the banking sector in response to the Independent Commission on Banking to reduce the risk to the taxpayer from bank insolvency[4].

These reforms will require the Treasury to have the capacity to:

- provide Ministers with an independent assessment of advice from the Bank and PRA;
- communicate effectively with Parliament and the public;
- maintain its role as guardian of taxpayer interests during crises and in periods of instability;
- influence negotiations effectively on financial regulation in the European Union (EU), G20 and Financial Stability Board (FSB);
- oversee and monitor the effectiveness of the new regulatory framework;
- manage its existing interventions in the banking sector; and
- engage at working and Board level with the Bank, PRA, FCA and the City.

This will mean retaining a high degree of capability in financial services, to be provided primarily by mainstream staff (or 'generalists') with relevant experience, supplemented as necessary by specialist staff from outside the Treasury on particular issues. A more active approach to staff deployment and career development will be required in order to ensure the Treasury has available the people it needs to discharge its responsibilities. A higher degree of staff exchange with other institutions would help to support this.

Organisational challenges

If the Treasury is to enhance its financial sector capability, it will have to address some important organisational challenges. These include pay (which is less competitive than at the Bank or FSA), a flat structure with few senior jobs, and a very strong corporate culture which can make it hard

[4] 'The Government Response to the Independent Commission on Banking', HM Treasury (2011)

for outsiders to succeed, particularly at senior levels. The Treasury attracts the highest calibre staff, but has difficulty retaining them. Annual turnover is around 25 per cent. This includes officials returning to other organisations after short spells on loan or secondment at the Treasury.

Although pay is one factor, the Review has found evidence that retention could be improved through non-financial levers as well, particularly through a greater emphasis on career development that goes beyond the Treasury for officials with specialist skills. Addressing these and other issues highlighted by the Review will help to ensure that the Treasury is best placed to deliver its substantial ongoing agenda and manage any future crisis.

Summary of recommendations

That the Treasury:

- strengthens its contingency planning by ensuring that people on standby to work on the crisis ('reservists') are properly trained, have clear roles and operate within a clear management structure;
- retains the requisite skills and experience needed to manage interventions in the banking sector through better career progression;
- sets out its medium term role in relation to financial services regulation, markets and stability and ensures it has the capabilities required to fulfil it;
- develops a more structured programme to support staff to develop and maintain expertise through training, interchange with the Bank of England and other financial institutions;
- strengthens its relationship with the Bank by clarifying respective roles and responsibilities and introducing more joint working and planning at senior levels;
- develops a strategy to manage its turnover rate and sets an annual turnover target of 15 to 20 per cent;
- places greater emphasis on experience, expertise, and people management in its promotion and reward policies, including greater use of pay flexibilities and allowance;
- improves knowledge management through better recognition and reward for staff and learning from best practice elsewhere;
- improves risk management by seeking constructive challenge and scrutiny from outside experts;
- improves staff succession planning, supported by longer handovers between posts; and
- creates a more enabling environment to challenge policy orthodoxy, by involving outside experts more routinely in policy debates and recruiting staff from more diverse backgrounds.

1 Introduction

1.1 The Treasury Select Committee (TSC), the Public Accounts Committee (PAC) and the National Audit Office (NAO) have all investigated various aspects of the handling of the financial crisis by UK authorities. These reviews also examined the value for money of the Government's interventions and consequences for the governance of the financial sector. The NAO and PAC considered the Treasury's capability, although not in great detail.

1.2 In its first report into Northern Rock in 2009, the NAO identified various weaknesses in the Treasury's capability[5], and made some specific suggestions relevant to this Review, specifically that the Treasury should:

- consider the training and development it provides to officials to handle crises drawing on civil and military contingency planning, and ensure this is part of staff development;
- make better use of financial and commercial expertise within the Treasury and elsewhere in the public sector, for example, Partnerships UK[6] and the Shareholder Executive;
- develop more effective approaches to working with external advisers by putting in place robust contracts; and
- strengthen the weak records management that had the potential to undermine the Treasury in any judicial review or litigation.

1.3 The NAO conducted a follow up report in 2010, which assessed Government interventions in the financial sector since the nationalisation of Northern Rock.[7] That report made further recommendations about how the Treasury could improve its management capability in the context of financial crises, specifically that it should:

- determine the future capability it requires in financial services, taking account of schemes in place and the challenges of removing Government support;
- build effective working relationships with the Bank and the PRA, following reforms to the regulatory landscape;
- develop a deeper understanding of and expertise in banking, regulation and crisis management;
- maintain a core team of financial stability experts, with limited staff turnover and career structures that allow staff to develop in that area; and
- ensure that the lessons learnt from the crisis are embedded in the new regulatory structures that the Treasury is putting in place.

[5] p12, 'HM Treasury: the nationalisation of Northern Rock', NAO (2009)
[6] Now Infrastructure UK (based in the Treasury)
[7] 'Maintaining financial stability across the United Kingdom's banking system: update on support schemes', NAO (2010)

1.4 The NAO also conducted a cross-government review on the 'use of consultants and interims' in 2010[8]. It concluded that the Treasury's use of private sector advisers, including those employed during the crisis, had been poor and costly. The NAO recommended that the Treasury should define more clearly what it sought from private sector advisers, as well as identifying and addressing internal skills gaps that could be filled by civil servants.

1.5 The FSA conducted a review of its role during the crisis[9], and further afield the International Monetary Fund (IMF) assessed why its financial sector surveillance did not foresee the crisis[10].

The Review

1.6 Sir Nicholas Macpherson, Permanent Secretary to the Treasury, commissioned a Review into the Department's management of the financial crisis on 17 October 2011. This followed calls from the NAO and the PAC to conduct a lessons learnt exercise[11].

1.7 The remit of this Review is to assess the Treasury's management response to the financial crisis and to make recommendations to ensure that the necessary capability is in place in the future. The Review does not examine the efficacy of the policy interventions made during the crisis or the Treasury's failure to predict the crisis. The Terms of Reference are set out in Box 1 below.

Box 1: Terms of reference

The Review will examine:

- The Treasury's capability on financial services ahead of the crisis;
- The pace at which the Treasury built its capability when the crisis hit; and
- Whether the capability and senior management arrangements put in place to handle the crisis and the aftermath have been adequate.

This Review will also inform decisions on the organisational arrangements of HM Treasury as part of its Spending Review settlement, making recommendations with the aim of:

- Ensuring that the Treasury has the capability it needs going forward;
- Improving the retention of people with the necessary skills, expertise, and experience, having consideration to issues of Treasury culture and values, as well as remuneration; and
- Ensuring that the Treasury has robust arrangements for risk management, contingency planning and knowledge management.

1.8 The Review has taken a broad view of capability including: technical skills; resilience to crises; management ability; engagement with the Bank, FSA and the City; and the procurement and use of external experts.

1.9 The views presented throughout this report are judgements of the Review team and not the Treasury. Over 150 stakeholders from more than 50 organisations were consulted. All discussions followed Chatham House rules to encourage an open and frank exchange of views. The views expressed are those of the individuals and not the organisations for which they work.

[8] 'Central Government's use of consultant's and interims', NAO (2010)
[9] 'The Turner Review: a regulatory response to the global banking crisis', FSA (2009)
[10] 'IMF Response in the Run-Up to the Financial and Economic Crisis: IMF Surveillance in 2004-07', Independent Evaluation Office of the International Monetary Fund (2011)
[11] http://www.publications.parliament.uk/pa/cm201012/cmselect/cmtreasy/uc874-vi/uc87401.htm

The names of interviewees are not listed in this Review. The organisations to which interviewees belong are provided in Annex C[12].

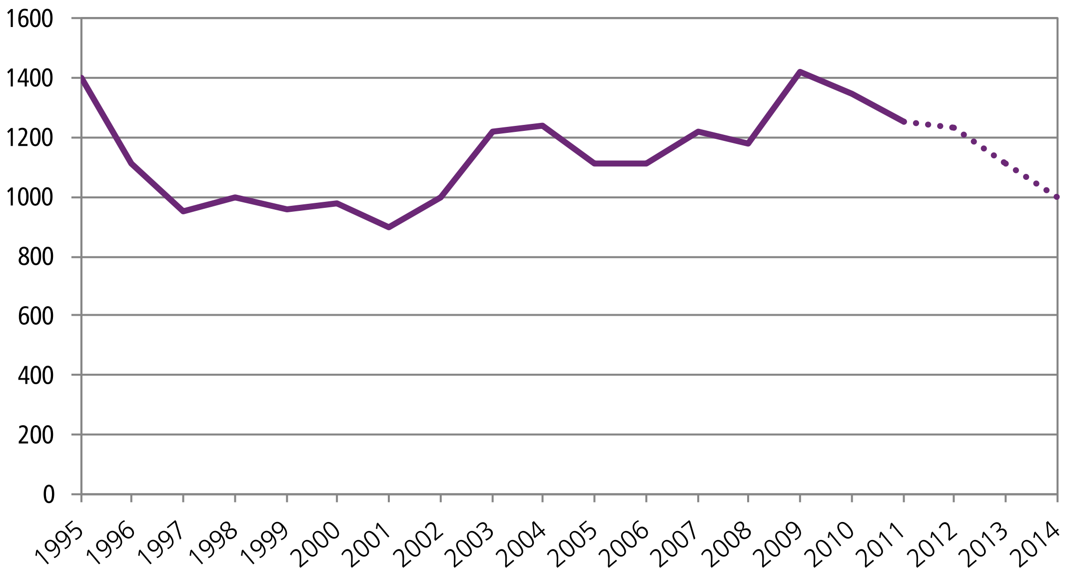
1.10 Stakeholders consulted include the Bank, FSA, the Treasury and its arm's length bodies, banks, financial institutions, current and former Ministers and Government officials. Workshops, facilitated by the Institute for Government, were held with Treasury staff, including those who worked on the crisis and those currently working on financial services.

1.11 In reaching its judgements in relation to crisis management, the Review consulted the Cabinet Office's Civil Contingencies Secretariat, the Department for Environment, Food and Rural Affairs (Defra), the Foreign and Commonwealth Office (FCO), as well as finance ministries in other countries. A desk-based review of relevant assessments of the financial crisis and previous reviews of the Treasury's management and organisation was also conducted. Relevant publications are set out at Annex D.

HM Treasury

1.12 The Treasury is a small strategic policy department at the heart of government. It is an economics and finance ministry with financial services forming a core part of its remit. The Department is responsible for public expenditure, macroeconomic and fiscal policy. The Treasury's core remit has changed over time. For example, the granting of independence to the Bank in 1997 reduced its core role, conversely the transfer of tax policy to the Treasury from HM Revenue and Customs (HMRC) led to an increase in responsibilities. The Treasury employed around 1,165 staff at the end of January 2012.

Chart 1: Treasury workforce (1995-2014)



Source: HM Treasury

[12] Some organisations have not been listed at the request of the interviewee.

Box 2: The Fundamental Review of HM Treasury's Running Costs (1994)

The Chancellor (Kenneth Clarke) instigated the review because he considered that the "Treasury had got a bit left behind [by] more modern management approaches, attitudes and styles". The review introduced significant changes in management and organisational structure. The Department became much flatter. Senior Civil Servants (SCS) were reduced by 25-30 per cent. Grades below the SCS were amalgamated, and management and policy responsibility was delegated to more junior grades.

As there was less opportunity for promotion, the use of non-consolidated performance bonuses increased. The review made several specific recommendations to improve skills and expertise, though few took root.

It also concluded that over the long term the Finance, Regulation and Industry Directorate should become almost entirely focused on financial regulation; and recommended significant reorganisation of teams working on banking and markets.

1.13 The Department has a relatively flat organisational structure. The 'Fundamental Review of HM Treasury's Running Costs'[13] in 1994 led to a de-layering of middle management and delegation of responsibility down the line.

1.14 The Treasury is a relatively youthful department. It has a median age of 32 compared to 45 across the civil service[14]. Turnover is high compared to the rest of the public sector. Approximately one half of the Treasury's staff joined in the three years from 2008 to 2010. There is also a lot of internal movement. Most staff are 'generalists' and would expect to work in a range of jobs across the Treasury's key functions. At the end of 2011, the median time spent at the Treasury by staff below the Senior Civil Service was three to four years. The vast majority of officials would have had no experience of a period of economic turbulence or bank failure.

1.15 The table below describes in general terms the different grades within the Treasury.

Box 3: Treasury staff grades

Staff Range		Description of role
B	Administrative or support roles	Business and policy support, personal assistants; finance, HR, IT or communications specialist.
C	Administrative or support roles	Business and policy support, personal and executive assistants; finance, HR, IT or communications specialist.
D	Policy Adviser	Officials with specific policy responsibilities
E	Senior Policy Adviser	Experienced officials with significant policy responsibility.
F	Deputy Director	Senior Civil Servant (SCS). Team leader and member of senior management team.
G	Director	Accountable for corporate objectives and policy areas including the budget and staff required to deliver them.
H	Director General (formerly Managing Director)	Part of the Treasury's Executive Management Board. Accountable for the Treasury's overall direction and key issues such as resourcing and risk management.
1A	Second Permanent Secretary	Responsible for the oversight of the Treasury's interests in international, European and financial sector issues.
1	Permanent Secretary	Accounting Officer for the Department. Responsible for overall decision making, coordination and management of the department and communications with the media and public.

Source: HM Treasury

[13] 'Fundamental Review of HM Treasury's Running Costs', HM Treasury (1994)
[14] Office for National Statics (2011)

Report structure

1.16 This report is organised in two parts: Part 1 (chapters 2-4) sets out the context for and history of the crisis. Part 2 (chapters 5-8) discusses the Treasury's future capability needs.

Part 1

- Chapter 2 considers the regulatory framework and the place of financial services within the Treasury in the 20 years before the financial crisis.
- Chapter 3 describes in headline terms the key events during the financial crisis from the run on Northern Rock through to the end of 2009.
- Chapter 4 assesses the Treasury's evolving capability and management of the financial crisis.

Part 2

- Chapter 5 makes an assessment of the Treasury's current capability in relation to financial services and financial stability.
- Chapter 6 assesses the Treasury's future capability needs in the context of regulatory and banking reforms.
- Chapter 7 sets out the organisational challenges that hinder the Treasury's capability.
- Chapter 8 provides recommendations to improve the Treasury's contingency planning and crisis management, and strengthen its financial services capability, including through organisation-wide changes.

2 Financial services in HM Treasury before the crisis

2.1 This chapter examines the Treasury's capability in financial services ahead of the crisis. It describes how the management of financial services and financial stability evolved from the 'Big Bang' in 1986 until the summer of 2007. The most significant development during the period was the establishment of the Tripartite system of regulation.

Big Bang to Tripartite (1986-1998)

Financial services regulation

2.2 In October 1986, the London Stock Exchange abolished long-standing restrictive practices. Electronic screen-based trading was introduced alongside open-outcry trading which it soon replaced. That 'Big Bang' was followed by an expansion of international financial institutions in the UK, product innovation, securitisation, and investment in the financial services sector.

2.3 During this period, the Department for Trade and Industry (DTI) was responsible for regulating securities and insurance, and the Treasury for banks and building societies. About 30 Treasury officials worked on financial services policy in the Financial Institutions and Markets Group (FIM). The Treasury was the sponsor department for the Bank which directly supervised banks and had oversight of the whole financial sector.

2.4 Outside FIM, the Treasury engaged with financial services in other areas. The Government's focus on privatisation during the 1980s and 1990s led to the development of in-house corporate finance skills and close relationships with the City.

2.5 In 1993, the Treasury took over responsibility for regulating securities from DTI. Sixty staff moved to the Treasury. They brought additional markets experience and specialist knowledge of financial institutions, corporate and European law. The change was largely driven by the Chancellor's responsibility for negotiating major financial services directives in the EU's Economic and Financial Affairs Council (ECOFIN). Locating responsibility for financial services in the finance ministry brought the UK in line with other EU member states.

2.6 A Financial Services Regulation group was subsequently created within a new Finance, Regulation and Industry Directorate (FRI). In 1997, the Treasury took over responsibility for regulating insurance from DTI. A further 40 staff moved to the Treasury. Some returned to DTI at the end of their posting. They were replaced over time by Treasury officials. The practice in the Treasury was to move jobs more frequently, with the result that staff were less able to develop specialist experience.

Financial stability

2.7 The 1980s and 1990s were a period of relative stability. The last run on a bank before Northern Rock had been Overend, Gurney and Co in 1866. There were more recent instances of individual banks or subsets of the banking sector failing but none that put the financial system at risk:

- Johnson Matthey Bank, an investment bank and one of only five banks dealing in bullion, collapsed in 1984 due to bad loans;
- Bank of Credit and Commerce International (BCCI) closed in 1991 due to fraud;
- Some small banks in the early 1990s failed as a result of the withdrawal of wholesale funds from small and medium banks following BCCI; and
- Barings Bank collapsed in 1995 due to unauthorised activity by a single trader.

The Tripartite regime (1997-2007)

2.8 In 1997, the Government set out a new framework for financial services and financial stability. It brought together regulatory responsibility for all financial services under one body – the Financial Services Authority – and set up a Tripartite regulatory framework where each authority had its own distinct remit:

I. The FSA was responsible for prudential and conduct of business regulation of all financial services including banks and building societies[15];

II. The Bank gained powers to set interest rates, independent of Government, but relinquished responsibility for banking supervision to the FSA. The Bank's core purpose remained to ensure monetary and financial stability and it retained a surveillance function, to identify threats to the financial system; and

III. The Treasury was responsible for the institutional structure of financial regulation and legislation and, in the event of a crisis, for authorising certain types of financial interventions and keeping Parliament informed.

2.9 The Tripartite set out arrangements for dealing with a possible financial crisis in a Memorandum of Understanding (MoU) in 1997, subsequently revised in 2006. The MoU confirmed the Bank's responsibility for the stability of the financial system as a whole; the FSA's responsibilities for prudential and conduct of business supervision; and gave the Treasury a clearly defined locus in exceptional cases. The Bank and FSA were responsible for alerting the Treasury to cases with potential system-wide consequences.

2.10 The MoU also established a Standing Committee for Financial Stability – a monthly meeting of senior officials from across the Tripartite. The Committee shared information and developed contingency plans. Whilst the latter largely focused on the financial sector's resilience to operational disruption, such as a terrorist attack, war games or dummy runs of a possible financial crisis were played out. In 2004, this included a major stressed bank – like Northern Rock – in difficulty because of its mortgage lending book; in 2005, it was a liquidity crisis in an investment bank – a re-run of Barings.

2.11 The war games revealed the lack of a statutory resolution framework to deal with a failing bank. This was followed up by the Treasury, but not vigorously, as the risk of major financial instability was deemed to be low. In this period there were no real life cases of a bank failure.

[15] Nine agencies were combined to form the FSA. It regulates banks, building societies, friendly societies, investment firms and brokers and credit unions. From 2004, the FSA became responsible for mortgage regulation and insurance.

Financial services and financial stability

2.12 Financial services were not a high profile area of the Treasury's business. The area did not receive significant attention from Ministers or from top management. Indeed, one of the attractions continued to be the relative autonomy that it afforded to more junior officials.

2.13 The number of people working on financial services remained fairly constant between 2000 and 2005 at around 70-80 officials. A few experienced staff moved to the Bank and FSA. The Treasury focused on consumer issues, scandals such as Equitable Life and pensions mis-selling, lending to small businesses, and City promotion. There continued to be a significant amount of work to implement a single market in financial services and further financial services integration across the EU. After the 9/11 terrorist attacks in the US, there was a shift towards financial crime related issues.

2.14 Financial stability was not a significant area of Treasury business. After 2003, when the Bank began to reduce its own staffing on financial stability, the Treasury chose not to increase its capability.

2.15 After a period of continuity in the Treasury's leadership on financial services, there followed significant staff turnover. In 2001, the long-standing Managing Director retired. His immediate successors stayed only briefly before a senior City figure took over in 2002. After he left in 2005, there were three different Managing Directors in as many years. Financial services policy was moved twice in two years to different parts of the Treasury (2006-07).

2.16 In the immediate run-up to the crisis, in summer 2007, there was, intentionally, limited capacity on financial stability issues – a team of three people. The strong global consensus at the time, of which the Treasury was part, believed that the regulatory approach and new methods of securitising debt had substantially reduced systemic risk in the financial sector[16]. On top of that, the Treasury looked to the greater resourcing and expertise of the rest of the Tripartite.

Conclusions

2.17 The Treasury acquired a core of experience in corporate finance and capital markets in the 1980s and early 1990s as a by-product of the Government's focus on privatisation. When responsibility for regulating some financial services sectors transferred to the Treasury in 1993 and in 1997, the Department acquired a significant amount of technical knowledge. Some of that capability eroded over time as the Tripartite developed.

2.18 Financial services and stability were not a high profile area – and not in the spotlight of Ministers or top management. Unusually for the Treasury, there was quite a high legislative component to the work. It offered officials the chance of greater autonomy than other more mainstream areas of Treasury business, such as tax or public expenditure, and may not have attracted officials seeking high visibility roles.

2.19 The entire period was characterised by relative financial stability, particularly so after 1997. Very few officials in 2007 had direct experience of managing any type of crisis. The Tripartite did, however, conduct war games involving a bank failure. The Treasury had in place a small policy team on financial stability, based on the judgement and broader global consensus that systemic risks had been substantially reduced. The position of Managing Director with responsibility for financial stability changed relatively frequently in the run-up to the crisis.

[16] "There is growing recognition that the dispersion of credit risk by banks to a broader and more diverse group of investors, rather than warehousing such risk on their balance sheets, has helped make the banking and overall financial system more resilient. The improved resilience may be seen in fewer bank failures and more consistent credit provision. Consequently the commercial banks, may be less vulnerable today to credit or economic shocks." Global Financial Stability Report, IMF (2006).

3 Brief history of the financial crisis (2007-09)

3.1 The financial crisis of 2007-09 was unprecedented in scale. It grew from a problem at a single institution to a systemic crisis with global dimensions, under the scrutiny of 24/7 media. Understanding the key events of the crisis is important context to an assessment of the Treasury's organisational response, as set out in Chapter 4.

3.2 This chapter provides a high level summary of the key events from the summer of 2007 through to the end of 2009. It is not a comprehensive record and does not comment on the efficacy of the policy response, which is outside the remit of this Review.

The run on Northern Rock

3.3 The Treasury's Executive Management Board were alerted to problems in the market in July 2007. The Tripartite authorities had an initial discussion of the difficulties at Northern Rock on 14 August[17]. Treasury officials informed the Chancellor on 15 August.

3.4 By 10 September, the Tripartite authorities agreed that Northern Rock would require immediate financial support. On the evening of Thursday 13 September, following a leak, the BBC revealed that Northern Rock had approached the Bank for liquidity support.

3.5 A run on Northern Rock's retail deposits began the following morning. Around £4.6 billion in deposits was withdrawn. The Treasury confirmed that day that it had authorised the Bank to provide an emergency loan to Northern Rock. That announcement, combined with a growing awareness among the public that the Financial Services Compensation Scheme only provided a full guarantee on the first £2,000 of deposits[18], exacerbated the run.

3.6 The Chancellor announced on Monday 17 September that the Government would, if necessary, make arrangements to guarantee all retail and certain other deposits at Northern Rock.

3.7 Between September and November 2007, the Treasury held extensive discussions with the European Commission about the nature of the support, including the potential for state aid provided to Northern Rock and the guarantee to depositors. On 5 December, the Commission gave assent to both measures.

3.8 Northern Rock searched for a buyer between September 2007 and February 2008, while Treasury officials also worked on proposals for public ownership as a contingency plan. On 17 February 2008, the Treasury announced that Northern Rock would be taken into public ownership. The Banking (Special Provisions) Act 2008 was passed on 21 February, to provide the Government with temporary powers to nationalise banks. Northern Rock was nationalised the following day.

[17] p35, 'The run on the Rock', House of Commons Treasury Committee (2008)
[18] 90 per cent of the next £33,000, up to a total compensation payable of £31,700 for each depositor.

Wider market instability

3.9 In September 2007, Northern Rock was seen as a single institution problem. For example, during oral evidence to the Treasury Select Committee on 20 September 2007, the Governor of the Bank of England commented that:

> "*It [the British banking system] is very well capitalised, it is very strong... I cannot believe and do not believe that there is any lasting damage to the reputation of the British banking system [from the run on Northern Rock*]."

3.10 Behind the scenes, the Tripartite authorities were examining the health of all financial institutions. The FSA drew up a watch list of vulnerable institutions, and gave regular reports to the Treasury and the Bank.

3.11 From February 2008, the Standing Committee of the Tripartite undertook significant work focused on potential problems in major banks. On 14 July, Alliance & Leicester announced that it had agreed to be taken over by Santander.

3.12 Contingency planning for broader systemic problems began in August 2008. The Treasury, the Bank and the FSA worked extensively on how big the solvency problem might be. Initial estimates suggested this might amount to anything from £0 to 200 billion.

Collapse of Lehman Brothers and Bradford & Bingley

3.13 On 15 September 2008, the United States (US) investment bank Lehman Brothers filed for bankruptcy. That destabilised the global banking system. It had been widely assumed that the US Government would bail out Lehman Brothers.

3.14 Over the fortnight following Lehman Brothers' collapse, financial markets came under increasing pressure. There were steep falls in the share price of banks, including Halifax Bank of Scotland (HBOS). Lloyds Bank agreed to buy HBOS on 17 September, and was subsequently renamed Lloyds Banking Group (LBG) on 19 January 2009.

3.15 Bradford & Bingley was part-nationalised on 29 September 2008 under secondary legislation using the Banking (Special Provisions) Act 2008. The Spanish bank group Santander bought Bradford & Bingley's branch network and its deposit book. The deal was put together over the weekend of 27-29 September 2008.

Recapitalisation

3.16 By early October 2008, it was clear that the financial system was at real risk of collapse. The process of arriving at a decision to recapitalise financial institutions was long and complicated and involved many interested parties. These issues were extensively discussed by the Treasury, the Bank and FSA.

3.17 A decision to recapitalise was taken on the evening of Tuesday 7 October. Treasury officials and bankers discussed the technical details late into the night. The Prime Minister and the Chancellor announced the recapitalisation plan at a joint press conference early on the morning of Wednesday 8 October. The Chancellor made a statement to the House on the same day. Under the plan, the Bank would increase the availability of funding to eligible banks under the Special Liquidity Scheme (SLS) and the Treasury would establish a Credit Guarantee Scheme (CGS) to encourage eligible banks to lend to each other, and provide capital to eligible banks that needed it – recapitalisation.

3.18 The Treasury only had days to work out the details of the plan with individual banks. Over the weekend of 11-12 October, Treasury staff and external advisers worked around the clock in shifts to prepare a public announcement.

3.19 On 13 October, the Chancellor announced £37 billion of capital support for UK banks. The Treasury acquired holdings of £20 billion in Royal Bank of Scotland (RBS), £12 billion in Halifax Bank of Scotland (HBOS) and £5 billion in Lloyds TSB.

3.20 On 3 November, the Chancellor announced that the Treasury would set up an arm's length body, UK Financial Investments (UKFI), to manage the Government's shareholdings and its investments in Northern Rock and Bradford & Bingley.

Icelandic banks

3.21 As the recapitalisation plan was being finalised, the Treasury had to deal with the collapse of Icelandic banks – Kaupthing, Landsbanki and Heritable – and the potential impacts on UK depositors. When it appeared that the Icelandic government might not provide fair and equal treatment to all depositors, the Treasury decided to freeze the UK assets of Landsbanki. On 8 October, the same day as the Chancellor announced the recapitalisation plan, the Treasury announced separate guarantees to protect UK retail deposits in the three Icelandic banks.

3.22 In October 2009, the Icelandic Parliament agreed to terms to repay £2.3 billion compensation provided by the UK Government to investors in the failed banks. However, the decision went to a referendum where it was rejected by the Icelandic people. Discussions to resolve this matter are ongoing.

Asset Protection Scheme

3.23 Towards the end of 2008, the Government reassessed whether enough had been done to shore up the UK's financial system. The authorities discussed a range of options during November and December. In December they became aware that RBS was close to collapse. By the end of December, preliminary work to bolster recapitalisation was finalised. In January 2009, the Treasury opted for a state backed insurance scheme – the Asset Protection Scheme (APS).

3.24 In January, RBS announced a £24.1 billion loss, the biggest in corporate history. The Treasury announced on 19 January 2009 an outline of the APS, which would allow banks to pay a fee in return for protection of an agreed portfolio of assets. The intention was to provide a floor for bank losses to restore confidence. Also in January, the Treasury began work on establishing an Asset Protection Agency (APA) to run the APS.

3.25 The Treasury undertook to provide further details of the APS agreement alongside the announcement by RBS and LBG of their 2008 results. On 26 February, the Treasury announced the form of the APS and agreement, in principle, to RBS's participation in the scheme, and on 7 March to LBG's participation. In each case the Treasury also announced the proposed terms, subject to due diligence and EU state aid approval.

3.26 The main focus of work in 2009 was implementation of the APS and the negotiations between the Treasury, its advisers, RBS and LBG. By the time negotiations were completed in the autumn, market conditions had improved. The Treasury announced on 3 November 2009 that LBG would not participate in the scheme but RBS would, under revised terms.

3.27 The extension of the CGS and recapitalisation of banks received state aid approval from the European Commission in April 2009.

Dunfermline Building Society

3.28 In March 2009 Dunfermline Building Society, a small building society with 300,000 members, became insolvent. Over the weekend of 28-29 March, it was resolved by the Bank under the Banking Act 2009. On 30 March, the Chancellor and Governor of the Bank of England announced the transfer of its deposits, branches, head office, and residential mortgage book to the Nationwide Building Society. Dunfermline's social housing mortgage book was transferred to a bridge bank wholly owned by the Bank. The remaining assets were placed under administration.

International context

3.29 A G20 summit on financial regulation took place in November 2008 in Washington. Participants decided that the UK, which held the G20 presidency in 2009, would host a major summit in London in April. The UK also hosted three meetings of G20 Finance Ministers and Central Bank Governors during 2009: one ahead of the London G20 Summit, one ahead of a second Leaders' Summit in Pittsburgh in September, and one towards the end of the year.

Conclusions

3.30 The Treasury faced an unprecedented series of events over an extended two years period. There was an initial period after difficulties arose at Northern Rock when the crisis appeared to be that of a single institution. By autumn 2008, it had become clear that the impact would be much wider.

3.31 There were two big peaks of activity: the recapitalisation of banks in autumn 2008 and related measures; and the establishment of the Asset Protection Scheme in 2009. The nature of the regulatory framework – the Tripartite – and the global dimensions of the crisis meant that the Treasury had to work with a complex set of stakeholders and communications objectives. There was also substantial Ministerial engagement, some of it cross-government.

3.32 The response to the crisis was highly operational in nature and required major delivery and project management skills that were not a feature of the pre-crisis Treasury. The complex nature of the interventions required some specialist skills alongside traditional Treasury capabilities. By the end of 2009, the markets had stabilised and the Treasury had contingent liabilities of £316.6 billion[19].

[19] 'Annual Report and Accounts: 2010-11', HM Treasury (2011)

4 Management response to the financial crisis

4.1 The previous chapter set out the scale and nature of the challenge presented by the financial crisis. This chapter assesses the Treasury's organisational response as it evolved through the crisis looking in turn at:

- staffing levels;
- skills and expertise;
- the role of senior management;
- relations with the City and Tripartite;
- knowledge and risk management; and
- communications.

Staffing levels

4.2 The Treasury significantly boosted its internal staffing levels, from a small team working on the Northern Rock crisis to about 120 officials working directly on financial stability in the summer of 2009. These numbers were boosted by support from Treasury Legal Advisers (TLA) and teams in other parts of the Treasury[20].

4.3 At the peak of resourcing, in the summer of 2009, there were around 200 officials working on various interventions in the banking sector and money markets, international negotiations, and regulatory reforms. The Treasury also drew significantly on external legal and investment banking advice (see paragraphs 4.22-4.26).

4.4 Outside observers have remarked on the flexibility and speed with which the Treasury was able to redeploy resources in this period, and the challenges that their own organisations would have faced in mounting a similar exercise.

> *"When the Treasury did get its act together, the response was very impressive (within the constraints). It was striking how the Treasury was able to operate so flexibly – bringing in people on secondment."*
>
> *Senior Bank official*

4.5 As described in Chapter 2, the Treasury entered the crisis with a limited number of staff working on financial stability. These officials were part of a group of about 80 staff working on wider financial services issues.

[20] Debt Reserves Management Team, International teams, the Financial Services Bill Team, the Financial Sanctions Unit, macroeconomic advisers, business support staff, and staff borrowed from other standing teams for short periods.

4.6 After serious concerns were first raised about Northern Rock in mid-August, it took the Treasury about four weeks to appreciate that there might be systemic dimensions which would mean wider handling and greater Treasury input.

4.7 After this initial delay, the Treasury acted quickly to put in place a team on Northern Rock. The Second Permanent Secretary moved from his responsibilities for the public services and growth side of the Treasury to be the senior lead for Northern Rock, supporting the existing Managing Director for financial and international issues.

4.8 The initial team on Northern Rock consisted of seven officials, supported by in-house lawyers – Treasury Legal Advisers. The team grew through early autumn to approximately 20 officials by the end of September and 24 officials by mid-October. Also in October, the Treasury established an additional team of 12 officials specifically to address banking reform that grew to about 20 over the course of the crisis.

4.9 After the nationalisation of Northern Rock, the Second Permanent Secretary returned to his former role within the Treasury and the resolution team was cut back. In February 2008, approximately 12 officials remained. They continued to work on the bank's business plan and state aid issues. Officials who had been working on the emergency legislation began to focus on knowledge management.

4.10 Concerned about possible further bank failures, the Treasury began to gear up its resourcing from the spring of 2008. This was led by an additional Managing Director appointed to a new post in February to run jointly the International and Finance Directorate with the existing Managing Director. Special flexibilities were introduced to recruit staff quickly, although some officials felt the resulting process could have been more transparent. By summer 2008, there was a team of around 20 staff working on broader financial stability issues. Several were recruited from other government departments and the Northern Rock team.

4.11 As we saw in Chapter 3, the collapse of Lehman Brothers gave rise to the concern that the crisis was about to turn calamitous. The Treasury increased the number of staff working on financial stability from 20 to about 45 by the end of October and engaged external advisers. This scaling up proved to be inadequate and resources were thinly stretched. This put pressure on workloads and had an impact on staff well-being. In hindsight, staffing should have been more substantially increased.

"In retrospect, we did not gear up nearly enough. We should have had five teams and 100 people, not two teams with 30."

"From July 2008 to January 2009, I was working 7am to 10 or 11pm seven days a week, with no let-up thereafter. I felt under extraordinary pressure from July-October. I often had only three to four hours sleep, but always went home. I was constantly asking for more people."

Senior Treasury officials

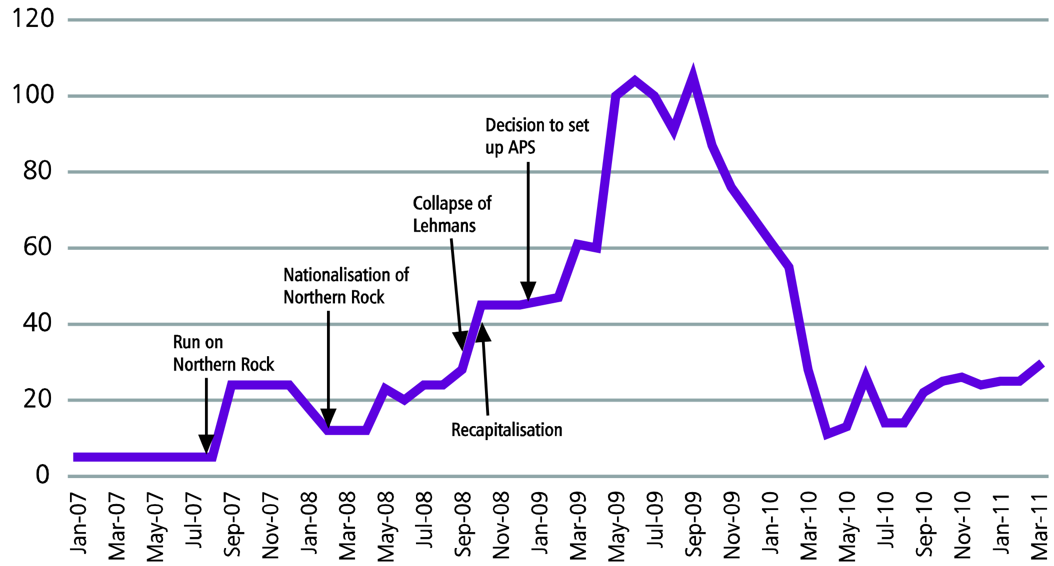
"There was an initial jump as the first few Financial Stability teams were set up. Then things were more gradual. More and more people were pulled in as risks apparently grew greater. There was an amber phase from early 2008 to summer 2008, before there was a sudden realisation, in late 2008, of the sheer magnitude of the crisis."

Treasury official

4.12 The APS was the second major peak in workload. The Treasury undertook a major recruitment drive in February 2009. Overall numbers working on financial stability increased to 59 officials by the end of March and to 118 in May. Recognising the need for additional senior capability in March 2009, the Treasury created a new post – Second Permanent Secretary for financial and international issues.

4.13 The scaling up eased pressures on workload and would ideally have come earlier in the year, when teams were working to produce the outline terms of a deal with RBS and LBG before publication of their annual results for the previous financial year. Chart 2 shows the evolution of resourcing over the course of the crisis.

Chart 2: Number of Treasury officials working on financial stability



Source: HM Treasury

4.14 Consideration of overall staffing levels hides trends in churn, which in the early phase of the crisis was high. Three different team leaders led on Northern Rock before its nationalisation. The team leader appointed in mid-September with experience of corporate restructuring moved to another Treasury post after two months, and one other left after six weeks. In the next phase of the crisis, there was greater stability within the teams working on financial stability.

"There have been times when the turnover of staff at the Treasury has been so rapid and we've had to build around that. For example, the Northern Rock team leaders seemed to change all the time. We had to live with that and help get them up to speed."

Senior Bank official

Skills

4.15 The crisis demanded a range of skills. These encompassed traditional Treasury skills, such as high quality policy advice and briefing to Ministers at pace. But it also went beyond these to include: knowledge of banks; technical skills for the development of specific interventions; and, increasingly, delivery and project management skills related to bank holdings and execution of the APS. The Treasury was able to mobilise large numbers of staff with traditional skills, but internally there were far fewer who had more specialist skills and knowledge.

4.16 There were important pockets of expertise in-house: the Debt Reserves Management (DRM) team understood capital markets and central bank balance sheets, and played a critical role in the run-up to recapitalisation; the Debt Management Office[21] (DMO), an Executive Agency of the Treasury, had working knowledge of markets; and Treasury Legal Advisers, were expert in financial services legislation, public law and state aid, and knew how to procure commercial legal expertise.

4.17 Going into the crisis, few mainstream Treasury officials had technical banking and financial markets experience or expertise. Over time, the Treasury built up its experience in these areas, but was reliant throughout the crisis – especially in the early stages – on a range of external experts, some of whom brought skills which it would not be practicable or cost-effective for the Treasury to maintain 'in-house'.

4.18 Some attention was given to the skills and experience of those brought in to work on Northern Rock. The then Second Permanent Secretary was a former head of FRI in the Treasury. He and one of the team leaders had experience of corporate restructuring, specifically British Energy. The official leading the Bill to prepare emergency legislation for bank resolution in autumn 2007 had financial legislation experience.

4.19 However, officials with relevant background were thin on the ground and most of those deployed to work on the crisis were 'generalists', who faced a steep learning curve. At later stages of the crisis, in 2008 and 2009, there were Treasury staff with a banking or financial services background who were not called on. That may sometimes have been because there was – and remains – no systematic recording of people's skills and background within the Treasury.

"It was not necessarily the people with the right skills and knowledge that were brought in – rather, stray people who did not necessarily have a finance background. [...] It is difficult to step in without any background knowledge."

"We recognise that it's very difficult to have detailed discussions with the Bank without a degree of technical knowledge and experience, which we just don't have currently."

"We [Treasury] have never needed them before, but in future we will need greater competency in relation to money market operations, capital and debt markets."

Treasury officials

"The Treasury needs depth of expertise in times of crisis, not lots of people."

Former Chancellor

4.20 This is not to underestimate the critical importance of traditional Treasury skills to the crisis. The following comments by interviewees are typical of the views expressed in relation to the Treasury's role in recapitalisation.

[21] An Executive Agency of the Treasury responsible for delivering the Government's debt management policy.

"This was [the] Treasury at its best: pulling people out of teams all over the place, writing briefings, officials being willing to take on new challenges. Treasury people are generally very flexible and enjoy a good crisis. Most bureaucratic organisations wouldn't necessarily operate like this."

Former senior Treasury official

"The country is lucky to have HMT officials [...] they have a very demanding role and operate in near impossible conditions. The recap in October 2008 was handled very neatly."

Senior banker

4.21 With many people coming new to the subject area, induction was of critical importance. This improved over time, particularly from the spring of 2009. While there was no induction for the Northern Rock teams, by the time the APS was announced a formal induction programme had been developed.

External expertise

4.22 With limited in-house expertise, the Treasury turned extensively to external advisers and experts:

- **Northern Rock** – Slaughter and May for corporate law advice and Goldman Sachs for investment banking advice;
- **Recapitalisation** – several investment banks, consultancy firms and Slaughter and May; and
- **Asset Protection Scheme** – consultants and accountants with project management expertise on secondment from the big City firms.

4.23 The experience of working with secondees from the private sector was mixed in the early phase of the crisis but improved over time. Part of the difficulty at the beginning was that the Treasury had had no significant experience of working with external specialists on such a scale. It took the Department time to get to grips with the sort of advice that it required. While the relationship with Slaughter and May – which had advised the Treasury in the past – worked well from the start. The relationship with investment bankers was less effective initially. Over time, the Treasury became a more intelligent customer and was able to consider critically the advice that it sought and was given.

4.24 The use of outside expertise on the APS was mixed. There were large numbers of consultants at the peak of the project[22]. Where roles were clear and they understood what the Treasury wanted, consultants contributed effectively. But that was not always the case. Project management was successful and supported better planning and governance. It was commended by the NAO[23].

[22] Consultancy fees, around £100 million, are recorded in NAO reports, for example, Appendix 6 of 'HM Treasury: the Asset Protection Scheme', NAO (2010), and 'Central Government's use of consultants and interims' (2010), but the number of people involved is not.
[23] Appendix 6, 'HM Treasury: Asset Protection Scheme', NAO (2010)

"The APS was a project on an unprecedented scale. [The] Treasury was dealing with bank books which were hugely complex, banks themselves did not understand them [...]. Treasury and their financial advisers wanted as much detail and data as they would need for securitisation. They were incredibly data hungry."

Senior external adviser

'Treasury did a good job in leveraging the few people with skills to utilise the very large numbers of sub-contractors, secondees and HMT staff. However, the Treasury is thin on expertise and project management skills. There is a real talent management issue here. "

Senior external adviser

"The Treasury was not used to project management – it really is a skill, and a key capability for managing a crisis."

Senior external adviser

4.25 The setting up of new bodies, at arm's length from the Treasury and from Ministers, to manage the delivery side of the crisis (APA to manage the APS; and UKFI to manage the Government's shareholding in RBS, Lloyds, Northern Rock and Bradford & Bingley) was a huge task. Both the APA and UKFI have been able to recruit people with the relevant skills, helped by greater flexibility on pay. This has allowed the Treasury to keep its focus on strategic policy making.

4.26 The Treasury has built up home grown experience and expertise over the course of the crisis. This was bolstered by the recruitment of two new senior advisers in 2009; one a former senior official from the Bank with expertise in the financial sector; the other a senior Foreign Office official with experience of working at the Bank. In January 2010, a new Managing Director for Financial Services with City experience was appointed.

Management

4.27 The Treasury significantly increased the number of senior managers during the crisis. In mid-September 2007, there were three senior managers in that area: one Managing Director; one Director; and one Deputy Director. By January 2010, there were eleven: a Second Permanent Secretary; one Managing Director; three Directors; and six Deputy Directors. Much of that increase occurred in 2009, although the post of Managing Director for Financial Services was vacant from March 2009 until the appointment in January 2010, referred to above. That temporary gap had a significant impact on Director workloads.

4.28 Senior managers played a key role advising Ministers, coordinating Whitehall and managing relationships with the Tripartite and City. The role of the two Second Permanent Secretaries was particularly critical. Such was the reliance on the Second Permanent Secretary, appointed in March 2009, that stakeholders worried about who might step into his shoes in his absence.

4.29 Managers took some critical decisions on the organisational response, including: the preparation of emergency legislation in autumn 2007 to resolve a failed bank by statute; the development of options for recapitalisation in summer 2008; the establishment of robust procedures for procuring external legal advice, consultants and corporate finance advice[24]; and the introduction of 24-hour business support.

4.30 The highly demanding nature of their roles and pace of work meant that senior managers were not able to give their full attention to staff management. There were costs to this: staff and advisers working on the crisis did not always have a clear idea about their role or how they fitted into the team; jobs vacated by people working on the crisis were not always 'back filled', which increased work pressures and inevitably led to some slippage in ongoing business; and a big backlog of unanswered letters from MPs and members of the public built up in 2008, which was only effectively tackled in 2009.

4.31 Staff communications were a bit patchy to begin with but improved over time. With the benefit of hindsight, greater investment in the management and coordination of staff would have made the Treasury's response more effective. This is supported by evidence of crisis management best practice in other government departments (see Box 4).

"Senior management was very good at keeping people's spirits up during the crisis. [They] listen to juniors and delegated work, but there ought to be more resources to cope with the pressures."

"At the time nobody took responsibility for organising."

"At some point Range Ds and Es [policy advisers and senior policy advisers] tried to develop ideas on strategies and skills to fill the gap left by senior management, but management was not interested."

Treasury officials

4.32 During the crisis the Treasury began to put more weight on leadership and management skills for staff aspiring to become senior managers, supported by a new learning and development programme.

Relations with the City and Tripartite

4.33 Prior to the crisis, the Treasury did not have strong links with the City and financial institutions but quickly developed constructive relations led by one or two key senior officials. Both Second Permanent Secretaries were critical interlocutors during the crisis.

4.34 The Treasury also had good relations generally with the other Tripartite authorities at working level all the way through the crisis (although those at Principal level were sometimes more strained). These were strengthened by the shared experience of the crisis, despite not always having common policy positions.

4.35 There were sometimes issues arising from different cultures and working styles between the Treasury and Bank. Bank officials are accustomed to working in a more hierarchical structure and took a more considered and analytical approach. The Treasury worked more directly to Ministerial demands and at a faster pace.

[24] Six banks were invited to tender in October 2008 and were assessed by a panel of senior officials against criteria in the tender documents. Following an open competition, in July 2011 the Treasury put in place a call-off panel of 11 financial institutions to provide corporate finance advice.

4.36 At the start of Northern Rock, there was some difficulty around the Bank's reluctance to provide liquidity support because of its belief that the underlying problem was one of solvency and not liquidity, with attendant worries about moral hazard.

"It [the Tripartite] didn't work badly, both in pre-crisis time when there was time to discuss and resolve issues and at the height of crisis when the scale of the problem focused minds. But in the run-up unresolved issues of principle (e.g. the moral hazard question of whether you should provide liquidity or let banks fail), as well as the unresolved question of who ultimately would decide, hindered resolving issues.'

"The Bank's and FSA's expertise was invaluable. Colleagues at the FSA were sometimes the only genuine experts we could draw on and fully trust. Sometimes there were misgivings about their speed and the strategic awareness of their advice, but without them we wouldn't have coped. By and large they have provided us high quality and professional advice, and they were very collaborative in their approach."

Senior Treasury officials

4.37 Given the scale of the crisis, the Treasury took a close interest in issues of detail that would normally be the preserve of the FSA. At times there was some difficulty in communication between the Treasury and the FSA over the need for detailed information about the banks which the former felt was not forthcoming from the latter.

Knowledge and risk management

4.38 Knowledge management began weakly but improved over the course of the crisis. When Northern Rock collapsed, robust systems and processes were not always in place to record policy decisions or to easily retrieve information about previous corporate restructurings. In late September 2007, a small team was assigned to knowledge management. After nationalisation, officials archived emails on the crisis to assist the NAO.

4.39 In March 2008, the Treasury set up a Financial Stability knowledge management team and began encouraging staff to use handover notes and exit interviews as a matter of routine. The effectiveness of that practice was variable, partly because some staff worked for very short periods on the crisis.

4.40 In similar vein, the Treasury strengthened its risk management processes. When the crisis hit, the Treasury already had in place a Fiscal Risks Group addressing risks to the economy and public finances. However, decision making on Northern Rock took place '*largely outside normal risk management procedures',* according to NAO analysis. During the crisis, the Treasury sought to improve its risk management, setting up two further risk groups in 2008-09: one on economic risks, the other on operational risks[25]. All three report to the Treasury's Board.

Communications

4.41 Communications were another key aspect of the Treasury's response that evolved significantly as the crisis unfolded. Traditionally, the Treasury worked through the Westminster

[25] The Treasury had a Fiscal Risks Group from 2006. In 2008-09, it established: an Economic Risks Group to assess the assumptions driving macroeconomic and fiscal risks, and risks related to the international economy, capital and money markets; and an Operational Risks Group, to address risks to the delivery of Treasury operations.

lobby of political reporters. Financial markets and banking were not an integral part of the Treasury's media operations which, in financial services, focused on consumer finance and deregulation.

4.42 During the Northern Rock crisis, it took some time for the Treasury to appreciate the scale of the communications challenge – providing assurance to the public on quite technical issues under the spotlight of 24 hour media coverage. The whole communications team needed to understand financial markets but there was a shortage of communications experts with this background and the Treasury did not have many existing relationships with the financial press. There was also a lack of capacity in the teams dealing with the crisis to plan communications and provide briefing to the Treasury's press office.

4.43 The Treasury learned from these initial difficulties by the latter half of 2008. Teams working on recapitalisation included dedicated resources to develop and plan communications with Ministers, the public and the financial sector. For the APS, all members of the central communications operation were comprehensively briefed and able to field enquiries. Links with the RBS and LBG and other members of the Tripartite also made communications around APS much smoother.

Conclusions

4.44 The Treasury began the crisis with weak capability due to the global consensus that systemic risks had been substantially reduced. After a short, initial delay, the Treasury ramped up resources quickly and flexibly drawing on what limited internal expertise it had and using outside advisers with mixed success. Going into the crisis, the Treasury had good working level relationships across the Tripartite and developed good links with the City. Its knowledge and risk management processes were somewhat weaker.

4.45 The Treasury strengthened its resource over the course of the crisis, building up more in-house experience, working more effectively with advisers and bringing in project management skills to good effect. It also developed its risk processes. The two second Permanent Secretaries played an influential role, but their importance could have put the Treasury's response at risk had one or other of them become unavailable for some reason. With the benefit of hindsight, the Treasury should have scaled up resourcing more substantially in summer 2008 and it should also have put more investment into staff management.

5 Current capability on financial services

5.1 This chapter outlines the Treasury's current capability on financial services and stability. It then goes on to describe how this is being affected by a recent major reorganisation of the Treasury in response to the reduction in budgets that is affecting the whole of the public sector.

Staffing levels and skills

5.2 The Treasury currently has around 150 officials working in financial services and financial markets, of whom around 50 focus on financial stability, contingency planning and the ongoing management of the Government's interventions in the banking sector. Work on contingency planning is further reinforced by teams working on international and European issues. Compared to other parts of the Treasury, there is a reasonably high ratio of senior management.

5.3 There is a small core of experienced officials who have been working on financial sector policy since 2009. It is hard to be definitive about precise skills and expertise as these are not systematically recorded. Evidence to the Review suggested a mixed picture. There was recognition that the Treasury has a core of very bright officials with financial sector and crisis management experience at working level, but also a suggestion that not many are technical experts in their policy area. That view was shared by certain Treasury officials.

5.4 Financial services teams tend to be made up of Treasury 'generalists'. There are a few officials who have deep experience of financial services, markets and regulation. Those officials have tended to anchor their Treasury careers in this area, or have supplemented their experience with stints outside, for instance in Brussels or the Cabinet Office, leading work on EU negotiations, or the Bank or DTI – when the latter was responsible for financial regulation. A much smaller number of officials have relevant City experience.

5.5 Many interviewees suggested that the biggest challenge the Treasury faces is maintaining its financial sector expertise. This issue goes beyond the financial sector and is a broader organisational challenge (see chapter 7). Most people who were working on the crisis in 2009 have moved on to new roles in the Treasury or have left. The upside is that the Treasury has a large number of alumni who could potentially be drawn on in the event of a future crisis.

5.6 The NAO recently conducted a review of central government strategies and governance arrangements for identifying and addressing skills needs[26]. In one of the case studies the Treasury was cited for the lack of time officials spent in post – nine months in some instances. This was described as a factor that undermined the Department's ability to embed skills and provide continuity in managing relationships with stakeholders. The NAO also recognised that the Treasury had taken action to increase the length of time officials spend in post.

5.7 Senior managers across the financial services groups maintain contact with private sector advisers who worked on the crisis, which should promote more effective working in future. The

[26] 'Identifying and meeting central government's skills requirements', NAO (2011)

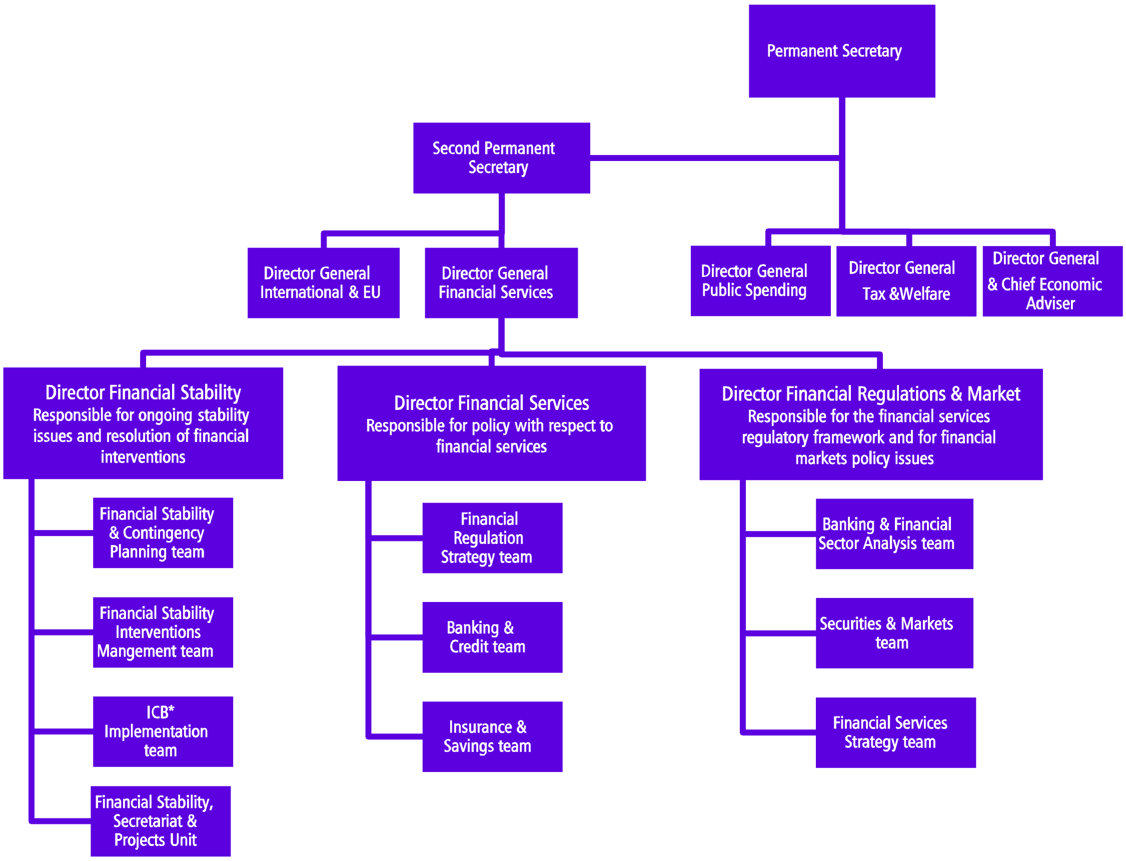
Treasury set up a new process for procuring corporate finance advice, which allows contracts to be made quickly among a group of private providers selected in the summer of 2011 following an open competition. This should improve value for money.

Organisation of financial services groups[27]

5.8 The Treasury's broad policy interests across the financial services sector are complex and overlapping. They are organised into three groups: financial stability; financial services; and financial regulations and markets. To a large extent the current management structure evolved during the crisis (see Chart 3).

5.9 This Review has found that there is scope to improve both the structure of the financial services groups and ways of working between them. Staff within the groups placed great stress on good communication and information sharing by senior management, and clearer strategic direction. They were at times unclear as to which teams or officials led on a particular policy issue.

Chart 3: HM Treasury organogram – financial services (2011/12)



*Source: HM Treasury; * Independent Commission on Banking.*

[27] The Financial Services Group, Financial Regulation and Markets Group and Financial Stability Group.

"We need more structure and better business processes in place across financial services. There's a lack of clarity about who leads on what, especially on cross cutting issues like banking – even for those of us working on these policies."

"Having a central team like the tax or spending groups would make us more joined up. Someone needs to be thinking about the big picture; the linkages between financial services, competitiveness, growth, tax and stability."

"Does it make sense to have three separate groups working on the financial sector? We should develop a shared strategy and business plan."

Treasury officials

Contingency planning

5.10 The state of the Treasury's contingency planning is substantially improved compared to 2007. There is a dedicated team considering what actions might be taken in the event of a serious deterioration in financial markets or vulnerabilities in one or more institutions. This team works closely with the Bank and FSA.

5.11 The Treasury has developed a 'reserve list' of staff with relevant experience who could be drawn on in a crisis. Improvements have been made to business support arrangements so that practical issues such as IT, security passes, and out-of-hours support can be resolved at short notice.

5.12 Despite significant progress, there are areas where the Treasury might learn from best practice in other government departments (see Box 4 below). These include crisis management training and rotation of staff.

Box 4: Contingency planning and crisis management – Whitehall best practice

- Clarity about who is responsible for key policy and operational decisions, team structures and individual job roles.
- Strengthening of senior management capacity during a crisis.
- Plans in place to rotate staff to prevent burn out.
- Staff with the right skills identified in advance and any practical support that will be needed (e.g. childcare) planned for.
- Extra capacity built in so that extra staffing can be brought in quickly if there is a surge in workload.
- Logistics set up for communications, for example dedicated operation rooms and communication teams, standard briefing lines.
- 24 hour media monitoring so that press briefings can be put out quickly to reassure the public and others.
- Daily staff briefings so that everyone who needs to know is fully up to date with events.
- Crisis management training for staff.
- External scrutiny of risk management processes.

5.13 In addition, there is an issue as to how well developed contingency plans are to address stability risks related to non-banking institutions such as clearing houses or shadow banks which did not feature in the 2007-09 crisis.

Risk and knowledge management

5.14 The Treasury has continued to strengthen its risk and knowledge management since the crisis, though there is further improvement that could be made.

5.15 Risks to the financial sector are now a core feature of the Treasury's risk management processes. Non-Executive Directors play a more prominent role. Risk processes are appraised annually and improvements made. Against that, the Treasury's high level of internal churn is an inhibiting factor. And there is more to do to assess low probability but high impact risks, as well as risks that are complex and link the financial sector and real economy, such as a disruption to the UK's payment and settlement systems.

5.16 The Treasury has made a big effort to improve awareness of the importance of keeping accurate records. There has been some progress: by the end of 2011, seven in eight staff received an induction when they started a new job and 60 per cent received a handover note from their predecessor. However, there is more to do to embed knowledge management fully within the culture of the Treasury, particularly at more senior levels.

5.17 Use of the Treasury's records management system has declined due to its unreliability.

> *"Senior management is prepared to tolerate a lot of non-compliance on knowledge management."*
>
> *Treasury official*
>
> *"Lots of Treasury's tools are standard risk registers [...]. Complex unknowns are harder to capture this way and need different approaches."*
>
> *Treasury official*

Strategic Review of the Treasury

5.18 The Treasury conducted a strategic review in the autumn of 2010 to improve its capability in the face of budget cuts. Like other central government departments, the Treasury has to reduce its administrative spending by one third and will do so partly by cutting staffing levels from 1,350 in March 2010 to 1,000 in March 2014. The planned level for March 2012 is 1,240, though the Treasury is ahead of that target with current staffing at around 1,140. The review prompted a major internal reorganisation with a direct bearing on the effectiveness of the financial services and stability teams.

5.19 The strategic review introduced a more flexible structure designed to produce more responsive and less siloed policy making. There is a new business planning process to align resources more closely with priorities.

5.20 Structural changes have been underpinned by a modern IT system which has enabled more flexible working for Treasury staff. Greater emphasis has been placed on staff development: the training budget has been protected; managers have been encouraged to spend more time on talent management and workforce planning; and greater emphasis has been placed on management and leadership capabilities for staff seeking promotion to the Senior Civil Service.

5.21 The strategic review had envisaged a scaling back in staffing on financial stability and the winding down of UKFI and the APA. The continuing strains in global markets, uncertainty in the Eurozone and weak economic growth – which among other things seems likely to delay the divestment of the Government's bank holdings – have caused this to be put partially on hold.

Conclusions

5.22 The Treasury has improved many aspects of its capability. There is a core of experienced staff and much greater experience of crisis management, although overall numbers have fallen. There have been significant improvements in contingency planning driven by uncertainty in financial markets arising from the Eurozone crisis. Improvements have also been made to risk management processes but there is scope for further progress to be made, as well as opportunities to give greater priority to knowledge management.

5.23 The next chapter makes proposals for the Treasury's future capability on financial services issues in the context of upcoming regulatory changes.

6 HM Treasury's future capability

6.1 This chapter sets out the Treasury's future capability needs in relation to the financial sector based on its changing role in a new regulatory regime.

Impact of regulatory change

6.2 The Treasury's future financial sector capability will be shaped by the scope and nature of its future responsibilities. Its role is going to be significantly affected by three major changes in the regulatory environment. The Treasury is also likely to have a more enduring role in relation to its shareholdings in RBS and LBG than previously envisaged owing to continuing strains in financial markets.

6.3 First, the transfer of responsibilities for prudential supervision to the Bank of England and the abolition of the FSA. A new macro-prudential body, the Financial Policy Committee (FPC), is being established in the Bank, and is already operating in shadow form. A new prudential regulator – the Prudential Regulation Authority (PRA), a subsidiary of the Bank – and a new conduct of business and markets regulator – the Financial Conduct Authority – will be set up.

6.4 The Treasury will continue to have responsibility for the overall regulatory framework and the protection of the public finances. Legislation will also make clear the Bank's responsibility for protecting and enhancing the stability of the UK financial system, identifying future crises and developing contingency plans. In a crisis, the Chancellor will be responsible for all decisions that involve public funds or liabilities, and will have a statutory power of direction over the Bank when public funds may be at risk.

6.5 Second, the strengthening of the banking sector in response to the Independent Commission on Banking (ICB). The Government intends by 2019 to introduce several measures: high-street banking will be ring-fenced from wholesale and investment activities; banks will be required to have a larger cushion of capital; and greater competition will encouraged. The Government has noted that implementing these reforms will require the Treasury to introduce a significant amount of primary and secondary legislation over the next few years.

6.6 Third, proposed regulatory changes emanating from the EU and international bodies. For example, the European Commission is calling for a new EU-wide approach to resolving banks and investment firms, as well as changes to existing financial regulation. The Financial Stability Board (FSB) is seeking closer cross-border supervision and greater cooperation between the supervisors of financial institutions that are of global systemic importance.

Implications for Treasury capability

6.7 Taken as whole, these reforms will have important implications for the capability that the Treasury will require in future. The changes to the UK's regulatory regime and banking sector will place significant responsibility on the Treasury to develop policy and deliver legislation over the coming years.

6.8 There was virtual unanimity amongst those giving evidence to the Review that the Treasury would need to develop further the skills and experience to:

- provide Ministers with an independent assessment of advice from the Bank and the PRA and, where necessary, develop independent options for financial intervention;
- maintain its role as guardian of taxpayer interests in a crisis;
- develop a better understanding of the remit, culture and institutional capacity of the Bank group, so that it can engage constructively as an intelligent customer at working level and at Board level;
- better understand the linkages between money markets, external balances and the macro economy;
- influence negotiations and advise Ministers on proposed regulatory changes emanating from the EU and internationally;
- monitor the impact of the various regulatory changes on the Government's wider economic and financial objectives;
- manage existing interventions in the banking sector, including oversight of the APA and UKFI; and
- maintain effective relationships with the City, in part to understand market analysis and trends and to inform Treasury judgements about individuals that it will have to nominate for top level positions in the regulatory authorities.

6.9 At the same time, it will be important that the Treasury does not seek to duplicate the Bank's roles and responsibilities, or operate a shadow supervisory or stability function.

"As a matter of principle, in future HMT will need to ensure it is an intelligent customer of advice from the Bank. It will therefore need to maintain expertise and experience to scrutinise the Bank's advice. At a practical level the Bank will require a shift in culture to effectively manage its new remit. It currently takes discrete, periodic decisions with little delegation in decision-making. However, in future it will need to move to a more continuous, strategic approach which will necessarily involve a more delegated approach".

Former senior Treasury official

"In peacetime, the Treasury will have an important role to play in resolving and balancing policy conflicts in the new regulatory structure – between systemic policy and economic policy, consumer protection and financial stability. During a crisis there has never been any doubt for me that the Treasury, and ultimately the Chancellor, calls the shots when there is the possibility of fiscal action occurring."

Former senior Bank official

Conclusions

6.10 The Treasury will continue to need capability in some key areas in the future, as a result of big changes in the regulatory environment and continued threats to financial stability. With the right training and longer periods in post Treasury 'generalists' ought to be able to provide much of this capability. However, some of this capability implies quite specialist skills and knowledge

garnered from a career anchored in financial services. A key issue for the Treasury is how much of this it develops in-house and how much it buys in.

6.11 There are already people with relevant specialist finance backgrounds and City experience in the Treasury (Infrastructure UK), its arms length bodies (UKFI and APA) and in other parts of Government (the Shareholder Executive). Ideally, this group of officials would combine technical expertise with knowledge of, and an ability to operate effectively in, the Treasury. The Review would expect the Treasury to retain and develop this in-house expert capability. To achieve that some wider organisational challenges will need to be addressed. These are discussed in the next chapter.

7 Organisational challenges

7.1 This chapter sets out the organisational challenges that need to be addressed in order to strengthen the Treasury's capability in addition to the specific issues related to financial services raised in chapter 5 and 6. The key organisational challenges are: staff turnover and its impact; pay; and cultural barriers.

Staff turnover

7.2 The Treasury has the highest turnover of any Whitehall department – three times higher than the UK civil service average[28]. Since 2005-06, turnover has fluctuated around 25 per cent. It peaked at 38 per cent in 2008 and fell back to an annualised figure of 28 per cent in 2011[29]. Roughly half of officials who leave the Department join the private sector; the other half go elsewhere in the public sector[30]. High staff churn makes it hard to develop experience or establish effective relations with stakeholders.

"A turnover rate of 28 per cent is unhealthy [...] it's a tremendous cost in terms of knowledge, skills and investment in staff. We [NAO] actively manage turnover. When it started to move towards 15 per cent last year we took steps to bring it down."

Senior NAO official

"The Treasury needs the right balance between fresh blood and new ideas, and some degree of institutional knowledge and experience. Turnover of five per cent, like the Bank, is too low for the Treasury; we [FSA] target a band between 11-16 per cent to get the right balance. Treasury is more dynamic and may need to be a little higher, maybe 15-20 per cent, but no more than that."

Senior FSA official

"There's been a lot of turnover [recently] and it's difficult to find out what's been happening in relevant policy areas."

Treasury official

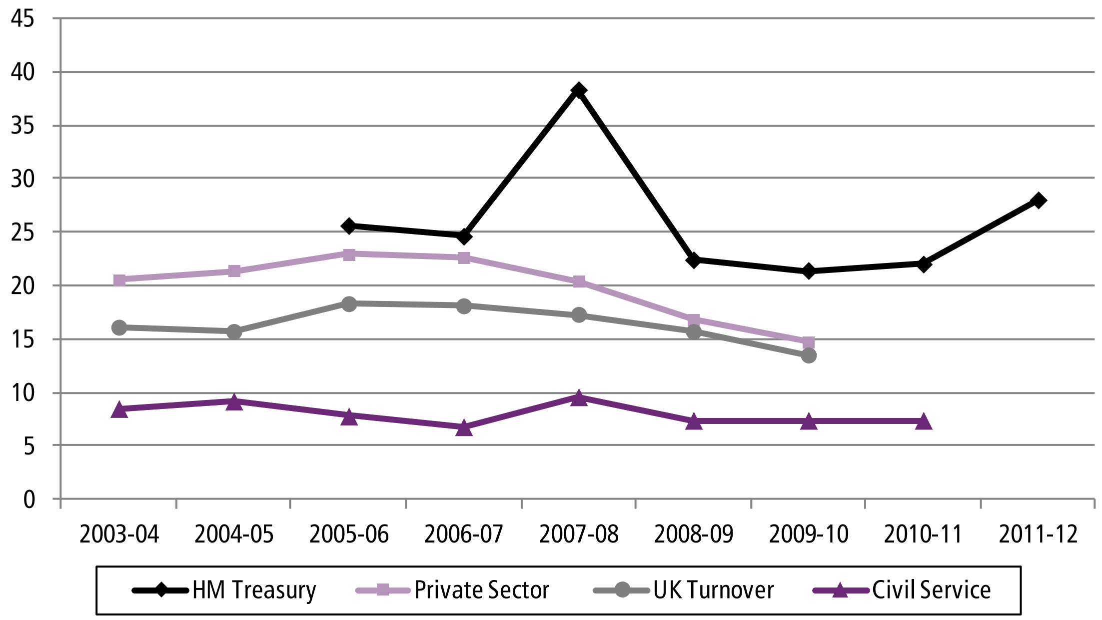
7.3 The high rate of turnover means that many staff joined the Department relatively recently. Around half of the present workforce joined after 2008. More than half of policy advisers (Range D and E – see Box 3) have three years or less length of service.

[28] The Treasury's turnover rate includes all leavers, but does not include loans and secondments of Treasury officials to other organisations.
[29] As at the end of December 2011, the annualised staff turnover figure for year beginning April 2011.
[30] 'Leaver Survey 2010-11', HM Treasury (2011)

7.4 A significant minority of staff do not expect to have a long term career in the Treasury. The 2011 staff survey suggested that approximately one third wanted to leave the Department within a year.

7.5 Turnover is high relative to the private sector. Such high turnover is more commonly found in semi-skilled parts of the service sector, such as call centres and in hospitality. Turnover is elevated by the fact that 10 per cent of the total workforce come into the Treasury from other government departments or the private sector on a time limited basis.

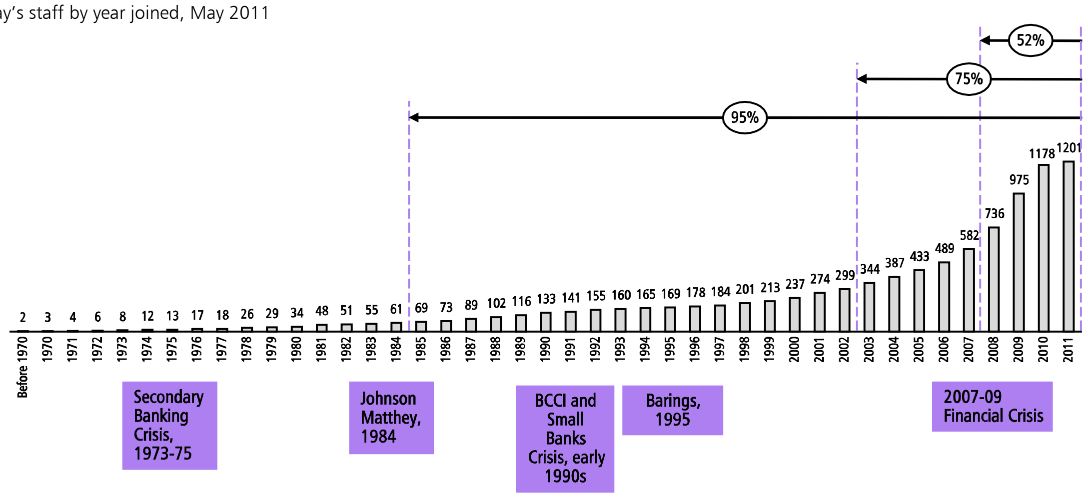
Chart 4: Turnover



Source: HM Treasury, Cabinet Office, ONS, CIPD, and Xpert HR.

Chart 5: Length of service

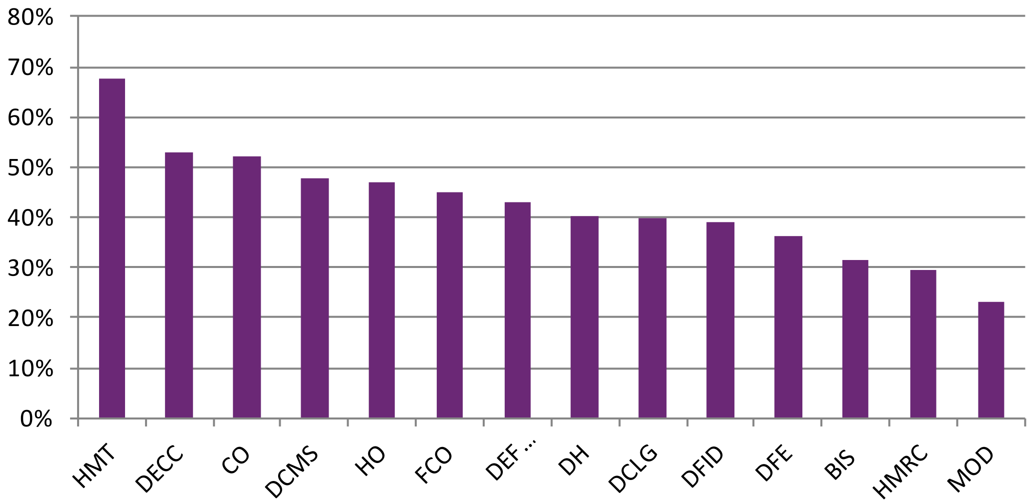
Today's staff by year joined, May 2011



Source: HM Treasury.

7.6 The Treasury's staff are relatively youthful. The median age in 2010 was 32 years compared to 45 years in the rest of the civil service[31]. Sixty seven per cent are aged between 20 and 39.

Chart 6: Percentage of staff aged between 20 and 39



Source: ONS

7.7 Uncompetitive salaries and limited career progression are the key reasons cited by staff who leave. These factors are co-dependent: a lack of promotion opportunities due to the flat organisational structure, relative to other Whitehall departments, hinders pay prospects; and low relative pay puts a higher premium on promotion.

7.8 There is a general perception that promotion prospects for policy officials are enhanced by acquiring generalist policy skills and gaining experience of working in a variety of high profile roles on Ministerial priorities. This is a factor in the length of time policy officials spend in post – the internal churn in the labour market – and also has an impact on expertise and experience.

Pay and Whitehall

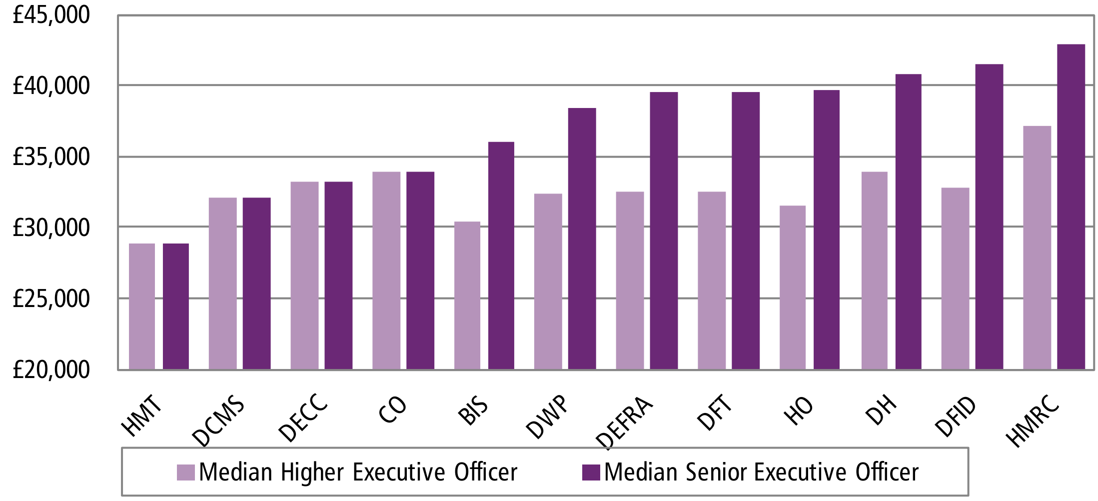
7.9 As the Government's economics and finance ministry, the Treasury has sought to lead by example and restrain relative pay for its staff (the process of devolving decisions on pay to departments began in earnest in the mid 1990s). Treasury policy officials are now the lowest paid in Whitehall: median pay is at least 10 per cent lower at the Treasury than in other departments. For Senior Civil Servants, the pay disparity is 14 per cent[32]. The Treasury's business and policy support staff (Range B and C) have the lowest median pay and the lowest starting salary in Whitehall.

7.10 The gap partly reflects the Treasury's lower minimum starting salaries, high turnover and the abolition of certain grades. It may also reflect a pay drift in other departments. In 2005, Treasury median pay at Range D and E (policy and senior policy advisers) was broadly equivalent with median pay across central government departments. In the 2011 Civil Service people survey, the Treasury ranked 96th out of the 97 organisations in terms of staff satisfaction with pay and benefits[33].

[31] The median age as at end of February 2012 increased to 33 years.
[32] Cabinet Office (2011)
[33] 'Civil Service people survey', Cabinet Office (2011)

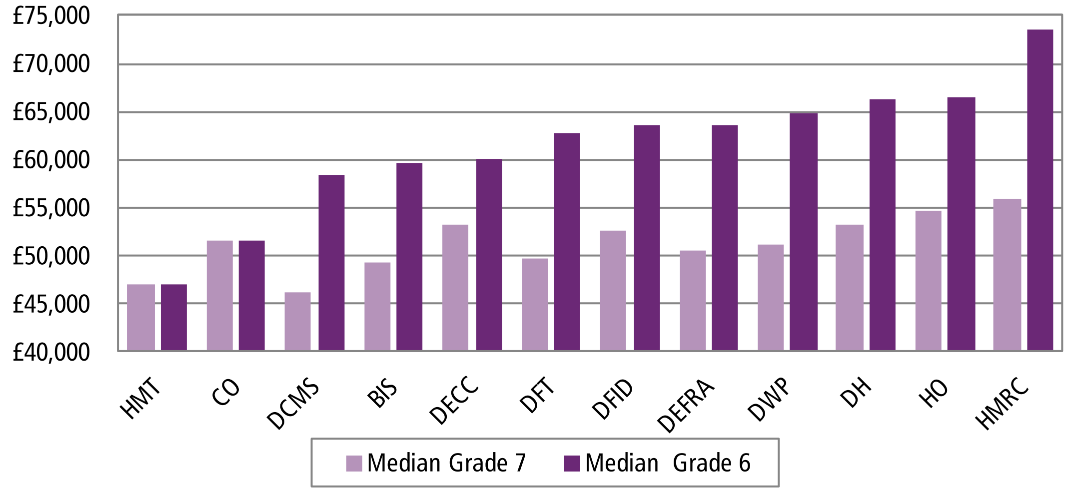
7.11 Pay and grade structure create strong incentives for staff at these grades to seek promotion rather than to move up a pay-scale within a grade. Promotion from the median Range D pay to the minimum Range E starting salary provides a 55 per cent increase in salary; Range E median to SCS starting salary provides a 25 per cent increase. The high level of competition for promotion internally has meant that Treasury officials often move at the same grade or on promotion to other departments to increase their pay.

Chart 7: Civil Service median pay 2010-11 – Treasury range D equivalents[34]



Source: ONS

Chart 8: Civil Service median pay 2010-11 – Treasury range E equivalents[35]



Source: Cabinet Office

[34] Following the 'Fundamental Review of HM Treasury's Running Costs' in 1994 a new grade was introduced – Range D. This grade amalgamated two separate grades – Higher Executive Officer and Senior Executive Officer – into one. Most other departments, except the Cabinet Office, still retain these grades.
[35] As above, the Treasury also introduced the Range E grade. This grade amalgamated Grade 6 and Grade 7.

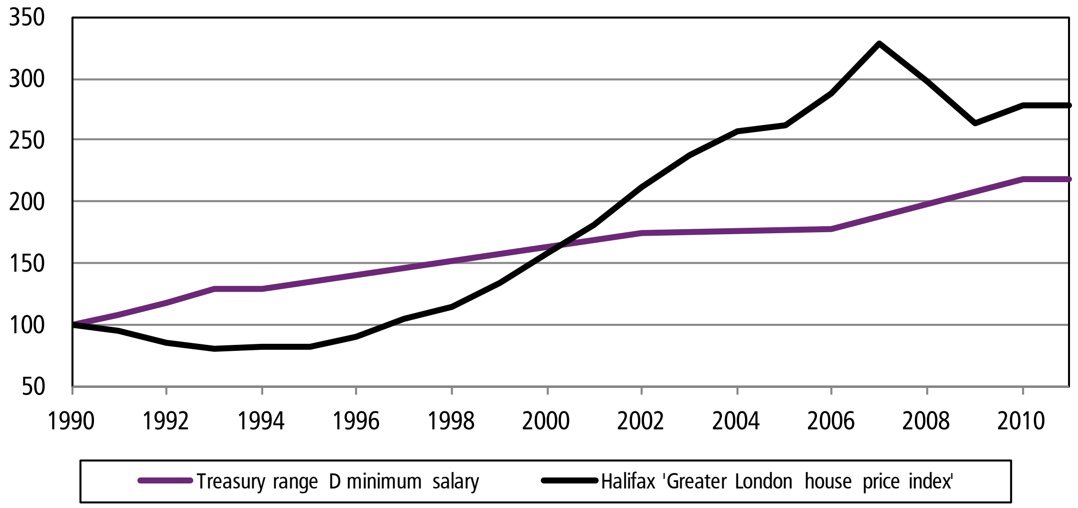
"Pay in HMT for Ds and Es [policy advisers] seems to be more defined by Whitehall politics than in relation to actual value, market or otherwise, and can act as the reverse of an incentive to maintaining expertise in the Department."

"I don't do the job for the money. I could get a lot more at the Bank or in the City. We [Treasury officials] just want fair pay compared to Whitehall. Everyone knows we work long hours and have a level of responsibility that you'd generally expect at one grade higher in another department. It's really odd that we're the lowest paid."

Treasury officials

7.12 Since 2000, house price inflation has significantly outstripped pay growth. Some interviewees commented that this was leading to a situation where only staff with other income could afford a long term career in the Treasury, which could lead to a narrowing in the diversity of Treasury staff.

Chart 9: House price and wage inflation (Index: 1990 = 100)



Source: HM Treasury and Halifax

Pay and financial services

7.13 Treasury pay is significantly below that elsewhere in the Tripartite. Basic salaries at the Bank and FSA can be as much as 50 and 100 per cent higher, respectively, for comparable jobs. Pay scales also allow staff significant pay progression at their grade. The pay gap with the City is commensurately greater; evidence from officials who have left for the City suggests that basic salary packages are at least two to three times those in the Treasury.

Allowances and pay flexibilities

7.14 The Treasury has taken action to try to offset low pay and high turnover. More money is available for a range of circumstances and skills: staff who stay in post for longer, although this is not frequently disbursed, or have weighty responsibilities for their grade; and staff with accountancy, audit, or procurement qualifications, or corporate finance expertise. However, the

Treasury does not provide allowances for staff with financial services, tax or economics[36] qualifications, professional diplomas or other expertise.

Culture

7.15 The Treasury has a strong corporate culture, which has enormously positive aspects. There is a very high level of employee engagement compared to the rest of the civil service[37]. Staff are highly collegiate and adaptable, and pull together well in times of crisis.

7.16 Such a strong corporate culture can make it hard for outsiders to integrate well into the Department at senior levels. Alongside this, there is a strong focus placed on acquiring good generalist skills in order to demonstrate the ability to work in a range of posts, rather than developing a deep specialism in one area. The Treasury has previously tried to address this and some of the issues identified in this chapter (see Box 5).

> *"Range Ds [policy advisers] find it easier to advance by moving laterally to different roles in quick succession [...]. The Treasury's focus on generalism could become a weakness in an increasingly specialised world."*
>
> *Treasury official*

Box 5: Previous initiatives to improve capability

In 2002 Gus O'Donnell (now Lord O'Donnell of Clapham), then Permanent Secretary to the Treasury, commissioned a review to assess how the Treasury could develop and modernise its management capability. This concluded:

- the Treasury was weak at spotting new emerging issues and moving resources to respond in a timely fashion;
- the standing teams structure undermined collaboration;
- the culture undervalued expertise and people management skills; and
- staff were incentivised to do short stints in a variety of posts as a means to attain promotion.

Many of these issues had been identified in 1994, in the 'Fundamental Review of HM Treasury's Running Costs' (see Box 2). The review recommended a number of changes. These included strengthening corporate management and business planning processes; and putting greater emphasis on flexible management and project working. There was also a series of recommendations to enable the Treasury to move away from the 'traditional one dimensional civil service grading structure' through:

- the creation of a variety of career paths for experts; and
- greater flexibility to pay and reward staff according to the challenge of the job, market rate and specialism needed for the role.

These findings suggest that the Treasury recognised that developing and maintaining specialist expertise would require an adjustment to the standard civil service pay and performance model. These aspects of the review were not directly acted upon.

In 2006, the Treasury developed a 'Workforce and Skills Strategy' to address gaps in its skills and expertise, and high turnover; and to encourage officials to remain in post for longer.

[36] An increment of £2000 is available to Range Ds with a relevant Masters qualification in economics.

[37] A measure of how committed employees are to their organisation's goals and values.

Conclusions

7.17 High turnover and short job tenure can hamper the Treasury's ability to develop relationships with stakeholders, and grow the skills and expertise of its workforce. These trends also have implications for knowledge and risk management.

7.18 Developing the capability that the Treasury will need in future on the financial sector – more experienced 'generalists' and some specialists – will mean addressing issues of staff churn, low relative pay and a corporate culture to which it can be hard for outsiders to adapt.

7.19 The final chapter sets out a number of recommendations that the Review believes will help the Treasury to achieve the capability it needs.

8 Recommendations

The Review's remit has been to assess the Treasury's management response to the financial crisis. Other aspects of the handling of the financial crisis by UK authorities, including the policy efficacy, have been investigated extensively by the Treasury Select Committee (TSC), the Public Accounts Committee (PAC) and the National Audit Office (NAO).

The Treasury has worked hard to learn lessons since the financial crisis and has made improvements in a number of areas, including knowledge and risk management, contingency planning and mobilisation. The recent reorganisation of the Department has led to more flexible and less siloed working and better use of project management.

This chapter makes recommendations that should support the Treasury in making even further progress in three areas:

- contingency planning and crisis management in respect of the Eurozone;
- the broader capability of the financial sector side of the Treasury; and
- the organisation-wide changes necessary to achieve this broader capability.

Contingency planning and crisis management

The Treasury has already substantially improved its contingency planning. There is scope, however, to bring the Treasury fully into line with best practice in other parts of Government to ensure that its crisis management capability reflects the lessons of 2007-09.

A1. Develop the effectiveness of rapidly deployable 'crisis reservists', by:

i. developing clear structures and functions for crisis teams, including generic job roles, to support more effective management and use of resources. This might draw, for example, on the experience of project teams established to deal with Northern Rock, recapitalisation and the Asset Protection Scheme;

ii. including individuals from other parts of government and the City with relevant skills and expertise in the list of crisis reservists;

iii. speeding up recruitment and selection, particularly for secondees and Treasury officials who are not on the reservist list and ensuring senior management oversight of these processes;

iv. regularly updating the reservist list and providing individuals with crisis management training; and

v. clarifying the staff benefits package (for example, emergency child care costs, overnight accommodation, transport and overtime).

A.2. Retain the skills and experience needed to manage interventions in the banking sector: general Treasury skills; financial sector and markets expertise; project and crisis management. This would require greater opportunities for career progression for staff who spend longer working on financial services in the Treasury, and more visible recognition from senior management of the importance of financial sector skills.

A.3. Expand operational contingency plans to include the second round fiscal, macroeconomic and public expenditure resourcing risks that may arise from a financial crisis, including the backfilling of posts where officials are redeployed from other areas of Treasury business.

A.4. Develop a network with crisis management experts from other parts of Government (such as the Civil Contingencies Secretariat, Defra, MoD and DfT). This would allow the Treasury to keep up-to-date with best practice and make better use of Cabinet Office coordination to manage any second round effects on other Government departments.

A.5. Expand understanding and, if necessary, enhance ability to manage stability risks related to non-banking institutions, such as clearing houses, money markets and shadow banks, the failure of which could pose at least as great a risk as a bank failure.

A.6 The Treasury should work with relevant regulatory authorities and other central government departments to consider whether the UK has in place appropriate and proportionate 'horizon scanning' capabilities in relation to domestic and international financial stability so that the Government is best placed to spot, plan for and mitigate risks that might develop.

Financial services

The Treasury has a core of experienced staff working on financial sector issues. There are challenges in retaining them and in building a small group of specialist staff to support the Treasury's role under new regulatory arrangements. The Review recommends that the Treasury should:

B.1. In the next three to six months, develop a medium term strategy for its roles and responsibilities in relation to financial services regulation, financial markets and financial stability and identify capabilities required to deliver these – both generalist and specialist. This could be facilitated by an assessment of current functions, skills and expertise and by a plan to manage talent and staff succession in key financial services posts, including those covering the international and EU regulatory agenda.

B.2. In the next six to twelve months, clarify the level of resourcing, and management structures that can most effectively deliver the strategy. This might involve a degree of restructuring to increase central coordination and prioritisation across these groups, as well as more effective mechanisms to manage strategic policy trade-offs.

B.3. In the next year to two years, develop an enabling framework to support staff to develop and maintain expertise and professionalism across financial services and markets, by:

i. creating an in-depth training programme, including access to relevant Bank and FCA training courses and seminars;

ii. establishing a career path between the Treasury and other organisations for people who want to specialise in the financial sector, for instance through structured secondments with the Bank (see below), the Debt Management Office, financial institutions, the European Commission, international regulators and other finance ministries;

iii. increasing the use of pay flexibilities and allowances so that staff with key skills and experience can be retained; and

iv. encouraging staff to stay in post for longer.

B.4. Strengthening the Treasury's working relationship with the key institutions in the new regulatory framework, particularly the Bank, by:

i. clarifying the Treasury's strategic interests in relation to financial services and financial stability and ensuring that, within the framework established by the Financial Services Act and other relevant legislation, the practical implications are spelt out clearly in the division of roles and responsibilities between the Treasury and other agencies, notably the Bank;

ii. creating opportunities for senior management at the Bank, including the PRA, FCA and Treasury to discuss joint strategy and business priorities (for example, joint away days);

iii. developing a two-way secondment programme; and

iv. greater use of 'job shadowing', so that Treasury staff can see the Bank at work and the other way round.

Organisational challenges

The Treasury has made progress towards addressing some of the broader organisational challenges that this Review has outlined. If the Treasury is to achieve the capability it needs in the financial services sector it will need to go further. This could be taken forward as part of the ongoing follow-up to the Treasury's strategic review. Specifically, the Review recommends that the Treasury should:

C.1. Develop a strategy to manage the Treasury's turnover rate to support its long term workforce capability, including an annual turnover target rate of 15 to 20 per cent.

C.2. Place greater emphasis on experience, expertise and people management in its promotion and reward policies, by:

i. ensuring that pay and rewards policy is designed to enable the Treasury to attract and retain people with the right skills;

ii. reintroducing a new higher grade for senior advisers with specific skills, experience or significant management responsibilities;

iii. introducing more comprehensive support for senior managers, including formal 360 degree feedback on leadership and management;

iv. making greater use of opportunities to hire experienced senior advisers from other organisations and the private sector to fill gaps in expertise that cannot be met in-house;

v. using the annual performance appraisal process to value and reward good management; and

vi. reintroducing funding for MBA programmes so that officials can get practical training in management, leadership, corporate finance and markets.

C.3. Improve knowledge management by:

i. providing better recognition and reward through the annual staff performance appraisal process;

ii. introducing a more stable and user-friendly software platform to store key records, as well as an up-to-date office directory, to improve the infrastructure that underpins basic knowledge management; and

iii. using internal benchmarking to compare the Treasury's knowledge management to other government departments and knowledge-based organisations in the private sector.

C.4. Strengthen the processes and assumptions underpinning its risks groups by seeking constructive challenge and scrutiny from risk management experts; and

i. ensure that the three risk groups are better co-ordinated, by more clearly defining their respective remits and holding joint risk group meetings on a quarterly basis; and

ii. consider amalgamating the fiscal and economics risk groups.

C.5. Improve existing process for succession planning at all grades, by:

i. encouraging senior management to support longer handover periods and front loading introductory training for staff moving from one position to the next; and

ii. identifying critical posts across the Treasury and holding Directors to account to have in place credible plans to manage succession.

C.6. Create a more enabling environment to challenge to policy orthodoxy, by:

i. increasing and valuing a greater diversity of backgrounds, cultures and working styles across the Treasury;

ii. involving external experts more often, including in Board discussions, to provide an alternative view;

iii. testing ideas with trusted external stakeholders during the early stages of policy development where appropriate; and

iv. encouraging greater use of steering boards to discuss policy issues, including inviting officials from Treasury Groups that do not have a policy interest to provide a critical challenge role.

Implementation

The Review recommends that the Treasury reports publically on progress against these recommendations in the departmental report and invites the National Audit Office to review progress on knowledge and risk management, and expertise by 2013-14.

A Timeline of key events

2007

14 September	Northern Rock issues a statement that the Bank of England stepped in to provide support.
17 September	Chancellor guarantees all deposits held by Northern Rock.
19 September	Bank of England announces an injection of £10 billion into the money markets in an attempt to bring down the cost of inter-bank lending.
9 October	Treasury confirms that the guarantee arrangements previously announced to protect existing depositors of Northern Rock will be extended to all new retail deposits made after 19 September.

2008

22 February	Northern Rock is nationalised.
21 April	Bank of England launches the Special Liquidity Scheme allowing banks temporarily to swap high-quality mortgage backed and other securities for Treasury bills.
17 September	Lloyds TSB agrees to buy Halifax Bank of Scotland.
29 September	Part of Bradford & Bingley is brought into public ownership, the rest is transferred to Santander.
8 October	Treasury announces a major package to support the banking sector; a recapitalisation scheme allowing it to purchase £25 billion of Tier 1 capital (common stock and disclosed reserves) in eight eligible institutions; £25 billion to buy preference shares; and a £250 billion Credit Guarantee Scheme for new and short term debt issuance for up to three years.
	Treasury announces measures to protect UK depositors in Icelandic banks – Landsbanki, Icesave, Kaupthing Singer & Friedlander.
13 October	Treasury announces details of the recapitalisation of the Royal Bank of Scotland (RBS), Lloyds TSB and HBOS.
	The Debt Management Office announces the operating arrangements for the Credit Guarantee Scheme.
3 November	Government sets up UK Financial Investments Ltd (UKFI) to manage its investments in Lloyds Banking Group (LBG) and the Royal Bank of Scotland Group.

2009

19 January	Treasury announces the Asset Protection Scheme (APS) to protect financial institutions against exposure to exceptional future credit losses on certain portfolios of assets. LBG and RBS announce their intention to participate in the APS.

	Treasury also announces the Asset-backed Securities Guarantee Scheme on 19 January (launched on 22 April). The Scheme provides credit guarantees and liquidity guarantees in respect of residential mortgage-backed securities issued under the sponsorship of UK banks and building societies.
February and March	Initial terms of APS participation agreed with RBS and LBG. Legally binding lending commitments are agreed with RBS on 26 February and LBG on 7 March, for the period from March 2009 to February 2011.
21 February	Banking Act 2009 comes into effect, strengthening the UK's statutory framework for financial stability and depositor protection.
5 March	Bank of England announces plan to undertake a policy of 'Quantitative Easing' (injecting money directly into the economy to meet inflation targets).
18 March	Financial Services Authority publishes "The Turner Review", a wide-ranging review of global banking regulation following the crisis.
30 March	Dunfermline Building Society is taken over by Nationwide Building Society.
15 April	European Commission gives the Government permission to extend the Credit Guarantee Scheme and recapitalisation of banks under state aid rules.
3 November	LBG announces it will not participate in the Asset Protection Scheme and pays an exit fee for the implied insurance.
26 November	RBS signs the agreement to join the Asset Protection Scheme.
7 December	Treasury established the Asset Protection Agency (APA) to operate APS.
18 December	Bank of England states in its financial stability report that the financial system has been significantly more stable over the past six months, underpinned by the authorities' sustained support for the banking system and monetary policy measures.

2010

16 June	Chancellor announces the Independent Commission on Banking (ICB) and regulatory reform.
20 October	Comprehensive Spending Review requires the Treasury to make administrative cost savings of one-third, which in turn will require staff numbers to fall from 1,350 to around 1,000 by March 2014.

2011

9 February	Government announces 'Project Merlin', an agreement between the government and five major high street banks (Barclays, HSBC, LBG, RBS and Santander) to extend lending to small and medium sized enterprises (SMEs).
12 September	Independent Commission on Banking (ICB) publishes its final report setting out plans to fundamentally reform the structure of banking in the UK.
19 December	Government responds to the ICB's recommendations.

B Policy interventions

Scheme and date	Description
Banking (Special Provisions) Act 2008	The Special Provisions Act 2008 permitted the Government to nationalise failing banks under emergency circumstances. The Treasury used this Act to nationalise Northern Rock and parts of Bradford & Bingley (B&B). The Treasury also used an Order under the Act to transfer all retail deposits in UK based Icelandic banks – Heritable and Kaupthing Edge – to ING Direct.
Special Liquidity Scheme (SLS) (April 2008)	The Bank of England introduced the SLS to improve the liquidity position of the banking system. It allowed banks and building societies to swap some of their illiquid assets for Treasury Bills. Around £185 billion was lent under the scheme.
Credit Guarantee Scheme (CGS) (October 2008)	The Treasury introduced the Credit Guarantee Scheme to provide short term liquidity and to ensure that the banking system had the necessary funds to maintain lending in the medium term.
Emergency Liquidity Assistance (ELA) (October 2008)	In exceptional circumstances, as part of its central banking functions, the Bank of England acts as 'lender of last resort' to financial institutions in difficulty in order to prevent a loss of confidence spreading through the financial system. ELA was provided to RBS and HBOS.
Recapitalisation Scheme (2008 and 2009)	The Government recapitalisation scheme provided capital support to eligible institutions from public resources. The Government invested £45.5 billion in RBS Ordinary and B Shares and £20.3 billion in Lloyds Banking Group (created following the merger of Lloyds TSB and HBOS) Shares. UK Financial Investments (UKFI) was set up to manage the Government's shareholding in financial institutions.
Asset Purchase Facility (APF) (January 2009)	Established by the Bank of England to purchase high-quality private sector assets, including commercial paper and corporate bonds.
Asset Protection Scheme (APS) (January 2009)	The Asset Protection Agency, an Executive Agency of Treasury, operates the Asset Protection Scheme (APS). In return for a fee, the APS protects exceptional credit losses on certain bank assets by bearing 90% of the losses after a first loss. RBS is the only institution participating in this scheme.
Banking Act 2009	The Banking Act 2009 provides powers for 'special resolution regimes' (SRR). This enables the Bank of England to transfer all or part of a failing bank's business to a commercial purchaser, or to a temporary vehicle, owned and controlled by the Bank of England. The Act also provides for the Treasury to take a failing bank (or, as a last resort, its holding company) into temporary public ownership.
UK Asset Resolution (UKAR) (January 2010)	After Northern Rock was taken into temporary public ownership, it was restructured into two entities: Northern Rock and Northern Rock Asset Management (NRAM). NRAM and Bradford & Bingley (B&B) were then integrated under a single holding company, UK Asset Resolution (UKAR) which is wholly owned by the Treasury.

C Organisations consulted by the Review

C.1 The Review team carried out consultations with a number of stakeholders across the Tripartite, the banking sector and other organisations and bodies. To encourage free and frank exchange of views, the names of individuals consulted have not been listed. The views expressed are those of individuals alone. Some organisations have not been listed at the request of interviewees.

- Asset Protection Agency (APA)
- Association of British Insurers (ABI)
- Bank of England
- Barclays Bank PLC
- British Bankers Association (BBA)
- Cabinet Office (CO)
- Confederation of British Industry (CBI)
- City of London Corporation, Economic Development Office
- Committee on Standards in Public Life, The
- Credit Suisse Group
- Department for Environment, Food and Rural Affairs (Defra)
- Department of Finance, Canada
- Department of Finance and Deregulation (Australia)
- Federal Ministry of Finance (Germany)
- Financial Services Authority (FSA)
- Financial Times (FT)
- Foreign and Commonwealth Office (FCO)
- Goldman Sachs
- HM Revenue & Customs (HMRC)
- HM Treasury (HMT)
- Independent Evaluation Office of the International Monetary Fund (IEO IMF)
- KPMG
- Lloyds Banking Group (LBG)
- McKinsey & Company

- Merlan Financial
- Ministry for the Economy, Industry and Employment (France)
- National Audit Office (NAO)
- National Institute of Economic and Social Research (NIESR)
- New Zealand Treasury
- Office of Lord Mayor of the City of London
- PricewaterhouseCoopers LLP (PwC)
- Public Accounts Committee
- Royal Bank of Scotland Group (RBS)
- Slaughter and May
- Standard Chartered Bank
- Trades Union Congress (TUC)
- The United Kingdom Permanent Representation to the EU (UK Rep)
- UK Financial Investments Ltd (UKFI)

D Relevant reports and publications

'A new approach to financial regulation: building a stronger system', HM Treasury (2011)

'A new approach to financial regulation: judgement, focus and stability', HM Treasury (2010)

'A new approach to financial regulation: securing stability, protecting consumers', HM Treasury (2012)

'A new approach to financial regulation: the blueprint for reform', HM Treasury (2011)

'Annual Report 2011', Bank of England (2011)

'Back from the Brink: 1000 days at Number 11', Alistair Darling (2011)

'Banking Crisis: dealing with the failure of the UK banks', Treasury Select Committee (2009)

'Banking Crisis: regulation and supervision', Treasury Select Committee (2009)

'Central government's use of consultants and interns', National Audit Office (2010)

'Civil Service People Survey 2011', Cabinet Office (2011)

'Economic and fiscal outlook', Office for Budget Responsibility (2011)

'The Financial Services Bill', HM Government (2012)

'Fundamental Review of HM Treasury's Running Costs', HM Treasury (1994)

'The Government response to the Independent Commission on Banking', HM Government (2011)

'HM Treasury: the nationalisation of Northern Rock', National Audit Office (2009)

'HM Treasury - Stewardship of the wholly-owned banks: buy-back of subordinated debt', National Audit Office (2011)

'Identifying and meeting central government's requirements', National Audit Office (2011)

'IMF Response in the Run-Up to the Financial and Economic Crisis: IMF Surveillance in 2004-07', Independent Evaluation Office of the International Monetary Fund, (2011)

'Independent Commission on Banking final report', Independent Commission on Banking, (2011)

'Labour Market Statistics', Office for National Statistics (2012)

'Maintaining financial stability across the United Kingdom's banking system', National Audit Office (2009)

'Maintaining the financial stability of UK banks - update on the support schemes', Public Accounts Committee (2011)

'Progress and next steps', HM Treasury Capability Review (2009)

'The run on the Rock', Treasury Select Committee (2008)

'The Secret Treasury: how Britain's economy is really run', David Lipsey (2000)

'Spending Review 2010', HM Treasury (2010)

'Staff Survey Report', HM Treasury (2011)

'The Treasury's 2010-11 Accounts: the financial stability interventions', National Audit Office (2011)

'The Turner Review: a regulatory response to the global banking crisis', Financial Services Authority (2009)

'A Very Peculiar British Crisis?: institutions, ideas and policy responses to the credit crunch', Thain, C. (2009)

'World Economic Outlook Update', International Monetary Fund (2012)

E List of acronyms

APA	Asset Protection Agency
APF	Asset Purchase Facility
APS	Asset Protection Scheme
BCCI	Bank of Credit and Commerce International
BIS	Department for Business, Innovation and Skills
CGS	Credit Guarantee Scheme
CIPD	Chartered Institute for Personnel and Development
CRD	Capital Requirements Directive
CRR	Capital Requirements Regulation
Defra	Department for Environment, Food and Rural Affairs
DCLG	Department for Communities and Local Government
DCMS	Department for Culture, Media and Sport
DECC	Department for Energy and Climate Change
DfE	Department for Education
DfID	Department for International Development
DfT	Department for Transport
DH	Department of Health
DMO	Debt Management Office
DTI	Department for Trade and Industry
DWP	Department for Work and Pensions
ECOFIN	Economic and Financial Affairs Council
ELA	Emergency Liquidity Assistance
EU	European Union
FCA	Financial Conduct Authority
FCO	Foreign and Commonwealth Office
FER	Fundamental Expenditure Review
FPC	Financial Policy Committee
FRI	Finance, Regulation and Industry Directorate
FSA	Financial Services Authority
FSB	Financial Stability Board
HBOS	Halifax Bank of Scotland
HO	Home Office
HMRC	Her Majesty's Revenue and Customs
IEO	Independent Evaluation Office
IMF	International Monetary Fund
HBOS	Halifax Bank of Scotland
HMT	Her Majesty's Treasury
ICB	Independent Commission on Banking
LBG	Lloyds Banking Group
MoD	Ministry of Defence
MoU	Memorandum of Understanding

NAO	National Audit Office
OBR	Office for Budget Responsibility
ONS	Office for National Statistics
PAC	Public Accounts Committee
PRA	Prudential Regulatory Authority
RBS	Royal Bank of Scotland Group
SCS	Senior Civil Service
SLS	Special Liquidity Scheme
SRS	Special Resolution Regime
TSC	Treasury Select Committee
UKAR	United Kingdom Asset Resolution
UKFI	United Kingdom Financial Investments

HM Treasury contacts

This document can be found in full on our website: http://www.hm-treasury.gov.uk

If you require this information in another language, format or have general enquiries about HM Treasury and its work, contact:

Correspondence Team
HM Treasury
1 Horse Guards Road
London
SW1A 2HQ

Tel: 020 7270 5000
Fax: 020 7270 4861

E-mail: public.enquiries@hm-treasury.gov.uk

ISBN 978-1-84532-953-2