REPORT BY THE
COMPTROLLER AND
AUDITOR GENERAL

HC 567
SESSION 2010–2011

21 DECEMBER 2010

HM Treasury

The Asset Protection Scheme

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National Audit Office

HM Treasury

The Asset Protection Scheme

Ordered by the House of Commons
to be printed on 20 December 2010

Report by the Comptroller and Auditor General
HC 567 Session 2010–2011
21 December 2010

London: The Stationery Office
£14.75

This report has been prepared under Section 6 of the National Audit Act 1983 for presentation to the House of Commons in accordance with Section 9 of the Act.

Amyas Morse
Comptroller and
Auditor General

National Audit Office

17 December 2010

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Printed in the UK for the Stationery Office Limited
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2404702 12/10 7333

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This report can be found on the National Audit Office website at www.nao.org.uk/Asset-Protection-2010

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Summary

1 Since 2007, economies around the world have suffered financial shocks leading to a number of bank failures. In October 2008, the Treasury announced a package of measures to support the UK banking system. A key element involved purchases of shareholdings in the Royal Bank of Scotland (RBS) and Lloyds Banking Group (Lloyds) totalling £37 billion.

2 By providing banks with additional capital to withstand the economic conditions at that time, the October 2008 measures avoided a collapse of the UK banking system. However, the economic downturn continued to intensify, undermining market confidence in the value of banks' assets. As banks remained unsure about the value of assets on their balance sheets, the Treasury was concerned that they would respond to this uncertainty by retaining capital. Banks' reduced willingness to lend was seen as a risk to economic recovery, which could in turn lead to further declines in the value of banks' assets.

3 In January 2009, a further set of measures was announced, including an Asset Protection Scheme (the Scheme) which would protect banks against exceptional losses on loans, mortgages and other financial assets. In November 2009, the Treasury agreed that:

- RBS would place £282 billion of assets in the Scheme. To ensure that RBS could absorb further losses, the Treasury injected additional capital of £25.5 billion, with a promise of up to a further £8 billion if needed.
- Lloyds would not participate further in the Scheme, but would instead raise additional capital from shareholders, including the taxpayer, and pay a fee of £2.5 billion to exit the Scheme.

4 We have previously reported on the nationalisation of Northern Rock, and in December 2009 and 2010 published overviews of the subsequent measures taken to maintain financial stability. This report on the Scheme considers whether the Treasury:

- based its decision making on a robust assessment of the options;
- maintained financial stability by ensuring that the banks would have enough capital in a severe economic downturn;
- protected the taxpayer interest as far as possible; and
- encouraged lending to the wider economy.

Key findings

Options analysis

5 A range of options, including public ownership and purchases of banks' assets, were considered. The Treasury judged that taking a major bank into public ownership carried significant risks, including a further fall in confidence in other banks, and therefore considered this a last resort. Implementing an asset purchase, rather than a protection scheme, for major banks would have taken longer to set up and would have involved the transfer of legal ownership of assets, many of which were located outside the UK. An asset protection arrangement had the advantage of not requiring, in itself, an immediate cash call on the Exchequer.

6 The maintenance of financial stability was key in the final decision to go ahead with the Scheme. Before finalising the Scheme, the Treasury considered whether an alternative of a larger capital injection might be better value for money. In the event of a severe economic downturn, such a change might have reduced the cost to the taxpayer, but would not have provided as much certainty to the markets that RBS would remain solvent. As a consequence, the risk to financial stability was judged to be too great and the Scheme was implemented.

Maintaining financial stability

7 The Treasury's actions reduced the risks faced by the banks as the economy suffered a steeper downturn than expected in late 2008 and early 2009. Following the announcement of the Scheme in January 2009, market sentiment towards the supported banks stabilised. To date, the Scheme has contributed to the Treasury's aim of maintaining financial stability.

8 As a result of the support, through capital injections and the Scheme, ordinary shareholders saw the value of their holdings reduced considerably but some private holders of bank capital were to a degree protected. International agreements on bank capital allow some types of borrowing by banks to be counted as capital if, among other conditions, the debt is subordinated to the claims of other creditors in the event of insolvency. Because the Government's intervention avoided insolvency, holders of subordinated debt were not put at immediate risk, although the market value of their holdings declined. In addition, the banks did not suspend interest payments or early repayments of the debt, which they had a right to do in a financial crisis, for fear of putting future funding from such sources at risk. With support from the Treasury, both banks exchanged or bought back subordinated debt during 2009-10, increasing capital by over £5 billion. Further buy-backs and exchanges of subordinated debt by both banks could increase core capital further.

Protecting the taxpayers' interest

9 Under the final agreement with RBS, the Treasury agreed that:

- RBS bears the first £60 billion of losses (termed the "first loss");
- the Treasury meets 90 per cent of losses incurred thereafter (termed the "second loss"); and
- RBS will pay annual fees subject to an overall minimum fee on exit of £2.5 billion or, if higher, 10 per cent of the capital relief provided by the Scheme.

First loss

10 The Treasury set the first loss equal to its estimate of the losses likely to be incurred by RBS under the most likely economic scenario. The Scheme therefore only provides protection against further losses if the economy performs below expectations. By September 2010, losses stood at £37 billion. Setting the first loss at or above the expected loss was crucial in providing the right incentive to the bank to manage assets effectively – up to the first loss, all losses are borne by the bank. The Treasury conducted extensive due diligence on the assets proposed by RBS for the Scheme – a highly complex task encompassing assets held across the world – and designed a series of stress scenarios which were used to calculate a range of possible losses. An early estimate of losses by the Asset Protection Agency, established by the Treasury to oversee the Scheme, suggests that the first loss was set at a reasonable level.

11 Both banks encountered major difficulties in providing the Treasury with data on their assets within the timescales set, particularly in terms of the volume of data and the format required. Where the data was judged to be insufficient, the Treasury adopted a conservative view of potential losses or refused to allow the assets into the Scheme. As the legality of some covered assets at the time could not be confirmed beyond reasonable doubt, the Treasury's Accounting Officer sought and was given a direction by the Chancellor of the Exchequer to proceed with the Scheme.

Second loss

12 If the first loss is exceeded, RBS will have less financial incentive to stem further losses although the bank considers it will still have a legal and moral obligation to manage the assets as best it can. The Treasury decided against RBS bearing a higher percentage of second losses as this would have required a higher injection of capital upfront to strengthen the bank's position. Any payments by the taxpayer for second losses will, however, be delayed by two years from the point at which the loss is realised, providing time for any recoveries on assets to be offset. More significantly, second loss payments must be repaid by RBS if it wishes to exit the Scheme before December 2099.

13 The taxpayers' position would be particularly vulnerable if losses were to exceed about £73 billion. Our estimates suggest that, up to this tipping point, RBS will have a financial incentive to exit the Scheme long before December 2099, taking account of the annual fees that it would have to pay to stay in. If losses were, however, to exceed about £73 billion, RBS would have an incentive to stay in the Scheme until the end, rather than incur a large and immediate repayment to the Exchequer. After this point the remaining incentives on RBS to stem any further losses are unlikely to be effective. Losses of this magnitude would only occur in seriously stressed economic circumstances, the probability of which has reduced since the Scheme was announced in January 2009.

Fees

14 The £2.5 billion exit fee agreed with Lloyds was set at a level that would meet regulatory capital requirements and avoid jeopardising the rights issue. The exit fee was equivalent to an annual return of 16.4 per cent on the capital benefit obtained by Lloyds. This rate of return was approximately 2 per cent higher than the bank's cost of capital in late 2009, but was below returns that might have been demanded by investors during the early part of 2009, when economic conditions were difficult. On the basis of a cost of equity of 20-30 per cent a year, the fee could have been fixed within a range of £3-4.5 billion for the period that the bank benefited from the Scheme. The Treasury, however, accepted that Lloyds would not have been able to secure shareholder approval to pay a higher fee, pass the Financial Services Authority's stress test, and successfully proceed with its proposed capital raising exercise. The Treasury judged that overall value for money would be better secured by exit rather than keeping Lloyds within the Scheme. Our analysis suggests that the fee paid was at the upper end of the range paid by Bank of America when it exited the US Asset Guarantee Program.

15 In light of the deal reached with Lloyds and likely market perceptions, the Treasury decided a minimum exit fee for RBS of £2.5 billion was appropriate. In setting the fee at this level, the Treasury aimed to charge the maximum fee possible, consistent with leaving RBS well-capitalised and securing the primary objective of financial stability, and to ensure that the pricing structure maintained an incentive on RBS to exit as quickly as possible.

16 The Treasury's analysis underpinning the minimum RBS exit fee did not include the breadth and depth of analysis we would expect, given the amounts at stake. But even with a more complete analysis, the Treasury would still have had to consider the risks to financial stability. Our examination suggested that, in its analysis of the fee, the Treasury did not consider all the risks being covered by the taxpayer and hence the fee that might have been appropriate if wider considerations had not been paramount. For instance, our analysis of cash flows suggested that a minimum fee in the range £1.4-4.4 billion could have been justified without breaching minimum capital requirements, with the weight of analysis pointing towards the upper end of the range. But if the Treasury had conducted this analysis to inform its judgement, it would have had to judge the impact of a different fee on broader financial stability, market perceptions and the overall pricing structure. In addition, the Treasury would have had to obtain approval from the Financial Services Authority on the adequacy of RBS's capital position.

Scheme rules

17 RBS is required to manage the assets in line with detailed requirements set out in the agreement, including the need to obtain approval from the Asset Protection Agency on key decisions involving major assets. Ultimately, the Agency has power to replace the asset managers or take over the management of the relevant assets. In practice, the extent to which assets are managed in the interests of the taxpayer if the first loss of £60 billion is breached will depend heavily on the incentives built into the pricing structure, the ability of the Agency to obtain the information it needs to assess whether taxpayers' interests are safeguarded, and the willingness of the Agency and RBS to work together effectively.

Lending commitments

18 Both banks achieved targets for mortgage lending in the first year of operation, but there was a shortfall of £30 billion against targets for lending to businesses (£8 billion for Lloyds and £22 billion for RBS). As part of the Scheme, Lloyds and RBS agreed to meet lending targets for 2009 and 2010. While the fall in business lending could have been due to a combination of a lack of demand and a shortage of supply, recent research by the Bank of England suggests that there is evidence of a tightening in credit supply conditions from mid-2007, as well as weaker credit demand. Changes have been made to the targets for the second year of operation to reflect changes in borrower behaviour, particularly the greater use of alternative sources of finance by larger businesses. The Treasury considered introducing a range of potential sanctions if targets were not met but decided that all would face insurmountable difficulties. The Treasury has few levers through the Scheme to encourage either bank to deploy extra resources to meet the targets.

Conclusion on value for money

19 Along with capital injections into the banks, the announcement of the Scheme had a beneficial impact on the financial markets, helping to achieve the Treasury's aim of maintaining financial stability. By avoiding the huge economic and social consequences of the failure of a major UK bank, the Scheme was a key component in delivering value for money.

20 The Treasury did well to maintain flexibility in developing and negotiating the Scheme as more information on the assets became available and 2009 unfolded. With the exception of weaknesses in the Treasury's analysis of potential fees for RBS, the principal elements of the Scheme, particularly the first loss, were based on a robust assessment of the incentives that impact on value for money, and on as complete information as was available at the time on the underlying assets. Value for money in the longer term will depend heavily on the incentives built into the pricing structure to encourage good asset management.

21 Overall, the global economy remains highly uncertain, and much will therefore depend on the Asset Protection Agency's ability to hold RBS to its commitments to manage the assets well. As it stands now, the Scheme has contributed to financial stability, the Treasury's overriding aim. But the Scheme has, so far, only been partially successful in encouraging lending to creditworthy borrowers on the scale originally envisaged.

Recommendations

a **The Treasury put considerable effort into assessing the overall pricing structure for RBS's participation in the Scheme, in particular the level of first loss, but there were gaps in its analyses supporting its assessment of fees.** The Treasury should explore the use of approaches to challenge the breadth and depth of key analyses and enable it to step back and re-examine some of the assumptions implicit in its thinking. This challenge should include consideration of the potential upside for the taxpayer as well as the risks.

b **To avoid potential funding difficulties, the banks did not exercise features of subordinated debt designed to preserve capital in adverse economic conditions, leaving ordinary shareholders and the taxpayer to bear the risk.** With support from the Treasury, the banks have bought back some of their subordinated debt at discounts, leading to increases in their capital ratios. However, a substantial level of subordinated debt remains outstanding. The Treasury should work with the Bank of England, the Financial Services Authority and international authorities to develop new debt instruments that will support banks' capital resources in a crisis.

c **Over the past three years, the Treasury has accumulated much knowledge and practical experience of dealing with banks in difficulty.** Before that experience is lost, the Treasury should capture the lessons learned in putting the Scheme together. Where relevant it should also share the lessons with the Bank of England.

Part One

Background

1.1 Banks are vital to the UK's economy, providing a crucial part of the payment mechanism for households and businesses. But banks are vulnerable if the value of their assets decline. As with other businesses trading with limited liability, banks are required to remain solvent in the sense that the value of assets should exceed the value of liabilities. The difference is capital. Under international agreements banks must maintain minimum levels of capital, particularly what is often referred to as "core capital", which includes ordinary shares and retained profits.

1.2 In 2007, the world's financial markets entered a period of turbulence triggered by fears of exposure to American sub-prime mortgages. Financial institutions and investors reduced their purchases of mortgage-backed assets, effectively closing an important source of funding for banks. Consequently, the value of such assets started falling. Banks began to retain cash to meet their own requirements and became reluctant to lend to one another as there were concerns about which banks were carrying large undisclosed losses. The resulting shortage of liquidity across the global banking system undermined the financial health of banks that relied on the wholesale markets. The scale of the economic and social costs if one or more major UK banks had collapsed is difficult to envision.

The aim and objectives of public support

1.3 The Financial Services and Markets Act 2000 created a single, independent, regulator for UK financial services, the Financial Services Authority. A framework for financial stability had also been established under which a Tripartite Standing Committee of the Treasury, the Financial Services Authority, and the Bank of England (the Authorities), became responsible for stability of the financial system. In exceptional circumstances, ultimate responsibility for the authorisation of a support operation rested with the Chancellor of the Exchequer.

1.4 The financial crisis prompted governments across the world to intervene to support their financial systems. In the UK, the Treasury's main objectives were to:

- stabilise and restore confidence in the financial system;
- protect retail depositors;
- protect taxpayers' interests; and
- ensure continued lending to creditworthy borrowers.

The measures taken before January 2009

1.5 The Authorities:

- increased liquidity in the banking system;
- facilitated resolutions of individual financial institutions in difficulty; and
- in October 2008, introduced wider measures to improve solvency and liquidity across the banking sector, including the purchases of shares in RBS and Lloyds.

1.6 The October 2008 interventions were sufficient to arrest falling market confidence in the UK's largest banks, as reflected in a fall in the price of insuring against default (**Figure 1** overleaf). The NAO reported on these interventions in December 2009.[1]

Announcement of the Asset Protection Scheme

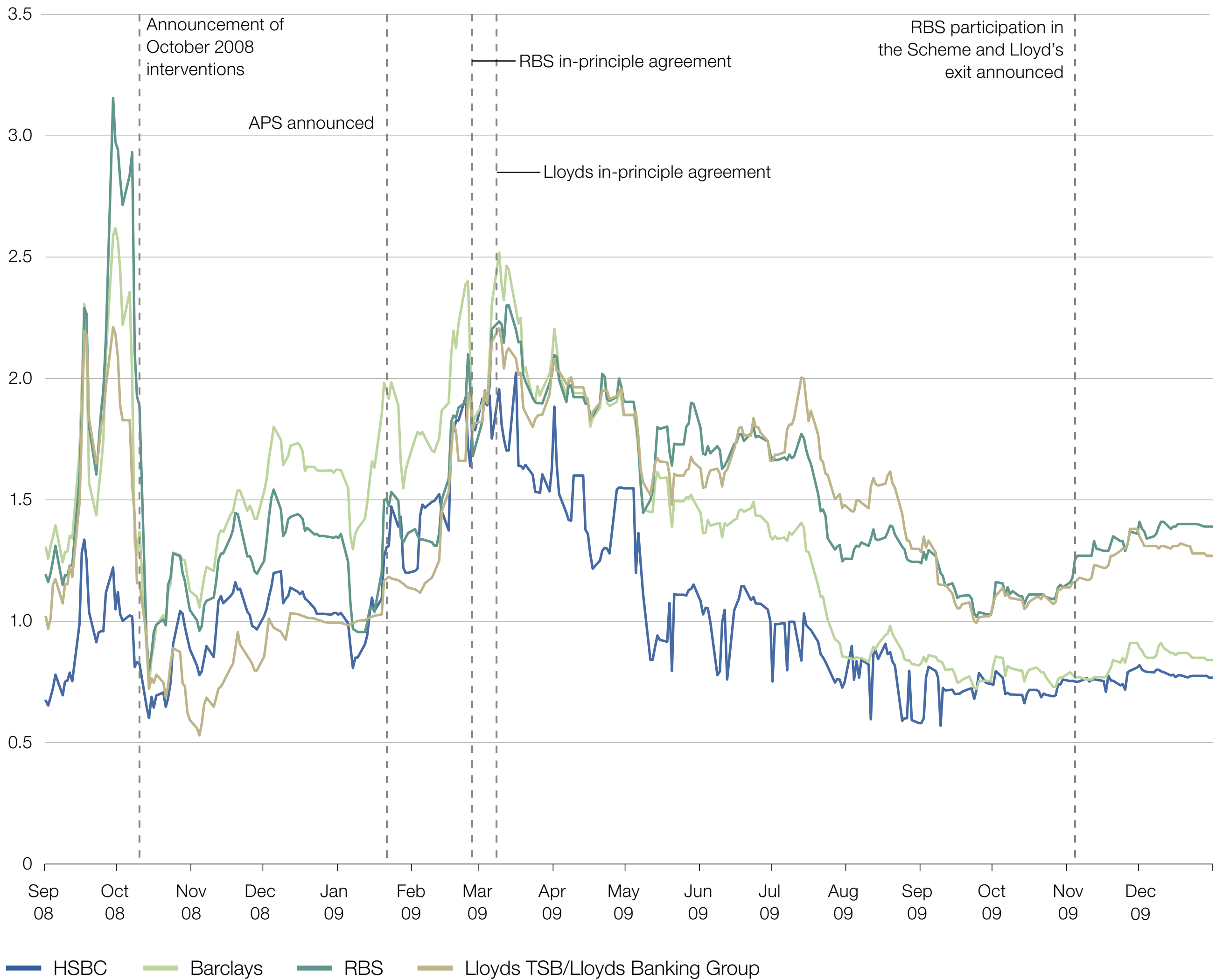
1.7 Although a degree of stability had been achieved following the October 2008 interventions, market confidence remained weak and the price of default insurance increased gradually (Figure 1). By the end of 2008, economic data suggested that the downturn in the economy was likely to be deeper than the Treasury had forecast in November 2008 (**Figure 2** on page 13). By early January 2009, the Treasury had become increasingly concerned about growing risks to financial stability. It was aware that the US Government was preparing support for Bank of America and that there would be further negative news about UK banks. During this time, the Treasury considered a range of options for further interventions, including public ownership of banks in difficulty and the purchase of legacy assets (Appendix Three).

1 Report by the Comptroller and Auditor General, "*Maintaining financial stability across the UK's banking system*", HC91, Session 2009-2010.

Figure 1

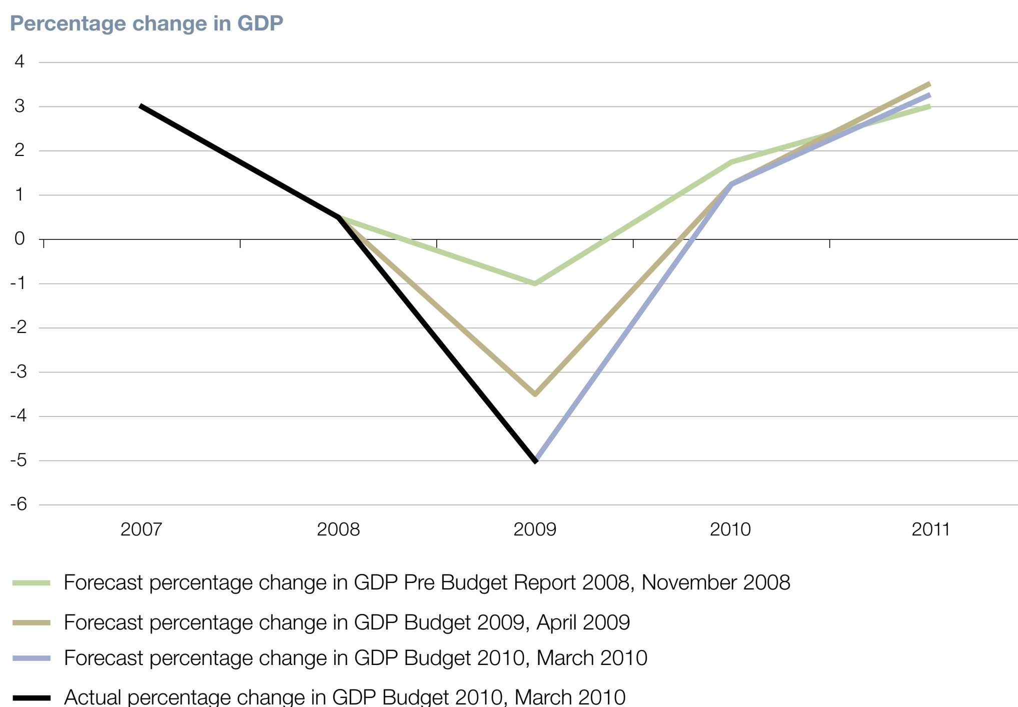
The price of insuring against default by the UK's major banks fell immediately after the October 2008 intervention, but market confidence remained weak

Annual fee for insuring debt in the UK's largest banks (percentage of the amount insured)



Source: Markit Group Ltd

Figure 2
Between November 2008 and April 2009, the forecast reduction in GDP for 2009 deepened markedly



Source: HM Treasury

1.8 On 19 January 2009, RBS announced that it was likely to incur a loss of £7-8 billion for the year ended 31 December 2008. On the same day, the Chancellor announced that an Asset Protection Scheme would be developed as part of a wider package of measures to address capital shortfalls and maintain lending to the economy.

1.9 The Scheme was open to all banks meeting qualifying criteria and would protect assets in participating banks against the risk of default. Tests conducted by the Financial Services Authority to check whether UK banks had adequate capital to withstand a severe economic shock indicated that both RBS and Lloyds might breach their minimum capital to asset ratios during 2010.

1.10 In February and March 2009, in the midst of deteriorating economic conditions, the Treasury announced that it had reached in-principle agreements with:

- RBS to protect some £325 billion of assets, with the bank bearing a first loss of £42 billion and paying a fee through the issue of £6.5 billion in non-voting shares. In addition, the Government agreed to inject up to a further £19 billion of capital, also in the form of non-voting shares.
- Lloyds to insure £260 billion of assets in return for a fee of £15.6 billion that would be paid through issuing non-voting shares.

1.11 These announcements were followed by detailed due diligence on the assets to be placed in the Scheme, and negotiations between the participating banks and the Treasury on contract terms and state aid clearance. A timeline of key events is at Appendix One.

Scope of this report

1.12 This report provides Parliament with an evaluation of the protections put in place for the taxpayer under the Scheme (Part Two) and lending commitments entered into by the banks (Part Three). Our methodology is summarised at Appendix Two. However, this report does not consider:

- the causes of the credit crisis or the regulatory regime operated by the Financial Services Authority, which at the time was outside our statutory audit responsibilities, and have been examined by others;
- the Bank of England's role in respect of monetary policy and the stability of the financial system, which are outside our statutory audit responsibilities; and
- support from the Department for Business, Innovation and Skills to non-financial companies, which has been covered in a separate report.

1.13 A Glossary and Appendices Three to Seven of this Report have been published separately on the web and can be found at www.nao.org.uk/Asset-Protection-2010.

Part Two

Protecting taxpayers

2.1 This Part considers how risks to the taxpayer were reduced while achieving appropriate levels of capital adequacy for RBS and Lloyds:

- Lloyds' exit and the decision to proceed with the Scheme for RBS.
- The terms of RBS's participation in the Scheme.
- Conversions of subordinated debt into core capital.
- The Treasury's use of resources.

Lloyds' exit and the decision to proceed with the Scheme for RBS

2.2 In March 2009, the Treasury began negotiations with RBS and Lloyds to agree the detailed Scheme rules and commissioned more due diligence on the asset pools proposed by the two banks. As part of the early negotiations, Lloyds and RBS made commitments to extend lending to households and businesses and to restrict bonus payments.

2.3 In early summer 2009, in parallel with continuing negotiations over the Scheme, Lloyds began developing a proposal to raise additional capital through a rights issue. The Financial Services Authority assessed Lloyds' plan and considered that the bank could raise sufficient capital to pass a severe stress test without additional support through the Scheme. The Treasury concluded that the proposal was deliverable, and offered better value for money than the alternative of keeping Lloyds in the Scheme. While allowing the rights issue to go ahead in November 2009, the Treasury charged Lloyds an exit fee of £2.5 billion.

2.4 To ensure that RBS could absorb further losses, the Treasury agreed to inject additional capital of £25.5 billion. To continue trading on the London Stock Exchange, the UK Listing Authority's rules required some RBS shares to remain in the open market. As a result of the additional capital injection, the taxpayer's economic interest in the bank increased from 70 per cent to 84 per cent[2], a level of ownership below the upper limit of 90 per cent that would require de-listing. The Treasury also committed to provide up to a further £8 billion of contingent capital in a stress scenario.

2 In March/April 2010, RBS conducted capital management transactions to exchange and convert subordinated debt into core capital and issue new shares to fund deferred 2009 employee awards. These transactions increased the number of RBS shares in issuance and reduced the Government's share ownership from 84 per cent to 83 per cent.

2.5 Prior to reaching final agreement with RBS, the Treasury re-examined the available options. By late 2009, the performance of the economy was mixed but the risk of more extreme downturns had begun to ease. Although the fall in GDP proved greater than expected in late 2008, the projected decline in UK house prices had been less severe. Money markets stabilised and improved confidence was reflected in a period of equity gains. With the extreme risks perceived to be lower and the Authorities having better knowledge of what was on the banks' balance sheets, the Treasury considered there was scope to rebalance the support in favour of further recapitalisation.

2.6 The decision to proceed with the Scheme in November 2009 had been finely balanced. The Treasury had considered replacing the Scheme by increasing the contingent capital commitment to RBS from £8 billion to £17 billion. Analysis of this proposed change indicated a small saving of around £200 million under the base case scenario and a potential saving of the order of £4 billion in the stress case.

2.7 The Treasury decided to proceed with the Scheme as:

- further consideration of alternatives risked prolonging negotiations with RBS into 2010 and might be misinterpreted by the markets as a signal that problems at RBS were worse than expected;
- the Scheme provided more certainty that RBS could survive a severe economic downturn without further contingent capital and risking de-facto nationalisation; and
- there would be some benefits in bringing the Scheme into operation and having it available to other banks, if needed.

The terms of RBS's participation in the Scheme

2.8 Under the November 2009 terms, the Treasury and RBS agreed that:

- RBS bears the first £60 billion of losses (termed the "first loss") on a £282 billion pool of covered assets;
- the Treasury meets 90 per cent of losses incurred thereafter (termed the "second loss"). If RBS exits the Scheme before December 2099, it must repay what it has received plus interest; and
- RBS pays £700 million a year for the first three years, reducing thereafter to £500 million a year, subject to an overall minimum fee of £2.5 billion or, if higher, 10 per cent of the capital relief provided by the Scheme.

2.9 While seeking financial stability, the Treasury also aimed to:

- set a first loss equal to the expected loss, so that the Scheme covered only extreme, so called "tail risk", events;
- ensure that second losses borne by RBS encourage it to maximise the value of covered assets;
- put in place rules that align the interests of RBS with those of the taxpayer; and
- establish a fee structure that compensated the taxpayer for risks taken.

First loss

2.10 The Scheme needed to incentivise RBS to manage covered assets in the interests of taxpayers. If RBS expects losses on its covered assets to be below the first loss, it is more likely to expend effort to minimise losses on those assets since, up to the first loss, each £1 of additional loss is borne 100 per cent by the bank.

2.11 The Treasury's ability to set the first loss at or above the expected loss was therefore crucial to achieving value for money. If RBS were to judge that, despite effort on its part, the first loss would be exceeded and the taxpayer would be stepping in, it might be tempted to devote less effort to limiting losses on the covered assets.

2.12 The terms agreed with RBS in November 2009 represented a significant tightening of the initial terms. The initial terms announced in February 2009 had envisaged RBS meeting the first £42 billion of losses on a pool of covered assets totalling £325 billion compared with the £60 billion first loss on the smaller pool of assets agreed in November. The final terms reflected the Treasury's better knowledge of the underlying assets; improved economic circumstances; a sharper awareness of the importance of the first loss figure in driving value for money; and its concern that the initial terms were too generous and might not receive approval from the European Commission under the state aid framework.

2.13 The agreed first loss of £60 billion was the Treasury's best estimate of the expected losses from the portfolio of assets. Obtaining a robust estimate of the expected loss depended upon a good understanding of the covered assets (due diligence) and the choice of economic scenarios in which to assess the potential losses (financial modelling).

2.14 In March 2009, the Treasury asked KPMG and Ernst & Young to review data on assets that RBS and Lloyds had put forward for inclusion in the Scheme. The due diligence was intended to provide assurance on the existence and terms of the assets (for instance, who the debtor was and the banks' rights in the event of a default). The due diligence exercises involved assessing the quality of several million pieces of data on assets ranging from residential mortgages to complex financial instruments such as credit default swaps, with 60 per cent of the RBS portfolio originated outside the UK.

2.15 Both banks struggled, in the set timetables, to provide all the data required by the Treasury in the formats prescribed, which did not always match those used by the banks. Matters were complicated at Lloyds because of its then recent acquisition of HBOS. Lloyds was still in the process of reviewing HBOS's systems. RBS attributed delays in extracting data to its strategy of growth through buying other banks that had left it with over 20 different IT systems in operation across the group. Where the data was judged to be insufficient, the Treasury adopted a conservative view of potential losses or refused to allow the assets into the Scheme. Nevertheless, by November 2009, the Treasury could not gain sufficient assurance that the Scheme would not be providing cover for assets where there had been fraud or other criminal conduct by third parties. The Treasury's Accounting Officer therefore sought, and obtained a direction to proceed with the Scheme.

2.16 Our advisers, Mazars, conducted a high level review of the Treasury's due diligence processes, noting that the fast moving and complex environment in which the due diligence was conducted made the initial scoping and objective setting difficult. Mazars concluded that despite recurring difficulties with the quality of the data provided by the banks, the work undertaken appears to have given the Treasury a reasonable understanding of the risks that were to be transferred under the Scheme.

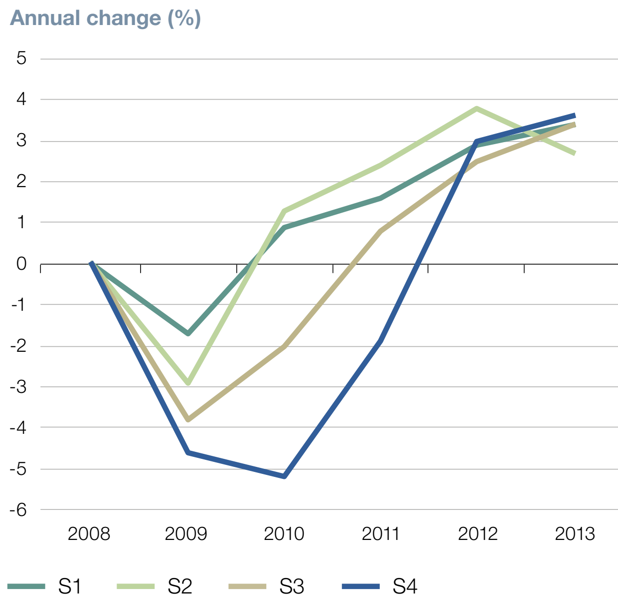
2.17 The Treasury engaged Credit Suisse, Citigroup and BlackRock to estimate losses associated with four "what if" economic scenarios over a five-year period (**Figure 3**). All the scenarios were based, in part, on past recessions and were produced with inputs from the Bank of England, the Treasury and the Financial Services Authority. Credit Suisse and Citigroup conducted their loss estimation work by applying, where possible, statistical models of expected default rates and losses on market-rated assets or, when such models were unavailable, through qualitative analysis on samples of assets within relevant groupings. BlackRock provided a cross-check through separate analyses using its own models of asset performance in each scenario.

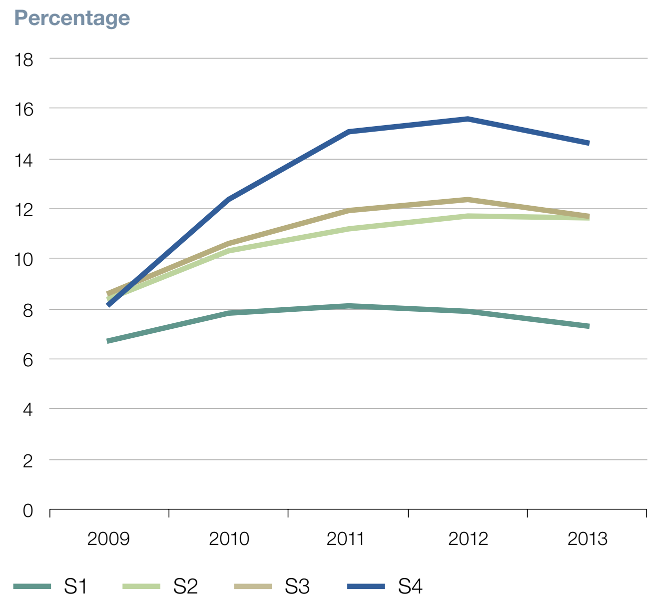
2.18 The Treasury determined the aggregate loss estimates and considered that the performance of the UK's economy was likely to be between scenarios 1 and 2. This mid-scenario became the Treasury's base case, under which the expected losses on RBS assets covered by the Scheme would amount to £60 billion, falling within a range of £50-76 billion.

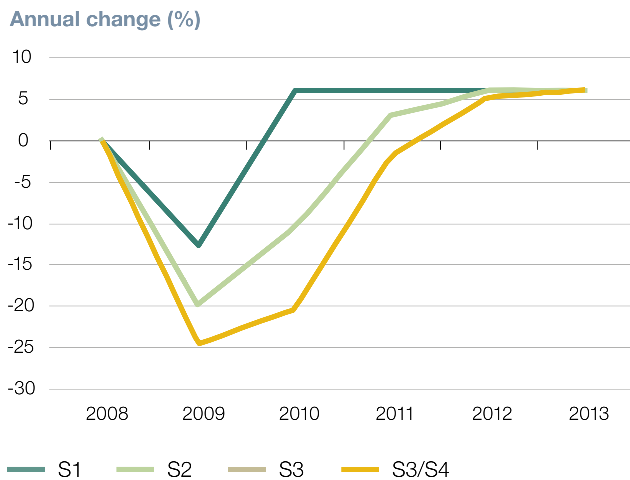
2.19 Scenario 3 projections for GDP, house prices and commercial property prices were conservative. For instance, by October 2009, the Treasury assigned a probability of only 5 per cent or less to GDP being lower than that projected in Scenario 3. In the round, the Treasury concluded that this Scenario was an unlikely outcome and therefore an appropriate stress case. In the stress case, the estimated range for losses was between £87-98 billion. For assets outside the UK, the Treasury and its advisers also took account of economic forecasts used by RBS and Lloyds and stress test parameters used by the Authorities in other countries.

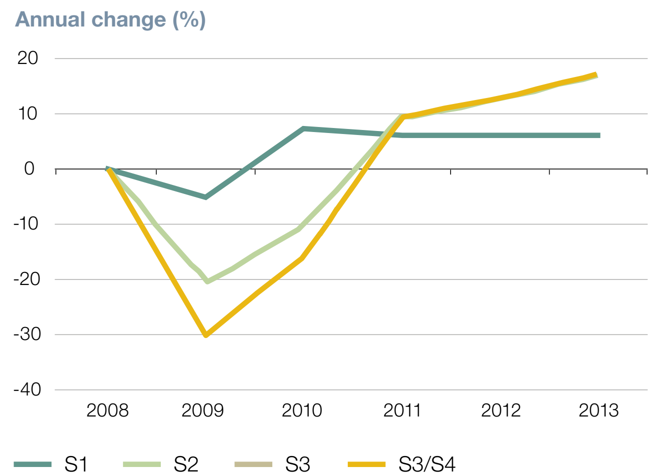
Figure 3

"What if" scenarios for movements in Gross Domestic Product, unemployment, house prices and commercial property prices









NOTES

S1 = Scenario 1 (a 1990s recession)

S2 = Scenario 2 (a 1980s "V" recession)

S3 = Scenario 3 (a 1980s "U" recession)

S4 = Scenario 4 (Finnish 1990s "V" recession)

Source: HM Treasury

2.20 The Asset Protection Agency, established by the Treasury to administer the Scheme, has developed a model to calculate expected losses, recoveries and potential payouts by the taxpayer over the life of the Scheme. Based on data at 31 December 2009, the Agency estimated that there may be a temporary breach of the first loss by the end of 2011, but subsequent recoveries are expected to keep the life-time expected net loss at £57 billion, just below the agreed £60 billion first loss. At 30 September 2010, RBS's third quarter results indicated that the net assets in default and counting against the first loss totalled just over £37 billion, lagging behind the Asset Protection Agency's trajectory in **Figure 4**.

Second Loss

2.21 Should losses on covered assets approach the first loss, there is a risk that RBS would not be encouraged to manage the assets to minimise further losses. To guard against this risk, where losses exceed the first loss, RBS would be liable for ten per cent of any further losses, with the Treasury taking the remaining 90 per cent. In the United States, the Asset Guarantee Program, which pre-dated the announcement of the UK's Asset Protection Scheme by two months, also used a 10:90 split for losses beyond the first loss, shared respectively between Citigroup and US Government authorities. The Federal Deposit Insurance Corporation in the US, when arranging a sale of a failing bank, offers a loss-sharing arrangement to align the buyer's interest in maximising asset values with those of the US taxpayer. Depending on the circumstances and likely level of losses, a buyer's share of losses is set at no less than 20 per cent.

Figure 4
Forecast net losses under the Scheme

Source: Asset Protection Agency

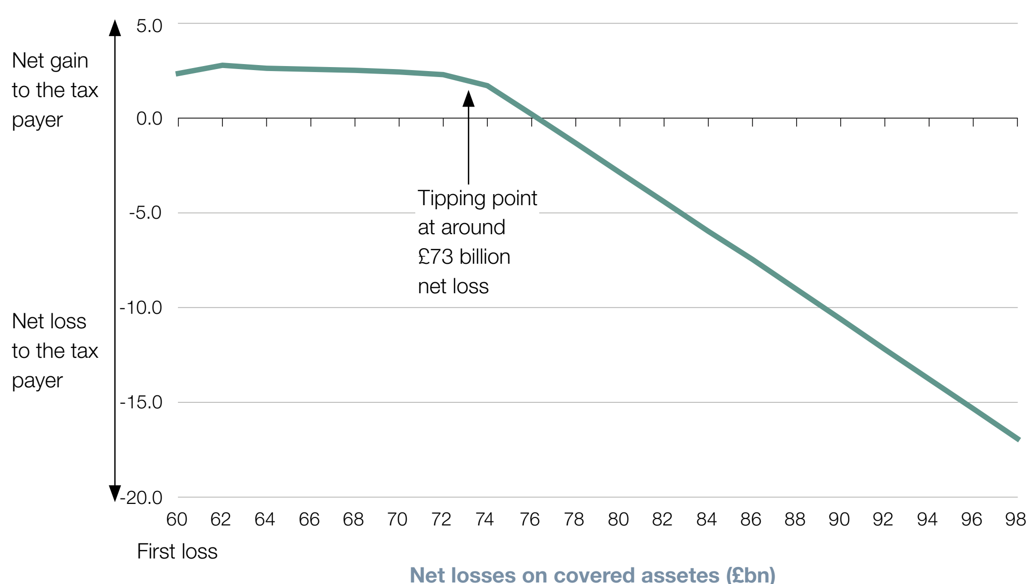
2.22 It was unlikely that RBS's residual exposure to losses would, by itself, keep the bank sufficiently incentivised to manage the assets appropriately. The Treasury considered using a 20:80 ratio but the benefit of the Scheme on RBS's capital position would have been reduced, requiring changes to other elements of the support package, such as a higher capital injection. The proportion of the second loss borne by RBS is, however, less important than the first loss in protecting the taxpayer as the Scheme makes provisions that any payments made by the Treasury:

- are delayed by two years, providing time for any recoveries on assets to be offset against payments; and
- must be repaid by RBS plus interest if it wishes to exit the Scheme before December 2099, the latest maturity date of the covered assets.

2.23 Our analysis of the potential cash flows suggests that there is a tipping point when, in financial terms, it would be in RBS's interest to remain in the Scheme until 2099. RBS would need to set the benefit it receives from the taxpayer's share of second losses against continuing to pay the annual fee and repaying payments for second losses, should the bank leave the Scheme early. Our analysis suggests that the balance, in purely financial terms, would begin to shift away from the taxpayer and in favour of RBS staying in the Scheme if overall losses were to reach about £73 billion (**Figure 5**). After this point, the financial incentive on RBS to restrict further losses would weaken significantly.

Figure 5

Value of the Scheme to the taxpayer in 2009 at various levels of net loss on covered assets



Source: National Audit Office analysis

Scheme rules

2.24 If the financial incentives for RBS to maximise the value of assets covered under the Scheme prove insufficient, there are a number of potential remedies available to the Treasury in the Scheme rules. RBS must manage the covered assets in line with detailed requirements designed to protect the taxpayer and ensure that its customers are fairly treated. RBS has, for example, to:

- minimise any losses and maximise any recoveries on covered assets;
- ensure that there is no discrimination against covered assets when compared with other assets;
- comply with an agreed internal framework for the management and governance of covered assets and ensure that any conflicts of interest are avoided or appropriately managed; and
- comply with various monitoring, reporting, governance and oversight conditions set out in the Scheme rules.

2.25 The Asset Protection Agency has extensive rights to take action where it considers that the taxpayer is not adequately protected. Further details of the range of protections for the taxpayer in the Scheme rules are at Appendix Four.

2.26 The Scheme rules are highly complex, reflecting the varied nature of the covered assets. In framing the rules, the Treasury sought to take account of the broad range of scenarios that might be encountered. In practice, the extent to which assets are managed in the interests of the taxpayer if the first loss of £60 billion is breached will depend heavily on the incentives built into the pricing structure, the ability of the Agency to obtain the information it needs to assess whether taxpayers' interests are safeguarded, and the willingness of the Agency and RBS to work effectively together.

Fees

2.27 The Treasury negotiated fees with RBS and Lloyds to reflect, as far as possible, the value of the support under the Scheme. We examined the analyses underpinning the amounts to be charged.

Exit Fee paid by Lloyds

2.28 While there was no binding Scheme contract between the Treasury and Lloyds, they both acknowledged that the taxpayer had provided support for much of 2009. With no established mechanism to determine the value of the support, negotiations led to an agreed exit fee of £2.5 billion. Based on calculations used by banks to estimate how much capital they should hold against assets, Lloyds received an implied capital benefit of £23.5 billion from the announcement that it would participate in the Scheme. The £2.5 billion exit fee received by the taxpayer was therefore equivalent to an annual return of 16.4 per cent on the capital benefit obtained by the bank.

2.29 This rate of return was approximately 2 per cent higher than the bank's cost of capital in late 2009, but was below the returns that might have been demanded by investors during the early part of 2009 when economic conditions were difficult. Barclays Bank conducted a capital raising exercise in 2008 with an annual return on equity of 30 per cent or more. For the period March to October 2009, the Treasury estimated that the average cost of equity for Lloyds would have been 23 per cent. However, the Treasury considers the support was not equivalent to equity as Lloyds had not, under the Scheme, received a cash injection.

2.30 On the basis of a cost of equity of 20-30 per cent a year, the fee could have been fixed within a range of £3-4.5 billion for the period that the bank benefited from the Scheme. The Treasury accepted that Lloyds would not have been able to secure shareholder approval to pay a higher fee, pass the Financial Services Authority's stress test, and proceed successfully with the proposed capital raising exercise. As allowing Lloyds to raise additional capital offered better value for money than the alternative of keeping it in the Scheme, the Treasury judged that the negotiated fee was as close to the limit of what could be charged, without jeopardising the bank's exit from the Scheme. In Lloyds' view, the exit fee fell within a range that reflected the benefit it had received from the Scheme, albeit at the high end of that range.

2.31 The fee paid by Lloyds was at the upper end of the range paid by Bank of America when it exited the US Asset Guarantee Program. Bank of America paid $35,000-44,000 a day, per billion dollars of gross assets in the Asset Guarantee Program, while Lloyds paid £40,000-45,500 a day, per billion pounds of assets.

Fees paid by RBS

2.32 In October 2009, RBS and the Treasury agreed a change from a single up-front fee paid in shares to an annual fee paid in cash, subject to a minimum amount. The annual fee was fixed at £700 million a year for three years starting in January 2009 and, thereafter, £500 million a year, reflecting expected reductions in protected assets as borrowers pay off their loans. If RBS chooses to exit the Scheme before 2099, it will have to pay a minimum total fee of £2.5 billion or 10 per cent of the capital relief provided, whichever is higher. If economic conditions allow RBS to exit the Scheme within the next few years, the minimum fee of £2.5 billion is the most important element in the pricing structure. In such circumstances, it is unlikely that a higher fee of 10 per cent of the capital benefit would apply, making this provision less significant.

2.33 In setting the minimum exit fee at £2.5 billion, equal to the exit fee charged to Lloyds, the Treasury attached significant weight to a range of wider factors: to ensure RBS was sufficiently well-capitalised, and perceived as such by the markets; satisfy European Union State Aid requirements; take account of the fiscal impact, bearing in mind the taxpayer owned 83 per cent of the company; and ensure the pricing structure maintained an incentive on RBS to exit the Scheme as quickly as possible.

2.34 The Treasury analysis underpinning the minimum exit fee did not include the breadth and depth of analysis we would normally expect. In our view, in addition to financial stability considerations, the analysis needed to take account of:

- the risk borne by the taxpayer between February 2009 and November 2009 when the Scheme was being negotiated and during which the probability of stressed economic conditions was relatively high;
- the risks to be borne across the life of the Scheme; as well as
- the need to ensure that RBS's capital ratio stayed above a minimum set by the Financial Services Authority.

2.35 The Treasury conducted a preliminary analysis of a potential proxy for the risks borne by the taxpayer, based on what the fee for RBS might have amounted to if it had exited in November 2009. Using the same methodology as applied to Lloyds, the Treasury considered a fee of £1-1.5 billion could have been levied to reflect the risk covered by the taxpayer. This analysis was subsequently superseded by consideration of the issues set out in paragraph 2.33. Our analysis indicates that the initial calculation could also have legitimately included the benefit to RBS of the Treasury's agreement to provide additional capital as part of the Scheme. If this proposed capital injection had been included, the calculated minimum fee would have been £3.5 billion. Alternatively, if the Treasury had calculated an exit fee for RBS on the basis of the Lloyds daily rate in paragraph 2.31 above, the fee for protection provided between February 2009 and November 2009, would have produced a figure of approximately £3.2 billion. These calculations do not take account, however, of the risks covered by the taxpayer beyond November 2009.

2.36 In the absence of reliable market benchmarks for pricing the Scheme, we analysed the likely cash flows in a base case and stressed economic scenario to try to capture the taxpayers' overall exposure to RBS (see Appendix 5). Our analysis suggested a minimum fee somewhere in the range £1.4-4.4 billion could be derived depending on the assumed probability of a stressed scenario, with the weight of analysis pointing to the upper end of this range.

2.37 Our analysis of the capital model used by the Treasury suggested that, without taking wider factors into account, there was latitude to set a higher fee. In the stress scenario, with the minimum fee set at £2.5 billion RBS's capital ratio ranged from 4.4 per cent to 7.1 per cent between 2009 and 2013, above the minimum of 4 per cent required by the regulator. An increase in the minimum fee to £4.5 billion would have caused capital ratios to fall slightly ranging between 4.2 per cent and 6.8 per cent. In practice, any assessment of capital adequacy would have required approval from the Financial Services Authority, which would have undertaken its own analysis.

Conversion of subordinated debt into core capital

2.38 International agreements on bank capital allow some types of borrowing by banks to be counted as capital if, among other conditions, the debt is subordinated to the claims of other creditors in the event of a bank becoming insolvent. Prior to 2008, UK banks[3] had approximately £115 billion of outstanding subordinated debt, representing about half of total bank capital.

2.39 While the holdings of RBS and Lloyds shareholders were heavily diluted following the recapitalisations in October 2008, holders of subordinated debt have to a degree been protected. Both banks, in common with other institutions, continued to pay interest, and investors had their capital repaid in full on call dates in keeping with established market practice, even though such repayments were at the banks' discretion. Banks had feared that exercising these discretionary rights would adversely affect their ability to borrow money at reasonable rates in the future. Subordinated debt therefore failed to provide a loss-absorbing buffer between shareholders and creditors.

2.40 In March 2009, with support from the Treasury, both banks exchanged or bought back subordinated debt totalling £13 billion, making a profit of £5.3 billion, which increased core capital. These transactions, known as liability management exercises, were made possible because the banks were able to offer holders a small premium to market prices, which had fallen below the face value of the debt due to uncertainty over the severity of actions that might be taken by governments to protect financial stability. Those holders of subordinated debt who participated in the March 2009 transactions received around 51 per cent of the par value of their investments. After the exercises, RBS and Lloyds each still had about £31 billion of outstanding subordinated debt.

2.41 In July 2009, the Treasury estimated that further buy-backs and exchanges of subordinated debt by both banks could increase core capital by £14-40 billion. Such exercises could only be conducted with investors who were willing to sell their investments. In the autumn of 2009, the European Commission instructed national authorities to prevent banks that had received state support from paying interest on or repaying certain subordinated debt. The immediate consequence of the measure was a further reduction in market value of subordinated debt issued by publicly supported banks. RBS has taken advantage of market conditions to conduct a further liability management exercise in early 2010, which raised a further £1.3 billion of core capital. Lloyds, alongside its £13.5 billion rights issue, undertook a major conversion of subordinated debt to contingent capital. The conversion generated approximately £7.5 billion of contingent core capital thereby reducing the likelihood that further taxpayer support would be needed. Lloyds carried out further liability management exercises during the course of 2010, resulting in a gain of over £400 million.

3 Barclays, HBOS, HSBC, Lloyds TSB, RBS and Standard Chartered.

Use of internal resources and external advisers

2.42 Our previous reports on Northern Rock and maintaining financial stability found that the Treasury had been stretched in terms of the availability of people with relevant skills and experience. For the Scheme, the Treasury enhanced its capacity and capability by:

- retaining key personnel with experience of the previous interventions;
- redeploying and bringing in additional staff as the work progressed;
- establishing a Steering Board to oversee the project; and
- using a Challenge Group drawn from across the Treasury to provide advice during the development of the Scheme.

2.43 The Treasury also retained specialist legal and financial advice services it had used for earlier interventions to work on the Scheme. Just over £54 million was spent on development of the Scheme and related activities. All of this cost, plus the Treasury's own staff costs, have been recovered from the banks. Further information on project management and the use of external advisers is at Appendix Six.

Part Three

Lending commitments

3.1 This Part considers the mechanisms put in place by the Treasury as part of the Scheme to secure lending to the wider economy.

3.2 In late 2008, the previous Government was increasingly concerned about the availability of credit to the wider economy. The Treasury feared that banks, facing difficulties raising funds in the inter-bank markets and the prospect of losses on existing assets would shore up capital and thereby reduce lending. The Treasury considered that a reduction in the supply of credit would:

- hamper economic activity, leading to defaults on loans, a spiral of business closures, higher losses for banks and further lending reductions; and
- fail to keep pace with increases in demand when the economy began to recover.

3.3 Lending figures published by the Bank of England show a sharp contraction in net lending since the second half of 2008 (**Figure 6** overleaf). The contraction reflected:

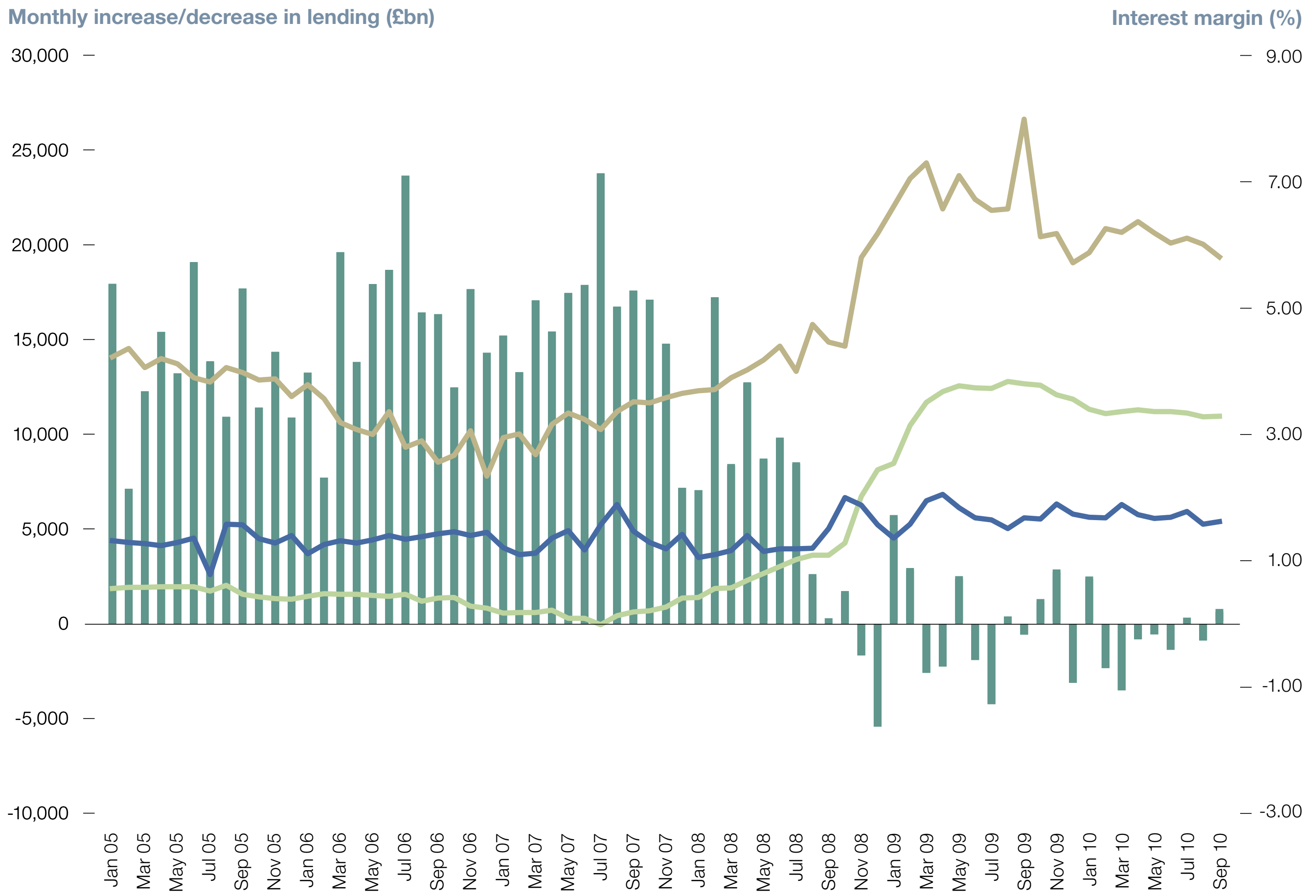
- a rapid drop in confidence and an increase in uncertainty, with businesses cutting back on investment and repaying loans; and
- weaker demand from businesses for new borrowing facilities, because of tighter credit terms and conditions (contraction in demand); as well as
- a reduction in the availability of loans from banks (reduction in supply).

3.4 By February 2009, the Treasury assumed that:

- the economy would contract – the then expected fall in Gross Domestic Product (GDP) during 2009 was 3.5 per cent; and
- most foreign banks would withdraw from the UK market, leaving a funding gap for businesses and households.

Figure 6

Monthly increases/decreases in lending to households and non-financial businesses by UK resident banks and building societies



- Monthly increases/decreases of lending by UK banks and building societies to individuals and private non-financial corporations
- Weighted average interest rate for loans to households that are not secured on dwellings after deducting the Bank of England's bank rate.
- Weighted average interest rate for loans to households that are secured on dwellings, e.g. mortgages, after deducting the Bank of England's bank rate.
- Weighted average interest rate for loans to private non-financial corporations after deducting the Bank of England's bank rate.

Source: Bank of England

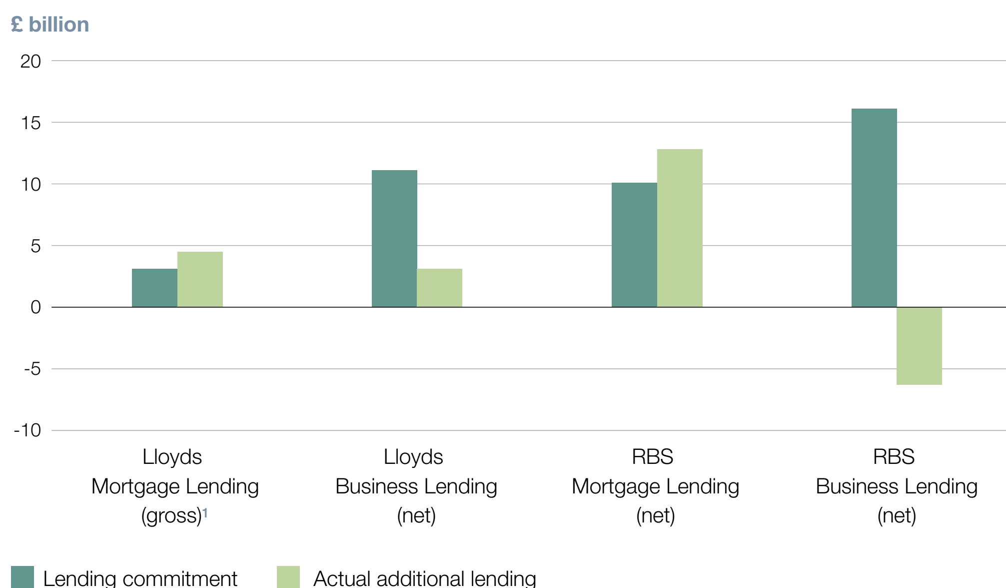
3.5 The Treasury sought to shore up lending to the wider economy in return for taxpayer support to the banks. It therefore required the banks to sign up to lending commitments as a condition of participating in the Scheme because, in part, the Treasury believed that the Scheme would reduce the banks' need to conserve capital in the face of economic uncertainty. The Treasury, RBS and Lloyds negotiated lending commitments for a two-year period from 1 March 2009, based on the banks' lending plans at the end of 2008.

Lending commitments for the first year

3.6 In the first year, Lloyds committed to lend an additional £14 billion and RBS agreed an additional £25 billion of lending. The additional lending would be on commercial terms, and subject to market demand. In addition to these direct commitments, the Treasury also had the implicit aim of demonstrating to potential borrowers that the banks were open for business, thereby bolstering confidence.

3.7 Both banks exceeded their mortgage lending targets for 2009-10. However, they did not achieve targets for lending to businesses. Lloyds provided £3 billion of additional lending, net of repayments, against a target of £11 billion. RBS received repayments that were £6.2bn greater than gross lending, thereby missing its target by £22 billion (**Figure 7**).

Figure 7
Performance against first year additional lending targets



NOTE

1 The setting of mortgage lending targets took account of the banks' different circumstances, systems and position in the market. As Lloyds had the largest share of the mortgage market, the Treasury chose to focus the target on gross lending for house purchases rather than net lending, which would have included remortgaging.

Source: HM Treasury

3.8 The failure to meet the commitments for the first year could be attributed to a range of factors, including:

- subdued demand from businesses for additional credit in uncertain economic conditions, reflected in a steeper fall than expected in GDP of 5 per cent rather than 3.5 per cent;
- higher than expected repayments of loans as businesses sought to reduce their liabilities; and
- the ability of larger businesses to use the bond and equity markets to raise finance. During 2009, businesses raised £42 billion from the capital markets compared with only £8 billion in 2008. This funding route was, however, not available to small and medium sized businesses.

3.9 Higher interest margins and fees on bank loans are also likely to have restricted access to credit. In September 2010, the Bank of England reported the view of businesses that credit conditions had become increasingly polarised. Smaller businesses continued to report difficulties in accessing affordable finance, with fees and interest margins remaining higher than pre-crisis levels. Larger businesses and those perceived by banks as stronger propositions had seen a gradual improvement in the cost and the availability of bank funding through 2010.

3.10 While weakness in bank lending since mid-2007 reflects a combination of tighter credit supply and weaker credit demand, the Bank of England reported in December 2010 that tight credit supply is likely to have been the dominant influence. Weak demand would typically be associated with lower rather than higher interest margins on loans and is not consistent with the increasing use of bond and equity markets by larger companies to raise finance. It is, however, difficult to assess the relative contribution of demand and supply more precisely.

3.11 Although the Treasury has monitored progress, the only formal sanction available if targets are not met is a potential refusal to extend guarantees for wholesale borrowing under the Credit Guarantee Scheme. The Treasury decided not to apply this sanction. It judged that both banks had made loans available to commercially viable businesses, but had failed to meet the commitments due to a fall in demand, which was beyond their control.

Lending commitments for the second year

3.12 In agreeing the second year lending commitments to be applied from 1 March 2010, the Treasury changed the basis of its target setting to take account of larger than expected loan repayments and alternative financing routes. While the basis for mortgage lending targets remained unchanged, those for business lending were adjusted to a gross lending basis.[4] Gross lending is essentially the flow of new lending from banks, ignoring any repayments of past lending by borrowers.

4 Lloyds agreed to a second year of targets as a condition of exiting the Scheme.

3.13 The Treasury re-examined both banks' lending to businesses for the first year on a gross rather than a net basis, and aimed to agree commitments for the second year that would result in higher targets. For the second year, the Treasury agreed that the business lending targets would be set on a gross rather than a net basis, to avoid the distortion introduced by increased repayments by businesses. On this basis, RBS had lent £41 billion and Lloyds £38 billion to businesses in the first year. Following negotiations, RBS agreed to lend £50 billion to businesses for the second year, ending 28 February 2011, while Lloyds agreed to lend £44 billion (**Figure 8**). As at 30 September 2010, both banks reported that they were on course to meet their mortgage and business lending commitments.

3.14 The Treasury considered a range of additional sanctions if the second year targets were not met:

- Linking chief executives' remuneration more directly to achievement of the lending commitments.
- Requiring the banks to transfer any shortfalls in lending to another lender, such as an existing capital investment fund or a new fund set up for the purpose.
- Naming and shaming any bank that did not meet its lending commitments, for instance, by requiring banks to provide a public report at the end of the lending commitment year.
- Restrict the ability to bid for government work in the future.
- Impose a fine or penalty.

3.15 For any of the options to work they had to be credible, legal, have a fairly rapid effect and maintain financial stability without restricting banks' access to capital or creating funding pressures. After further analysis, the Treasury considered that any new sanctions would face insurmountable difficulties in implementation and none of the options were taken forward. In July 2010, the Government issued a consultation document on wider changes that might be made to the way that businesses are funded and undertook to keep the lending commitments agreed with RBS and Lloyds under review.

Figure 8
Year 2 additional lending commitments

	Lloyds (£bn)	RBS (£bn)	Total (£bn)
Businesses (gross)	44	50	94
Mortgages	3	8	11

Source: HM Treasury

Appendix One

Timeline of key events

Timeline of key events

January 2009 = 100

160
140
120
100
80
60
40
20
0

Jan 2009 | Feb 2009 | Mar 2009 | Apr 2009 | May 2009 | Jun 2009 | Jul 2009 | Aug 2009 | Sep 2009 | Oct 2009 | Nov 2009 | Dec 2009 | Jan 2010 | Feb 2010 | Mar 2010 | Apr 2010 | May 2010

FTSE 100 Index
FTSE Bank Index

Source: Published market indices

Government actions

UK banks - key events

Appendix Two

Methodology

Study Scope

The report reviews the negotiation of the Scheme. We have not evaluated the value for money of the operation of the Scheme because too little time has elapsed to form conclusions about its success. As explained in Part One, this report does not consider: the causes of the credit crisis or the regulatory regime operated by the Financial Services Authority; the Bank of England's role in respect of monetary policy and financial stability; or support from the Department for Business, Innovation and Skills to businesses.

We developed a number of key questions:

- Were all options considered and reappraised as negotiations progressed?
- Were the risks to the taxpayer assessed and priced appropriately?
- Are lending commitments being met, and if not why, and what action has been taken by the Treasury?
- Did the Treasury have sufficient resources in terms of staff and external professional advice?

Method	Purpose
Literature review A substantial amount of material has been published about the financial crisis and the steps taken to contain it.	**To identify** National and international developments relevant to the crisis, with particular emphasis on material published by authorities in the United States on the Asset Guarantee Program.
Document review We reviewed documentary evidence provided by the Treasury, including: • key submissions and supporting papers; • due diligence and asset valuation reports from the Treasury's advisers; • material produced by the Asset Protection Agency; and • published reports and accounts from RBS and Lloyds	**To identify** • The Treasury's objectives. • The options considered by the Treasury. • The Treasury's assessment of the risks it was taking. • The means of protecting the taxpayer from unnecessary risk. • The Treasury's capacity and capability.
We also commissioned Mazars to review documentary evidence of the due diligence carried out on assets to be placed in the Scheme.	The Treasury's understanding of the risks inherent in the assets proposed for the Scheme.
Semi-structured interviews To fill gaps in our knowledge we interviewed: • Treasury officials; • KPMG, which conducted due diligence of the assets that RBS wanted to include within the Scheme; • Citi and Credit Suisse, who calculated asset losses under various economic scenarios; • Bank of England and Financial Services Authority, who supported the Treasury in the early design of the Scheme and in producing the economic scenarios; and • officials responsible for the Asset Guarantee Program in the United States.	**To identify** • The Treasury's objectives. • The options considered by the Treasury. • The Treasury's assessment of the risks it was taking. • The means of protecting the taxpayer from unnecessary risk. • The Treasury's capacity and capability. • The economic scenarios used to test the performance of the Scheme. • Key terms and conditions of the Asset Guarantee Program.

Numerical analysis

- Information from the Bank of England was used to extract the quantity and price of lending to business and individuals before and during the financial crisis.
- We obtained share prices for UK banks for the period September 2008 to mid-January 2009, which we used to show share movements in this period.
- Data about five-year Credit Default Swaps for UK banks were obtained from Markit to indicate changes in investor's perception of the creditworthiness of UK banks.
- We conducted a discounted cash flow analysis of RBS's possible payments/receipts under the Scheme for various scenarios.
- Lloyds' exit fee was compared with that paid by Bank of America when the latter decided not to proceed with participation in the Asset Guarantee Program.

Design and Production by
NAO Communications
DP Ref: 009420-001

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