HM Treasury Resource Accounts 2011-12

The Comptroller and Auditor General's Report to the House of Commons

This is an extract from the Certificate and Report of the Comptroller and Auditor General on HM Treasury Annual Report and Accounts 2011-12 (HC 46 July 2012)

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Part One

Key features of HM Treasury's Resource Accounts

1.1 HM Treasury is the UK's economics and finance ministry with overall responsibility for public spending. The largest items in the Treasury's accounts are the support provided in the financial crisis and the accounting treatment of Quantitative Easing (**Figure 1**). The accounts also contain the majority of the Government's contingent liabilities.

Figure 1
Key figures from the 2011-12 accounts

	Financial stability support schemes (£bn)	Quantitative Easing (£bn)	New support schemes[1] (£bn)	Other[2] (£bn)	Total (£bn)
Assets[3]	94.90	38.47	1.21	4.28	138.86
Liabilities[3]	(0.85)	–	–	(1.68)	(2.53)
Net assets	94.05	38.47	1.21	2.60	136.33
Contingent liabilities and commitments[4]	(109.17)	(335.00)	(23.22)	(0.05)	(467.44)
Income[5]	5.54	27.97	0.01	0.16	33.68
Expenditure[5]	(14.42)	–	–	(0.63)	(15.05)
Net income	(8.88)	27.97	0.01	(0.47)	18.63
Cash generated by the Treasury[6]	7.68	–	(1.21)	(0.63)	5.84
Net amount paid to the consolidated fund					(5.90)
Net change in cash					(0.06)

NOTES
1 'New support schemes' is the bilateral loan to Ireland and the contingent liabilities for the National Loan Guarantee Scheme and Business Finance Partnership.
2 'Other' includes the shares in the Bank of England and the provision for Equitable Life as well as the day to day operations of the Treasury Group.
3 Assets and liabilities under 'Financial stability support schemes' include the outstanding shares and loans from Figure 4 as well as accrual of interest.
4 'Contingent liabilities and commitments' includes those which also give rise to financial assets or liabilities.
5 Income under financial stability includes the amounts shown in Figure 6 and Figure 7 plus a residual amount relating to accounting adjustments such as the amortisation of loans. Expenditure shown under financial stability is mainly the impairment on the Lloyds and Royal Bank of Scotland shares and the loss on the sale of Northern Rock plc.
6 Cash figures for financial stability are the fees and interest from the support, the repayment of the loans and the cash received from the sale of Northern Rock plc. This does not include finance costs of some £5 billion, which are recognised in the Debt Management Account. The Quantitative Easing figures do not include any increase in the money supply resulting from the policy.

Source: National Audit Office analysis of HM Treasury Resource Accounts

1.2 While the Treasury and National Audit Office have worked to ensure transparency over the various government interventions, including within the Treasury's financial statements, it is not easy for a casual inquirer to gain an overview of how much support has been provided, how much is still outstanding and how much it is costing. Part Two of this Report provides this overview.

1.3 The financial crisis has continued over 2011-12 and the Treasury, working with the Bank of England, is establishing new schemes to promote lending to UK businesses and protect the UK economy. These are described in Part Three of this Report.

The main impact of the financial interventions on the accounts

1.4 Since 2007, the Treasury has made a series of large financial interventions to support the financial stability of UK banking. Details of these interventions and the current financial position of the individual schemes are set out in Part Two.

Cash paid to the Consolidated Fund: Statement of Cash Flows

1.5 The Statement of Cash Flows shows that in 2011-12 the Treasury paid a total of £5.90 billion cash over to the Consolidated Fund as well as funding all its operations and paying £1.21 billion cash to Ireland. (paragraph 3.17). This cash was mainly generated from the repayment of loans (£4.32 billion), the sale of Northern Rock (£747 million received by 31 March 2012) and the fees generated by the support schemes. However, the cash paid back to the Exchequer is mostly offset by the annual cost, some £5 billion, of the cash borrowed to buy the shares and provide the loans, which falls outside the scope of the Treasury's accounts.

1.6 Meanwhile, the accounts contain a significant amount of non-cash fair value movements and impairments. Changes in the valuation of the Asset Protection Scheme and the Bank of England Asset Purchase Facility (Quantitative Easing, see paragraphs 2.39 to 2.41) have created gains in 2011-12 of £28.44 billion. These have been offset by £14.43 billion of impairments on the shares in Royal Bank of Scotland (RBS) and Lloyds Banking Group, reflecting the decline in bank share prices over the year. Together these are the main causes of the Treasury's £18.63 billion of net income for the year (the equivalent of net profit in a company account).

1.7 The non-cash profit on the Quantitative Easing derivative is unlikely to be fully realised as a cash gain for the Exchequer (paragraph 2.41). On the other hand, some of the reduction in the market value of the shares may be crystallised when the shares are sold (paragraph 2.12).

Other notable items in the accounts

Equitable Life: Notes 19.1 and 19.3.1 of the Treasury's Accounts

1.8 The largest element of the accounts that does not relate to the financial crisis is the provision for compensating former policy holders of Equitable Life for the failure of regulation. Out of the total £1.49 billion total expected to be paid out and provided for last year, £168 million was paid out in 2011-12.

Clear Line of Sight: Note 3 of the Treasury's Accounts

1.9 As is the case for all government departments, the 2011-12 accounts have been expanded under the 'Clear Line of Sight' initiative to include more of the Treasury's arm's-length bodies. The initiative has resulted in the inclusion of the Financial Services Compensation Scheme, the Money Advice Service and UK Financial Investments Ltd. The newly created Office for Budget Responsibility has also been included. The comparative figures have been restated.

Governance: Chapter 3 of the Treasury's Annual Report and Lead Non Executive Board Member's Report

1.10 The Annual Report also includes a new 'Governance Statement'. This replaces the Statement on Internal Control included in previous years and provides more detail as to how the Treasury governs itself, the risks it manages, and its own assessment of these governance arrangements. The Governance Statement also highlights the key risks faced by the Treasury:

- Continuing uncertainty in the global economy and its potential impact on the domestic economy.
- Stimulating growth across the economy by introducing additional measures such as the National Loans Guarantee Scheme.
- Fiscal consolidation and the reduction of the structural deficit.
- The longer-term health of the public finances.
- Achieving its own Spending Review settlement.

Remuneration Report: Chapter 7 of the Treasury's Annual Report

1.11 The Remuneration Report discloses the remuneration of Treasury ministers and its senior management and includes, for the first time, the relationship between the remuneration of the highest paid official and the median pay of the workforce of the Treasury and the bodies included within its accounts.

Part Two

The Financial Stability Support

2.1 This Part of the Report updates a similar report I produced within the Treasury's 2010-11 Resource Accounts (HC 984 2010-12) and follows my December 2009 and 2010 reports on *Maintaining financial stability* (HC 91 2009-10 and HC 676 2010-11).

2.2 Since 2007, the Treasury has made a series of large financial interventions to support the financial stability of UK banking. These interventions supported three broad aims: to protect depositors; maintain liquidity and capital for UK banks through the period of market closures; and to encourage banks to lend to creditworthy borrowers.

2.3 To remove the support, the guarantees will be withdrawn, the loans repaid and, eventually, the shares returned to private ownership. As at 31 March 2012, the total outstanding support stood at £228.03 billion (**Figure 2**) of which £109.17 is outstanding guarantees (**Figure 3** on pages 8 and 9) and the majority, £118.86 billion, was provided as cash (**Figure 4** on pages 10 and 11).

Figure 2
Total support and fees

	Guarantee commitments (Figure 3) (£bn)	Cash outlay (Figure 4) (£bn)	Total support (£bn)
Total support – peak[1]	1,029.30	132.89	**1,162.19**
Total outstanding support – 31 March 2011	332.40	123.93	**456.33**
Total outstanding support – 31 March 2012	**109.17**	**118.86**	**228.03**
	Total cash received as at 31 March 2011 (£bn)	**Cash received 2011-12 (£bn)**	**Total cash received as at 31 March 2012 (£bn)**
Fees and income from guarantees (Figure 6)	9.10	1.73	**10.83**
Fees and income from cash support (Figure 7)	2.64	0.89	**3.53**
Total fees	**11.74**	**2.62**	**14.36**
Estimated finance cost[2]	(11)	(5)	**(16)**

NOTES
1 See footnote 1 in Figure 3 and Figure 4.
2 Finance cost stated to nearest £1 billion.

Source: National Audit Office analysis of HM Treasury Resource Accounts

Figure 3
Support provided as guarantees, indemnities and commitments

	Peak support including amounts pledged but not drawn down[1] (£bn)	Outstanding guarantee commitments as at 31 March 2011 (£bn)	Outstanding guarantee commitments as at 31 March 2012 (£bn)	Notes to Treasury Resource Accounts
Sector-wide schemes				
Credit Guarantee Scheme[2]	250.00	115.00	24.20	24.2
Special Liquidity Scheme[2]	200.00	71.00	–	36.4
Asset Backed Securities Scheme	50.00	–	–	
Unused commitment to recapitalisation fund	13.00	–	–	
Unused facilities for loans to support deposits[3, 4]	0.27	0.56	0.03	36.3
Royal Bank of Scotland and Lloyds Banking Group				
Asset Protection Scheme[5]	456.57	110.00	54.70	24.2
Contingent capital in Royal Bank of Scotland	8.00	8.00	8.00	24.1
Northern Rock and Northern Rock (Asset Management)				
Guaranteed liabilities	24.00	15.40	11.10	24.2
Contingent capital	3.40	1.60	1.60	24.1
Unused working capital facility[6]	3.80	2.50	2.50	20
Indemnities to Virgin Money following the sale of Northern Rock plc[7]	0.31	–	0.31	24.1
Bradford & Bingley				
Guaranteed liabilities (including pension scheme)	17.00	5.39	3.21	24.1, 24.2
Unused working capital facility[3]	2.95	2.95	3.52	20
Total guarantees[8]	**1,029.30**	**332.40**	**109.17**	

Figure 3 *continued*
Support provided as guarantees, indemnities and commitments

NOTES

1 The table shows the maximum support pledged, including amounts which were not used. Each scheme and support facility was available from different times so the total peak guarantee of £1,029.30 billion was not all available at a single point in time. The total peak support excludes any emergency support pledged by the Bank of England or other authorities as part of their normal market operations. The emergency £60 billion support to HBOS and RBS is excluded to avoid double counting with the use of the additional funding, including the Credit Guarantee Scheme, which replaced it.

2 The amounts shown for the guarantee schemes are the maximum contingent liability disclosed in the Treasury's Accounts. Use of the Special Liquidity Scheme was not capped and actual usage peaked at £185 billion. The Credit Guarantee Scheme peaked at some £140 billion.

3 The figure for unused facilities for loans to support deposits includes undrawn facilities for loans to support deposits in insolvent firms (Bradford & Bingley, KSF, Heritable, London Scottish Bank, Icesave and Dunfermline) and the Icelandic Depositors' and Investors' Guarantee Fund, and the peak figure includes indemnities to the Bank of England for direct loans and the working capital facility provided to Dunfermline.

4 Where support is provided in the form of a loan facility which is only partially used, in order to avoid double counting with the corresponding lines in Figure 4, the peak figure is calculated as the maximum support pledged (including cash paid out and unused facilities) less the total cash actually provided between 2008 and 2012.

5 The peak figure for the Asset Protection Scheme includes expected usage of the scheme by Lloyds. In the event, RBS was the only user of the Asset Protection Scheme.

6 The peak contingent liability of £3.40 billion related to a potential further recapitalisation of Northern Rock. The commitment was reduced when the bank was split and no cash has been paid to date.

7 In line with standard private sector practice, indemnities were provided to Virgin Money when Northern Rock plc was sold in 2011.

8 The total peak guarantee reported this year is £0.27 billion greater than the peak figure reported last year. This is because the additional £0.31 billion of indemnities to Virgin Money is partially offset by £0.04 billion reduction due to cash being added to the 'loans to support deposits' line (effectively a transfer of support from this figure to the cash support set out in Figure 4).

9 In addition to the amounts in the table, Note 24.1 to the Treasury's Accounts also includes the following, unquantified, contingent and potential liabilities:

- Indemnities to the directors of Northern Rock (Asset Management), Bradford & Bingley, UK Asset Resolution, and UK Financial Investments.
- Maintaining the capital in Bradford & Bingley.
- Potential compensation for former shareholders in Northern Rock, Bradford & Bingley and Dunfermline and indemnities for the members of the Appointment Panel for Dunfermline.
- Indemnities to Virgin Money relating to the Treasury's legal ability to sell Northern Rock plc (considered highly unlikely to be called).

10 This table also excludes loans and commitments to other countries, other interventions to support the economy and any costs and benefits created by the expectation of future taxpayer support.

Source: National Audit Office analysis of HM Treasury Resource Accounts

Figure 4
Support provided as cash

Support as at 31 March 2012

	Gross capital injections and loans advanced (cash)[1] as at 31 March 2012 (£bn)	Net capital injections and loans advanced (cash)[2] as at 31 March 2012 (£bn)	Impairment (cumulative to 31 March 2012) (£bn)	Fair value movements (cumulative to 31 March 2012) (£bn)	Value in Treasury Resource Accounts as at 31 March 2012 (£bn)	Notes to Treasury Resource Accounts
RBS ordinary and B-shares	45.80	45.80	(20.77)	0.02	25.05	13.1
RBS dividend access share	0.00	0.00	–	1.80	1.80	13.1
Lloyds shares	20.54	20.54	(11.76)	0.50	9.28	13.1
Northern Rock plc shares[3]	1.40	0.65	(0.65)	–	–	13.1
Northern Rock (Asset Management) and Bradford & Bingley shares[4]	–	–	–	4.68	4.68	13.1
Northern Rock (Asset Management) loan[5]	27.44	19.84	–	–	19.84	15.1
Bradford & Bingley working capital facility	8.55	7.98	–	–	7.98	15.1
Other loans to support deposits	29.16	24.05	(0.84)	–	23.21	15.1
Total	**132.89**	**118.86**	**(34.02)**	**7.00**	**91.84**	

Figure 4 *continued*
Support provided as cash

Support as at 31 March 2011

	Gross capital injections and loans advanced (cash)[1] as at 31 March 2011 (£bn)	Net capital injections and loans advanced (cash)[2] as at 31 March 2011 (£bn)	Impairment (cumulative to 31 March 2011) (£bn)	Fair value movements (cumulative to 31 March 2011) (£bn)	Value in Treasury Resource Accounts as at 31 March 2011 (£bn)
RBS ordinary and B-shares	45.80	45.80	(9.37)	0.54	36.97
RBS dividend access share	0.00	0.00	–	2.29	2.29
Lloyds shares	20.54	20.54	(8.73)	4.23	16.04
Northern Rock plc shares	1.40	1.40	(0.21)	–	1.19
UKAR Ltd shares[4]	–	–	–	3.04	3.04
Northern Rock (Asset Management) loan[5]	27.44	21.59	–	–	21.59
Bradford & Bingley working capital facility	8.55	8.55	–	–	8.55
Other loans to support deposits[6]	29.12	26.05	(1.35)	–	24.70
Total	**132.85**	**123.93**	**(19.66)**	**10.10**	**114.37**

NOTES

1 The first column represents the loans gross of repayments, and the total cost of shares purchased. To avoid double counting, the preference shares in RBS and Lloyds are not included in the peak total as the proceeds on their redemption were immediately reinvested into share capital. Dividends and the premium on redemption are included in Figure 7.

2 The second column shows the loans net of repayments but before amortisation and impairments.

3 The £0.65 billion impairment in 2011-12 is the loss, on the basis of cash received to date, resulting from the sale of Northern Rock plc.

4 UK Asset Resolution Ltd (UKAR) is the holding company for the wholly-owned banks, Northern Rock (Asset Management) and Bradford & Bingley plc. UKAR was recognised in the accounts at its historical cost (£1,000 of share capital) but in 2011-12 this was restated at net asset value.

5 Loan shown is the total cash provided by the Treasury but does not include amounts lent by and repaid to the Bank of England before the bank was nationalised.

6 Other loans to support deposits as at 31 March 2011 have been restated because the loans are recovered through the Financial Services Compensation Scheme, which is now consolidated into the Treasury's accounts.

Source: Natonal Audit Office analysis of HM Treasury Resource Accounts

2.4 The Treasury announced in June 2012[1] that it will implement some of the structural reforms proposed by the Independent Commission on Banking. The Treasury aims to improve the resilience of UK banks and to ensure that future bank failures can be resolved without passing the costs to the taxpayer.

The reduction in support in 2011-12

2.5 The total level of outstanding support has reduced by £228.30 billion to £228.03 billion as the schemes near the expected end of their lives. Of this, just £5.07 billion represented the return of cash support (**Figure 5**).

Figure 5
The £228.30 billion reduction in support over 2011-12

	Cash (£bn)	Non-cash (£bn)	Total (£bn)	
Credit Guarantee Scheme	–	(90.80)	**(90.80)**	Maturity of debt issued by scheme users
Special Liquidity Scheme	–	(71.00)	**(71.00)**	Ending of scheme
Asset Protection Scheme	–	(55.30)	**(55.30)**	Maturity and disposal of assets by RBS
Other guaranteed liabilities	–	(6.48)	**(6.48)**	Maturity of liabilities
Bradford & Bingley working capital facility	(0.57)	0.57	**–**	Although £0.57 billion cash was repaid, it remains available for future drawdown
NRAM loan	(1.75)	–	**(1.75)**	Repayment
Other loans	(2.00)	(0.53)	**(2.53)**	Repayment and reduction in unused facility
Northern Rock plc	(0.75)	0.31	**(0.44)**	Cash received on sale of shares and granting of quantified contingent liabilities as part of the sale
Total reduction	(5.07)	(223.23)	**(228.30)**	
Support as at 31 March 2011	123.93	332.40	**456.33**	
Support as at 31 March 2012	**118.86**	**109.17**	228.03	

Source: National Audit Office analysis of HM Treasury Resource Accounts

1 www.hm-treasury.gov.uk/fin_stability_regreform_icb.htm

The fees and interest received from the banks

2.6 In return for providing the support, the Treasury has charged fees and interest of £14.36 billion to 31 March 2012. This comprises £10.83 billion for providing the guarantees (**Figure 6**) and £3.53 billion from the shares and loans (**Figure 7** overleaf). The majority of the income has been from fees charged on the financial guarantee schemes, and has included large one-off payments such as the fee paid by Lloyds for the Asset Protection Scheme.

2.7 Unless the shares in RBS and Lloyds Banking Group start paying substantial dividends, the government as a whole will make annual cash losses on the support once the cost of borrowing the money used to purchase the shares and provide the loans is taken into account. This loss will not be reflected in the Treasury Resource Accounts as the government's borrowing costs are recorded in the separate Debt Management Accounts.

Figure 6

Fees and income from the non-cash support

	Total cash received as at 31 March 2011 (£bn)	Income recognised in 2011-12 Accounts (£bn)	Accruals adjustments (£bn)	Total cash received as at 31 March 2012 (£bn)	Notes to Treasury Resource Accounts
Sector-wide schemes					
Credit Guarantee Scheme fees	3.10	0.93	0.13	4.16	36.1
Special Liquidity Scheme fees[1]	0.27	2.27	(2.26)	0.28	13.2.1
Royal Bank of Scotland					
Asset Protection Scheme fees	2.10	0.48	(0.23)	2.35	23.3, 14.1
Commitment fee for contingent capital	0.64	0.32	–	0.96	28.2
Lloyds Banking Group					
Asset Protection Scheme fees	2.50	–	–	2.50	
Northern Rock plc and Northern Rock (Asset Management)					
Fees for guaranteed liabilities	0.12	0.02	–	0.14	26.3
Bradford & Bingley					
Fees for guaranteed liabilities	0.37	0.07	–	0.44	27.3
Total	**9.10**	**4.09**	**(2.36)**	**10.83**	

NOTE

1 The majority of the year's income for the Special Liquidity Scheme was not received as cash by the Treasury before 31 March 2012. The income also includes amounts paid to the Debt Management Office which pays half to the National Loans Fund.

Source: National Audit Office analysis of HM Treasury Resource Accounts

Figure 7

Fees and income from support provided as shares and loans

	Total cash received as at 31 March 2011 (£bn)	Income recognised in 2011-12 Accounts (£bn)	Accruals adjustments (£bn)	Total cash received as at 31 March 2012 (£bn)	Notes to Treasury Resource Accounts
Royal Bank of Scotland					
Underwriting fees for 2009 rights issue	0.30	–	–	0.30	
Redemption of preference shares	0.27	–	–	0.27	
Lloyds Banking Group					
Underwriting and commitment fees for 2009 rights issue	0.38	–	–	0.38	
Redemption of preference shares	0.23	–	–	0.23	
Northern Rock (Asset Management)					
Interest on loan	0.58	0.15	–	0.73	26.4
Bradford & Bingley					
Fees for working capital facility	0.36	0.37	(0.04)	0.69	27.4
Other loans to support deposits					
Interest on loans	0.52	0.45	(0.04)	0.93	27.4, 31-34
Total	**2.64**	**0.97**	**(0.08)**	**3.53**	

Source: National Audit Office analysis of HM Treasury Resource Accounts

The subsidy in the support provided

2.8 The income generated by fees and interest is less than would be expected from a normal market investment and has not compensated the taxpayer for the degree of risk accepted by taxpayers in providing the support. Once the opportunity cost and risks are factored in, the schemes have represented a transfer of at least £5 billion from taxpayers to the financial sector (**Figure 8**). This does not include the cost of holding the shares which have not paid a dividend or seen a capital gain.

2.9 The fees and interest were generally set with a view of what the recipient banks could afford at the time, in keeping with the schemes' aims for financial stability. The £5 billion can be regarded as part of the cost of preserving financial stability in the crisis, and as I reported in 2009, had the support not been provided, the potential costs would have been difficult to envision.[2]

2 Comptroller and Auditor General, *Maintaining financial stability across the United Kingdom's banking system*, Session 2009-10, HC 91, National Audit Office, December 2009.

Figure 8
Identified subsidies in the support total at least £5 billion

Scheme	Identified subsidy (£bn)	Explanation
Credit Guarantee Scheme	At least 1	Value of benefit provided to the banks and not recovered through fees.
Asset Protection Scheme	1	Amount which could have been added to minimum fee for RBS to reflect the risks taken on.
Loans to UKAR	3	Shortfall between the expected return (including interest charged and value realised at liquidation) and an amount which would reflect the risk taken on (including finance cost).
	At least 5	
Identified subsidies not quantified		
RBS shares Lloyds shares		No return (dividends or capital gain) has been made on the equity provided to the banks. The exact value will not be known until the shares are sold but at a required annual return of, say, 10 per cent over the four years of public ownership, the taxpayer would have required a return of £26 billion (including recovery of the cost of the cash provided), but the shares have lost £32 billion.
Other loans to support deposits		Shortfall between return and the interest charged and amount to be repaid and an amount which would reflect the risk taken on (including finance cost). Estimating the cost would require a commercial comparator.

Source: National Audit Office reports on the Asset Protection Scheme, Maintaining financial stability of UK banks and The creation and sale of Northern Rock plc

The shares in RBS and Lloyds

Shares in RBS and Lloyds: Note 13.1 of the Treasury's Accounts.

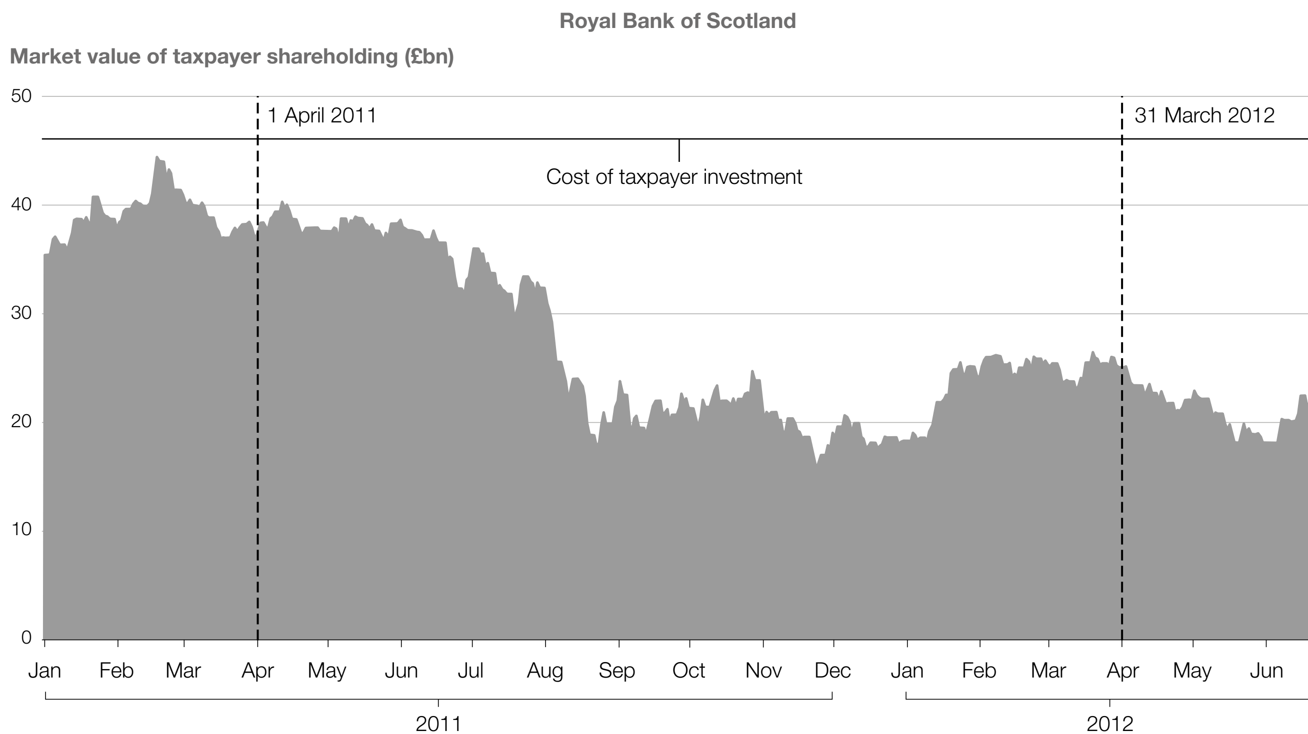
2.10 The Treasury has invested £66.34 billion in shares in RBS and Lloyds to provide the banks with sufficient capital. The shares are held in the accounts at their market value, which has fallen by £18.68 billion over the year and £32.01 billion since the government's original investment (**Figure 9** overleaf). In line with accounting standards, the £32.01 billion fall in value is split between a temporary increase in value (£0.52 billion) offset by a more permanent impairment of £32.53 billion. Only the impairment is recognised as a loss in the *Statement of Comprehensive Net Expenditure* with £14.43 billion occurring in 2011-12.

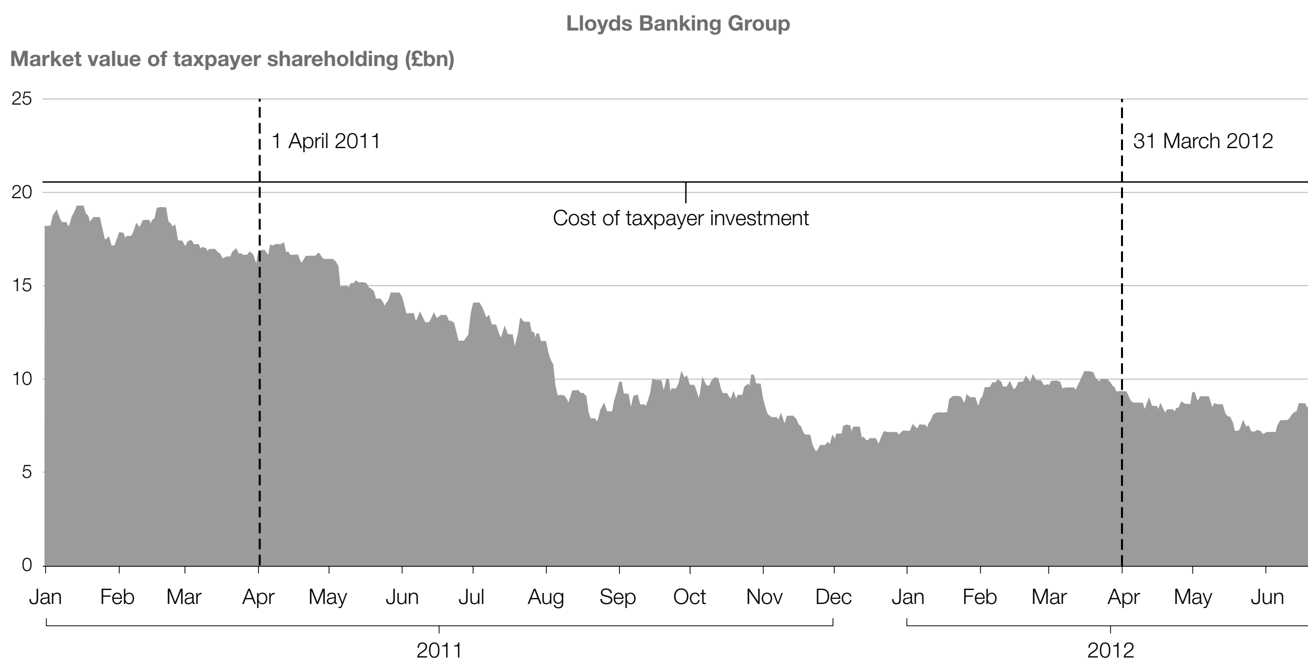
2.11 The government remains committed to returning the banks to private ownership. However, UK Financial Investments, who manage the government shareholding, has warned that until economic and regulatory uncertainties subside it will be difficult to deliver value for money from a sale of the shares, and that at least some of this fall in value may represent a permanent cost.[3]

3 UK Financial Investments, Annual Report and Accounts, 2011-12.

Figure 9

The shares in RBS and Lloyds lost £18.68 billion over 2011-12





NOTE

1 These graphs do not include the dividend access share in RBS, finance costs or account for inflation. They assume RBS B-shares are valued as if they had been converted to RBS ordinary shares.

Source: National Audit Office analysis of Bloomberg data

2.12 While economic conditions have been challenging for all banks, shares in RBS and Lloyds Banking Group have continued to underperform those of their UK competitors. In its June 2012 White Paper on banking, the Government estimated that implementing ring-fencing as recommended by the Independent Commission on Banking (ICB) will lead to a permanent reduction in value totalling £6 billion to £9 billion, against a counterfactual where the ICB's proposals were not implemented.[4] The market is likely to have reflected at least some expectation of this cost in the current share price.

Changes to the capital structures at RBS and Lloyds Banking Group

2.13 Meanwhile, taxpayer ownership of the banks is slowly reducing. Lloyds Banking Group and RBS continue to issue ordinary shares, for example as part of employee remuneration schemes and to fund the payment of dividends on preference shares. The effect of this has been to reduce the taxpayer ownership of Lloyds from 40.6 per cent to 39.8 per cent and of RBS from 82.4 per cent to 81.7 per cent[5] over 2011-12 with further reductions since 31 March 2012.

2.14 In May 2012, RBS shareholders voted to swap every ten ordinary shares for one share. RBS believe that this will reduce the share price volatility. The transaction has no impact on the 2011-12 accounts or the percentage of taxpayer ownership.

The Dividend Access Share

Dividend Access Share: Notes 13.1, 2.4 and 23.5.3 of the Treasury's Accounts

2.15 The dividend access share is a single share in RBS which entitles the holder to a greater share of any dividend than other holders of ordinary shares. The share cost 50 pence but is currently valued at £1.80 billion in the accounts. The share can only be held by the government, so there is no market price for the share. The accounts value the share using a valuation model that includes various assumptions about RBS's future dividend policy, for example that no dividend would be declared before 2015, two years later than assumed last year.

2.16 In practice, the dividend access share makes paying a dividend on the ordinary shares expensive for RBS because its terms mean a minimum of £1.8 billion must be paid to the dividend access share holder before any further dividend on the ordinary shares can be paid.

2.17 Some commentators regard removing the dividend access share as a prerequisite to returning the bank to private ownership. The theoretical valuation calculated by the model does not necessarily reflect the price RBS would pay to remove the dividend access share.

4 HM Treasury, White Paper, available at: www.hm-treasury.gov.uk/fin_stability_regreform_icb.htm

5 The figures for RBS include voting rights on a hypothetical conversion of B-shares into ordinary shares. Excluding B-shares, the taxpayer's share of RBS has decreased from 67.2 per cent to 66.1 per cent over 2011-12.

2.18 Under the state aid agreement made after the taxpayer purchased its shares, RBS was prevented from declaring a dividend on its shares until 30 April 2012. RBS resumed payments of dividends on its preference shares (but not on its ordinary or B-shares) in May 2012, which was partly funded by issuing new ordinary shares to private sector investors.

The loss on the sale of Northern Rock plc

Disposal of Northern Rock plc: Note 23.3 to the Treasury's Accounts

2.19 The Treasury and UKFI sold Northern Rock plc to Virgin Money at the end of 2011. I reported on the decision to split Northern Rock plc from the rest of the Northern Rock assets, the financial performance of Northern Rock plc while in public ownership, whether the sale was the best available option, and whether the sale process was handled well in *The creation and sale of Northern Rock plc* (18 May 2012, HC 20, 2012-13).

2.20 Virgin Money paid for the taxpayers' shares using a mixture of upfront cash, deferred cash, a capital instrument and a clawback agreement which will yield additional proceeds if Virgin Money sells or lists Northern Rock plc. There are therefore various reasonable ways to value the loss on the sale. The accounts include a loss of £527 million, of which £212 million was recognised as an impairment last year, and £315 million is recognised as a loss on sale. This is within the £423 million to £537 million range included in my value-for-money report[6] and is above the £480 million mid-point because some of the non-cash elements are excluded by accounting standards.

Advisor fees: Notes 38.6 to the Treasury's Accounts

2.21 In addition to the loss on the sale, the Treasury paid some £3.2 million of transaction costs relating to the sale. Further information is available in UK Financial Investments' *Publication on Sale* (February 2012).

The capital instrument received as part of the sale

2.22 The proceeds from selling Northern Rock plc included a capital instrument which provides taxpayers with a continued economic interest in Virgin Money. The instrument is perpetual subordinated debt with a principal value of £150 million. It will pay a discretionary coupon at 10.5 per cent from 2013. The instrument forms part of Virgin Money's Tier 1 capital. Should Virgin Money list its shares on the stock exchange, the instrument will convert into shares which will be sold as part of the listing.

Capital instrument: Note 13.1 to the Treasury's Accounts

2.23 The accounts originally valued the capital instrument at £66 million, due to the low certainty over whether it could be sold, the delay in paying the coupon and its highly subordinated nature. By 31 March it had gained £16 million in value as market conditions for bank debt improved and because there is less time before coupons could be paid.

6 Comptroller and Auditor General, *The creation and sale of Northern Rock plc*, Session 2012-13, HC 20, National Audit Office, May 2012.

The UK Asset Resolution shares

2.24 The majority of the Northern Rock assets and liabilities, along with those of Bradford & Bingley, remain in public ownership under the holding company UK Asset Resolution Ltd (UKAR). The proceeds from winding down these companies will be used to repay the outstanding loans, over the next 10 to 15 years.

UKAR shares:
Note 13.1 to the Treasury's Accounts

2.25 This year, UKAR has been recognised on the Treasury's balance sheet at its net asset value of £4.68 billion. Previously, the shares were held at their cost, reflecting that the Treasury made no payment when the banks were nationalised. The Treasury have a special Accounts Direction to allow this departure from the usual government accounting policy. The new accounting treatment is the same as the way the Treasury accounts for its ownership of the Bank of England. Bringing the net asset value of these institutions into the Treasury's accounts gives taxpayers more information about their investment than if they remained at historical cost.

2.26 The valuation of UKAR at net asset value represents a substantial premium compared to other banks. The proceeds from the Northern Rock plc sale were valued at 80 per cent to 90 per cent of its book value and at 31 March 2012, RBS shares traded at around 50 per cent of book value and Lloyds were trading at 42 per cent. Because the UKAR shares are not traded there is no market price with which they can be valued and the Treasury expects to receive more than £4.68 billion from the net assets when UKAR is eventually liquidated.

The loans to the UKAR companies

2.27 The return from the equity in UKAR is offset by the cost of the loans provided to UKAR. The Treasury expects to recover the cash lent to Northern Rock and Bradford & Bingley, including the cost of gilts issued to fund the loans, but the taxpayer may not be compensated for the risk taken on or the opportunity cost of the money lent. This could produce a net present cost of some £3 billion.[7]

2.28 In line with recommendations from the National Audit Office, the Treasury has increased the interest rate on its loans to UKAR.[8] The rate increase is likely to be cash-neutral for the taxpayer until the banks are liquidated but will improve the taxpayers' claims in the residual net assets at liquidation.

7 Discounted using a 6 per cent (nominal) discount rate. The discount rate reflects a commercial cost of capital as well as the Social Time Preference Rate set out in *The Green Book*.

8 Comptroller and Auditor General, *Stewardship of the wholly-owned banks: buy-back of subordinated debt*, Session 2010-11, HC 706, National Audit Office, March 2011.

Other loans to support deposits

Taxpayer loans to banks: Note 15.1 to the Treasury's Accounts

2.29 The other loans to support deposits were issued to ensure depositors in various insolvent firms did not lose their money. Recovery depends on the administration of those entities, the international tribunal requiring the Icelandic authorities to pay interest, and the Financial Services Compensation Scheme levy on the banking industry. Further details of the nature and disclosure of these loans were set out in paragraphs 27 and 28 of my report on Treasury's 2010-11 Accounts.[9]

The Special Liquidity Scheme

Special Liquidity Scheme: Notes 36.4, 13.2.1 and 9.1 to the Treasury's Accounts

2.30 The Special Liquidity Scheme ended during 2011-12, the first of the major schemes to be withdrawn. It was a Bank of England scheme in which participating banks and building societies swapped illiquid assets for Treasury bills. The taxpayer indemnified the Bank of England against losses and was exposed to a maximum of £185 billion of risk at the scheme's peak, against which a significant amount of collateral was held. In the event, no payout was made under the scheme.[10]

2.31 Because the scheme ended without any defaults, the Bank of England made a £2.26 billion surplus from the scheme. The final treatment of this surplus was not agreed at the outset and it has not been previously recognised in the Treasury's Accounts. It was paid in full by the Bank to the Treasury in April 2012 and is shown as a receivable in the Treasury's Accounts. This amount includes corporation tax of £0.6 billion, which the Bank paid to HM Revenue & Customs but has now been refunded.

The Credit Guarantee Scheme

Credit Guarantee Scheme: Note 24.2 to the Treasury's Accounts

2.32 The Credit Guarantee Scheme is a scheme in which the taxpayer guarantees debt issued by UK banks and building societies. The scheme is being wound down as banks repay the private sector holders of this debt. The guaranteed debt has reduced to £24.20 billion as at 31 March 2012.

2.33 Before April 2012, participants could roll over (extend) their use of the scheme by replacing maturing debt with new issued debt or they could reduce their use of the scheme by repurchasing debt for a one-off fee. No bank made significant use of the rollover facility and only one bank repurchased any debt in the scheme. The scheme has now passed the period, between October and December 2011, when the bulk of debt in the scheme matured (**Figure 10**) and will now wind down to zero by the end of October 2012.

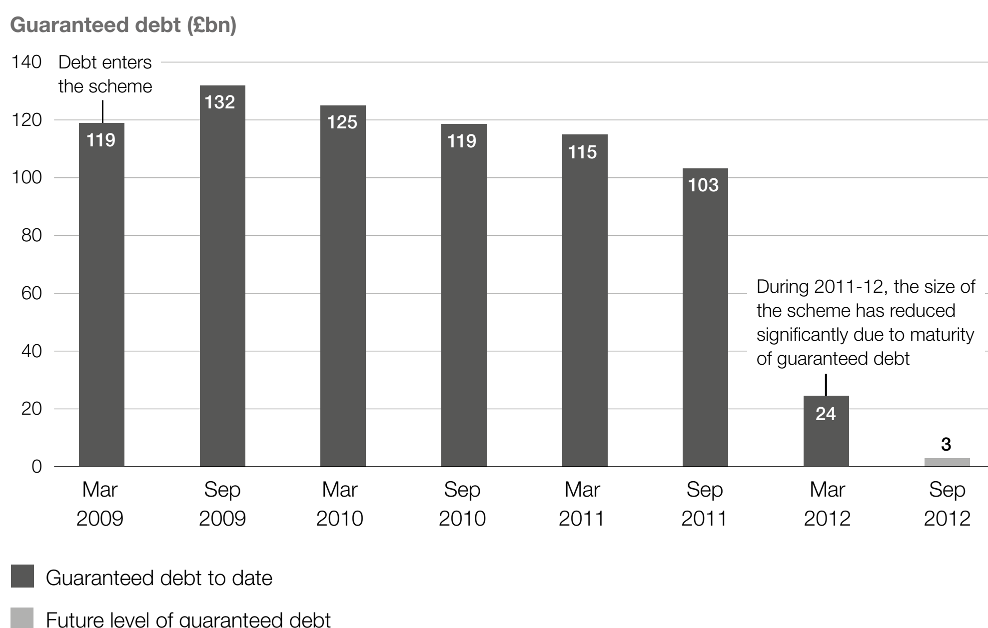
2.34 I reported in December 2010 that the scheme was providing a benefit to the participating banks of substantially more than £1 billion (over the life of the scheme) in the form of a reduced funding cost which was not captured by the fees charged.[11] The Treasury accepted this analysis but did not revise the fees for the remaining period of the scheme.

9 Part of the Comptroller and Auditor General's Certificate and report on *HM Treasury's Annual Report and Accounts 2010-11*, HC 984, 2010-12, July 2011.

10 The Bank of England summarised the operation and wind-down of the scheme and commented on lessons it could learn for its usual market operations in its March 2011 *Quarterly Bulletin*, www.bankofengland.co.uk/publications/Pages/quarterlybulletin/a11.aspx

11 Comptroller and Auditor General, *Maintaining the financial stability of UK banks: update on the support schemes*, Session 2010-11, HC 676, National Audit Office, December 2010.

Figure 10
The size of the Credit Guarantee Scheme has reduced significantly over 2011-12 and will be wound up by the end of October 2012



Source: National Audit Office analysis of HM Treasury data

The Asset Protection Scheme

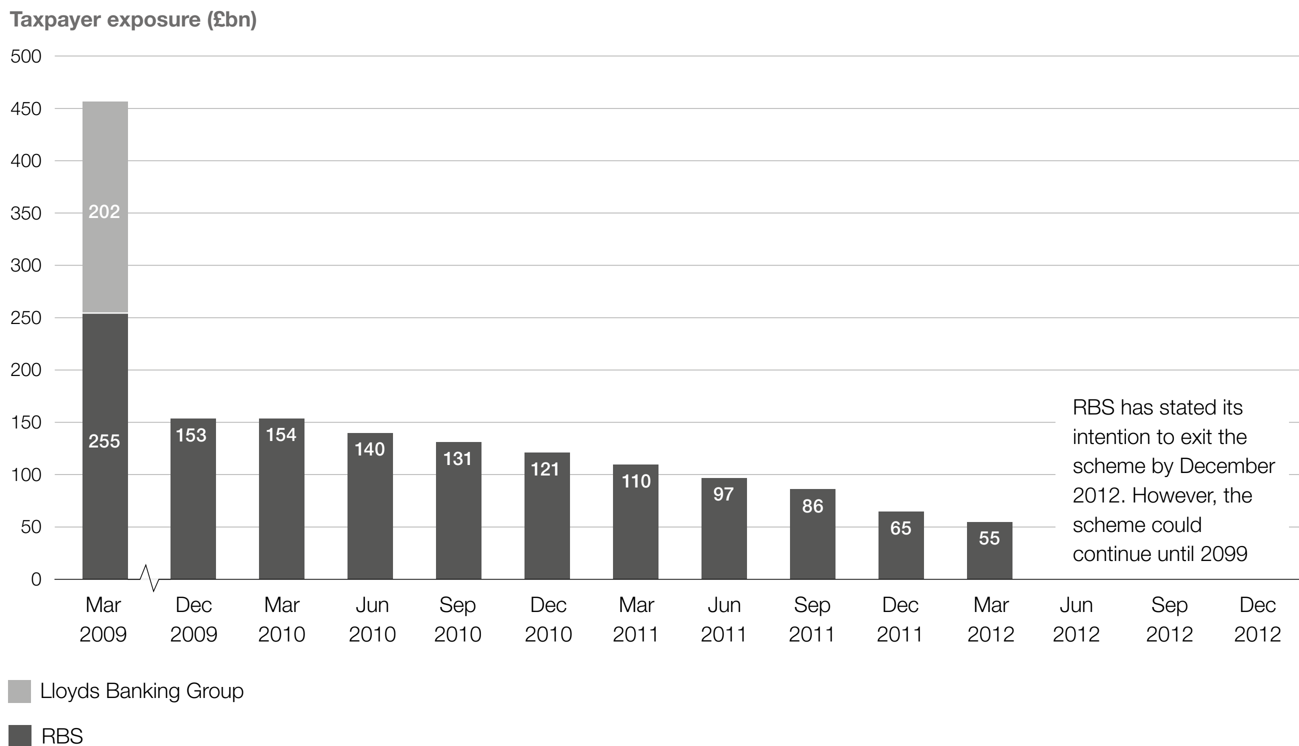
Asset Protection Scheme: Note 24.2 to the Treasury's Accounts

2.35 Under the Asset Protection Scheme, the taxpayer indemnified participants against losses on certain of its assets. RBS was the only bank to place assets into the scheme. The taxpayer exposure to the insured assets has reduced to £54.70 billion as at 31 March 2012 (**Figure 11** overleaf).

2.36 The terms of the scheme were set so that RBS bears the first £60 billion of losses, and 10 per cent of any remaining losses. The actual losses on the covered assets totalled £33 billion as at 31 March 2012, and the Asset Protection Agency, which administers the scheme, reported that the taxpayer is not likely to bear any loss under the level of economic downturn as envisioned by the Financial Services Authority (FSA) stress tests. The Asset Protection Agency modelling further suggests that the level of economic stress that would necessitate a payout would be so great that the economic climate would have to deteriorate rapidly and dramatically to levels where banks around the world, not just RBS, would be facing significant difficulties.[12]

12 Asset Protection Agency, Annual Report and Accounts 2011-12.

Figure 11
The Asset Protection Scheme continues to reduce



NOTES

1 The maximum taxpayer exposure reflects original expectations that both Lloyds and Royal Bank of Scotland would use the scheme. The final agreed maximum value of the assets placed into the scheme by Royal Bank of Scotland in December 2009 was £282 billion (subsequently revised upwards to £286 billion). The value of the covered assets has since been reduced through run-off of the portfolio, disposals, early repayments and maturing loans.

2 The scheme terms are such that Royal Bank of Scotland bears the first £60 billion of any losses, and 10 per cent of any losses above that. Any remaining loss falls to the taxpayer.

Source: National Audit Office analysis of RBS published financial results and HM Treasury Resource Accounts

2.37 The minimum fee for RBS's use of the scheme was set at £2.5 billion, which will have been paid by December 2012. RBS has announced that it intends to exit the scheme in late 2012, subject to FSA approval of its capital position after leaving the scheme. The potential exit of RBS makes it uncertain that the Asset Protection Agency will continue to be needed and the Agency has begun to prepare for closure.

2.38 The insurance provided by the scheme improves the capital position of RBS. As at 31 March 2012, participating in the scheme increased RBS's Core Tier 1 ratio by 85 basis points to 10.8 per cent.[13] The European Banking Authority required EU banks to achieve a minimum Core Tier 1 capital ratio of 9 per cent by 30 June 2012.[14]

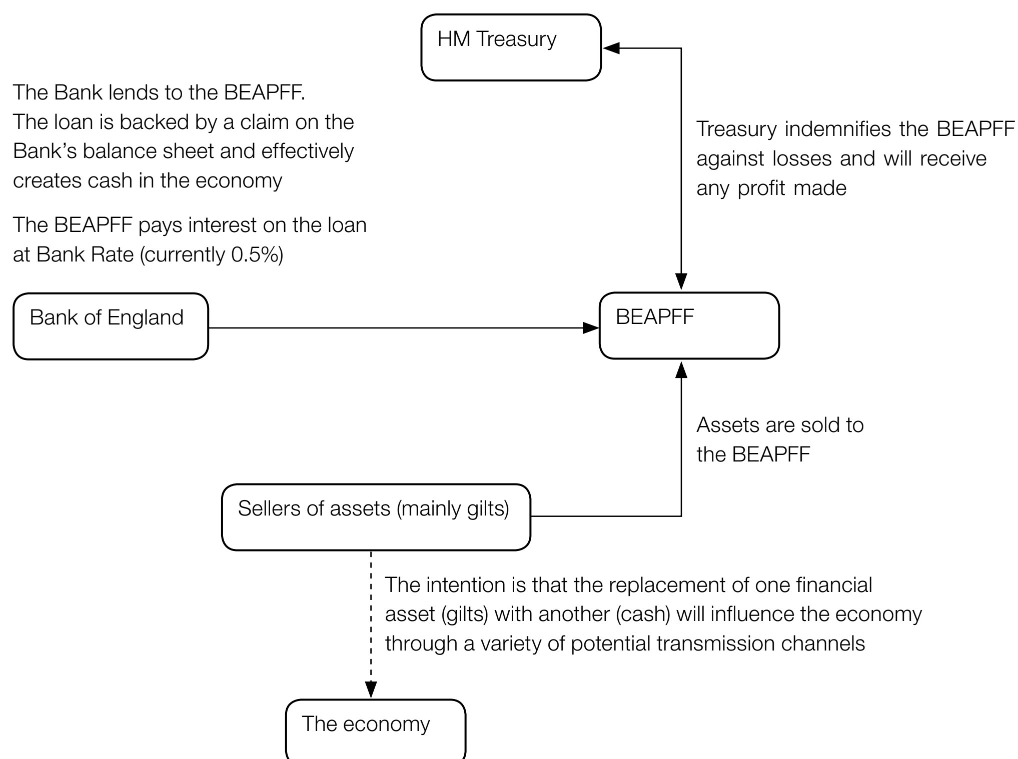
13 RBS Interim Management Statement, Q1 2012
14 www.eba.europa.eu/News--Communications/Year/2011/The-EBA-details-the-EU-measures-to-restore-confide.aspx

Quantitative Easing

Quantitative Easing: Note 36.2 to the Treasury's Accounts

2.39 The Bank of England operates Quantitative Easing as a monetary policy tool to boost the money supply through the purchase of assets, mainly gilts.[15] The measure is run through the Bank of England Asset Purchase Facility Fund Ltd (BEAPFF), a subsidiary of the Bank of England which is not consolidated into the accounts of the Treasury or the Bank of England. The Treasury indemnifies the BEAPFF against any loss and will receive any profits generated by selling the assets back to the market or holding them to maturity (**Figure 12**). As at 31 March 2012 the size of the programme was £325 billion, this was increased to £375 billion in July 2012.

Figure 12
How Quantitative Easing is implemented



Source: National Audit Office

15 www.bankofengland.co.uk/markets/Documents/money/publications/redbookqe.pdf

Quantitative Easing derivative: Notes 14.1 and 23.2 to the Treasury's Accounts

2.40 The Treasury's indemnity gives rise to a derivative in Treasury's Accounts which is currently an asset valued at £38.47 billion. This represents the cumulative net gain generated by the assets purchased by the BEAPFF, and mainly reflects the coupons received and the increased market value of the gilts held. The value of the derivative is volatile but has generally increased over the past two years, in line with rising gilt prices and the expansion of the programme. Accounting standards require the increase in 2011-12 (£27.97 billion) to be recognised as income in the Treasury's Accounts.

2.41 It is not certain that this £27.97 billion non-cash income recognised in the Treasury's Accounts will crystallise into a net cash gain for the Exchequer. This is because:

- The gain from holding the gilts to maturity is mainly cash-neutral for the Exchequer because cash received as gilt coupons and principal is effectively a transfer from one part of government to another.
- The Exchequer may make a cash gain if the assets are sold at a profit. The gilts are held in such a large volume that selling them would reduce their value. The gilts are not held for trading, and would only be sold if the Monitory Policy Committee voted to relax monetary policy.

Part Three

New Support for the Economy

3.1 The wider impact of the financial crisis continues to be felt throughout the economy including through a reduction in lending and continued financial instability in the Eurozone. These impacts are linked because banks are exposed to losses from sovereign default, and countries retain the risk that they must recapitalise their banks.

3.2 The original guarantees have not lead to any payout to date, and the ongoing crisis does not directly impact the Treasury's 2011-12 Accounts. Nevertheless, the taxpayer remains exposed to risk. The Treasury has worked to prepare contingency plans to respond to financial instability in the Eurozone and, in conjunction with the Bank of England, has started to introduce new measures to stimulate lending.

Actions by central banks

3.3 Central banks routinely intervene to ensure markets continue to function. In addition:

- During 2011-12, the European central bank provided some €1 trillion of liquidity support to European banks through its Long Term Repo Operations. Recipients of this support included subsidiaries of UK banking groups, including groups that were reducing their reliance on the UK support schemes.
- On 14 June 2012, the Bank of England announced[16] a new 'Funding for Lending' scheme which will see the Bank provide funding to UK banks, at a subsidised interest rate, to encourage an increase in lending.

Bank of England share capital: Note 13.1 to the Treasury's Accounts

3.4 Even where no taxpayer indemnity is explicitly given, the UK taxpayer retains exposure to central bank interventions through the Treasury's share capital in the Bank of England (100 per cent owned by the Treasury) and, less directly, through the Bank of England's share capital in the European Central Bank.

16 www.bankofengland.co.uk/publications/Documents/speeches/2012/speech587.pdf

The Treasury's actions to support lending

3.5 To reduce their reliance on taxpayer support, banks need to either replace it with alternative funding or to reduce their overall funding requirements, which is likely to lead to a reduction in lending. The continuing financial crisis has decreased the availability of funding that is cheap and low-risk.

3.6 Because lending to individuals and businesses has not recovered to its pre-crisis levels, the Treasury and the Bank of England have responded by introducing new schemes to support the UK economy. These actions and any response to financial instability in the Eurozone may lead to new contingent liabilities for the Exchequer.

3.7 The Treasury's previous attempts to generate lending have included:

- lending targets for RBS and Lloyds agreed as part of the Asset Protection Scheme;
- a series of agreements ('Project Merlin') with major UK banks; and
- residential mortgage lending targets for Northern Rock plc.

3.8 These schemes did not fully meet their objectives and Treasury's 2011-12 Accounts include two new schemes, the National Loan Guarantee Scheme and the Business Finance Partnership, to encourage lending to businesses.

National Loan Guarantee Scheme

National Loan Guarantee Scheme: Notes 24.2 and 37.2 to the Treasury's Accounts

3.9 The National Loan Guarantee Scheme, launched in March 2012, is intended to provide subsidised lending of up to £20 billion to small businesses. As was the case with the Credit Guarantee Scheme, the government will guarantee debt issued by banks to the market to reduce the funding cost of the banks.

3.10 The participating banks are required to use this cost saving to fund loans which are cheaper by 1 percentage point to small businesses.[17] The Treasury charges the participating banks a fee that is intended to capture all the benefit provided by the guarantee, less the amount passed on to the small business recipients.

3.11 As at 31 March 2012, four banks have announced that they will participate in the scheme and a fifth has agreed in principle to participate. The first guaranteed debt instrument was issued in April 2012 and banks have begun issuing loans to small businesses. Treasury's Accounts show a contingent liability for the maximum £20 billion of bank debt that could be guaranteed. This amount will be released in stages and, as at 30 June 2012, some £5 billion had been committed to four banks, with the remainder available on demand.

3.12 The increased contingent liability is offset by a reduced indemnity for the part of quantitative easing available for purchasing corporate bonds, a facility which had not been used significantly.

17 Banks may choose to provide this saving in the form of a reduced interest rate, or they may keep the interest rate unchanged and give the recipient an upfront cash payment equal to the net present value of such a reduction.

Business Finance Partnership

Business Finance Partnership: Note 37.1 to the Treasury's Accounts

3.13 The Treasury intends to invest £1.2 billion to support lending through non-bank channels by investing alongside private sector investors, similar to a venture capital fund. No investment had been made as at 31 March 2012.

Support to other countries

3.14 Because of the link between governments and their banks, the continuing financial situation has made it difficult for some countries, particularly some members of the Eurozone, to finance their ongoing activities. This has led to some countries seeking financial assistance from other states, including from the UK.

UK exposure to the Eurozone

Budget for contingency planning: Note 4.3.1 to the Treasury's Accounts

3.15 The Treasury increased their budget to allow for £15 million of expenditure to allow it to respond to wider financial stability risks in the Eurozone. This contingency remained unused as at 31 March 2012. The UK's other potential commitments to the Eurozone are included in the Consolidated Fund and the National Loans Fund. These include:

- Contributions to the International Monetary Fund (IMF). The IMF has provided loans to various countries including Ireland, Portugal and Greece.
- Contributions to the European Financial Stability Mechanism. The Mechanism has lent to Portugal and Ireland and is secured on contributions to the EU budget. The Mechanism is expected to be replaced by a new European Stability Mechanism, to which the UK will not contribute, in 2013.
- Contributions to multinational lending institutions such as the European Investment Bank.

3.16 In June 2012 the European Commission proposed new legislation to provide a common framework for resolution of EU banks which encounter financial difficulties. The current draft would require the UK to establish a dedicated fund for bank resolution which might be required to contribute to the resolution of banks established in EU Member States if they had operations in the UK.

Loan to Ireland

Loan to Ireland: Notes 15.1, 19.3.2 and 35 to the Treasury's Accounts

3.17 The UK made available a bilateral loan of £3.23 billion to Ireland as part of a package of financial assistance. In 2011-12, £1.21 billion was drawn down by Ireland.

3.18 The interest rate on the loan was renegotiated to make the loan more affordable. This is in line with the new interest rate charged by other providers of the financial assistance to Ireland and is expected to cover the funding cost of the loan. However, it is below the rate that would be charged by the market. In 2011-12, Ireland was due to pay £8.76 million in interest but this will be reduced by £2.83 million to reflect the new rate.

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Comptroller and Auditor General

13 July 2012

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