
HM Treasury Resource Accounts 2012-13

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
2012-13 (HC 34 July 2013)

This report has been prepared under Section
6 of the Government Resources and
Accounts Act 2000

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Summary

This is my third report on HM Treasury's Departmental Report and Accounts. My report covers progress in the Treasury's interventions to maintain financial stability, its wider support for the economy, its capacity to respond to future financial crises, and new reporting developments.

On the interventions to maintain financial stability

- As well as funding all its day-to-day operations, the Treasury paid £18 billion to the Consolidated Fund (£6 billion in 2011-12). Most of this payment consisted of the transfer of cash, for the first time, from the Bank of England Asset Purchase Facility Fund. The Treasury's balance sheet continued to expand in 2012-13 to take account of profits on the Asset Purchase Facility.
- The market value at 31 March 2013 of the shares in RBS and Lloyds Banking Group was £28 billion below the total cash injected into the banks in 2008 and 2009 and more than £34 billion below the proceeds which would need to be realised to reflect the cost of financing the purchases of shares.
- Contingent liabilities fell from £123 billion in 2011-12 to £26 billion this year, largely as a result of the closure of the Asset Protection and Credit Guarantee Schemes.
- The Treasury's current forecasts indicate that the majority of its outstanding loans to failed financial institutions will be repaid over the next decade.

On supporting the wider economy

- To provide further stimulus to the economy, the Bank of England and the Treasury launched the Funding for Lending Scheme in July 2012. At 31 March 2013, drawings on the Scheme totalled £16.5 billion and the Bank of England and the Treasury are monitoring the success of the scheme through a joint Oversight Board.

On the Treasury's capacity to respond to any future crises

- The Committee of Public Accounts expressed concerns last year that any reduction in headcount might jeopardise the Treasury's effectiveness. Treasury staff numbers, excluding those employed within Infrastructure UK, are expected to fall from 1,085 at 31 March 2013 to around 1,000 by April 2014. A further reduction of 10% in the Treasury's budget was announced in May 2013. In its response to the Committee, the Treasury stated that a new group structure will support a clear focus on core activities and that steps are being taken to retain specialist knowledge and experience.

On reporting developments

- In response to growing concerns that departmental accounts laid before Parliament should be more accessible, the Treasury published a consultation document in June 2013 seeking views on whether annual reports and accounts are meeting the needs of users.
- Cabinet Office guidance to all departments in 2012 required them to seek formal assurance from persons appointed through off-payroll arrangements that their tax obligations were being met. In line with this new guidance, the Treasury's Annual Report for 2012-13 includes a table which summarises new off-payroll engagements.

Part One: Key features of the Annual Report and Accounts

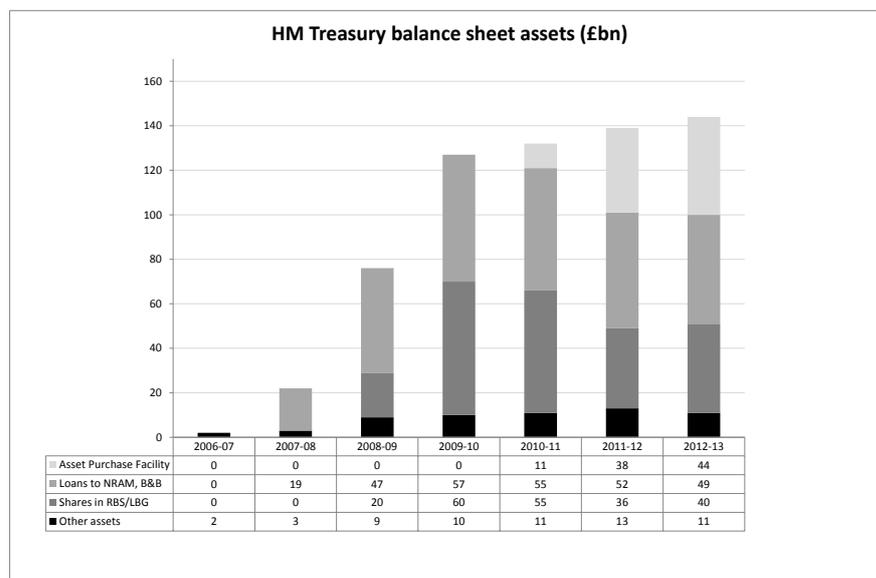
1.1 HM Treasury (the Treasury) is the UK's economics and finance ministry with overall responsibility for public spending. Since 2007, the Treasury has made a series of interventions to maintain financial stability. Details of these interventions and changes in the financial position of individual schemes since last year are set out in **Part Two** of this report. **Part Three** covers wider support for the economy and **Part Four** looks at the Treasury's capacity to respond to a future financial crisis.

1.2 The environment in which the Treasury has operated during 2012-13 continued to be challenging, with continuing uncertainty in the global economy, problems in the Eurozone and a sustained period of subdued growth. Across the world, recovery over the past three years has been slower than forecast, making the Treasury's objectives to reduce the deficit, rebalance the economy and restore stability more demanding.

The Treasury's balance sheet continues to grow

1.3 The Treasury's balance sheet has grown significantly since the onset of the financial crisis in 2007 (**Figure 1**). This expansion has been caused by the interventions to maintain financial stability, particularly through loans made to a range of financial institutions and the purchase of shares in two large banks, RBS and Lloyds Banking Group. The Treasury's balance sheet continued to expand in 2012-13 to take account of profits on purchases of assets by the Bank of England under the Asset Purchase Facility (quantitative easing).

Figure 1: The Treasury's balance sheet has expanded since 2007



Source: Departmental Accounts

Receipts trebled and the value of the Treasury's largest assets have increased over the past financial year

1.4 As well as funding all its day-to-day operations, the Treasury paid £18 billion to the Consolidated Fund (£6 billion in 2011-12).¹ Most of this payment consisted of the transfer of cash, for the first time, from the Bank of England Asset Purchase Facility Fund (£11 billion)² and further repayments of loans by financial institutions and other bodies (£5 billion)³.

1.5 The accounts also contain significant non-cash accounting adjustments to reflect changes in the value of assets and liabilities. For instance, an increase in the market price of the shares in Lloyds Banking Group resulted in a gain of just over £4 billion⁴ and a change in the valuation of the Bank of England Asset Purchase Facility Fund created a gain of £17 billion.⁵

Other items in the accounts

1.6 The largest element of the accounts that does not relate to maintaining the stability of UK banks is the payment of compensation of just over £409 million (£168 million in 2011-12)⁶ to former policy holders of Equitable Life for the failure of regulation. In April 2013, I reported on the administration of the Equitable Life Payment Scheme and the Committee of Public Accounts took evidence from the Treasury and others in May 2013.⁷

1.7 In 2012-13 the FSA imposed large fines on financial institutions, particularly for the attempted manipulation of a benchmark interest rate (the London Inter-bank Offered Rate – LIBOR). Following a change in the law⁸, the net proceeds from these fines (£342 million)⁹ were paid to the Treasury in April 2013 and will be surrendered to the Consolidated Fund as excess cash.

The role of HM Treasury

1.8 Last year, the Committee of Public Accounts took evidence from the Treasury based on my report on the 2011-12 Departmental Report and Accounts. In its subsequent report¹⁰, the Committee reached a number of detailed conclusions and

¹ Departmental Accounts, Statement of Cash Flows, page 5

² Departmental Accounts, Note 14.1

³ Departmental Accounts, Note 15.1

⁴ Departmental Accounts, Note 13.1

⁵ Departmental Accounts, Note 14.1

⁶ Departmental Accounts, Note 19.2.1

⁷ C&AG's Report, Administering the Equitable Life Payments Scheme, HC 1043, Session 2012-13; Oral evidence 21 May 2013, HC 111-I, Session 2012-13

⁸ Financial Services Act 2012.

⁹ Departmental Accounts, Note 9

¹⁰ 27th Report of Session 2012-13, HC 659

recommendations, which are considered in Parts Two to Four of my report this year. The Committee also concluded more generally that, as a finance ministry, the Treasury must exercise central oversight to prevent poor spending decisions and the Treasury's Ministerial Board met only once in 2011-12, limiting its ability to steer both the Treasury and the rest of Government.

1.9 Sections of the Annual Report¹¹, which accompanies the Treasury's accounts, highlight progress in addressing most of these concerns:

- The Treasury considers that it needs to balance its responsibilities as a finance and economics ministry while delivering its own spending review settlement.
- As part of the Treasury's finance ministry role, the monitoring and control of public spending has been enhanced by a new online system for central accounting and reporting. Departments, devolved administrations, and their arms-length bodies are now required to monitor and manage information about spending more effectively and improve the skills needed to deliver their spending plans.
- Contingency plans are maintained to ensure that, regardless of any development, the Treasury is ready to respond rapidly with the appropriate resource, skills and experience.
- Over the course of 2012-13, the Treasury considered what action it could take to make corporate governance more robust. Following the challenge by the Public Accounts Committee, the Treasury Board agreed to meet four times in 2013-14, in accordance with its terms of reference. The Board actually met twice during 2012-13¹².

^{1.10} In addition, the Committee of Public Accounts stated last year that the Treasury should be a leading proponent of clarity in financial reporting. In response to growing concerns that departmental accounts are difficult to understand, the Treasury published a consultation document in June 2013 on whether annual reports and accounts are meeting the needs of users.¹³

Staffing issues

1.11 The Committee expressed concerns last year that any reduction in headcount might jeopardise the Treasury's ability to control the risks it is managing on behalf of the taxpayer, staff turnover remained very high, and that there were very few women at senior levels.¹⁴

1.12 Treasury staff numbers, excluding those employed within Infrastructure UK, are expected to fall from just under 1,085 at 31 March 2013 to around 1,000 by April 2014,

¹¹ Chapter 2: paragraphs 2.48 to 2.66

¹² Departmental Accounts, para 2.22

¹³ HM Treasury: Consultation on simplifying and streamlining the presentation of annual reports and accounts (June 2013)

¹⁴ 27th Report of Session 2012-13, HC 659

reflecting the Spending Review settlement for the period 2010-2015. A further reduction of 10% in the Treasury's budget was announced in May 2013, as part of the current spending review.

1.13 In its response to the Committee, the Treasury stated that considerable thought had gone into contingency planning, a new group structure will support a clear focus on core activities and that steps are being taken to retain specialist knowledge and experience. The Treasury has stated that staff turnover fell slightly from just over 25% in 2011-12 to 22% in 2012-13¹⁵.

1.14 Although the percentage of female staff has remained constant at around 47%, the representation of women at senior levels in the Treasury has fallen during 2012-13 (from 46% at 31 March 2012 to 43% at 31 March 2013¹⁶). At Executive Management Board level within the Treasury (13 posts at Director and above) the number of female staff increased from 2 to 4.¹⁷

Off-payroll engagements

1.15 Following the publication of a Treasury review of the tax arrangements of public sector appointees, the Committee of Public Accounts took evidence in July 2012 from the Treasury and other departments¹⁸. Shortly after the hearing, in August 2012, new guidance¹⁹ was issued by the Cabinet Office which required departments to take a number of actions, including to:

- seek formal assurance from appointees that income tax and national insurance obligations were being met;
- terminate any contracts where formal assurance is not provided; and
- report to Parliament on the application of the new guidance as part of the 2012-13 annual report and accounts process.

1.16 In accordance with this guidance, the Treasury's Annual Report for 2012-13 includes, for the first time, a table²⁰ which summarises new off-payroll engagements between August 2012 and 31 March 2013. At the time of writing this report, the Treasury had received formal assurances from all the appointees involved.

¹⁵ Table 3.D of Annual Report

¹⁶ Table 3.H of Annual Report

¹⁷ Table 6.B of Annual Report

¹⁸ 12th Report of Session 2012-13 (HC 532, October 2012)

¹⁹ <http://www.cabinetoffice.gov.uk/resource-library/procurement-policy-note-0712-tax-arrangements-public-appointees>

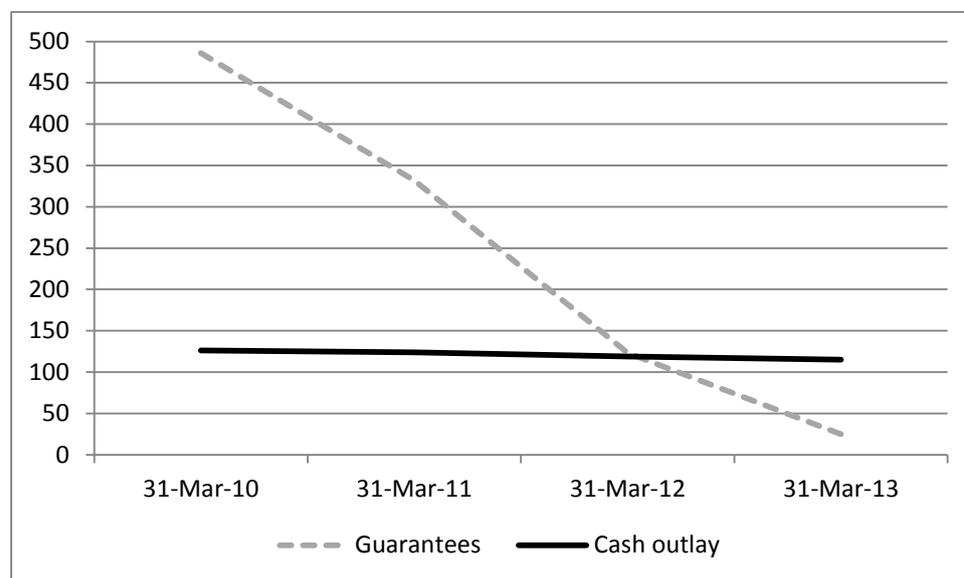
²⁰ Table 3.F of Annual Report

Part Two: Maintaining financial stability

2.1 This Part of the Report updates my previous reports on the Treasury's Departmental Accounts²¹ and my separate reports²² in December 2009 and 2010 on *Maintaining financial stability*. The interventions to support UK banks took the form of loans, guarantees and share purchases. The interventions had 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.

2.2 To remove the support, the loans will need to be repaid, the guarantees withdrawn, and the shares transferred to private ownership. At its peak, support for the banks totalled more than £1 trillion. The scale of these interventions, particularly the guarantees outstanding, has reduced substantially in 2012-13 (**Figure 2**). Contingent liabilities fell from £123 billion in 2011-12 to £26 billion this year, largely as a result of the closure of the Asset Protection Scheme and Credit Guarantee Schemes. Northern Rock Asset Management (NRAM) and Bradford & Bingley repaid £3.1 billion of loans and recoveries of loans from other financial institutions totalled £1.5 billion.

Figure 2: The scale of the outstanding guarantees reduced substantially during 2012-13 (£bn)



Source: National Audit Office analysis

²¹ HC 46 2011-12 and HC 984 2010-11

²² HC 91 2009-10 and HC 676 2010-11

RBS and Lloyds Banking Group

2.3 During 2008 and 2009 the financial markets ceased to function and the Treasury had to inject £66.3 billion in the form of ordinary and non-voting B shares into RBS and ordinary shares into Lloyds to ensure they would have sufficient capital to continue trading. The shares are held in the accounts at their market value, which has fallen to £38.4 billion since the government's original investment. In line with accounting standards, the overall decline in value is split between a temporary increase in the value of the shareholdings of £4.6 billion in 2012-13, offset by a more permanent impairment of £32.6 billion.²³

2.4 The government remains committed to returning the banks to private ownership and UK Financial Investments²⁴ continues to manage the shareholdings on the taxpayers' behalf. However, until economic and financial market uncertainties fully subside it is unlikely that any sales of the shares will recover the costs of the original investments, particularly in RBS. **Figure 3** shows that, at 31 March 2013, the market values of the shares remained below the amounts injected into the banks.

2.5 Even if any future sales did recover these amounts, it would not reflect fully the costs of the interventions. This is because the Government borrowed the money needed to make the original investments (net of underwriting fees received) in 2008 and 2009 and the cumulative cost of financing (just under 4% a year) this borrowing should be taken into account. On this basis, the market price of the shares in RBS represented a shortfall of over £25 billion at 31 March 2013 and the shares in Lloyds Banking Group a shortfall of £9 billion.

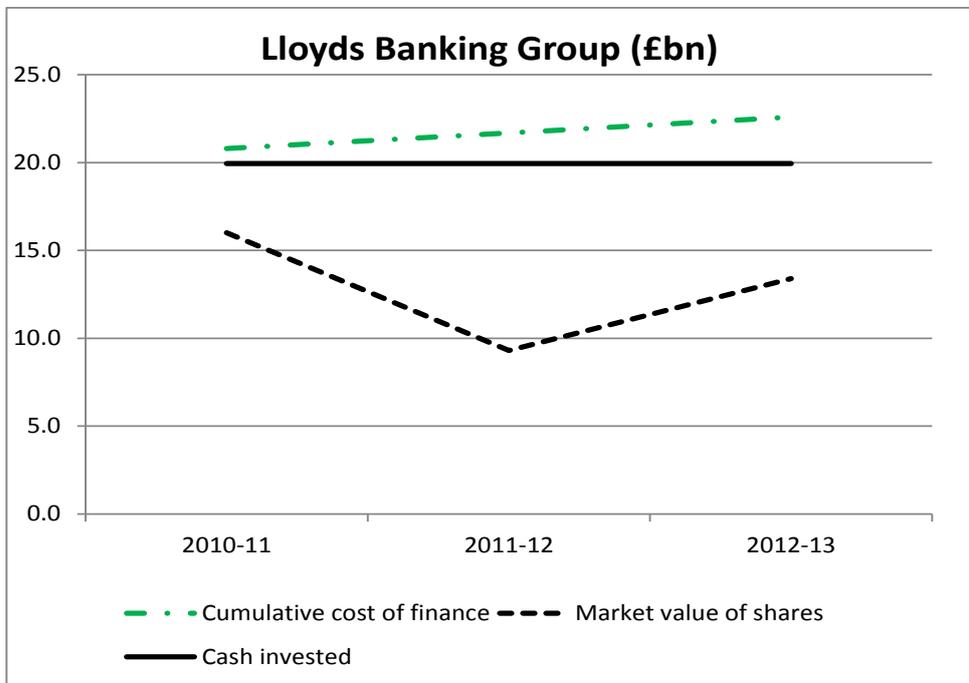
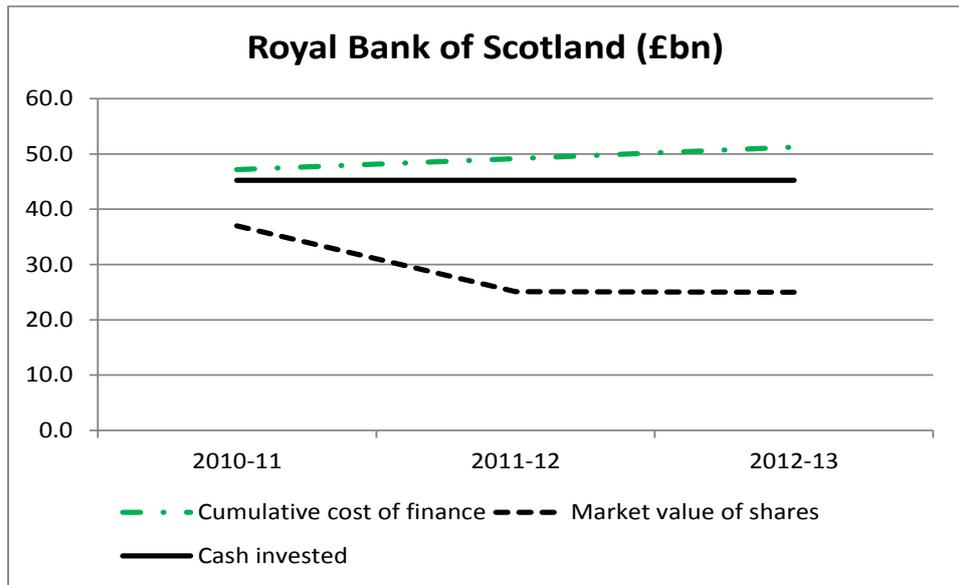
2.6 The eventual returns for the taxpayer from the disposals of the government's shareholdings in both banks will depend on how well their business plans are developed and delivered, as well as the performance of the UK economy, and these will not be known until the shareholdings are disposed of. Any shortfalls between these returns and a theoretical return that might be estimated can be regarded as part of the necessary cost of maintaining financial stability during the financial crisis and, as I reported in 2009, had public support for the banks not been provided, the potential costs would have been difficult to envision.²⁵

²³ Table 4.F Annual Report

²⁴ UKFI is responsible for managing the shareholdings in RBS and Lloyds Banking Group and is also responsible for managing UK Asset Resolution Ltd (UKAR). UKAR was formed during 2010 to integrate the activities of Northern Rock (Asset Management) and Bradford & Bingley

²⁵ 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 3: The potential loss on RBS shares increased in 2012-13, while the potential loss for Lloyds Banking Group shares declined slightly



Source: Market prices and NAO analysis

The Dividend Access Share

2.7 The Treasury also holds a Dividend Access Share (DAS) in RBS. In addition to the B shares, the DAS was created at the time the Asset Protection Scheme was being negotiated to prevent any return of capital to shareholders or payment of dividends without first paying the Treasury a preferential dividend. In practice, the DAS 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 Treasury before any further dividend on the ordinary shares can be paid.

2.8 As the DAS can only be held by the government, there is no market price for the share and accounting standards require that its value has to be estimated by modelling future dividends. Furthermore, the DAS expires when the market price of the ordinary shares in RBS equals or exceeds 650p a share over a certain period. There is therefore a significant element of uncertainty in modelling potential dividend payments, particularly in judging when any payments might commence, the period over which they would be received and in choosing an appropriate discount rate to calculate their present value. On the basis of this modelling, the DAS was estimated to have a value of £1.5 billion at 31 March 2013 (£1.8 billion at 31 March 2012). The main cause of the fall in the valuation was a change in the assumed date that dividends would begin to be paid.²⁶ This theoretical valuation does not necessarily reflect the price RBS would be prepared to pay to remove the dividend access share, which would be determined after negotiations with the Government. Some commentators regard removing the dividend access share as a prerequisite to returning RBS to private ownership.

2.9 In addition to the DAS, the Treasury remains committed until December 2014 to providing up to £8 billion of contingent capital to RBS if its regulatory capital falls below a pre-determined ratio. RBS pays an annual fee of £320 million to the Treasury for this commitment. RBS and Lloyds Banking Group announced in May 2013 that they would not require additional equity from shareholders as they expected to meet increased international requirements for regulatory capital on the basis of their existing business plans.

Progress in meeting State Aid conditions

2.10 The injections of taxpayer-funded capital into RBS and Lloyds Banking Group are subject to state aid agreements with the European Commission. These are designed to ensure a level playing field between companies that have received direct public support and those that have not. Under these agreements, both banks were required to sell elements of their businesses, including parts of their branch networks, within agreed timescales. At the beginning of 2012-13, RBS was negotiating the sale of over 300 branches to Santander and Lloyds Banking Group was in discussions to sell some 600 branches to the Co-op Bank. By April 2013, both deals had collapsed:

²⁶ Departmental Accounts, Notes 2.3, 13.1 and 23.5.2

- Santander announced in October 2012 that it had withdrawn from the deal, following delays in finalising the detailed terms. RBS has stated that it is now auctioning the branches to other potential purchasers. The deadline set by the European Commission for completion of the divestment is 31 December 2013. As the sale may not be completed by this time, it is likely that the State Aid deadline will need to be renegotiated.
- In April 2013, the Co-op announced that it was withdrawing from negotiations with Lloyds Banking Group before a contract had been signed, citing adverse economic developments. Lloyds Banking Group is now aiming to create a stand-alone bank from the 600 branches which will be floated on the stock market. It is likely that the original state aid deadline of November 2013 for completion of the disposal will also need to be renegotiated with the European Commission.

2.11 The Treasury is accountable to the European Commission for compliance by the banks with these state aid conditions and the banks would have to repay any state aid, with interest, that breached the terms of the agreements.

Strategy for the shareholdings

2.12 A Parliamentary Commission on Banking Standards was established in July 2012 to consider and report on the professional standards and culture of the banking sector and lessons to be learned about corporate governance, transparency and conflicts of interest, and their implications for regulation and for Government policy. The Commission's final report, published in June 2013, made a wide range of recommendations, including changes to the way that senior bankers are remunerated, vetted and sanctioned for misconduct. In response to the final report, the Chancellor of the Exchequer announced on 19 June 2013 that the Treasury will introduce amendments to legislation arising out of the Commission's work and consider further the recommendation that RBS should be split into a "good bank/bad bank". The Chancellor of the Exchequer also announced that the Treasury was actively considering how to sell the shareholding in Lloyds Banking Group.

Outstanding loans to financial institutions

2.13 During the financial crisis, the Treasury:

- provided a loan to Northern Rock Asset Management (NRAM) and a working capital facility to Bradford & Bingley, which together account for most of the money outstanding; and
- funded the Financial Services Compensation Scheme with loans so that it could make payments to depositors up to the compensation limit in force at the time. In addition, the Treasury also made top-up payments where deposits exceeded the existing compensation limit (referred to as statutory debt).

UK Asset Resolution

2.14 The assets and liabilities of NRAM and Bradford & Bingley remain in public ownership under a 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 has been recognised on the Treasury's balance sheet at its net asset value of £5.3 billion (£4.7 billion in 2011-12).

2.15 During 2012-13, NRAM made loan repayments of £1.9 billion (2011-12: £1.8 billion), resulting in an outstanding loan balance of £17.9 billion (2011-12: £19.8 billion). B&B made repayments of £1.2 billion (2011-12: £0.6 billion), with £6.8 billion outstanding at 31 March 2013 (2011-12: £8.0 billion). The NRAM loan and B&B working capital facility are both interest bearing. The interest rates on these loans were increased with effect from May 2012 and August 2011 respectively. Total interest charged during the year was £678 million (2011-12: £521 million).

2.16 The eventual return from UKAR is offset by the cost of the loans provided to NRAM and Bradford & Bingley, including the cost of the gilts issued to fund the loans. However, as I set out in my report²⁷ on the sale of Northern Rock plc, the taxpayer may not be fully compensated for the risk taken on, or the opportunity cost of the money lent, producing a net present cost of some £2 billion²⁸ for the Northern Rock intervention. UKFI published its first estimate of the expected returns to the taxpayer from UKAR in 2012²⁹, and will publish updated figures when there is a material change to this estimate.

Other loans

2.17 During 2012-13, repayments of £1.5 billion were received from the administrators of failed financial institutions (£1.4 billion in 2011-12). It is expected that the FSCS loans in respect of B&B, the Icelandic banks and London Scottish Bank will be recovered through payments from the failed banks and industry levies. The FSCS loans are interest bearing and, with effect from 1 April 2012, the interest rate was increased in line with EU State Aid requirements so that it does not fall below the government's cost of funding. Interest charged during 2012-13 was £429 million (£370 million in 2011-12).

2.18 Recoverability of the top-up payments made by the Treasury for deposits in excess of the FSCS limit is dependent on the administration process at each failed institution. In 2012-13, the Treasury considers that the risk of non-recovery has reduced, leading to an £8 million reduction in the level of impairments recorded³⁰. Estimates of the timescales for the recovery of all the loans outstanding are subject to inevitable uncertainty but the Treasury's current forecasts indicate that the majority of the outstanding money will be repaid over the next decade.

²⁷ Comptroller and Auditor General, *The creation and sale of Northern Rock plc*, Session 2012-13, HC 20, National Audit Office, May 2012.

²⁸ 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*.

²⁹ UKFI: Publication on the Sale of Northern Rock plc (February 2012)

³⁰ Paragraph 4.68 of Annual Report

2.19 For the failed Icelandic bank Landsbanki (which operated under the name Icesave in the UK), the Treasury also compensated depositors for the share of their deposits which should have been guaranteed by the Icelandic Depositors and Investors Guarantee Fund (the equivalent of the FSCS in the UK). In a judgment announced on 28 January 2013, the Court of the European Free Trade Association ruled that Iceland was not obliged to ensure payment of compensation to depositors after the collapse of the Icesave in 2008. This means that the Treasury cannot charge interest on the loan and can only make recoveries from the administration of Landsbanki rather than the Icelandic government.

Guarantee schemes

2.20 In addition to lending money to failing financial institutions, the Treasury also put in place two major guarantee schemes, one covering all UK banks above a certain size and the other for the Royal Bank of Scotland.

The Credit Guarantee Scheme

2.21 The Credit Guarantee Scheme (CGS) provided taxpayer guarantees for debt issued by UK banks, in return for a fee. If a bank defaulted on a debt payment covered by the scheme, the Treasury would have had to reimburse the holder of the debt. The CGS closed in 2012-13 as the last guaranteed debt issuance reached maturity in October 2012. Over the life of the scheme, fees totalled £4.3 billion and no pay-outs were made.

2.22 I reported in December 2010 that, over the life of the scheme, participating banks would benefit from reduced funding costs of substantially more than £1 billion, which was not captured by the fees charged.³¹

The Asset Protection Scheme

2.23 The Asset Protection Scheme (APS) was designed to provide participating banks with a form of insurance against future losses above a certain level on defined portfolios of assets, in exchange for a fee. By limiting potential losses in this way, the APS bolstered the regulatory capital of RBS (the only bank to participate) helping to maintain financial stability. The contingent liability for the taxpayer was around £55 billion at the start of 2012-13 and as high as £457 billion at the Scheme's peak³².

2.24 As RBS continued to manage down non-performing assets without incurring losses covered by the APS, the scheme no longer provided a material benefit for the bank's financial position. In October 2012, RBS reached the minimum fee of £2.5 billion and, with no pay-out under the scheme deemed likely, RBS was allowed to exit. The Asset Protection Agency, which was set up to administer the APS, closed during the year and its residual responsibilities have been transferred to the Treasury.

³¹ 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.

³² The maximum taxpayer exposure reflects the expectation when the Scheme was being designed that both Lloyds Banking Group and RBS would participate (C&AG's Report on 2011-12 Accounts, Figure 11)

The fees and interest received from the banks

2.25 Figure 4 shows that the Treasury received fees and interest income of £1.7 billion in 2012-13 (£4.2 billion in 2011-12). The expected returns from the wholly-owned banks, along with the fees charged for the Credit Guarantee and Asset Protection Schemes, are less than would be expected from normal market investments and have not fully compensated the taxpayer for the degree of risk accepted by taxpayers in providing the support. The fees and interest income were generally set with a view of what the recipients could afford at the time, in keeping with the aim of maintaining financial stability. Once the opportunity cost and risks are factored in, I consider that, since 2008, the support measures together represent a transfer of at least £5 billion³³ in total from taxpayers to the financial sector. This does not include the cost of holding shares in RBS and Lloyds Banking Group (paragraphs 2.4-2.5 above), which have not paid an ordinary dividend or seen a capital gain.

Figure 4: Fees and interest income in 2012-13

	2012-13 (£m)	2011-12 (£m)
Financial guarantees	150	985
RBS contingent capital fees	320	320
Interest on loans	1229	658
Special Liquidity Scheme (closure)	-	2262
Totals	1699	4225

Source: Departmental Accounts: Notes 9 and 23.3

Change in use of fines imposed by the FSA

2.26 When the FSA imposed fines on financial institutions in the past, the income was used to reduce the overall level of fees paid to the regulator by the financial services industry. During 2012-13, the FSA imposed significant fines on financial service firms, including unprecedented fines on some banks in relation to the attempted manipulation of LIBOR. The government made provision in the Financial Services Act 2012 for all financial services regulatory fines, net of enforcement case costs, to be paid to the Treasury, which will then transfer the fines to the Consolidated Fund as excess cash. Total fine income payable to HM Treasury for 2012-13 was £342 million. The Government announced in the 2013 Budget that regulatory fines will be used to

³³ The £5 billion subsidy is composed of £3 billion over the lifetime of the outstanding loans to UKAR and £1 billion each during the operation of the Credit Guarantee and Asset Purchase schemes, both of which closed in 2012-13 (C&AG's Report on 2011-12 Accounts, Figure 8)

help veterans with mental health issues and fund Christmas boxes for all troops on operations in 2013 and 2014.

Northern Rock plc

2.27 I have already reported on the sale, at the end of 2011, of Northern Rock plc to Virgin Money³⁴. The initial sale proceeds comprised £747 million cash. Further proceeds (deferred cash) of £73 million were received during 2012-13 based on the agreed net asset value of Northern Rock at completion, higher than the £60 million originally forecast. The sale agreement also included a capital instrument³⁵ and a claw back provision, which may give rise to additional proceeds:

- the capital instrument has been valued by the Treasury at £123 million, after taking account of the risk that future payments of interest and principal might not be received;
- an additional cash consideration of £50 million to £80 million would be received upon a profitable flotation or trade sale of Virgin Money in the five years following the transaction.

2.28 In addition to the sale of Northern Rock plc, in July 2012 NRAM announced the sale of £465 million of mortgages to Virgin Money.

Actions to reduce the risk to the taxpayer in a future financial crisis

2.29 The Financial Services Act 2012 abolished the Financial Services Authority and established a new system of financial services regulators from April 2013:

- The Financial Policy Committee within the Bank of England is responsible for identifying, monitoring and addressing risks to financial stability. The FPC has powers of direction over two new bodies:
 - The Prudential Regulation Authority, a subsidiary of the Bank of England, with responsibility to promote the soundness of firms through minimising the risk they pose to financial stability. The PRA will regulate the larger deposit takers, insurers and a small number of complex investment firms.
 - a conduct of business regulator, the Financial Conduct Authority, that regulates the conduct of all firms and the prudential regulation of smaller, simpler firms. It also works to ensure that the financial markets function well.

2.30 The Act also appointed the Comptroller and Auditor General as the auditor of the Prudential Regulation Authority and the Financial Conduct Authority, as well as a

³⁴ Comptroller and Auditor General, *The creation and sale of Northern Rock plc*, Session 2012-13, HC 20, National Audit Office, May 2012.

³⁵The capital instrument consisted of debt issued to the Treasury with a principal value of £150 million and discretionary interest payments of 10.5 per cent a year from 2013

number of other bodies³⁶. The Bank of England remains outside the NAO's statutory audit responsibilities.

2.31 To improve the resilience of UK banks and to ensure that future bank failures can be resolved without passing the costs to the taxpayer, a number of further reforms are underway. The Financial Services (Banking Reform) Bill was introduced in February 2013 to implement many of the recommendations of the Independent Commission on Banking, including establishing a ring-fence to separate important everyday banking activities from investment banking activities. The Bill also gives the Prudential Regulation Authority a new objective to promote the continuity of core banking services in the UK, protect banks from risks that could threaten continuity and ensure that core banking services can be maintained in the event of bank failure.

³⁶ Financial Services Compensation Scheme, Financial Ombudsman Service, Money Advice Service

Part Three: Wider support for the economy

3.1 In conjunction with the Bank of England, the Treasury has introduced measures to stimulate the economy, as well as preparing contingency plans to respond to financial instability in the Eurozone.

Actions to stimulate the economy

3.2 In exceptional circumstances, central banks may use unconventional monetary policy measures to stimulate demand in an economy. Following the failure of Lehman Brothers in September 2008, confidence in the world economy collapsed and financial markets became dysfunctional.

Quantitative Easing

3.3 In the UK, the Bank Rate was cut sharply and, in early 2009, the Bank of England initiated a programme of asset purchases (often referred to as Quantitative Easing) to stimulate demand further. Quantitative Easing is a monetary policy tool to boost the money supply by purchasing assets, mainly gilts.³⁷ The Bank creates new money electronically and uses it to purchase assets from the private sector. These investors typically would not want to hold this money in bank accounts, because it yields a low return. So they are likely to use it to purchase other assets, such as corporate bonds and shares. This additional demand for assets, other than gilts, lowers longer-term yields and borrowing costs, which should stimulate spending by businesses and households.

3.4 The aim of the policy is to inject money into the economy in order to boost nominal spending and thus help to achieve the 2% inflation target. The Bank of England's Quarterly Bulletin, published in September 2011³⁸, analysed the effectiveness of the first £200 billion of asset purchases and estimated that the programme had stimulated spending, raising UK inflation by around $\frac{3}{4}$ - 1½ percentage points and real GDP by around 1½ - 2%.

3.5 The programme is run through a wholly owned subsidiary of the Bank of England (the Bank of England Asset Purchase Facility Fund Limited – BEAPFF Ltd), which is indemnified by the Treasury against losses and the Treasury will receive any profits generated by selling the assets back to the market or holding them to maturity. As at 31 March 2013, the size of the asset purchase programme was authorised to be up to £385 billion.

3.6 The Treasury's exposure to any gains or losses is recorded in the accounts as the difference between the fair value of the assets and liabilities of BEAPFF Ltd at 31 March 2013. At 31 March 2013, the programme had made cumulative profits of £55.5 billion (2011-12: £38.5 billion). These profits mainly reflect the coupons (interest) received and the increased market value of the assets (mainly gilts) held. The profits

³⁷ <http://www.bankofengland.co.uk/markets/Documents/money/publications/redbookqe.pdf>

³⁸ <http://www.bankofengland.co.uk/publications/Documents/quarterlybulletin/gb110301.pdf>

figure is volatile but has generally increased over the past three years, in line with rising gilt prices and the expansion of the programme. The increase in profits of £17 billion during 2012-13 is recognised as a fair value gain as it increases the amount that would be due from BEAPFF Ltd to the Treasury if the programme were to close on 31 March 2013.

3.7 During 2012-13, the Treasury and the Bank of England agreed to a revised indemnity which requires excess cash to be transferred between BEAPFF Ltd and the Treasury (**Figure 5**). The purpose of this change is to enable more efficient cash management across government.

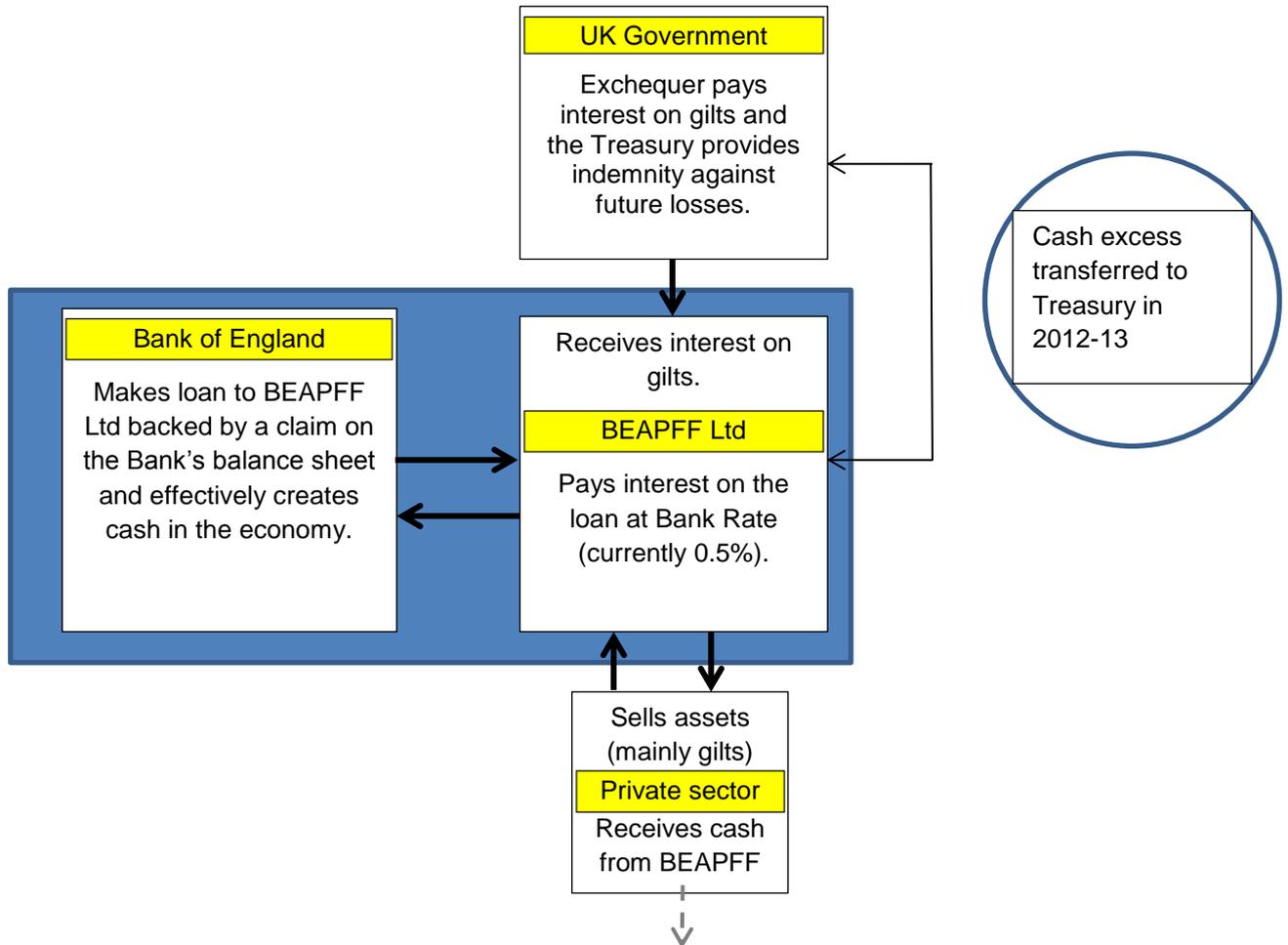
3.8 Cash transfers to the Treasury commenced in January 2013 and totalled £11.3 billion by 31 March 2013. If there is a deficit of cash in any quarter, then a transfer is made in the opposite direction, from the Treasury to BEAPFF Ltd. As and when the Bank of England's Monetary Policy Committee decides to exit quantitative easing, cash transfers are expected to reverse, consistent with the terms of the revised indemnity.

3.9 The size of these quarterly transfers, and the ultimate net amount transferred to or from BEAPFF Ltd, is uncertain and depends on a number of factors, including the future path of Bank Rate and the price of the assets when they are sold. In early 2013, the Bank of England published an article explaining how the expected size of the transfers varies depending on the assumptions made for these uncertain factors. The scenarios presented in the article involved total net transfers within a range of an £8 billion loss (a net transfer from the Treasury to the Bank) to a £51 billion gain. But the size of the net transfers is uncertain and outcomes outside this range are possible depending on the assumptions chosen³⁹. The Office for Budget Responsibility has projected a net transfer to the Treasury of around £45 billion.

3.10 It is not certain that the fair value gain recognised in the Treasury's Accounts will crystallise into a net cash gain for the Exchequer. This is because there are a number of factors that will affect the price of the assets when they are sold, such as volume of assets held and the future path of Bank Rate.

³⁹ <http://www.bankofengland.co.uk/publications/Documents/quarterlybulletin/2013/qb130103.pdf>

Figure 5: Cash transfers between BEAPFF Ltd and Treasury in 2012-13



The replacement of one financial asset (gilts) with another (cash) will influence the economy through a variety of potential transmission channels.

The Bank of England creates new money electronically and uses it to purchase gilts from private investors such as pension funds and insurance companies. These investors typically would not want to hold this money in bank accounts, because it yields a low return. So they are likely to use it to purchase other assets, such as corporate bonds and shares. In the Bank's view, this additional demand for assets, other than gilts, lowers longer-term yields and borrowing costs, which should stimulate spending by businesses and households.

3.11 In its report⁴⁰ on last year's accounts, the Committee of Public Accounts was concerned that the Treasury did not appear to know what had happened to the £375 billion injected into the economy or how the effects might be distributed across the economy. In its response⁴¹, the Treasury did not explain how the investing institutions used the £375 billion they received in return for selling their gilt holdings to BEAPFF Ltd, but has pointed to some research on its distributional impact.

3.12 The Bank of England assessed the distributional impact of quantitative easing on pensioners and savers in a paper published in July 2012⁴². The Bank considered that economic growth would have been lower without quantitative easing and unemployment would have been higher, leading to a significant detrimental impact across society. For savers, the key influence has been the significant and prolonged reduction in Bank Rate by the Bank of England, rather than quantitative easing. Nevertheless, by pushing up the prices of a range of assets, quantitative easing has boosted the value of household wealth held outside pension funds. However, the impact is heavily skewed with the top 5% of households holding some 40% of the assets affected.

3.13 For pensioners, the incomes of those already receiving a pension have not been affected. The impact on future pensioners has been broadly neutral as, for instance, the fall in annuity rates caused by a fall in gilt yields has been offset by a rise in the price of bonds and equities held in pension funds.

3.14 The Treasury Select Committee is currently taking evidence on quantitative easing, including on its distributional impacts, and will publish a report in due course.

Other actions to support lending

3.15 To reduce their reliance on taxpayer support, banks need to find alternative sources of funding or reduce their overall funding requirements, which is likely to lead to a reduction in lending to the economy. Because lending to individuals and businesses has not recovered to pre-crisis levels, the Treasury has responded by introducing a number of schemes to support the economy.

The National Loans Guarantee Scheme

3.16 The National Loan Guarantee Scheme (NLGS) was launched by the Treasury in March 2012 to provide businesses with access to up to £20 billion of cheap finance. The NLGS provides a government guarantee for unsecured borrowing by banks, reducing their cost of borrowing by one percentage point. Participating banks pass on the benefit of the guarantee through cheaper loans to businesses. Guarantees totalling £2.9 billion were made in April 2012 to Barclays and Lloyds Banking Group. Falls in the interest rates paid on secured wholesale borrowing by banks since the introduction of the NLGS mean that it is less economical for banks to raise unsecured

⁴⁰ 27th Report of Session 2012-13, HC 659

⁴¹ Government responses on the Twenty Fourth and the Twenty Sixth to the Thirty Fifth Reports from the Committee of Public Accounts Session: 2012-13 , Cm 8613, May 2013

⁴² <http://www.bankofengland.co.uk/publications/Documents/quarterlybulletin/qb120306.pdf>

funding. Banks are now using the Funding for Lending Scheme and it is unlikely that further guarantees will be made under the NLGS.

Funding for Lending

3.17 Despite the Bank of England lowering Bank Rate to 0.5% from early 2009 and purchasing £375 billion of assets under quantitative easing, lending by banks to UK households and businesses has remained broadly flat. An increase in the cost of funding for banks, caused by the intensification of the euro-area crisis, was identified by the Bank of England as one restraint on lending.

3.18 To provide further stimulus to the economy, the Bank of England introduced the Funding for Lending Scheme (FLS) in July 2012⁴³ to encourage more lending to the UK economy than would have been the case. In return for a fee, the FLS allows banks and building societies to exchange assets on their balance sheets for Treasury Bills. The Treasury Bills can then be used to borrow cash or held in banks' liquid asset buffers. The scheme also encourages lending by offering further funding to those banks that increase their net lending to the UK economy during the period June 2012 to December 2013. Unlike quantitative easing, no indemnity has been given to the Bank of England by the Treasury for the Funding for Lending Scheme, but the UK taxpayer retains exposure through the Treasury's ownership of the Bank of England.

3.19 There is no overall limit on the amount of funding that banks can access through the FLS, provided a participant has sufficient collateral. At 31 March 2013, drawings on the FLS totalled some £16.5 billion (which is around 1 per cent of lending that could be increased by the FLS⁴⁴). The three largest users of the scheme were Barclays, Lloyds Banking Group and the Nationwide Building Society. Published data indicates that, since June 2012, the majority of scheme participants have increased their lending whilst a smaller number of banks have reduced their net lending, leading to an overall net reduction of some £0.3 billion.⁴⁵ The Bank's Deputy Governor has stated on 3rd June 2013 that this *"picture of flat lending growth overall is broadly as expected at this stage..... and the plans of the FLS participants suggest that net lending volumes will pick up gradually through the remainder of 2013."*

3.20 To encourage more lending to Small and Medium Sized Enterprises (SMEs) a number of changes were made to the scheme in April 2013⁴⁶. The scheme has been extended by a further year to the end of January 2015; incentives to boost new

⁴³ <http://www.bankofengland.co.uk/publications/Pages/news/2012/067.aspx>

⁴⁴ Bank of England: Funding for Lending Scheme – Usage and lending data, March 2013
<http://www.bankofengland.co.uk/markets/Pages/FLS/data.aspx>

⁴⁵ Bank of England News Release - Bank of England and HM Treasury Funding for Lending Scheme – usage and lending data – 2013 Q1. 3 June 2013
<http://www.bankofengland.co.uk/publications/Pages/news/2013/070.aspx>

⁴⁶ <http://www.bankofengland.co.uk/publications/Pages/news/2013/061.aspx>

lending will be skewed heavily towards SMEs and the scheme will include lending by non-bank credit providers, such as financial leasing and factoring companies.

3.21 The Bank of England and the Treasury are monitoring the scheme through a joint Oversight Board that meets on a quarterly basis. The extent to which banks and other financial institutions make further use of the FLS will depend on the cost of alternative sources of funding, which have fallen since the FLS was introduced.

Business Finance Partnership

3.22 The Business Finance Partnership (BFP) was introduced in the Chancellor's Autumn Statement in November 2011 with the aim of increasing the supply of capital through non-bank lending channels and, in the longer term, to help to diversify the sources of finance available to businesses. It aims to co-invest a total of £1.1 billion through these channels, matched by at least equal private sector capital, to help create new sources of lending for small and mid-sized businesses in the UK. Since the scheme's introduction, the Treasury, through its Infrastructure Finance Unit Limited, undertook tender exercises to appoint the first tranche of fund managers to manage the investments. Once the first fund manager was appointed in November 2012, it began to seek businesses to invest in and undertake due diligence. The first investment was made in March 2013 of some £5 million⁴⁷.

UK Guarantees

3.23 The UK Guarantees scheme was announced in July 2012 in response to constraints in the long-term debt markets. Up to £40 billion of guarantees can be offered in aggregate. Two guarantees were approved but not issued in 2012-13: to support up to £1 billion of borrowing by the Greater London Authority for the Northern Line extension and a guarantee of £75 million to Drax Power for the partial conversion of a power station to biomass.

Help to Buy Scheme

3.24 In recent years, increased deposit requirements and falling equity values have left many people unable to get onto the housing ladder or move home. In March 2013, the Government announced a Help to Buy Scheme, developed by the Treasury, which will provide a new mortgage guarantee to enable people to obtain mortgages on both new build and existing homes, without the need for a large deposit.

3.25 The Help to Buy mortgage guarantee is designed to increase the appetite of mortgage lenders for high loan-to-value lending to creditworthy customers. From January 2014, the scheme will provide lenders with the option to purchase a Government guarantee that compensates them for a portion of their losses in the event of foreclosure. The Government will charge a commercial fee for the provision of this guarantee.

⁴⁷ Departmental Accounts, Note 13 and Annual report paragraphs 4.87 and 4.88

Support to other countries

3.26 Financial market tensions led to some countries seeking international financial assistance, including from the UK.

Bilateral loan to Ireland

3.27 During 2012-13, Ireland drew down a further £1.2 billion against its £3.2 billion facility, bringing the total loan balance to £2.4 billion. A further instalment of £0.4 billion was made in June 2013 and the final tranche of £0.4 billion will be drawn down as soon as is practicable following the end of the next reporting period, which ends on 30 September 2013.

3.28 In July 2011, following the euro-area's commitment to lower the interest rate on their loans to Ireland, the Chancellor committed in principle to lower the interest rate on the UK's bilateral loan to Ireland. On 4 October 2012 the bilateral loan agreement was revised, reducing the interest rate to the UK's cost of funding plus a service fee of 0.18 per cent, below the rate that would be charged by the market. The new interest rate was applied retrospectively. Following the reduction to the interest rate, the interest charge for 2012-13 was £45.9 million.

IMF and European Union

3.29 In addition to the bilateral loan to Ireland, the Government has continued to support IMF programme loans through the National Loans Fund (NLF). The UK holds contingent liabilities for the European Financial Stabilisation Mechanism, which is available to all EU Member States, and the European Balance of Payments Facility, which is available only to non-euro area Member States. Both these mechanisms are financed by the European Commission raising money on capital markets, guaranteed by the EU budget. The UK's contingent liabilities for these mechanisms are reflected in the Consolidated Fund Accounts 2012-13.

3.30 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.

Part Four: The Treasury's capacity to respond to a future financial crisis

4.1 Prior to 2007, the maintenance of financial stability had not, in terms of staff resources, been a major part of the Treasury's work. In dealing with Northern Rock and subsequent events, the Treasury had to respond very quickly. The availability of people with relevant skills and experience was severely stretched. The Treasury was therefore very reliant on key officials and external advisers for the expertise it needed.

4.2 Following calls from the NAO and the PAC for a lessons learned exercise the Treasury conducted an internal review of its management response to the financial crisis with the aim of making changes to ensure that the necessary capability would be in place for future events. The Financial Crisis Management Review's main conclusions were that Treasury needed to improve its horizon scanning, financial services expertise, staff management and retention, contingency planning and crisis management.

4.3 Horizon scanning has been improved by the establishment the Financial Policy Committee of the Bank of England, which will monitor the UK economy and report on risks to long term growth. The new Prudential Regulation Authority will act on concerns raised by the FPC. A Treasury team has been set up to analyse and advise the Chancellor on outputs from the Bank. In addition, the Treasury's own business planning and risk management framework provides for the monitoring of risk indicators across its portfolio of responsibilities.

4.4 Other recommendations are being addressed by a wider review of the Treasury, which reorganised the department into more flexible business units, including a central project pool. The Treasury is also addressing the recommendations around the creation of a more stable workforce by reducing turnover and developing, adequately rewarding and retaining desirable skills. Among the steps being taken is the introduction of a new grade, just below the level of the Senior Civil Service, to recognise and stretch staff with specialist knowledge, professional skills and valuable experience. The first tranche of post holders is in place, with the intention of building to around 80 posts.

4.5 The capacity of the Treasury to react quickly to events was tested in 2013 when Treasury officials provided technical assistance to and worked with the Cypriot authorities to develop a solution for deposits held in the UK branch of Cyprus Popular Bank.

4.6 Implementation of the Financial Crisis Management Review recommendations was recently examined by the Treasury's internal auditors who concluded that good progress had been made and that work should continue to ensure that the initiatives become fully operational. The Treasury's Accounting Officer has undertaken to provide an update on progress to the Committee of Public Accounts during the summer.

Amyas C E Morse
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