National Audit Office

HM Treasury Annual Report and Accounts 2013-14

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

This is an extract from the Certificate and Report of the Comptroller and Auditor General on the HM Treasury Annual Report and Accounts 2013-14 (HC 20 July 2014)

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

Sir Amyas Morse KCB

Comptroller and Auditor General

National Audit Office

14 July 2014

Our vision is to help the nation spend wisely.

Our public audit perspective helps Parliament hold government to account and improve public services.

The National Audit Office scrutinises public spending for Parliament and is independent of government. The Comptroller and Auditor General (C&AG), Sir Amyas Morse KCB, is an Officer of the House of Commons and leads the NAO, which employs some 820 staff. The C&AG certifies the accounts of all government departments and many other public sector bodies. He has statutory authority to examine and report to Parliament on whether departments and the bodies they fund have used their resources efficiently, effectively, and with economy. Our studies evaluate the value for money of public spending, nationally and locally. Our recommendations and reports on good practice help government improve public services, and our work led to audited savings of £1.1 billion in 2013.

Contents

Summary

Scope of this report

1 This is my fourth report on HM Treasury’s Annual Report and Accounts. The purpose of my report is to provide an overview of the context in which I have carried out my audit of the Treasury's 2013-14 financial statements; and details of my assessment of audit risk arising from the Treasury's major financial stability and wider economic support schemes. This includes the approach I have taken to the risks which had the most impact on directing my audit effort.

Scope of financial audit

2 The purpose of an audit is to enhance the degree of confidence of intended users in the financial statements. This is achieved by the expression of my opinion which reports whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework. I also express an opinion on the regularity of the entity’s income and expenditure (i.e. whether they accord with Parliamentary intention). Under the Government Resources and Accounts Act 2000, I am required to audit, certify and report on the financial statements of HM Treasury.

3 I applied the concept of materiality both in planning and performing my audit, and in evaluating the effect of misstatements on my audit and on the financial statements. This approach recognises that financial statements are rarely absolutely correct, and that an audit is designed to provide reasonable, rather than absolute, assurance that the financial statements are free from material misstatement or irregularity. A matter is material if its omission or misstatement would reasonably influence the decisions of users of the financial statements. Annex 1 provides more detail on my approach to determining materiality and the materiality levels applied to my audit of the HM Treasury financial statements.

4 My audit approach is risk based, informed by my understanding of HM Treasury's activities and my assessment of the risks associated with the financial statements. This focusses my audit on the areas of highest risk, such as those affected by significant accounting estimates or management judgement. These areas are defined as significant risks. The risk solely relates to the risk of material misstatement in the presentation of the financial statements or risk of material irregularity, so a business or operational risk, on its own, is not sufficient to be considered a significant risk, although there may be overlap between the two.

5 My audit opinion on the financial statements considers the regularity of transactions but does not consider whether the activities of HM Treasury represent value for money. I have statutory authority to examine and report to Parliament on whether departments and the bodies they fund have used their resources efficiently, effectively, and with economy. In addition to the findings of my financial audit, this report draws on observations from my wider work on HM Treasury and reports to Parliament on my scrutiny of public spending.

Conclusions

6 I completed my audit in line with my planned audit approach and have issued clear opinions on HM Treasury's 2013-14 financial statements. In reaching these opinions I am satisfied that I have obtained sufficient appropriate evidence that the key risks I identified have not led to material misstatement in the financial statements. Further details of these risks can be found in the remainder of this report.

Part 1 - The context for my financial audit of the Treasury

1.1 HM Treasury (the Treasury) is the UK's economics and finance ministry with overall responsibility for public spending. The Treasury's financial statements show the Statements of Comprehensive Income, Financial Position and Cashflows of the Treasury and the Debt Management Office (the parent) and all bodies within Treasury's departmental boundary (the group)[1], as defined by the Government Financial Reporting Manual.

1.2 From a Statement of Financial Position perspective, there are two bodies in the group, in addition to HM Treasury (**Figure 1**), that are significant to my audit: the Financial Service Compensation Scheme (FSCS); and the UK Asset Resolution group (UKAR).

- FSCS was established under the Financial Services and Markets Act 2000 to provide compensation to customers of authorised financial services firms that are unable, or likely to be unable, to pay claims against them. Compensation paid by FSCS is recovered from the administrators of the failed financial services firms or recovered from the financial services industry through an annual levy. In addition to accounting for levies and compensation, the most significant balances in the FSCS accounts are the loans received from HM Treasury to finance compensation paid during the financial crisis, totalling some £16.6 billion at 31 March 2014 and the related receivables to recover this compensation, of some £16.6 billion.
- UK Asset Resolution was established to facilitate the management of the closed mortgage books of the nationalised Northern Rock (Asset Management) and Bradford and Bingley banks. The most significant transactions in the UKAR accounts are mortgages and other loans to customers, totalling some £61.2 billion at 31 March 2014, and the interest and other income statement movements relating to these of £ 2.3 billion. Other significant transactions and balances relate to the debt securities totalling £25.9 billion relating to the securitisation process used by the banks to raise funds backed by their assets, primarily mortgages.

[1] The Office for Budget Responsibility, UK Financial Investments Ltd, Infrastructure Finance Unit Ltd, Financial Services Compensation Scheme, Money Advice Service, UK Asset Resolution Group (including the Bradford and Bingley and its subsidiaries, Northern Rock (Asset Management) and its subsidiaries and UK Asset Resolution Corporate Services Ltd)) and Help to Buy (HMT) Ltd.

Figure 1
HMT Group Balance Sheet – Bodies with the largest assets

Notes
1 Figures represent gross assets of individual components at 31 March 2014.
2 HM Treasury Group figure is net of intra-group eliminations.

Source: National Audit Office analysis of HM Treasury Annual Report and Accounts 2013-14

1.3 Since 2007, the Treasury's interventions to maintain financial stability and support wider economic growth have dominated its financial statements. As a result the costs associated with running the administrative functions of the Treasury are insignificant to the accounts in comparison.

Financial stability support

1.4 Between 2007 and 2010, the Treasury made a series of large financial interventions to support UK banks. Support (**Figure 2**) was provided in the form of:

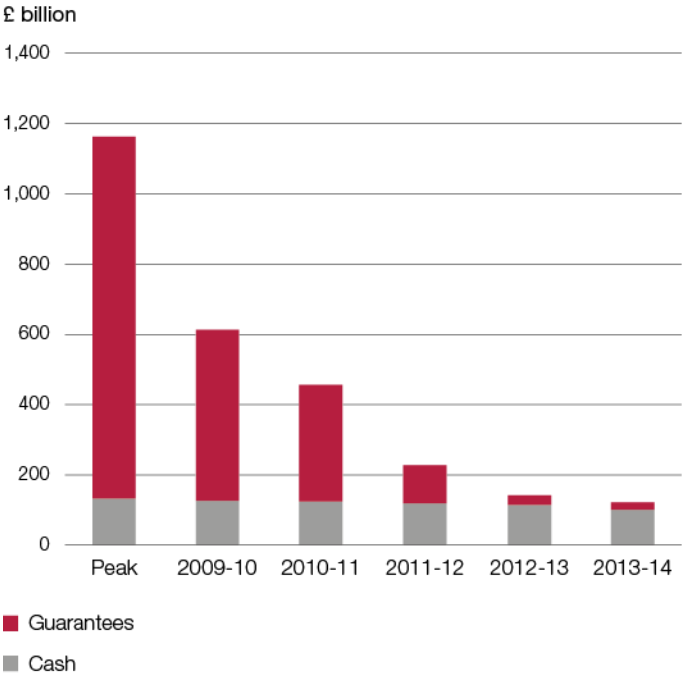
- Cash - direct cash support such as loans made to a range of financial institutions and the purchase of shares in two large banks, RBS and Lloyds Banking Group, are recognised as assets in the Statement of Financial Position.
- Guarantees - Guarantees do not involve direct cash support but expose HM Treasury to potential liabilities if the guarantees are called[2].

[2] Under accounting standards, the Statement of Financial Position only records the fair value of the guarantee liability (a representation of the risk to which HM Treasury is exposed which is usually equal to the fee received for provision of the guarantee). The maximum exposure to losses due to the guarantees is disclosed as a contingent liability

1.5 The Treasury's focus has shifted from financial stability to economic growth since 2009-10. The balances associated with these support mechanisms have steadily decreased as loans are repaid, shares are sold and guarantees are extinguished. This pattern is expected to continue in the coming years. I provide further comment on financial stability support in Part 2.

Figure 2

Financial stability support to banks



Notes

1 Cash support refers to the cash investment in shares and loans to banks.

2 Investment in shares includes losses on the basis of sales proceeds received to date.

3 Guarantees represent contingent liabilities and financial commitments to banks.

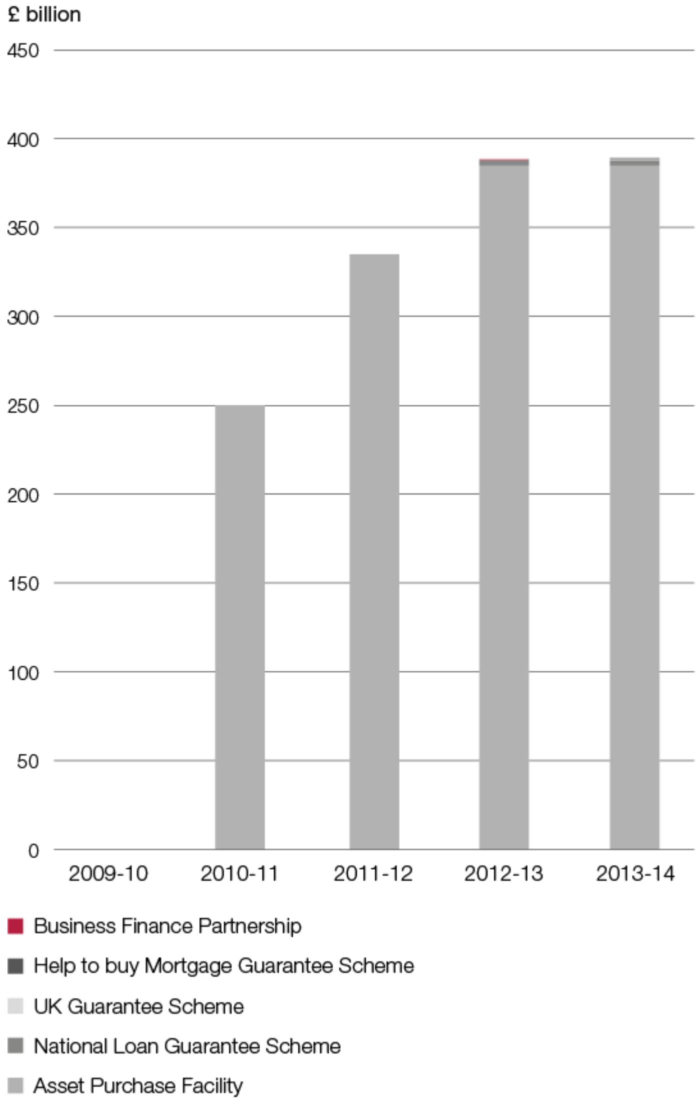
Source: National Audit Office analysis

Wider economic support

1.6 Following the end of the immediate financial crises, the Treasury has focussed on schemes to support the wider economy. Under the majority of these schemes the Treasury has provided guarantees or indemnities rather than direct cash support. This means that the support schemes' impact on the Statement of Financial Position is limited, at present, but the maximum liability to which the Treasury is exposed is increasing (**Figure 3**) and will over the coming years become the dominant feature in the Treasury's financial statements. Due to their nature, the likelihood of guarantees being called upon is closely linked to the economic position of the UK, which means that the Treasury's financial exposure will be directly linked to macroeconomic risk in the coming years. I provide further comment on the wider economic support initiatives in Part 3.

Figure 3

Wider economic support schemes



Notes

1 Figures represent maximum exposure through contingent liabilities for Help to Buy Mortgage Guarantee Scheme, UK Guarantee Scheme, National Loan Guarantee Scheme and Asset Purchase Facility.

2 UK Guarantee Scheme also includes commitments to provide loans.

3 Business Finance Partnership represents investment made and excludes future commitments to invest.

Source: National Audit Office analysis

Statement of Financial Position focus

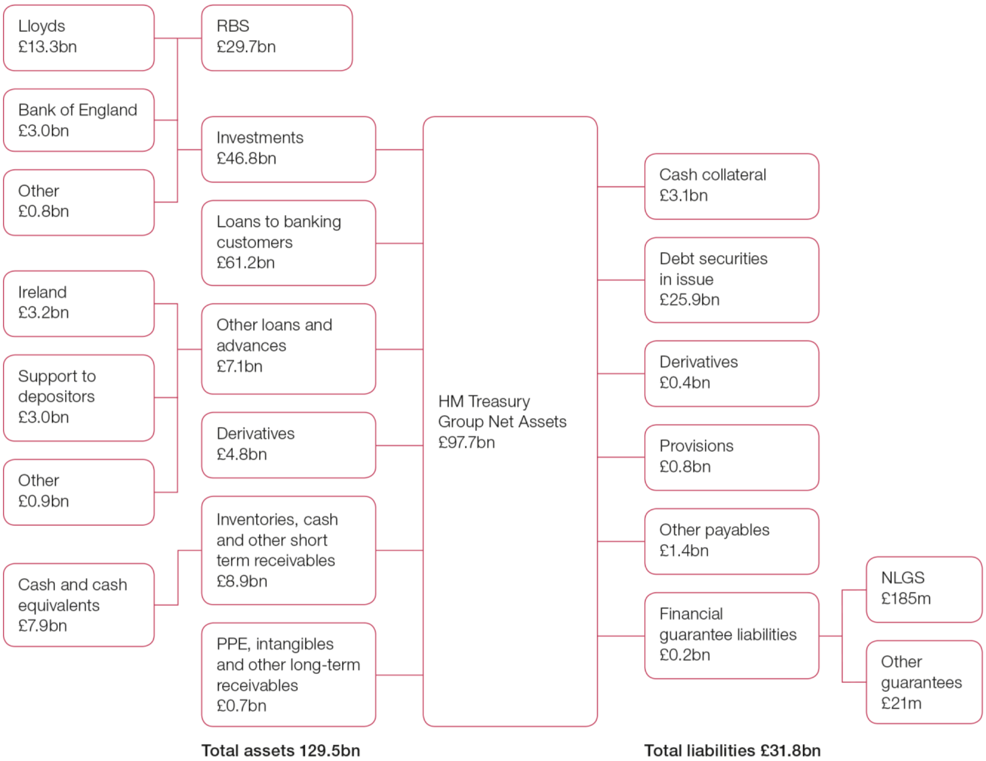
1.7 These interventions, together with the activities of FSCS and UKAR, illustrate that the main financial risks for HM Treasury are derived from the Statement of Financial Position (**Figure 4**) which has grown significantly since the financial crisis

(**Figure 5**) rather than expenditure reported in the Statement of Comprehensive Net Expenditure. In addition, the size and significance of FSCS and UKAR, together with the operations of the majority of the financial stability and wider economic support interventions, the majority of which are run by external parties on behalf of the Treasury means that the core department needs to manage a range of diverse partners to control the Group's finances.

1.8 It is important that the Treasury's approach to financial management is able to address the financial risks that these items represent, particularly as the investments in banks; UKAR's mortgage book; the UK Guarantee Scheme; and the Help to Buy Guarantee Scheme are long term in nature and will be in place for many years to come.

Figure 4

HM Treasury Group Statement of Financial Position as at 31 March 2014



Notes

1 Other loans and advances are stated net of £41.1 billion of loans provided by HM Treasury and FSCS to Bradford and Bingley and NRAM eliminated on consolidation.

2 Investments are stated net of HM Treasury's £6.1 billion investment in UKAR eliminated on consolidation.

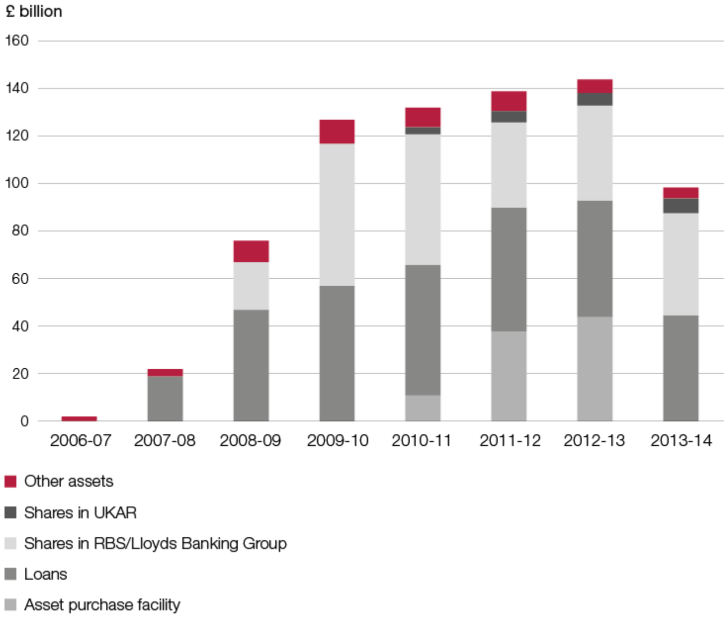
3 Deposit guarantees are stated net of £460 million provided by HM Treasury to Bradford and Bingley and NRAM eliminated on consolidation.

4 Contingent liabilities of £12.8 billion (£9.7 billion of which are eliminated on consolidation) relating to financial guarantees are disclosed in the accounts but not recognised in the Statement of Financial Position.

Source: National Audit Office Analysis of HM Treasury Annual Report and Accounts 2013-14

Figure 5

HM Treasury core gross assets



Note

1 Figures represent gross assets of Core HM Treasury.

Source: National Audit Office analysis of HM Treasury Annual Report and Accounts

Parliamentary control totals over resources

1.9 The impact of the Treasury's Statement of Financial Position is also shown in its Statement of Comprehensive Net Expenditure and outturn against its Parliamentary Supply Estimate[3]. The most significant items of income and expenditure in the accounts are derived from the financial interventions, for example interest on loans totalling some £2.9 billion, gains on disposal of shares of £4.1 billion and fair value movements on derivatives of £13.0 billion.

1.10 HM Treasury is in a unique position[4] among the main government departments whereby the income and cash received from the Financial Conduct Authority's fines

[3] Supply Estimates provide income and expenditure, both capital and resource, on an accruals basis and cash requirements for each government department. The supply received is voted by Parliament and authorised under the Supply and Appropriation Act for the financial year. The amounts voted under the Supply and Appropriation Act are known as parliamentary control totals. These control totals can be amended during the year through the Supplementary Estimates but spending cannot be carried forward to the next financial year unless it is included in a subsequent Estimate

[4] Other Departments that generate significant revenue for Government, such as HM Revenue and Customs or the Department for Transport via the Drivers and Vehicle Licencing Agency, include their revenue within Trust Statements and it is paid directly to the Governments central Consolidated Fund.

exceeds its expenditure and therefore its Departmental Expenditure Limit control totals are negative. HM Treasury also has a negative capital Annually Managed Expenditure capital control total, due to the treatment of the capital payments on its loans and disposal of shares. Outturn against each of the voted Parliamentary control totals is reported in the Statement of Parliamentary Supply and is subject to my opinion on regularity every year. HM Treasury has not breached any of the control totals for this financial year.

Part 2 - Financial stability schemes

2.1 This Part of the Report provides an overview of my assessment of risk of material misstatement for my audit arising from the Treasury's significant financial stability schemes and the impact on my audit approach.

2.2 Following the closure of the Asset Protection Scheme[5] and Credit Guarantee Scheme[6], which exposed HM Treasury to contingent liabilities and other support of more than £1,000 billion at their peak[7], unwinding of the financial stability schemes has continued through 2013-14. The most significant changes are the further £5.7 billion repayment of loans and the sale of shares in Lloyds Banking Group which generated proceeds of £7.4 billion.

2.3 The main residual elements of the Treasury's financial stability interventions are the loans to Northern Rock Asset Management (NRAM) and Bradford and Bingley, which following the sale of Northern Rock plc[8] to Virgin Money in 2012 have been brought under the control of UK Asset Resolution (UKAR)[9], and the Treasury's holdings of shares in Lloyds and Royal Bank of Scotland.

Loans

2.4 During the financial crisis some financial institutions could no longer guarantee that they had sufficient funds to repay depositors, which meant that their customers' cash was at risk. To counter this and provide support and confidence in the UK banking sector, the Treasury provided loans to UK banks and the FSCS, which administered the Government backed compensation scheme for deposits that could not be repaid.

2.5 Northern Rock Asset Management (NRAM) and Bradford and Bingley are the two remaining financial institutions that continue to benefit from significant support in

[5] The Asset Protection Scheme was an insurance based scheme that provided coverage for banks that had significant exposure to bad loans during the financial crisis. The NAO reported on the Scheme in December 2010. http://www.nao.org.uk/report/hm-treasury-the-asset-protection-scheme/

[6] The Credit Guarantee Scheme was part of the Government’s actions to support the banking sector in October 2008. The purpose of the scheme was to help restore confidence by making available, to eligible institutions, a government guarantee of new debt issuance.

[7] Comptroller and Auditor General, HM Treasury Annual Report and Accounts 2011-12, HC 46, HM Treasury, July 2012, Chapter 8, Figure 3

[8] Northern Rock was split into two businesses in 2009: Northern Rock plc, a deposit-taking and mortgage-providing bank that could be returned to private sector ownership; and Northern Rock (Asset Management) plc (NRAM), to retain in public ownership the majority of the outstanding mortgages that would be wound down.

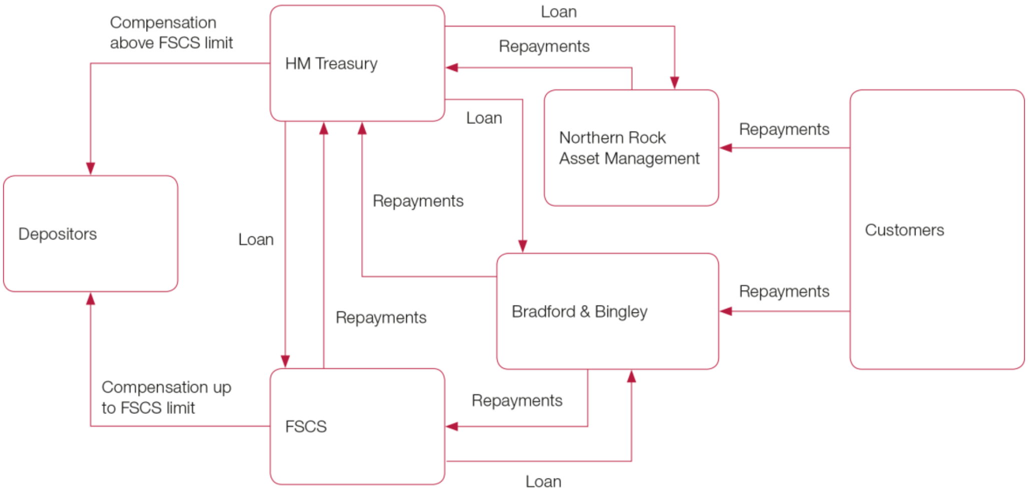
[9] UKARs 2013-14 results announcement, http://www.ukar.co.uk/~/media/Files/U/Ukar-V2/Attachments/press-releases/ukar-annual-report-and-accounts-2014-press-release.pdf, accessed 12 June 2014

the form of loans from the Treasury. The Treasury also has outstanding loans relating to a range of other financial institutions, which are supported by FSCS's powers to impose levies on the wider banking industry.

2.6 Bradford and Bingley and NRAM continue to run-down their mortgage books, but are closed to new business. The loans provided to these banks, which total some £37.9 billion, are being recovered by the Treasury through the income and capital repayments generated by the winding down of the banks' residential mortgage books, as illustrated by **Figure 6**, which total some £61.2 billion. The loans used to pay compensation to depositors in other financial institutions, totalling some £3.0 billion, are being recovered by the Treasury and FSCS through the administrators of the failed institutions and levies imposed on industry to cover any shortfall.

Figure 6

Cash flows associated with loans to Bradford and Bingley and NRAM



Notes

1 HM Treasury has provided loans to NRAM and Bradford and Bingley and a working capital facility to Bradford and Bingley.

2 FSCS has provided Bradford and Bingley with a loan to pay compensation to depositors.

Source: National Audit Office

2.7 The total value of loans outstanding is recorded as an asset in the Treasury accounts. At the year end this totalled £44.5 billion, a reduction of £4.5 billion compared to the prior year.

Audit risk

2.8 The repayment of loans by UKAR will be made over the next 10 to 15 years, using the cash flows from interest payments and redemptions of residential mortgages held by Bradford and Bingley and NRAM. If the cash flows from these mortgages are insufficient to repay the loans from the Treasury, then this may indicate a need for the Treasury to reduce their carrying value. Where loans are recoverable directly from the administrators of failed institutions, there is uncertainty around the level of funds to be distributed from the winding down of their business and the repayment of loans by FSCS is dependent upon recoveries from administrators and its ability to levy the industry for any shortfall.

2.9 Due to these uncertainties. I assessed that the valuation of the loans represented a significant risk of material misstatement for my audit of the Treasury's individual financial statements and the consolidated group, due to the inherent uncertainty over their recoverability and the expected timing of repayments.

Audit approach

2.10 My audit approach addressed this significant risk through my review of the modelling techniques, assumptions and judgement made by management which underpin the valuation of the loans in the HM Treasury financial statements. This involved examining the evidence to support the recoverability of the loans, the assumptions made by management and the expected timing of cash flows. I have also taken assurance from the audit opinion provided by the auditors of UKAR and from my own audit of FSCS.

Investment in UKAR

2.11 As explained in paragraph 1.2, UKAR is the holding company for the nationalised NRAM and Bradford and Bingley banks. In September 2012, UKAR was designated for consolidation with the HM Treasury group accounts from 2013-14[10]. As a result, UKAR's financial statements have been fully consolidated into the Treasury's group accounts for the first time this year. To achieve this consolidation UKAR has produced financial statements with accounting policies and reporting periods that align with HM Treasury's.

2.12 The consolidation of UKAR means that the group accounts now recognise the substantial assets and liabilities of Bradford and Bingley and NRAM. The most

[10] 2013 No. 3187, The Government Resources and Accounts Act 2000 (Estimates and Accounts) (Amendment) Order 2013

significant assets are the residential mortgage books and other loans totalling £61.2 billion. The most significant liabilities, excluding UKAR's loans from HM Treasury which are eliminated on consolidation, are debt securities totalling £25.9 billion relating to the securitisation process used by the banks to raise funds backed by their assets, primarily mortgages.

Audit risk

2.13 I assessed that the first time consolidation of UKAR within the Treasury group represented a significant risk to my audit as the inclusion of the balances and transactions fundamentally changes the nature of the Treasury's consolidated accounts. In addition, UKAR's business, as a commercial bank, is very different to the Treasury's, which increased the complexity of the consolidation process and significantly increased the range of disclosures in the group accounts. This is mainly due to the financial instruments held by UKAR, but also the cash flows associated with them.

Audit approach

2.14 My approach to the audit of the significant risk was to focus on HM Treasury's work to align the accounting policies of UKAR with those of the group and the process it followed for consolidating the bodies to prepare group accounting. This included the preparation of restated comparatives, which comply with the disclosure requirements of the accounting framework and meet the needs of users of the financial statements. I used the work UKAR's auditors performed on the component information provided to HM Treasury by UKAR and tested the consolidation process including adjustments to the information submitted by UKAR made by HM Treasury.

2.15 The process of combining UKAR's figures with the other bodies in the Treasury's group has been difficult to implement and challenging to audit. One particular area of concern was my audit of the group's Statement of Cash Flows. The Treasury has struggled to combine UKAR's reconciliation of its Statement of Cash Flows with the remainder of the Group due to methodological differences in its presentation. To address this, the Treasury has included additional items relating to UKAR cash flows in the group Statement of Cash Flows and I have obtained assurance on the accuracy of UKAR's statement from the work performed by its auditors. Whilst it was resolved to my satisfaction for 2013-14, the Treasury is doing further work with UKAR to improve the presentation in future years.

Investments in RBS and Lloyds

2.16 The Treasury injected capital of £66.3 billion in the form of shares in the Royal Bank of Scotland (RBS) and Lloyds Banking Group (Lloyds) during the financial crisis to ensure that they would have sufficient capital to continue trading. In addition to purchasing ordinary shares in both banks, the Treasury subscribed to 51 billion non-voting B shares in RBS and received one enhanced Dividend Access Share (DAS) as part of the arrangements for RBS’s participation in the Asset Protection Scheme. The DAS was created to prevent any return of capital to shareholders or payment of dividends without first paying the Treasury a preferential dividend by conferring upon holders of B shares an additional dividend over that paid to ordinary share holders.

Figure 7

Shareholding in RBS and Lloyds at 31 March 2014

Type of share	Number of shares (m)	Share price (pence)	Value (£m)
Lloyds ordinary shares	17,771	74.65	13,266
RBS ordinary shares	3,964	311	12,330
RBS B shares	51,000	311	15,861
RBS Dividend Access Share	1	n/a	1,485[1]

Note

1 Valuation of RBS Dividend Access Share is based on the retirement agreement between RBS and HM Treasury.

Source: HM Treasury Annual Report and Accounts 2013-14

2.17 The Government is committed to returning the banks to private ownership and the first disposals of Lloyds shares were made during 2013-14 in two separate sales processes in September 2013 and March 2014[11]. It is widely considered that the first stage required in disposing of RBS shares will be to extinguish the DAS. In April 2014 RBS announced that it had reached agreement with the Treasury and the European Commission for the future retirement of the DAS for some £1.5 billion, which was approved by its independent shareholders on 25 June 2014.

2.18 As shown by **Figure 7**, the value of ordinary shares of £12.3 billion in RBS and £13.3 billion in Lloyds represents their market price at 31 March 2014. The RBS B shares are convertible to ordinary shares at a ratio of 10:1 and their value of £15.9 billion at 31 March 2014 is therefore based on the market price of ordinary shares on this date. Changes in the value of shares, other than significant reductions in value, are recognised directly in the Treasury's reserves and are only recognised as income or expenditure when the shares are sold. This means the Lloyds sale resulted in the recognition of an accounting profit of £4.1 billion despite the difference between the sale price and purchase price being a loss of £7.1 billion as previous falls in share price of £11.2 billion have already been recognised as expenditure in previous years (**Figure 8**).

[11] Comptroller and Auditor General, *The first sale of shares in Lloyds Banking Group*, Session 2013-14, HC 883, December 2013

Figure 8

Lloyds share sale calculation of accounting profit

Sale date	Shares sold (m)	Purchase price[1] (pence)	Sale price (pence)	Net gain /(loss) (£m)	Previous impairments (£m)	Profit on disposal recognised in 2013-14 Statement of Comprehensive Net Expenditure[2] (£m)
17 September 2013	4,282	174.46	75.0	(4,259)	6,032	1,774
26 March 2014	5,555	126.92	75.5	(2,857)	5,184	2,328
Total	**9,837**			**(7,116)**	**11,216**	**4,102**

Notes

1 HM Treasury account for share sales on a "first in, first out" basis. As shares sold in each transaction were bought at dfferent dates at different purchase prices, the purchase price shown above is the average price paid for those shares. The purchase price of 126.92 pence is adjusted to recognise the price of shares on completion of the transaction. HM Treasury purchased a tranche of shares under a forward contract, which meant that a gain of some £580 million was recognised on this contract.

2 Profit on disposal includes selling costs and rebates, which net to a gain of £1 million.

Source: National Audit Office summary of HM Treasury calculations for the purposes of the accounts

Audit risk

2.19 The ordinary shares have a market price so although they are a material balance in the accounts and have been the subject of significant public interest during 2013-14, their valuation and calculation of any profit or loss on disposal is not subject to management estimation or judgement and I do not consider there to be a significant risk of material misstatement for my audit. This also applies to the RBS B shares which are valued on the basis of the share price for ordinary shares.

2.20 In previous years, the valuation of the DAS has been based on a complex valuation model as the share has no quoted price. Following the announcement of the retirement agreement between RBS and the Treasury the level of estimation and judgement involved in this valuation has been reduced and while there remains some uncertainty around the timing of the dividend payments I did not consider this to represent a significant risk for my audit.

2.21 My report to Parliament, *The first sale of shares in Lloyds Banking Group*, in December 2013 considered the value for money obtained by HM Treasury in making the first sale of shares in Lloyds. **Box 1** provides an update to this report considering the value for money obtained from the second share sale in March 2014.

Box 1

Sale of shares in Lloyds Banking Group

To maintain financial stability at the height of the financial crisis in late 2008, the government provided public support to the banking sector, including the purchase of £20 billion of shares in Lloyds Banking Group. United Kingdom Financial Investments, a company established by the Treasury to manage the government’s stakes in banks, sold some of the shares in Lloyds in September 2013 and March 2014. The sales raised a total of £7.4 billion and reduced the taxpayers’ shareholding from 39 per cent of the bank’s entire share capital at 1 April 2013 to 25 per cent at 31 March 2014.

The first sale

In December 2013, the National Audit Office reported[1] to Parliament on the conduct of the first sale. In summary, the report found that the first sale represented value for money. The sale took place when the shares were trading close to a 12-month high and at the upper end of estimates for the fair value of Lloyds's business. UKFI conducted a thorough review of its options, chose a sale process that maintained flexibility and completed the transaction quickly. The shares were sold at a relatively low discount to their market price compared with discounts seen in similar sales, and the share price in the immediate after-market remained steady.

The second sale

The second sale was conducted using the same process as the first, but was the largest sale of its type on record (outside of the US). The second sale was completed at a higher discount to the market price of the shares than the first sale, although the discount was below the average seen in comparable transactions (Figure 9).

Pricing and allocation of shares

In planning and executing the second sale, UKFI took action to implement a recommendation from the NAO that would help in the pricing and allocation of shares for the second and future sales. After the first sale, UKFI analysed the Lloyds shareholder register and trading records from investment banks, to assess whether or not the pricing and allocation of shares was appropriate.

The analysis, which covered some 80 per cent of the trading flows, supported UKFI’s policy of ensuring a stable aftermarket by allocating shares to institutions regarded as longer-term rather than shorter- term investors. Trading flows in the three months following the first sale indicated that institutional investors who were seen as longer-term holders of the shares were in aggregate net buyers while those seen as shorter-term investors were net sellers. UKFI intends to build on this analysis for future sales.

Taxpayer gain or shortfall

In 2009, the first report on maintaining financial stability published by the National Audit Office concluded that the scale of the economic and social costs from the collapse of one or more major UK banks was difficult to envision and that the interventions to support the banks were justified.[2] The final cost to the taxpayer would not be known for a number of years, but its major determinant will be the prices obtained for the taxpayers' shareholdings in Lloyds and Royal Bank of Scotland.

The Government purchased shares in Lloyds at an average net cost of 72.2p a share. Lloyds has paid no dividends on its ordinary shares since the share purchases. A comparison of the average cost with the price obtained of 75p in the first sale gives a gain, in purely cash terms, of just under £120 million[3]. In the second sale, the gain amounted to £180 million. The combined gains of £300 million do not, however, take account of the cost of funding the purchases of the shares.

The money needed to buy the shares was provided by longer-term funding in the form of Gilts, at a cost of just under 3 per cent a year. If this cost of financing is taken into account, the first sale resulted in a shortfall of £230 million[4] and the second sale a shortfall of £300 million. The combined shortfall of £530 million should be seen as part of the cost of securing financial stability during the financial crisis.

Figure 9

Comparisons of the two sales with other comparable sales

	First sale (September 2013)	Second sale (March 2014)	Averages for comparable sales[1]
Sale proceeds (£bn)	3.2	4.2	1.9
Discount to market price of shares ahead of the sale (%)	3.1	4.6	5.3
Proportion of total issued share capital sold (%)	6	7.8	10.8
Shares sold as a multiple of average daily trading volume	x18	x29	x26

Note

1 Largest 20 comparable share sales in European markets since 2008.

Source: JP Morgan analyses for first and second sales

NOTES

1. Comptroller and Auditor General, *The first sale of shares in Lloyds Banking Group*, Session 2013-14, HC 883, December 2013
2. Comptroller and Auditor General, *HM Treasury: Maintaining financial stability across the United Kingdom's banking system*, Session 2009-2010, HC 91, December 2009, paragraph 19
3. Comptroller and Auditor General, *The first sale of shares in Lloyds Banking Group*, Session 2013-14, HC 883, December 2013, paragraph 3.18
4. ibid, paragraph 3.19

Part 3 - Wider economic support

3.1 Since 2009, the Treasury has introduced a number of initiatives to support the wider economy. This Part of the report provides an overview of my assessment of the risk of material misstatement for my audit arising from three most significant direct support interventions that impact on the Treasury's financial statements and will be increasingly important to the Treasury's financial management in the coming years. These are the Quantitative Easing programme; the Help to Buy Guarantee Scheme and the UK Guarantee Scheme.

Quantitative Easing

3.2 In early 2009, the Bank of England initiated a programme of asset purchases (often referred to as Quantitative Easing) to stimulate demand by boosting the money supply. The programme is run through a wholly owned subsidiary of the Bank of England, the Bank of England Asset Purchase Facility Fund Limited (BEAPFF). Under the programme, the Bank made a loan to BEAPFF, backed by a claim on the Bank's balance sheet. BEAPPF used this loan to purchase assets held by investors, mainly gilts, and effectively injected money directly into the economy (**Figure 10**).

3.3 The BEAPPF 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. This agreement is accounted for as a derivative contract[12] and recognised as an asset for the Treasury. The balance represents the amount that would be due from BEAPFF should the scheme be unwound completely at the year-end, in effect the difference between the value of the assets and liabilities of BEAPPF at 31 March 2014. As the assets held by BEAPPF are gilts, the value on the derivative will change as gilt prices move and interest is accrued.

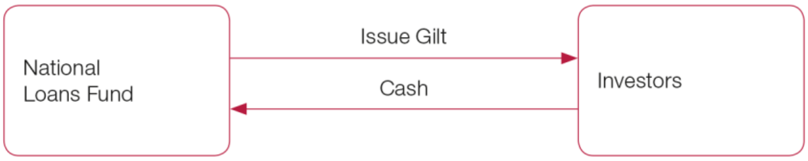
[12] Defined as a financial instrument or other contract whose value changes in response to the change in a specified variable that requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors; and is settled at a future date.

Figure 10

Quantitative Easing

1 Standard Gilt Issuance

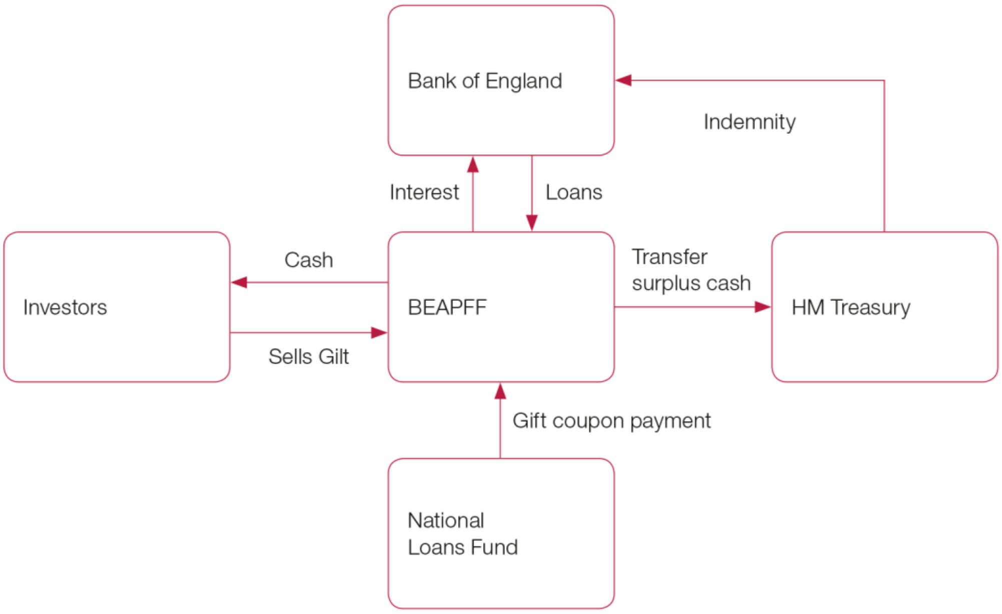
Gilts were liabilities of the National Loans Funds and held as assets by investors.



2 Quantitative Easing

The BEAPFF purchases gilts from investors using a loan from the Bank of England. The Gilts become assets for BEAPFF. They remain liabilities for the NLF.

Treasury indemnify any Bank of England losses and receive any gains. This results in a derivative in Treasury's account. The value of the derivative is reduced as gilt interest is transferred.



Source: National Audit Office analysis

3.4 Until January 2013, coupons (interest) paid on gilts held by the BEAPPF were held by BEAPFF. During 2012-13, HM Treasury and the Bank agreed to a revised indemnity to require excess cash to be transferred between BEAPFF and HM Treasury to enable more efficient cash management across government. £11.3 billion was transferred by 31 March 2013 and a further £31.1 billion during 2013-14 leading to a significant reduction in the value of the derivative.

3.5 The financial statement recognised a derivative asset of £230 million at 31 March 2014 and movements in value of £12.9 billion are recognised in the Statement of Comprehensive Net Expenditure relating to the value of the derivative, excluding cash transfers. It is not certain that the fair value gain recognised in HM Treasury's accounts will crystallise into a net cash gain for the Exchequer when the scheme closes. This is because there are a number of factors that may affect the price of the assets when they are sold.

Audit risk

3.6 Although the value of the derivative and its associated fair value movements are significant and the instrument is volatile, its valuation is based on quoted market prices and cash transactions with few management assumptions and is therefore not subject to significant estimates or judgements. As a result I concluded that there was no significant risk of material misstatement arising from the quantitative easing indemnity this year.

Help to Buy Mortgage Guarantee Scheme

Background

3.7 The Help to Buy Mortgage Guarantee Scheme aims to increase the availability of mortgages on new or existing properties for those with small deposits. It targets those who could afford interest repayments on a mortgage, but are unable to save the large deposits required.

3.8 The Scheme, which launched in January 2014 and will run until December 2016, allows lenders to purchase a guarantee where a borrower has a deposit of between 5% and 20%[13]. The guarantee lasts for seven years and will cover the loss suffered by the lender, net of recoveries, minus the first five per cent, in exchange for a fee (**Figure 11**). The Treasury's maximum exposure will be limited to £12bn on mortgage lending of up to £130bn over the three years of the scheme.

3.9 Mortgages guarantees under the Scheme must be:

- on a UK property with a purchase price of £600,000 or less;
- a residential and repayment mortgage; and
- for the buyer’s only property and not for buy-to-let or commercial properties.

3.10 European Commission guidance on state aid requires the Treasury to charge a market oriented fee to lenders in return for issuing the guarantee. The Treasury has followed this guidance in setting the fees for Help to Buy, which requires the fees charged to cover the expected losses associated with granting the guarantee ; the administrative costs of the scheme; and an annual amount to cover the Treasury's exposure to the risk of default.

[13] The Mortgage Guarantee Scheme was announced at the same time as the Help to Buy Equity Loan Scheme, which is run by the Department for Communities and Local Government, in the 2013 Budget. I reported on the Help to Buy equity loan scheme in March 2014. http://www.nao.org.uk/report/help-buy-equity-loan-scheme/

Figure 11
Example Help to Buy Mortgage Guarantee Scheme calculation

Issue of guarantee

95 per cent loan to value mortgage taken out on property worth £100,000.

Purchaser provides 5 per cent deposit **£5,000**

Lender provides 95 per cent mortgage **£95,000**

HM Treasury provides 15 per cent guarantee **£15,000**

Purchaser defaults

The purchaser defaults on the mortgage and the lender raises **£65,000** through repossession of the property. Without a guarantee, the loss to the lender would be **£30,000**.

£15,000 guarantee

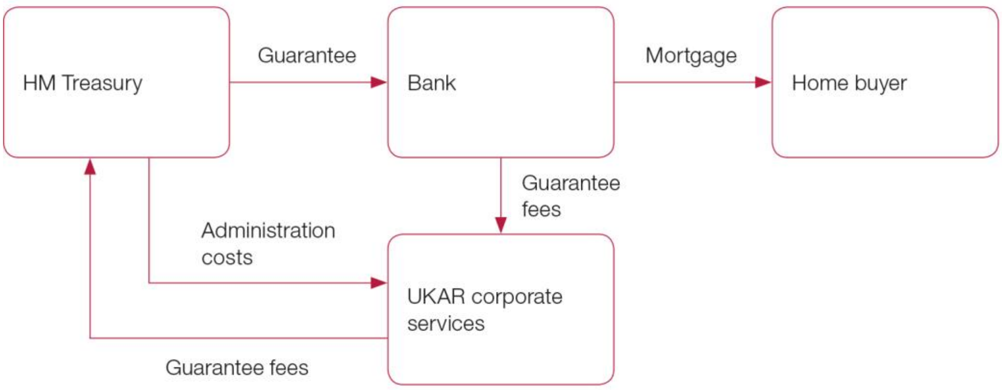
But lender takes first 5 per cent of loss **£750**

In total, the government has guaranteed **£14,250** or 14.25 per cent of the value of the property

Source: National Audit Office

3.11 The Scheme is administered by UK Asset Resolution Corporate Services (UKARcs) on behalf of the Treasury (**Figure 12**). UKARcs is required to undertake an annual audit of lenders on compliance with the eligibility criteria and Scheme rules. These audits will consider the annual assurance programme carried out by the internal auditors of each lender which are also a requirement of the scheme. The Bank of England's Financial Policy Committee will monitor the Scheme and can make recommendations on its size or the fees to be charged, but any changes are the Treasury's responsibility.

Figure 12
Administration of the Mortgage Guarantee Scheme



Source: National Audit Office

3.12 The Treasury has a liability for each guarantee that it signs which is equal to the fees payable. The maximum exposure to losses, based on the amount of lending guaranteed (subject to caps on some lenders maximum claim), is disclosed as a contingent liability. A total of 7,313 guarantees have been issued in 2013-14 covering mortgage lending of £1 billion. This has resulted in the recognition of a financial guarantee liability of £9 million and a contingent liability of £95 million at 31 March 2014. So far no claims in relation to the guarantees have been received.

Audit risk

3.13 The Treasury's announcement that it will provide up to £12 billion of guarantees under the Scheme means that this is a significant intervention in the housing market and will be significant to the accounts over the coming years. However, as only £145 million of lending had been guaranteed at 31 March 2014 I concluded that there is not a significant risk of material misstatement for my audit this year. Given the significant estimates and judgements required for the Scheme, particularly around the probability of a guarantee being called, I will revisit my risk assessment in 2014-15 when the Scheme is likely to be material to the accounts.

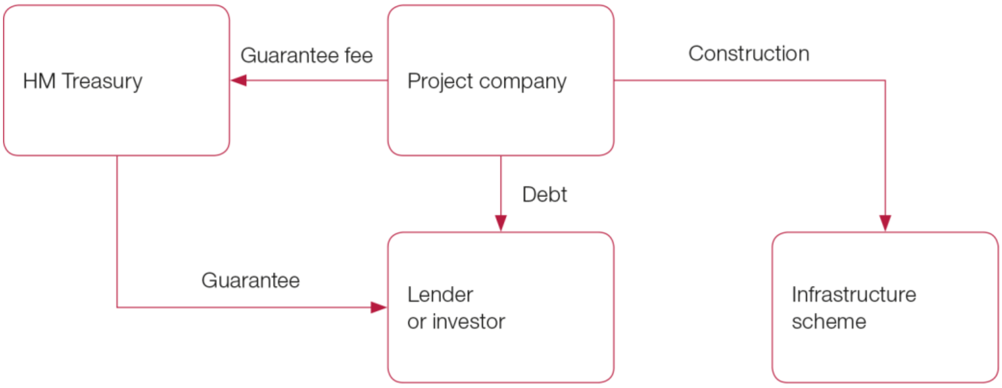
3.14 I plan to report to Parliament on the Value for Money of the Treasury's Help to Buy Mortgage Guarantee Scheme in 2015.

UK Guarantee Scheme

Background

3.15 The UK Guarantee Scheme (UKGS) aims to prevent infrastructure projects being delayed or cancelled by difficulties in obtaining debt financing. The scheme aims to meet its objective is by utilising the Government's credit rating to provide protection against default for the lenders to the projects. This is achieved through an irrevocable and unconditional guarantee from the Treasury to support a specified loan or bond issued by the project company delivering the particular infrastructure project. This means that lenders or bond investors are able to provide debt with confidence that the Treasury will compensate them in full for the guaranteed debt if the project company is unable to finance the interest and principal.

Figure 13
UK Guarantee Scheme Structure



Note
1 Diagram shows structure for a financial guarantee under the UK Guarantee Scheme.

Source: National Audit Office

3.16 In return for the guarantee, the Treasury is paid a fee by the project company (**Figure 13**). Under the Guarantee Scheme the Treasury assumes the full rights associated with being a lender, for example the power to take recovery action against the defaulter. Some £40 billion has been allocated to infrastructure projects to be guaranteed, provided applications are approved by the Treasury.

3.17 The Treasury has established five main criteria for determining eligibility which are that a project must be:

- Nationally significant;
- Ready to start construction;
- Financially credible;
- Dependent on a guarantee to start; and
- Good value to the tax payer.

3.18 EU State aid rules require the Treasury to charge fees at a market rate in return for issuing the guarantee. In the absence of a comparative market, the Treasury has benchmarked guarantee premiums against a database of comparable instruments. The Treasury has a liability for each guarantee that is signed equal to the value of the fees payable for the guarantees, offset by an equal asset for fees receivable. The maximum exposure to losses, based on the amount of debt guaranteed, is disclosed as a contingent liability.

3.19 A total of two guarantees have been issued under the Scheme in 2013-14 resulting in the recognition of a receivable for fees of £6.8 million and a financial guarantee liability of £7.1 million (based on undiscounted fees of £10.0 million) and a contingent liability of £83.8 million at 31 March 2014. In addition to the two financial guarantees, the Treasury have also provided a loan commitment, under the Scheme, of £750 million to the Greater London Authority in relation to the Northern Line extension to Battersea and a commitment to provide a financial guarantee of £257.2 million for the Mersey Gateway Bridge[14]. So far no claims in relation to the guarantees have been received and the Treasury has assessed that it is not probable that any guarantees will be called upon at 31 March 2014.

3.20 Around a further 40 projects have been declared as pre-qualified and therefore the Treasury's exposure is likely to increase substantially in future years[15]. The most significant project that is under consideration is the Hinkley Point C nuclear power station.

Audit risk

3.21 The Treasury's announcement that it will provide up to £40 billion of guarantees under the Scheme means that it will be material to the accounts in the future. However, as only £83.8 million of guaranteed debt had been issued at 31 March 2014 I concluded that there is no significant risk of material misstatement for the 2013-14 accounts arising from the UK Guarantee Scheme. Given the significant estimates and judgements required for the Scheme, particularly around the probability of a guarantee being called where the Treasury will need to put in place an ongoing process to monitor projects, I will revisit my risk assessment in future years.

3.22 I plan to report to Parliament on the value for money of the UK Guarantee Scheme in the coming year.

[14] The guarantee for the Mersey Gateway Bridge was signed on 30 March 2014 however the guaranteed debt was not issued until 2 April 2014.

[15] https://www.gov.uk/government/publications/uk-guarantees-scheme-prequalified-projects/uk-guarantees-scheme-table-of-prequalified-projects

Annex 1: Materiality

4.1 I applied the concept of materiality both in planning and performing my audit, and in evaluating the effect of misstatements on my audit and on the financial statements. This approach recognises that financial statements are rarely absolutely correct, and that an audit is designed to provide reasonable, rather than absolute, assurance that the financial statements are free from material misstatement or irregularity. A matter is material if its omission or misstatement would reasonably influence the decisions of users of the financial statements. I consider the primary users of this account to be Parliament, however the accounts will be of general interest to others, in particular the general public and media given the accounts contain disclosures on flagship financial stability interventions and wider economic support schemes.

4.2 In my professional judgement, the main source of interest in the financial statements of HM Treasury is the Statement of Financial Position (SoFP) as this is where the impact of HM Treasury's financial stability interventions and wider economic support schemes can be seen, whereas the most significant transactions in the Statement of Comprehensive Net Expenditure are derived from movements in the fair value of the schemes in the SoFP. As the vast majority of the SoFP balances are assets my professional judgement is that gross assets should be used as my materiality base.

4.3 The schemes and interventions contained within the financial statements have been subject to significant public interest. As a result I consider the HM Treasury account to be highly sensitive so apply, 0.5%, to give a lower materiality and therefore a lower tolerance for error. As a result the materiality for the financial statements as a whole was set at £647 million for the group and £492 million for the parent (HM Treasury and agencies).

4.4 As well as quantitative materiality there are certain matters that, by their very nature, would influence the decisions of users if not corrected. These included, for example, salary information of ministers and senior management disclosed in the Remuneration Report and any expenditure incurred without authority. Assessment of any such misstatements would take into account these qualitative aspects as well as the size of the misstatement.

4.5 I applied the same concept of materiality to my audit of regularity. In planning and performing audit work in support of my opinion on regularity, and evaluating the impact of any irregular transactions, I took into account both quantitative and qualitative aspects that I consider would reasonably influence the decisions of users of the financial statements.

4.6 I agreed with the Treasury Corporate Audit Committee that I would report to it all corrected and uncorrected misstatements identified through my audit in excess of £250,000, as well as differences below that threshold that in my view, warranted reporting on qualitative grounds, including irregular transactions.