Report on Accounts: HM Treasury 2014-15

17 July 2015

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

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Summary

Scope of this report

1 This is my fifth 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 2014-15 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 that have been the focus of my audit effort.

Scope of financial audit

2 The purpose of an audit is to enhance the degree of confidence that intended users have 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. Appendix One gives more detail on my approach to determining materiality and the materiality levels applied to my audit of HM Treasury's 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 relates solely to the risk of material misstatement in the presentation of the financial statements or risk of material irregularity. This means 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 I have identified three significant risks for my audit, which are set out in Part One and Two of this report. These are; the production of the Group accounts and the valuation of HM Treasury's loans to Icesave and UK Asset Resolution (UKAR):

- **Production of the Group accounts -** the consolidation process is complex, due to the differing activities of HM Treasury, UKAR and the Financial Services Compensation Scheme (FSCS). This means the format of the financial information underlying their accounts differs. HM Treasury has also introduced new processes and a new format for collecting consolidation information and so there is an increased inherent risk and level of challenge associated with the consolidation.
- **Valuation of HM Treasury's loan to Icesave** - this is subject to inherent uncertainty, as the assets from which the loan will be repaid are in Iceland and denominated in Icelandic Krona. There have been capital limits in place over Krona which have restricted repayment of the loan. Recoveries have consequently been less than forecast in recent years. The recoverability of the loan, and any associated write-down, is therefore subject to significant management judgement and represents a significant risk.
- **Valuation of HM Treasury's loan to UKAR and the mortgages supporting the loan -** the cash flows associated with repayment of mortgages raised by UKAR are subject to significant uncertainty, due to associated impairments. Though UKAR and the Office of Budgetary Responsibility have forecast full repayment, the valuation of HM Treasury's loan to UKAR, which is dependent on recovery of the underlying mortgages, is also uncertain and I therefore concluded that there is a risk that the loan may need to be impaired due to the timing of repayments from UKAR.

6 The other areas of the accounts are not deemed to represent significant risks for my audit. This is because their size is not material to the accounts or because their valuation is not subject to management estimation or judgement.

7 My audit opinion on the financial statements considers the regularity of transactions but does not consider whether HM Treasury's activities 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.

Key findings

8 The number of bodies within the scope of HM Treasury's financial statements continues to grow. There continue to be two bodies in the group, in addition to HM Treasury, that are significant to my audit: FSCS and UKAR**.** The size of

the group has increased during 2014-15 to include three new companies.[1] The group will continue to grow in 2015-16, to include the Government Internal Audit Service, which was formally launched on 1 April 2015; and the creation of UK Government Investments which will combine UK Financial Investments with the Shareholder Executive under the control of HM Treasury. This reflects HM Treasury's expanding operational responsibilities.

9 The most significant changes to HM Treasury's financial stability schemes are repayment of loans of £2.2 billion; UKAR's sale of part of its mortgage book for £2.7 billion; and the £36.2 billion increase in the value of the Bank of England Asset Purchase Facility Fund derivative due to an increase in gilt prices, offset by cash transfers. HM Treasury has also disposed of Lloyds shares, as part of the trading plan announced in December 2014. This raised proceeds of £1.7 billion in 2014-15. The main residual elements of HM Treasury's financial stability interventions are the loans to NRAM and Bradford & Bingley, valued at £34.3 billion and the investments in Royal Bank of Scotland, valued at £32.0 billion.

10 HM Treasury continues to support the wider economy, with the expansion of the Help to Buy Mortgage Guarantee Scheme and the UK Guarantee Scheme. The Help to Buy Guarantee Scheme will provide up to £12 billion of guarantees under the Scheme, making this a significant intervention by the UK Government in the housing market. However, as only £631 million of lending had been guaranteed at 31 March 2015, this is yet to be a significant element of HM Treasury's financial statements. Six guarantees have been issued under the UK Guarantee Scheme. These are valued at £113.5 million with an exposure of up to £884.6 million, excluding interest; HM Treasury has also provided a loan commitment of £750 million to the Greater London Authority in relation to the Northern Line extension to Battersea. So far no claims in relation to the guarantees have been received and HM Treasury has assessed that it is not probable that any guarantees will be called upon at 31 March 2015.

11 HM Treasury continues to actively manage its Statement of Financial Position. During 2014-15, HM Treasury received the transfer of the Department for Transport's holding in Eurostar, worth £325 million. It completed the sale of the holding for £757.1 million in May 2015. HM Treasury set up HM Treasury UK Sovereign Sukuk plc, a special purpose vehicle set up to issue the UK's first sovereign Sukuk (Islamic bonds), which issued £200 million Sukuk and has been designated for consolidation. The £328 million HM Treasury element of the Business Finance Partnership has been transferred to British Business Investments Limited, which is part of the Department for Business, Innovation & Skills. HM Treasury also received £1.4 billion of fines from

[1] HM Treasury UK Sovereign Sukuk plc - which issued £200 million of Sukuk (Islamic bonds); and two companies that will hold investments in the Private Finance 2 scheme, which is the successor to the private finance initiative.

the financial services industry in 2014-15,which are now accounted for in separate trust statement acccounts.

12 HM Treasury's Statement of Financial Position will continue to fluctuate through 2015-16 and beyond. HM Treasury's Statement of Financial Position will be affected by: continued sales of Lloyds Banking Group shares and of UKAR's mortgage book; the recently announced programme of sales of Royal Bank of Scotland shares; and the expansion of the Help to Buy programme to include the issuance of Help to Buy Individual Savings Accounts, which will provide enhanced savings options for first time buyers supplemented with government support. This reflects HM Treasury's continued drive to normalise the functions of the UK's financial sector while supporting the wider economy and is part of the government's wider plan to realise value from its assets following the May 2015 election.

Conclusions

13 I completed my audit in line with my planned audit approach and have issued clear opinions on HM Treasury's 2014-15 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 One

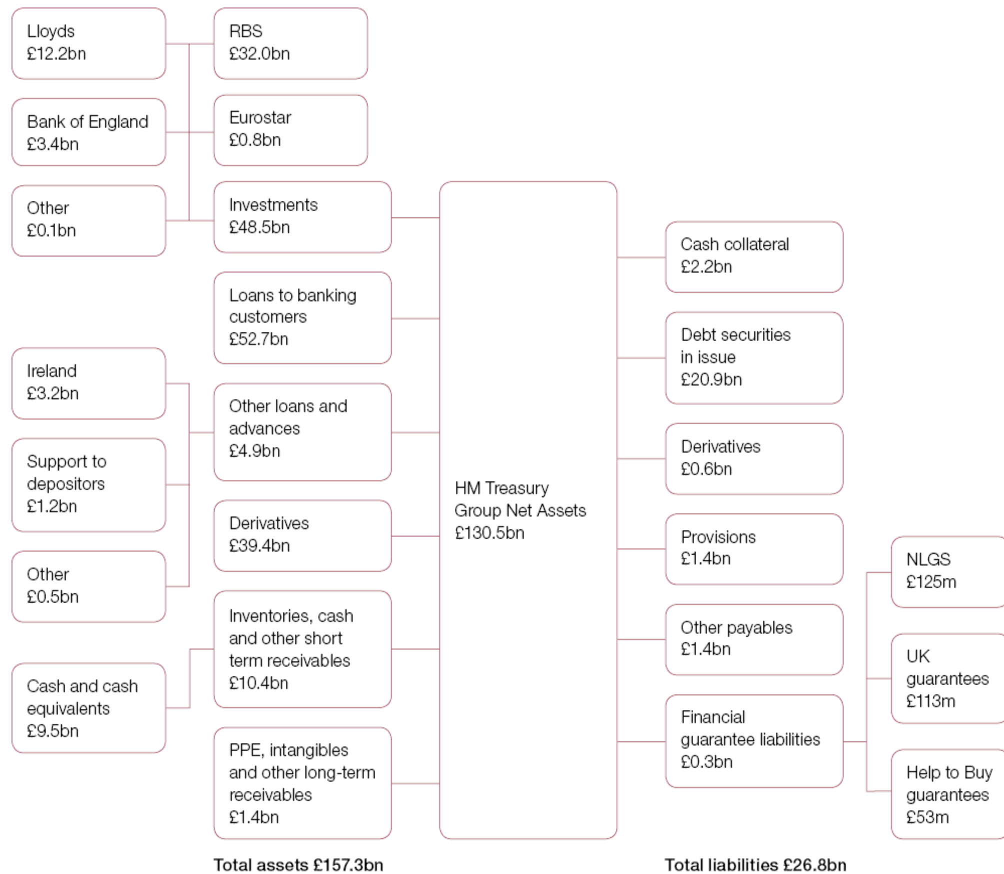
Context

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 Net Expenditure, Financial Position and Cash flows and Changes in Equity of the Treasury and the Debt Management Office (the parent) and all bodies within Treasury's departmental boundary (the group)[2], as defined by the Government Resources and Accounts Act 2000 (Estimates and Accounts) Order 2014.

1.2 According to the Statement of Financial Position, the Treasury group has net assets of £130.5 billion (**Figure 1)**.

[2]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 Bradford & Bingley and its subsidiaries, NRAM and its subsidiaries and UK Asset Resolution Corporate Services Ltd), Help to Buy (HM Treasury) Ltd, HM Treasury UK Sovereign Sukuk plc, IUK Investments Ltd and IUK Investments Holdings Limited.

Figure 1
HM Treasury Group Statement of Financial Position as at 31 March 2015

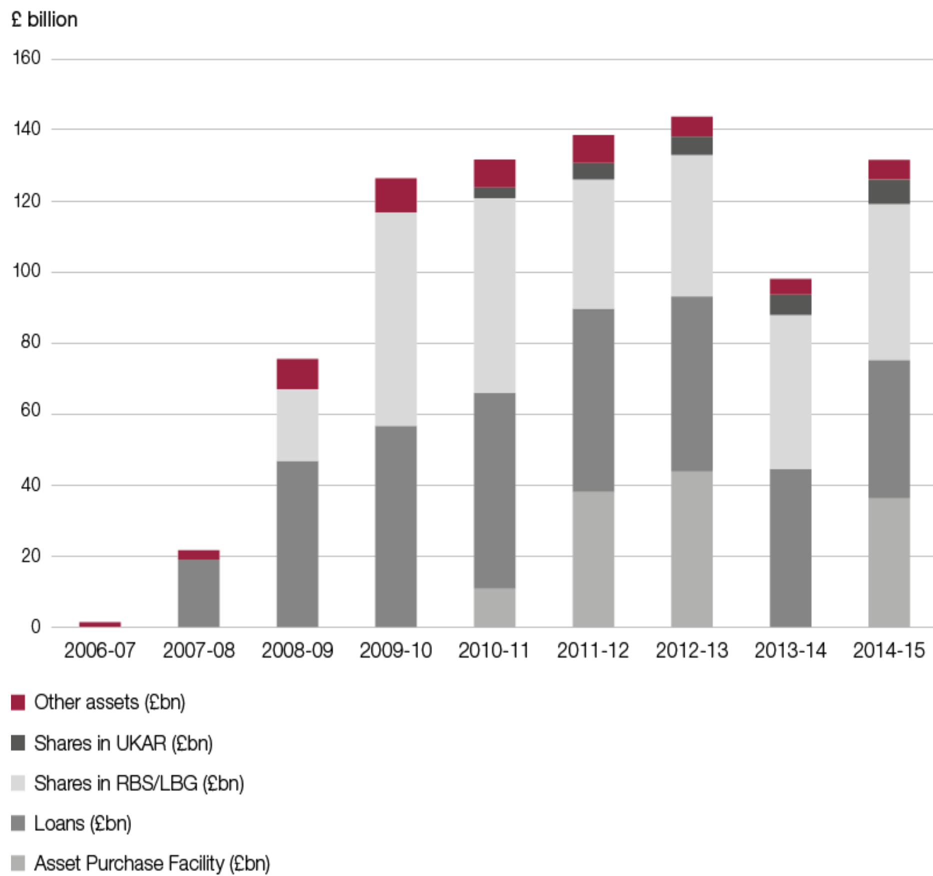


Notes
1 Other loans and advances are stated net of £34.3 billion of loans provided by the Treasury and FSCS to Bradford & Bingley and NRAM eliminated on consolidation.
2 Investments are stated net of the Treasury's £7.0 billion investment in UKAR eliminated on consolidation.
3 Deposit guarantees are stated net of £391m provided by the Treasury to Bradford & Bingley and NRAM eliminated on consolidation.
4 Contingent liabilities of £13.3 billion (£8.9 billion of which are eliminated on consolidation) of financial guarantees are disclosed in the accounts but not recognised in the Statement of Financial Position.

1.3 The derivatives, loans and advances and investments relating to core Treasury are analysed further in **Figure 2**. This demonstrates that movements in the Treasury's gross assets are largely due to changes in the value of the Bank of England Asset Purchase Facility Fund (BEAPFF).[3]

[3] The BEAPF accounts for the financial impacts of the Bank of England's quantitative easing programme.

Figure 2
HM Treasury core gross assets



Note
1 Figures represent gross assets of Core Treasury.

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

1.4 In addition to the Treasury, there are two bodies in the group that are significant to our audit (**Figure 3**): the Financial Services 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 failed financial services firms and 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 from the Treasury to finance compensation paid during the financial crisis, totalling some £15.8 billion at 31 March 2015, and the related receivables to recover this compensation, of some £16.0 billion.
- UK Asset Resolution was established to facilitate the management of the closed mortgage books of the nationalised Northern Rock (now known as NRAM) and Bradford & Bingley banks. The most significant transactions in the UKAR accounts are mortgages and other loans to customers, totalling some £52.7

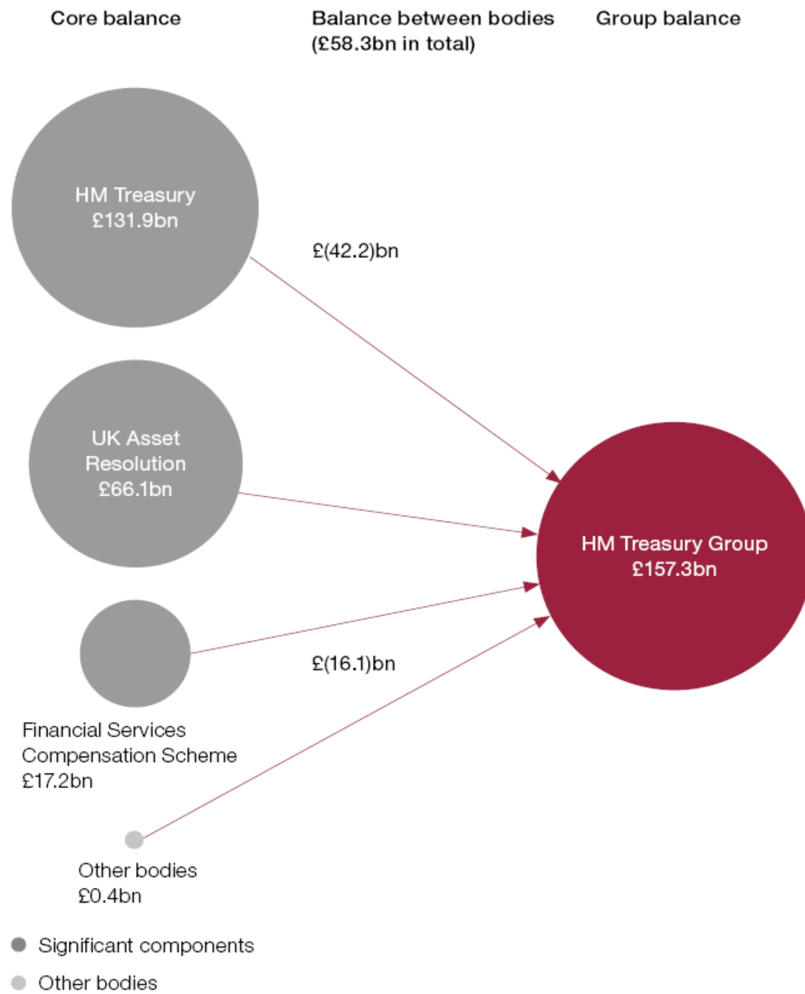
billion at 31 March 2015.

1.5 The Treasury has set up three new companies in 2014-15[4]. These include HM Treasury UK Sovereign Sukuk plc, a body set up to issue the UK's first sovereign Sukuk (Islamic bonds), and two companies in relation to the Private Finance 2 scheme. These have been designated for consolidation, highlighting the changing nature of the Treasury group. The group will change further in 2015-16 as the Treasury's activities evolve. For example, the Government Internal Audit Agency was created as a new Executive Agency of the Treasury from 1 April 2015 and, as disclosed in the accounts, the Chancellor has announced that the Shareholder Executive (currently a function of the Department for Business, Innovation and Skills) will be brought together with UK Financial Investments under a new Treasury owned company, UK Government Investments. These will be consolidated in the Treasury's accounts from 2015-16.

1.6 The group accounts are produced by summing the balances and transactions across all of the bodies, adjusting for any intra-group transactions (see **Figure 3**). The key intra-group transactions are the loan balances between the Treasury, FSCS and UKAR, and the NRAM and Bradford & Bingley guarantees between the Treasury and UKAR.

[4] HM Treasury UK Sovereign Sukuk plc, IUK Investments Ltd and IUK Investments Holdings Limited.

Figure 3
HM Treasury Group Statement of Financial Position – Bodies with the largest assets



Notes
1 Figures represent gross assets of individual components at 31 March 2015.
2 The Treasury Group figure is net of intra-group eliminations.

Source: National Audit Office analysis of HM Treasury *Annual Report and Accounts 2014-15*

Audit risk

1.7 The consolidation process is complex, due to the differing activities of the components of the Treasury, UKAR, FSCS and the continued expansion of the group. As the group includes government bodies, a bank and financial services company respectively, the format of the financial information underlying each of the group bodies' accounts varies significantly. In previous years, the Treasury found it

challenging to identify the appropriate adjustments and eliminations that should be made to form the group accounts, as detailed understanding is required about each component. The Treasury has introduced new processes and a new format for the collection of consolidation information to reflect recent changes that have been made to the group structure, particularly with the inclusion of UKAR. This increased the inherent risk and level of challenge associated with the consolidation further during 2014-15.

1.8 Due to these complexities, I assessed that the production of the Group accounts represented a significant risk of material misstatement for my audit of the consolidated group.

Audit approach

1.9 My audit approach addressed this significant risk through my review of the consolidated accounts model that underpins the Group financial statements. This involved examining evidence, such as the consolidation returns from the bodies, to ensure that sufficient and appropriate evidence had been collected by the Treasury from the component bodies. I also used the consolidation returns to support my review of the transactions and balances between bodies in the group that should be eliminated and my testing of the arithmetic accuracy of the consolidation. I have taken assurance from the audit opinion provided by the auditors of UKAR and from my own audit of FSCS.

Financial stability support

1.10 Between 2007 and 2010, the Treasury made a series of large financial interventions to support UK banks. Support (**Figure 4**) 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 (Lloyds), are recognised as assets in the Statement of Financial Position.
- Guarantees - guarantees do not involve direct cash support but expose the Treasury to potential liabilities if the guarantees are called[5].

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

[5] Under accounting standards, the guarantee liability (a representation of the risk to which the Treasury is exposed which is usually equal to the fee received for provision of the guarantee) is measured at fair value upon initial recognition and then subsequently recorded at amortised cost in the Statement of Financial Position. The maximum exposure to losses due to the guarantees is disclosed as a remote contingent liability under Managing Public Money.

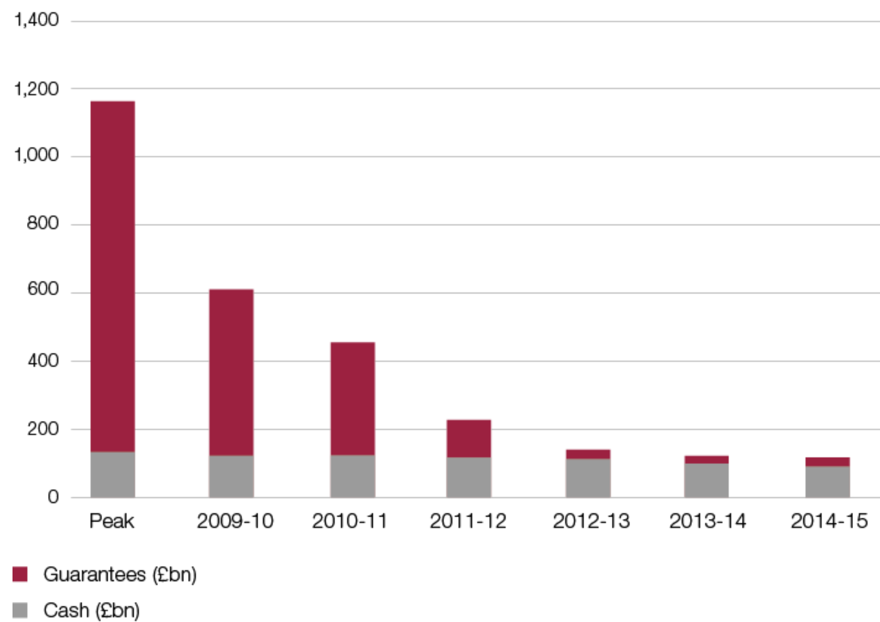
1.12 The balances associated with these support mechanisms have steadily decreased as loans are repaid, shares are sold and guarantees are extinguished. This pattern is expected to continue in the coming years as the Treasury's interventions in the financial sector unwind and enabling it to focus on its role in managing the economy. I provide further comment on financial stability support in Part Two.

Figure 4

Financial stability support to banks

Banking Support

£ billion



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

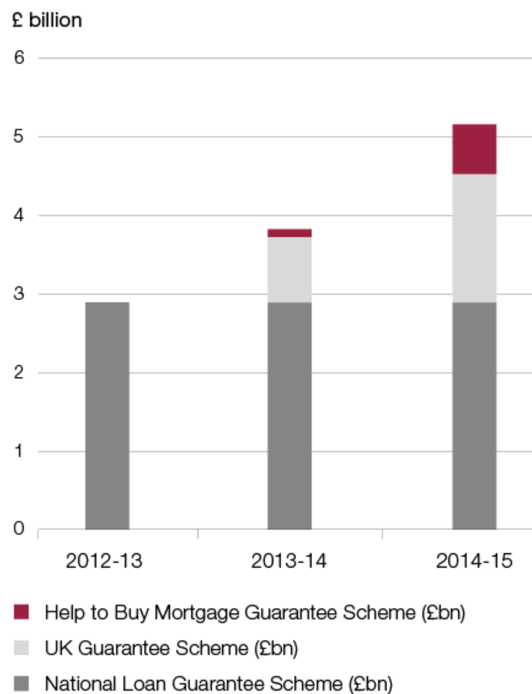
Wider economic support

1.13 Following the stabilisation of the financial sector, 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 5**).Over the coming years these guarantees will become the dominant feature of the Treasury's financial statements. Due to their nature, the likelihood of guarantees being called upon is closely linked to the UK's economic performance which means that the Treasury's financial exposure will be correlated with macroeconomic risk. I provide further comment on the wider economic support initiatives in Part Three.

Figure 5

Wider economic support schemes

Financial guarantees related to economic growth



Notes

1 Figures represent maximum exposure through contingent liabilities.

2 UK Guarantee Scheme also includes commitments to provide loans.

3 The graph shows guarantees external to government; the Treasury also has indemnified the Bank of England Asset Purchase Facility.

Source: National Audit Office analysis

Statement of Financial Position focus

1.14 These interventions, together with the activities of FSCS and UKAR, illustrate that the main financial risks for the Treasury are derived from its Statement of Financial Position, rather than the income and 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.

1.15 It is important that the Treasury's approach to financial management can 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 Mortgage Guarantee Scheme are long term in nature and will be in place for many years.

1.16 During the coming years, the Treasury's Statement of Financial Position will continue to fluctuate. The Treasury will continue its programme of sales of investments in Lloyds and UKAR and the Chancellor announced the initiation of a programme of sales of RBS in June[6]. Together with the continued expansion of the Treasury's guarantee schemes and the introduction of the Help to Buy Individual Savings Account scheme announced in March 2015[7], the nature and extent of the Treasury's assets and liabilities will continue to represent its major financial risks for the foreseeable future.

Parliamentary control totals over resources

1.17 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[8]. The most significant items of income and expenditure in the accounts are derived from the financial interventions, for example interest on loans totalling some £2.5 billion, gains on disposal of shares of just over £1.0 billion and fair value movements on derivatives of £46.9 billion.

[6] https://www.gov.uk/government/speeches/mansion-house-2015-speech-by-the-chancellor-of-the-exchequer

[7] https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/413899/Help_to_Buy_ISA_Guidance.pdf

[8] 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.

1.18 The Treasury has a negative capital Annually Managed Expenditure control total, due to the treatment of the capital payments on its loans and disposal of shares which also results in a negative Net Cash Requirement. 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. The Treasury has not breached any of the control totals for this financial year.

Part Two - Financial stability schemes

2.1 This Part of the Report provides an overview of the audit risks 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[9] and Credit Guarantee Scheme[10], which exposed the Treasury to contingent liabilities and other support of more than £1,000 billion at their peak[11], unwinding of the financial stability schemes has continued through 2014-15.

2.3 The most significant changes are the further £5.7 billion repayment of loans[12], with £0.9 billion of this relating to the Icesave statutory debt, and £2.7 billion relating to the sale of a portfolio of mortgages by UKAR, which is part of a broader strategy to divest its mortgage servicing activities further[13]. The Treasury has also disposed of Lloyds shares, as part of the trading plan announced in December 2014[14]. This has generated proceeds of £1.7 billion, with further sales anticipated. The Treasury's shareholding fell below 20% in May 2015.

2.4 The main residual elements of the Treasury's financial stability interventions are its loans to NRAM and Bradford & Bingley, which were brought under the control of UK Asset Resolution in 2010, and the Treasury's remaining holdings of shares in Lloyds and RBS.

2.5 As announced in the March Budget 2015[15], the government plans to sell a further £9 billion of Lloyds shares in 2015-16 and the Chancellor announced in his annual Mansion House speech on 10 June 2015[16] that the Government will begin to sell off its

[9] 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/

[10] 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.

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

[12] This £5.7 billion is reflected in the Treasury's Core accounts, which gives the most complete reflection of the transations in relation to these schemes.

[13] http://www.ukar.co.uk/media-centre/press-releases/2015/18-03-2015?page=2

[14] https://www.gov.uk/government/news/government-to-sell-part-of-its-remaining-shareholding-in-lloyds-through-a-trading-plan

[15] March 2015 Budget https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/416330/47881_Budget_2015_Web_Accessible.pdf

[16] https://www.gov.uk/government/speeches/mansion-house-2015-speech-by-the-chancellor-of-the-exchequer

stake in RBS. UKAR has also announced a major sale of £13 billion of assets held from the nationalisation of Northern Rock. The Treasury will also receive dividend income from Lloyds from 2015-16, following Lloyds' announcement that it will pay a dividend for the first time in six years[17]. I plan to publish a report on the government-owned banks which will cover these sales.

Loans

2.6 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.

2.7 Under the control of UKAR, NRAM and Bradford & Bingley continue to benefit from significant support in the form of loans from the Treasury. Bradford & 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 £34.3 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**. These total some £52.7 billion. In October 2014, £2.7 billion of these mortgages were sold off to Commercial First Group, to accelerate the wind-down process. Plans to sell off a further £13 billion were announced in the March 2015 Budget, which the government plans to use to pay down national debt. UKAR currently forecasts that it will repay all of the loans to HM Treasury by 2024, or 2026 under the Prudential Regulation Authority's stress scenario. Full repayment of the loans is supported by UKAR's 2014-15 accounts, which demonstrate that UKAR's assets exceed its liabilities.

2.8 The Treasury and FSCS are recovering the loans used to pay compensation to depositors in other financial institutions, totalling some £15.8 billion, through the administrators of the failed institutions and by imposing levies on industry to cover any shortfall in the FSCS elements. During 2014-15, the FSCS repaid its loans issued by the Treasury in respect of the Heritable, London Scottish Bank and Icesave banks. The core and group accounts reflect different values for the loans. The loan to FSCS for the compensation paid out up to the FSCS depositors' limit, and the statutory debt for the amount above this limit, are included in the core accounts. Recoveries are received from the administrators for both loans.

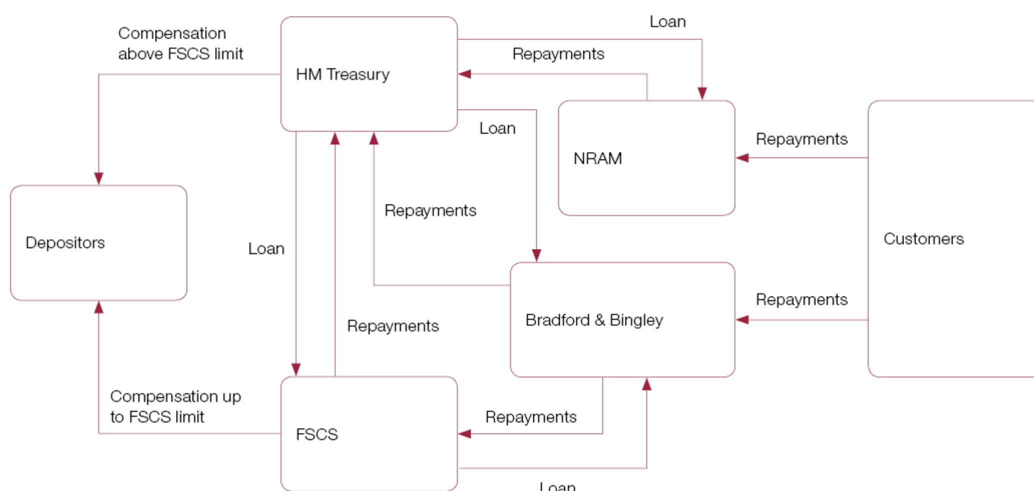
[17] Lloyds have announced that they will pay a dividend of 0.75p per share for the full year 31 December 2014
http://www.lloydsbankinggroup.com/globalassets/documents/investors/2015/2015feb27_lbg_dividend_arrangements.pdf

2.9 FSCS can recover any shortfall in its element of the loans (i.e. the amounts paid out up to the depositors' limit) not recovered from administrators from levy payers. In 2014-15, FSCS has recovered more from levy payers than the shortfall that it anticipated. It has, therefore, used this excess to repay more of its loan from the Treasury. However the group accounts reflect that this balance will ultimately be repaid to levy payers if the amounts currently forecast are recovered from the failed banks. As the FSCS loans are intra-group transactions, these loans are then eliminated when preparing the group accounts.

2.10 There is also £389.5 million outstanding on the Treasury's loan to Dunfermline Building Society. The Treasury receives recoveries in respect of this loan from the administrator. Any shortfall is then raised from levy payers via FSCS, subject to a cap. This cap represents the cost that FSCS would have incurred had the Treasury not intervened. FSCS made a first payment of £100 million towards the cap in 2014-15.

Figure 6

Cash flows associated with loans to Bradford and Bingley and Northern Rock Asset Management



Notes

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

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

Source: National Audit Office analysis

2.11 The total value of loans outstanding is recorded as an asset in the Treasury accounts and is measured at amortised cost. At the year end this totalled £38.6 billion, which was a reduction of £5.8 billion compared with the prior year. This movement comprises £5.7 billion repayments, £60.3 million impairment reversals, £3.7 million foreign exchange movement, and £128 million amortisation of the loans, with £939 million being earned as interest on the loans during 2014-15. No interest is charged on the statutory portion of the loans.

Audit risk

2.12 I assessed that the valuation of the UKAR loan represented a significant risk of material misstatement for my audit of the Treasury's individual financial statements and the consolidated group. This is because 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 & 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[18]. This is because the cash flows associated with the UKAR mortgages, and any associated impairment are subject to significant judgement. Thus, I consider it a risk for my audit opinion that the UKAR loan will not be paid back in full to the Treasury.

2.13 I have also assessed that the valuation of the Treasury's statutory debt recoverable from Icesave is subject to inherent uncertainty. This is because the assets from which the loan will be repaid are in Iceland and denominated in Icelandic Krona. There have been capital limits in place over Krona which have restricted the repayments being made and recoveries have subsequently been less than forecast in recent years. The recoverability of the loan, and any associated impairment, is therefore subject to significant management judgement and so represents a significant risk. In 2014-15, the Treasury recovered £928 million from Landsbanki in respect of the loan and £446 million of the statutory debt is outstanding at year-end.

2.14 The other loan balances, including the FSCS Icesave debt, are not deemed to be a significant risk. Although there is uncertainty around the level of funds to be distributed from winding down the business where loans are recoverable directly from the administrators of failed institutions, these balances are not of a significant size. If there are insufficient recoveries from administrators to repay loans by FSCS, FSCS is able to levy the industry for any shortfall and thus the FSCS loans are fully recoverable.

Audit approach

2.15 My audit approach addressed this significant risk through my review of the Treasury's financial models, assumptions and judgement made by management which underpin the valuation of the loans in the Treasury's 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.

Investments in Royal Bank of Scotland and Lloyds Banking Group

2.16 During the financial crisis, the Treasury injected capital of £66.3 billion into RBS and Lloyds, by purchasing shares. This ensured that they would have sufficient capital

[18] UKARs 2014-15 results announcement, http://www.ukar.co.uk/media-centre/press-releases/2015/16-06-2015?page=1

to continue trading. As well as 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 shareholders.

2.17 The Government is committed to returning the banks to private ownership. In December 2014, it announced that it would dispose of further Lloyds shares, as part of a trading plan. HMT has raised over £1.7 billion in 2014-15 under the trading plan.[19] 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. The first payment to the Treasury of £320 million has been made and the timing of the final payment is at RBS's discretion. In the Mansion House Speech[20] on 10 June 2015, the Chancellor announced that the Treasury will start disposing of its shares in RBS.

Figure 7

Shareholding in RBS and Lloyds at 31 March 2015

Type of share	Number of shares (percentage shareholding)	Share price (pence)	Value (£m)
Lloyds ordinary shares	15,552m (22%)	78.28	12,174
RBS ordinary shares	3,964m (64%)[3]	340	13,479
RBS B shares[2]	51,000m	34	17,340
RBS Dividend Access Share	1	n/a	1,159[1]

Notes

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

2 10 RBS "B" shares convert into 1 ordinary share.

3 The Treasury now has 79% of the economic ownership of RBS.

Source: HM Treasury *Annual Report and Accounts 2014-15*

2.18 As shown by **Figure 7**, the value of ordinary shares of £13.5 billion in RBS and £12.2 billion in Lloyds represents their market price at 31 March 2015. The RBS B shares are convertible to ordinary shares at a ratio of 10:1 and their value of £17.3 billion at 31 March 2015 is therefore based on the market price of ordinary shares on

[19] https://www.gov.uk/government/news/chancellor-extends-successful-lloyds-trading-plan

[20] https://www.gov.uk/government/speeches/mansion-house-2015-speech-by-the-chancellor-of-the-exchequer

this date. The Lloyds sales, as part of a trading plan, resulted in the recognition of an accounting profit of £1.0 billion in 2014-15. **Figure 8** sets out the accumulated transactions and financial statement impacts of the sales of Lloyds shares.

Figure 8

Lloyds share sale: calculation of accounting profit

Sale date	Shares sold (million)	Purchase price[1] (pence)	Sale price (pence)	Net gain/ (loss) (£m)	Previous impairments (£m)	Profit on disposal recognised in Statement of Comprehensive Net Expenditure in-year[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
1 January 2015 to 31 March 2015	2,219	58.30	78.5	449	539	989
Total	**12,056**			**(6,667)**	**11,755**	**5,091**

Notes

1 The Treasury account for share sales on a "first in, first out" basis. This means the purchase price is based on the average price paid for the shares sold on each date. The purchase price is adjusted to recognise the price of the shares on completion of the transaction.

2 Profit on disposal includes selling costs and rebates.

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 over the last few years, 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. There is a broader risk associated with the future disposals of shares in RBS and Lloyds, however, as the Treasury needs to ensure that the sales represent value-for-money. I considered the value obtained by the Treasury in making the first two sales of shares in Lloyds in my report in March 2014[21] and my report on the 2013-14 accounts.

UK Asset Resolution

2.20 Apart from the shareholdings in RBS and Lloyds, the main residual elements of the Treasury's financial stability interventions are the outstanding loans to NRAM and Bradford & Bingley. UKAR is the holding company for the nationalised NRAM and Bradford & Bingley banks.

2.21 The repayment by UKAR of the outstanding loans from the Treasury, which total some £34.3 billion, is through cash flows from interest payments and redemptions of

[21] http://www.nao.org.uk/report/hm-treasurys-2013-14-annual-report-accounts/

residential mortgages held by Bradford & Bingley and NRAM, totalling £52.7 billion. The most significant liabilities, excluding UKAR's outstanding loans from the Treasury, are debt securities totalling £20.9 billion issued by the former banks to raise funds backed by their assets, primarily mortgages.

2.22 During the year, UKAR accelerated the on-going process of winding down the closed mortgage books of Bradford & Bingley and NRAM by selling a portfolio of mortgages and buying back some of the former banks' market traded debt securities.

2.23 In October 2014, UKAR sold £2.7 billion of mortgages to Commercial First, part of a consortium of investors led by JP Morgan. The price obtained represented a small premium of about 2% (£55 million) over the book value of the mortgages.

2.24 In January 2015, UKAR bought back £277 million of outstanding subordinated debt that had been sold to investors by Bradford & Bingley and NRAM. The subordinated debt carried relatively high rates of interest of up to 13%. This reflected the fact that the debt holders would have to bear losses before other types of borrowing by the former banks. However, due to the increasing capital strength of UKAR it was very unlikely that the subordinated debt would ever suffer losses. The benefit of retaining the subordinated debt, rather than buying it back with much cheaper government funding, was therefore limited.

2.25 In March 2015, the Chancellor of the Exchequer announced a major UKAR asset sale involving Granite, a securitisation vehicle established by Northern Rock in 2001. At the same time, UKAR is exploring options for the disposal of its mortgage servicing activities. In May 2015, it announced that it had redeemed €2 billion of outstanding bonds that had been issued to investors by NRAM. I plan to report on these transactions as part of a report on the government-owned banks during 2015-16.

Part Three - 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 of the most significant direct support interventions that impact on the Treasury's financial statements. These will be increasingly important to the Treasury's financial management in the coming years. These are the Help to Buy Guarantee Scheme; the UK Guarantee Scheme and the Quantitative Easing programme.

Help to Buy Mortgage Guarantee Scheme

Background

3.2 The Help to Buy Mortgage Guarantee Scheme is now in its second year, having launched in January 2014. The Scheme will run until 2020 and allows lenders to purchase a guarantee where a borrower has a deposit of between 5% and 20%. The guarantee offers lenders the option to purchase a guarantee that lasts for seven years and will cover the loss suffered by the lender down to 80% of the property value, net of recoveries, minus the first 5% (Figure 9). The Treasury's maximum exposure will be limited to £12 billion on mortgage lending of up to £130 billion over the life of the scheme.

3.3 Loans made under the mortgage guarantee scheme must meet certain eligibility criteria, including[22]:

- the property must be a UK property with a purchase price of £600,000 or less;
- the mortgage must be a residential and repayment mortgage;
- the mortgage is for the buyer's only property and not for buy-to-let or commercial properties; and
- borrowers will have to pass credit and affordability checks.

3.4 The Treasury charges a commercial fee to lenders in return for issuing the guarantee. The fee covers all expected losses under the guarantee, the administration costs and a cost of capital. Thee fee complies with the European Commission guidance on state aid and Treasury reviews the fee annually to take account of

[22] Further eligibility criteria are detailed in the scheme rules, which are available at www.gov.uk/government/publications/help-to-buy-mortgage-guarantee-scheme-rules

changing economic conditions. For 2014-15, the Treasury has left the Scheme fees unchanged.

3.5 The Bank of England's Financial Policy Committee monitor the Scheme and report annually in October. Specifically, they provide advice on whether the fee and house price cap remain appropriate and make recommendations on its size or the fees to be charged, though any changes are the Treasury's responsibility.

3.6 In his letter of October 2014 to the Chancellor, the Governor of the Bank of England, Mark Carney, confirmed that the Committee had assessed that:

- the scheme does not pose a material risk to financial stability
- the scheme has not been a material driver of recent house price rises; and
- the key parameters of the scheme (the house price cap and fee charged to lenders) remain appropriate

Figure 9

Example Help to Buy Mortgage Guarantee Scheme calculation

Issue of guarantee

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

Purchaser provides 5% deposit **£5,000**

Lender provides 95% mortgage **£95,000**

HM Treasury provides 15% 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**.

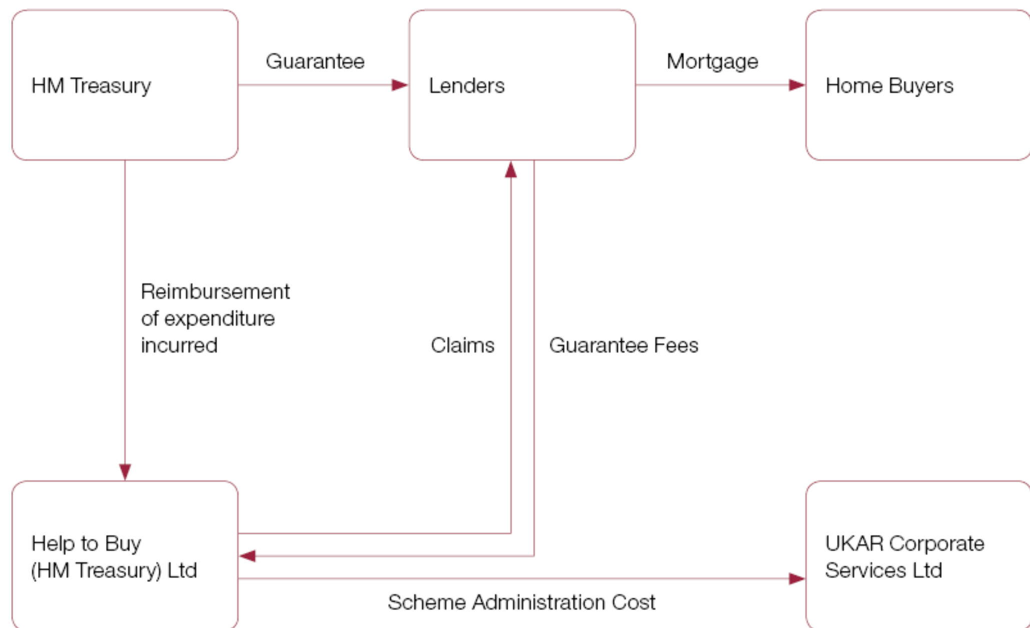
£15,000 guarantee

But lender takes first 5% of loss **£750**

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

Source: National Audit Office

Figure 10
Administration of the Mortgage Guarantee Scheme



Source: National Audit Office

3.7 The following table **(Figure 11)** gives a summary of the key data relating to the MGS and the financial guarantee liability recognised in the financial statements.

Figure 11
Help to Buy Mortgage Guarantee Scheme Data

	2014-15	2013-14	Total (outstanding)
Number of guarantees[1]	39,578	7,299	46,877
Financial Guarantee liability (£m) at 31 March 2015	45.4	7.7	53.1
Maximum Exposure (£m)	536	95	631

Notes
1 So far no claims in relation to the guarantees have been received.
2 Differences between financial years will arise due to redemption of mortgages, claims being made in relation to the guarantees and amortisation on the financial guarantee liability.

Source: National Audit Office analysis of UKAR monthly reporting data from May 2015

Changes in the housing market

3.8 The mortgage guarantee scheme is a targeted intervention designed to improve availability of access to mortgages for borrowers with small deposits in the wake of the financial crisis. The number of lenders signing up to the Scheme has steadily increased since 2013-14 and as of 31 March 2015 there were 13 financial institutions offering mortgages backed by a Help to Buy guarantee. These 13 institutions include many of the largest and well known high street banks. Since the launch of the scheme, there has been an increase in the availability of high loan to value products offered by non-scheme lenders with rates comparable to those offered Help to Buy mortgages.

3.9 The amount covered by the Treasury on each guarantee is based on the loss incurred by the lender where there is a default and the outstanding balance of the mortgage cannot be recovered through the sale of property. The ability of the lender to recover the full mortgage balance will depend on the sale price of the property which can be greatly influenced by regional house price movements. The ONS publishes monthly statistics on house prices and as **Figure 12** shows, the average UK house price has risen by £21,000 in the period that the mortgage guarantee scheme has been in operation. Any rise in house prices, if realised by a lender on a sale as result of default, will reduce the amount of loss incurred by the lender and also the Treasury.

Figure 12
Average UK house price

Source: Office for National Statistics, available at: www.ons.gov.uk/ons/taxonomy/index.html?nscl=House+Price+Indices

Uptake and administrative costs

3.10 The scheme limit of £12 billion was expected to support around 570,000 mortgages over its three year life. The Treasury chose to base the fees on a 50% uptake rate (285,000 mortgages). The fees as a minimum need to cover scheme's administration costs, all successful claims by lenders and provide an adequate cost of capital to the Treasury.

3.11 As at 31 March 2015, in the 15 months that the Scheme has been in operation, the total number of mortgages supported by Scheme was 46,877, 61% less than the expected uptake at the outset of the scheme, pro-rated for 15 months, of 118,750 mortgages. The fees as a minimum need to cover scheme's administration costs, all successful claims by lenders and provide an adequate cost of capital to the Treasury. The Treasury has the power to adjust future lender fees to ensure that the scheme remains self financing and that they cover all administrative costs and lender claims. The fee can be reset each calendar year to take account of changing scheme volumes and updated economic conditions.

3.12 Scheme administration costs up to 31 March 2015 were approximately £8.1 million. The number of mortgages in arrears and default at the year end were 64 and 6 respectively whilst total lender fees receivable for the 15 month period were £58.9 million. Whilst the number of mortgages issued under the scheme is currently less than predicted, it is difficult to conclude on the self-financing aspect of the Scheme as the guarantees issued by the Treasury may be called upon at any time during the seven years that the guarantee is provided for. Furthermore as interest rates start to rise above their current historically low levels, mortgage payments may increase resulting in a likely rise in the number of claims made by lenders, although any losses for the Treasury are likely to be offset by rises in house prices. For this reason it is also too early to conclude on the overall value for money of the Scheme.

Audit risk

3.13 Given the £12 billion scheme limit, the Help to Buy Mortgage Guarantee Scheme represents a potential significant intervention in the housing market. However, as only £58.9 million of guarantees based on fees received had been issued at 31 March 2015, I concluded that there was not a significant risk of material misstatement for my audit this year as the number of guarantees issued has not reached a material level.

UK Guarantee Scheme

Background

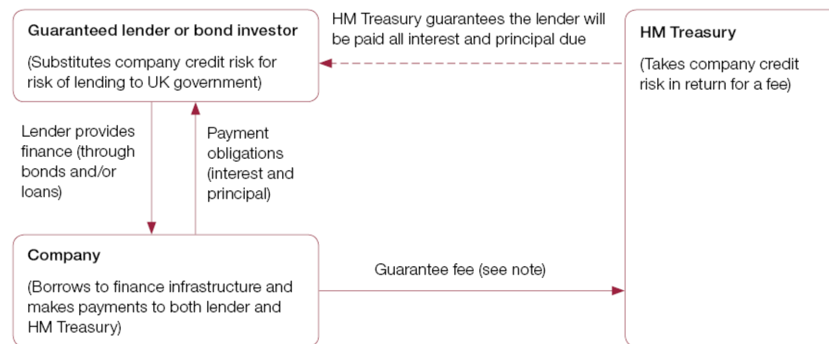
3.14 The UK Guarantee Scheme (UKGS) aims to prevent infrastructure projects being delayed or cancelled by difficulties in obtaining debt financing. The scheme aims to meet its objective is by utilising the Government's credit rating to provide protection against default for the lenders to the projects. It achieves this 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 issue 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.

3.15 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. HMT can guarantee up to £40 billion of finance under the Scheme.

Figure 13

How the Scheme works



Note

1 The company agrees to reimburse HM Treasury for any payments under the UK Guarantees Scheme. HM Treasury and the company document various bilateral rights.

Source: National Audit Office

3.16 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.

3.17 The Treasury employs a team of experienced commercial specialists to undertake an assessment of project risk based on due diligence and other techniques used by commercial infrastructure lenders and rating agency methodologies. In practice, the Treasury considers many infrastructure projects with construction risk are likely to be non-investment grade. To comply with European State Aid guidance on the issue of guarantees by member states, the Scheme is not intended to provide subsidised loans to infrastructure projects. To ensure this, the Treasury charges each infrastructure project company a market-oriented fee. The fee is determined by the

Treasury's assessment of project risk and prevailing market prices for equivalent risks. The Treasury's accounts recognise a financial guarantee liability for each guarantee that is signed equal to the net present value of the fees payable for the guarantees, providing that the fee is an accurate reflection of the risk of the underlying project. The maximum exposure to losses, based on the amount of debt guaranteed and unpaid interest, is disclosed as a remote contingent liability under Managing Public Money.

3.18 As at 31 March 2015, six guarantees have been issued under the Scheme, with four of these being issued in 2014-15 **(Figure 14)**. This has led to the recognition of a receivable for fees of £107.3 million, a financial guarantee liability of £113.5 million (based on undiscounted fees of £150.4 million) and a contingent liability of £884.6 million at 31 March 2015. The Treasury has 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 £80 million for Countesswells, a housing development. 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 2015.

3.19 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[23]. The most significant project that is under consideration is the Hinkley Point C nuclear power station.

Audit risk

3.20 The Treasury's announcement that it will provide up to £40 billion of guarantees under the Scheme means that it is likely to be material to the accounts in the future. However, as only £884.6 million of guaranteed debt had been issued at 31 March 2015 I concluded that there is no significant risk of material misstatement for the 2014-15 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 ensure that they have a rigorous ongoing process to monitor projects, I will revisit my risk assessment in future years.

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

Figure 14

UK Guarantee Scheme timeline

	Date	Project Name	Sector	Scheme Status
2013-14	April 2013	Drax Power	Energy	Signed (£75 million)
	December 2013	Sustainable Development Capital - UK Energy Efficiency Investments Fund	Transport	Signed (£8.8 million)
	November 2013	Northern Line Extension[1]	Transport	Signed (£750 million)
2014-15	April 2014	Mersey Gateway Bridge	Transport	Signed (£257 million)
	August 2014	Ineos Grangemouth Ethane Import and Storage Facilities	Transport	Signed (€285 million/£226 million)
	August 2014	Speyside CHP Plant	Energy	Signed (£48.2 million)
	November 2014	University of Northampton	Education	Signed (£292 million)
2015-16	Not signed	Countesswells	Housing	Approved (£80 million)

Note

1 The Northern Line Extension project is a loan commitment, not a guarantee.

Source: National Audit Office analysis of Government Scheme Data

3.21 I reported to Parliament on the value for money of the UK Guarantee Scheme in January 2015. This considered the rationale and implementation of the scheme, the Treasury's approach to measuring and managing taxpayer risks and how the Treasury derives the price of guarantees and the role of financial market indicators. This report considered all of the guarantees issued to date, with the exception of the University of Northampton and Speyside. While I found that the Treasury has a formal governance process and employs commercial specialists to determine the pricing of the guarantees, I questioned whether this approach can measure long-term risks to taxpayers reliably. The Treasury should ensure that its eligibility criteria for this Scheme includes a rigorous and objective assessment that guarantees are needed. The Treasury needs to report to Parliament on the level of risk associated with the guarantees and should develop an additional pricing methodology based on appropriate capital charge. The scheme is currently under review and the Treasury is considering these recommendations.

Quantitative Easing

3.22 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 the Bank of England Asset Purchase Facility Fund Limited (BEAPFF), a wholly owned subsidiary of the Bank of England. Under the programme, the Bank made a loan to BEAPFF, backed by a claim on the Bank's balance sheet. BEAPFF used this loan to buy assets held by investors, mainly gilts, and effectively injected money directly into the economy (**Figure 15**).

3.23 The BEAPFF 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[24] 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 BEAPFF at 31 March 2015. As the assets held by BEAPFF are gilts, the value on the derivative will change as gilt prices move and interest is accrued.

3.24 Until January 2013, coupons (interest) paid on gilts were held by the BEAPFF. During 2012-13, the Treasury and the Bank agreed to a revised indemnity to require excess cash to be transferred between BEAPFF and the Treasury to enable more efficient cash management across government. £42.4 billion was transferred by 31 March 2014 and a further £10.7 billion during 2014-15, offsetting movements in the value of the derivative.

3.25 The financial statements recognised a derivative asset of £36.4 billion at 31 March 2015 and an increase in value of £46.9 billion is recognised in the Statement of Comprehensive Net Expenditure relating to the value of the derivative, which is offset by cash transfers of £10.7 billion.

[24] 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 15

Quantitative Easing

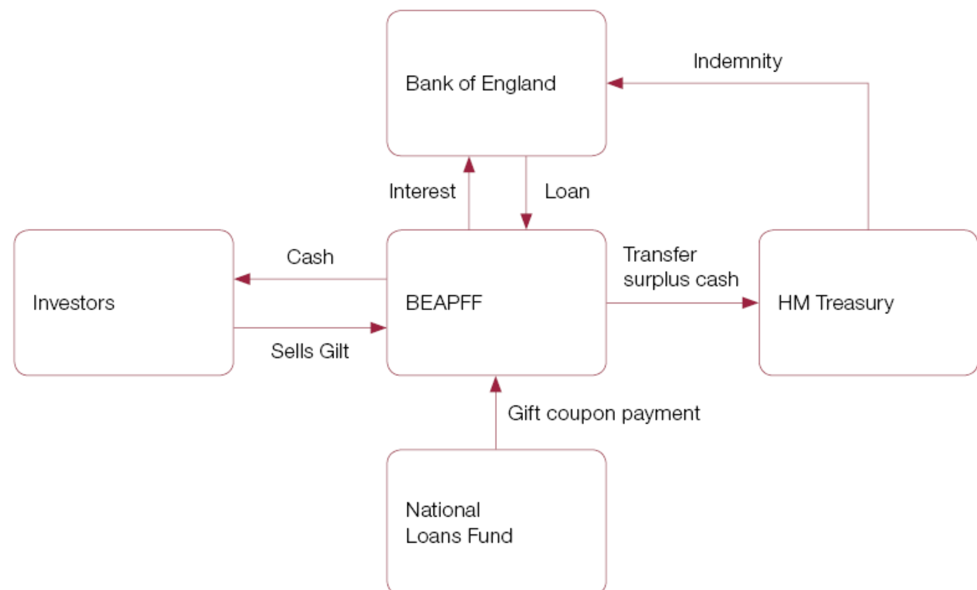
1 Standard Gilt Issuance

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

Audit risk

3.26 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. It 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.

Business Finance Partnership, National Loans Guarantees Scheme and Funding for Lending Scheme

Background

3.27 The National Loans Guarantees Scheme (NLGS) was introduced in March 2012, to reduce the cost of bank loans and help businesses access cheaper finance. This was then superseded by the Funding for Lending Scheme (FLS), which provides funding to banks and building societies for an extended period, with both the price and

quantity of funding provided linked to their lending performance[25]. Both schemes are designed to increase lending, with the scope of the FLS being scaled back and incentives being introduced to encourage lending to primarily small and medium sized businesses.

3.28 The Business Finance Partnership (BFP) was set up to invest £1.2 billion in increasing lending to small and medium-sized businesses, to encourage private sector investment[26]. The Treasury element of this scheme (£328 million) was transferred in June 2014 from Infrastructure Finance Unit Limited (IFUL) to British Business Investments Limited, part of the Department for Business, Innovation and Skills (BIS). This has led to the Treasury recognising £328.2 million as a capital grant-in-kind, to reflect that the Treasury no longer has the rights to cash flows associated with this investment.

Audit risk

3.29 I concluded that there is no significant risk of material misstatement for the 2014-15 accounts arising from these schemes. NLGS is not considered a risk, as it is not open for new guarantees and so there has been no new activity during 2014-15, and FLS is not reflected in the Treasury's accounts, as it is administered by the Bank of England. As the BFP is no longer held by the Treasury, there is no risk to the Treasury's accounts.

[25] http://www.bankofengland.co.uk/markets/Pages/FLS/default.aspx

[26] https://www.gov.uk/government/policies/making-it-easier-to-set-up-and-grow-a-business--6/supporting-pages/encouraging-private-sector-investment

Part Four - New Developments

4.1 There have been several new developments in the Treasury during 2014-15 and so I have considered the impact of these on the accounts, when conducting the audit.

4.2 The Department for Transport's (DfT) holding in Eurostar, worth £325 million, was transferred to the Treasury in June 2014. The valuation of the holding is not material to the accounts and so there is no significant risk associated with this investment. The Treasury agreed to sell this holding for £757.1 million in 2015-16, as announced in March 2015. I plan to consider this transfer in further detail in a value for money report on the government's holding in Eurostar.

4.3 In 2014-15, the Treasury received £1.4 billion of fines from the financial services industry, mostly in relation to foreign exchange misconduct by the banks. In 2013-14, the fines were disclosed in the Treasury accounts, however as they have now reached a material level, a separate trust statement has been produced to account for these in accordance with the requirements of the Government Financial Reporting Manual. The prior year figures in the Treasury's accounts have therefore been restated to remove the fines and I have issued a separate report on the trust statement.

4.4 In March 2015, the Treasury announced that it would be expanding its assistance to first time buyers in the housing market by launching a range of Help to Buy Individual Savings Accounts.[27] This programme is designed to support those who are saving deposits for their first home and will provide a government bonus of 25% of the amount saved by each individual within the scheme up to a maximum of £3,000 per person. This is likely to be a popular scheme for first time buyers and will impact on the accounts due to the accumulation of the government bonus as the savings grow.

27 https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/413899/Help_to_Buy_ISA_Guidance.pdf

4.5 The Treasury announced[28] in Budget 2014 that all individuals with defined contribution pension savings would be offered free and impartial guidance at the point of retirement. In its July response to the Budget consultation, it was announced that the Treasury would hold overall responsibility for delivery of this service through a website, face to face and telephone sessions. The Treasury spent £21.9 million to develop and set up the service in 2014-15, and ensure it was ready across all three channels from April 2015, when the new pension freedoms commenced. This is immaterial to the accounts in 2014-15 and will continue to impact the accounts in future years, as the Treasury are overseeing the whole policy. In the longer-term, the ongoing running costs of this guidance will be funded through levies raised by the Financial Conduct Authority (FCA) instead of by the Treasury.

Sir Amyas C E Morse

Comptroller and Auditor General

17 July 2015

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[28] http://www.parliament.uk/business/publications/research/briefing-papers/SN07042/pensions-the-guidance-guarantee

Appendix One: Materiality

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.

In my professional judgement, the main source of interest in the financial statements of the Treasury is the Statement of Financial Position (SoFP) as this is where the impact of the 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.

The schemes and interventions contained within the financial statements have been subject to significant public interest. As a result I consider the Treasury account to be highly sensitive so apply 0.5% of gross assets, 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 £786 million for the group and £659 million for the parent (the Treasury and agencies).

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.

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.

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.