National Audit Office

Report
by the Comptroller
and Auditor General

HM Treasury

Financial institutions landscape

HC 418 SESSION 2015-16 10 SEPTEMBER 2015

Summary

1 Since the financial crisis began in 2008 the number of government interventions in financial markets has increased. These interventions include the acquisition of significant stakes in banks and the creation of many new financial institutions. It is not clear that any single area of government is taking a portfolio view of the institutions associated with these interventions, so we intend to highlight them in this report.

2 This report describes a landscape of 54 such institutions representing a total asset value of over £200 billion.[3] This includes:

- the four financial institutions acquired (in part or in full) during the financial crisis – these cost £107.6 billion and have a current value of approximately £109 billion;[4]
- seven core-financing institutions;
- membership of seven international financial institutions; and
- ownership or contractual agreement with 36 'policy-related' institutions.[5]

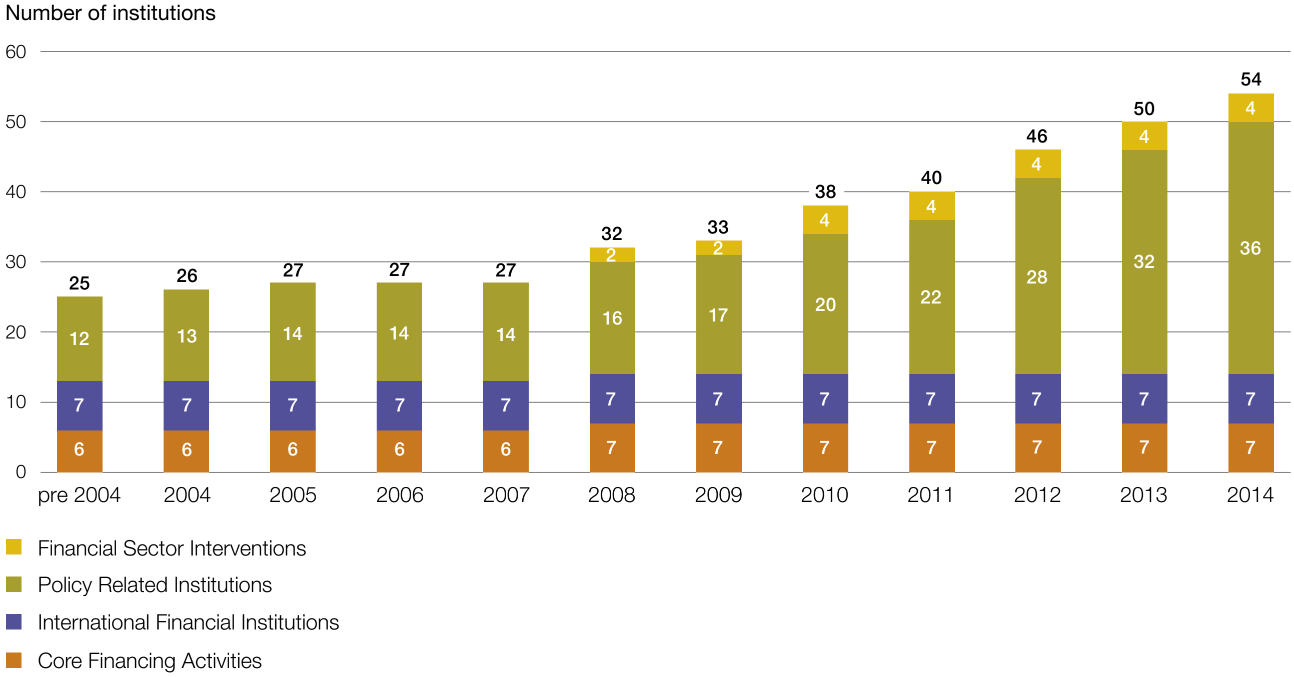
3 Between 2004 and 2014, the number of policy-related financial institutions increased three-fold, from 12 to 36 (**Figure 2**). These 36 institutions collectively administer £123 billion in total assets and £138 billion total liabilities.[6] This landscape is evolving rapidly, for example several new institutions have been launched recently, several are growing rapidly, and others have been merged or closed to new applicants.

3 This excludes the sponsor departments, and subsidiaries, which may perform a similar range of activities.
4 The current value figure of £109 billion consists of the total assets for UK Asset Resolution and the market value of equity stakes in Lloyds Banking Group and the Royal Bank of Scotland. Market values may vary.
5 Policy-related institutions are institutions created to implement a specific policy objective. Several central government departments also undertake financial transactions (eg issuing loans or guarantees), however, these have not been counted as additional institutions.
6 These figures include the student loan book which is reported on the BIS departmental accounts.

Figure 2

Cumulative number of financial institutions

Since the crisis there has been a significant growth in the number of policy-related institutions



Source: National Audit Office analysis of departmental and institutional published annual reports and accounts

4 Drawing on government guidance on financial transactions, and legislation on regulated financial sector activities, this report defines the financial institutions based on the following activities:[7]

- statutory compensation schemes and reinsurance, funded mainly or exclusively by industry levies;
- issuing financing guarantees – including arranging, distributing and administering guarantees and related insurance arrangements and indemnities;
- lending – including arranging, distributing and administering loans to a variety of customers and industries;
- investment and asset management – including managing equity investments, government property, pensions and related advisory services; and
- other services – for example, clearing houses associated with energy market reforms.

7 These activities are defined in the FSMA (see paragraph 2.38).

Scope

5 This landscape report identifies the characteristics of individual financial institutions, including their activities, sectors, customers, distribution methods, accountability models, regulatory considerations, ownership stakes, financial performance and funding arrangements. We have identified a number of institutions that perform an administrative function and therefore do not report the relevant financial instrument related to it in their financial statements. In these cases, the financial instrument is reported in the financial statements of the sponsor department (the largest such example concerns student loans).

6 In order to contain the scope of this report, we have excluded local government, social housing, local enterprise partnerships and special purpose vehicles set up to manage private finance initiative (PFI) and private finance 2 (PF2) transactions. We have also excluded organisations in Northern Ireland, Scotland and Wales. There are a number of sectors where we have included the largest institutions but excluded the smaller ones, for example property, pensions, insurance, leasing, financing aggregators and asset-backed vehicles.

7 The report is based on publicly available information at 31 March 2015. More detailed further financial information is included in Appendix Six.

Key findings

8 **There has been a significant growth in the number of financial institutions over the past ten years, reaching a total of 54, including the four financial institutions government acquired (in whole or part) during the financial crisis.** Alongside government interventions to maintain financial stability, the number of policy-related institutions has increased three-fold, from 12 to 36 since 2004. This is because the government has tended to establish separate companies to conduct financial transactions and perform related activities, eg administer consumer funding models such as student loans. State aid, a form of government intervention, only allows lending whereby there are demonstrable cases of market failure (paragraphs 1.1 to 1.4 and Figure 2).

9 **The government's exposure to the financial sector, measured by public sector net debt, was over £2 trillion between November 2008 and February 2014.** Lloyds Banking Group was removed from the national statistics after the government sold some of its shares in March 2014. Royal Bank of Scotland (RBS) and UK Asset Resolution (UKAR) (which manages the legacy assets of Bradford & Bingley and Northern Rock) remain classified as being within the public sector (paragraphs 2.12 to 2.14, Figure 3 and Appendix Two).

10 The government plans to reduce its exposure to some sectors but this may be offset by growth in policy-related activities. The Office for Budget Responsibility (OBR) estimates the government will receive around £94.6 billion between 2015 and 2020, from selling shares and selling or collecting loans it has issued. Outgoings from the issuance of new loans and other initiatives will total £94.8 billion over the same time period. In relation to the residential mortgage sector, the £2.7 billion proceeds from selling part of the UKAR portfolio is offset by Help to Buy schemes, which have grown to £3 billion (paragraphs 2.27 to 2.29 and Figure 6).

11 The government has announced plans to divest of a number of assets, which the OBR estimates will result in proceeds of £62.6 billion. These assets are: a portion of the student loans portfolio; the remaining shares in Lloyds Banking Group; a portion of the mortgage portfolio in UKAR and a proportion of its RBS shares. A government commissioned report[8] estimates that the cost of the financial sector interventions was £107.6 billion, that receipts to June 2015 were £43.8 billion and if all the shares were sold at March 2015 values, there is an overall cash surplus of £14.3 billion (subsequent OBR data at July 2015 suggests the surplus is now £14.9 billion). The estimates do not take account of the cumulative cost of financing these investments, which is approximately £10.88 billion for Lloyds Banking Group and RBS[9] (paragraphs 2.1, 2.2, Figure 6 and Appendix Two).

12 The student loan book is an increasingly important and material[10] feature of the government balance sheet. Of the £64.1 billion lent to students, the government expects to recover £42.2 billion. The OBR forecasts that £84.4 billion of new student loans will be issued in the period of 2015–2020, and a total of £11.9 billion will be repaid on past loans during the same period. The government expects to generate about £11.5 billion of proceeds from sales of the pre 2012 student loan book. The total value of student loans is expected to reach £100 billion by 2018 (paragraphs 2.29, 3.11 to 3.13, Figure 6, Figure 10 and Appendix Six).

13 There are five policy-related institutions with assets or liabilities greater than £10 billion each, six with gross assets or liabilities greater than £2 billion each and three greater than £1 billion each. We estimate that, in addition to the student loan book, the government's wholly-owned policy-related institutions held £70 billion of assets and £69 billion of liabilities at 31 March 2015. The OBR forecasts a further £10 billion increase in public sector net debt by 2020 due to the expansion of Help to Buy, Green Investment Bank, British Business Bank and other policy-related financial institutions (paragraphs 2.22 to 2.28, Figure 4, Figure 5, Figure 6 and Appendix Six).

8 Rothschild, *The UK investment in the Royal Bank of Scotland*, 10 June 2015, p. 11.
9 The cumulative cost of financing these investments excludes UKAR.
10 IAS 8 defines material as: "Omissions or misstatements of items are material if they could, individually or collectively, influence the economic decisions that users make on the basis of the financial statements."

14 The policy-related institutions exhibit significant variety and span the public–private sector divide. The institutions undertake a variety of activities in numerous sectors and are sponsored by ten central government departments. Their delivery models include units of departments, arm's length bodies, government companies and private sector delivery partners. Government ownership ranges from 0–100% (paragraphs 1.4, 2.5 and Figure 9).

15 There is rarely an accessible way to distinguish between a temporary market intervention and an enduring financial institution, or to identify the intended duration of taxpayer exposure. If the government decides to reduce its financial services portfolio, an orderly exit from the sector will take many years (paragraphs 2.3 and 2.9).

16 The government is the main, or only, source of capital for most of these institutions, but only two institutions paid a dividend in the last year. Sponsor departments can provide initial share capital, equity commitments and loans. It is hard to predict whether, or when, additional capital will be required to achieve commercial success or withstand adverse events. Many of the financial institutions do not operate with significant reserves (paragraphs 2.31 to 2.33).

17 Most government companies are categorised as central government bodies rather than public corporations and are therefore technically exempt from the requirement to generate a commercial return. Our review indicates that 16 have not been classified by the ONS at all. Historical financial information is available for 30 of 36 policy-related institutions (paragraphs 2.5, 2.33 and Appendix Six).

18 Financial institutions within central government are generally exempt from financial services regulation. We found 11 financial institutions to be listed on the Financial Conduct Authority register. The absence of the rest is explained by crown exemption and the administrative nature of their activities.[11] Some administer financial transactions on behalf of their sponsor departments; others are responsible for direct or indirect distribution of financial services to a range of retail and institutional customers. Only two of the institutions, RBS and Lloyds, are subject to the Prudential Regulation Authority's stress-testing (paragraphs 2.36 to 2.40 and Appendix Six).

Concluding remarks

Seven years after the financial crisis, the government has announced that it intends to accelerate its asset sale programme. The programme is unprecedented in scale and aims to reduce the government's exposure to the financial sector. The one-off inflow of proceeds can be used to repay national debt, although the overall impact on government borrowing is uncertain, not least as the growth in some financial institutions may offset sale proceeds. We expect the government to demonstrate good practice when it disposes of these investments.

11 The US Government Accountability Office (GAO) found that shadow banking, such as various special purpose entities and non-bank mortgage origination companies lacked significant prudential regulation. See GAO, Bank *Regulation: Lessons Learned and a Framework for Monitoring Emerging Risks and Regulatory Response*, GAO-15-365, 25 June 2015.

A diverse population of other public bodies has emerged in recent years to perform a range of activities commonly found in the financial sector, including lending, issuing financial guarantees and managing government investments. As a group, these institutions are becoming material to the government balance sheet and create a range of opportunities and risks. Some of these institutions appear to have survived the market conditions they were created to alleviate, and the rationale for their existence in the public sector is questionable. We consider that government should adopt a portfolio management approach alongside the traditional departmental oversight model to provide heightened assurance over the portfolio.

Issues this landscape report raises

19 The development of this landscape report has highlighted a number of issues that merit further discussion and more detailed review:

a **How to assess value for money of the divestiture programme.** We have reported on privatisations and asset sales after they have completed and we may return to this theme as the divestiture programme unfolds. To reach a conclusion on value for money it is important to assess the value generated through holding onto an asset versus selling it. It is also important to consider a range of factors, including valuation, the design and management of sale process and bidder dynamics during a sale process.

b **How to manage policy initiatives over their full life cycle and ensure they last no longer than necessary.** This may be informed by considering more explicitly the differences between temporary and enduring institutions, and how to assess whether an institution or government intervention should continue to operate. It may be appropriate to define the parameters for an exit at an early stage (eg formation of a policy-related institution) and keep these under review. This assessment may best be performed independently of the institution affected to minimise risk of bias.

c **How to achieve the benefits of portfolio management at a reasonable cost.** The advantages of taking a portfolio approach to the financial institutions landscape include: the ability to identify potentially offsetting effects, such as expansion and contraction; risk-modelling to measure and manage exposure to individual asset classes; and the ability to benchmark performance across institutions and within sectors, apply stress tests and develop scenarios. A range of analytical techniques could be applied to provide better assurance over the portfolio. Examples of operational performance metrics that could be used to compare bodies with similar responsibilities in the public and private sector include: investment performance; expense ratios; loan default; loss and recovery rates. It may be appropriate to consider reviews of start-ups and principal interventions including their implications for the existing policy landscape and other knock-on effects.

d **How to achieve an appropriate balance between minimising risks to the taxpayer, and avoiding inefficient use of government working capital or reserves.** Some of these activities present risks to the taxpayer, which is understandable given their responsibilities to address market failures. Unplanned developments (eg a shortfall of income or deterioration of asset value) could spill over to departments, and place pressure on other planned expenditure in the context of tight budgets. However, the emergence of substantial capital reserves to minimise reversionary risk for an individual institution may be inefficient from an overall government balance sheet perspective.

e **How to improve understanding of these institutions and their impact on the government's finances.** The differences in classification of public bodies and recording of financial transactions between the national statistics, whole of government accounts and financial statements of individual financial institutions creates a range of challenges in understanding the true scale and extent of activities. For example, approaches to value assets and liabilities, recognise and report contingent liabilities and other potential exposures, differ and some balances may be split across more than one public body.