National Audit Office

Report
by the Comptroller
and Auditor General

HM Treasury

Evaluating the government balance sheet: financial assets and investments

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Key facts

£400bn	£7bn	£106bn
value of financial assets recorded on the 2014-15 WGA balance sheet	income generated from financial assets in 2014-15	forecast proceeds from asset sales and loan and interest payments between 2015-16 and 2019-20

one-third	financial assets as a proportion of government borrowing
£25 billion	proceeds the government has committed to raise from its stake in the Royal Bank of Scotland Group Plc (RBS) by end of 2019-20
73%	size of the government's shareholding in RBS
100%	increase in the face value of the English student loan book between 2009-10 and 2014-15
£400 billion	government forecasts for the face value of outstanding student debt by 2040 in 2015 prices
£16 billion	proceeds government aims to raise from sales of Bradford & Bingley mortgages by end of 2017-18

Summary

1 The government holds a significant and varied portfolio of financial assets. These assets include those created as a result of specific policy decisions, such as its interventions during the financial crisis and loans issued to students to encourage them into higher and further education. Financial assets also include assets held for the sole purpose of supporting the government's day-to-day cash management. The government's financial assets entitle it to receive future financial benefits and include investments such as company shares; as well as loans and cash deposits. Aside from the assets used to manage the government's cash flows, the government's most significant assets relate to: student loans; the portfolio of businesses managed by the Shareholder Executive (ShEx); and the assets that are a legacy of the financial crisis. The legacy assets comprise government's investments in the Royal Bank of Scotland Group plc (RBS) and Lloyds Banking Group plc (Lloyds); as well as its ownership of the former Northern Rock and Bradford & Bingley mortgage books; and the Bank of England's Quantitative Easing programme.

2 The government has historically held relatively low levels of financial assets. In 2014-15, financial assets, including cash, totalled £400 billion, equivalent to just over a quarter of total assets (£1,455 billion), around £14,814 per UK household and around a third of total government borrowing, as reflected in the Whole Government Accounts (WGA). In addition, financial assets generated income of £7.2 billion in 2014-15, representing a 1.8% return, which was equivalent to just over half of stamp duty income (£13.5 billion), 26% more than capital gains tax (£5.7 billion) and almost double inheritance tax (£3.8 billion).

3 Effective asset management is essential to the health of the overall public finances. To get the most out of its asset holdings, the government must manage them effectively and professionally and be aware of the risks that influence the income streams that drive their value. If selling assets, the government must choose when and how best to maximise the return for the taxpayer. This can be more or less challenging depending on the type of financial assets held; and their interactions with wider economic performance and the government's policy initiatives.

4 A range of public sector bodies have a role in managing the government's financial assets and to date assets have been handled individually. As the department responsible for the public finances, HM Treasury (the Treasury) has overall responsibility for the government's financial assets and most of the organisations that manage the assets are part of its reporting group. From April 2016, the government brought together the functions and corporate finance expertise of UK Financial Investments Limited (UKFI) and ShEx under a new Treasury-owned company, UK Government Investments (UKGI).

5 The government plans to sell an unprecedented number of financial assets over the remainder of the Parliament. The Office for Budget Responsibility (OBR) forecasts that these sales will generate proceeds of around £106 billion for the government. The most significant sales will be the government's remaining shares in Lloyds and its holding in RBS; part of the student loan book; and sales of mortgages held by UK Asset Resolution Limited (UKAR) relating to the nationalised former Northern Rock and Bradford & Bingley businesses.

Scope of our report

6 This report is one of a series that explore the major risks to public finances highlighted in the WGA balance sheet. These reports examine how these risks to the balance sheet have changed in recent years and consider how the government currently manages them. This report sets out the range of the government's financial assets and investments and discusses how the government is addressing the risks these represent to the public finances. The Committee of Public Accounts has previously recommended that the Treasury makes better use of the WGA to inform decisions.[1,2]

7 Part One provides an overview of the government's financial assets drawing on the WGA; while Parts Two and Three examine in greater detail those significant assets generated for specific policy reasons. In Part Two we focus on student loans and the portfolio managed by ShEx. Part Three examines the government's legacy assets from the financial crisis.

8 In the main, the report uses annual report and accounts data from 2014-15 in line with the most recent WGA and because 2015-16 accounts have not been published for all of the public sector bodies covered in the report. We have not carried out any further examination of particular asset sales or evaluated the government's decisions to hold or sell these assets. We also have not examined any increases in government borrowing required to finance the government's investments as we will carry out a more detailed review of borrowing later in 2016-17.

1 HC Committee of Public Accounts, *Whole of Government Accounts 2011-12*, Thirty-second Report of Session 2013-14, HC 667, December 2013.

2 HC Committee of Public Accounts, *Whole of Government Accounts 2012-13*, Twenty-sixth Report of Session 2014-15, HC 678, January 2015.

Key findings

Nature of the challenge

9 **The government has to manage a significant portfolio of assets across a range of organisations.** The assets have been created in a number of ways and have been taken on for different reasons. Depending on the nature of the assets and the risks associated with them, they will require a different management approach. Some assets such as those used to manage the government's cash flows can be very short-term and the management of them necessarily day-to-day and reactive. By comparison, long-standing assets such as loans issued to students or equity holdings in businesses such as the Green Investment Bank or British Business Bank require the government to take a longer-term view and to make projections about future income and management costs as well as the potential impact of wider economic factors (paragraphs 1.1 to 1.3, 2.9 to 2.10 and 2.14).

10 **The government's assets are concentrated in the banking, housing and student finance sectors.** The value of these assets is closely related to the wider economic performance of the country, in particular the employment market, interest rates, inflation and the willingness of companies to invest. This increases the risks to the public finances as these factors also influence the government's major taxation revenues; and are affected by wider policies on the management of the economy. This concentration also affects the government's ability to sell assets quickly or achieve quoted market prices for its investments (paragraphs 1.9 and 1.21 to 1.22).

11 **Identifying the value of the government's assets can be difficult.** Valuing assets on the balance sheet can be more straightforward where, like with the Lloyds shares, there is an active market for the assets, although even then the market price will not always necessarily reflect the economic value for the reasons set out below. In other cases, a significant amount of management judgement and financial modelling is needed to forecast the value of the future income that assets, such as the student loan book, might generate. This increases uncertainty over the values, which are sensitive to changes in assumptions. Even where it may be comparatively simple to establish an accounting value, identifying the economic value, can be much more difficult due to the relative size of the government's holding of assets or the unique nature of them. The economic value attributed can affect decisions about whether, when and how to sell an asset. For example:

- As at 31 March 2015, the government's shares in RBS and Lloyds were valued at £32 billion and £12 billion respectively based on quoted market prices at the reporting date.[3] However, this value represents a point in time only in a volatile market and expectation of a large share sale could adversely affect market prices. The government has delayed its launch of a retail offer on its remaining Lloyds shares due to a fall in share price and uncertain market conditions (paragraphs 1.24, 3.7 to 3.8).

3 The value of RBS shares includes £30.8 billion for ordinary and B shares and £1.2 billion relating to the Dividend Access share. The Dividend Access share was created to provide enhanced dividend rights to the Treasury when it provided capital to support RBS.

- Most of the government's investments in companies managed by ShEx are not traded on an active market. In accounting terms, most of these investments are valued based on the government's share of the net assets. Nonetheless, this value does not necessarily reflect the economic value of the businesses or the future income that the government would forego, although ShEx would consider the economic value when assessing whether to retain or sell individual assets. As seen in the sale of Eurostar, the asset was valued at £325 million but sold for £585 million, because the sale attracted competitive bids and market conditions were favourable (paragraphs 1.16, 2.13 and 2.14).[4]

12 **The introduction of UKGI from April 2016 is a positive step towards professionalising the government's asset management.** The government has not historically had significant skills in the management of its full range of financial assets, relative to the private sector. Previously, different assets had been managed by different organisations and sales had been handled on an individual basis without an overarching government strategy which considers its financial assets as a whole. By bringing together UKFI and ShEx to create UKGI, the government has consolidated its management of its shareholdings and corporate finance expertise. However, responsibility for some significant assets such as student loans remain outside of this arrangement because of their unique nature (paragraph 1.4).

Student loans

13 **Managing student loans will become more challenging as the scale of the loans in issue increases.** Between 2009-10 and 2014-15, the face value of the English loan book – which makes up the majority of student loans – had more than doubled to £64 billion. Increases in the maximum loan available, the introduction of postgraduate loans and an extension of the repayment period to 30 years mean the government is forecasting that the face value of outstanding student debt could be around £400 billion by 2040 in 2015 prices. These are unsecured loans available to all individuals meeting the eligibility criteria, although repayment is tied to potential future earnings and backed by legislation. The main risk is that people who have taken out the loans do not earn enough to repay them in full. Uncertainties around recovery of the loans are reflected in the value on the balance sheet (£42 billion in 2014-15). These assumptions are particularly sensitive to economic factors such as earnings potential and the jobs market as well as inflation (paragraphs 2.4 to 2.9).

14 **Because of the unique nature of the student loan book, identifying its value is particularly complex.** Identifying the economic value of the loan book is difficult because there is no comparison in the private sector and there are uncertainties around the level of debts that will be recovered. The value of the loans is also correlated with the terms of the loan and, in particular, the relative interest rate charged. The last 'mortgage-style' loans, where repayment is over a fixed number of instalments, were sold for £160 million compared to a face value of £890 million. Of the sale proceeds received, £128 million related to loans issued to students resident in England and Wales which had been valued on the balance sheet at £116 million (paragraphs 2.4 to 2.8 and 2.10).

4 Comptroller and Auditor General, HM Treasury, *The Sale of Eurostar,* Session 2015-16, HC 490, National Audit Office, November 2015.

Legacy assets

15 **The government has clearly stated its plans to sell its remaining Lloyds shares and is winding down the former Northern Rock and Bradford & Bingley mortgage books.** Further sales in 2015-16 have reduced the government's stake in Lloyds to less than 10%, compared to 43% in 2009. It plans to sell the remainder through a fully marketed offering including retail in 2016-17 if conditions are favourable. Similarly, the government sold £13 billion of former Northern Rock mortgages in 2015 and, having received backing from a group of UK banks to provide financing for the sales, is exploring the possibility of a major sales programme of Bradford & Bingley mortgages by the end of 2017-18 to generate proceeds of at least £16 billion. Nonetheless, the amount generated from these sales will depend on market conditions at the time of the sale. The fair value of the Bradford & Bingley mortgage book was £2.7 billion (10.1%) less than the carrying value as at 31 March 2015 and £3 billion (11.9%) less than the carrying value as at 31 March 2016 (paragraphs 3.10 and 3.16).

16 **The government's strategy and timeline for exiting from RBS is less clear given the size of the shareholding.** The government has committed to raising £25 billion from its RBS stake during this Parliament. In 2015, it sold around 5% of its holding generating £2.1 billion of proceeds and in March 2016 the Treasury received £1.2 billion from the retirement of the Dividend Access Share. However, further sales will require careful management given the size of the shareholding and it is not clear whether the government will recoup its initial investment in the bank, given the losses reported by RBS; and the market and regulatory conditions in the banking sector (paragraph 3.11).

17 **The Quantitative Easing programme exposes the public finances to volatility in market prices and interest rates but the strategy and timescales for exiting from it will depend upon economic growth.** The Bank of England's Monetary Policy Committee introduced its Quantitative Easing programme to help stimulate the economy by increasing the money supply; and supported asset values by purchasing £375 billion of gilts and, effectively, injecting money directly into the economy. Although it intended the programme to be a temporary intervention and made its last asset purchase in July 2012, the Bank does not expect to start winding up the scheme until the bank rate has increased from 0.5% to around 2%. As gilts are traded on an active market, the arrangement exposes the public finances to fluctuations in prices and interest rates. As the programme unwinds, the Treasury will need to meet any shortfall between the bank loan used to finance the gilt purchases and the value of the gilts held at the time of any sale made. The size of the gilt holding (£407 billion at 31 March 2015) relative to the scale of the market would require any exit to be carefully managed. Globally, in October 2014, the US Federal Reserve made its last asset purchase; the European Central Bank has extended the quantitative easing programme it introduced in 2015 through to at least March 2017; and the Bank of Japan has increased its programme (paragraphs 3.18 to 3.24).

Accountability and transparency of asset management

18 The government's decisions to hold or sell assets could be influenced by short-term incentives. The influences on the decisions to hold or sell assets are varied:

- Current constraints on public spending could encourage the government to sell assets to make resources available that would otherwise need to come from increased government borrowing or raising income such as taxes. This needs to be balanced with the income streams that the government receives from its assets (paragraph 1.19).
- The reduction in the risks to the public finances from reducing the government's holding of assets needs to be considered carefully, particularly with reference to wider policy initiatives. For example, the government's ability to sell mortgage assets in the buy-to-let market could be affected by recent increases in stamp duty and the Bank of England's policy to ensure buy-to-let lending is carried out in a prudent manner (paragraphs 1.17 to 1.18 and 3.13).
- The exclusion of some significant assets from the government's key fiscal measures for government debt could encourage asset disposals. For example, any sale of the student loan book or shares in RBS and Lloyds would increase cash and therefore reduce the debt as measured under public sector net debt regardless of the profit or loss made on the sale or future income foregone (paragraph 1.20).[5]

19 In the main, the current process for selling assets does not require parliamentary input to the government's decisions to sell its investments. The Parliamentary Estimate approval process along with disclosures in annual accounts of government departments provide some accountability over assets bought and sold in year. In some cases, legislation may be required to make changes before assets can be sold. For example, the Postal Services Act 2011 provided for the restructuring of the Royal Mail and the transfer of its pension liabilities to the government. Although such legislation highlights sales to Parliament and may enhance scrutiny, the government does not require prior parliamentary approval of its decision to sell significant financial assets as a matter of course. As a result, Parliament cannot see or comment on other options that may have been available for these assets (paragraphs 1.25 to 1.27).

20 Disclosures in the WGA over financial assets limit transparency to readers. The disclosures in the WGA regarding the risks associated with the government's asset holdings do not provide sufficient clarity on potential influences over the value of the assets. In addition, accounting rules mean a gain or loss made from an asset sale is not transparent because of the need to recognise any impairment in value each year. Government departments are not required to disclose separately the difference between sale proceeds, the original cost of the asset and the cost of financing. Some annual accounts such as those produced by the Department for Business, Innovation & Skills (BIS) highlight the sensitivity of the key assumptions used to value assets such as the student loans discount rate. However, the WGA does not disclose how much of the year-on-year movements in value are due to changes in these underlying assumptions (paragraphs 1.28 to 1.30).

5 Such asset sales would not have the same impact on the accounting measure of net assets (paragraph 1.20 and Figure 6).

Concluding remarks

21 The scale and concentration of the government's financial assets presents a significant management challenge. The concentration of assets in the banking, housing and student finance sectors exposes asset values to volatility in the economy, particularly the employment market, interest rates and inflation which need to be managed. As illustrated by some of the legacy assets that remain on the government's balance sheet more than seven years after the financial crisis, the size of asset holdings can also affect the government's ability to sell assets quickly or achieve market prices.

22 The introduction of UKGI should help to consolidate the government's management approach as well as enhance the skills and expertise needed to understand and manage risks to the value of its asset portfolio. This also presents the government with the opportunity to develop an overarching strategy for the management of its whole portfolio of assets, including asset sales, which is visible to Parliament and the public. However, some important assets such as student loans will still be managed outside of this arrangement because of their unique nature.

23 As the government increasingly seeks to sell its assets, it will need to consider both the long- and short-term impact on the public finances and the risks associated with holding them, to ensure the return they generate provides value for money for the taxpayer and recoups its initial investment as far as possible. In doing so, the government will need to have sufficient understanding of the economic value of these assets, taking into account future income foregone, the benefits of reductions in the risk of the portfolio and any financing and management costs of the assets, as well as wider market conditions. While the government is delivering its policy of winding down its investments in Lloyds and UK Asset Resolution Limited (UKAR), it will need a clear and carefully managed plan for exiting from its significant holding in RBS; and a strategy for ongoing management of student loans and its housing investments. Winding up the Quantitative Easing programme will also need to be managed carefully so as not to disrupt the gilt market.

Issues this report raises

24 This landscape report has highlighted a number of issues that merit further consideration and discussion:

The government's strategy for financial assets

a **How the government can build on the creation of UKGI to develop an overarching strategy for managing its portfolio of financial assets.** In addition to the assets that have been earmarked for sale, government should clearly set out its intention for each asset that it holds. In some cases, assets are held for policy reasons and, therefore, this would be limited to developing an approach for managing the asset holdings. However, with others, while there may not be an immediate plan to sell the assets, there may be no long-term reason for holding the asset in which case an exit strategy should be developed.

b **How the Treasury should assess the short- and long-term value of its assets in deciding whether to hold or sell them.** This assessment should take account of the correlation between economic performance and value; the income these assets generate now and in the future; the risks to holding the assets in the long term; the costs of the investments; and the interactions between government policy and the asset portfolio.

c **How the government can manage the risks of the student loan book as it increases in size; and maximise returns from sales of parts of it.** It is important that the skills and expertise needed to manage the student loan book keep pace with both its expansion and any wider economic factors which could affect repayment. Although outside of the UKGI's remit, BIS should draw on its expertise and advice where necessary to ensure wider lessons learned on asset management and sales of the UKAR mortgage book are transferred.

Enhancing accountability and transparency around asset sales

d **How the decision-making process for the government's portfolio of financial assets could be tailored to allow early input from Parliament.** Such a process would need to be proportionate. Sharing an overarching strategy for the asset portfolio with Parliament could provide an opportunity for them to highlight assets of particular interest and to engage in the wider public interest around the management of the portfolio.

e **Whether disclosures in the departmental accounts and WGA could be enhanced to aid transparency.** This should include providing detail on the risks to the value of the asset holdings; the gain or loss made on asset sales compared to the original costs; and the costs of financing. Showing the impact of changes in significant assumptions on the year-on-year movement in the value of assets would aid oversight and a reader's understanding.