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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HM Treasury

Evaluating the government balance sheet: financial assets and investments

Report by the Comptroller and Auditor General

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Comptroller and Auditor General
National Audit Office

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The report examines financial assets on the Whole of Government Accounts (WGA) balance sheet, the associated risks and benefits to the UK's public finances and how the government is managing them.

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Contents

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Foreword

The government has a significant portfolio of financial assets and a range of public sector bodies have a role in managing them. In 2014-15, the government's financial assets were valued at £400 billion: equivalent to £14,814 per UK household and around a third of total government borrowing, as reflected in the Whole of Government Accounts (WGA). These assets represent a significant income stream for the government. In 2014-15, income from the portfolio was £7.2 billion, which was equivalent to just over half of stamp duty income, over a quarter more than capital gains tax and almost double inheritance tax.

The government's assets are concentrated in housing, banking and student finance, all of which are correlated with the wider performance of the economy, such as the employment market, interest rates and inflation. This increases the risks to the public finances as the same factors affect the government's income from taxation; and are subject to policy interventions.

The government plans to sell an unprecedented range of financial assets over the remainder of this Parliament and potentially raise over £100 billion from asset sales; and loan and interest payments. Nonetheless, market conditions and the economy along with the relative size of the government's asset holdings could have a significant impact on the value obtained from these assets and the long-term impact on the public finances of the government's sale programme.

This report is one of a number that explore the major risks to public finances highlighted in the WGA balance sheet and how the government currently manages them. Specifically, this report sets out the range of the government's financial assets and investments; and the challenges for the government of maximising value from its holdings.

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.

Part One

Financial assets landscape

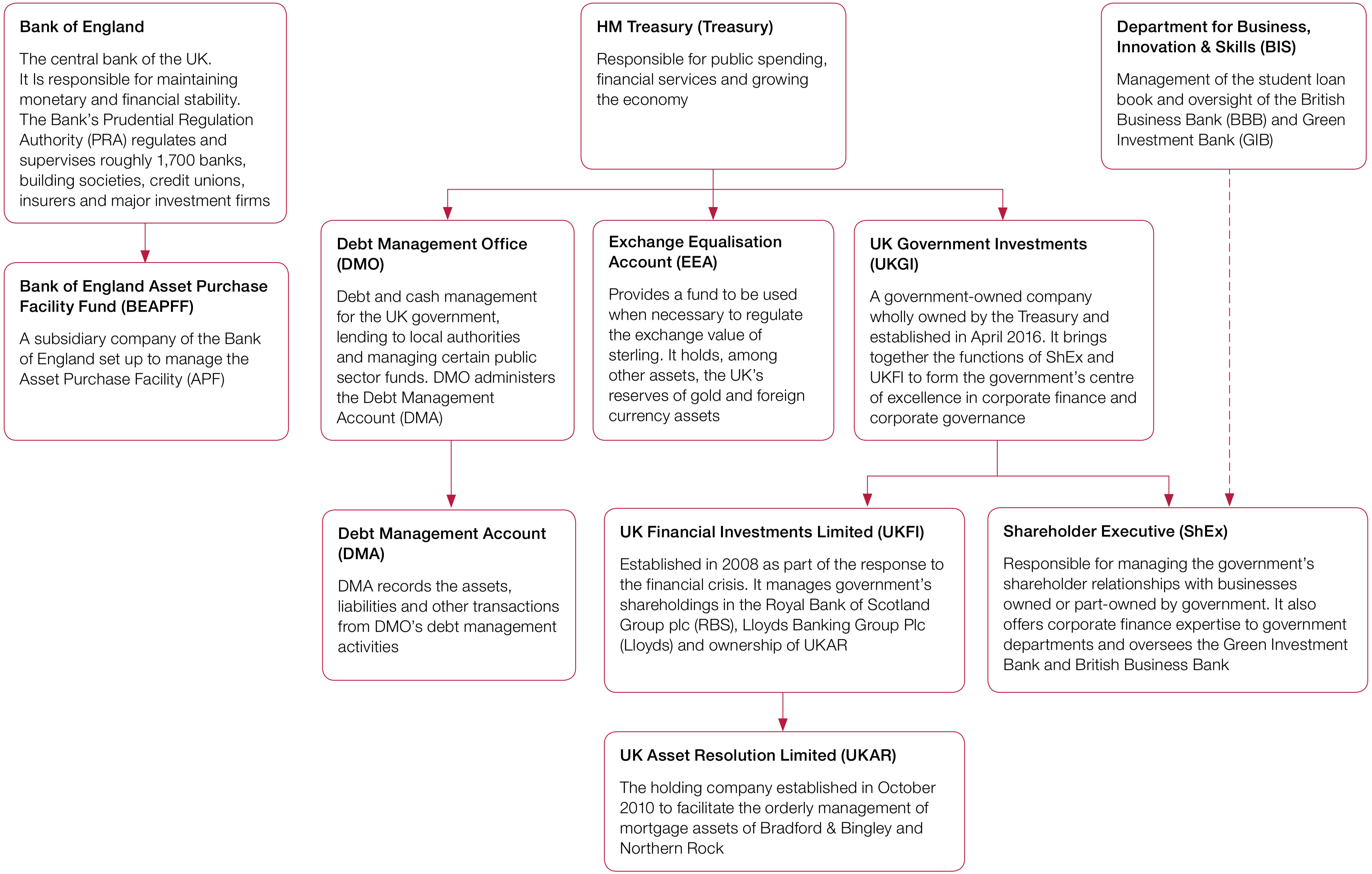
1.1 The government holds assets to support its day-to-day activities, such as land, property and equipment and cash, as well as to provide financial support and to generate a return in the future when sold. Financial assets, specifically, are those assets which entitle the owner to receive future financial benefits and can include cash and investments such as company shares as well as loans and deposits.[6] The government has a significant and varied portfolio of financial assets. These assets include those created as a result of specific policy decisions such as interventions it took 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.

1.2 Effective asset management is essential to maintaining the health of the government's balance sheet and overall public sector finances. The government holds a significant portfolio of financial assets which it must manage effectively and professionally in order to get the most value out of them. In doing so, it has to make careful decisions about whether to continue to hold or sell the assets given the income they generate and their function. If selling, the government may have a number of choices about the timing of a sale and the approach it takes depending on the type of financial asset.

1.3 A range of public sector bodies have a role in managing the government's financial assets. As the government department responsible for public spending, financial services and maintaining financial stability and the economy, HM Treasury (the Treasury) has overall responsibility for the public sector's financial assets. **Figure 1** sets out the main organisations with responsibility for government's portfolio. With the exception of the Department for Business, Innovation & Skills (BIS) and the Bank of England, all are part of the Treasury group.

6 The international accounting standard which covers the presentation of financial instruments (IAS32) provides a detailed definition of a financial asset.

Figure 1
Responsibilities for financial assets



Note

1 Dashed line represents BIS responsibilities for ShEx prior to its transfer to the Treasury from 1 April 2016.

Source: National Audit Office analysis

1.4 To date, the government's skills in managing financial assets have been concentrated in organisations that focus on particular types of assets. The government has not, historically, had significant skills in the management of its full range of assets, relative to the private sector. Until now, different assets have been managed by different organisations and sales have been handled on an individual basis. However, recently the government has made changes aimed at strengthening its professional management of its asset portfolio and its approach to asset sales. By creating UKGI as a new government-owned company from April 2016, the government has brought together the functions of UKFI and ShEx and, in doing so, consolidated the government's management of its shareholdings and its expertise in corporate finance. The new company will be responsible for the sale of government investments including parts of the student loan book and, through UKFI, will oversee the UKAR assets sale process.

1.5 In this part we set out the broad picture of government's financial assets, drawing on the Whole of Government Accounts (WGA) which provide the most comprehensive picture of the government asset holdings across the public sector. We also consider some of the difficulties of valuing these assets and the challenges the government faces when deciding whether, when and how to sell them. Parts Two and Three will 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 while Part Three examines the government's investments in financial institutions following the financial crisis.

Overview of financial assets in the WGA

1.6 The WGA was first published for the 2009-10 financial year and now consolidates the accounts of over 6,000 organisations across the public sector to produce an accounts-based picture of the UK public finances. It is the largest consolidation of public sector accounts in the world. The WGA represents a major step forward in the accountability and transparency of financial assets as it provides a record of all the assets that are largely comparable across the different entities within the WGA. It can also provide useful trend analysis which shows movements over time. Nonetheless, the Committee of Public Accounts has previously recommended that the Treasury makes better use of the WGA to inform decisions.[7]

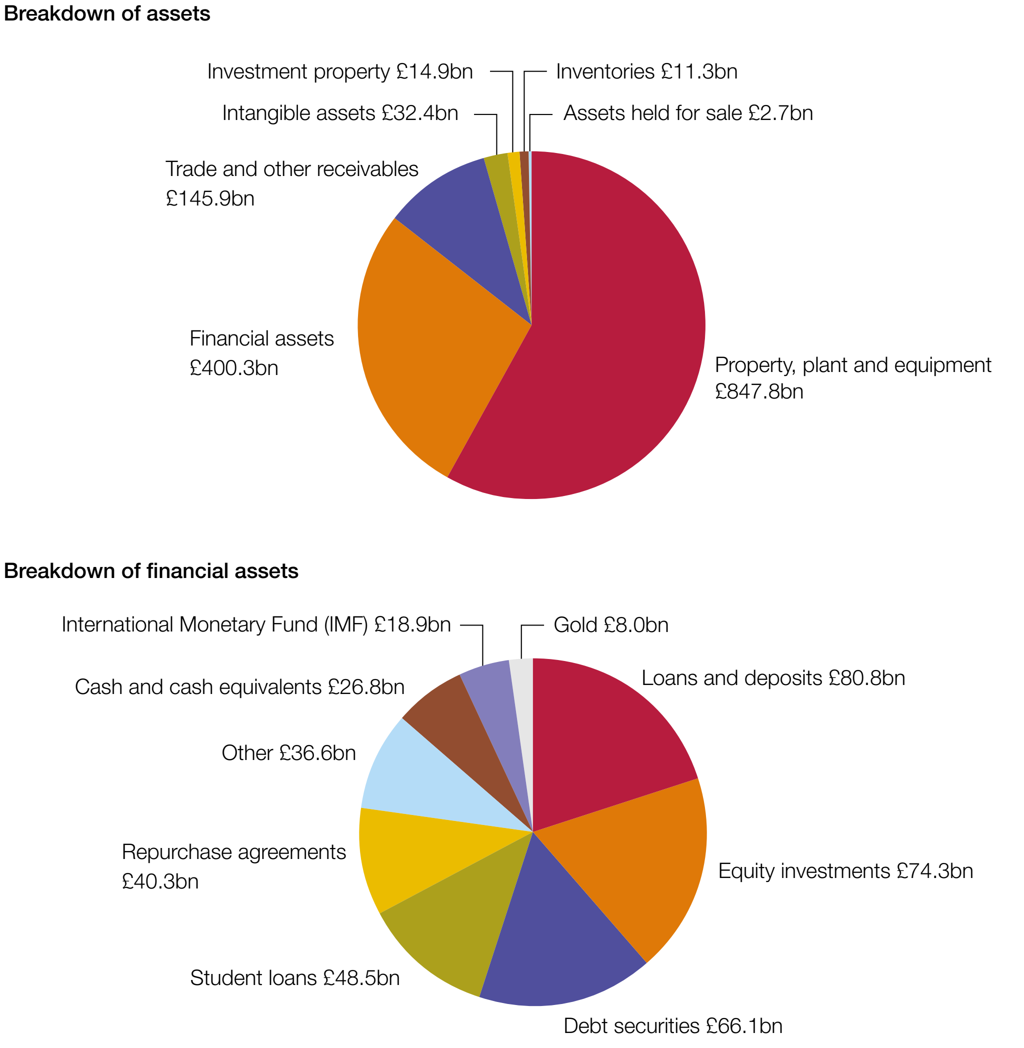
1.7 Government has not historically had significant holdings of financial assets. As the 2014-15 WGA shows, government owns a significant volume of financial assets currently (**Figure 2**). Financial assets, including cash, totalled £400 billion, equivalent to just over a quarter of total assets (£1,455 billion) and around £14,814 per UK household.[8] Over the last five years, financial assets have increased by 48% from £271 billion in 2009-10.

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

8 Office for National Statistics, Statistical bulletin: Families and Households: 2015

Figure 2

2014-15 Whole of Government Accounts assets



Source: Whole of Government Accounts 2014-15

1.8 In addition, financial assets in 2014-15:

- were almost a fifth larger than the government's infrastructure assets (£337 billion);
- were equivalent to one-third of total government borrowing (£1,175 billion), as reflected in the WGA;
- were equivalent to around three-quarters of government's financial liabilities (£546 billion);
- reduced in value by £2.2 billion. The majority of which (£1.9 billion) related to changes in the value of the student loan book (see Part Two); and
- generated income of £7.2 billion in 2014-15 (representing a return of 1.8%) which was equivalent to just over half of stamp duty income (£13.5 billion), 26% more than income from capital gains tax (£5.7 billion) and almost double inheritance tax income (£3.8 billion). Of this, £1.8 billion related to interest on student loans; £2.5 billion was for interest on loans and deposits; and £0.8 billion was dividend income which included £0.3 billion from shares held in the Royal Bank of Scotland.

1.9 Parts Two and Three will outline the most significant assets in more detail. The government's holdings are concentrated in housing, banking and student finance. These sectors are correlated with wider economic performance, such as the employment market and the performance of investments in companies and property. As Figure 2 highlights, the main types of financial assets on the government's balance sheet are:

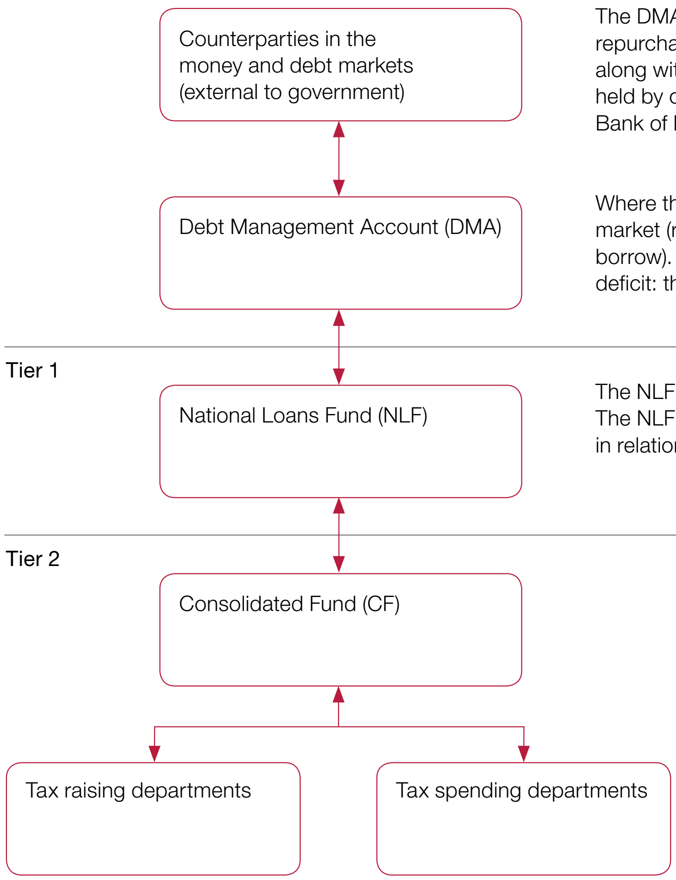
- **Loans and invested cash balances (£80.8 billion)** – Around two-thirds of total loans relate to mortgage assets held by UKAR (£52.7 billion) which we discuss further in Part Three. Other significant balances include deposits made by local government to commercial institutions (£17.2 billion) as well as further loans made as part of government's financial stability interventions: £3.2 billion bilateral loan to Ireland and £1.2 billion in other loans and advances to financial institutions.
- **Equity investments (£74.3 billion)** – the majority of equity investments relate to government's remaining shares in RBS and Lloyds as at 31 March 2015 (£44.2 billion) acquired in response to the financial crisis in 2008 (Part Three). Equity investments also include the portfolio managed by ShEx with those businesses which are part-owned by the government. Most of the portfolio includes businesses such as the Met Office which carry out a particular function. Other significant equity investments include those in international financial institutions (£3.4 billion) held by the Department for International Development and investments in the European Investment Bank (EIB) (£7.1 billion) held by the Consolidated Fund.

- **Debt securities (£66.1 billion)** – these assets are mainly held by the Exchange Equalisation Account (EEA) (£53.8 billion). The EEA's debt securities help to manage fluctuations in the value of sterling. Debt securities are a type of secured borrowing and can be traded: the holder receives interest payments and repayment of the loan amount on a fixed date.
- **Student loans (£48.5 billion)** – loans issued by the Student Loans Company (sponsored by BIS) to students in further and higher education. We highlight these loans in Part Two.
- **Repurchase agreements (£40.3 billion)** – these assets are managed by the Debt Management Office (DMO) and recorded in the Debt Management Account (DMA) as part of the government's cash management activities. Repurchase agreements are secured loans made to banks and other organisations trading in the money and debt markets. The 'secured' element relates to the agreement to transfer a government bond and repurchase it at an agreed price at a later date.
- **International Monetary Fund (IMF) (£18.9 billion)** – the government owns an equity stake in the IMF. Special drawing rights are assets created by IMF which can be exchanged by IMF members for foreign currency.
- **Other (£36.6 billion)** – Other assets include investments held by the Bank of England (£3 billion) and the DMO (£1 billion).

1.10 Different types of financial assets present different management challenges. For example, financial assets acquired to generate and manage cash to support the government's operational activities are short term in nature. As a result, the management of them is more day-to-day and reactive than for long-standing policy assets such as student loans. Nonetheless, it is important that these assets are managed efficiently so that the cost of managing them is not greater than the benefit they provide.

1.11 These 'operational' assets comprise cash and cash equivalents, gold, repurchase agreements, debt securities and financial investments relating to the government's membership of the IMF and EU. By way of context, **Figure 3** overleaf shows the government's various central Exchequer Fund accounts through which cash flows. We do not discuss government borrowing in detail here as we plan to publish a separate report on it in 2016-17.

Figure 3
Daily government cash management



The DMA will primarily trade in debt securities and repurchase agreements. These are recorded in the WGA along with debt securities and repurchase agreements held by other government entities such as the EEA and Bank of England.

Where there is a surplus of funds, the DMA lends to the market (reducing the amount the government needs to borrow). The process also works in reverse where there is a deficit: the DMA will borrow money from the money markets.

The NLF deposits/withdraws funds into/from the DMA. The NLF also holds and manages government assets in relation to the IMF quota subscription.

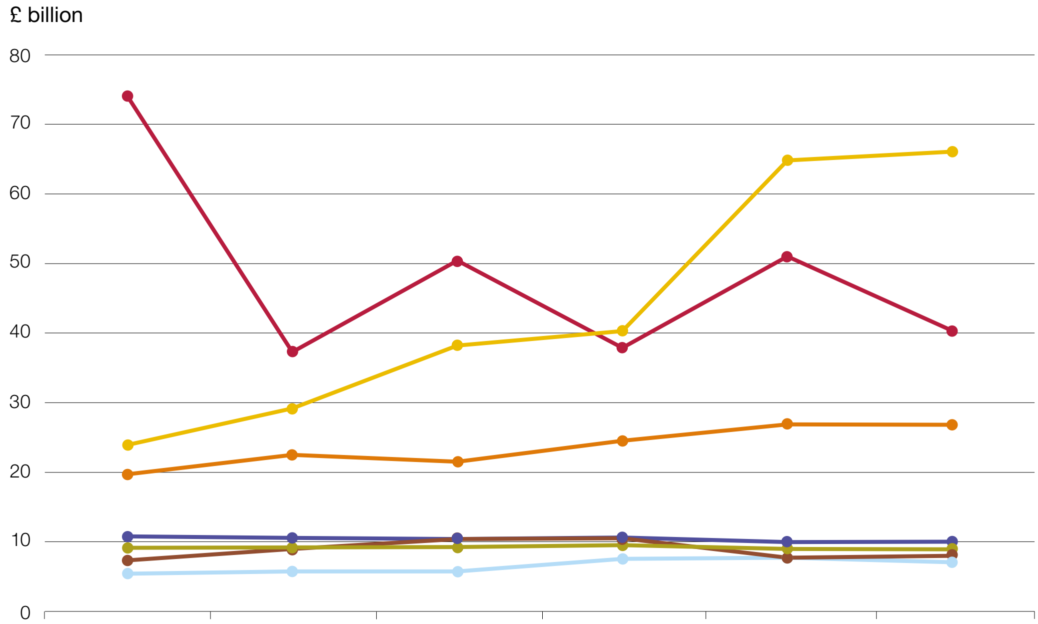
The Consolidated Fund acts as the government's current account through which money goes in and out. At the end of each day the balance in the CF is cleared to nil by depositing/drawing down funds into/from the NLF. The CF also holds government's investment in the European Investment bank.

Source: National Audit Office analysis

1.12 The value of most of these significant operational financial assets has remained stable since the WGA was first published in 2009-10 (**Figure 4**). At 31 March 2015 these assets were valued at £167 billion compared to £150 billion at the end of 2009-10. The most significant movements since 2009-10 were on the largest of these assets: repurchase agreements and debt securities. These assets are traded on an active market and the values can be relatively volatile as a result. At the same time, holdings of these types of assets can change significantly from one day to the next depending on the number of transactions entered into for cash management purposes.

Figure 4
Operational financial assets

Changes in operational financial assets between 2009-10 and 2014-15



	2009-10	2010-11	2011-12	2012-13	2013-14	2014-15
Repurchase agreements	74.08	37.30	50.43	37.86	51.00	40.33
Debt securities	23.90	29.20	38.20	40.30	64.80	66.10
Cash and cash equivalents	19.70	22.50	21.50	24.50	26.90	26.80
IMF Quota Subscription	10.76	10.58	10.39	10.64	9.97	10.01
IMF Special Drawing rights	9.16	9.20	9.27	9.49	8.96	8.94
Gold holdings	7.33	8.95	10.37	10.50	7.73	7.97
Investment in EIB	5.42	5.75	5.72	7.55	7.72	7.06

Source: Annual Reports and Accounts of the Consolidated Fund, National Loans Fund, Whole of Government Accounts, Exchange Equalisation Account, Debt Management Account and Bank of England

Valuing assets

1.13 The value of a financial asset is generally related to its ability to generate future income. The value assigned to an asset is important in terms of providing transparency over the government's balance sheet and informing management decisions about whether to hold or sell an asset compared to the future income it might generate.

1.14 Accounting rules are used to value financial assets in departmental accounts and the WGA. These rules increase the consistency and accuracy of reporting across government and enhance transparency. However, because some financial assets are easier to value than others, different approaches are used to value different categories of assets. Most assets are valued on the balance sheet at either fair value or amortised cost, defined below. Where assets are not held at fair value then accounts must show the difference between the value on the balance sheet and an estimate of what the fair value would have been:

- **Fair value** reflects the price that would be received if the asset was sold at that time. Assets held at fair value include equity investments such as the government's shares in Lloyds and debt securities which are held for trading.
- **Amortised cost** is equivalent to the amount first recognised when the asset was obtained plus adjustments to reflect any repayments and interest which will be received in the future and any events which have occurred which would affect future cash flow received (such as a borrower defaulting on repayments), also known as impairments.

1.15 A number of methods can be used to measure assets at fair value. However, to highlight any inherent uncertainty around asset values, the accounts must explain the extent to which values have been based on market data or estimated using other techniques. **Figure 5** shows the hierarchy around fair value measurement and how the government's most significant financial assets have been categorised. In 2014-15, 57% of assets were held at fair value and 43% at amortised cost. Of those measured at fair value, two-thirds were categorised as 'Level 1' and include debt securities and shares in RBS and Lloyds which are traded on an active market. However, current market price may not reflect economic value of the assets due to the size of asset holding.

1.16 Nonetheless asset values on the balance sheet represent the value at a point in time only and can be volatile. Furthermore, without market data it can be difficult to isolate the factors that would affect the valuation. As seen in the government's sale of its stake in Eurostar, the asset was valued at £325 million in the Department for Transport's 2013-14 accounts but sold for £585 million in March 2015 and generated further proceeds of £172 million as Eurostar agreed to redeem the government's preference share.[9] The valuation was particularly sensitive to the likelihood of a competing rail service emerging but the sale attracted competitive bids and took place during favourable market conditions which increased its value. Similarly, with the sale of Royal Mail, it was difficult for the government to value the company as its shares were not traded and the government's estimates depended on the professional judgement of its advisers.

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

Figure 5
Categories of valuation for financial assets

Investments measured at fair value eg gilts, equity investments

Investments measured at amortised cost eg loans, Treasury bills

Higher — Confidence over valuation method — Lower

Fair Value Level 1 inputs	Fair Value Level 2 inputs	Fair Value Level 3 inputs	Amortised cost
These are quoted prices (unadjusted) in active markets for identical assets or liabilities that the entity can access at the measurement date	These are things like quoted prices in an active market for similar assets or liabilities or prices for an identical asset in a non-active market	These inputs reflect management's own assumptions about how they would value or price a financial asset or liability	Put simply, amortised cost is the initial cost of the asset, plus interest and minus any repayments or impairment. For instruments held at amortised cost, the value in the accounts does not necessarily reflect the amount that the entity would expect to get from a sale
For example, Lloyds and RBS ordinary shares	For example, RBS B shares	For example, majority of investments managed by ShEx	For example, student loans and UKAR mortgages

Source: IFRS 13 – Fair value measurement

Deciding whether to keep or sell assets

1.17 To maximise value from its assets, the government has to know when to hold onto them and when to sell. This decision requires the government to make judgements about the value and management costs of the assets in the future; the risks of changes in value affecting the public finances; the value of any future income foregone; and the price it could get for selling the asset now. UKGI will carry out such analysis once the decision to sell has been made. Economic factors such as inflation and interest rates could have a significant impact on such decisions, particularly if the rate of interest or other returns received on significant assets is higher than the risk-adjusted cost of capital.

1.18 Selling assets now rather than later provides relative certainty over the income that would be received and avoids the risk of reductions in value arising from fluctuations in the economy and any costs or loss of value being incurred by holding the asset for longer. Values of assets traded on the markets, in particular, can be highly volatile and could be subject to significant price movements in the future. Confidence in the markets and forecast interest rates and expected returns on assets would also impact on investors' appetite to invest and the price they would pay.

Short-term incentives

1.19 When making decisions on its assets, the government needs to manage the trade-off between getting cash in the short term from a sale and keeping a regular income stream in the longer term. Current budgetary constraints could incentivise the government to sell assets to release capital for other priorities which would otherwise only be available from increasing government borrowing or income from other sources such as taxation.

1.20 The exclusion of financial assets which cannot be readily converted into cash (illiquid assets) from the government's key performance measure of public sector net debt (PSND) could encourage asset disposals. For example, the government justified the sale of Eurostar on the basis that the proceeds could be used to reduce national debt, whereas a broader accounting view of this transaction would show the exchange of a financial asset for cash, with debt only reduced by the profit on the sale. Any proceeds of sales of assets such as student loans or shares in RBS and Lloyds would generate cash and reduce the debt regardless of the profit or loss made on the sale. **Figure 6** shows the different impact of asset sales on PSND and the WGA.

Figure 6

Impact on government debt measure and Whole of Government Accounts of asset sales

Liquid assets	**Sold at a profit**	**Sold at fair value**	**Sold at a loss**
Impact on PSND	Decrease	–	Increase
Impact on WGA net liabilities	Decrease	–	Increase

Includes assets such as cash, gold and debt securities

Illiquid assets	**Sold at a profit**	**Sold at fair value**	**Sold at a loss**
Impact on PSND	Decrease	Decrease	Decrease
Impact on WGA net liabilities	Decrease	–	Increase

Includes assets such as loans and shares

Note

1 The WGA impacts for illiquid assets are limited to the profits or losses on sale. Under PSND the full sale proceeds are recognised.

Source: National Audit Office analysis

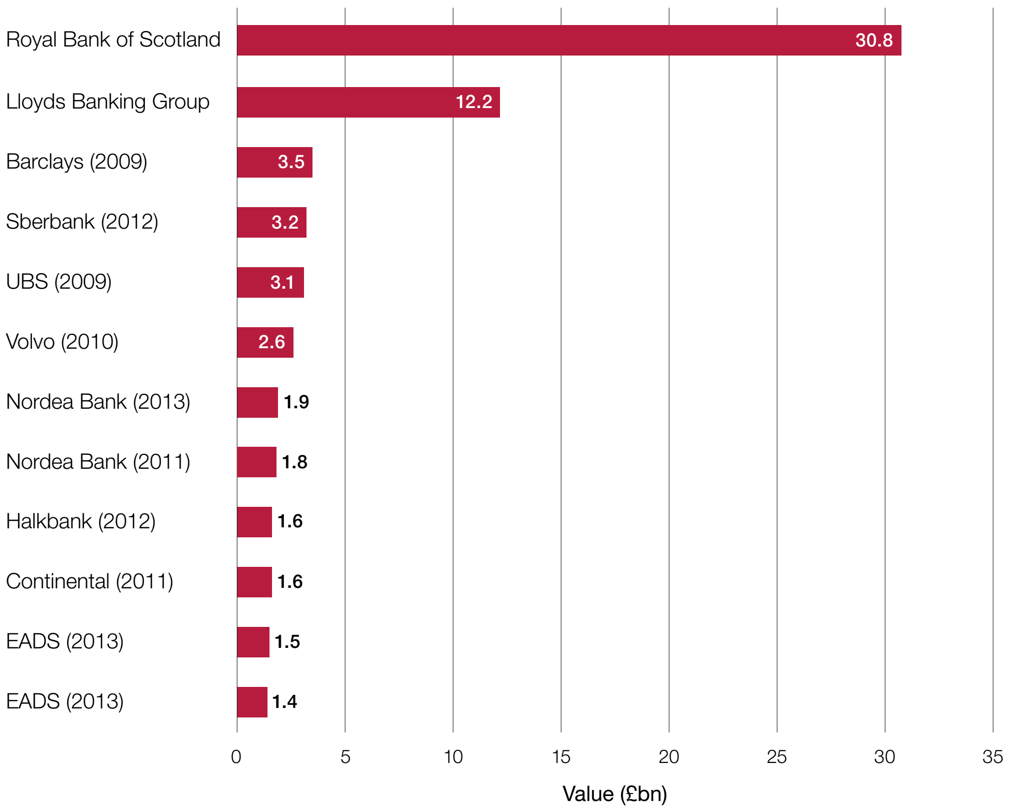
Limitations on the government's ability to sell

1.21 Nonetheless, as shown by the government's investment in RBS and Lloyds, the size of the assets held relative to the total market can restrict a sale and limit options around when and how to sell them. The government's holding in Lloyds and RBS is several times higher than other recent comparable share sales (**Figure 7**) and selling its shares over a short period of time would exceed market capacity and affect its ability to get a competitive price.[10]

Figure 7

The government's holding in RBS and Lloyds as at 31 March 2015 compared to other share sales

The government's holding in RBS and Lloyds is several times higher than other recent comparable share sales



Notes

1 Largest 10 secondary share sales in the European market between 2008 and 2013.

2 Lloyds and RBS holding as at 31 March 2015. RBS excludes the £1.2 billion relating to the RBS Dividend Access Share.

Source: JP Morgan, Dealogic, Bloomberg – chart adapted from Comptroller and Auditor General report on *The first sale of shares in Lloyds Banking Group*; *HM Treasury Annual report and Accounts 2014-15*

10 Comptroller and Auditor General, HM Treasury and UK Financial Investments Limited, *The first sale of shares in Lloyds Banking Group*, Session 2013-14, HC 883, National Audit Office, December 2013.

1.22 The nature of some financial assets held can limit the available market for a sale. Loans, for example, would require investors who could either manage or contract out interest and repayment collection from borrowers. By comparison, equity investments do not require such active management and would be open to a larger number of potential investors. However, investors requiring income from the outset such as pension funds may not invest in any shares which had not yet started paying dividends.

Timing of asset sales

1.23 The government's policy is to sell assets unless there is a particular policy or strategic reason to keep them and the government has announced future sales in its last two Budgets. Nonetheless, selling financial assets under a prescribed timetable or using a specific approach could affect the value achieved. For example, the wish to sell the Royal Mail within the current Parliament and before the 2015 General Election meant the timing of the sale was relatively inflexible and took place under conditions of considerable uncertainty which affected the price obtained.[11]

1.24 Expectation of a large government share sale could artificially suppress prices and disrupt normal market conditions. However, when selling the first shares in Lloyds, UKFI maintained flexibility on timing and allowed the transaction to be completed quickly once a decision to sell had been made.[12] More recently, the launch of a retail offer for the government's remaining Lloyds shares has been delayed from spring 2016 due to a fall in share price and uncertain market conditions.

Accountability for decision-making in relation to investments

1.25 Government departments can commit and spend resources or generate income in line with their statutory powers and the annual approval of Parliamentary Estimates. These Estimates along with the disclosures in the departmental annual accounts provide a degree of accountability over the assets bought and sold in year, although they do not necessarily provide visibility of significant individual assets. In some cases, legislation may be required to make changes before some 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 the sale 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. Departments do not have to share the business case for an asset purchase or sale with Parliament.

1.26 Similarly, departments do not have to gain the Treasury's approval to buy or sell assets except where the cost of the asset or loss made on the sale exceeds delegated limits or the transaction could be considered 'novel, contentious or repercussive' as defined by the Treasury's manual, *Managing Public Money*.

11 Comptroller and Auditor General, Department for Business, Innovation & Skills, *The Privatisation of Royal Mail*, Session 2013-14, HC 1182, National Audit Office, April 2014.

12 Comptroller and Auditor General, *The first sale of shares in Lloyds banking group*, Session 2013-14, HC 883, National Audit Office, December 2013.

1.27 Nonetheless, the creation of UKGI as a single body responsible for managing the portfolio of government's financial assets may enhance accountability if it provides an opportunity for Parliament to engage earlier on in discussions around the government's overarching strategy for its most significant financial assets and decisions to hold or sell them.

Transparency of asset disclosures in the accounts

1.28 The articulation of the risks to the valuation of assets are required to be disclosed in the WGA. However, aside from the mortgage assets that are held by UKAR, the nature of these risks, the potential impact of them and how they are managed by government are poorly articulated in the WGA.

1.29 In line with accounting standards, departmental accounts and the WGA report on the profit or loss from the sale of financial assets compared to the value on the balance sheet. However, the requirement to revalue assets each year means the profit or loss recognised when an asset is sold could be relatively small. Departments are not required to disclose separately the difference between sale proceeds and the original cost of the asset. The impact of this can be seen in the first Lloyds shares sale which delivered an accounting profit of £1.8 billion instead of a £4.3 billion loss when compared to the original purchase price. Falls in the Lloyds share price totalling £6 billion had already been recognised in the accounts in previous years (**Figure 8**).

1.30 Where shares in a company have been bought in a number of different tranches at different prices, this can also distort the profit or loss reported on disposal. For example, the Treasury's accounting policy to account for share sales on a 'first in, first out' basis means that the loss on the first sale of Lloyds shares was much greater as the price of the first tranche of shares purchased was much higher than later tranches.

Figure 8

Proceeds from the first sale of Lloyds shares

	Value of Lloyds holding (£m)	Profit or loss on sale (£m)
Original cost of share purchase	7,470	-4,259
Balance sheet value (after £6 billion impairment)	1,438	1,774
Value net of underwriting fees received[1]	3,092	120
Value after financing costs[2]	2,982	-230
Market value prior to sale	3,314	-103

Notes

1 Fees the Treasury received from Lloyds for underwriting an issue of additional shares to existing investors in December 2009.

2 Longer-term funding in the form of gilts (interest-bearing government bonds purchased by investors for periods of up to 50 years) at a cost of just under 3% a year.

Source: HM Treasury Annual Report and Accounts 2013-14; Comptroller and Auditor General report on *The first sale of shares in Lloyds Banking Group*

Future changes to financial assets

1.31 The government's Autumn Statement 2013 set a target to deliver £20 billion of corporate and financial asset sales by 2020 and the last two Spending Reviews have asked departments to set out their asset disposal plans for the rest of the Parliament. Latest projections by the OBR show that the government could generate £106 billion in proceeds from selling an unprecedented range of financial assets as well as repayments and interest over the next five years (**Figure 9**). However, over the same period, significant growth in the student loans issued and other loans to government-owned financial institutions will reduce the net receipt to government to £6.2 billion.

1.32 The government's policy is to sell assets if there is no policy need to keep them and value for money can be obtained from the sale. However, it is unclear whether the government has an overarching strategy for managing asset disposals which includes the full range of the government's financial assets and considers the overall impact of sales given any interdependencies between them.

Figure 9
Balance sheet projections to March 2020

	Expected cash flows March 2016 outlook (£bn)	Description
Receipts		
Lloyds Banking Group	11.0	Trading plan and retail offer
Student loans	9.6	Sale of loan portfolio
Student loans[1]	12.7	Interest and repayments
UKAR	48.8	Interest and repayments and sale of £13 billion mortgage portfolio
RBS	23.6	Sale of stake
Receipts subtotal	**105.7**	
Payments		
Student loans[1]	(86.7)	New loans issued
Help to Buy, British Business Bank, Green Investment Bank and other	(12.8)	New loans issued
Payments subtotal	**(99.5)**	
Total cash movement expected	**6.2**	

Note

1 Student loans cash flows reflect loans issued in England, Wales, Scotland and Northern Ireland and also include further education loans.

Source: Office for Budget Responsibility, *Economic and Fiscal Outlook*, March 2016

Part Two

Policy assets requiring ongoing management

2.1 Financial assets include those assets which the government took on for particular policy reasons. We consider the assets taken on in response to the financial crisis separately and in more detail in Part Three because the government's strategy for those legacy assets will be different. This part will focus on the most significant other financial assets relating to ongoing government policy which are student loans, managed by the Department for Business, Innovation & Skills (BIS) through the Student Loans Company (SLC), and the government's portfolio of equity holdings, managed by ShEx.

Student loans

2.2 Since the Education (Student Loans) Act in 1990, the government has issued loans to students to encourage them into higher and further education. BIS has overall responsibility for the system of issuing loans and collecting repayments from students in England and from EU students attending English universities. The Student Loans Company (SLC) and HM Revenue & Customs (HMRC) operate the system for collecting interest and loan repayments through either salary deductions or lump sum payments. Students start repaying loans when their earnings exceed a set threshold: £17,495 for loans received before September 2012 and £21,000 for subsequent loans.[13]

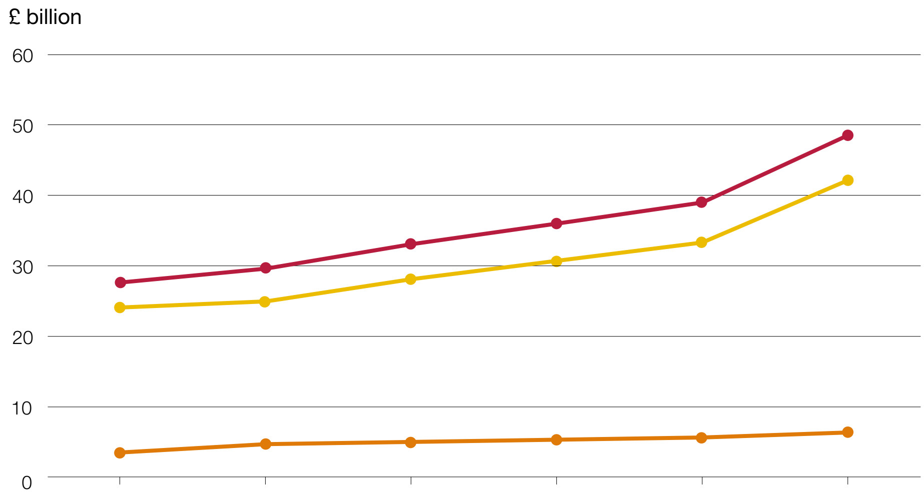
2.3 In the last five years, the total value of student loans on the WGA balance sheet has increased by around three-quarters to £48.5bn in 2014-15 (**Figure 10** overleaf). The majority of the student loans balance (87% in 2014-15) is made up of student loans issued in England which show a similar upwards trend whereas loans issued in Scotland, Wales and Northern Ireland have remained broadly static. The rest of this part will focus on the English loan book as it makes up the majority of the balance in the WGA.

13 These thresholds are set as of April 2016. Although the earning threshold increases in line with inflation for pre-2012 loans, it is currently fixed for those students who took out a loan on or after 1 September 2012.

Figure 10

Student loans in the Whole of Government Accounts

Value of student loans between 2009 and 2014-15



	2009-10	2010-11	2011-12	2012-13	2013-14	2014-15
Total Student Loans (WGA)	27.60	29.60	33.10	36.00	39.00	48.50
England	24.10	24.95	28.07	30.70	33.35	42.18
Scotland, Wales and Northern Ireland	3.50	4.65	5.03	5.30	5.65	6.32

Note

1 From 2013-14 onwards, this includes loans to students in further education as well as higher education.

Source: Whole of Government Accounts and Department for Business, Innovation & Skills' Annual Report and Accounts

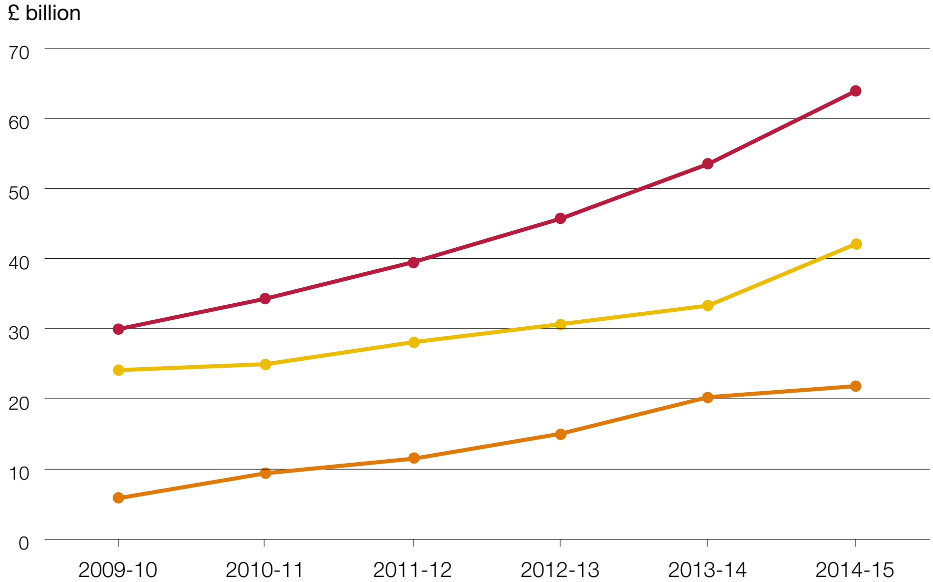
Valuing student loans

2.4 Student loans are unsecured as they are not backed by a claim on property or other assets, although repayment is tied to potential future earnings and backed by legislation. The main risk is that people who have taken out student loans do not earn enough to repay them in full. In the private sector, loans which are unsecured require borrowers to have high credit ratings to reduce the risk of them defaulting on repayments. However, student loans are issued to all eligible students in the UK who apply for them and the level of repayments are based on earnings, which increases the risk to the government that the level of loans which are not repaid is higher than expected. As a result the government has to make some assumptions about the level of loans which will not be repaid, which increases uncertainty over the value reflected in the accounts.

2.5 The BIS accounts and the WGA disclose the value of student loans at amortised cost. This is the amount that BIS expects to recover, also known as the 'book value', and, as **Figure 11** shows, it is significantly less than the face value of loans issued to students which have more than doubled since 2009-10 to £64.1 billion.

Figure 11
Value of student loans in England

Student loans between 2009-10 and 2014-15



	2009-10	2010-11	2011-12	2012-13	2013-14	2014-15
● Total value of loans in issue	29.93	34.33	39.56	45.75	53.60	64.14
● Expected recoverable amount (Net book value)	24.10	24.95	28.07	30.70	33.35	42.18
● Write down provision	5.83	9.38	11.49	15.05	20.25	21.96

Note
1 Based on higher education loans which make up the majority of the loan balance.

Source: Department for Business, Innovation & Skills' Annual Report and Accounts

2.6 The value of student loans on the balance sheet therefore includes impairments for those loans which the government does not expect to recover. At the end of 2014-15, the impairment provision was 34% against the value of the loans. In calculating the impairment, BIS uses a model to forecast future repayments based on key assumptions including inflation, earnings growth and distribution as well as the discount rate used to allocate future cash receipts across the expected life of the loan. There are two 'parts' to the impairment calculation:

- When loans are issued they are automatically impaired when recognised on the balance sheet to reflect that a certain percentage will never be fully repaid. In 2014-15, this was determined by the BIS model to be 45% of all loans issued in year.
- The impairment charge is adjusted in subsequent years to reflect revisions to repayment forecasts produced by the model and to reflect more up-to-date data on the government's assumptions.

2.7 The BIS accounts disclose how much of the year-on-year movement in the value of student loans is due to changes in the underlying assumptions and highlight the sensitivity of these assumptions to potential changes in a wide range of economic factors (**Figure 12**). For the 2015-16 accounts, the government's discount rate has fallen to 0.7% plus Retail Prices Index (RPI) which BIS expects will increase the value of student loans further as future cash flow from interest and loan repayments are discounted less than in previous years and the level of the impairment charge will fall to between 20 and 25%.[14]

2.8 The NAO's audit certificate on the BIS financial statements includes an emphasis of matter paragraph to draw attention to the uncertainties inherent in the valuation of student loans (**Figure 13**).

Figure 12
Sensitivity of student loans value to changes in key modelling assumptions

Possible scenario	Effect on total value	Modelling assumptions
The discount rate is increased to RPI + 2.3%	Decrease by £400m	The government's cost of capital is estimated at RPI + 2.2%
Inflation is 0.5% lower than assumed in every year	Increase by £1,500m	The model uses OBR forecasts to estimate inflation
Graduate earnings growth is 0.5% lower than assumed in every year	Decrease by £1,200m	The model uses OBR forecasts to estimate real earnings growth
Graduate income distribution profiles are 5% lower than assumed	Decrease by £1,600m	The model assumes distributions to be similar to historic patterns
Base interest rates are 0.5% lower in every year	Decrease by £400m	The model uses OBR forecasts of base interest rates

Source: Department for Business, Innovation & Skills Annual Report and Accounts 2014-15

Figure 13
Emphasis of matter on student loans

Issue highlighted	**1** Long-term nature for the recovery of loans **2** The number and volatility of the assumptions underpinning their valuation **3** Considerable degree of uncertainty over the recoverable amounts of the loans issued **4** Uncertainty about subsequent information and events
Number of years NAO reported an emphasis of matter	The last three years

Note

1 Emphasis of matter paragraphs in 2012-13, 2013-14 and 2014-15.

Source: National Audit Office analysis of Business, Innovation & Skills' Annual Report and Accounts

14 Written questions and answers – HL5098 available at: www.parliament.uk/business/publications/written-questions-answers-statements/written-question/Lords/2016-01-18/HL5098/

Managing student loans

2.9 Managing student loans will become more challenging as the number of loans in issue is set to increase in the future. The Office for Budget Responsibility (OBR) predicts that the value of new loans issued will increase year on year although repayments will remain relatively static due to increases in the cap on tuition fees, and therefore the maximum loan available, to £9,000 plus inflation; the introduction of loans for postgraduates from 2016-17 academic year; and increases in the loan repayment period from 25 to 30 years. The government forecasts that the value of outstanding student debt in England before impairments will be around £400 billion by 2040 in 2015 prices (**Figure 14** overleaf).

2.10 The government is continuing to pursue the sale of the pre-2012 income contingent repayment student loan book (face value of £45.49 billion) where the level of repayments is based on earnings, with a first sale expected in 2016-17. It sold the UK portfolio of the last 'mortgage style' student loans, where the loan is repaid over a fixed number of instalments, in 2013. These loans had a face value of £890 million and were sold to the private sector for £160 million. Of the proceeds received from the sale, £128 million related to loans issued to students resident in England and Wales which had been valued on the balance sheet at £116 million. Without an active market for these assets, identifying the economic value of the loan book and reducing the risk of underselling the loans is a significant management challenge. BIS considers that the value recognised in the accounts is a reasonable approximation of fair value although, as highlighted above, the underpinning assumptions are subject to considerable uncertainty. The Committee of Public Accounts has also stressed the importance of establishing a robust understanding of a realistic value of the student loan book; the long-term cost to the taxpayer of any early sale; and the expected level of competition between bidders.[15] We expect to examine and report on the sale in 2017.

The ShEx Portfolio

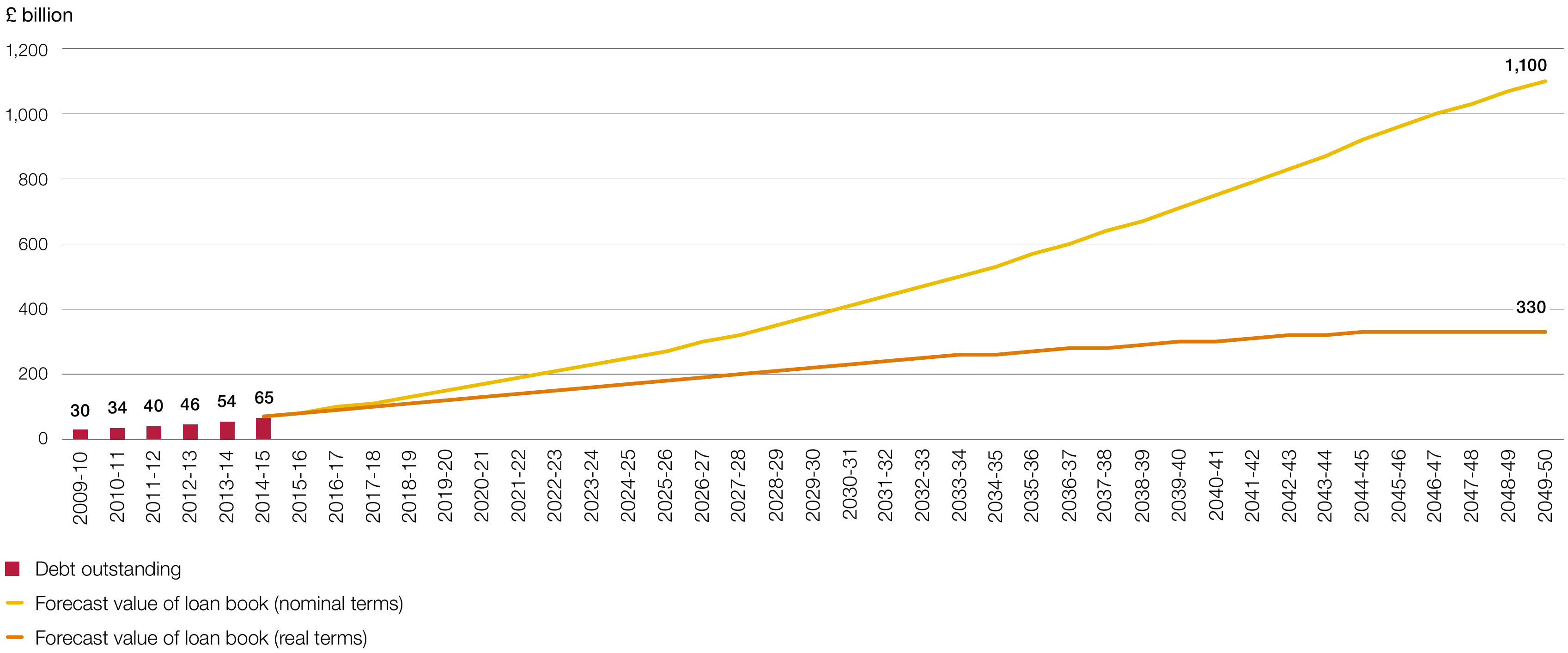
2.11 The government also has a number of equity investments as a result of owning bodies that carry out a state function such as the Met Office. It also has investments due to its financing of projects or organisations which have been set up to fulfil a specific policy objective. ShEx manages the government's shareholder relationships with these businesses, which are owned or part-owned by the government. **Figure 15** on page 35 shows the companies managed by ShEx along with the sponsoring Department and how the entity is recorded in the government's accounts.

15 HC Committee of Public Accounts, *Student loan repayments*, Forty-fourth Report of Session 2013-14, HC 886, February 2014.

Figure 14

Forecast value of the student loan book

Current and forecast value of student loans



Note

1 This chart shows the most recently published data on the government's forecasts of the value of outstanding student debt. However, BIS now forecasts that this will increase to around £400 billion by 2040 in 2015 prices.

Source: From National Audit Office report, *Financial Institutions Landscape*, September 2015. National Audit Office analysis of Department for Business, Innovation & Skills' accounts and House of Commons Debate, Volume 582, No.9, 18 June 2014, 655W–659W

Figure 15
Government shareholdings managed by ShEx as at 31 March 2015

Fully consolidated into Departmental Accounts and WGA[1]

Entity	Sponsoring Department	Net assets (£m)
Highways (England)[2]	DfT	108,000
Nuclear Decommissioning Authority	DECC	(70,912)
Network Rail[3]	DfT	6,391
UK Green Investment Bank	BIS	981
British Business Bank	BIS	648
Channel 4	DCMS	443
Land Registry	N/A	360
UK Export Finance	N/A	180
Nuclear National Laboratory	DECC	56
Insolvency Service	BIS	54
Electricity Settlements Company	DECC	0.0
Low Carbon Contracts Company	DECC	0.0
Nuclear Liabilities Fund	DECC	0.0

Held as a financial investment asset in Departmental Accounts

Entity	Sponsoring Department	Share of net assets (£m)
Royal Mail (30% holding as at 31 March 2015)[4]	BIS	1,315
Commonwealth Development Corporation	DFID	3,369
Eurostar (40% holding)[4]	HMT	757
London and Continental Railways	DfT	555
Urenco (33% holding)	BIS	438
Post Office Limited	BIS	394
NATS (49% holding)	DfT	261
The Met Office	BIS	229
Ordnance Survey	BIS	169
Companies House	BIS	77
Royal Mint	HMT	55
Working Links (33% holding)	DWP	4.3

Notes

1 Businesses where the government has a controlling interest are fully consolidated into the relevant departmental accounts and WGA. All other businesses are disclosed as investment assets.

2 The majority of Highways Agency assets were transferred to the Highways England Company Limited on 1 April 2015. The net assets shown represent an estimate of the position based on information in the Highways Agency 2014-15 annual report and accounts.

3 In the future, the Network Rail's assets will be valued on a depreciated replacement cost basis on consolidation into the Department for Transport's accounts and the WGA.

4 The government sold its remaining holding in Royal Mail and Eurostar after the 2014-15 year end.

5 DfT = Department for Transport, DECC = Department of Energy & Climate Change, BIS = Department for Business, Innovation & Skills, DCMS = Department for Culture, Media & Sport, DFID = Department for International Development, HMT = HM Treasury, DWP = Department for Work & Pensions.

Source: National Audit Office analysis

2.12 The majority of investments managed by ShEx relate to organisations that directly carry out a particular function. By comparison, through its investment in the Green Investment Bank (GIB) and British Business Bank (BBB), the government invests in private sector companies and projects and acquires and holds investments:

- **The GIB** is the first bank of its type in the world. It was created in 2012 by the government, its sole shareholder, and given access to an initial £3.8 billion of public funds. It uses this finance to fund green projects on commercial terms and to encourage investment from the private sector into the UK's green economy. The financing of these green projects gives rise to investment assets. In the three years since it has launched, GIB has committed £1.8bn of capital into around 46 green infrastructure projects including wind farms and waste and bioenergy projects as at 31 March 2015.

- **The BBB** is wholly-owned by the government and was set up to make finance markets work better for smaller businesses in the UK. Its main aims are to increase the supply of finance in areas where finance markets do not work effectively and to help create greater choice for smaller businesses in terms of finance options and providers. It delivers its objectives by working through the market, providing finance and offering guarantees in partnership with over 80 commercial lenders and investors. The BBB does not lend directly to businesses.

2.13 The majority of the investments managed by ShEx, the GIB and the BBB relate to investments that are not traded on an active market. The total value of the investment assets held in departmental accounts and WGA is £8.6 billion at 31 March 2015. Over £7 billion of this amount relates to assets that are relatively straightforward to value on an accounting basis and are either held at amortised cost or based on the government's share of net assets in individual entities. As seen with student loans, those valuations which are based on models carry the greatest uncertainty. Of the total assets managed by ShEx, the GIB and the BBB only £0.57 billion (7%) are based on valuation models.

2.14 The government is seeking to privatise some of its ShEx portfolio. In March 2016, it invited expressions of interest from potential bidders for the GIB and expects to complete the sale in 2016-17. The government is also due to consult on options to move the Land Registry into the private sector. The main challenge for the government is understanding the economic value of these assets and the value they might represent on sale. This is not currently disclosed in the accounts of the bodies responsible for these investments or in the WGA. Because this portfolio represents a potential store of public wealth and important assets which generate income, the government will need to make careful decisions about its management and the right route for any sales.

Part Three

Legacy assets

3.1 During the financial crisis the government acquired shareholdings in both RBS and Lloyds and took ownership of Northern Rock and Bradford & Bingley. The Bank of England's Monetary Policy Committee initiated the Quantitative Easing programme to help stimulate the economy by increasing the money supply. **Figure 16** overleaf shows a timeline of the key interventions.

3.2 These legacy assets represent around a quarter of the total financial assets in 2014-15 WGA. Just over half of the assets are loans and deposits (£58 billion), the majority of which relate to the Northern Rock Asset Management plc (NRAM) and Bradford & Bingley (B&B) mortgage books (£52.7 billion). The remaining assets relate to the shares the government acquired in RBS and Lloyds.

3.3 **Figure 17** on page 39 shows how the value of these assets has changed since the WGA was first published in 2009-10. The significant increase in loans between 2010-11 and 2011-12 is due to changes in accounting boundaries which meant that UK Asset Resolution Limited (UKAR), which holds the NRAM and B&B loans, was fully consolidated into the Treasury's accounts and the WGA for the first time in 2011-12.

3.4 The government plans to sell all its legacy assets as it no longer has a policy need for them. Since the financial crisis, the government has retained NRAM but sold the other part of Northern Rock, Northern Rock plc, to Virgin Money in 2011. The size of the government's equity holdings in RBS and Lloyds has reduced over recent years after a number of highly publicised share sales. The government has sold 11 billion of its Lloyds shares since the first share sale in September 2013.

Investment in RBS and Lloyds

3.5 The government's interventions to stabilise the British banking system included substantial investments in RBS and Lloyds to protect customer deposits and to allow the banks to maintain lending to businesses and homeowners. The government's aim was to manage these investments at arm's-length and return the banks to private ownership in the future.

Figure 16

Timeline of government interventions during the financial crisis

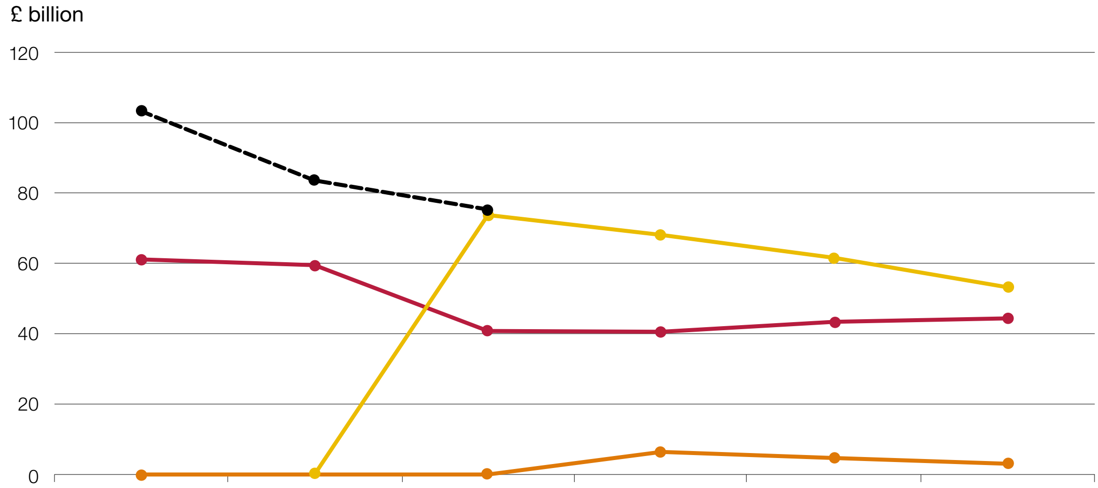
	RBS and Lloyds	Bradford & Bingley and Northern Rock	Bank of England Asset Purchase Facility Fund (BEAPFF)
2007		Northern Rock requests emergency assistance from the Bank of England, leading to a run on Northern Rock	
2008	Government acquires controlling equity stake in RBS and a 43% stake in Lloyds	Northern Rock plc, B&B brought into public ownership. B&B's UK retail deposit business sold to Abbey National	
2009	Preference shares converted into new ordinary shares and £25.5 billion injection into RBS		Bank of England initiates programme of asset purchases to stimulate demand by boosting the money supply (QE) and BEAPFF is set up
2010		Northern Rock split into Northern Rock (Asset Management) plc (NRAM) and Northern Rock plc UKAR established as a holding company to manage closed mortgage books of NRAM and B&B	
2012		Northern Rock plc sold to Virgin Money	
2013	Government sells first tranche of shares in Lloyds (4.3 billion shares; 15.5% of shareholding)		Cash transfers from BEAPFF to Exchequer begin, reaching £11.3 billion by end of March 2013
2014	Further sale of Lloyds shares (5.6 billion shares; 24% of remaining holding). Trading plan to sell Lloyds shares launched Agreement reached to retire the RBS Dividend Access Share. Initial DAS retirement dividend of £320 million paid by RBS to HM Treasury		
2015	Government announces sale of 630 million shares in RBS and its intention to sell at least three-quarters of its stake over next parliament Between December 2014 and May 2015 the government sells 4.2 billion Lloyds shares, bringing the shareholding to less than 19%. Further sales of the government's shareholding in Lloyds are made between June 2015 and October 2015, bringing the shareholding to less than 10% overall	UKAR announces sale of £13 billion 'Granite' portfolio of mortgages	
2016	RBS makes the final payment of £1.2 billion to the Treasury to retire the RBS Dividend Access Share	In June 2016, UKAR completed the transfer of its mortgage servicing operations to Computershare Limited	

Source: National Audit Office analysis

Figure 17

Movement in valuation of legacy assets since 2009-10

Legacy assets between 2009-10 and 2014-15



	2009-10	2010-11	2011-12	2012-13	2013-14	2014-15
Equity	61.9	59.52	40.81	40.52	43.41	44.31
Loans			73.68	68.02	61.56	53.15
Derivatives			0.01	6.38	4.62	2.96
Loans (pre-consolidation)	103.30	83.54	75.29			

Note

1 Loans held by UKAR relating to Bradford & Bingley and Northern Rock mortgage books were reflected in the WGA from 2011-12 when they were consolidated for the first time.

Source: HM Treasury Annual Report and Accounts

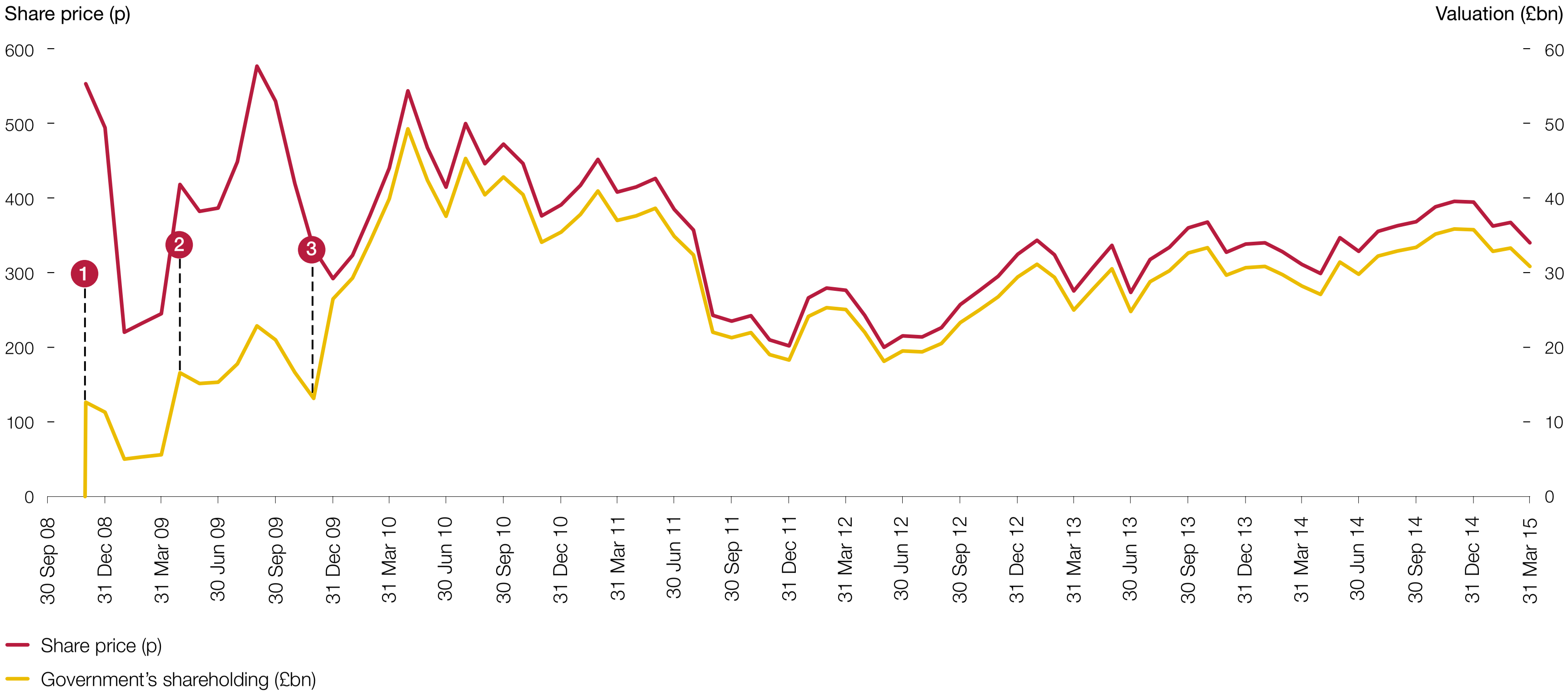
3.6 Between December 2008 and December 2009, the government injected a total of £65.8 billion into the two banking groups, acquiring 84% ownership of RBS (£45.5 billion) and 43% of Lloyds (£20.3 billion) respectively. Because of the size of the government's holding in RBS, it split its investment between ordinary shares and 'B shares'. This arrangement meant that the government's holding of ordinary shares remained within the 75% limit for voting rights and avoided RBS breaching stock market listing rules. Linked to the B shares was a single Dividend Access Share (DAS) which ensured that the Treasury would get an additional dividend compared to those paid on the ordinary shares.

3.7 **Figure 18** and **Figure 19** on pages 40 and 41 show how the value of the government's shareholdings have fluctuated over time due to investments and disposals as well as changes in share prices. The government has already recouped some of its initial investment from share sales to date. However, amounts generated from future sales will depend on movements in share prices and the timing of any sales. As at 31 March 2015, the government's shareholdings were valued at £32 billion (RBS) and £12.2 billion (Lloyds).[16]

16 The value of RBS shares includes £30.8 billion for ordinary and B shares and £1.2 billion relating to the Dividend Access Share.

Figure 18
Valuation of the government's shareholding in RBS between 2008 and 2015

RBS: Value of government shareholding versus share price



1 December 2008	Initial recapitalisation	Investment	2,285 million shares	£15.0 billion
2 April 2009	Preference share conversion	Investment	1,679 million shares	£5.1 billion
3 December 2009	Purchase of 'B shares'	Investment	5,100 million shares	£25.5 billion

Notes

1 Number of shares adjusted to account for share consolidation exercise in June 2012 and presented for comparison.

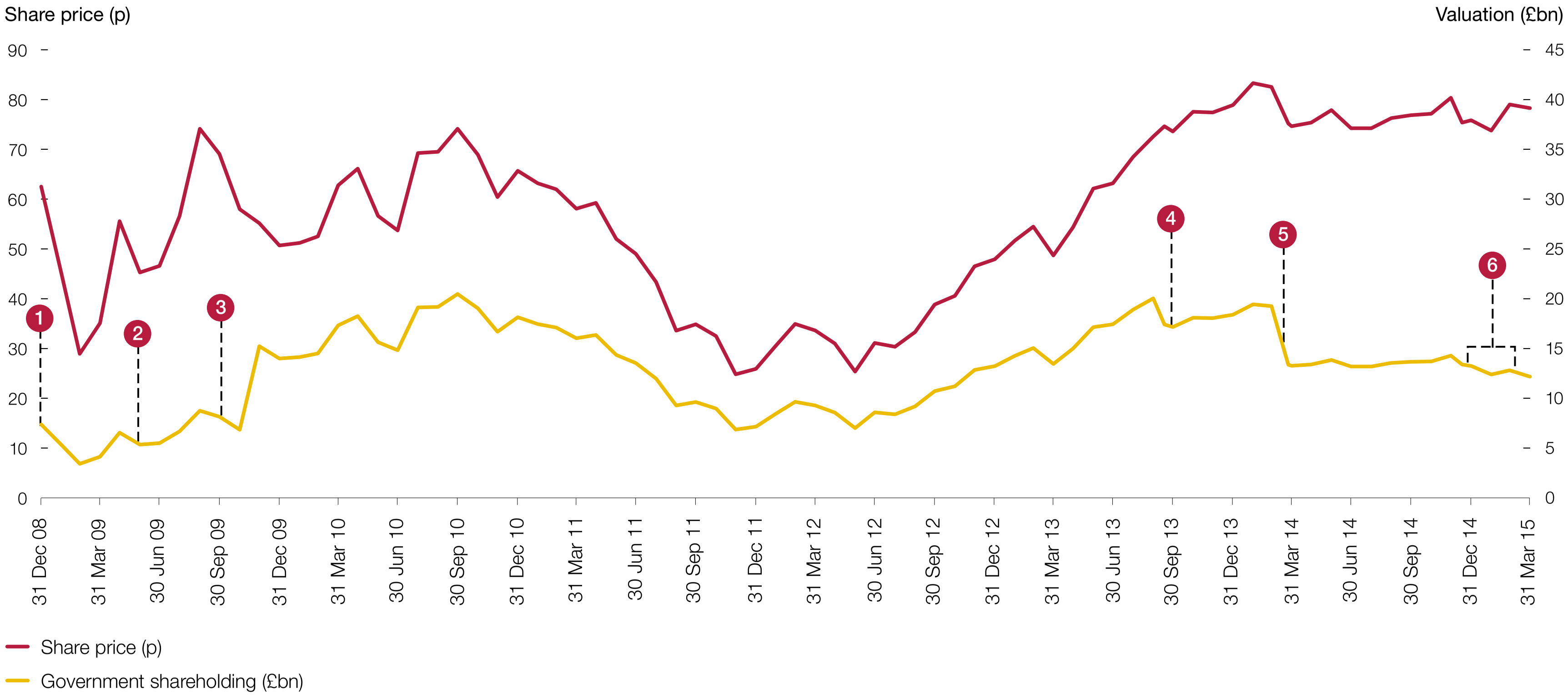
2 This valuation does not include the value of the RBS DAS which after the initial dividend of £320m was valued at £1.2 billion at 31 March 2015. The DAS was created to provide enhanced dividend rights to the Treasury when it provided capital to support RBS. In March 2016 a final payment of £1.2 billion was made by RBS to the Treasury and the DAS retired.

Sources: Share price data from Bloomberg. Data on shareholdings from UKFI Annual Report and Accounts

Figure 19

Valuation of the government's shareholding in Lloyds between 2008 and 2015

Lloyds: Value of government shareholding versus share price



1 January 2009	Initial recapitalisation	Investment	7,277 million shares	£13.0 billion
2 June 2009	Preference share conversion	Investment	4,521 million shares	£1.5 billion
3 December 2009	Rights issue	Investment	15,810 million shares	£5.8 billion
4 September 2013	Accelerated bookbuild sale	Disposal	(4,282 million) shares	£3.2 billion
5 March 2014	Accelerated bookbuild sale	Disposal	(5,555 million) shares	£4.2 billion
6 December 2014 – March 2015	Trading plan sale	Disposal	(2,219 million) shares	£1.7 billion

Note

1 Further sales were made between March 2015 and October 2015 which brought the government's shareholding down to less than 10%.

Sources: Share price data from Bloomberg. Data on shareholdings from UKFI Annual Reports and Accounts

Valuing the shareholdings

3.8 Putting an accounting value on the government's investments in RBS and Lloyds is straightforward given the market data available. These shares are quoted on the London Stock Exchange and therefore the quoted price on the reporting date is used to value them. However, this value represents a point in time only in a volatile market and the ability to achieve this price will depend on having a functioning market. Further, the government will not necessarily be able to realise this value from asset sales as a discount may be required to place its significant holding in the market.

Managing the shareholdings

3.9 The government's aim is that it should not be a permanent investor in financial institutions. UKFI manages the government's shareholdings in RBS and Lloyds. The Treasury requires UKFI to act in line with best practice for institutional shareholders by exercising its voting rights and engaging with the banks at a strategic level. UKFI's overarching objective is to manage these shareholdings commercially and develop and execute a strategy for the disposal of the investments in an orderly and active way over time in order to create and protect value for the taxpayer. Disposals must be undertaken in agreement with the Treasury.

3.10 Having reduced its stake in Lloyds to less than 19 per cent by the end of May 2015, the government has made further sales during 2015-16 to reduce its holding to less than 10% and now plans to launch a retail sale in 2016-17 to sell its remaining shares.[17,18]

3.11 The government's strategy and timeline for selling its shares in RBS is less clear and the sales will require careful management given the size of the government's shareholding in the bank. Nonetheless, the Chancellor has committed to raising £25 billion from the RBS holding during this Parliament. In 2014, RBS paid an initial DAS dividend of £320 million and in August 2015 UKFI sold 630 million shares, equivalent to 5.4% of RBS.[19] Since then, the government's B shares have been converted to ordinary shares and a final payment of £1.2 billion received from RBS in connection with retiring the DAS which will help to open up share sales to a wider market of investors. The government now owns 73% of RBS. However, it is not clear as to whether the government will be able to recoup its investment in RBS eight years on from the initial crisis.[20]

17 UK Financial Investments Limited, Annual Report and Accounts 2014-15, p. 7.
18 HM Treasury, *Government sells a further 1% shareholding in Lloyds*, October 2015, available at: www.gov.uk/government/news/government-sells-a-further-1-shareholding-in-lloyds
19 HM Treasury, *Government begins sale of its shares in the Royal Bank of Scotland*, August 2015, available at: www.gov.uk/government/news/government-begins-sale-of-its-shares-in-the-royal-bank-of-scotland
20 Nick Macpherson, '…the longer they [the banks] stay in the public sector, the greater the likelihood that you will lose value', quoted in George Parker, 'Sell RBS at a loss, says outgoing Treasury head', Financial Times, 13 April 2016, available at: www.ft.com/cms/s/0/0d113008-ff31-11e5-99cb-83242733f755.html#axzz4COahRWNb

UKAR mortgage book

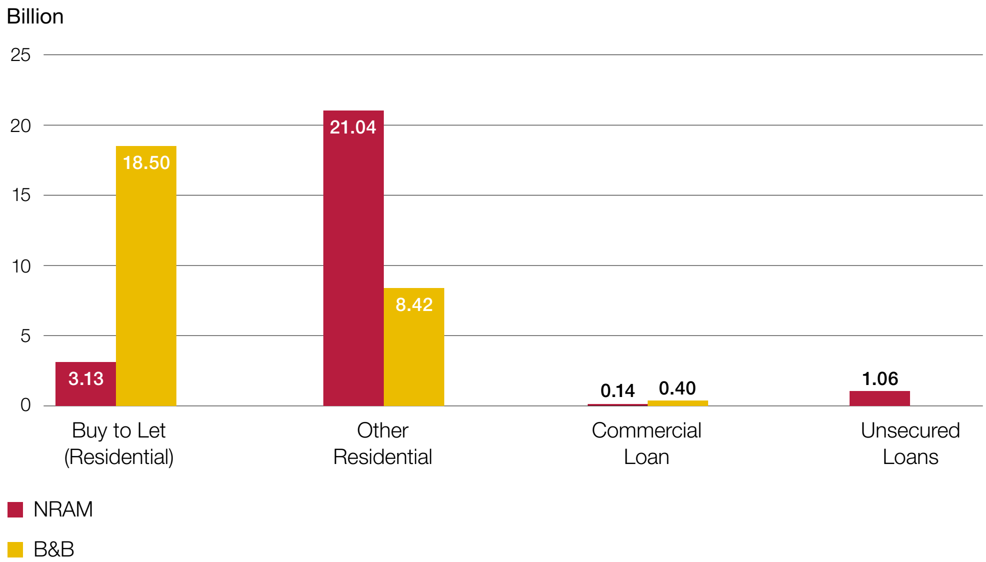
3.12 The majority of assets held by UKAR are the mortgages and other loans issued by the former Northern Rock and Bradford & Bingley banks. While the balance sheets of both banks are made up primarily of mortgages, the composition of the loan books is significantly different, reflecting the differing business models of the two banks during their active participation in the market (**Figure 20**).

3.13 Whereas the Bradford & Bingley book is characterised by a high proportion of buy-to-let mortgages (68%), the NRAM book comprises mainly residential mortgages with only 12% being buy to let. Of NRAM's residential mortgages, 41% are a combination of a secured mortgage and an unsecured loan. Further, NRAM's business model was to offer high loan to value mortgages as shown in **Figure 21** overleaf. The buy-to-let mortgage market has recently been subject to policy intervention by the government, through revisions to stamp duty and the Bank of England's supervisory statement on buy-to-let underwriting standards. This has the potential to influence the value of the buy to let portfolio and shows the potential conflicts between the government's wider policy initiatives and its asset portfolios.

Figure 20

NRAM and B&B mortgages as at 31 March 2015

Composition of mortgage books as at 31 March 2015

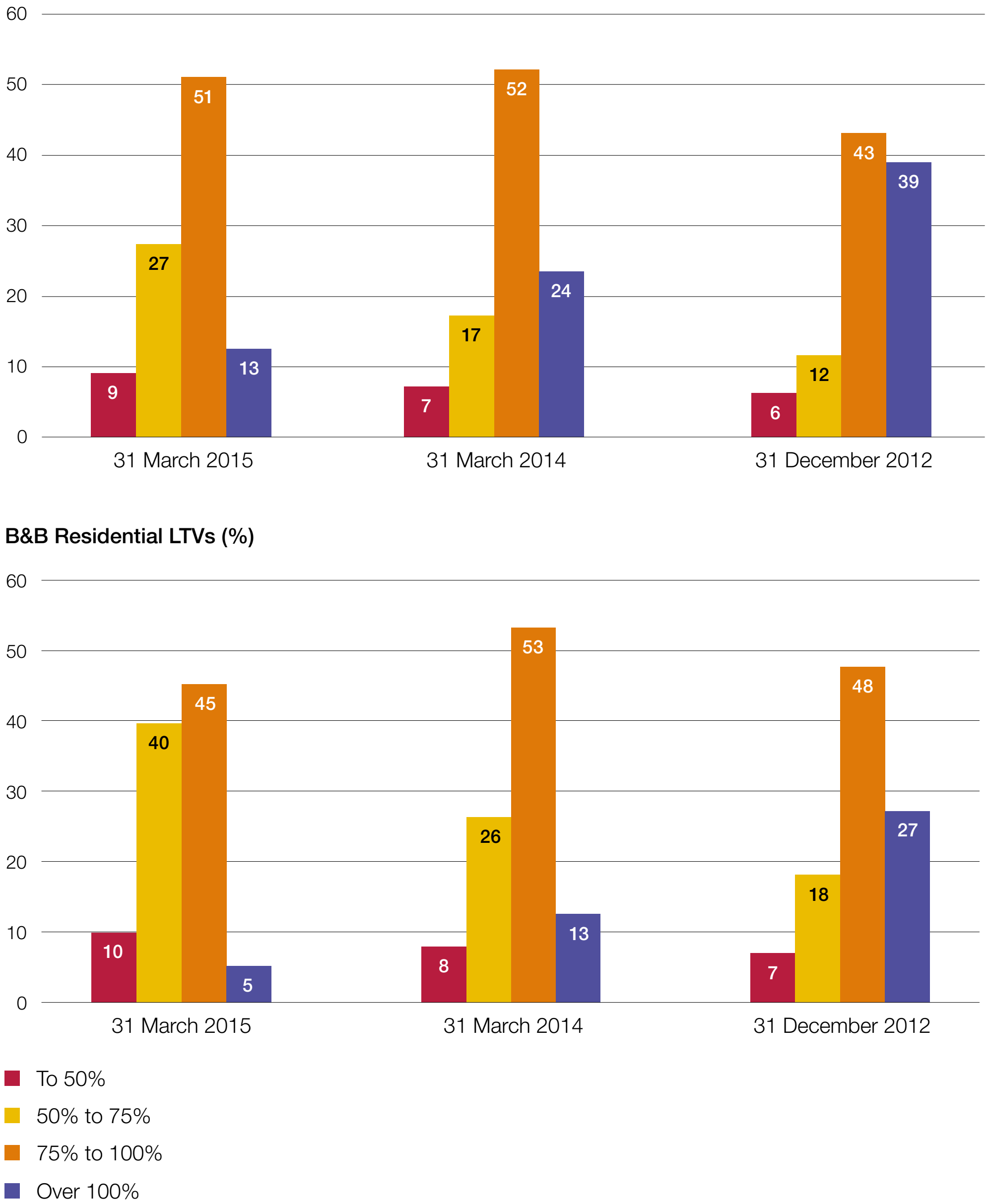


Sources: NRAM and Bradford & Bingley Annual Report and Accounts 2014-15; UKFI Annual Report and Accounts 2014-15

Figure 21
NRAM and B&B residential mortgages by loan–to–value ratio

Changes in loans-to-value ratio

NRAM Residential LTVs (%)



Source: NRAM and B&B audited accounts

Valuing the mortgage book

3.14 Payments of capital and interest are contractual. In the main, the mortgages and loans were issued to individuals meeting set eligibility criteria such as credit checks and were secured against property and other assets which would mitigate any loss arising from non-payment of the loan. As a result, the impairment provision for UKAR's loan assets as at 31 March 2015 is relatively small at £1.2 billion and represents 2.2% of the total loan balance (**Figure 22**).

3.15 As with student loans, the main area of uncertainty in the valuation is around the assumptions underpinning the impairment provision. Key assumptions which would affect the level of impairment include the probability of borrower default, house price inflation, fraudulent property valuations and interest rates. However, due to the scale of the UKAR impairment, changes in these assumptions would not have a sizeable impact on the overall value on the balance sheet unless there was a significant downturn in the economy. For example, UKAR's 2014-15 accounts report that a 10% decrease in house prices would increase impairment provisions by £53.8 million for NRAM and £33.5 million for Bradford & Bingley.

Managing the mortgage book

3.16 UKFI manages the government's investment in UKAR on behalf of the Treasury. UKFI is represented on UKAR's board and works directly with the board and management teams to develop and execute projects to wind down the balance sheet. Following a number of smaller transactions over recent years, in November 2015, UKAR announced that it had reached an agreement to sell £13 billion of NRAM mortgages. This sale was a significant step towards selling off the UKAR mortgage portfolio and the National Audit Office will report on the value for money of the sale in 2016-17. The Budget 2016 announced that the government was looking to build on this sale and was 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. However, the amount generated will depend on market conditions at the time of sale and whether the fair value reflects the value on the balance sheet. At 31 March 2015, the fair value was £2.7 billion (10.1%) less than the carrying value. One year on, at 31 March 2016, the fair value was £3 billion (11.9%) less than the carrying value.

Figure 22
UKAR loan impairments

Type	Gross value (£bn)	Impairment (£bn)	Carrying amount (£bn)	Impaired (%)
Residential	52.0	0.9	51.1	1.7
Commercial	0.6	0.1	0.5	12.5
Unsecured	1.3	0.2	1.1	16.2
Total	**53.9**	**1.2**	**52.7**	**2.2**

Source: UK Asset Resolution Limited Annual Report and Accounts 2014-15

3.17 In addition, in June 2016, UKAR completed the transfer of its mortgage servicing operations to Computershare Limited so that it can continue to provide a service to its borrowers while its balance sheet is wound down.

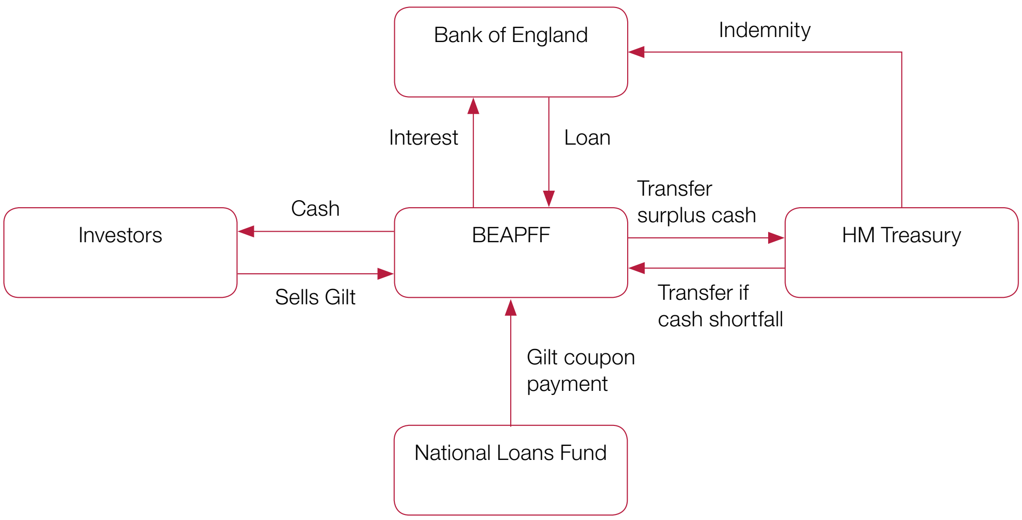
Quantitative easing

3.18 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 and supporting asset prices. 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 which it used to buy assets held by investors, mainly gilts, and effectively inject money directly into the economy. The BEAPFF is indemnified by the Treasury against losses and the Treasury will receive any profits generated by selling the gilts back to the market or holding them to maturity (**Figure 23**).

3.19 The £375 billion of gilts purchased by the BEAPFF were valued at £407 billion at 31 March 2015. The Treasury's 2014-15 financial statements recognised an asset of £36.4 billion which is the difference between BEAPFF's assets and liabilities at the year end and is the amount it would receive if the scheme was unwound at that point. However, these assets are not visible in the WGA because they represent an internal transfer between BEAPFF and the Treasury and are removed on consolidation

Figure 23

The quantitative easing arrangement



Source: National Audit Office analysis

Valuing the assets

3.20 The assets held by BEAPFF are gilts which are valued at quoted market prices and are sensitive to fluctuations in interest rates. As a result, the Treasury's derivative will change as gilt prices move in line with the market and interest is accrued. The movement in the value of gilts held by the BEAPFF against the loan from the Bank of England can be seen in **Figure 24** overleaf.

3.21 Because the value of the assets of the BEAPFF are currently greater than its liabilities (excluding the amount due to the Treasury under the indemnity), the Treasury recognises an asset of £36.4 billion in its accounts. This is mainly due to the fair value of gilts being currently higher than their original purchase price and the loan from the Bank of England. If interest rates were to rise, the value of gilts would likely fall and the Treasury would recognise a liability if the value of BEAPFF's assets became less than its liabilities. Low rates of interest have also meant interest received on the gilts has been greater than the interest BEAPFF pays on the loan to the Bank. Since 2012-13, following a revision to the indemnity, excess cash has been transferred from the BEAPFF to the Treasury. By 31 March 2015, £53 billion had been paid to the Treasury.

Managing the scheme

3.22 The BEAPFF is a complex arrangement and exposes the public finances to fluctuations in market prices and interest rates. For example, the Treasury would have to meet the shortfall if rises in the Bank of England base rate meant the interest BEAPFF owed on the bank loan was higher than the interest it received on the gilts or if, when unwinding the scheme, proceeds from redeeming the gilts were insufficient to repay the loan.

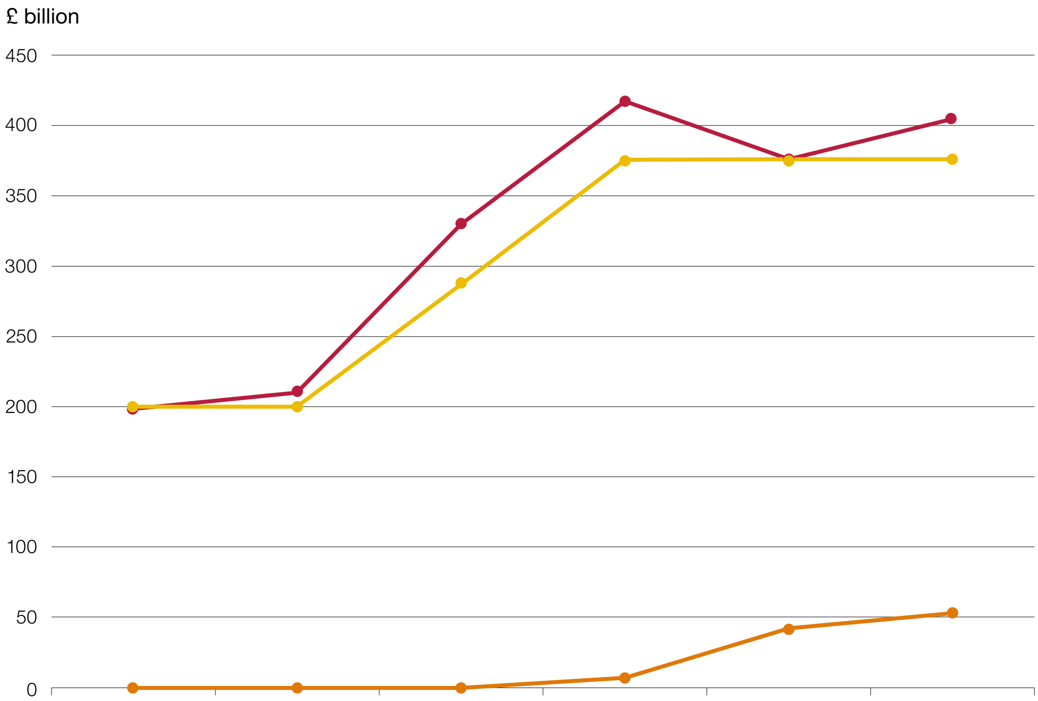
3.23 Although quantitative easing was originally intended to be a temporary intervention, the Bank's Monetary Policy Committee does not currently expect to start winding up the scheme until the bank rate has increased from 0.5% to around 2%. Its policy to hold the gilts to maturity and then reinvest the proceeds means that, although the last asset purchase was in July 2012, there has been no reduction in the scale of the overall scheme and assets held since it began in 2009. Further, the size of the gilts held in the scheme relative to the market (24% of total gilts in issue at 31 March 2015) means that any exit from the scheme would need to be carefully managed to avoid disrupting the gilt market.

3.24 Globally, in October 2014, the US Federal Reserve made its last asset purchase. The European Central Bank has extended the quantitative easing programme it began in 2015 through to at least March 2017; and the Bank of Japan has increased its programme.

Figure 24

BEAPFF assets compared to the Bank of England loan

BEAPFF assets, Bank of England loan and cash paid to the Treasury



	28 Feb 2010	28 Feb 2011	29 Feb 2012	28 Feb 2013	28 Feb 2014	28 Feb 2015
Value of BEAPFF assets	198.25	209.69	329.27	416.57	375.59	404.37
Bank of England loan	200.00	199.86	286.66	375.31	375.31	375.32
Cumulative cash paid to HMT	–	–	–	7.52	42.38	53.11

Note

1 BEAPFF accounts report with a February year end.

Source: Asset Purchase Facility Annual Report and Accounts

Appendix One

Our approach and evidence base

1 This study examined financial assets on the Whole of Government Accounts (WGA) balance sheet, the associated risks and benefits to the UK's public finances and how government is managing them. We reviewed:

- how significant financial assets are valued and reported;
- the current size, profile and nature of these assets and how these are changing;
- the long-term financial risks associated with financial assets;
- the government's approach to managing financial assets; and
- how the WGA could help to improve the government's understanding and management of these assets.

2 We reviewed the asset-related information in all WGAs published since its inception in 2009-10 and the individual financial accounts that are consolidated into the WGA. Much of our assurance comes from the significant body of financial audits that we carry out across central government. We reviewed fiscal sustainability reports published by the Office for Budget Responsibility to gain insight into the long-term implications of the government's commitments on financial assets. We reviewed other relevant information in the public domain including publications by the Shareholder Executive, UKFI and HM Treasury.

Appendix Two

Operational financial assets

1 In 2014-15 WGA, the most significant operational financial assets relate to:

- **Cash and cash equivalents** (£26.8 billion) which include cash balances held across many different central and local government bodies. These balances are valued in sterling. Any foreign currency holdings are translated to sterling using the year end exchange rate.
- **UK's gold reserves** (£8 billion) which are managed by the Exchange Equalisation Account (EEA) and valued at fair value using the sterling equivalent of the bid price set by the London Bullion Market Association which regulates the market for gold and silver. At end of March 2015, the price of gold had risen by 3 per cent to £799 an ounce compared to the previous year. As a result the EEA's 2014-15 accounts recognised a gain on revaluation of £246 million.
- **Repurchase agreements** (£40.3 billion) which are held by the Bank of England and the DMA and are used for short-term cash management. Repurchase agreements in the EEA are used for reserves management and are held in foreign currency. These balances fluctuate depending on how much cash government has to lend or needs to borrow on a daily basis. Under these agreements government buys gilts or Treasury bills from a counterparty and agrees to sell it back for a higher price at a later date. These agreements are treated as secured short-term loans in the accounts and the loan reflected on the government's balance sheet while the gilt or Treasury bill purchased remains on the counterparty's balance sheet. Approximately £28.5 billion of these agreements are held at amortised cost which spreads the difference between the purchase and resale price over the length of the agreement. The remaining £11.8 billion of repurchase agreements is held at fair value and discounted using the government discount rate to adjust cash, which will be received in future when the assets are sold, to today's prices.

- **Debt securities** (£66.1 billion) which like repurchase agreements are held for short-term cash management purposes or, in the case of the Bank of England, for a mixture of policy and trading purposes. In the main, they are held by the Bank of England, EEA, DMA and the Pension Protection Fund. Most debt securities are valued using fair value based on quoted market prices.
- **IMF** (£18.9 billion) which comprises the UK's quota subscription (£10 billion) managed by the National Loans Fund and IMF Special Drawing Rights (SDR) (£8.9 billion) which are managed by the EEA. IMF balances are translated to sterling at the SDR exchange rate at the year end.
  - The quota subscription is the primary means of financing the IMF with each member of the IMF assigned a quota, based broadly on its relative size in the world economy. The subscription determines the maximum amount of financial resources the member is obliged to provide to the IMF and the subscription must be paid in full before joining. The quota also determines a member's voting power in IMF decisions and the amount of financing a member can obtain from the IMF. It is valued in the accounts at amortised cost.
  - Related to the IMF quota subscription are the IMF Special Drawing Rights (SDR) which IMF allocates to member countries in proportion to their quotas. SDRs are an IMF reserve asset which can be exchanged for currencies and countries can buy or sell their allocation of SDRs. The allocation is recorded as a liability in the EEA accounts on which the government pays interest expense and the resulting holding of the SDRs are assets on which the government earns interest income. Where a country's holding of SDRs is equal to its allocation, the interest income and expense net off. The allocation and holding are recognised using fair value as they can be traded.
- **Equity investment in the European Investment Bank (EIB)** (£7.1 billion) is managed by the Consolidated Fund. The EIB is the European Union's bank representing the interests of the European Union member states and working closely with other EU institutions to implement EU policy. The EIB aims to further the objectives of the EU by making long-term finance available for investment projects. The EIB's capital comes from subscriptions by EU member states which are in proportion to the Gross National Product of the individual countries. The UK's investment is based on its 16.11% share of subscribed capital and is translated from euro to sterling at the year end exchange rate.

Other operational financial assets include derivatives held by the Pension Protection Fund, EEA and the Bank of England to hedge against interest and foreign exchange rate risk as well as inflation risk. These totalled £14.0 billion in 2014-15 compared to £1.1 billion in 2009-10. However, the majority of the difference between 2014-15 and 2009-10 is attributable to the Pension Protection Fund, which has £9.5 billion of derivatives, being consolidated into the WGA in 2014-15 for the first time. The Department for International Development also held approximately £3.4 billion of equity investments in international financial institutions which relate to government's operations abroad.

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