National Audit Office

Report
by the Comptroller
and Auditor General

**HM Treasury and United Kingdom Financial Investments**

# The first sale of shares in Royal Bank of Scotland

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HM Treasury and United Kingdom Financial Investments

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Report by the Comptroller and Auditor General

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Comptroller and Auditor General
National Audit Office

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This report examines whether UK Financial Investments Limited and HM Treasury achieved value for money from the August 2015 sale of shares in Royal Bank of Scotland.



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# Key facts

**£2.1bn**
proceeds from the sale of Royal Bank of Scotland shares

**2.3%**
discount to the market price

**72.9%**
HM Treasury's economic interest in Royal Bank of Scotland after the sale

| | |
|---|---|
| **338 pence** | share price immediately before the sale |
| **2.4 times** | amount by which demand exceeded the number of shares on offer at the sale price |
| **330 pence** | price at which the shares were sold, representing a 2.3% discount |
| **630 million** | number of shares sold, representing 5.4% of the outstanding shares in the bank |
| **346 pence** | share price at the end of the first week of trading |
| **£45.5 billion** | amount the government injected into Royal Bank of Scotland |
| **6.8 years** | time between the government buying the shares and the first sale |
| **234 pence** | average share price during the first quarter of 2017 |

# Summary

**1** To maintain financial stability at the height of the financial crisis, the government injected a total of £45.5 billion into the Royal Bank of Scotland (RBS) between October 2008 and December 2009. The government intended to return RBS to the private sector as soon as possible but uncertainty regarding changes in the regulatory environment for banks, and ongoing restructuring and litigation proceedings concerning RBS made a sale difficult. In the period up to the sale, the Independent Commission on Banking published a report in September 2011, followed by the Parliamentary Commission on Banking Standards in June 2013. This led to the government's 'RBS and the case for a bad bank' review in November 2013, and RBS's announcement detailing its new strategy in February 2014.

**2** On 4 August 2015, the government sold 630 million shares in RBS (5.4% of the bank) to institutional investors, reducing government's holding to 72.9%.[1] The shares sold for 330 pence each. This represented a 2.3% discount to the market price and raised £2.1 billion. This initial disposal of RBS shares was executed at a price that was £1.9 billion less than the cost for those shares, which the government acquired for reasons of financial stability and not for the purpose of making a profit. In his 2015 Mansion House speech before the sale, the Chancellor of the Exchequer stated that the purchase price was not a relevant consideration when disposing of the shares and that this cost was part of protecting the wider economy during the financial crisis. This disposal was part of a long-term strategy to reduce the government's holding in RBS to a minority position by 2020. In the November 2016 Autumn Statement, the Chancellor announced that further disposals were unlikely until legacy issues were resolved.

**3** United Kingdom Financial Investments Limited (UKFI), which HM Treasury owns, managed the sale. UKFI was created in November 2008 to manage the government's shareholdings in RBS and Lloyds Banking Group (Lloyds), as well as the government shareholdings and loans in UK Asset Resolution and its subsidiaries. It operates at arm's-length from the government, although HM Treasury sets out its role and remit in UKFI's Framework Document and Investment Mandate. UKFI's overarching objective is to manage these shareholdings commercially, to create and protect value for the taxpayer, and to devise and implement a strategy for realising the value of these investments. In any asset disposal UKFI must seek HM Treasury's views, and obtain its approval.

1 HM Treasury's economic interest in RBS after the sale.

## Scope

4 This report examines whether UKFI and HM Treasury achieved value for money from the August 2015 sale of shares in RBS. Our assessment criteria includes the preparation UKFI undertook in the run-up to the sale, the sale process itself and the proceeds achieved. This approach is consistent with our other reports into asset sales, such as Eurostar and Royal Mail. We have not evaluated the value for money of the government's overall investment in RBS, nor the effectiveness of banking reforms or RBS's restructuring efforts that occurred before the sale.

## Key findings

### Preparation leading up to the sale

5 **UKFI began the sales process on a timely basis and took a lead role in preparing for the sale.** RBS announced its new long-term strategy in February 2014. At this time market analyst views were negative, with nearly 60% recommending shareholders to sell. By September 2014, investor sentiment had improved and UKFI began considering a first sale of shares. It made submissions to HM Treasury in advance of the Chancellor's 2015 Mansion House speech covering options for a disposal plan, and the size and timing of individual sales transactions. UKFI's advice was often provided jointly with HM Treasury, which it believed to be a more efficient way to advise HM Treasury's ministers and the Permanent Secretary. However, there was not always a clear distinction between UKFI's views and those of HM Treasury despite their different roles in joint submissions. The views on size, timing and form of disposal of RBS shares expressed in the joint advice are consistent with UKFI's internal documents, which demonstrates its lead role in developing the disposal strategy for HM Treasury (paragraphs 1.10 to 1.13, Figure 3).

6 **UKFI reviewed all disposal options and chose the most appropriate one to sell the shares**. UKFI and its advisers[2] received no indications of interest from a strategic investor to buy a stake in RBS. In the absence of such a buyer, UKFI reviewed the disposal options via the public markets. It concluded, in our view correctly, that an accelerated book-build (ABB) was the most appropriate option to achieve the £2 billion sale announced in the 2015 Summer Budget at the lowest possible discount and execution risk (paragraphs 2.2, 2.4 to 2.11, Figure 5).

2 Privatisation adviser: Goldman Sachs. Capital markets adviser: Rothschild

## Process of the sale

7 **Government's 'inside information' limits sale 'windows'**. UKFI may at times be in possession of material non-public information on RBS, for example as a result of its stewardship duties. It is a legal requirement that no sale can take place if UKFI holds inside information. In addition, UKFI is unlikely to recommend any sizeable public sale of RBS shares for reputational reasons when RBS is in a closed period, which occur in the run-up to key financial announcements. Also, for reputational reasons, HM Treasury chooses not to sell in advance of government announcements which may affect the share price, for example in the run-up to fiscal events such as the Budget or Autumn Statement. This reduces the available execution windows but supports its position as reputable seller (paragraphs 2.12 to 2.17, Figure 8).

8 **UKFI chose the August 2015 sale window as market conditions were good, and potential investors were supportive**. Following the 2015 Mansion House speech UKFI's advisers asked investors about their appetite for RBS shares. This feedback was supportive of the planned transaction size (£2 billion) and the type of sale. Most positive feedback came from speculative rather than from long-term investors, which is not surprising considering the uncertainty around RBS's future performance. Market conditions were conducive to launching a sale in August 2015 after RBS's half-year results. UKFI preferred this window to later options owing to a risk of market deterioration. The market did, in fact, deteriorate after the sale and RBS shares traded below the 330 pence sale price after September 2015 (paragraphs 2.8 to 2.10, 2.17, 2.18, 3.11, Figure 6 and Figure 9).

9 **UKFI negotiated a nominal fee of £1 with its financial advisers but it did not make full use of its former privatisation adviser's contracted services**. The low fees, similar to the Lloyds ABB transaction, reflect: competition among financial advisers wishing to work on a high-profile government mandate; and involvement in this relatively straightforward sale offering an opportunity to gain insights useful in tendering for later, possibly more complicated and therefore profitable, transactions. As market conditions change or different types of transactions are used, this low fee environment may not continue. UKFI also engaged a privatisation adviser to provide ongoing strategic advice on privatisations of both Lloyds and RBS. According to UKFI, this adviser provided support on RBS up to March 2015 although the contract ended in June. In June 2015, UKFI appointed a new privatisation adviser. UKFI did not request the previous adviser to provide formal recommendations on RBS from March 2015 because it was aware of a potential change of adviser, and the confidential nature of the transaction (paragraphs 3.13 to 3.17, Figure 19).

**10 One adviser had an initial role advising HM Treasury and subsequently UKFI**. HM Treasury considered a range of issues before beginning this first sale, such as the likelihood of government recovering its original investment and the potential impact on financial stability. In doing so, it sought independent assurance from the Governor of the Bank of England and an independent financial adviser. Prior to the Mansion House speech, Rothschild advised HM Treasury on RBS's value loss, and the implications for a disposal programme. Subsequently, Rothschild provided an independent opinion to UKFI on the privatisation adviser's work, Goldman Sachs. Rothschild's initial advice adds credibility to the process of such a sizeable first disposal but also increases the cost and duplicates some of UKFI's functions as independent arm's-length adviser to the government (paragraphs 1.13 to 1.15 and 3.14).

## Proceeds and valuation of the sale

**11 The 330 pence sale price was within the fair value range, but the range was wide**. UKFI's advisers conducted a comprehensive valuation on a timely basis before the sale. They used appropriate methodologies for the banking sector as well as tailored methodologies to reflect RBS's ongoing restructuring activity. The full valuation range of all valuation methodologies was between 177 pence and 488 pence, when RBS traded at 342 pence, which reflected uncertainties about RBS's future prospects. This range implies a share price upside and downside of 43% and 48% respectively, and was wider than for the Lloyds' ABB in 2013. This was the first fair value assessment since July 2014 (paragraphs 2.21 to 2.23, 3.13, Figure 10, Figure 11, and Appendix Three).

**12 UKFI and its advisers made an adjustment to the fair value calculation, which had a conservative bias although it did not affect the fair value conclusion**. RBS had made provisions of £4.8 billion for various litigation, conduct and regulatory issues. UKFI and its privatisation adviser, Goldman Sachs, estimated a higher provision of £10.4 billion to £11.8 billion. This estimate was slightly higher than the range of equity research analysts' consensus estimates. UKFI and Goldman Sachs' provision included an additional adjustment of £2.9 billion to £4.3 billion for future conduct charges as a result of a more stringent regulatory environment. UKFI stated that its regular engagement with potential investors supported this approach. UKFI's capital markets adviser, Rothschild, acknowledged that an adjustment for potential future conduct charges may be appropriate but viewed the size of the adjustment as 'pessimistic'. A cautious approach to RBS's future provisions turned out to be appropriate as they were higher than UKFI forecast at the time of the sale (paragraphs 2.24 to 2.26, Figure 12).

**13 The demand in the sale was high and UKFI achieved a smaller discount than in recent privatisations**. The shares were sold at 330 pence, a 2.3% discount to the 338 pence closing price on the day of the announcement. This was better than the 4% to 7% range advisers' estimated, and the 4.3% discount of comparable transactions in the previous 12 months. Only 23% of demand came from 'Tier 1' priority investors – those who UKFI expected were most likely to form a stable long-term and supportive shareholder. Evidence from the privatisation of Royal Mail demonstrates that priority investors do not always hold for the long term. Considering the uncertainty around RBS's future prospects, a higher level of participation by Tier 2 and Tier 3 investors is not surprising (paragraphs 3.5 to 3.10, Figures 15 to 17).

**14 The details of the sale leaked into the market about an hour before the official announcement but it had no impact on the sale price**. The leak resulted in the shares briefly dropping to 336 pence before closing at 338 pence. UKFI could not identify the source of the leak. Its analysis of the effect of the leak concluded that it did not affect the taxpayer negatively. The price achieved was at the top end of the bookrunner's expectations, which were communicated before the leak. UKFI reviewed the amount of short selling in RBS stock before the transaction and concluded that it had increased by 12 million shares or 1.9% of the 630 million shares sold. This was not meaningful in relation to the size of the offering and not out of the ordinary relative to RBS's past levels or those of other UK banks (paragraphs 3.3, 3.4, Figure 14).

## Conclusion on value for money

**15** The sale was consistent with HM Treasury's overarching objective to not be a permanent investor in UK financial institutions, and UKFI's objective to execute a strategy for disposing of investments in an orderly and active way. UKFI selected an appropriate sale window based on a combination of factors including the need to first stabilise the bank, to sell into benign market conditions, and to ensure a sufficient level of interest among potential investors. It launched the sale in relatively favourable conditions, and closely assessed investor demand and the fair value of the shares to ensure it was protecting taxpayer value within the policy context to sell. This first sale of shares in RBS was executed as skilfully as could reasonably be expected, and on the basis of the preparation, process and proceeds of the transaction, UKFI achieved value for money.

## Recommendations

**16** In the context of UKFI's objective to protect and create value for the taxpayer in a sale of a listed equity instrument we recommend the following:

**a** To conduct regular fair value assessments of all its investments, irrespective of market conditions, or whether insider information makes a sale impossible.

**b** To clearly state the rationale for and risks of valuation adjustments which differ to industry standards and document the evidence supporting such approach.

**c** To make full use of advisers as appropriate according to the service arrangements it has agreed.

**17** UKFI has sold down its Lloyds holding and made considerable progress in disposing of mortgage assets. Given that the Chancellor has put on hold further sales in RBS until legacy issues are resolved, the government should take this opportunity to:

**d** consider the impact on realised value of a limited number of sale windows. If it is significant, we would expect to see an analysis of potential solutions which weigh the costs and benefits of each; and

**e** consider how to maintain the corporate finance and capital markets expertise of UKFI as the stake in, and work on, returning the banks reduces. Subsequently, HM Treasury should consider how to redeploy these skills for the benefit of wider government.