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

The first sale of shares in Royal Bank of Scotland

Report by the Comptroller and Auditor General

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Sir Amyas Morse KCB
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	2.3%	72.9%
proceeds from the sale of Royal Bank of Scotland shares	discount to the market price	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.

Part One

Background to sale

1.1 This part of the report provides background to the government's activities relating to the Royal Bank of Scotland (RBS), RBS's performance, the preparation leading up to the sale and the sale's objectives.

Government's initial involvement and restructuring activities

1.2 During the financial crisis RBS got into severe financial difficulties. Between October 2008 and December 2009, the government injected £45.5 billion of capital into the bank, resulting in an economic ownership in excess of 80%. The rescue was structured to retain RBS's listing on the main market of the London Stock Exchange and enable a speedy return to the private sector. This was achieved by splitting its investment in RBS between ordinary and non-voting B-class shares and limiting the government's ownership of the ordinary shares to below 75%. The overall investment was equivalent to 502 pence per share (**Figure 1**).[3]

Figure 1
Government cash injections into Royal Bank of Scotland (RBS)

Government became majority shareholder, injecting £45.5 billion of capital

Date	Event
October–December 2008	RBS participates in the UK government's recapitalisation scheme. The government pays £15 billion for 57.9% of RBS's ordinary shares. At the same time, it also subscribes to £5 billion of new RBS preference shares, which were due to pay an annual dividend of £600 million.
April 2009	The government converts its £5 billion of preference shares into ordinary shares. Its ownership of RBS increases to 70.3%.
December 2009	HM Treasury subscribes to £25.5 billion new 'B-class' shares on 22 December 2009 to raise further capital for the bank. This increased the government's economic ownership of the bank to 84.4%. Its voting ownership remained unchanged.

Notes

1 Ordinary shares carry voting rights in proportion to the shareholding owned. Dividends can be paid to these shareholders from profits after dividends to preference shareholders have been paid.

2 Preference share dividends pay a fixed dividend before any dividends are paid on ordinary shares.

Source: HM Treasury annual report and accounts 2008-09, RBS annual accounts 2010, UK Financial Investments

3 The figure of 502 pence relates to cost of the intervention without payments received under the preference shares. The adjusted cost is 499 pence. This is set out in more detail in Part Three.

1.3 In the years immediately after the financial crisis the government focused on reforming banking regulation to minimise the risk of future banking crises. In June 2010 the government established the Independent Commission on Banking (ICB) to consider reforms to the UK banking sector to promote financial stability. This led to uncertainty for RBS and the whole UK banking sector as the outcome would affect the operational and financial requirements of the industry. The ICB published its final report in September 2011.

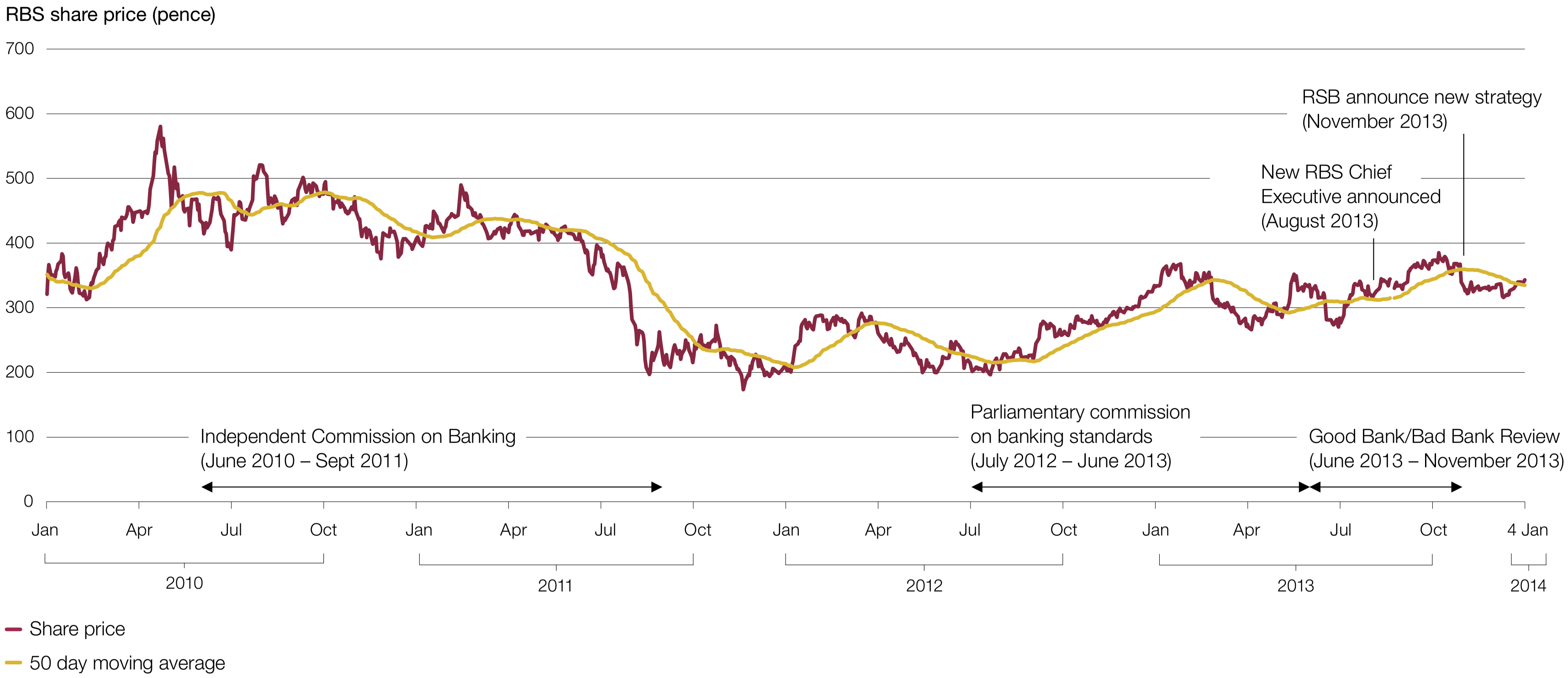
1.4 In July 2012, the government set up the Parliamentary Commission on Banking Standards to conduct an inquiry into professional standards and culture in the UK banking sector and to make recommendations for legislative action. It published its report in June 2013, recommending that the government undertake a detailed analysis on splitting RBS into a 'good bank / bad bank'. In November 2013, HM Treasury published the conclusions of its review. Simultaneously, RBS announced how it intended to separate its assets into an internal 'bad bank' and undertake a strategic review of its remaining businesses under new Chief Executive Ross McEwan. HM Treasury welcomed the creation of the internal 'bad bank' as did United Kingdom Financial Investments Limited (UKFI) and the Bank of England. This announcement made clear the future structure and long-term strategy of RBS (**Figure 2**).

1.5 In February 2014 RBS's chief executive officer, who had been appointed chief executive in summer 2013, announced the company's long-term strategy. The strategy took account of the government's findings. At this time, equity research analysts' sentiment on RBS was negative, with close to 60% of analysts providing a 'sell' recommendation on RBS. The clarity about the company's future strategy and direction enabled analysts to assess more accurately the value of a potential investment. As a result, investors' interest in the shares started to increase. From mid-2014 onwards, RBS's share price started to rise. In December 2014, it had briefly traded above 400 pence, a three-year high, and 'sell' recommendations had fallen to below 40%.

Figure 2

Royal Bank of Scotland (RBS) share price between 2010 and 2014

RBS's long-term strategy announcement helped to increase investors' interest



Source: Bloomberg

Sale objectives

1.6 UKFI's overarching objective, set by HM Treasury, regarding its disposals of RBS and the government's other financial assets, is to devise and implement a strategy for realising the value of these investments in an orderly and active way. UKFI's Framework Document notes that any disposal strategy should:

- be within the context of protecting and creating value for the taxpayer as shareholder;
- pay due regard to the maintenance of financial stability; and
- act in a way that promotes competition.

1.7 UKFI's objectives are consistent with HM Treasury's stated aim that it should not be a permanent investor in UK financial institutions, and should maximise sustainable value for the taxpayer, taking account of risk.

1.8 Regarding the sale of any RBS shares, HM Treasury and UKFI want assurance on three key value-for-money areas:

- **fair value**: the share price at the time of the sale reflected fair value;
- **market conditions**: supportive market conditions; and
- **investor demand**: sufficient demand from investors for the size and type of sale, and an acceptable discount.

1.9 UKFI is wholly owned by HM Treasury and its role and remit are set out in its Framework Document and Investment Mandate. HM Treasury also sets UKFI's annual budget and authorises its board members. UKFI provides advice on strategy and timing of potential disposals. But the final decision on the sale of the shareholding in RBS ultimately rests with HM Treasury, the legal owner of the shares in RBS.

Preparations for the sale

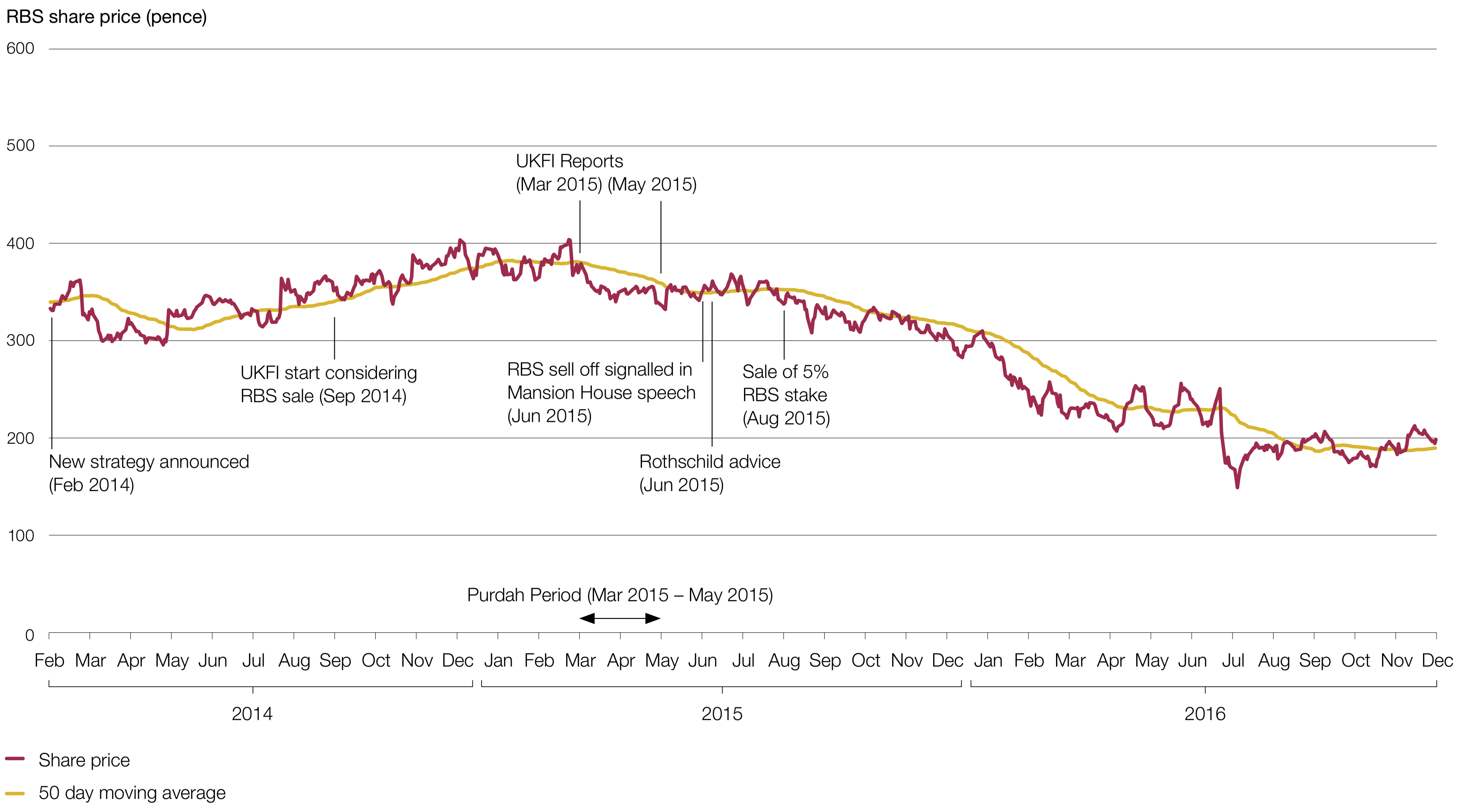
1.10 After RBS announced its new strategy in February 2014 (**Figure 3**), investor sentiment started to improve. UKFI's board began to consider the potential investor proposition for RBS in September 2014. It explained that it had not considered recommending a sale of shares in RBS before 2014, mainly because of the uncertainty about the bank's future direction. In addition, UKFI also possessed inside information on RBS because of its involvement in the company's new strategy. This prevented it from selling shares earlier. In November 2014, UKFI presented its potential strategies to the Executive Management Board of HM Treasury.[4] The focus of these strategies was on reaching a minority position in RBS as quickly as possible while maintaining flexibility on the disposal methods and timing of execution.

4 The directors-general and permanent secretaries make up the senior management team for HM Treasury, known as the Executive Management Board (EMB). EMB meets once a week to discuss corporate and policy issues, focusing its time on the management and coordination of the department as a whole.

Figure 3

Royal Bank of Scotland (RBS) share price since 2014

Investor sentiment improved following the announcement of a new strategy in February 2014



Source: Bloomberg

1.11 In May 2015, UKFI officials noted that it was unlikely that the government would ever recover the full price paid for the shares, given the reduced future size and earning power of RBS, and the new regulatory environment. UKFI's own analysis gave RBS a valuation range between 210 pence and 499 pence, which was below the in-price of 502 pence. It argued that this should not be a barrier to starting a sale process as the price paid for the shares is not a relevant factor in considering their fair value.

1.12 In his 2015 Mansion House speech, the Chancellor announced that the government would start to return RBS to the private sector. In the period leading up to the speech, UKFI provided multiple submissions to HM Treasury advising on options, size and the timing of a disposal plan. UKFI based the advice on its own experience and feedback from a panel of advisers. It had discussions with its then privatisation adviser, J.P. Morgan, around valuation methodology but did not ask it to provide a formal opinion or valuation analysis to support its view. UKFI's submissions to the Chancellor were frequently joint submissions with the State-Owned Financial Assets team (SOFA) within HM Treasury, which evaluated risks to the financial stability of RBS and the economy. UKFI believed that joint submissions are a more efficient way to provide advice to HM Treasury's ministers and Permanent Secretary. Although SOFA and UKFI have different roles in joint submissions, there is not always a clear distinction between UKFI's views and those of HM Treasury. 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.

1.13 Following the general election in May 2015, HM Treasury recommended to the Chancellor that either HM Treasury or UKFI, together with the assistance of independent advisers, should review the case for selling RBS shares or appoint a senior independent adviser to undertake the review. Following this, if the case were made, the Chancellor should announce a disposal of RBS shares in his 2015 Mansion House speech, which would help test investor demand and help fine-tune the disposal strategy.[5]

1.14 To conduct that review, HM Treasury subsequently selected Rothschild through an open competition. Rothschild's review considered a wider scope than UKFI's mandate and took account of government's policy objectives, assessed whether the government was likely to recover more proceeds than the original interventions and also considered the progress RBS had made since the crisis and its readiness to be sold.[6] The Chancellor also sought the Governor of the Bank of England's opinion on the public interest, competition and financial stability impacts of a sale.

1.15 This additional independent advice was used to gain assurance that all aspects of the decision were considered including the likelihood of government recovering its original investment, and wider systemic financial stability. The request for independent advice adds assurance to the decision, but the financial advice appears to duplicate some of UKFI's functions as an independent arm's-length adviser to government.

5 HM Treasury. Mansion House 2015: Speech by the Chancellor of the Exchequer. June 2015. Available at: www.gov.uk/government/speeches/mansion-house-2015-speech-by-the-chancellor-of-the-exchequer

6 Rothschild, *The UK investment in Royal Bank of Scotland*. Available at: www.gov.uk/government/uploads/system/uploads/attachment_data/file/434153/Rothschild_report_on_the_UK_investment_in_RBS.PDF

Part Two

Choosing the method of sale

2.1 This part of the report examines the sales options available to United Kingdom Financial Investments Limited (UKFI), the rationale for selecting the preferred sales method, and whether UKFI made an informed decision based on the available evidence.

Sales options

2.2 The Royal Bank of Scotland (RBS) is a listed company on the London Stock Exchange. This means there are two potential routes to a sale: selling shares on the public market; or selling all, or a significant part of the holding, to a strategic investor. UKFI and its advisers received no interest from a strategic investor. UKFI's privatisation adviser, Goldman Sachs, deemed such a sale unlikely in 2015 because:

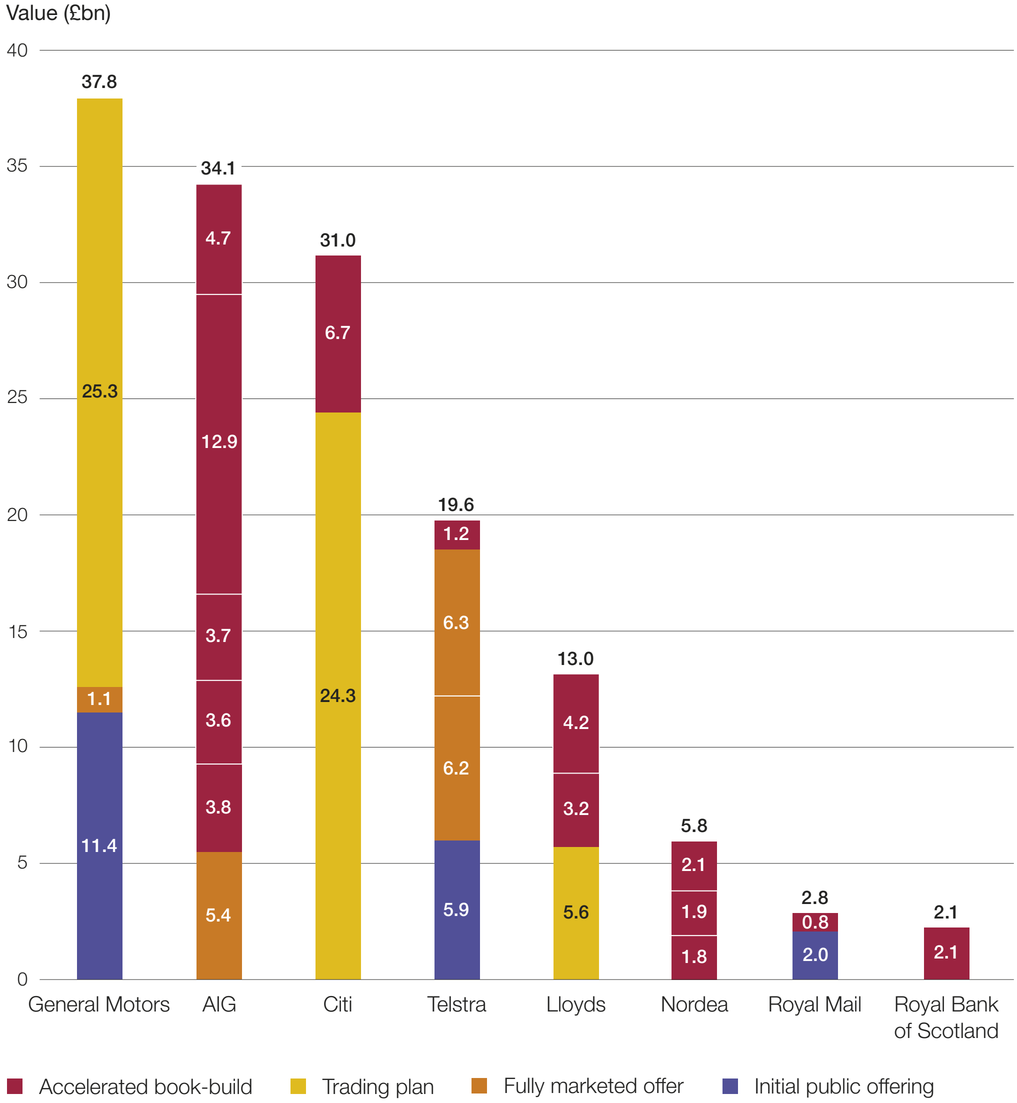
- there was an unfavourable regulatory environment for large mergers or acquisitions in the banking sector;
- the size, scale and complexity of RBS's restructuring plans were likely to be an impediment;
- there was limited interest from international peers in entering the UK banking market; and
- given RBS's valuation levels, a transaction would have a negative effect on the valuation for the majority of global banks.

2.3 UKFI and its privatisation adviser therefore recommended a sale via the public market. Considering that the government's holding in RBS had a market value of £31 billion in July 2015, a sale would require a phased disposal over time with all capital markets options considered as appropriate. Evidence from past privatisations suggests that the length of time needed to dispose of a large shareholding like RBS in the public market takes multiple years and can vary significantly (**Figure 4** overleaf).

Figure 4

Size of transactions and disposal methods used across selected large privatisations

Large share disposals can vary significantly and sometimes require a combination of different sale methods



Notes

1 Selected large international privatisations between 1997 and 2015.

2 Accelerated book-build: selected investment banks place shares with institutional investors via a book-building process.

3 Trading plan: a small number of shares are sold each day during normal market trading.

4 Fully marketed offer: the sale of a large number of shares to both institutional and retail investors.

5 Initial public offering: the offering of shares to the public for the first time.

6 Figures may not sum due to rounding.

7 Figures correct at 31 July 2015.

Source: Goldman Sachs, Bloomberg

2.4 UKFI and its privatisation adviser analysed a long-term disposal plan before the sale. They concluded that £25 billion of RBS shares could be sold by 2020, and that the government could potentially even achieve a full exit, provided that three conditions were met:

- supportive market conditions;
- sufficient flexibility on the timing and type of disposal methods; and
- that RBS executes its strategic plan in line with expectations, in particular, starts to pay dividends in 2017 and achieves its restructuring plans to use excess capital to conduct a significant share repurchase plan.

An earlier plan prepared by UKFI in May 2015 reached similar conclusions. It supported the Chancellor's announcement in the Summer Budget 2015 that the sale would raise at least £2 billion in the fiscal year 2015-16, and that the government could sell three-quarters of its stake by the end of the Parliament.

2.5 UKFI and its advisers considered the capital markets options in **Figure 5** overleaf, in addition to the capital return plan mentioned before, to develop its long-term disposal plan.

Figure 5

Overview of potential share sale options

UK Financial Investments and its advisers considered all capital market options

Sale options	Description	Exposure length	Preparation time	Potential size	Advantages	Disadvantages
Accelerated book-build (ABB)	Selected investment banks place shares with institutional investors via a book-building process.	One-day execution	1 week	£2bn – £3bn	Requires no prospectus and can be completed in a matter of hours Minimises the risk from share price fluctuations Targets specific institutional investors who have expressed willingness to buy RBS shares	Can discourage longer-term investors who require more time to make investment decisions Limited sale size
Trading plan	A small number of shares are sold each day during normal market trading.	Continuous	1 week	£1bn – £2bn (2015-16 tax year)	Shares are sold at market price during normal trading windows Can by-pass close periods where shares are not normally traded	Limited sale size Disposal of a meaningful stake takes time
Fully marketed offer (FMO)	The sale of a large number of shares to both institutional and retail investors.	Two-week offer period	3 – 6 months	£4bn – £8bn	Can sell a large number of shares in a single transaction Encourages participation from long-only investors Greater participation of investors can increase competitive tension and help secure a better price	Requires a long preparation and marketing period Increased exposure to share price fluctuations Costly and larger discounts are often required High level of investor demand required
Equity-linked/ derivative structures	Multiple options, including an exchangeable bond sold to institutional investors and converted into shares at a set exercise price in the future. Converting bonds into shares is optional.	One-day execution	1 – 2 weeks	£2bn – £3bn	Can be used alongside other sales options such as an ABB to increase the size of the transaction High demand for equity-linked products	The sale of shares is not guaranteed because converting bonds to shares is optional and depends on a future share price Difficult to assess value for money at the outset because the conversion into shares happens in the future Requires coordination with other government departments such as the Debt Management Office (DMO)

Note

1 There are other sales options that have not been included in this table. These have not been included because they were not relevant to the sale of RBS shares.

Source: National Audit Office analysis of UK Financial Investments Limited and Goldman Sachs documentation

Preferred initial sale method (sales structure)

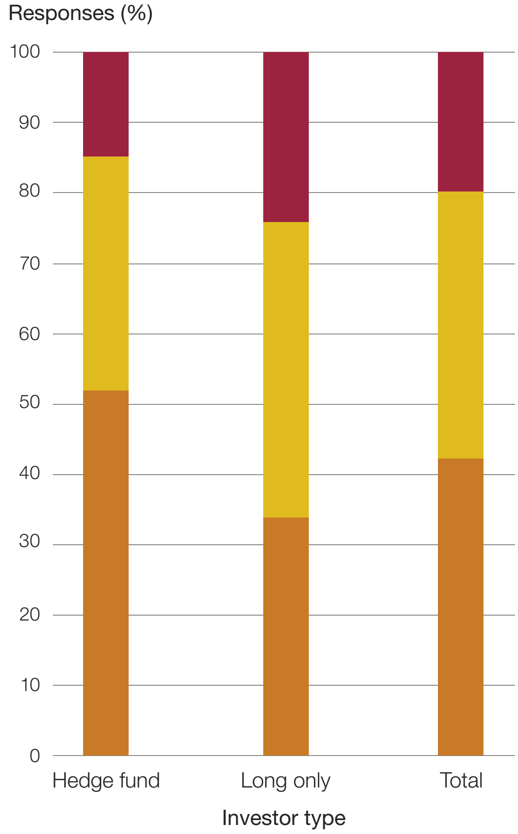
2.6 UKFI kept all the options under review in the lead-up to the sale. It decided that most options were not suitable for the first sale of shares, but were useful for future disposals. UKFI considered a trading plan unsuitable due to the low number of RBS shares trading in the open market because of the large government holding. To avoid putting downward pressure on the share price, UKFI would be limited to selling 10% to 15% of these low daily trading volumes. As a result, the amount of shares the government could have disposed of during the 2015-16 tax year would have been the lowest of all disposal alternatives. A trading plan remains a viable option for future sales.

2.7 UKFI judged an equity-linked offering as unsuitable because it does not guarantee that the shares will be sold. This is because the equity instrument holder will only convert bonds into RBS shares if the future share price is above the exercise price. If it is not, the shares will remain unsold. The complex nature of equity-linked solutions combined with the need to agree upfront a future price at which the shares will be sold make it more challenging to judge whether such a transaction offers value for money.

2.8 For the first disposal of shares, UKFI initially preferred a larger sale through a fully marketed offer (FMO), as it saw this as the best way of reaching a minority position by 2020. However, the continued uncertainty about RBS's outstanding litigation cases and the restructuring of the bank meant that the level of investor demand did not support an FMO. The Chancellor's Mansion House announcement enabled UKFI's advisers to gather meaningful feedback from investors. UKFI collected feedback from 116 investors, of which 58% were unsure or showed no interest. Those unwilling to invest cited resolution of the outstanding litigation cases as a necessary prerequisite for investment. The feedback highlighted that, out of the 42% that expressed a willingness to buy RBS shares, most interest was from short-term investors with 50% of these showing an interest compared with 34% of long-term (long-only) investors. **Figure 6** overleaf provides a breakdown of the investor feedback between short-term ('hedge funds') and long-only investors.

Figure 6
Investor interest in a Royal Bank of Scotland (RBS) placement

Overall investor appetite was mixed with greater interest from hedge funds



	Hedge fund	Long only	Total
No	8	15	23
Maybe	18	26	44
Yes	28	21	49

Notes

1 Breakdown of responses from 116 potential investors collected by investment banks, on UK Financial Investments' behalf, between June and July 2015.

2 The responses represent the interest from investors regarding the likelihood of purchasing RBS shares in the short term.

Source: National Audit Office analysis of UK Financial Investments Limited documentation

2.9 In total, Goldman Sachs identified explicit investor demand of £2 billion to £4 billion, which did not support an FMO. The level of demand identified by Goldman Sachs would mean that an FMO would have required a high discount to encourage investment on a large scale. However, an accelerated book-build (ABB) specifically targets institutional investors who have expressed a willingness to buy shares, so an ABB could fully satisfy the demand identified without needing a high discount. Also, an ABB needs less preparation time, which limits the risk of a fluctuation in the share price. It is also a tried and tested method – UKFI used an ABB in the first sale of Lloyds' shares and achieved value for money. UKFI, in our view, correctly decided to use an ABB as the first method of sale.

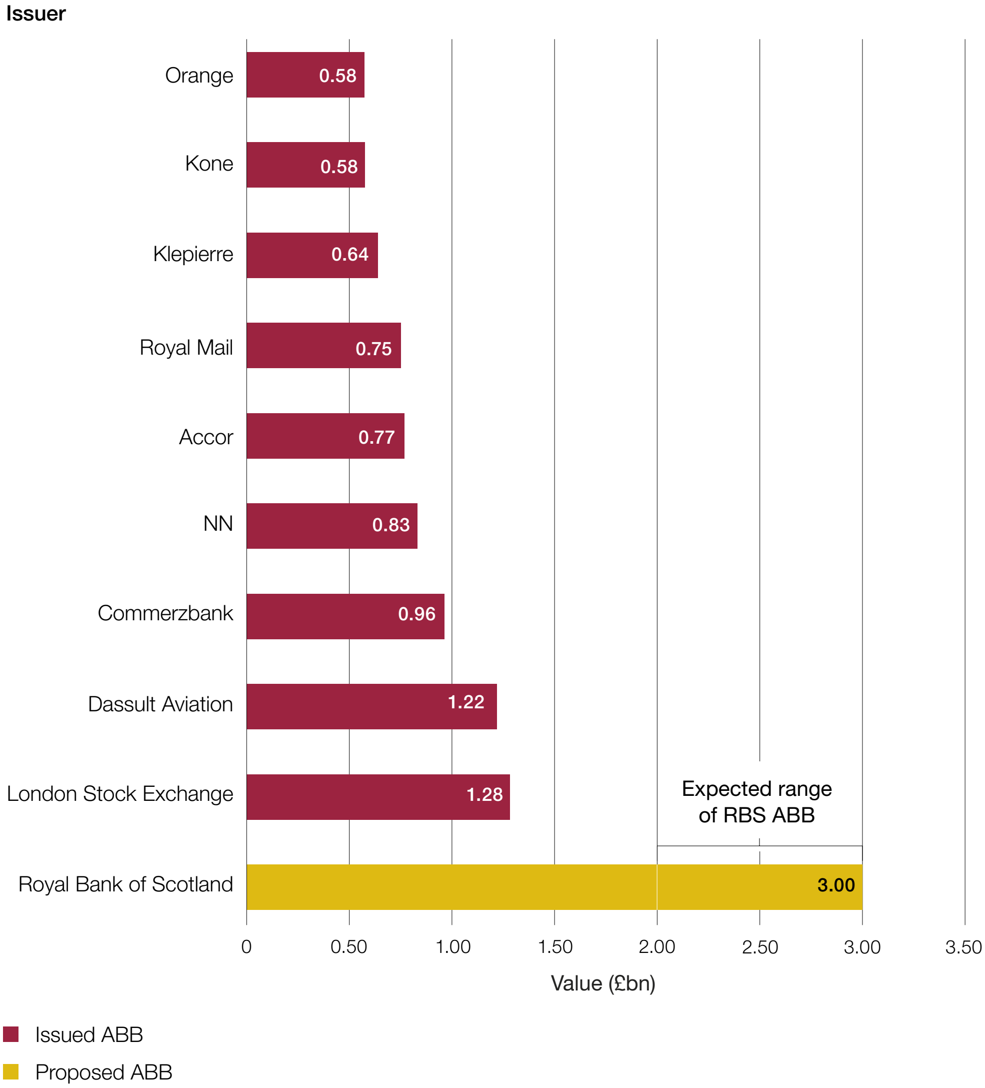
Sale size

2.10 UKFI decided that a first ABB placing of £2 billion to £3 billion (representing 5% to 7.5% of RBS's entire share capital) would be suitable for a first sale. Goldman Sachs and Rothschild both agreed that this range was appropriate given the level of investor demand. Other European ABBs conducted at the time suggested that the market could absorb a sale of £2 billion to £3 billion (**Figure 7** overleaf).

Figure 7

Largest European accelerated book-builds (ABB) in the five months leading up to the Royal Bank of Scotland (RBS) share sale

UK Financial Investment's proposed ABB placing between £2 billion and £3 billion was at the upper end of recent ABBs across Europe



Notes

1 Largest 10 European ABBs between March 2015 and July 2015.

2 All figures, except RBS and Royal Mail, converted from USD to GBP using exchange rate at 30 July 2015.

Source: Goldman Sachs, Bloomberg

2.11 HM Treasury would have been willing to reduce the sale size if it could achieve a smaller discount. However, Goldman Sachs advised that a smaller transaction would not affect the discount and that a sale of less than 5% risked being seen as too small by investors. A placing over 7.5% would exceed investor demand, resulting in willing investors demanding a larger discount on the price. UKFI therefore decided to sell 5.2% of the economic ownership of RBS.

Timing of the sale

2.12 There are a limited number of windows each year where a sale of RBS shares can take place. These windows are influenced by three factors:

- **RBS black-out periods** – close periods[7] in the run-up to key financial announcements;
- **UKFI inside information** – UKFI can only consider a sale of RBS shares if it is not in possession of material non-public information on RBS as a result of exercising its stewardship function; and
- **government inside information** – as a responsible seller, the government chooses to sell shares only if it has no material non-public information.

RBS black-out periods

2.13 Companies listed on the London Stock Exchange operate a close period in the run-up to a release of financial results. This is standard industry practice. During this period, it is unusual for owners of large shareholdings to sell shares in a public sale. The length of the close period varies depending on the type of announcement. A two-month close period is assumed before the release of RBS's full-year results. Shorter close periods apply for half-year results or quarterly interim management statements.[8] Shareholders do not necessarily need to follow this rule; however, market convention is that major disposals of shares are not normally executed in the period, given the proximity to a potential major news event.

UKFI inside information

2.14 When performing its RBS stewardship role, UKFI may sometimes be in possession of inside information, for example when RBS informs it of something before it is made public. To avoid trading with the knowledge of inside information, which is illegal, UKFI must run a cleansing process whereby the information is made public or RBS provides assurance that the information has been superseded or is no longer relevant. Until any inside information is cleansed, a sale of RBS shares cannot take place.

7 A close period is the time between the completion of a company's financial statements and the public release of these statements. During this period, capital market transactions do not usually take place because of a higher risk of insider trading.

8 Interim management statements provide information on a company's current position and likely short-term performance. They do not provide detailed financial information.

Government inside information

2.15 In the run-up to fiscal events such as the Budget, it is possible that measures ministers are considering may affect RBS's share price. Unlike UKFI, HM Treasury is not bound by UK insider dealing legislation, although it takes a similar approach in order to maintain a reputation as a responsible seller. Therefore, the government imposes on itself a close period prior to Budget and Autumn Statement announcements.

2.16 The government may also hold information on future regulatory announcements for example from the Bank of England, Financial Conduct Authority, Prudential Regulation Authority, or Competition and Markets Authority. These announcements could have a material impact on the RBS share price. If shares are sold immediately before such announcements then this creates a reputational risk for the government. For example, our 1996 report on the sale of shares in National Power and PowerGen found that a regulator's announcement shortly after the government share sale had a negative impact on the share price.[9]

Available windows

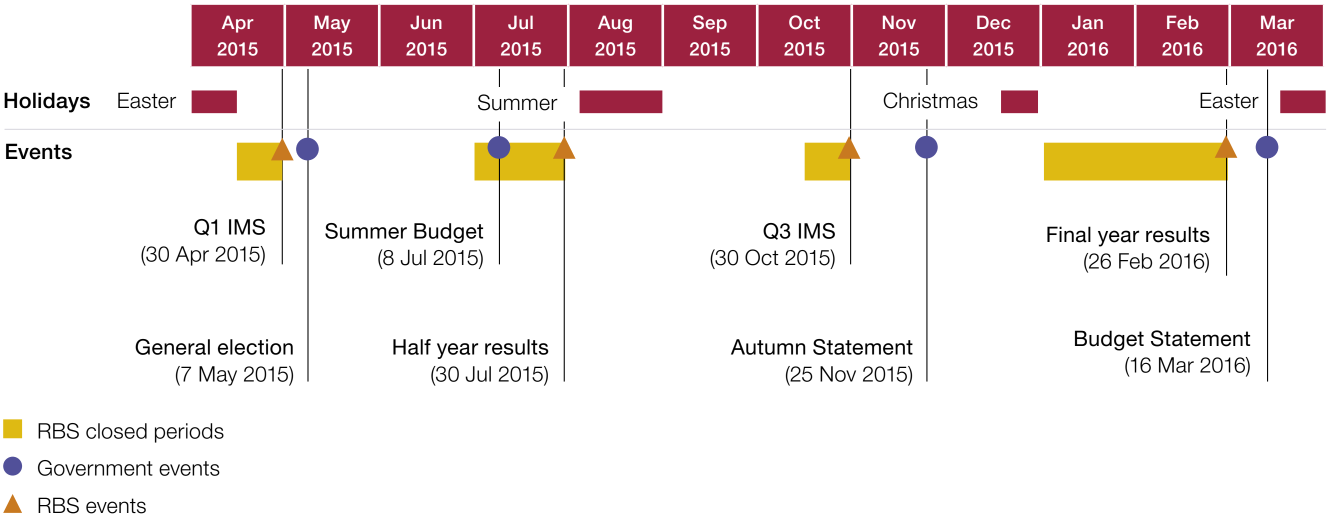
2.17 **Figure 8** illustrates that after these factors were taken into account, there were only four potential sales windows in the 2015-16 financial year. UKFI told us that it did not consider the window between May and June 2015 because of its proximity to the 2015 general election. The remaining windows were the first half of the summer break period and around the Autumn Statement 2015. While August is traditionally a holiday period, there were several earlier examples of large ABBs carried out successfully at the beginning of August. Concerning the later windows, UKFI saw a risk of market deterioration if the Greek sovereign debt restructuring process unravelled, or confidence in China's economic prospects deteriorated further. As a result, August was selected as the most practical window for a sale because this was the first available period after the half-year results on 30 July 2015.

9 Comptroller and Auditor General, *The Second Sale of Shares in National Power and PowerGen*, Session 1995-96, HC 310, National Audit Office, April 1996.

Figure 8

Available sales windows to conduct a disposal of Royal Bank of Scotland (RBS) shares

UKFI had four potential sales windows between April 2015 and March 2016



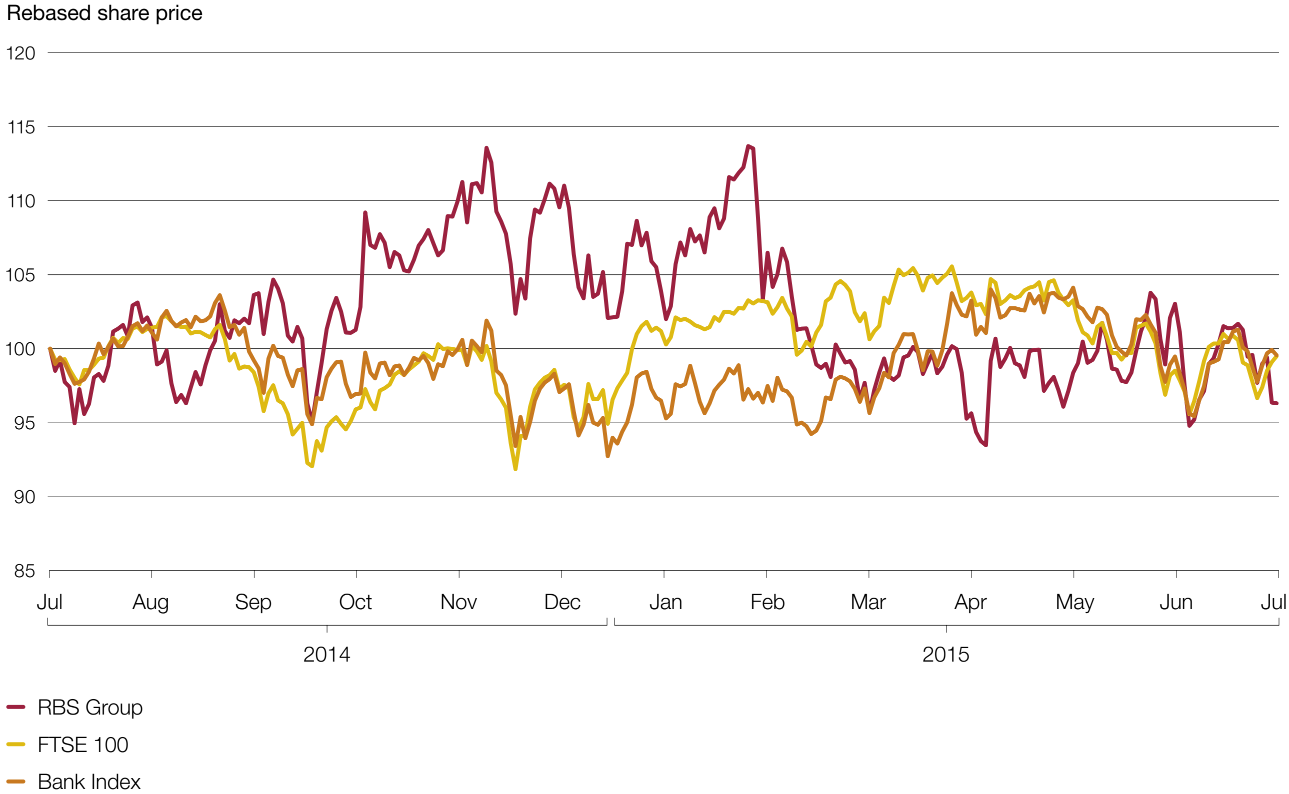
Source: National Audit Office analysis of advisers' documentation

2.18 After identifying 3 August as the earliest opportunity to launch a sale, UKFI then needed to assess the market to ensure that the conditions were conducive to launching a sale. Goldman Sachs sought market feedback and found that the market supported an ABB. It highlighted that RBS's share price performance was in line with peer banks, global demand for UK equities was high, and growth in European equity markets remained strong (**Figure 9** overleaf). The market conditions on the day of the sale were also kept under constant review before the final decision.

Figure 9

Royal Bank of Scotland (RBS) share price performance comparison

The RBS share price performed in line with the FTSE 100 and an RBS calculated bank index in the 12 month period leading up to the share sale



Notes

1 Data is derived from the closing price for RBS shares, the FTSE 100 and an RBS-calculated banking index.

2 Data has been rebased to display a comparison of performance.

Source: National Audit Office analysis of data from the RBS Investor Centre

Sale structure

2.19 A sale through an ABB can be carried out either on a 'best efforts' basis or through an underwritten transaction. In a best efforts placement the final price is determined at the end of the book-building process based on investor demand. No minimum price is agreed between the seller and the bookrunners. In an underwritten transaction the final price is determined before the announcement of the transaction. Bookrunners agree to buy a certain amount of shares from the seller at a fixed price and then sell these on to investors.

2.20 To maintain flexibility UKFI requested that both options were made available right up to the point of launching the sale. Before the announcement of the transaction the bookrunners indicated their willingness to underwrite the sale at 325 pence. Based on market conditions and investor feedback, in our view, UKFI correctly decided to use a best efforts placing. It judged that the risk of not meeting the target price was low. It also preferred the greater transparency over the price and share allocation that the best efforts placing provided.

Valuing the shares

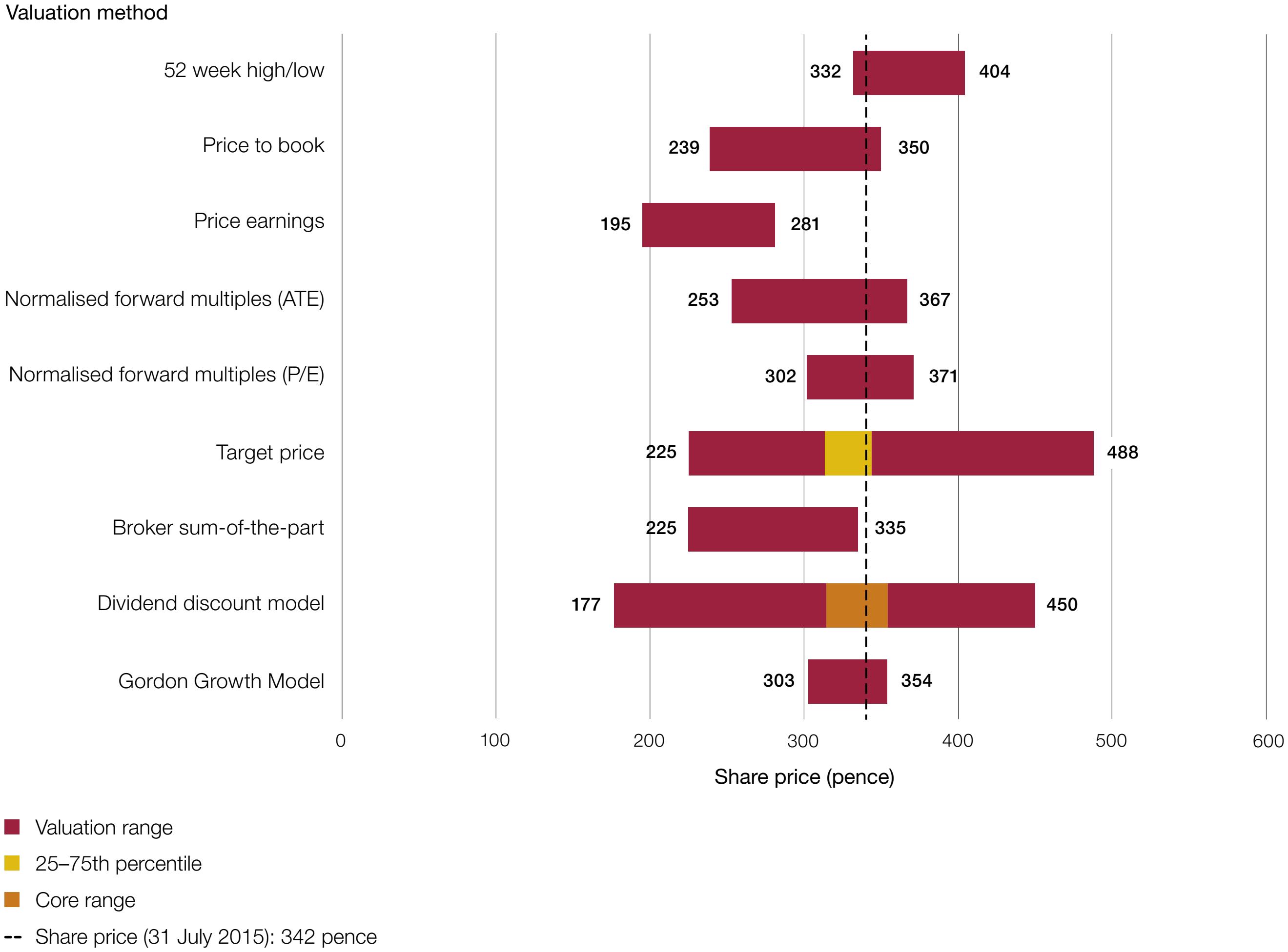
2.21 UKFI asked its privatisation adviser whether the market price of RBS's shares reflected the fair value of the business. Rothschild, acting as UKFI's capital markets adviser, conducted a separate independent fair value assessment and also reviewed Goldman Sachs' analysis. Both advisers provided their analysis to UKFI on 31 July 2015 when RBS's share price closed at 342 pence. This valuation was carried out shortly after RBS's half-year results so that it reflected the latest financial position close to the government's final decision on whether to go ahead with the sale. This was UKFI's first full valuation and fair value assessment of RBS since beginning the sales discussions in 2014. UKFI only conducts a full valuation if it thinks a prospective sale is a realistic possibility, for example if market conditions are supportive of a sale and it is not in possession of inside information.

2.22 The outcome of the valuation analysis is illustrated in **Figure 10** overleaf. The illustration compares RBS's share price on 31 July 2015 (vertical yellow dotted line) with the outcome of each valuation methodology (horizontal bars) and sets it in the context of RBS's historical trading level. We concur with UKFI and the advisers' view that the share price traded within the ranges implied by the valuation methodologies and therefore represented fair value. The share price is at the bottom end of the historic trading range because of a pronounced drop after an increase in below-the-line charges announced at the first quarter results of RBS in May 2015. A trading range is not a valid method of assessing fair value; it is included to show the valuation relative to historical performance. Appendix Three explains the valuation methodologies in more detail.

Figure 10

Comparison of Royal Bank of Scotland share price to valuation methodologies

Share price traded within the ranges implied by valuation methodologies



Notes

1 Data is derived and simplified from Goldman Sachs' analysis, displaying the minimum and maximum across two years instead of displaying each year.

2 'Price to book' is price to tangible book value regression for both 2015-16 (Min: 249, Max: 320) and 2016-17 (Min: 239, Max: 350).

3 'Price earnings' is P/E for 2016 (Min: 195, Max: 281) and 2017 (Min: 197, Max: 266).

4 'Normalised forward multiples (ATE)' is a discounted regression of the price to adjusted total equity on RBS's 2019 bank. Combining FY2 (Min: 269, Max: 366) and FY3 (Min: 253, Max: 367).

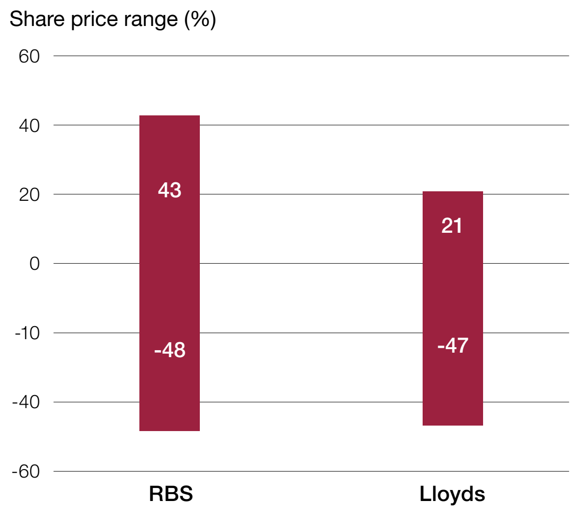
5 'Normalised forward multiples (P/E)' uses the discounted P/E (2019) and combines both FY2 (Min: 318, Max: 371) and FY3 (Min: 302, Max: 362).

Source: Goldman Sachs

2.23 Considering all valuation methodologies, RBS's valuations range between 177 pence and 488 pence per share. The range implies that RBS's shares could be 48% lower or 43% higher than the share price at that time. This is wider than the range on the Lloyds offering (**Figure 11**) and highlights the uncertainty in RBS's investment story due to the restructuring and litigation cost.

Figure 11
Valuation range of Royal Bank of Scotland (RBS) and Lloyds

Valuation range for RBS was wider compared with Lloyds



	RBS (342p)	RBS (%)	Lloyds (77p)	Lloyds (%)
High	488	43	93	21
Low	177	-48	41	-47

Source: National Audit Office analysis

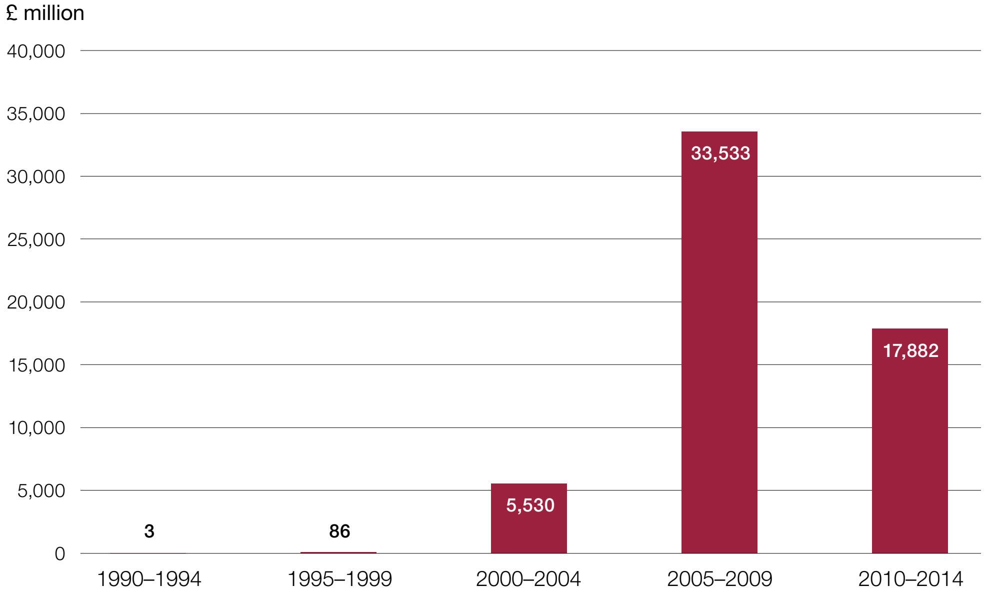
2.24 The valuation ranges take account of RBS's conduct and restructuring charges. These are often referred to as below-the-line charges and affect the gap between operating and statutory profit. RBS had significant below-the-line charges historically, incurring £55 billion between 1999 and 2014. Of these charges, £33 billion were due to past mergers and acquisitions and £9 billion due to conduct (**Figure 12** overleaf).[10] Most of these charges occurred during the financial crisis (£49 billion) and only a limited amount before 2008. However, following this period, the regulatory environment in the UK has become more stringent and increased the risk that there will be higher charges in the future.

10 Of the M&A charge, 98% relates to 2008 and 99.9% of conduct charges occurred between 2011 and 2014.

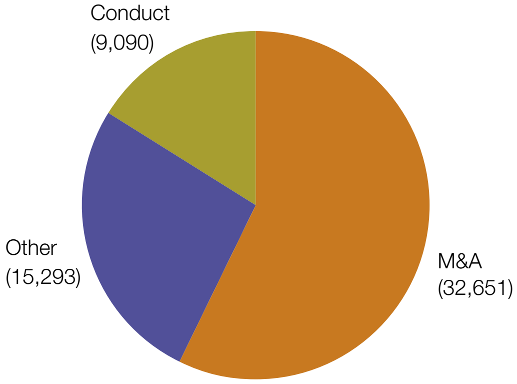
Figure 12
Royal Bank of Scotland (RBS) below-the-line charges

Majority of charges occurred during the financial crisis

Total below-the-line charges



RBS charges between 1990 and 2014 by type (£m)



Source: Goldman Sachs

2.25 Goldman Sachs estimated £7.5 billion of charges for the outstanding conduct-related costs for the period 2015 to 2017. This charge was above RBS's existing provisions for conduct risk of £4.8 billion but within the range of equity research analysts' consensus estimate of £5.6 billion to £10.0 billion. These provisions relate to pending litigation cases at the time of the transaction, for example:

- US mortgages – principally with the US Federal Housing Finance Agency and US Department of Justice;
- foreign exchange and market manipulations;
- customer redress – for example, Payment Protection Insurance (PPI), packaged accounts and interest rate hedging products; and
- shareholder litigations – for example, some shareholders alleging that RBS misrepresented the state of the bank's health at the time of its £12 billion rights issue in April 2008 before the governments intervention.[11]

In addition, UKFI and its advisers believed that the duration and consistency of the below-the-line charges meant that they could not be thought of as 'one-off' charges. Rather, they are a result of the change in the UK regulatory environment and so are more akin to a perpetual cost of doing business in the UK. UKFI stated that its regular engagement with potential investors supported this approach. Based on historic charges and professional judgement, UKFI and Goldman Sachs estimated this future conduct charge, or perpetual cost, as a £2.9 billion to £4.3 billion charge, which equated to 25 pence to 38 pence per share. This adjustment represented 7% to 11% of the market capitalisation of RBS at the time of the transaction.

2.26 Rothschild agreed that some downward adjustment is required to reflect the new regulatory environment but viewed the size of the future conduct charge as "pessimistic". We reviewed 19 different equity research reports on RBS around the time of the transaction and have found that equity research analysts acknowledged this risk but did not quantify it in their valuations to determine a target price. We recognise that the uncertainty of the new regulatory environment represents a new risk; however, we find the size of the adjustment gives a conservative bias to UKFI's fair value calculation. In the case of this sale, a smaller adjustment, or even excluding it fully, would not have changed the conclusion that the share price represented fair value. Since the sale, RBS has increased its provision for conduct charges substantially and made £12.8 billion of provisions in its 2016 full-year accounts, as well as providing guidance to investors that below-the-line charges are likely to continue in the new regulatory environment.[12] With hindsight, RBS's new provisions are higher than UKFI and Goldman Sachs' total adjustment of £10.4 billion to £11.8 billion.[13] However, the methodology and use of a perpetual adjustment should be revisited as the uncertainty regarding the UK regulatory environment clears.

11 At the time of the publication of this report the litigation cases regarding US mortgages, foreign exchange and market manipulations and customer redress were still outstanding whereas the shareholder litigation case mentioned above concluded in June 2016.

12 Royal Bank of Scotland *Annual Results 2016*, February 2017. Forward-looking statements transcript pg. 28.

13 A combination of Goldman Sachs' estimated provision of £7.5 billion plus the additional perpetual charge of £2.9 billion to £4.3 billion.

Part Three

The outcome of the sale

3.1 This part of the report examines the market during, and following, the day of the sale. It also assesses and evaluates the process and the outcome of the sale.

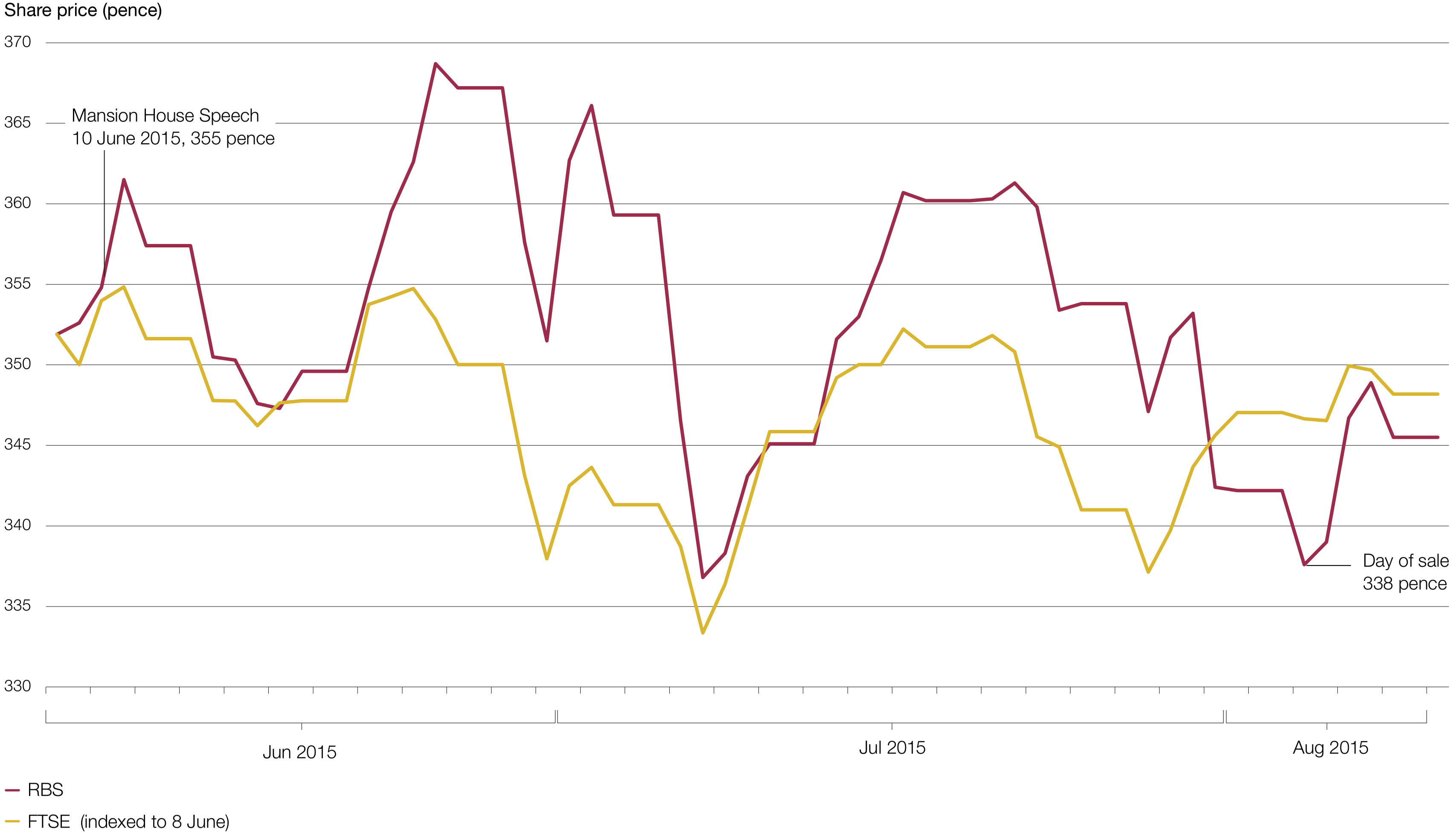
The closing price ahead of the sale

3.2 As the Royal Bank of Scotland (RBS) is traded on a stock exchange, its share price can be tracked and its performance analysed in order to assess the impact of various events. **Figure 13** shows RBS's market price since the Chancellor's 2015 Mansion House speech, in which he announced the start of the privatisation process.

Figure 13

Royal Bank of Scotland's (RBS's) share price from June to August 2015

RBS performed well against the FTSE following the Chancellor of the Exchequer's 2015 Mansion House Speech



Note

1 FTSE 100 revalue to indexed to match RBS's share price on 8 June 2015.

Source: National Audit Office analysis of Bloomberg data

3.3 The sale was announced at 4.45pm on Monday 3 August, after the stock market closed. The price closed at 338 pence, compared with 342 pence the previous Friday. Before the announcement, at 3.54pm, Sky News released a story outlining the government's sale, causing the share price to drop to around 336 pence (**Figure 14**).

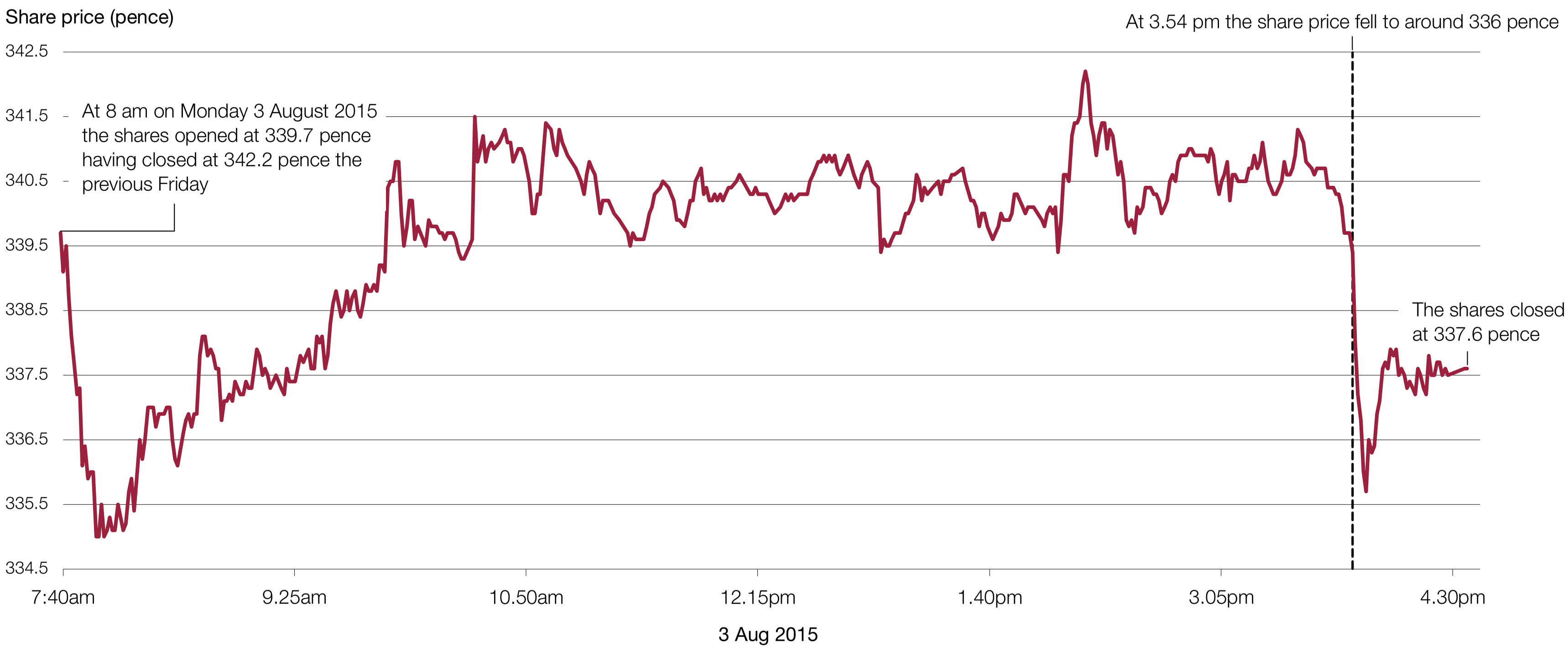
3.4 United Kingdom Financial Investment Limited (UKFI) conducted a leak enquiry but failed to determine how the journalist obtained the information. The investigation into the leak concluded that there was no material increase in short selling.[14] The amount of shares on loan in the run-up to the placing increased by 12 million – 1.9% of the 630 million shares sold. UKFI's analysis showed that this was not meaningful in relation to the size of the offering and not out of the ordinary relative to RBS's historical levels or those of other UK banks. It also calculated that the most that could have been made by these traders was around £4.6 million, which represents 0.22% of the transaction proceeds. The investigation concluded that this did not have a negative impact on the taxpayer. The four bookrunners, UBS, Goldman Sachs, Morgan Stanley and Citi, were able to price the transaction at the top end of the price range announced before the leak.

14 Short selling: a financial transaction where an investor first borrows the shares from a third party at the prevailing market price and then buys the same number of shares at a later stage in the market to return them to the third party. The investor will make a profit if the share price falls by more than the transaction cost.

Figure 14

Royal Bank of Scotland (RBS) share price on the day of sale

Share price fell to around 336 pence following leaked news story of the government's sale of RBS shares



Source: National Audit Office analysis of Bloomberg data

Demand, pricing and allocation of the shares

3.5 The book-building process started with the announcement of the transaction.[15] Within approximately 40 minutes, investors had already expressed sufficient demand to cover the number of shares on offer. This strong early demand created a supportive environment in setting the price, and helped to move the price to the upper end of the book-runner's confidential price guidance of 325 pence to 330 pence. At 7:30pm the book-building process closed and final demand was 2.6 times the number of shares on offer at 325 pence and 2.4 times the number at 330 pence (**Figure 15**). Given the levels of demand seen, it was possible to increase the sale by 5% from 600 million shares sold to 630 million. At the sale price of 330 pence the government achieved proceeds of £2.1 billion.

3.6 In order to ensure a stable aftermarket, UKFI needed to allocate shares to the appropriate investors while not reducing the price achieved. This meant striking a balance between institutions that would be supportive in the immediate aftermarket as well as in the long term. In order to accomplish this, investors were grouped into three tiers – Tier 1 being the most preferred and Tier 3 being the least. The grouping of institutions into 'tiers' makes it difficult to analyse the split between long term and speculative investors as they are based on principles. These principles consider (with examples):

- stability (how long they were likely to hold the stock and size of existing RBS holdings);
- depth (engagement with RBS, UKFI and its advisers); and
- leadership (aiding momentum in the offering, timing and size of order).

15 Book-building is the process of capturing the level of investor demand between the announcement and placement of the shares to support an efficient price discovery.

Figure 15
Coverage of shares to be sold

Demand fell away on prices above 330 pence

Note

1 Compares demand, as reported to the advisers, with the 630 million shares sold.

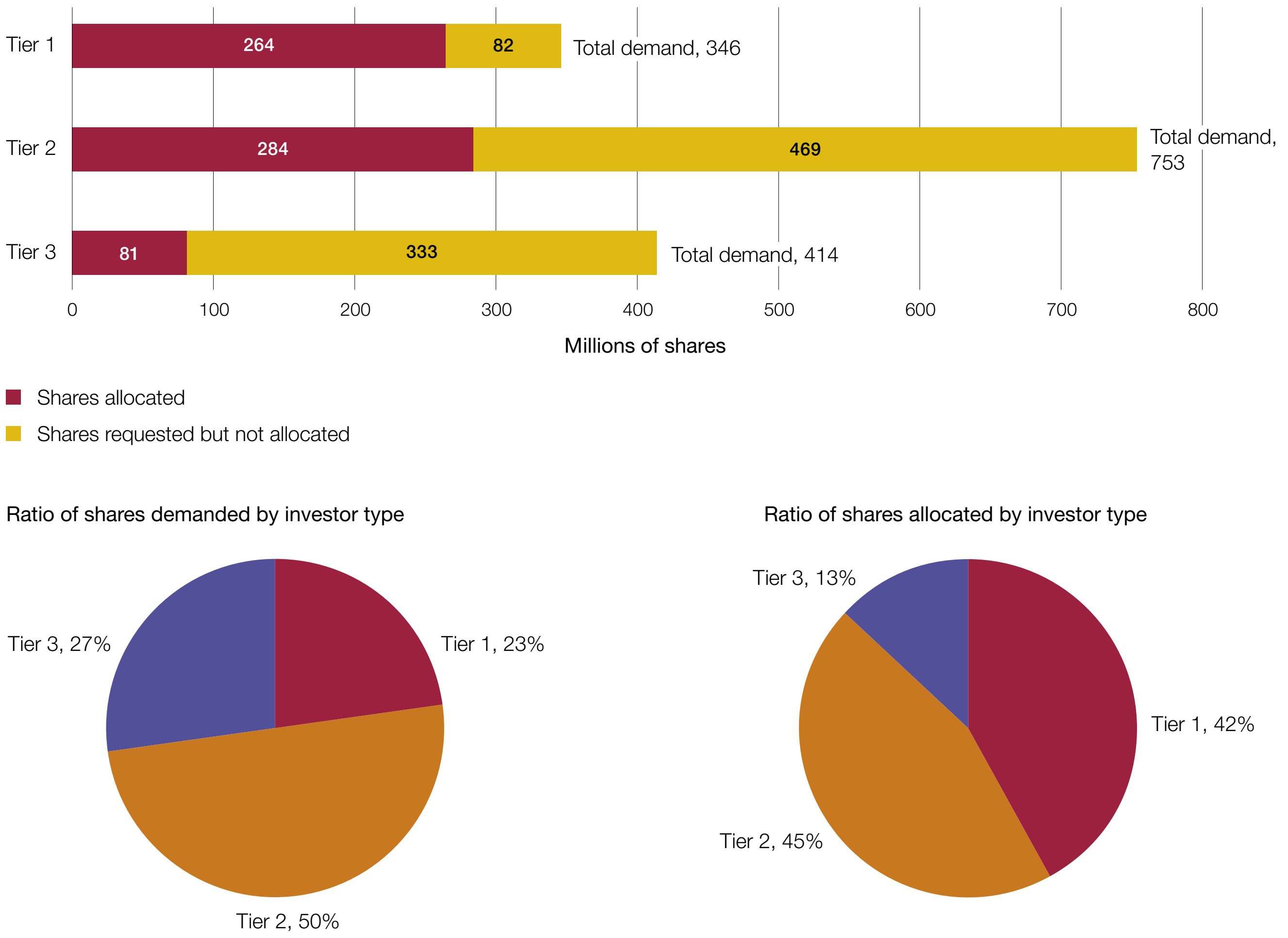
Source: National Audit Office analysis of transaction data

3.7 **Figure 16** overleaf illustrates the presence of greater interest from lower-tier investors. At 330 pence per share the initial demand from Tier 1 investors was only 23%, less than the 27% from Tier 3 investors. The bookrunners also warned UKFI that short-term investors often inflate their orders in the expectation that there will be a significant scale-back of allocations. In turn, allocations that exceed the short-term investors' true demand were likely to be sold soon after the disposal and so disrupt the aftermarket. This is captured in the fact that Tier 3 investors received 13% of the allocations rather than the 27% they demanded.

Figure 16

Demand and allocation of Royal Bank of Scotland shares by investor type

Lower-tier investors had greater interest and presence at 330 pence



Note

1 Totals may not sum due to rounding.

Source: National Audit Office analysis of data from the transaction

3.8 Rothschild was in constant discussions with the bookrunners regarding the allocations to investors to make certain that UKFI's principles were observed. The final allocations were then agreed by UKFI before the market reopened. The allocations included four orders from investors affiliated with two of the four bookrunners on the sale.[16] These investors expressed interest for 26.7 million shares, and received an allocation of 16.5 million shares. This represents 1.8% of the orders and 2.6% of the allocated shares. Their allocation was in line with the allocation of their respective tiers. UKFI and Rothschild reviewed these allocations and satisfied themselves that these allocations were fair and in line with allocation principles.

Discount to the closing price

3.9 When a large number of shares are sold, typically investors require a discount to the prevailing market price. The size of the discount is determined by:

- the absolute size of the sale, the size relative to the average daily trading volume, and the size of the seller's shareholding;
- the seller's reputation as a vendor; and
- market conditions and uncertainty about the company's performance.

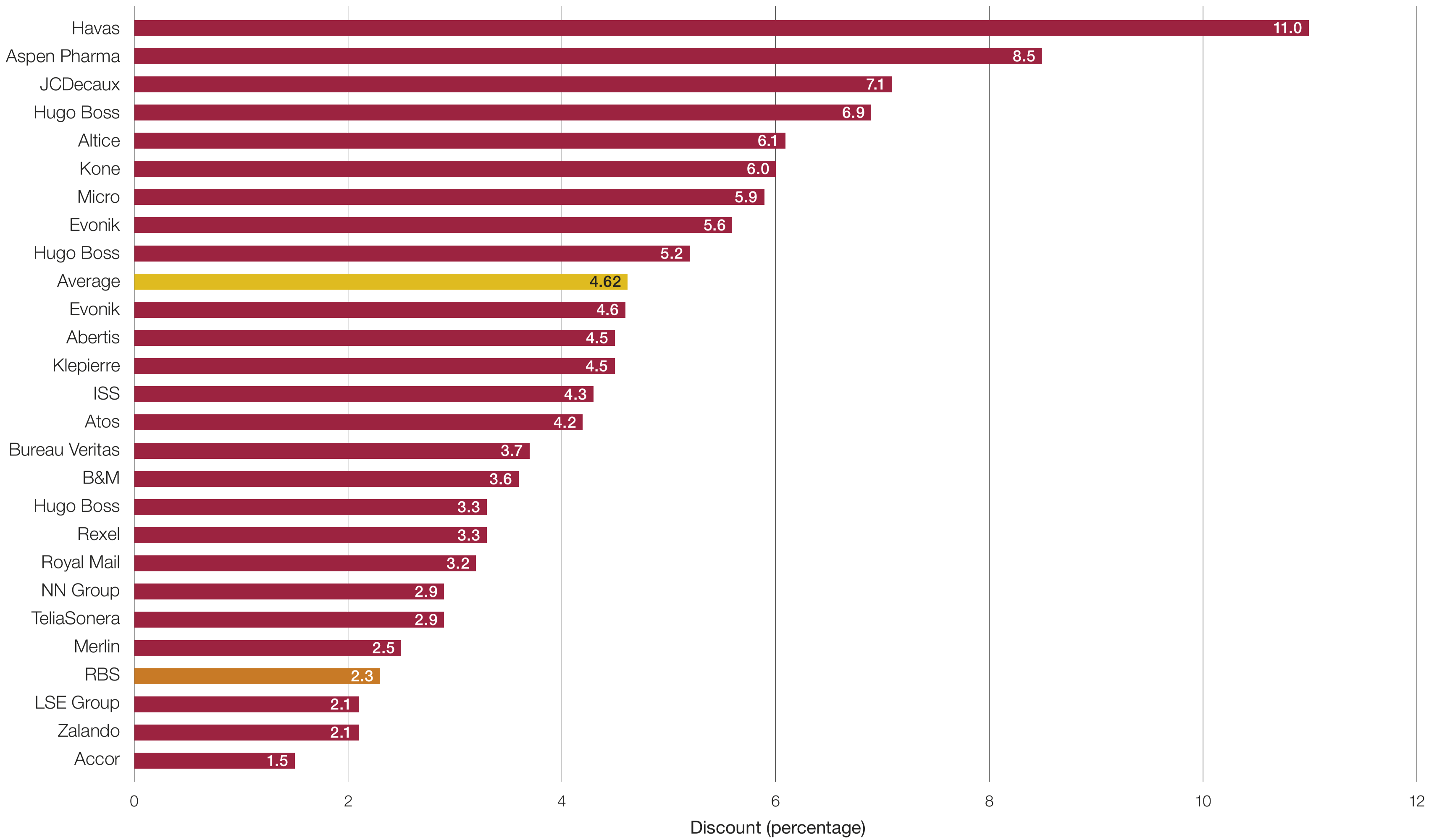
3.10 Before the sale, the advisers expected the discount to be between 4% and 7%. At a close price of 338 pence, the shares were sold at a discount of 2.3%. This is lower than the 3.6% average discount on the three previous UK government placings. Taking the leak into consideration and assuming at the closing price on the day of valuation (342 pence) the discount would have been 3.5%. In the absence of the leak, it is considered likely that the discount may have been greater but the price achieved was unlikely to have been higher. **Figure 17** overleaf shows that the discount achieved compares favourably with that achieved in other sales.

16 UBS and Goldman Sachs.

Figure 17

Discount to share price comparison

Discount to closing share price was lower than average



Notes

1 Includes large European transactions where less than 20% of the company has been sold since July 2014. Average does not include RBS.

2 Companies appear more than once if there has been more than one transaction since July 2014.

Source: Goldman Sachs

The after-market

3.11 The shares eventually closed at 339 pence or 2.7% higher than the issue price on the day of pricing. Immediately after the sale the share price was stable. At the end of the first week of trading, the market price had increased slightly to 346 pence (**Figure 18** overleaf). By the end of September, RBS traded at a lower price – as did the rest of the market – but outperformed the market slightly. The price has remained below 330 pence ever since. This is owing to a number of factors including higher than expected litigation charges and provisions, uncertainty regarding its Williams & Glyn business, and the fact that it was revealed to have some capital inadequacies in the Bank of England stress tests in 2016.[17,18] This ultimately led to the Chancellor announcing in the November 2016 Autumn Statement that further disposals were unlikely in the near term until these issues were resolved.[19] The average share price during the first quarter of 2017 was 234 pence.

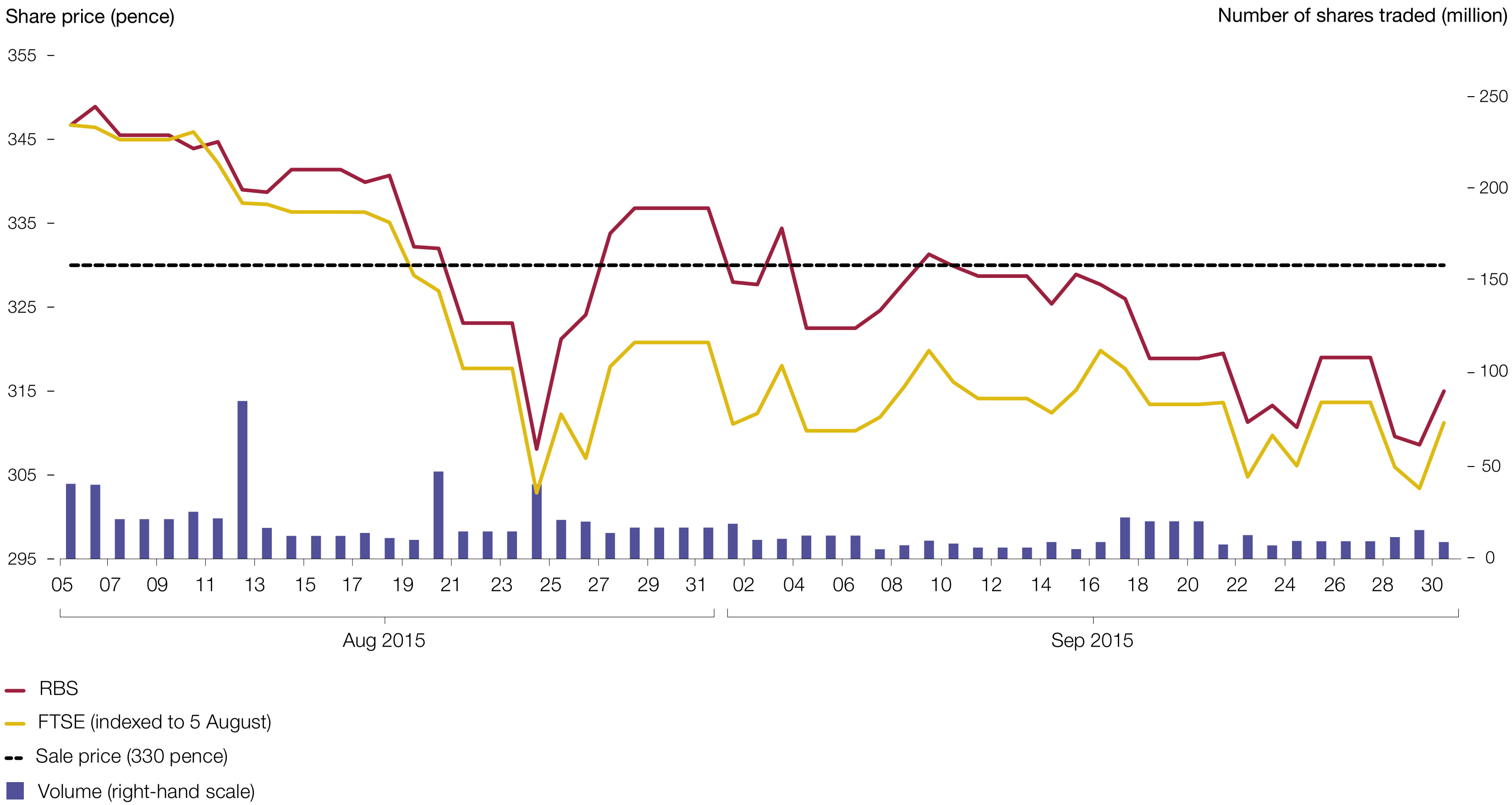
3.12 The sale has increased the number of RBS shares available for trading. From June to July 2015, market data show that 12.0 million shares were traded every day. After the transaction, average daily trading increased by 52%, reaching 18.1 million shares in August and September 2015.[20] This increase in trading has been sustained with a daily average of 18.3 million between January and February 2017.

17 RBS was required to divest part of its business which became known as Williams & Glyn. A divestment proved challenging and HM Treasury and the EU are investigating alternative options for RBS to meet its State Aid obligations.
18 Bank of England, *Stress Testing the UK Banking System: 2016 results p.5,* "While the Prudential Regulation Authority (PRA) Board judged that some capital inadequacies were revealed for three banks (The Royal Bank of Scotland Group, Barclays and Standard Chartered), these banks now have plans in place to build further resilience."
19 HM Treasury, *Autumn Statement 2016*, 23 November 2016, paragraph 1.64.
20 This excludes the 630 million shares sold in the transaction on 3 August 2015.

Figure 18

Royal Bank of Scotland's (RBS's) share price during two months after the sale

RBS's share price fell from September onwards but outperformed the FTSE



Note

1 FTSE 100 revalued to match RBS's share price on 5 August 2015.

Source: National Audit Office analysis of Bloomberg data

Costs of arranging the sale

3.13 UKFI has a panel of banks that it interacts with throughout the year. In June 2015, Goldman Sachs was appointed as the privatisation adviser, replacing J.P. Morgan. This role relates to UKFI's shareholdings in the banks that the government has invested in – both Lloyds Banking Group (Lloyds) and RBS. 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. According to UKFI, J.P. Morgan provided support on RBS up to March 2015 although the contract ended in June. Goldman Sachs' July submission was the first detailed fair value assessment and disposal strategy conducted by an independent adviser.

3.14 HM Treasury appointed Rothschild in May 2015 as a valuation and corporate finance adviser, following a tender. This required Rothschild to analyse, identify and quantify RBS's value loss and its implications for the disposal programme. Rothschild's fee was £50,000. In July 2015, following termination of Rothschild's work as adviser to HM Treasury, UKFI appointed it as its capital markets adviser. Its role was to provide an independent opinion on the work of the privatisation adviser. This appointment was a direct award through a framework agreement. Although separate teams within Rothschild were appointed for the work with HM Treasury and UKFI, these sequential roles reinforce the perception that HM Treasury influences UKFI's decision-making. Freshfields provided UKFI legal advice.

3.15 All of UKFI's advisers, except Freshfields, supplied their services for a consideration of £1 and the legal fees were reimbursed by RBS as per the Resale Rights Agreement with HM Treasury. The advisers told us in interviews that the low fees reflect significant competition among investment banks to work on a high-profile mandate for the government. It also provides them with the opportunity to gain insights into RBS's privatisation plans for potential future fee paying sales. Financial advisers also benefit from league table credit, which supports their ranking for capital markets business as well as an opportunity to make money elsewhere – for example, an increase in their share of secondary market trading.

3.16 **Figure 19** overleaf also highlights that fees vary depending on the type of disposal. The government's recent accelarated book buildings (ABB's) on Lloyds and RBS all benefited from substantially lower fees than Eurostar's trade sale or Royal Mail's initial public offering (IPO). This is due to the short execution period and substantially lower risk and work requirements for the advisers. Since RBS's disposal programme may use multiple methods, including an FMO which has similar requirements to an IPO, the fees for future prospective transactions could be significantly higher.

Figure 19

Adviser fees on recent government asset sales

Fees vary depending on type of disposal with recent government accelerated book-builds (ABBs) benefiting from substantially lower fees

Shares being sold	Type of transaction	Total adviser fees (£k)	Advice received
Royal Bank of Scotland (August 2015)	Accelerated book-build	41	Financial, running the transaction, legal
Eurostar (March 2015)	Trade sale	8,167	Financial, legal, due diligence, data room, independent valuation, management incentive and reimbursement of Eurostar's legal cost
Royal Mail (October 2013)	Initial Public Offering (to retail and institutional investors)	18,000	Financial, independent financial advice, running transaction for retail and institutional offers, legal, communications
Lloyds (September 2013)	Accelerated book-build	Less than 100	Financial, running the transaction, legal

Note

1 Royal Bank of Scotland fee excludes the £50,000 fee to Rothschild (see paragraph 3.14).

Source: National Audit Office reports

3.17 UKFI is aware that the low fees may not be available for all future sales. In order to continue to achieve a fair price for the advice received, UKFI aims to maintain competition between the prospective advisers. This will help to counteract the possibility that a bank is selected for the larger, possibly more profitable, transactions on the basis that it has provided discounted advice previously as a 'loss leader'. The advisers do, nevertheless, claim that reputational benefits are the main driver behind their motivation to work for the government.

Taxpayer gain or shortfall

3.18 The scale of the economic and social impact that the collapse of one or more UK banks would have had is difficult to predict. Given this, our 2009 report on maintaining financial stability determined that the interventions to support the banks were justified.[21] The final cost to the taxpayer is still unknown. A major determinant of this will be the prices obtained for the government's remaining shareholdings in RBS.

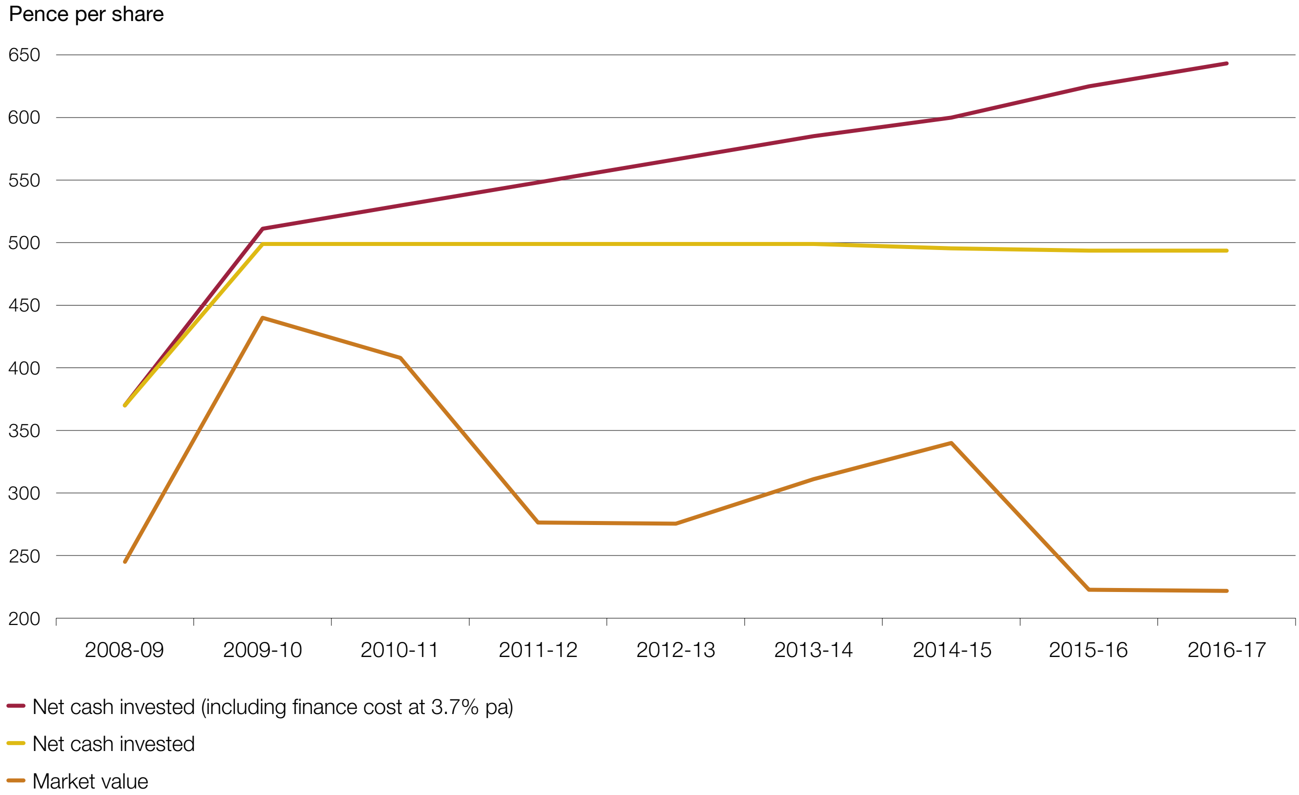
3.19 Through a series of transactions, the government purchased 83% of RBS at a cost of £45.5 billion. This included ordinary shares, B shares and a single dividend access share. This equates to 502 pence per share. However, HM Treasury received income from redeeming preference shares (£0.27 billion). This brought the average in-price down to 499 pence.

3.20 Comparing the sale price of 330 pence with the price of 499 pence would suggest a crystallised loss of £1.1 billion. This, however, does not factor in the financing costs of acquiring the shares. We have calculated that if the costs of financing the intervention are also taken into account, the government would have had to sell the shares at 625 pence each to break even. Against this price, the sale represents a loss of £1.9 billion (**Figure 20** overleaf). However, as the Chancellor stated in his 2015 Mansion House speech, unlike the sale of Lloyds shares, the in-price was not considered relevant by UKFI and HM Treasury when disposing of the shares. This loss is seen as a cost of ensuring financial stability and protecting the wider economy.

21 Comptroller and Auditor General, *HM Treasury: Maintaining financial stability across the United Kingdom's banking system*, Session 2009-10, HC 91, National Audit Office, December 2009, paragraph 19.

Figure 20
Net cash invested represented as pence per share

Selling the shares at 330 pence crystallised a loss



	Pence per share	Discount implied by a sale of 330 pence per share (%)	Loss crystallised (£bn)
Market value (day of sale)	338	2	N/A
Net cash invested (before sale)	499	34	1.1
Net cash invested including cost of finance (estimated at 3.7% per year)	625	47	1.9

Notes

1 Market value is as at 31 March each year, except for 2016-17 where 1 January 2017 has been used.

2 Net cash invested represents the total paid to buy the shares, less £0.27 million received from redeeming preference shares. From 2014-15 this is further reduced by the proceeds from retiring the Dividend Access Share and the first sale of shares.

3 Cost of finance is estimate at 3.7% per year based on the average interest rate on all government debt (gilts) borrowed in 2008-09 and 2009-10. This is an estimate of the interest on the debt raised by the government to buy the shares.

Source: National Audit Office analysis

Appendix One

Our audit approach

1 This study examined the value for money of the first sale of shares in Royal Bank of Scotland (RBS). We reviewed:

- whether the disposal options and timings were assessed appropriately;
- whether the sales process was effective in supporting the objectives of the transaction;
- whether the proceeds were maximised; and
- whether there was a gain or shortfall for the taxpayer.

2 **Figure 21** overleaf gives our evaluative criteria. Our evidence base is described in Appendix Two.

Figure 21
Our audit approach

HM Treasury/ UKFI objectives

UK Financial Investments is tasked by HM Treasury to devise and execute a strategy for realising value for the government's investment in Royal Bank of Scotland (as well as other banking assets it owns) in an orderly and active way over time.

How this will be achieved

UKFI considered different sale options, market conditions and investor demand. It aimed to maximise the price for the shares while allocating shares to investors in such a way as to ensure a positive but stable aftermarket.

Our study

The study examined whether the sale secured value for money.

Our evaluative criteria

Preparation Were the disposal options and timing of these options assessed appropriately?	**Process** Was the sales process effective to support the objectives of the transaction?	**Proceeds** Have the proceeds been maximised?

Our evidence

(see Appendix Two for details)

We interviewed officials in UKFI, HM Treasury and reviewed their advice to ministers. We reviewed the analysis provided by advisers and also interviewed them. We reviewed documentation relating to adviser appointments. We reviewed secondary market research.	We interviewed officials in UKFI, HM Treasury and reviewed their advice to ministers. We reviewed the analysis provided by advisers and also interviewed them. We analysed data on RBS share price data and investor allocation.	We interviewed officials in UKFI, HM Treasury and reviewed their advice to ministers. We reviewed the analysis provided by advisers and also interviewed them. We analysed data on the RBS share price and the cost of the intervention.

Our conclusion

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.

Appendix Two

Our evidence base

1 Our conclusion on whether the first sale of shares in Royal Bank of Scotland offered value for money was reached following an analysis of evidence collected between February and March 2017. Our main methods are outlined below:

Document review

2 We reviewed key documents including:

- RBS annual reports;
- submissions to ministers seeking authority to proceed;
- UK Financial Investments board papers and minutes;
- valuations and strategy papers prepared by UKFI's advisers ahead of the sale;
- records of the progress of book-building and allocations of shares;
- secondary research on the equity market conditions and analyst recommendations on RBS;
- contracts between HM Treasury/UKFI and their advisers; and
- advice by the Bank of England to HM Treasury.

Interviews

- we interviewed officials in UKFI and HM Treasury; and
- we interviewed the advisers involved in the sale.

Quantitative analysis

- we reviewed and analysed the performance of RBS shares.
- we examined the different valuation models and assumptions.
- we analysed the allocation of shares to investors and their behaviour in the aftermarket.

Appendix Three

Valuation methodologies

1 United Kingdom Financial Investments (UKFI) and its advisers used a broad framework to asses fair value including market-based valuations, fundamental valuations and equity research analysts' target prices. The market and fundamental valuations included the most commonly used methods for the banking sector, such as variations of earnings multiple, price to book ratios, dividend discount model and Gordon Growth Model. The approach was similar to the one used in the valuation of shares in the Lloyds Banking Group (Lloyds) and adapted to reflect the factors relevant to Royal Bank of Scotland (RBS). **Figure 22** provides an overview of each valuation methodology.

2 The advisers adjusted the valuation methodologies to reflect RBS's investment case and in particular the long time frame of the restructuring plans.

- UKFI and its advisers agreed that the most relevant valuation methodologies to assess the fair value of RBS shares at the time of the sale were normalised forward multiples and fundamental valuation methodologies. Considering these methodologies, RBS's share price was in the upper half of the normalised forward multiples, dividend discount model and Gordon Growth Model calculations. It was also at the top end of the 25–75th percentile of the equity research analysts' target price forecast (Figure 10, main report).
- Equity research analysts only expected RBS to start paying dividends by 2016-17. Therefore, the advisers did not include a dividend yield valuation.
- RBS's restructuring plan was expected to result in a significant change to RBS's financial and operating profile in the short term and a normalised performance was only expected by 2019. As a result, the advisers deemed the more conventional current market-based multiples less relevant and included forward multiples based on RBS expected future 'normalised' performance once it is fully restructured. These normalised multiples contain a higher level of uncertainty as RBS's management needs to deliver on its restructuring plans to release excess capital to shareholders.

Figure 22
Valuation methodologies

UK Financial Investments and advisers used various valuation methodologies

	Comment	Most relevant
Market-based valuation		
Price earnings	The price to earnings ratios (price of the shares relative to the income per share) measure the share price relative to the income the company generates (P/E ratio). Simple valuation method favoured by investors. Distorted by near-terms restructuring and conduct charges, capitalisation levels and earnings on surplus capital.	
Price to book	The price to book ratios (price of all shares relative to the total book value of the assets or regression analysis of the return to total book value or total adjusted equity value) measures the share price relative to the value of the company. Simple valuation method favoured by investors. Distorted by different capital ratios and excess capital.	
Dividend yield	Measures the value of a company based on the dividend yield offered to shareholders. Less relevant to RBS given lack of dividends in the near or medium term.	
Normalised forward multiples	Uses P/E or price to book methodologies based on a normalised sustainable bank in the future, 2019 in the case of RBS. More complex valuation requiring investors to take a forward look and make a judgement on the implementation of management's restructuring plans.	Yes
Fundamental valuations		
Dividend discount model	A long-term valuation method based on the expected dividend payments of a company discounted to today's price. Complex and sensitive to assumptions. Ability to reflect long-term value of restructuring plans and include scenario-based valuations.	Yes
Gordon Growth Model	A long-term valuation method based on price to book calculation derived from return on equity, cost of equity and expected long-term growth. Complex and sensitive to assumptions. Ability to reflect RBS's restructuring efforts.	Yes
Stockbroker's forecast		
Target price	Expected share price by equity research analysts. The timeliness of the report and underlying assumptions affect comparability between target prices.	Yes
Broker's sum-of-the-part	A valuation of the individual business units of a company to derive the overall value. Ability to apply the most appropriate multiples to each individual business.	

Appendix Four

RBS restructuring activities and performance

1 Since the government became a shareholder, the Royal Bank of Scotland (RBS) has become a much smaller bank as it has sold assets and reduced its lending. Management expected, in 2009, that by 2013 the operating profit would be £9.1 billion and that net income would be £6.5 billion. However, as illustrated in **Figure 23**, management projections in 2009 were optimistic relative to what was actually observed in 2013. The results show a £2.3 billion operating loss and £9 billion loss attributable to shareholders. Additionally, the core business performance had not recovered to the degree expected in 2009 largely due to the lower for longer interest rate environment putting pressure on profitability.

2 In the six years between 2009 and 2015, the business shrunk substantially more than originally expected. Changes in capital regulation through increased capital requirements and the risk-weightings assigned to various assets were a key driver in this. RBS's strategy to reduce its assets was endorsed by the government in their 'RBS and the case for a bad bank' review, published at the end 2013. Since then, in the most recent 2016 results, the risk weighted assets (RWAs) of the bank have reduced by more than £200 billion.

3 Clarity on RBS's future outlook improved with the announcement of its long-term strategy in 2014. This clarity reduced the level of uncertainty in equity research analysts' forecasts of RBS's performance. In 2015, equity research analysts' consensus was in line with actual performance by RBS on RWAs and operating profit (Figure 23). However, differences persisted on required capital and net income. These differences were driven mainly by uncertainty regarding the timing and size of restructuring and conduct-related issues and the continuing weak operating environment.

Figure 23

Royal Bank of Scotland (RBS) expected and actual performance from 2009 to 2016

2009 management projections were optimistic when compared with 2013 results

	2009 RBS expectations for 2013 (£bn)	RBS 2013 (£bn)	2015 Goldman Sachs expectations for 2016 (£bn)	RBS 2016 (£bn)
Risk-weighted assets	475	429	232	228.2
Required capital	38	51	38.8	30.6
Operating profit	9.1	-2.3	3.2	3.7
Net income	6.5	-9	1.2	-7

Sources: UK Financial Investments Limited data, 2013 and 2016 RBS Annual report and Accounts, Goldman Sachs data

4 Returning RBS to profitability has been more challenging than was at first anticipated. The bank has posted nine years of consecutive losses amounting to more than £50 billion since 2008. Unsurprisingly, the return to shareholders over this period has been poor. RBS has not paid an ordinary dividend since the government became the majority shareholder and, since 2011, the share price has been trading significantly below the average price the government paid for their holding.

5 UKFI has grouped the key factors behind RBS's losses and poor share price performance since 2009 into three categories:

- **Regulation**

  Changes in regulation have required RBS, and all banks to increase the capital they hold against assets. As a result, RBS restructured its business to become smaller and less risky. The reduction in the size and riskiness in turn reduced RBS's return on equity as it reduced the amount of income-generating assets it holds, and level of returns it can from these assets.

- **'One-off' costs**

  RBS incurred £15.2 billion of one-off costs from various items, such as restructuring, conduct and litigation charges.

- **Operating environment**

  Economic growth and interest rates have both been lower than expected for longer, putting pressure on profitability.

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