National Audit Office

Report
by the Comptroller
and Auditor General

HM Treasury and UK Government Investments Limited

The return of Lloyds Banking Group to private ownership

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Report by the Comptroller and Auditor General

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Sir Amyas Morse KCB
Comptroller and Auditor General
National Audit Office

20 June 2018

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This review does not form a judgement on the value for money of the share sales. However, our view of the process as a whole is positive: UK Financial Investments Limited (UKFI) and its advisers prepared for, and executed, the transactions professionally and in cash terms the sale returned the taxpayers' original investment. We found some areas where improvements could be made for future sales, and this report summarises those more technical observations and recommendations arising from our work.

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Preface

1 In 2008-09, the UK government provided support to the banking sector in order to maintain financial stability. This support included taking public ownership of a 43 per cent stake in Lloyds Banking Group (Lloyds). In June 2013, the Chancellor of the Exchequer announced that the government was preparing to sell its Lloyds shares. In May 2017, Lloyds was fully returned to private ownership. Excluding financing costs, the government sold the shares for more than it paid.

2 We have reported on several of the government's interventions following the financial crisis, including the first sale of shares in Lloyds Banking Group in September 2013.[1] Now that all Lloyds share have been sold we reviewed how the government prepared for and carried out the sales from March 2014 onwards. The purpose of this work is to identify any lessons which could be learned and applied to future sales of the government's 62.4% holding of Royal Bank of Scotland shares.

3 This review does not form a judgement on the value for money of the share sales. However, our view of the process as a whole is positive: UK Financial Investments Limited (UKFI) and its advisers prepared for, and executed, the transactions professionally; and in cash terms the sale returned the taxpayers' original investment.[2] We found some areas where improvements could be made for future sales, and this report summarises those more technical observations and recommendations arising from our work.

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

2 UKFI was created in November 2008 to manage the government's shareholdings in the Royal Bank of Scotland and Lloyds, as well as the government shareholdings and loans in UK Asset Resolution and its subsidiaries. UKFI was a company wholly owned by HM Treasury which ceased trading on 31 March 2018 and its responsibilities, from 1 April 2018, moved into its parent company – UK Government Investments Limited (UKGI).

Part One

Introduction

1.1 This part of the report provides background to the government's activities relating to Lloyds Banking Group (Lloyds), sets out the scope of this report, and outlines how we have presented our findings. A glossary of key terms is provided in Appendix One for explanations of technical terms used in the report.

Background to the Lloyds intervention

1.2 In response to a crisis in the financial markets in 2008-09, governments across the world intervened to support their financial systems. To maintain financial stability, the UK government provided public support to the banking sector, which reached almost £1 trillion in the form of guarantees, loans and purchases of shares.[3] This support included the purchase of over £20 billion of shares in Lloyds. **Figure 1** overleaf summarises the key events in the government's activities relating to Lloyds.

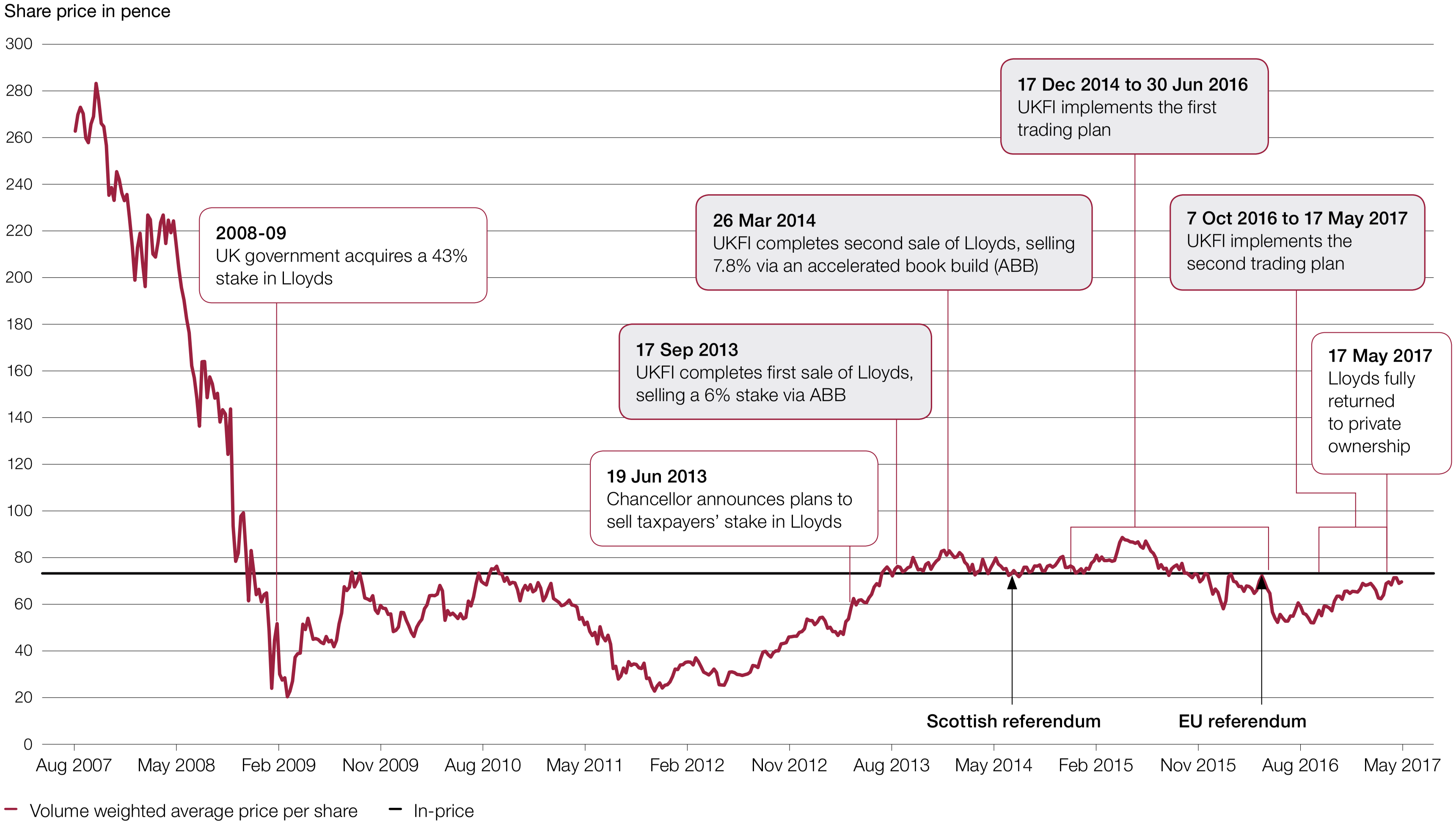
1.3 UK Financial Investments Limited (UKFI), which HM Treasury owned, was created in November 2008 to manage the government's shareholdings in Lloyds and Royal Bank of Scotland, and its shareholdings and loans in UK Asset Resolution and its subsidiaries. UKFI operated at arm's-length from the government, although HM Treasury set out its role and remit in UKFI's Framework Document and Investment Mandate. UKFI's objectives were 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 had to seek HM Treasury's views, and obtain its approval. UKFI ceased trading on 31 March 2018 and its responsibilities, from 1 April 2018, moved into its parent company – UK Government Investments Limited (UKGI), also a company wholly owned by HM Treasury.

3 Comptroller and Auditor General, *Maintaining the financial stability of UK banks: update on the support schemes*, Session 2010-11, HC 676, National Audit Office, December 2010.

Figure 1

Lloyds Banking Group (Lloyds) share price from initial intervention to final disposal, including timeline of key disposal events

UK Financial Investments (UKFI) has successfully returned Lloyds to the private sector, in four major disposals



Note

1 In-price is the average share price the government paid when acquiring Lloyds Banking Group in 2008-09.

Source: National Audit Office analysis of share price information and public announcements

1.4 In September 2013, the government used an accelerated book build (ABB[4]) to sell just over 15%[5] of its shares in Lloyds to institutional investors. We reviewed the sale in our report *The first sale of shares in Lloyds Banking Group*, and found that it represented value for money.[6] In March 2014, the government followed up this first sale with a second ABB of around 8% of the share capital – about a quarter of its remaining holdings (£4.2 billion). The remaining shares were sold through two trading plans which ran from December 2014 to June 2016 (around 16%[7] or £9.2 billion), and from October 2016 to May 2017 (around 9%[8] or £4.2 billion). The government reported that the total proceeds from share sales and dividends received was approximately £900 million more than it paid for the shares. In May 2017, Lloyds was fully returned to private ownership.

Scope of this report

1.5 This report summarises the observations and recommendations arising from our review of the return of Lloyds to private ownership. This report does not give an opinion on value for money, but rather focuses on what government can learn from its experience of the Lloyds sale for future sales, particularly for the sale of its remaining holding in Royal Bank of Scotland. We highlight potential for improvement in three areas:

- sale preparation;
- sale execution; and
- sale outcome.

1.6 The key observations arising from our work are detailed in Part Two of this report. Alongside these observations, we made recommendations to help those charged with governance in future decision-making, oversight and risk management. In line with our approach in letters to management on audit findings, each recommendation is risk rated against one of three categories:

- **high risk** – major risk to value for money, for the attention of senior management;
- **medium risk** – important issues to be addressed by management that may pose a risk to value for money; and
- **low risk** – problems of a more minor nature which provide scope for improvement.

1.7 A glossary of key terms is provided in Appendix One.

4 For an explanation of an accelerated book build (ABB) and other technical phrases in this report, please see the glossary in Appendix One.
5 This represents 6% of the total share capital of Lloyds.
6 Comptroller and Auditor General, *The first sale of shares in Lloyds Banking Group*, Session 2013-14, HC 883, National Audit Office, December 2013.
7 Expressed as a percentage of the total share capital of Lloyds.
8 See footnote 7.

Part Two

Lessons learned for future sales

2.1 This part sets out our observations from reviewing the return of Lloyds Banking Group (Lloyds) to private ownership and provides recommendations for future sales. Our observations focus on the government's use of trading plans to sell Lloyds shares.

Observation: Sale preparation

Rating: Low risk

2.2 We found that UK Financial Investments Limited (UKFI) had carried out little quantitative evaluation of the risks posed by the various options and the potential impact on proceeds. For example, it did not quantify the impact of selling shares at a discount via an accelerated book build (ABB) against the exposure to market risk from selling shares over a longer period via a trading plan. Based on our experience of reviewing other asset sales, we note that the government has quantified such risks in the past. Methods of evaluating the market risk of holding equity instruments can complement professional judgement and help demonstrate to decision-makers and other stakeholders the trade-off between accepting a discount versus continued exposure to market risk.

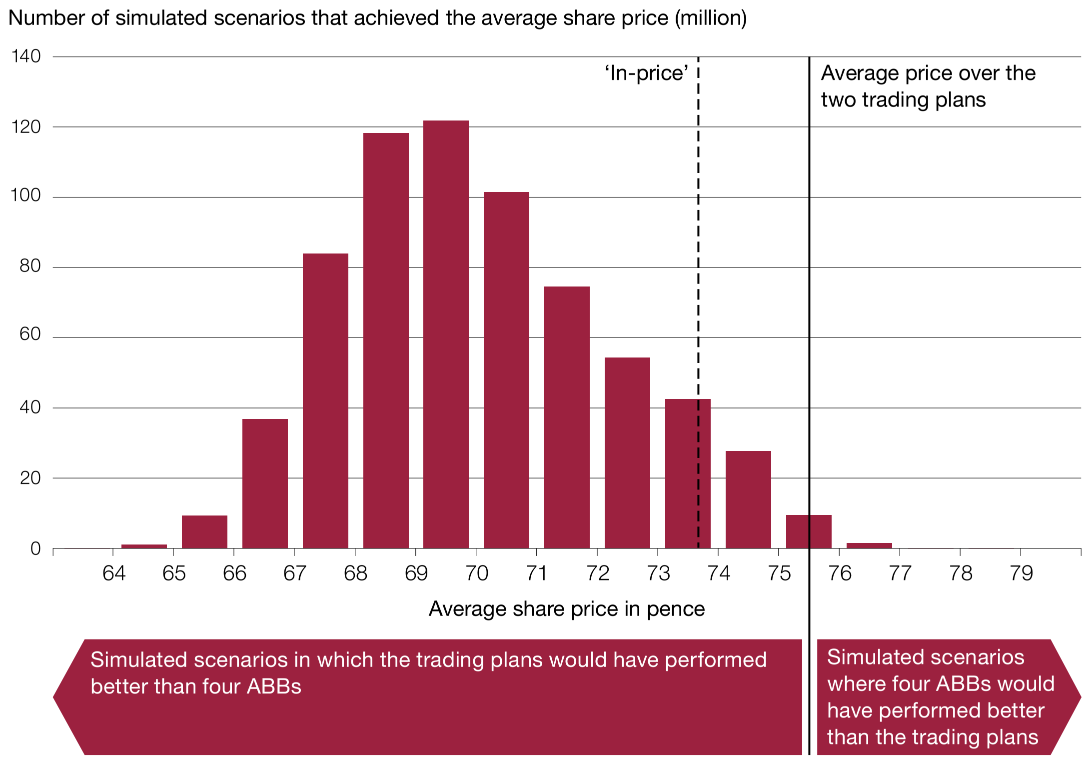
2.3 We performed a hindsight simulation analysis to assess how the two trading plans performed compared with four hypothetical ABBs (**Figure 2**). The results show that the proceeds achieved through the trading plans fall on the higher end of the simulated distribution. With hindsight, it is highly unlikely that UKFI could have secured a greater return by selling via ABBs.

2.4 UKFI incurred costs in evaluating options that allowed for a retail offer. These were small in the context of the overall transaction, and Lloyds ultimately reimbursed these costs. UKFI advised ministers that a retail offer would not secure value for money for the taxpayer. Based on the evidence we have reviewed, we have no reason to disagree with UKFI's assessment. A retail offer would expose the government to higher execution risk, incur higher cost and require a substantial discount to market value to be successful. Without a strong policy reason to pursue a retail offer, doing so would be unlikely to achieve value for money compared with alternatives.

Figure 2

Trading plan proceeds against four simulated accelerated book builds (ABBs)

With hindsight, it is highly unlikely that UK Financial Investments Limited (UKFI) could have secured a greater return by selling via ABBs



Method and assumptions

Method:

- We created a data set of all possible combinations of eligible days since the start of the first trading plan when four ABBs could have been executed to fully sell the government's stake.
- We then calculated the proceeds for each ABB based on historic prices, an ABB discount, and a range of transaction sizes.
- The share price of each simulation is compared to the actual 'in-price' and average price achieved in the trading plans.

Assumptions:

- Size of ABBs to be between 5% and 9% of the total of outstanding Lloyds shares.
- No sales during black-out periods and when the share price falls below the trading plan floor price.
- A 90-day gap between ABB transactions.
- ABBs executed at a 4% discount to the market price.

Notes

1 In-price is the average share price the government paid when acquiring Lloyds Banking Group (Lloyds) in 2008-09.

2 The illustration above shows the average share price UKFI could have achieved when disposing of the government stake through ABBs and compares them with the 'in-price' and actual outcome. The ABBs are based on simulation of over 680 million possible scenarios which vary the trade dates and transaction sizes. We then used historical share prices to simulate the proceeds arising from these transactions. The bars show the number of times a specific share price was achieved in our simulation.

Source: National Audit Office analysis of share price information

Recommendation: Use quantitative analysis in evaluating options

2.5 To help demonstrate to decision-makers and stakeholders the trade-offs between the sale options, UK Government Investments (UKGI) should quantify the risks and rewards of each option as part of the evaluation process. In assessing the risk that a share price may move up or down, UKGI should combine professional judgement with quantitative analysis. This may include identifying a range of upside and downside scenarios, evaluating their likelihood, and estimating the potential impact on proceeds of each scenario against the different sale options.

Recommendation: Set clear objectives when pursuing a retail offer

2.6 For listed shares, there should be a clear policy objective that supports a retail offer in order to justify the organisational and financial requirements of pursuing this disposal method.

Observation: Sale execution

Rating: Low risk

2.7 UKFI applied professional judgement when setting the two main sale parameters of the trading plans: the floor price and volume limits. The parameters were an effective method of achieving the sale objectives of selling at a reasonable pace, at fair value, without distorting the market. However, from the evidence we have reviewed, UKFI's approach to amending the sale parameters was not clear.

2.8 UKFI set a floor price for the trading plan that fell within a fair value range that it determined with its advisers. In setting the floor price, UKFI had to balance the need to sell shares at a reasonable pace with achieving a fair price. UKFI and its advisers made an adjustment to the fair value calculation, which reflects the government's view of the perpetual nature of financial services compliance costs; reflecting costs arising from operating a banking business in the UK. Historically, Lloyds has realised significant below-the-line charges, incurring £32 billion between 2011 and 2017. UKFI and its advisers estimated a £908 million annual below-the-line charge into perpetuity. The effect of this adjustment was to lower the fair value range and increase the number of situations in which the share price was deemed to represent fair value.

2.9 If this adjustment is reversed, most of the Lloyds sales through both ABB and trading plan would fall outside of UKFI's core fair value range (**Figure 3**). We commented on such adjustments in our report *The first sale of shares in Royal Bank of Scotland*, and found no market precedent supporting the extent of this conservative approach.[9]

9 Comptroller and Auditor General, *The first sale of shares in Royal Bank of Scotland*, Session 2017-19, HC 244, National Audit Office, July 2017.

Figure 3
Valuation ranges versus share price and floor price

The share price fell below the floor price for extended periods during the first trading plan. Without the adjustment for future compliance charges, most of the Lloyds Banking Group (Lloyds) sales would fall outside of UK Financial Investments Limited (UKFI) core fair value range

With below-the-line adjustments

Without below-the-line adjustments

Notes

1 The shaded coloured areas in these graphs represent the valuation ranges derived from the various valuation methodologies that UKFI and its advisers used to evaluate the fair value of the shares. The darker shaded areas represent the core area of the most relevant valuation methodologies, while the lighter shaded areas represent the full range of all methodologies. The core range is based on discussions with UKFI on how it applied the multiple valuation methodologies.

2 The floor prices reflect the instructions UKFI gave to the stockbroker in the execution of the trading plans. The floor price represents a minimum acceptable price for shares to be sold. It was one of many sale parameters of the trading plan.

Source: National Audit Office analysis of share price information and UK Financial Investments Limited valuation documents

2.10 During the first trading plan, there were extended periods when the share price was below the floor price and sales did not occur. UKFI could have lowered the floor price, but any subsequent sales would not have reflected UKFI's view of a fair price, and thus may have compromised value for money. Our analysis shows that, over time, the floor price was increasingly set towards the bottom of the core valuation ranges (Figure 3) although measures were also in place to benefit from a rising price. Our future studies are likely to focus on these areas to form a judgement on the value for money of a trading plan.

Recommendation: Strengthen audit trail of key judgements

2.11 UKFI should strengthen the audit trail of key judgements, such as judgements on the sale launch and amendments to trading plan parameters. This would enable greater accountability and review of material decisions, and ensure that key lessons are learned to inform future sales.

Recommendation: Use of below-the-line adjustments for perpetual conduct costs

2.12 UKGI should regularly review and assess the use of perpetual below-the-line charges adjustment as uncertainty regarding the regulatory environment clears.

Observation: Sale outcome

Rating: Medium risk

2.13 In May 2017, the government reported that the total proceeds from share sales and dividends received was approximately £900 million more than it paid for the shares. This gain included the dividends from owning the shares but did not include an estimate of its financing costs. We estimate that the government received between £3.2 billion and £5.9 billion less than it paid for the shares if the cost of finance is included in the calculation (**Figure 4**). This deficit must be seen in the context of ensuring financial stability and protecting the wider economy.

2.14 The lower end of the range, £3.2 billion, is based on the cost of financing government debt issued at the time government purchased the shares; it also assumes that a proportion of the debt is repaid when any shares are sold. The upper end of the range, £5.9 billion, is based on HM Treasury's Social Time Preference Rate as set out in *The Green Book* on appraising options.[10] This rate aims to set the value society places on the opportunity cost of tying up these public funds for a number of years. HM Treasury uses this rate to assess the 'retention value' of government asset sales. We acknowledge UKFI's mandate from HM Treasury does not include the cost of financing as a criteria for assessing value for money.

10 HM Treasury, *The Green Book,* March 2018. Available at: www.gov.uk/government/publications/

Recommendation: Estimating and reporting the whole cost of the intervention

2.15 HM Treasury should record and communicate the full financial cost of the intervention. This should include the initial cost of the intervention, any payouts to the government (for example, dividends), financing costs associated with the intervention and costs related to the sale.

Figure 4

Estimating the cost of financing the Lloyds Banking Group intervention

The government reported selling the shares for more than it paid for. However, when financing costs are included, the government received between £3.2 billion and £5.9 billion less than it paid for the shares

Event	Amount	Average price
Intervention		
Original investment (2008 to 2009)	£20.3 billion	73.6 pence
Sale programme		
First sale via ABB (September 2013)	£3.2 billion	75.0 pence
Second sale via ABB (March 2014)	£4.2 billion	75.5 pence
First sale via trading plan (December 2014 to July 2016)	£9.2 billion	81.4 pence
Second sale via trading plan (October 2016 to May 2017)	£4.2 billion	65.0 pence
Total dividends during holding period	£0.4 billion	–
Net proceeds excluding financing costs	**£0.9 billion gain**	**76.8 pence**
Net proceeds including financing at cost of debt[1]	£3.2 billion deficit	62.0 pence
Net proceeds including financing at STPR[2]	£5.9 billion deficit	52.0 pence

Notes

1 The cost of government debt was calculated using a weighted average yield of all government debt issued in 2008-09 and 2009-10.

2 We also estimated a cost of finance using the Social Time Preference Rate (STPR), in line with HM Treasury's *Green Book* guidance.

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

Appendix One

Glossary of key terms

Term	Definition
Accelerated book build (ABB)	A means of quickly selling a large number of shares, whereby selected investment banks allocate shares to institutional investors over a number of hours, and set a price according to the level of interest.
Below-the-line charges	Below-the-line charges are the differences between the reported profit of a company and the statutory profit. The difference may include costs like conduct charges or restructuring costs.
Financing costs	Financing costs or the cost of capital are the costs of raising funds and are sometimes expressed as an annual percentage rate.
Cost of government debt	The government primarily borrows by issuing government bonds – sometimes referred to as gilts – to large investors in the capital markets. The cost of government debt is the interest payable on these bonds.
Discount	The degree to which the price agreed with institutional investors in an ABB sale is below the market price of the shares. This is expressed as a percentage of the market price.
Floor price	A floor price is an instruction given to a stockbroker that gives a minimum acceptable price for shares to be sold.
Market risk	Market risk is one of the risks the government is exposed to by holding a share in Lloyds. It is the risk that the value of Lloyds falls due to market factors, like interest rate changes, macro economic announcements, or industry related events.
Retail offer	A retail offer is a means of selling shares that allows retail investors, including individual savers, to invest alongside large institutional investors.
Social Time Preference Rate (STPR)	Social Time Preference Rate is defined as the value society attaches to present, as opposed to future, consumption. Government uses this rate as a discount rate when making an economic assessment of its investment decisions.
Trading plan	A means of selling a large volume of shares over an extended time period. This is achieved by selling a small number of shares each day during normal market trading, subject to any parameters set by the owner of the shares, such as a floor price.
Volume limit	A volume limit is an instruction given to a stockbroker that limits the amount of shares that may be sold in a given time period. This instruction can be used to mitigate the risk of a large number of sales in a short time period distorting the market price of a share.

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