Supplementary written evidence submitted by Manus Costello, Managing Partner, Banks Research, Autonomous

The treatment of RBS and Lloyds in the national accounts

Under Eurostat guidance, the initial recapitalisations were treated as financial transactions considered to take place at the market price. Any excess payment above the market price at the time of purchase was recorded as a capital transfer. In effect, the government recognised a day one loss reflecting an unrequited payment to the private sector each time shares were purchased at above the market price. This excess was recognised as a permanent impact on the national accounts and so has already been reflected in the government's preferred national debt measures (which exclude the non-permanent impact of transactions related to the financial crisis).

The effect of this treatment is that the stakes are carried at the weighted average of the *market* prices from the days on which the shares were purchased, rather than at the *actual* prices paid. This carrying amount does not now vary with the market price and it is not written down regardless of any objective signs of impairment.

Taking RBS as an example (Table 1), this means that the shares are carried in the national accounts at a price of 41p. For Lloyds (Table 2), the shares are booked in the national accounts at 61p (versus the 74p average in price).

Table 1: UK government investment in RBS

£	Market price on day of purchase	Paid price ('in- price')
Initial recapitalisation Dec'08	55p	66p
Pref. share conversion Apr'09	30p	32p
APS B shares Dec'09	*38p	50p
Weighted average	**41p**	**50p**

Source: Bloomberg, UKFI, Autonomous **inclusive of the Dividend Access Share; see addendum, below*

Table 2: UK government investment in Lloyds

£	Market price on day of purchase	Paid price ('in- price')
Initial recapitalisation Jan'09	132p	183p
Pref share conversion Jun'09	66p	38p
Rights issue Dec'09	59p	37p
Weighted average	**61p**	**74p**

Source: Bloomberg, UKFI, Autonomous

Upon sale, the impact of the transactions becomes permanent and so the difference between the sale price and the carrying amount (***not the in-price***) would immediately impact the stock of national debt. For example, if RBS were sold for 35p, the incremental impact on the national debt would be based on a 6p loss (the difference between the 41p carrying value and the 35p sale price).

However this difference would only be recognised for the amount sold; a tranched sale program would not lead to the residual stake being revalued.

It should also be noted that there is an ongoing cost associated with carrying the stakes in terms of the gilt interest paid to finance the holdings. To the extent that any sale generated cash to reduce the stock of debt, this would generate ongoing savings.

The detailed impacts on each of the national debt measures are summarised in Table 3.

Table 3: Summary of accounting treatment

	PSNB[1]	PSNB ex[2]	PSND[3]	PSND ex[4]	Carrying value
Initial treatment	Excess payment above MV included in the relevant quarter (capital transfer)		Full cost included	Excess cost above MV included	MV on date of purchase
Subsequent treatment	No change; the holding is not remarked or impaired				MV from date of purchase
Sale treatment	No direct impact unless sold below MV; indirect benefit post-sale in the form of reduced borrowing requirements		The full difference between initial transaction and sale prices is included (permanent effect), offset by cumulative savings from reduced borrowing		For any residual holding, BV remains the MV from date of purchase

Source: ONS, Autonomous 1) net borrowing, reflecting the difference between income and expense in a period, 2) net borrowing ex. non-permanent impacts, 3) net debt, reflecting the stock of debt at a point in time, 4) net debt ex. non-permanent impacts

ADDENDUM AS OF 18 OCTOBER 2013

HM Treasury has subsequently clarified[1] that the 41p carrying value (which became 407p post the 2012 share consolidation) includes a per share apportionment of the Dividend Access Share (DAS) which the government owns in addition to its stake in the ordinary ('A' and 'B') shares.

The DAS entitles HM Treasury to 7% of £25.5bn (the total B share subscription amount) or an extra 150% of the dividend per share paid, whichever is higher, if a dividend is paid. There is no impact on the DAS if the B shares are converted, or if RBS buys back B shares. The 'reference amount' remains at £25.5bn. The DAS is cancelled if RBS trades above 650p for 20 days in a 30 day period. RBS may also repurchase the DAS.

The same accounting treatment applies to the DAS, such that it was and remains booked at its initial fair value. Per the 2009-10 Treasury accounts[2] the original modelled fair value for the DAS was £4.2bn. Excluding the DAS, the market price for the B shares on a standalone basis was 298p (equivalent to 29.8p pre-share consolidation), below the 38p stated in Table 1 above. Backing out the value of the DAS from the overall investment (Table 4) implies an average booked value of 361p per share for the ordinary ('A' and 'B') share investment.

Table 4: RBS (ex DAS) is held at 361p in the national accounts

£m, except as noted		
Total shares held (m)	**A**	9,064
Booked price per share (post consolidation)	**B**	407p
Total investment	(A x B) **C**	36,890
DAS booked value	**D**	4,200
Shares (ex DAS) booked value	(C – D) **E**	32,690
Booked price per share (ex DAS, post consolidation)	(E / A) **F**	361p

Source: Autonomous, UKFI

It is as yet unclear exactly how the ONS will apply the Eurostat guidance if the DAS is sold ahead of the ordinary ('A' and 'B') shares. The most recent UKFI valuation of the DAS (31 March 2013) was £1.5bn, implying that a significant loss versus the booked value may arise. If this were recognised when the DAS was sold, the booked value of the remaining investment may then shift downwards to 361p.

October 2013

[1] 'UKFI annual report and accounts 2012/13' p.19
[2] 'HM Treasury Resource Accounts: 2009-10' p.133