

UK Financial Investments Ltd

UK FINANCIAL INVESTMENTS LIMITED (UKFI)
UPDATE ON UKFI MARKET INVESTMENTS
MARCH 2010

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Introduction

UK Financial Investments (UKFI) was set up in November 2008 to manage the Government's investments in financial institutions for value and to develop and execute a strategy for disposing of these investments in an orderly and active way.

Through 2009, the Government has taken further steps to restore and maintain financial stability, providing additional capital and liquidity support to strengthen and protect UK financial institutions.

As part of this programme, the Government announced in November 2009 the conclusion of the agreement with The Royal Bank of Scotland Group plc (RBS) on participation in the Asset Protection Scheme (APS), and Lloyds Banking Group plc (Lloyds) set out plans to raise capital as an alternative to joining the APS.

RBS has now acceded to the APS and Lloyds has completed its capital raising and, in light of these developments, we are providing an update on the Government's investments in RBS and Lloyds. This update report includes detail on the total value of investment, level of ownership and average investment per share.

RBS investment

The Government currently holds a total of **90.6 billion** shares in RBS, including 51.0 billion non-voting B shares and the enhanced dividend access share issued in connection with RBS' participation in the APS. This is equivalent to **70 percent** of voting share capital and **84 percent** of total share capital.



HM Treasury ordinary shareholding in Royal Bank of Scotland	Shares	Total Investment	Investment per Share
	m	£m	p
Initial Recapitalisation	22,854	14,969	65.5
Preference Share conversion ¹	16,791	5,058	31.75
APS B shares	51,000	25,500	50.0
Total Investment	90,645	45,527	50.2 (avg)
Return on Investment			
Fees received ²		(305)	
Dividends received		-	
Profit/(loss) on disposals		-	
Total	90,645	45,222	49.9 (avg)

Notes

¹ Total investment adjusted to take account of accrued dividends and redemption premiums received of around £270 million

² Underwriting fees on transactions paid to HM Treasury, including the recapitalisation and preference share conversion

Lloyds investment

The Government currently holds a total of **27.6 billion** ordinary shares in Lloyds, including 15.8 billion shares taken up in Lloyds' rights issue. This is equivalent to **41 percent** of total share capital.



HM Treasury ordinary shareholding in Lloyds Banking Group	Shares	Total Investment	Investment per Share
	m	£m	p
Initial Recapitalisation ¹	7,277	12,957	182.5
Preference Share conversion ²	4,521	1,508	38.43
Rights issue	15,810	5,850	37.0
Total Investment	27,609	20,315	73.6 (avg)
Return on Investment			
Fees received ³		(376)	
Dividends received		-	
Profit/(loss) on disposals		-	
Total	27,609	19,939	72.2 (avg)
Total investment net of APS exit fee ⁴	27,609	17,439	63.2 (avg)

Notes

¹ Includes Lloyds Banking Group capitalisation issue on 11 May 2009 (177 million shares)

² Total investment adjusted to take account of accrued dividends and redemption premiums of around £230 million

³ Underwriting and commitment fees on transactions paid to HM Treasury, including the recapitalisation, preference share conversion and rights issue

⁴ £2,500 million paid by Lloyds for the implicit capital support provided by the APS in 2009

Market developments since July

UKFI published its *Strategy and Annual Report* in July 2009, setting out our remit, details of the investments we manage and our strategy for disposal in the context of economic and market conditions.

Since then, the Government has concluded discussions with RBS and Lloyds on further measures to support the banks. This section provides a summary of these developments, before moving on to an account of the impact of these developments on the investments managed by UKFI.

Royal Bank of Scotland

The Government and RBS agreed final terms for RBS' participation in the APS in November 2009. RBS' participation was approved by shareholders on 15 December 2009 with over 99 percent of votes cast in favour of the resolution (excluding UKFI, which was not permitted to vote on the resolution as a related party).

In connection with RBS' accession to the APS, the Government subscribed for an additional 51,000 million non-voting B shares, together with one enhanced dividend access share, on 22 December. The dividend access share is the right to an enhanced dividend of the greater of 7% of the B Share nominal amount or 250% of dividends paid on ordinary shares, payable at the discretion of the RBS Board. It expires when the RBS share price equals or exceeds 65p per share over a certain period. These investments are managed by UKFI.

BOX 1.1 ASSET PROTECTION SCHEME

The Asset Protection Scheme is designed to provide protection against future credit losses on certain assets. The final terms were signed on 26 November, and revise the terms originally envisaged in February. Key elements include:

- An increased first loss of £60 billion to be borne by RBS;
- A reduced asset pool of £282 billion based on RBS's balance sheet as at 31 December 2008;
- An up-front capital injection of £25.5 billion (comprising non-voting B shares and the enhanced dividend access share);
- An annual fee of £0.7 billion for the first three years and £0.5 billion thereafter;
- A potential exit fee, if RBS should leave the APS, of the larger of £2.5 billion or 10% of the actual capital relief provided by the APS (in either case less any annual fees already paid); and
- Removal of the undertaking, agreed by RBS in February, to forego certain tax losses and allowances for up to five years – the tax losses had an estimated value of £9-11 billion in RBS's accounts as at 30 June 2009.

In addition, the Government will provide a contingent capital commitment of £8 billion, only to be drawn down if RBS's capital position should deteriorate sufficiently. The Government will receive a fee of 4 percent per year in respect of any capital not drawn down calculated on the basis of the unused capital commitment.

The Asset Protection Agency manages the APS on behalf of the Treasury. Further detail on the APS, including the scheme's operation and the assets it covers, has been published by the Treasury and is available at www.hm-treasury.gov.uk.

Lloyds Banking Group

In November 2009, Lloyds announced fully underwritten proposals to generate at least £22.5 billion of core capital through a £13.5 billion rights issue and at least £9 billion in exchange offers.

These proposals provided Lloyds with an alternative to participation in the APS, meeting Lloyds' capital commitments with a combination of public and private sources of capital. This has resulted in Lloyds being able to exit from the APS in return for a fee to the Government of £2.5 billion, reflecting the implicit support it had received from the APS since March.

BOX 1.2 LLOYDS RIGHTS ISSUE

Successfully completed in December 2009, Lloyds' rights issue raised a total of £13.5 billion in equity capital, representing the largest ever rights issue undertaken in the UK.

Existing Lloyds shareholders were entitled to subscribe for 1.34 new ordinary shares for every ordinary share at a price of 37p per new ordinary share. On 14 December, Lloyds announced that 34,795 million shares had been taken up, representing over 95 percent of the total number of new shares in the offer. The remaining 1,711 million shares were placed successfully in the "Rump Placing".

The Government took up its rights as shareholder in Lloyds to participate in the rights issue, investing £5.7 billion net of a commitment fee in return for 15,810 million new ordinary shares.

Had Lloyds entered the Asset Protection Scheme on the terms set out in March, the Government's shareholding would have increased to 62 percent of total share capital. Through the capital raising measures outlined above, the Government's shareholding has not increased above the 43 percent of the October 2008 recapitalisation.

Following completion of the exchange offers in February 2010, the Government's shareholding as a percentage of total share capital has been reduced to 41 percent.

Impact on UKFI Market Investments

These developments have had a significant impact on UKFI's market investments in both scale and composition. The in principle commitments on the Asset Protection Scheme agreed with RBS and Lloyds in early 2009 would have increased the Government's equity investments by up to £41 billion, with an additional £15.6 billion in B shares in Lloyds and up to £25.5 billion in B shares in RBS.

Under the finalised agreements with Lloyds and RBS, the Government took up a total of £31.3 billion in additional equity investments, with £5.85 billion in ordinary shares in Lloyds and £25.5 billion in B shares in RBS.

The changes to the Government's investments since July 2009 are summarised in the table below.

HM Treasury ordinary shareholdings Developments since July	Ordinary Shares	Total Investment	Investment per Share	Government Ownership
	m	£m	p	%
Royal Bank of Scotland				
Total investment, July 2009	39,645	20,027	50.5	70%
Changes	51,000	25,500	50.0	
Total investment	90,645	45,527	50.2 (avg)	84%
Total investment net of fees	90,645	45,222	49.9 (avg)	
Lloyds Banking Group				
Total investment, July 2009	11,799	14,465	122.6	43%
Changes	15,810	5,850	37.0	
Total investment	27,609	20,315	73.6 (avg)	41%
Total investment net of APS exit fee ¹	27,609	17,439	63.2 (avg)	
Total		65,842		
Total net of fees ²		62,661		

Notes

¹ £2,500 million paid by Lloyds for the implicit capital support provided by the APS in 2009

² Underwriting and commitment fees on transactions paid to HM Treasury of £305 million for RBS and £376 million for Lloyds, and £2,500 million fee paid by Lloyds for the implicit capital support provided by the APS in 2009

Total investment

This brings the total cost of the Government's investments in Lloyds and RBS up to £65.8 billion. Including fees received by the Government, both underwriting and commitment fees and the fee paid by Lloyds for the implicit capital support provided by the APS in 2009, the total net investment is £62.7 billion.

The next two sections describe the impact on the investment in each bank in further detail.

Royal Bank of Scotland

The Government holds a total of **90.6 billion** shares in the Royal Bank of Scotland. This includes 51.0 billion non-voting B shares received in connection with the APS, and the one enhanced dividend access share, for which the aggregate subscription amount was £25.5 billion.

This is equivalent to **70 percent** of voting share capital and **84 percent** of total share capital. The Government has agreed with RBS that it will not convert B Shares into ordinary shares to the extent its holding of ordinary shares would represent 75 percent or more of RBS's issued ordinary share capital.

BOX 2.1 INVESTMENT IN RBS

The Government's investment in RBS has been made at three different prices:

- **Initial Recapitalisation:** The October 2008 recapitalisation was at a cost to the Government of 65.5p per share.
- **Preference Share conversion:** The redemption of the preference shares agreed in January 2009 was financed by the issuance of new ordinary shares at 31.75p per share.
- **Asset Protection Scheme:** The Government has subscribed for 51 billion B shares and one enhanced dividend access share at an aggregate cost of £25.5 billion, equivalent to an aggregate cost per share of 50p.

The weighted average of these investment prices is 49.9p per share. This represents the total cost per ordinary share of the Government's investment in RBS, net of transaction fees received by the Government.

Lloyds Banking Group

The Government holds a total of **27.6 billion** ordinary shares in the Lloyds Banking Group, including 15.8 billion shares taken up in Lloyds' rights issue. This is equivalent to **41 percent** of voting share capital.

In 2009, Lloyds successfully raised £22.5 billion of equity investment, with the majority from the private sector, in addition to the £4.0 billion Placing and Open offer completed earlier in the year.

BOX 2.2 INVESTMENT IN LLOYDS

The Government's investment in Lloyds has been made at three different prices:

- **Initial Recapitalisation:** The October 2008 recapitalisation was at a cost to the Government of 173.3p per Lloyds TSB share and 113.6p per HBOS share.
- **Preference share conversion:** The redemption of the preference shares agreed in March 2009 was financed by the issuance of new ordinary shares at 38.43p.
- **Rights issue:** The shares taken up in the December 2009 rights issue were priced at 37p per share.

The weighted average of these investment prices is 72.2p per share. This represents the total cost per share of the Government's investment in Lloyds Banking Group, net of transaction fees received by the Government.

For the implicit capital support provided by the in principle terms of the APS in March, Lloyds has made a payment to the Government of £2.5 billion. Taking into account this fee, reflecting the total capital support provided to Lloyds by the Government, the net cost of the Government's investment in Lloyds has been at an average price per share of 63.2p.