

Privatising the Banks



Creating a new generation
of shareholders

James Barty
Emily Redding



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Executive Summary

The Government had little choice when it decided to bail out RBS and Lloyds. It was either rescue the banks or face a meltdown in the financial system and the economy with it. The then Chancellor, Alistair Darling, took the decision not to nationalise RBS so it could be sold more easily when it had returned to good financial health. That process has taken longer than expected due to the aftermath of the financial crisis, including turmoil in the Eurozone, PPI and Swap mis-selling and Libor fixing. Five years on, though, the banks appear to be nearing the end of the adjustment process. RBS and Lloyds have both returned to profitability, they expect to meet the regulators' requirements in terms of capital and liquidity by next year and the bad assets are steadily being run down. In addition they have de-levered their balance sheets markedly. RBS is no longer the biggest balance sheet time bomb in history.

The two banks have both said they expect to be ready to return to the private sector in 2014 and we agree with that assessment. There are some like Lord Lawson, the Archbishop of Canterbury or even Sir Mervyn King who, in the case of RBS, disagree and either want the bank nationalised to create some alternative type of banking institution or want to split it into a good and bad bank. These are arguments that can only be made with the Government as an 81% shareholder in RBS (note they are not made for Lloyds) and represent one good reason why it is now right to privatise it. They are also five years too late. If the decision had been made to nationalise RBS in full back back in 2008/9 it could have been broken into a good bank/bad bank or split up or used as a state owned business bank. That decision was not taken. Instead Stephen Hester and team have spent the last five years getting rid of the bad bank element. They think they will have largely completed this by the end of this year.

Now is not the time to look back and wonder whether we should have done things differently, rather it is time to look forward and ask what we do with the banks now. Our view is that the longer they are in state ownership the more damaging that ownership is for the banks. Even a Conservative Chancellor cannot help but discuss how he would like the bank to look in the future, however much the relationship is described as arm's length. The RBS management team have made it clear that it is difficult to run the bank on commercial terms with the Government having such a large stake. In our view state ownership of the banks is, in the end, corrosive. This is not just our view. Sir Nicholas Macpherson the Permanent Secretary to the Treasury said as much back in 2012 when discussing Northern Rock "there is something corrosive about being in the public sector if you are running a business, particularly if it is a bank."¹

“The two banks have both said they expect to be ready to return to the private sector in 2014 and we agree with that assessment”

1 <http://www.publications.parliament.uk/pa/cm201012/cmselect/cmtreasy/uc1854-ij/uc185401.htm>

With the banks likely to be back on a solid financial footing by 2014 we believe it is time to put them back into the private sector. There are those who argue that we should not do so until we can recover the money we originally invested in the banks. Firstly, this is not the lens through which to look at the Government stakes in the banks. The measures taken to re-capitalise the banks were designed to prevent the collapse of the financial system as a whole not act as investments. On that basis it has worked. The UK faced economic catastrophe if the financial system had collapsed. The recovery since 2008 may have been muted but it could have been a lot worse. Moreover, five years on the banks have been able to rebuild themselves. The “investment” from that perspective has been a success.

Secondly, the original prices paid (503p for RBS and 73.5p for Lloyds) are not the correct benchmarks in our view. The Government has received fees from the banks over the last five years, which could, and in our view should, be deducted from the cost of recapitalisation. UK Financial Investments Ltd (UKFI) who look after the Government’s stakes in the banks have used such an adjustment in the past. If we deduct the fees paid for the Asset Protection Scheme (APS) then the “in-price” for Lloyds falls to around 63p and for RBS to around 470p. Further RBS will have to redeem the Dividend Access Share, which the Government imposed on it as part of the APS and the recapitalisation around it. That is worth around £1.5-2bn. Taking the mid-point of that and the RBS in price falls to a little over 450p. On this measure Lloyds is broadly at breakeven, although RBS is still trading at a loss.

That is not the only adjustment we should make. When the Government bought the stakes it had to record them at the share price at the end of the day in question. Since the share price was in fact lower, both RBS and Lloyds are entered into the Government accounts at lower prices, 407p and 61p respectively. If you were to deduct fees paid from those prices you can get down to around 360p for RBS and 53p for Lloyds. Overall that would put the Government in profit selling at current prices.²

The key point is that the headline losses proclaimed by some as a reason not to sell at current prices are not valid. At worst we would expect a modest write-down to the value of the Government’s stake in the banks in the national accounts, which is what we should be looking at.

Accordingly, we believe the headline “in-price” should not be a barrier to privatisation and that the Government should push ahead with moving the banks into private hands as soon as possible, which in all likelihood means next year. In this paper we examine four possible routes:

1. A staged sale to institutions, which has been the Treasury’s preferred option until now.
2. A traditional privatisation, like those of BT and British Gas in the 1980s.
3. A giveaway, as proposed by the likes of Nadhim Zahawi.
4. Distribution of shares to taxpayers, alongside an institutional and retail offering.

² The price, at the time of writing, of RBS was 335p and Lloyds 62p. These are the prices used throughout the document when referring to current prices.

The staged sale has the advantage of benefiting from allowing the Government to sell some shares now and then more later if the share price rises further. This has been the tactic up until now but with the banks taking much longer than

anticipated to recover no sales have thus far been possible. The major problem is that with less than two years to the election the political risk increasingly becomes a prohibitive factor in this approach. We understand from discussions with investment banks that, while placings are feasible, they are unlikely to be greater than £5bn at a time and a significant period of time would be needed between placings, probably 12 months or more. That means even Lloyds could not be fully privatised using this method ahead of the election and RBS would still be majority owned by the Government.

Staged sales also normally take place at a discount to give investors an incentive to participate. Given the escalating political risk (particularly with RBS) that discount would have to be even larger. This remains a possible approach for Lloyds but we think it is a non-starter for RBS.

A traditional privatisation would allow the Government to sell a bigger stake in the banks by including retail investors in the process. The more shares retail investors buy the more institutions would have to buy as the weighting of the banks would rise in the indices.³ However, such a route does present several risks. The sheer size of the privatisation and the risks surrounding bank shares may make attracting retail interest difficult, without a sizeable discount. As we understand it, such a discount would also have to be offered to all EU Citizens under EU law. That raises potential political difficulties for obvious reasons. It would also likely make institutions more wary of buying for two reasons; firstly the uncertainty over retail participation, secondly the fear that retail holders of shares would be more likely to sell should things go wrong. Given we cannot rule out another Euro Area crisis the Government also needs to consider the risk of selling a large slug of shares to the public and then seeing the share price fall. The headlines would not make attractive reading. Finally, and arguably, most importantly only those taxpayers who could afford to buy the shares could take part in the privatisation, whereas all taxpayers contributed to the bailout.

Like the staged sale this is a route it is more feasible for Lloyds than RBS, but it seems very unlikely that the Government could stage a privatisation for the full amount of its stake in Lloyds.

The giveaway option is probably easiest to dismiss as it would carry too high a cost to the Exchequer. Giving taxpayers the full value of RBS shares with no receipts for HMT would trigger a writedown in the accounts of a minimum of £33bn for RBS and close to £50bn if Lloyds were included. Whilst some taxes would flow back to the Exchequer they would be nowhere near enough to offset the loss. At a time when the Government is trying to get its fiscal position into shape this is simply not an option. It would also risk placing significant downward pressure on the share price as those receiving the shares looked to sell to cash out immediately and could, in extremis, result in a BP-style scenario where an undesirable institution, from a political perspective, picked up a large quantity of shares at a cheap price.⁴

The fourth option of distribution overcomes many of the inherent flaws within the other options, which is why it is our preferred method for privatising the banks. This option offers qualifying taxpayers⁵ (anyone who has an NI number and is on the electoral register) the opportunity to apply for shares at no initial cost but then pay for them at the time of sale. By offering a large portion of its shareholding to taxpayers in this way the Government is able to transfer much,

³ Government owned shares are normally excluded from index weights as they are deemed to be non-tradeable.

⁴ Post the BP privatisation in 1987 the share price fell sharply allowing the Kuwaiti Investment Office to buy a major stake in the company. See Chapter 3 for more detail.

⁵ We will refer to them from hereon as taxpayers for simplicity.

if not all, of the banks into private ownership in one go, while at the same time giving the taxpayer the bulk of the upside and generating the necessary conditions for a sizeable institutional and retail offering at full value alongside the distribution.

The scheme works because it tackles the issue of the Government overhang, i.e. the fact that the Government has a major (or in the case of RBS dominant) shareholding and is known to want to sell those shares. That results in discounts having to be offered in both the staged share sale and traditional privatisation. By issuing the shares to the public, who apply for them, with a fixed repayment price the Government takes away that overhang and ensures that the distributed shares will not be sold below the repayment price.⁶

By distributing a large proportion of its holding the Government also triggers institutional demand for the shares. This demand arises because Government shareholdings are normally not counted in indices as they are deemed to be non-tradable. Once they have been distributed, with full rights to vote and receive dividends, the shareholding will become eligible for index calculation. For RBS it is calculated that for every £100 of stock sold or distributed there would be £35 of demand from institutions due to the re-weight. For Lloyds given the higher starting private shareholding the numbers are smaller at £15 for every £100.

This, though, gives the Government the ability to trigger institutional demand alongside the distribution, thereby allowing them to place a greater amount of the shares for a higher value. For example, if the Government floated all of its 81% stake in RBS that would generate additional demand from institutions for up to 28% of total RBS stock.⁷ We also believe there would be demand for a traditional “fully funded” retail offering alongside those shares distributed to all taxpayers. We believe the Government should provide additional incentives for retail investors to do this by making any RBS or Lloyds shares bought in the offering eligible for ISA treatment (i.e. free of capital gains and tax on dividends). To participate in the retail offering the individual would first have to pay the Government back its floor price on the distributed shares. All of this would trigger additional upfront proceeds for the Treasury.

We believe that for RBS the Government could sell around 25% of RBS stock to institutional and retail investors, taking total private ownership up close to 45%, leaving 50-55% to be distributed to taxpayers. We would advocate the Government keeps a small stake for errors and omissions and to smooth any market movements should the share price jump for any reason afterwards. For Lloyds we would advocate a bigger proportional distribution with maybe 30% of Lloyds stock being distributed (of the 39% the Government owns) and the rest sold to institutional and retail investors (with a smaller percentage held back). For taxpayers, who applied, we calculate that this could mean a total of somewhere between £1100 and £1650 worth of shares being allocated depending on the number of applicants.⁸

The reason we suggest Lloyds is included in this scheme is threefold. First, it is the only method where we believe the Government can completely exit Lloyds ahead of the election. Second, it is the method best suited for getting a higher price for Lloyds courtesy of the re-weighting. And third, we believe the taxpayers deserve the upside in Lloyds as well as RBS. After all, if we are selling below the price the Government originally paid the taxpayer should be the major beneficiary.

6 That is why the repayment price is known as the floor price.

7 i.e. 35% of the 81% holding.

8 The lower figure assumes 20 million applicants, the higher one 30 million.

The great advantage of the scheme is that the share price for the banks is much better supported. First, there are no sellers of the distributed shares below the floor price. Second, institutions will have to come into the market to buy some of the distributed shares since they would not be able to buy all of the shares they need in the offering (the Government used this strategy in all of the 1980s and 90s privatisations), thereby supporting the share price after distribution. It would also mean that of the £48bn of RBS and Lloyds the government owns up to £34bn would end up in the hands of taxpayers.

Individuals receiving distributed shares would be given the option of various selling methods. They could opt to sell the shares themselves manually or they could opt in to an automated selling system. In the automated option they could elect to sell their shares at various premiums to the floor price. For example they could sell all of them 20% above the floor price or 25% at a 20% premium, 25% more at a 30% premium and the rest above 40%. The advantage of this is that it takes the hassle out of selling the shares and enables the share sales to be grouped and carried out by computer trading. For institutional investors they know there will be sellers above the floor price but they do not know where, when or how many. So it allows a gradual flow of shares into the market as the share price rises. In other words it creates an orderly aftermarket.

“ Over a 10 year period something would have to go very wrong for the share price to remain below the floor price for the entire period ”

We have heard two major criticisms of the scheme. First, what happens if the share price falls after flotation and taxpayers do not get to sell their shares? Second, as there will be tens of millions of taxpayers applying is it not bound to run into major logistical difficulties?

On the share price issue we acknowledge it has to be a risk. There could be another Eurozone crisis and we know banks have been the big victims of such crises in the past. We would say four things. First, the banks by 2014 will be much more robust financially than they were in previous euro crises so they should be less vulnerable to shocks. Second, and more importantly, this method of sale leaves the banks less vulnerable than other selling methods, because the sellers of the shares diminish as the price drops below the floor price. Third, the Government would already have sold more through this method to institutions and therefore realised more proceeds than any of the other proposed methods. Finally, no retail investor would lose money through the distribution.

We have argued that this scheme should be open for 5-10 years before it is wound up. Over a 10 year period something would have to go very wrong for the share price to remain below the floor price for the entire period. If it did the Government would retain the option of recalling the shares and if necessary re-striking the floor price. The good news for taxpayers who applied is that they would not lose any money. For the Government it is no different to having held on to the stock they had distributed – if the taxpayer has not been able to sell a share above the floor, nor would the Government.

Turning to logistics we estimate that there are around 48 million people who would be eligible. We think 20-30 million would apply. Since the application process would take a little bit of time and effort (although not much) we suspect there will be

some people who decide it is not worth their while. The application process is simple though, with people merely needing to supply an NI number, name and address. There is no need for any payment to be transferred or for any shares to be bid for. The shares that are distributed are simply divided amongst all the applicants equally. By insisting on an NI number and being on the electoral register there is a relatively straightforward cross check that should catch cases of fraud. The requirement of registration eliminates Government's need to develop systems and produce its own data set, which reduces the logistical risk by several orders of magnitude.

If there is a complexity it is in the sale process. However, since all shares would be held in nominee accounts, all proceeds could be transferred to those accounts and distributed to individuals afterwards. The nominee account acts as a buffer and ensures that HM Treasury receives payment.

The nominee account also deals with issues such as voting since distributed shareholders holding their shares in these accounts would have the right to vote but not attend shareholder meetings. They would also have their dividends paid into the nominee account, avoiding the issue of non-claimed dividends, which has been a problem with other privatisations.

We have been told by major logistical firms who have handled large scale national processes for the Government and others in the past that this scheme is entirely workable, providing the Government allows enough time for the building of the infrastructure and registering of applicants.

We like the scheme for a number of key reasons and this is why we recommend the Government adopts it and applies it to both RBS and Lloyds for full privatisation in 2014.

1. It is the only option that realistically allows RBS and Lloyds to be fully privatised ahead of the general election.
2. It is the scheme that is likely to generate the best price for the Government over that time horizon because it will force institutions to pay up for the shares rather than demand a discount.
3. The scheme offers the best route to raising the largest amount of cash for the Treasury in the shortest time frame. We estimate the Treasury could raise in the region of £14bn through the institutional and retail sales, even before any cash is realised from the sale of distributed shares.
4. It gives the upside to any taxpayer who applies. If the Government is to sell the shares at a price lower than it paid for them then the taxpayer who funded the original purchase should be the key beneficiary. Taxpayers could be in line to receive between £1100 and £1650 worth of shares.
5. By distributing some 50% of RBS and 30% of Lloyds we believe the Government will properly align the interests of the taxpayer with the banks and in one sweep create a whole new generation of shareholders.

The Chancellor has already said that he will set out a strategy for returning the banks to the private sector. In this paper we outline a scheme that allows him to do so in the shortest possible timeframe, realising the best price and, crucially, giving the taxpayer the bulk of the upside in the process. We urge the Chancellor to take on the doubters and move ahead with this scheme.

1

Introduction

Almost everyone accepts that it was the right decision for the last Government to bail out RBS and Lloyds rather than let them fail. To have not done so would have risked turning a major financial crisis and recession into a catastrophe. Whether the Labour Government got its tactics right in only bailing out RBS and Lloyds and not forcing capital on the better off banks like Barclays, HSBC and Standard Chartered, as the US Government did, is an interesting academic point. It is not relevant though for the discussion about what to do now with the two partly Government owned banks. We have to deal with them as they currently are, including the fact that the Government is sitting on a loss. The question we aim to deal with in this document is whether the Government should be looking to return RBS and Lloyds to the private sector and, if so, what the best method of doing so would be.

Our prior is that the banks should be returned to the private sector. We think there is little argument about Lloyds. The Government only holds a minority stake, the share price is closer to the Government's entry price (indeed above it on some calculations) and in its current form it is pretty much the domestic bank all politicians say they want to have. RBS is a slightly different animal because the Government has an 81% stake, it is well below the price the Government originally paid for it and it is still in a process of restructuring. Nevertheless, Stephen Hester and his team have done a great job in ridding it of its toxic assets and we agree with the management team that by next year it should be sufficiently robust to be returned to the private sector.

While the arguments that something should be done to restructure RBS, from the likes of Lord Lawson, Sir Mervyn King and the Archbishop of Canterbury, are understandable they are five years too late. If RBS had been fully nationalised five years ago, it could have been split into a good bank and a bad bank and refocused on supporting business. It could also have been split into a series of regional banks. To try and do it today would run into all sorts of legal issues with the European Commission on state aid and unfair competition. The private shareholders would also have to be bought out at a fair price so as not to leave the Government open to legal action. Finally, Stephen Hester has been running a bad bank within RBS for the last five years and is expected to close it down at the end of the year because it will have shrunk from more than £300bn to just £40bn. In short we do not believe there is any need for a good bank/bad bank split.

The then Chancellor, Alistair Darling, made the decision during the financial crisis not to nationalise RBS fully because he believed leaving some shares in

“The shares were not bought as an investment in the banks they were bought as an investment in the financial system”

private hands would facilitate a return to the private sector at a later date. That free float does at least give us an indication of what price RBS could be returned to the private sector at and it is noticeable that the price has been rising over the last 8-9 months, as investors have become more optimistic about the future.

The plan at the time of buying the stakes in the banks was to resell them when they had returned to good financial health. Obviously the Government should look to maximise the value it can get for the shares, but that is not the only consideration. The stakes in the banks were taken to ensure that the financial

system in the UK did not collapse and take the economy with it. While growth has been lacklustre, as the banks have rebuilt themselves, it could have been a lot worse and the plan has generally worked. The shares were not bought as an investment in the banks, they were bought as an investment in the financial

system. If it is right for the benefit of the financial system that the banks are returned to the private sector, the price the Government paid for them should not be an obstacle to sale.

The IMF recently said as much⁹ when it said that the Government needed a “clear strategy” for the banks and that “Any strategy should seek to return the banks to private hands in a way that maximises value for taxpayers, strengthens confidence and competition in the sector and minimizes outward spillovers.”

Moreover, we do not believe that keeping them in Government hands would necessarily mean the Government would eventually achieve a higher price. The RBS management team have made it clear that being majority owned by the taxpayer impacts on their ability to run the bank on commercial terms. At every bonus round there is another debate about what should not be paid to the RBS bankers. Even a Conservative Chancellor, though stressing that RBS is operated at arm’s length, cannot stop himself from going on to say that it should have a smaller investment bank or international presence. Combined with every grandee airing a view about what should be done with the bank, what hope does Stephen Hester have of hiring anyone into the investment bank or to more senior positions in the bank itself?

While the situation at Lloyds is a little better, it too operates in the shadow of Government. Neither bank could do what Deutsche Bank did recently, and go into the market to raise capital. Both had to face months of uncertainty after the Treasury refused the Bank of England’s request to inject equity capital into them. Government ownership of the banks is, in the end, corrosive.

In our view it is therefore right to plan on selling the banks sooner rather than later. Both RBS and Lloyds tell us that they will be ready for sale in 2014. If we take them at their word, and we do, then the only question should be - how?

We review four possible methodologies of privatisation:

1. Staged sales to institutional shareholders
2. Traditional privatisation by selling to institutional and retail investors
3. A giveaway to the taxpayers for free
4. A distribution to taxpayers with the Government to be repaid on sale, combined with an institutional and retail placing

⁹ <http://www.bbc.co.uk/news/business-22623519>

All have advantages and disadvantages, which we assess in detail in chapters 4 and 5.

We believe the one with the overall advantage is the distribution option. It is the only option that allows all (or almost all) of the shares in both Lloyds and RBS to be sold ahead of the general election at a price that does not have to be significantly discounted. It also offers the most stability of the share price post any placing, as the distributed shares would not be sold below the price which had to be repaid to the Government. We also think it facilitates a substantial retail and institutional placing alongside the distribution. Finally since the shares are likely to be sold below the price the Government originally paid for them it gives most of the upside in any share price rise to the taxpayer not just financial institutions.

The Government does not have to use the same mechanism for RBS and Lloyds although we would advocate that it does so in order to give the taxpayer a chance to benefit from the upside in both banks and because it is likely to realise the best price for the Government in the short term.

The document is set out as follows:

- Chapter 2 looks at the arguments around whether we should privatise the banks and examines the alternatives for RBS. It does so in the context of the mandate set out for UKFI when the stakes in the banks were originally bought and looks at the different measures of how RBS and Lloyds are valued in the Government's accounts.
- Chapter 3 examines the lessons we can learn from the privatisations of the 1980s and 90s and the de-mutualisations that followed.
- Chapter 4 explores the options for privatising RBS and Lloyds other than distribution, assessing them in terms of their practicality, price likely to be realised and the risk.
- Chapter 5 outlines the distribution option in detail, explaining how it would work and looking at the advantages of the scheme as well as the risks surrounding it.

2

Should We Privatisise the Banks?

The last Government originally bought the stakes in RBS and Lloyds because it had little alternative. It was a case of bail out the banks or see them go bust and with them the economy. As Alistair Darling put it in his book *Back from the Brink* “what was vital... was to prevent a complete collapse of the financial system”.¹⁰ The idea was not to nationalise the banks but to recapitalise them so that they could retain the confidence of the markets and withstand what were the inevitable losses that followed from the financial crash. To quote Darling again “the fact that RBS remains a quoted company means it will be easier to sell the shares and allow the Government to recover what, on any view, was a massive investment in the bank”. So the Government of the day’s objective was clear, it was to re-privatise the banks as and when it seemed right.

This desire to sell the banks was also reflected in UKFI’s goal (set in 2009) which was to “develop and execute an investment strategy for disposing of the investments in an orderly and active way through sale, redemption, buy-back or other means within the context of an overarching objective of creating value for the taxpayer as shareholder, paying due regard to the maintenance of financial stability and to acting in a way that promotes competition. This objective includes:

- Consistent with HM Treasury’s stated aim that it should not be a permanent investor in UK financial institutions, maximising sustainable value for the taxpayer, taking account of risk;
- Maintaining financial stability by having due regard to the impact of its value realisation decisions; and
- Promoting competition in a way that is consistent with a UK financial services industry that operates to the benefit of consumers and respects the commercial decisions of the financial institutions.

In pursuing this goal we will operate like any other active, engaged shareholder to protect and create value, operating on a commercial basis and at arm’s length from the Government.”

What this does not deal with explicitly is the timetable of when the Government should sell the shares. It does, though, provide some guidelines, since the UKFI was tasked with creating value for the taxpayer, while maintaining financial stability and promoting competition. We will consider the banks in terms of this mandate to see if they meet the criteria for sale and then go on to consider other alternative options.

Maximising Sustainable Value

In terms of creating value it is clear that UKFI and the Treasury should seek the highest possible price for the Government’s stakes. For many that means at a

¹⁰ Alistair Darling – *Back from the Brink: 1000 days at Number 11*

minimum recouping the money the Government paid for the shares in RBS and Lloyds. Indeed, that seemed to be the strategy of the current Government when it came to power - give the banks time to rebuild themselves, wait for the share price to recover as they did this and then sell the shares in stages to institutional shareholders over time to return the banks to the private sector. More than four years on from the recapitalisation though, the banks share prices sit substantially below the amount the Government originally paid for them. According to UKFI figures the Government paid 50.23p for RBS (now 502.3p since the change in the way the shares are quoted) and 73.58p for Lloyds. That compares to share prices at the time of writing of 335p and 62p respectively. So at the current share prices the Government would appear to be sitting on a loss of £15.1bn on RBS and £3.2bn on Lloyds in comparison to those entry prices.

This is not the entire story though as the Government has received fees from both RBS and Lloyds for various measures, including, most importantly, the insurance it provided under the asset protection scheme. It could be argued that this amount should not be included in the calculation because it was an insurance policy, which while not paid out, was a genuine risk. We would contend that the Government was on the hook regardless of whether the insurance was payable because in effect it stood behind both banks, so it should be included. These payments totalled £2.5bn each for RBS and Lloyds. Using UKFI numbers this reduces the “in-price” for Lloyds to 63.14p and for RBS to 471p. That reduces the loss to £12.3bn for RBS and just £200m for Lloyds. For RBS there is the additional issue of repaying the Dividend Access Share (DAS) to the Government, so it can pay dividends post privatisation. This is valued at between £1.5 and £2bn and should in our opinion be deducted from any initial purchase price.¹¹ Using the mid-point of that valuation would lower the in-price for RBS to 452p. RBS has also paid £305m for underwriting fees, £1.5bn for liquidity support and £1.28bn for contingent capital. If we include these as well that lowers the in price to 418p.¹² In addition the Government has also been raising money from all of the banks from the bank levy, which thus far has raised around £3.4bn and is due to raise £2.7bn annually going forward. That levy is in effect a payment for the insurance the Government is providing for the banking sector.

Finally it is important to look at the valuation of Lloyds and RBS in the Government’s accounts, since it is the difference between this price and the price at which they are eventually sold which impacts on the national debt. Analysis provided by Autonomous Research to the Treasury Select Committee points out that “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 the shares were purchased at above the market price. This excess was recognised as a permanent impact on the national accounts and so has been reflected in the Government’s preferred national debt measures.

The effect of this treatment is that the stakes are carried at the weighted average of the market prices from the day on which the shares were purchased, rather than

“The Government was on the hook regardless of whether the insurance was payable because in effect it stood behind both banks”

¹¹ See Chapter 5 for more details

¹² UKFI Annual Report 2011/12 and RBS Annual Report 2011

at the actual prices paid. This carrying amount does not vary with the market price and is not written down regardless of any objective signs of impairment.”¹³

In short the price of the shares of RBS and Lloyds in the accounts is the average of the market prices on the days in which the Government bought its stake. For RBS the market price was lower than the price paid on each occasion, while for Lloyds it was actually higher on two occasions but crucially lower on the first recapitalisation, as the table below shows. When the shares are sold any difference between the sale prices and the price in the Government’s accounts would impact the stock of the national debt. That difference would only be recognised for the amount sold. Thus if the Government sold the shares in tranches, any shares left unsold would not be revalued. This has important implications, which we will come on to later.

Table 1: Government investments in RBS¹⁴

Purchase	Market Price on day of Purchase	Paid Price (“in-price”)
Initial recapitalisation Dec 2008	55p	66p
Pref share conversion Apr 2009	30p	32p
APS B shares Dec 2009	38p	50p
Weighted average	41p	50p

Source: Bloomberg, Autonomous Research LLP

Table 2: Government investments in Lloyds

Purchase	Market Price on day of Purchase	Paid Price (“in-price”)
Initial recapitalisation Jan 2009	132p	183p
Pref share conversion June 2009	66p	38p
Rights issue Dec 2009	59p	37p
Weighted average	61p	74p

Source: Bloomberg, Autonomous Research LLP

In theory if the Government were able to include the fees taken for the APS scheme into account then this carrying price on Lloyds would drop to around 51p, thereby taking the price below the current market price. Similarly for RBS such an adjustment, plus the DAS, gets you to about 360p. That would imply a loss of just £2.25bn on RBS at current share prices but a £3.1bn profit on Lloyds compared to where they are currently valued, so a net profit of just under £1bn. Using the additional fees for RBS gets its price down to 324p, which would also mean a net profit vs the valuation in the national accounts at current share prices. To use all of these adjustments might seem extreme, but why should the Government not count the income it has received from the banks against the cost of owning the banks? Interestingly the US government in calculating the cost/return of its TARP programme does include fees and interest on loans (which its bailouts were channelled through).¹⁵

¹³ <http://www.publications.parliament.uk/pa/cm201213/cmselect/cmtreasy/73/73we02.htm>

¹⁴ Note that the RBS share price shown here is before the change in the method of quotation. Hence the 41p shown here would equate to 410p today.

¹⁵ See for example the analysis of its AIG investment - <http://www.treasury.gov/initiatives/financial-stability/TARP-Programs/aig/Pages/status.aspx>

For the Government we believe the key measure is whether any sale increases or decreases the national debt, so a case can be made that these adjusted prices are the ones that should be used. In essence the reference back to the original price paid, which many make in calculating the loss the Government is carrying, is misleading. We think it is a reasonable objective that any share sale should not lead to a significant increase in the stock of Government debt. This would suggest that the comparison should be the price in the Government's books, adjusted for fees paid if that can be agreed with the relevant statistical authorities. Even at current share prices the loss is modest compared to the book price and potentially nothing from the adjusted book price. If we can construct a method of sale which could increase the price from current levels, which we believe is possible, then it is plausible that the Treasury could start planning a sale now on the basis that it would not materially affect the national debt.

Financial Stability

The reference in the UKFI mandate to maintaining financial stability and the banks returning to normality are clearly linked. It would make no sense for the Government to re-privatise the banks when they are still vulnerable to financial shocks. Both RBS and Lloyds have had significant hurdles to clear to put themselves back on a path to financial stability. Both were underwritten through the Asset Protection Scheme¹⁶ where the Government agreed to take any losses that the banks suffered beyond a certain limit and both had to de-lever and shed large quantities of poorly performing assets.

We believe the banks have made sufficient progress to be considered to be well on the way to normality, with both RBS and Lloyds notably returning to profitability in the first quarter this year as provisions for bad loans and payouts for PPI, Libor-fixing etc finally began to subside. Yet the return to profitability, although important, is only part of the case for arguing that they are ready to be placed back into the private sector. The transition from two banks that were sitting on huge potential losses in 2008 to the stable and profitable versions now emerging has been very marked indeed.

If we take RBS first, in 2008 it had a balance sheet that stood at almost £1.6tn, with a capital ratio of just 4% and a huge reliance on wholesale funding. Stephen Hester has described his job at RBS as defusing the “biggest balance sheet time bomb in history”¹⁷ and the progress made over the last five years in doing that has been substantial, as the table below shows.

RBS has moved from a dependency on wholesale funding to the point where its loan to deposit ratio is in balance. Its liquidity position is currently almost four times its wholesale funding, meaning the bank is in a solid position should that funding come under pressure as it did in the financial crisis. Mr Hester and his team have just about halved the leverage in the balance sheet, taking it well inside the requirements set by the Government. That has been accomplished with a fall in balance sheet size from £1563bn at the peak to £870bn now. Meanwhile the capital ratio has risen from 4% to close on 11%. In terms of core tier one equity ratios as defined by Basel III RBS calculates that it has a fully loaded ratio of 8.2% at the end of Q1 and is targeting 9% by the end of this year. That compares to the FSA's estimate of just 2% at the end of 2007. While it seems that the Bank of England's recent work in re-calculating these ratios on a more prudent basis would imply a lower ratio,¹⁸ it is clear RBS is in a hugely stronger position on all fronts than when the Government had to come in to bail it out.

16 The Asset Protection Scheme worked by the Government underwriting the poor assets of the banks, subject to the banks taking the first loss, in RBS's case the first £60bn. The HM Treasury support was never called upon.

17 <http://www.guardian.co.uk/business/nils-pratley-on-finance/2012/feb/23/rbs-boss-stephen-hester>

18 <http://www.bankofengland.co.uk/publications/Pages/news/2013/013.aspx>

Table 3: Progress in RBS Financial Stability

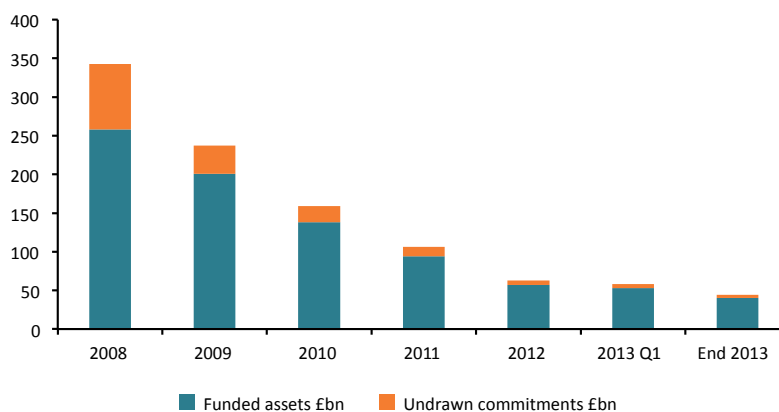
RBS Key Indicators	Worst Point	FY 2012	Q1 2013
Loan : Deposit Ratio (net of provisions) ¹	154%	100%	99%
Short term wholesale funding ²	£297bn ³	£43bn	£42bn
Liquidity Portfolio ⁴	£90bn ³	£147bn	£158bn
Leverage Ratio ⁵	28.7x ⁶	15.0x	15.0x
Core Tier 1 Capital Ratio	4% ⁷ Basel 2 ⁸	10.3% Basel 2.5 ⁹	10.8% Basel 2.5 ⁹

1 As of October 2008.
 2 Unsecured wholesale funding <1 year to maturity. Excluding derivatives collateral.
 3 As of December 2008.
 4 Eligible assets held for contingent liquidity purposes, including cash, Government issued securities and other securities eligible with central banks.
 5 Funded tangible assets divided by Tier 1 Capital.
 6 As of June 2008.
 7 As of 1 January 2008.
 8 Based on Basel II Regulatory Requirements.
 9 Includes impact of CRD3 Regulatory Requirements.
 Source: RBS Group

Another way to look at this is through the run-down of its non-core assets, which are the assets the bank’s management identified as needing to be divested. In 2008 these totalled some £353bn, including undrawn commitments. By Q1 of this year that was down to £53bn with the bank targeting £40bn or lower by the end of this year. At that point Stephen Hester has stated that the assets will no longer be a material part of the bank’s balance sheet and therefore will not need to be run separately. The progress in this area is the most significant rebuff to those who think splitting RBS into a good bank and bad bank is the right way forward. Five years ago that might have made sense when the non-core assets were so large but today these assets make up just 6% of the balance sheet. In addition in its latest set of results RBS argued that it felt that the Ulster Bank business, a key driver of bad debts, was finally starting to turn a corner.

The process of restructuring has also involved RBS shrinking its investment bank business, with the equities side of the business closed and risk weighted

Figure 1: RBS Non-Core Assets



Source: RBS Group

assets allocated to this business targeted to drop to £80bn. Equally its international operations have been scaled back with a stake in Citizens, its US subsidiary, likely to be sold later this year. With the bank posting a pre-tax operating profit of £826m in Q1 it is understandable why Sir Philip Hampton, RBS Chairman, stated that he felt that the bank would be in a position to be sold by the second half of 2014.¹⁹

Lloyds has gone through a similar process. It never really joined the Asset Protection Scheme opting to pull out in November of 2009, after paying a £2.5bn fee for the implicit support of the scheme during that year. The bank has also run down its non-core assets, which dropped from £236bn at the end of 2009 to £92bn by Q1 2013. Like RBS it has seen marked improvement in liquidity and capital with its loan to deposit ratio having fallen from 169% to 119% and its core tier 1 ratio had risen from 8.1% to 12.5%. On a fully loaded Basel III basis it now has a core tier 1 ratio of 8.1%, which it also hopes will be above 9% by the end of this year. Its profitability has recovered strongly with pre-tax profit topping £2bn in Q1 of this year and core operating profit at £1.87bn. Most notable was the fact that there were no further PPI provisions and a marked decline in impairment costs.

In summary by mid next year, which is the earliest that a full blown privatisation can reasonably happen, we believe both Lloyds and RBS will have improved their financial stability to a point where there can be little doubt that they are ready for a return to the private sector.

Competition

Finally in terms of competition both Lloyds and RBS are being forced to divest themselves of a significant number of branches by the EU Commission. The failure for this to happen thus far has not been for a lack of trying by the two banks, more that the current environment, both economic and regulatory, has discouraged buyers from taking on those branches. The decision by the Co-operative bank to pull out of buying branches from Lloyds was seemingly a function of capital, with the Moody's subsequent downgrade highlighting their problems in this area.²⁰ Nevertheless, both banks are committed to the divestment and we would expect it to have taken place well before any privatisation. Indeed, RBS is reported to be close to selling its 315 branches to one of two consortiums of investors for something in the region of £1bn. Lloyds meanwhile is reported to be considering a flotation of its branches under the TSB name.²¹

There are arguments, some put forward by the Archbishop of Canterbury, that Lloyds or RBS or both should be broken up to create a larger number of smaller banks. This probably would increase competition but it would also likely reduce the ability of UKFI to maximise the proceeds from any sale. Moreover, the consequences in terms of financial stability are far from clear. The regional banking systems of both the US and Spain saw major problems in the financial crisis and a number of the UK's smaller banks in terms of HBOS, Northern Rock, Bradford and Bingley and Alliance and Leicester all failed during the crisis. Given the recent problems the Co-op has experienced, following its takeover of Britannia Building Society, it is far from clear that smaller is necessarily better.

In addition to the two new banking groups looking set to be created out of the divested branches of RBS and Lloyds, the PRA and FCA are also trying to encourage new entrant banks with the offer of faster regulatory approval and lower capital charges²². Competition is also being strengthened through a 7 day

19 <http://www.telegraph.co.uk/finance/financevideo/10034908/Chairman-Philip-Hampton-RBS-ready-to-privatise-in-2014.html>

20 http://www.moodys.com/research/Moodys-downgrades-Co-operative-Bank-on-review-for-further-downgrade--PR_272729

21 Financial Times, May 1st 2013, Rivals charm Royal Bank of Scotland over Rainbow sale

22 <http://www.bloomberg.com/news/2013-03-26/fsa-final-proposal-to-gamble-on-low-capital-for-new-banks.html>

account switching about to start from September this year. Finally there are the alternative methods of financing such as peer to peer lending which are also challenging the existing banks, with the BBC reporting that the three largest companies have advanced more than £450m of loans thus far.²³

In our view this is a more sensible approach to keeping the large banks competitive than breaking them up. You need enough competition to keep banks honest but not so much competition that banks start to make bad decisions to gain market share, which is exactly what happened with the likes of HBOS and Northern Rock.

To nationalise? A non-starter

We would argue then that under the terms set out for UKFI, RBS and Lloyds could be ready for privatisation by 2014. That at least presents the Government with options. As the Government is only a minority shareholder in Lloyds we feel that the options break down into privatise soon or hold on for a better price. There are various different ways this can be done, which we will deal with in chapter 4. For RBS the choice is wider – privatise soon, hold on for a higher price or nationalise the bank in one form or another. The latter would be necessary if the Government were to follow the Archbishop of Canterbury's advice to create regional banks,²⁴ or to follow Sir Mervyn King's advice to create a good bank/bad bank structure²⁵ or indeed to follow Lord Lawson's advice to turn RBS into a vehicle for increasing lending to business.²⁶

Even though the Archbishop's and Sir Mervyn's recommendations would enable the new banks, be they regional or a large good bank, to be sold off, the Government would almost certainly have to buy out the minority shareholders in RBS before doing this. For the regional bank concept the Government would potentially face being sued by shareholders if they believed (probably correctly) that a decision to break up the bank would destroy some value. Unravelling the IT alone to enable it to serve individual banks would be a major task and smaller banks would of course lose the economies of scale traditionally associated with large banks raising funds or capital, or back office functions. For the good bank/bad bank proposal, nationalisation would be necessary as it would be incredibly difficult to value the cost to the Government of taking on the bad bank and shareholders would be unlikely to want a stake in a bad bank, since presumably by design it would be loss making.

Accordingly the first hurdle for the Government would be to find the £6bn or so to buy out the private shareholders in RBS. The further loss to the Government from the Archbishop's proposals is uncertain but we suspect it highly likely that the sale of regional bank shares to institutions or the public would require a significant discount over selling RBS in its current form.

For the Governor's plan to work there would also be significant hurdles. For sure a good bank would likely raise a better price from investors if it is shorn of all the bad assets, but the Government would have to bear the losses of the bad bank on its own balance sheet. It would be a sizeable exercise taking some time for this transfer of bad assets to take place and for the valuations at which the Government would take them onto its balance sheet to be agreed. Then there would be European Commission hurdles to cross since the creation of a good bank would almost certainly be treated as a recapitalisation. The Commission could easily decide that such a move would confer an unfair advantage on the new good bank, as almost

23 <http://www.bbc.co.uk/news/business-22401744>

24 The Guardian, 23/4/2013
Archbishop of Canterbury calls for introduction of regional banks

25 The Independent, 6/3/2013
Good bank, bad bank: split RBS or it'll never sell warns Mervyn King

26 Financial Times, 31/1/2013
Lawson urges full nationalisation of RBS

every other bank in the EU has its own share of bad assets sitting on its balance sheet. In the worst case scenario it might just veto it, or place restrictions on it that would prevent it achieving what the Governor was targeting, a rise in lending.

Lord Lawson's plan might well fall into some of the same problems, because the Government would presumably need to recapitalise the bank or split off a bad bank if it wants it to markedly increase its lending. Otherwise the nationalised bank would be in the same position as RBS now. Equally there is little or no evidence that Government owned banks are better allocators of capital than the private sector. The state guaranteed banks in Germany made some appalling risk decisions in the run up to the financial crisis. In addition there is the desire to meddle in the operations of a nationalised bank that we alluded to earlier. The pressure on such a bank to extend credit to projects that are politically favoured or, more likely, not to foreclose on a company were it to involve job losses would be huge, however arm's-length a Government tried to make such a bank.

The problem with all of these plans is that they might have been possible 5 years ago at the peak of the financial crisis when the EU authorities were prepared to look at most things if they prevented a financial meltdown. Now the world has moved on. Importantly so has RBS. It has run down its pool of bad assets markedly over that time. The non-core assets, as we noted above, have dropped from some £350bn to around £40bn by the end of this year.

Finally given that the Government is already facing a loss on its stakes in RBS and Lloyds we suspect there is little appetite for increasing the scale of those losses in the Treasury given the UK's fiscal position. So nationalisation in whatever form it takes should be a non-starter, in our view.

Privatise – now or later?

We believe the options, therefore, come down to holding on for a better price or to sell as soon as the banks are ready in the best way possible. As we mentioned above, many have argued that the Government should hold on to try and recuperate as much of the money that it invested in the banks as possible. We can certainly understand that instinct. With the banks returning to profitability and their financial strength having been substantially rebuilt it could indeed be argued that with time the share price will rise. It is possible, even likely, that this will happen but it is not guaranteed and there are other factors to consider.

First holding on to the shares in the hope that they will rise is not cost free. There is an opportunity cost to holding on to the shares. In other words the money the Government could raise from selling its shares in the banks could be used for other purposes. In particular it could be used to payback some of the debt issued to pay for RBS and Lloyds, or more likely reduce the amount of new debt to be issued by the Government. With interest rates on Government debt still low at the moment the cost is reduced but even so we calculate that it still amounts to around £700m per year.²⁷

Second, and arguably more importantly, keeping them in public ownership for too long may start to impact on the value of the underlying business creating another drag on the share price performance. Stephen Hester, CEO of RBS, has talked in the past of the "Leylandisation" of the bank and Sir Philip Hampton, Chairman of RBS, has said that the ability of management to run a bank on a commercial basis "can be hindered" by the public and media pressure.²⁸ The temptation for politicians to

²⁷ Calculated using share prices as of 3rd May 2013 and 10 year gilt yield

²⁸ www.bbc.co.uk/news/uk-scotland-17137525

interfere when the Government owns a sizeable stake is simply too great, whatever the UKFI documents say about arm's-length ownership. We see that every time there is a bonus round. That makes it difficult for the banks to run their business on a normal basis, particularly when it comes to hiring and retaining staff. Even a Conservative Chancellor, in the shape of George Osborne, cannot help but make comments about the fact that he would like to see RBS have a smaller investment bank and international presence.²⁹ Those are commercial decisions, which the board and the CEO should be taking, not politicians.

Third holding on to the shares for longer may make selling the stakes more difficult due to political risk. If a Conservative Chancellor finds it difficult not to interfere in the running of a part state owned bank then potential investors are going to demand an even greater risk premium for a possible change of Government the closer we are to an election. This is a particular risk if the strategy for selling the shares is one of piecemeal sales to institutions to try and get a better overall price for the shares.

We have spoken to a number of key figures in financial markets to ascertain the likely appetite amongst investors for the sale of bank shares. The normal figure that is believed to be possible for a traditional style offering of shares is said to be in the region of £5bn, possibly a little higher for Lloyds. For Lloyds that suggests that the Government's current stake could be sold in two or possibly three tranches. However, it is normally also suggested that each offering should ideally be a year apart to allow each one to be digested and for demand to be freed up for the next offering. Even if we started today then the Government would still likely be a shareholder in Lloyds by the time of the next election.

The situation for RBS is of course even more difficult. At £5bn per offering it could take 5-6 years to sell down the Government's stake in the bank, meaning that the Government would almost certainly be the dominant shareholder in the bank at the time of the next election. Investors know this and would factor that into whatever price they were prepared to pay for the shares. Either that would mean offering the shares at a discount or merely that the share price would simply be lower in any case as investors priced this in.

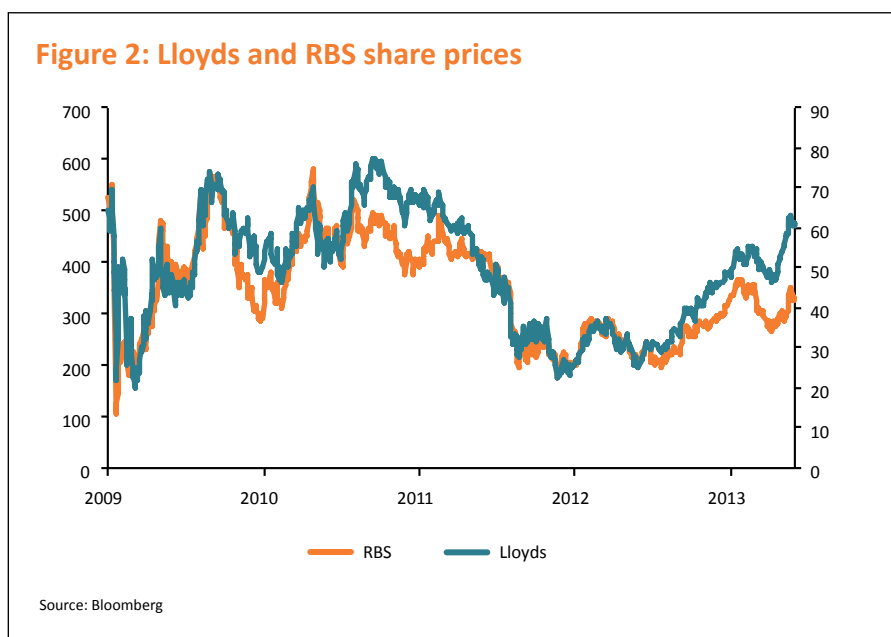
Finally, even aside from political risk, there is a downside to selling the shares in stages in that investors know that you are going to be selling more in the future. If they miss out this time then there is always the next offering to participate in. Again that is likely to provide a cap on the share price that the banks can be sold at.

So while it seems attractive to hold on to the shares to await a higher price there are significant downsides to doing so and you may well not get a higher price in any case. We believe the Government should view the purchase of the stakes in RBS and Lloyds for what they were – a recapitalisation to save the UK financial sector and hence the economy from a disaster. Even if the loss runs into a few tens of billions from the initial purchase price it could well be argued that it was a price worth paying. More importantly it should lift the shackles of the "in-price" from the Government.

We would argue instead that the right time to sell is when the banks are back to normality and market conditions are reasonable. The recovery in equity markets in the last year has seen bank shares start to recover, as the chart below shows. For sure RBS is some way off of its recent highs but that may well reflect both

²⁹ The Guardian 25/2/2013:
George Osborne rules out full RBS
nationalization – Chancellor tells
banking standards commission
RBS should focus on small
business, corporate and personal
banking

the uncertainty over the future of the bank and the Bank of England's demands that it raises more capital. Indeed, it is perhaps no great coincidence that the peak in RBS share price over the last 12 months came just before the Financial Times published Lord Lawson's article on nationalising RBS. As long as there is uncertainty about the future of RBS private shareholders are going to be wary of paying too high a price for them. Equally as long as the Government owns 81% of RBS the weight of that bank in the equity indices is sufficiently small for many investors to feel they can avoid owning it with little risk to their portfolios.



The recent results from Lloyds and RBS showing that they have returned to profitability and more importantly that impairments and provisions for mis-selling are starting to fall suggests that conditions are becoming normal again. So does the fact that RBS believes it can eliminate the division between its core and non-core business by the end of this year. The final key variable, in our opinion, is the financial stability of the two banks and with balance sheets having been shrunk, liquidity increased and capital rebuilt they are likely to be able to stand on their own in the private sector from next year.

That leads on to the question of how to sell the banks. They will, of course, be very large transactions dwarfing any previous such flotation in the UK's history. Nevertheless, there have been a lot of successful transactions of this type in the past and in the next chapter we will review the history of privatisations and de-mutualisations before moving on to discuss how this privatisation can be managed.

3

How Have Privatisations Worked in the Past?

The UK has a long history in large-scale privatisations and of encouraging large numbers of the general public to invest in them. Throughout the '80s and '90s larger and larger privatisations of national utilities and companies were achieved and the methods deployed to encourage individual investors and ensure maximum proceeds were constantly modified. This was all achieved with significantly less technology than that at the Government's disposal today.

Throughout the process the methods were adapted to take account of previous experiences but all retained a central aim of reaching as many potential individual investors as possible and widening the share-owning population, creating a stable aftermarket and maximising proceeds.

Between the years 1979 and 1997 63 companies were sold back into the private sector. Some were incredibly large and involved months-long marketing campaigns and costs such as British Gas with its sale of 4,150 million ordinary shares and some were relatively small, with comparatively low costs, for example British Aerospace at a cost of £1.8 million for its advertising campaign.³⁰

The scale of privatisations – getting the public involved

Each major privatisation during this period had as a core aim the involvement of as large a section of the general public as possible. This was achieved through a mix of advertising, incentives and various other methods that made it as simple and attractive for individuals who had never invested in shares before to apply. Attracting large scale interest from individual investors, aside from involving the public in the privatisation programme, was also instrumental in putting pressure on institutional investors and thereby increasing the likely success of the sale.

It was also the way the Government at the time believed they could dispose of such a large quantity of new shares. The result of this public interest meant that the average large privatisation³¹ during this time was 8.75 times oversubscribed, with millions of people becoming shareholders for the first time.

For every privatisation it was considered whether to sell the company in tranches or in one sale. From British Gas onwards the preference was to sell in one block. Underlying this was the belief that the stock market would be more receptive to a company that had no further Government influence on commercial operations (something we would wholeheartedly agree with!). A one-off sale also helped in the busy timetabling of further privatisations, allowing more to be achieved, often in tight election cycles. It also meant the Government did not

³⁰ Hansard, 18 January 1988

³¹ BT, part 1 and 2, British Gas, regional water companies, electricity distribution companies, National Power, Powergen, BA and BAA

have to wait a certain period to offload the second tranche of shares (witness the 7 years between the first and second BT share sale).

To attract sufficient numbers of investors (in particular first-time investors) the different Government departments used a variety of methods. They conducted extensive advertising campaigns in the months leading up to the larger sales to raise interest, the most famous being the ‘Tell Sid’ campaign for British Gas shares which cost approximately £40million³² and ran for several months in 1986. This campaign followed on from a widespread advertising campaign for the first part of BT’s privatisation, a couple of years beforehand, that succeeded in the shares being 9 times oversubscribed.

The effectiveness of ‘Tell Sid’ meant the Department of Energy received 4,550,206 applications from the general public and employees for shares in British Gas, making the sale 4 times oversubscribed. The public was bombarded with posters and newspaper and television adverts. To apply they had to cut out coupons from the newspapers and attach a cheque to the completed form and take it into designated banks or post offices. If successful they received an Allotment Letter that, in the short term, acted as a share certificate and, in fact, was able to be traded as such if the shares were sold very quickly after they were launched on the market. For retained applications this was subsequently replaced by a share certificate.³³

The paperwork generated in this sale and others was vast. Thousands of people were drafted in to sort all the coupons, letters and cheques and to log applicants. Inevitably there were instances of cheques being lost or coupons going astray but by the time of allocation the 6.6 billion³⁴ shares were allocated to the registered public in time for trading.

Table 4: Oversubscription of privatisations

Privatisation	Oversubscribed
Regional Water Companies	5.7
Electricity Distribution Companies	10.7
National Power and Powergen	5.0
BT Part 1	9.0
British Gas	4.0
BT Part 2	2.6
BA	23.0
BAA	10.0
Median	7.35
Average	8.75

Source: National Audit Office

32 National Audit Office, Department of Energy Sale of Government Shareholding in British Gas PLC 30th June 1987

33 Compare and contrast with the use of the internet we propose in Chapter 5.

34 *ibid*

Another important innovation was the use of incentives. For the first BT sale the sheer number of shares to be offered meant that the Government’s advisors were understandably concerned that there would be a lack of interest. One of

the ways, it was thought, to create interest was to offer a voucher incentive. Each voucher was valued at £18, which could be set against future BT bills (with the number of vouchers granted in line with the number of shares allocated and held to a specified date). When it came to the British Gas sale it was felt that because vouchers were offered to BT investors they had to be similarly offered in the sale of British Gas otherwise it would undermine public interest. The use of vouchers continued into the 1990s with the water and regional electricity privatisations. British Gas customers also had the option to register with a Customer Share Scheme that guaranteed them at least 200 shares and preference in the event of oversubscription and necessary adjustments. This 'reward' for holding the shares for a specified time also applied to incentives used in the water privatisation of 1989.

Thereafter vouchers that could be used against your telephone, gas, water or electricity bill were added to the costs of the sale. This incentive worked well in two ways. Firstly it successfully took advantage of the database of customers and potential investors that was already at each utility's disposal and, secondly, it tapped into those most likely to apply. Where there was not this natural customer base (e.g. British Airways and BAA) this incentive was discarded and only the bonus share incentive kept.

Bonus shares were also used to encourage take up but also to aid retention of shares. A standard offer was for one bonus share for every ten purchased up to a maximum (e.g. up to 300 in the sale of the 12 regional electricity companies). The costs of these incentives were comparatively small compared to proceeds and did help share retention rates (see below).

As the decade wore on further innovations that made it as easy as possible to apply for shares continued. By the time of the second BT sale in 1991 the Government planned 'share shops' where the public could purchase their shares directly from a network of high street retailers. These were not only to encourage people to buy shares but also to start trading them as well. To avoid these 'shops' having to become registered as financial advisers they were limited to the purchase and disposal of shares and could not offer investment advice. What they meant in practice was that individuals, when registering their interest in purchasing upcoming shares, could nominate a shop and would therefore be a preferred investor in the allocation stage. The share shop could then carry out any transactions the customer wanted, for a smaller commission than elsewhere. In addition to this, those who nominated a share shop and were allocated shares also received two vouchers for purchasing shares and two for disposing of them for the special commissioning rates at any share shop not just the one they had nominated. These share shops ended up representing 75% of all applicants in the UK public offer.

Even when the Government's aim was not to widen share ownership but to deepen it, as with the sale of Powergen and National Power the sale was still oversubscribed. It would therefore appear that so long as the sale was sufficiently advertised with favourable media public enthusiasm could be counted on to result in a large application for shares.

The only sale that struggled to attract enough applications was the sale of the Government's final tranche of shares in British Petroleum plc. In 1987 the Government were readying to sell 2.2 billion³⁵ shares using similar methods as

³⁵ New York Times 31/10/1987 - Thatcher's BP move is praised.

previous sales. The Government hoped that 3 million people would apply and 6 million people had applied for prospectuses, indicating the usual healthy public interest. Unfortunately when the stock market crashed in October 1987 interest evaporated, leaving only 250,000 to apply for shares. Despite the Government coming under pressure from the underwriters and BP itself to cancel the sale it, the Government pushed ahead. It did guarantee to buy back the shares from the underwriters at the recent market price thus pre-empting the underwriters offloading all their shares in the immediate aftermath of the price collapse. Nevertheless, the share price weakness led to the Kuwaiti Investment Office building a stake of some 20% in BP. This proved politically very difficult and in the end the Government had to intervene and to force the KIO to reduce its stake.

This demonstrates the impact an external event can have on a sale of this kind. Moreover, if the crash had happened after the shares had begun trading the loss would have had a much more damaging effect on individual investors.

Driving the price up

For the first large scale sale (BT, part 1), where mass public take-up was desired but not assured, the Government was forced to adopt a more cautious approach to price setting. Therefore where there was this uncertainty over how popular the sale would be, a fixed price sale was preferred, cautiously priced to ensure sufficient interest.

The eventual public enthusiasm, whilst also opening the benefits of privatisation to a wider group, was also very effective at creating price ‘tension’ between individual investors and institutions and overseas investors. In all large sales, from the 1984 BT sale onwards, the department in charge retained the option of ‘clawing back’ those shares allocated to institutions and overseas investors if the individual investor applications exceeded expectations. Initially this meant a larger share premium on fixed price sales as the inevitable reallocation meant institutions felt they did not receive as many shares as they would have liked and therefore when trading began they sought to make up the difference. As time went on and more sophisticated methods were employed to increase competition between applicants the Government was able to use the interest from the general public to squeeze the institutional investors’ allocated portion more effectively and make the pricing of the shares tighter. Often the potential amounts that could be clawed back were clawed back in full, as shown in Table 5.

For example, in the initial 1984 BT sale the Government decided on a fixed price offer partly because of fears that a tender process would deter individual investors, especially if they were new to the stock market. It was also thought that institutional investors would treat the minimum tender price as a fixed price offer. In the end following the substantial public interest the Government exercised the option of clawing back shares provisionally assigned to institutions and overseas investors. The resulting loss of allocation to the institutions and their consequently smaller holdings is credited with the large share premium that resulted when the shares started trading.

“The eventual public enthusiasm, whilst also opening the benefits of privatisation to a wider group, was also very effective at creating price ‘tension’ between individual investors and institutions and overseas investors”

Table 5: Allocations in Privatisations

Privatisation	Individual Provisional Allocation	Final Individual Allocation	Increase
BT Part 1	N/A	38.6	N/A
British Gas	38.0	62.0	24.0
BA	32.0	45.0	13.0
BAA	46.0	47.6	1.6
Regional Water Companies	23.5	44.0	20.5
Electricity Generators	28.4	49.4	21.0
Electricity Regional Companies	34.4	54.6	20.2
BT Part 2	50.0	66.7	16.7
Average increase %			16.7
Median increase %			20.2

Source: National Audit Office

This ability to reallocate (or clawback) the share pool to give different weightings to different investors was retained for all the following privatisations. It enabled the Government to keep on using the public interest to generate the idea of scarcity and therefore create more competition and interest in the shares and consequently enable the Government to set a higher, more accurate strike price.

Likewise with the sale of British Gas a sale by tender was considered but rejected, again partly for the concern that it would deter individual investors. Once again individual interest meant there had to be a reallocation once the registration period was over, with 40% of the overseas and institutions offer being reallocated to the UK public.

The offer to overseas and UK institutions with the option of a claw-back of allocation meant that despite the large number of shares going on sale a sense of scarcity was created and the inevitable increase in interest helped the Government to achieve a tighter pricing of the shares than that seen with the first BT sale and a smaller subsequent premium of 12½p.

The desirability of overseas investors to create more competition and increase share price continued with the selling of the 10 regional water companies in 1989. 18% of shares were set aside for overseas investors, 55% for institutions and 23.5% for individual investors. However as with earlier sales the Government had the option of reallocating those shares if there was sufficient public enthusiasm. Initially though there was a lack of interest from the public for various reasons, not least an unfavourable media outlook, so the intended competition between individuals, institutions and overseas investors was rather muted, to the advantage of UK institutions. Nevertheless, the Government argued that “the overseas offers created demand for shares which would not otherwise have been tapped taking some £970 million of stock (before clawback) out of the United Kingdom market, and the Department consider that this assisted the pricing of the offers”.³⁶

There is always an in-built discount in the price of shares in a flotation due to the danger that the price will drop between the announcement of the strike price and the closing date for applications. When the shares were being offered

36 P46 National Audit Office
14/2/1992 – Department of
Energy: Sale of the Water
Authorities in England and Wales

on a fixed price basis the Government used this interest from individual investors served to make that discount smaller than it might have been, and thus enabled the setting of the strike price to be 'tighter'.

As the privatisation programme advanced though, methods of setting the strike price became increasingly sophisticated and able to exploit competition between the three main potential investor groups. BAA in 1987 became the first share sale that did not automatically accept a fixed price for all shares and considered operating a full tender process before settling for a part-tender instead. 50% of the offer was at a fixed price and available to the general public, 25% was also offered at a fixed price to institutions but the remaining 25% was only provisionally granted to institutions and could be clawed back by way of a tender. Both the fixed price and tender elements of the sale were oversubscribed, the fixed price allotment by nearly 10 times and the sale by tender portion by 6 times, paving the way for tendering being used to greater advantage.

The 1991 sale of Powergen and National Power once again rejected a full sale by public tender because of concerns it would put off individual investors but this time a proportion of shares allocated to overseas and institutions at a fixed price were able to be clawed back and reoffered on a tender basis and reallocated to the highest bidders. Simultaneously with sufficient public interest the individual portion of the shares was reallocated upwards from 28.4% to 49.4% adding additional pressure on institutions.

By the time of the second BT sale in late 1991 the Government was sufficiently confident in the level of interest they could expect from individuals and institutions that they felt able to run it on a complete sale by tender basis. They also wanted to extract maximum benefit from the creation of competition between the different types of investors so that in this sale the three types (individuals, institutions and overseas investors) were in direct competition for shares for the first time.

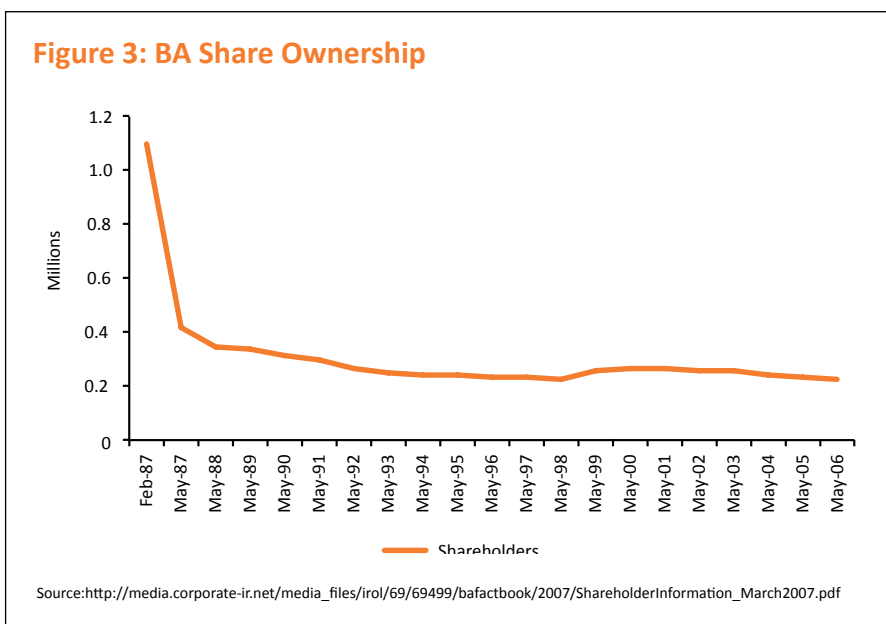
Half the shares on offer were offered to institutions around the world. There were ten regional syndicates including one based in the UK that were responsible for garnering interest from potential investors. To increase the eventual strike price the different syndicates could compete with each other for orders. The other half of the shares were provisionally assigned to the UK public offer aimed at individual investors. The price was not to be fixed until after the international tender had closed although individual investors were told that the shares would be payable in instalments and that the first instalment would be at 110p. After the international tender offer closed the Government then set the strike price taking into account current market price and demand from investors.

Book-building, first introduced in the Powergen and National Power sale, was also deployed here. Institutions had to say how much they would buy and at what price so the Government could provisionally allocate shares to the highest bidder and have a better idea of what price they could likely demand. The Government then announced that the allocation of shares between individuals and the UK and international institutions would be decided on the level of demand each section had shown. In the event only institutions that had made bids at or above the strike price ended up being allocated shares. Adding still further to the pricing tension to push up the final issue price.

Another consequence of this increased competition and sophisticated methods of predicting demand and price was that it was no longer necessary to underwrite all sales, significantly reducing the costs of the sale.

After the sale

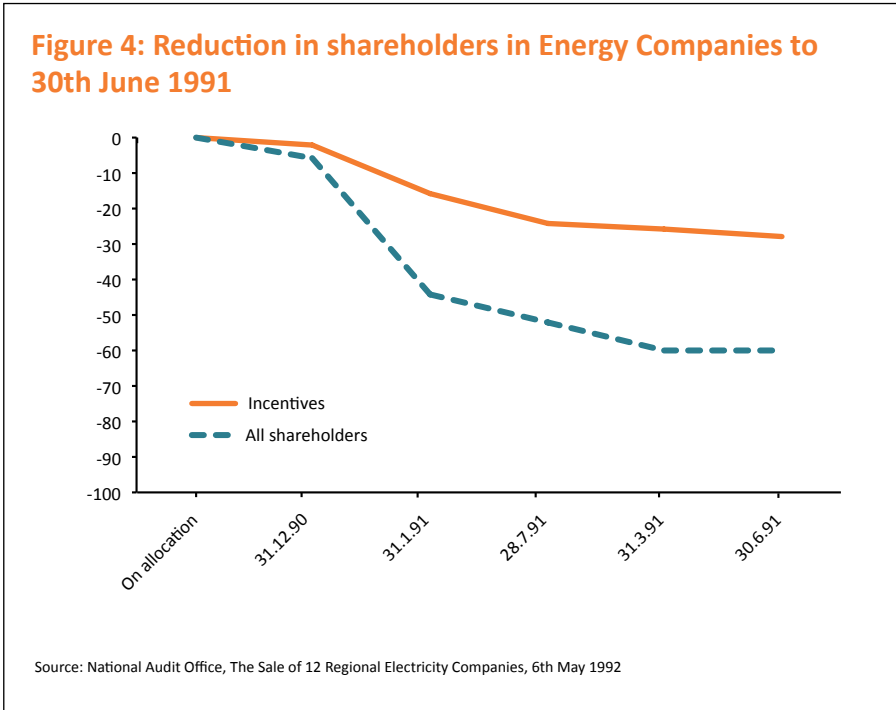
As has been seen public enthusiasm for acquiring shares in the new companies was constant throughout this period with millions of new investors regularly applying for shares. The Government didn't just want millions of new shareholders, however, they also wanted to create a stable after-market for the new companies to operate in (especially in those industries where there had been no market before). There was a worry before the first of the large sales (BT and British Gas) that the stock market would be unable to cope with a sudden flooding of new shares, especially on this scale (6.6 billion in the British Gas sale) but the markets even managed to cope with the 800 million British Gas shares traded within 90 minutes of dealing opening.



The very real dangers of flooding the market with cheap shares in the case of a failure at sale was one of the reasons the Government took the drastic action of stepping in and shoring up the BP shares on offer in 1987 (as discussed above). Happily this danger did not transpire in other later privatisations.

Generally speaking there was a fairly substantial drop in the number of investors in the first phase of trading and the larger the premium generally meant more people deciding to sell. However this initial activity steadied out over the following months and years. In the British Airways sale, for example, there was a fairly standard large drop in the first 3 months (from 1,100,000 shareholders to approximately 420,000) but this slowed and eventually plateaued out. Considering these shares were oversubscribed nearly 23 times resulting in the subsequent price spike it was inevitable that there was an immediate rush to cash in. Nevertheless, enough were willing to retain their investment to maintain a substantial number of shareholders.

Those who owned shares with incentives generally retained the shares for longer. For example in the sale of the 12 regional energy companies it was found that the rate of selling for those with incentives i.e. bonus shares granted after shares retained for a qualifying period was only 20% 2 months after dealings began compared with 40% of other shareholders.



In later sales as well the Government started to give preference to those institutions identified as more likely to hold the shares rather than sell them, which improved retention rates and helped in maintaining a more stable aftermarket.

Individual investors still make up a significant portion of the shareholders in the privatised companies. An unforeseen problem has been with a number of shareholders forgetting that they own shares in these companies. It is estimated that approximately 30,000 British Gas shareholders have forgotten they own stock which means not only are they losing out on the capital gains but also the dividend income.

Share performance in the intervening years has generally been very good. Capital return, as shown in the graph below, has generally provided a better return than that from the FTSE 100 as a whole. For those people who retained their holdings as well their stock is now worth considerably more. For example, it has been estimated that a minimum allocation of 100 British Gas shares costing £135 in 1986 would now be worth £1,720. The stock that has not performed so well, such as BA, which has delivered only half the return that would have been received if investing in the market as a whole has been in an industry that has received more operational and competitive challenges than perhaps others.

The success or otherwise of the different shares owes more to how well operated the individual companies have been rather than the nature of their original sale. The fact that most shares have performed well, that the market was able to cope with the placing of a large number of shares and subsequent heavy trading indicates that a more than adequate aftermarket was created.

De-Mutualisations

De-mutualisation naturally followed on from privatisation in the 1990s. Building societies were able to convert from being member-owned mutuals into public limited companies. Over 15 years many building societies went down this route. People who had savings or mortgages with the building society, held for a qualifying period, were given 'free' shares on demutualisation. For example, members of Halifax received an average windfall of 350 free shares which translated as £2,555.³⁷ Unlike the privatisations of the utilities members did not have to register or apply they just had to vote to demutualise then were granted free shares based on their accounts with the society. Inevitably, as they were given 'free' shares the numbers of people aggressively cashing in was large. There was no incentive to keep the shares and no initial payment price to recoup or to exceed to make a profit. Halifax went from 7.6 million people who had received shares in 1997 to just 2.2 million holding those shares by 2007. The sharpest fall was in Northern Rock where between October 1997 and October 2007 shareholders decreased by 79.7% but the median fall in shareholders in the 8 main societies demutualised was still 71% which far outstrips initial sell-off in the large privatisation sales of the 80s and 90s. As with the other privatisations there has been a similar problem in tracing unclaimed shares. Since the Halifax demutualisation, the largest at 7.6 million shares created, 75,000 haven't claimed their shares. Halifax have retained this as cash (£158million).³⁸ This was perhaps even more likely to happen as no payment or even application was required, making it even harder for people to keep track of what they owned/were entitled to and less concerned to follow their 'investment'.

37 The Guardian 13 October 2007 'Should you sell up now?'

38 http://www.unclaimedassets.co.uk/halifax_unclaimed_shares.htm

4

The Options for Privatisation

In privatising the banks there are a number of alternatives but in choosing the right one we probably should refer back to both the rationale for buying the stakes in the banks and the UKFI's mandate on selling them. The rationale was to recapitalise the banks, allow them to rebuild and then reprivatise them as and when they were ready to re-enter the private sector. The stakes in the banks were not bought as an investment. For UKFI there is a mandate to maximise the value, subject to financial stability and competition. As we have already argued we think the financial stability condition will be met by 2014 and with the sale of the branches by RBS and Lloyds new competitors are being created.

In our view the options on privatisation boil down to the following:

1. A staged sale to institutional investors, allowing the Government to sell the stakes with the best timing in order to get the best average price.
2. A traditional style privatisation with the Government offering shares to both retail and institutional investors at the same time. This could be done in stages as well.
3. A giveaway. Where the shares are simply given to the public for free as proposed by some including Nadhim Zahawi.³⁹
4. Distribution. This is where a large portion of the shares is offered to the public subject to the Government being paid back on sale of the shares, rather than on purchase. Again an institutional share offering could be made in conjunction with the distribution.

All have advantages and disadvantages which we will address in turn, but we believe that any privatisation has to be done in a way that will strengthen the banks and thereby allow them to compete on a fully commercial basis when back in private hands. In our view that means finding a solution that moves the banks quickly from the public sector to the private sector, while at the same time generating a stable share price and an opportunity for the banks to raise capital should they so wish. We also must be cognisant of achieving the best possible price for the Government in current circumstances.

The Chancellor also needs to consider the politics in this. A form of sale that means the share price is volatile is undesirable in any case but particularly so if retail investors end up buying a sizeable amount of shares. Similarly he would want to avoid a sale which leaves the shares vulnerable to some other investor being able to buy up a substantial stake in the banks, as happened with BP in

39 <http://conservativehome.blogs.com/platform/2013/05/from-nadhimzahawi.html>

1987.⁴⁰ Finally the Chancellor does not want to sell in a way that might lead him to being accused of selling the assets on the cheap, as Gordon Brown did when he sold some of the UK's gold reserves back in 1999.

We favour the distribution idea as we believe it meets most of the objectives with the least amount of risk, but first we will examine the other possibilities looking at both their advantages and crucially also their weaknesses. We should also highlight at this point that there are some options which are more feasible for Lloyds than RBS and the two banks do not necessarily have to be dealt with in the same way.

A staged sale

The arguments in favour of this method are simple. RBS and Lloyds have now reached the point where they are financially robust once again and are starting to generate profits. That should enable them to continue to rebuild their financial positions to the point where eventually they can even start to pay dividends. With the UK economy looking like it has turned a corner and other bank stocks starting to perform well it is only a matter of time before the share prices in RBS and Lloyds rise further to reflect this. Accordingly, there should be rising demand for bank stocks from investors which the Government can meet by selling shares in tranches. As conditions continue to improve and the overhang from the Government's stake reduces each sale should take place at a progressively higher price. Therefore even if the sales start well below the "in-price" there is a chance with later sales that higher prices will be achievable. In the meantime a clear message is sent to the markets that the Government is committed to selling down its stake.

This, as we understand it, is the strategy UKFI and the Treasury have had in mind since the last election. In many ways it does make sense. It is certainly right to wait for the banks to be in a better financial position before selling them and selling in tranches should provide the opportunity to avoid the downsides of the gold trade.

The problem is that it has taken longer for the banks to rebuild themselves and for the economy to recover than was hoped. The crisis in the Euro area certainly has not helped with the banks having to take significant writedowns on their euro assets, particularly in Ireland. It has also meant that it has taken longer to sell some of the impaired assets on the balance sheet as investors understandably have been reluctant to buy them given the uncertainty. The sluggishness of the UK economy has also exacerbated losses and made it more difficult to increase business. Then there have been the various scandals such as PPI mis-selling, Libor fixing and swap mis-selling, all of which have cost the banks very large amounts of money. Lloyds alone has provided for £6.8bn of losses on PPI. Without those provisions Lloyds fully loaded core tier 1 capital ratio would be over 10% compared to 8.1%. The story is not dissimilar for RBS.

All of these factors mean that the sale process is coming later than either UKFI or the Treasury had hoped for. As we noted earlier that makes things more difficult because we are now much closer to the next election and therefore the political risk premium investors will attach to any share sale that leaves the Government as a sizeable shareholder will be larger.

That does not mean staged sales cannot be a policy for the Treasury and UKFI, it just means they are more difficult and this weighs against the argument that

40 The Kuwaiti Investment Office bought a 21.6% stake in BP in 1987 shortly after the Government sold its remaining 31.5% stake in the company in October 1987.

you will get a higher price through such sales. As we mentioned in chapter 2 in our discussions with bankers and investors we have been told that staged sales to institutional investors probably could not be larger than £5bn each time, although some felt that it might be possible to do a slightly higher figure for Lloyds, and that there would likely need to be at least a year between sales to allow each sale to be digested. For Lloyds that would suggest minimum of two such sales, possibly three, while RBS would have to undergo five or even six rounds. At most the Government would be likely to undertake two such sales before the next election and possibly only one depending on when it judged that the banks were ready. We would assume any sales in 2015 would be unlikely as being too close to the election.

Since the Government is a 39% shareholder in Lloyds it is plausible that this stake could be below 15% by the time of the next election, with a fair following wind. At that point the Government would likely be considered by investors to be a genuine minority shareholder with little direct influence on the company. We consider that to be the minimum the Government should be aiming at in selling shares in both banks ahead of the election, since at that point private shareholders are the dominant force in the banks.

It would also seem more plausible for Lloyds since the share price at the time of writing sits right between the UKFI measurement of in price at around 63p (which includes fees paid) and the book price of 61p. It is well above the price of 53p that we calculate is the book price if you include fees.

Nevertheless, even if this is plausible for Lloyds, is it the best way to be selling the shares? One of the key problems is that private investors know the Government wants to sell the shares. Accordingly they do not have to buy them today, they can always wait for the Government to come to market. Since the Government would be a sizeable seller it would likely have to offer a discount to the prevailing market price. That is standard in almost all sizeable placings. It is difficult to know how much a discount would be necessary to “get the shares away” but there is likely to be one nonetheless. If the Government could get a higher price by selling Lloyds in a different way should it not go down that route?

Traditional privatisation

As we saw with the numerous historical examples in chapter 2 the UK has plenty of experience with privatisations, some of them very large indeed. The first BT flotation, in 1984, was for some £3.9bn, adjusting for the change in the level of the market since then that is equivalent to around a £25bn flotation today, compared to the Government’s stake £30bn stake in RBS. The British Gas privatisation was worth £5.4bn adjusted for movements in the market roughly £21bn. So very large privatisations are undoubtedly possible in the right conditions. It should be noted that both were part paid with the initial payments being roughly 40% of the total. That enabled investors to participate without having to pay the full amount of the cost of the shares. It was also the case that BT was sold in stages through this process with further issues of shares in 1991 and 1993. That would also suggest that the Government could do a privatisation in a staged process. Of course not all of the privatisations of the 1980s went according to plan and that of BP is a salutary lesson of what could go wrong if you happen to get the timing wrong. In this case it was the underwriters who ended up losing money through the privatisation but it could just have easily have been retail investors had the

stock market crash happened slightly later on. It also illustrates how shares can end up in the hands of investors that the Government finds politically difficult if something goes wrong.

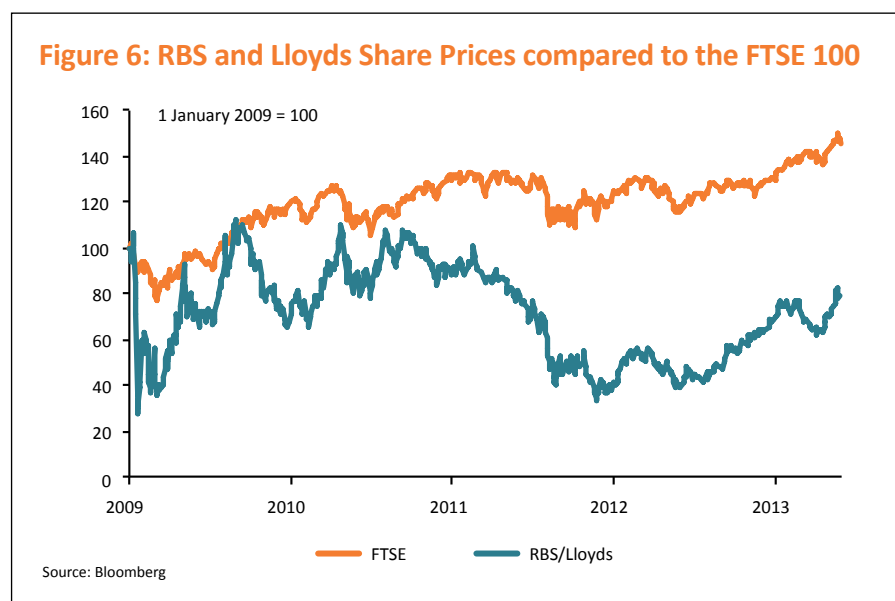
We believe a traditional style privatisation for the banks would be possible, particularly for Lloyds given the smaller size of the Government stake. A retail offering alongside an institutional placing could be successfully managed, not least if the sizing of the relevant offerings left the institutions underweight the stock.⁴¹ With retail investors alongside institutional investors a bigger proportion of shares could probably be sold in one hit, perhaps £10bn or even £15bn since the increased free float would make it more attractive to institutional investors as it would have a higher weighting in the index. It would also be more difficult for a future Government to reverse the sale or interfere with the bank if there was a sizeable retail (in other words voter) shareholding. That may well reduce the political risk premium which we highlighted as a problem in the staged sale option.

Nevertheless, it should be noted that most of the privatisations carried out in the 1980s were of utilities or utility type companies. These types of companies are generally regarded as safe by investors as they have stable cashflows. Despite the Government’s desire to de-risk RBS and Lloyds they are not utilities and they will likely be more volatile. Indeed, given the still substantial uncertainty about the Eurozone it is not implausible that should there be another shock there could be a sizeable drop in the share price post any flotation. Whether this happens or not and whether any share price decline is sustained or quickly reversed is of course impossible to know in advance. All we do know is that the share prices of the banks have been very susceptible to Eurozone shocks. In just the last year RBS shares have traded as low as 193p when Eurozone fears were at their peak compared to 335p at the time of writing, while Lloyds has been even more volatile trading as low as 25p compared to 62p.

That makes the shares a riskier proposition than a utility not just for the retail investors, but also for the institutional investors. For institutional investors a large proportion of shares being sold into retail hands also makes the shares more unpredictable. Retail investors may be unwilling to sit on losses and await a

41 Institutions would be underweight the stock if the percentage holding in the portfolio was below the percentage weighting in the index they tracked. Most investors would seek to close a significant underweight in order to reduce their tracking error. See the distribution section for a detailed description on how this might work.

Figure 6: RBS and Lloyds Share Prices compared to the FTSE 100



recovery in shares, so might be more likely to sell following any fall in the share price thereby exacerbating the decline. It is also the case, as we noted above, that retail shareholders have tended to sell out on the back of any significant profit. For institutional investors, that suggests that any discount they ask for in a share offering should be larger if retail investors are offered a sizeable holding.

Note also that were the share offering to be part paid as per the privatisations in the 1980s that would exacerbate the volatility of any share price movement, since the part paid share moves up and down as much as the full paid shares. As an example if you own a part paid share at £1.50 and the full share price is £3, then a 50p move in that full share price would also produce a 50p move in the part paid share price. The reason for this is that the rest of the payment for the shares is fixed, so providing your rights to the shares are the same as if they were fully paid (to receive dividends etc) then the price moves by the same amount not in proportion.

For the Government considering whether to sell the shares to the public this has to be a serious issue. It is one thing to sell the shares below the “in-price” to taxpayers so that they have the upside, it is another to see them lose money on the transaction. Of course if it worked well then the share price upside could be substantial too. The temptation to increase the discount to ensure that such a privatisation was a success like those of BT and British Gas would be very strong.

Any discount to make the issue a success would run into two significant problems. First, the Treasury mandarins have highlighted it is their role to ensure that the Government gets the best value for the shares⁴² (similar to the UKFI mandate). Second, any discount on the share price would probably have to be offered to all EU citizens under EU law. From a political perspective selling shares at a discount to non-UK taxpayers is bound to be awkward.

Moreover, a traditional privatisation is subject to the problem that only those who can afford it can participate, as you have to put the money up to buy the shares. So any benefit is restricted to those who can pay rather than those who, in effect, did pay to bail out the banks.

Given the size of any privatisation the logistics would be significant. First, to garner enough interest to ensure that the retail offering was a success there would have to be a major marketing campaign. Second, there would be the usual issues of dealing with large numbers of applications, either applying for different amounts of shares or at different prices. These can, we believe, be dealt with given modern technology and in particular the advent of the internet (remember in the age of BT and British Gas it was all done on paper or via the telephone). In addition there is a risk that not enough interest is generated and the sale has to be scaled back.

The risks for the Government in carrying out such a traditional style privatisation are, we believe, quite high. It could fail to generate interest in the first place or to generate interest a sizeable discount might have to be offered, in which case it has to be offered to EU citizens too. The sale might be a success but then an external shock might hit the share price, leaving investors (and importantly voters) nursing a loss. That might also risk the banks being open to buyers that the Government might not approve of. Finally, we doubt a privatisation could be executed in one sale because the numbers would be too big (particularly for RBS). It might be possible for Lloyds on its own but then we think an RBS privatisation would have to be delayed until the other side of the election.

42 The Times 20/5/2013 - Treasury opposes Osborne's RBS shares transfer to the public.

Of course the Government could choose to do institutional placings to sell Lloyds and a privatisation for RBS but we would argue that the retail investor (taxpayer/voter) should have the opportunity to participate in both since they bailed out both.

A giveaway

Before we move on to our preferred method of selling the shares via distribution we want to deal with the idea that the shares should be given away. There has often been a lot of confusion with the idea that shares should be distributed to taxpayers (with the Government being paid back on sale) and that of simply giving them away. Nadhim Zahawi is the most fervent proponent of the distribution idea arguing that taxpayers should be given the shares in RBS, as it would boost the economy and at one stroke “introduce a new generation to share ownership”.

We understand the premise behind the arguments but disagree with the idea for a number of reasons. First and foremost is the cost of giving away the shares. It would involve a major addition to the UK’s national debt at a time when

the Government is desperately trying to improve the fiscal position. Mr Zahawi is right that some of this would flow back to the exchequer in the form of higher tax receipts should the shares be sold and the proceeds spent and possibly from a wealth effect. However, that would be pale in comparison to a minimum of

£33bn or so write down to the national accounts that would need to take place.⁴³ If Lloyds were included as well the figure rises to close to £50bn.

Secondly, even if politically the cost were to be acceptable such a giveaway would be potentially de-stabilising for the banks. While the giveaway would trigger a re-weighting of RBS in the share indices, which means that institutions would have to buy some of the shares from the public, the fact is that the buying would fall well short of the giveaway. On calculations we have seen around 25% of RBS would need to be bought by institutions but that would leave another 56% without natural buyers. Should many more than a quarter of taxpayers decide to sell them it would start to overwhelm the institutional buying potentially sending the shares lower, possibly substantially. The evidence from the de-mutualisations is that shares given away are quickly sold. Indeed, the median reduction in shareholding was some 71%. Not all of this happened day one, but recipients of shares did at least have some link with the building societies concerned. This would not be the case this time round so in such a giveaway it would be reasonable to expect sizeable early selling. For the institutions this would make them wary buyers until they had seen the scale of the selling. While a large part of the current value of the shares would be transferred to taxpayers the upside would likely end up in the hands of professional investors.

The Government could, of course, deal with this via a lock up, where shareholders are restricted in the amount of shares they can sell over a fixed time period. That, however, could generate its own problems as investors would know when the selling was likely to come and pre-position for it. Whatever way

“Even if politically the cost were to be acceptable such a giveaway would be potentially de-stabilising for the banks”

43 This is based on our calculations, which take into account fees the Government has received. If these are not included the write down would be more than £37bn.

the Government deals with it, such a giveaway is likely to make the share price significantly more volatile. We believe that is the last thing the banks themselves would want.

Then there is the same risk as for traditional privatisation that someone else other than the institutions steps in to buy the shares.

Finally would the Government be able to give away the shares just to UK taxpayers? It could simply be argued that giving away shares is the same as offering them at a discount, albeit a 100% discount. That could mean that EU citizens might be able to apply for them. Given the potential profits from participating in a giveaway any attempt by the Government to keep it to UK taxpayers might well end up being challenged in court.

Accordingly we feel staged sales, traditional privatisations and giveaways all have potential problems. In the next chapter we outline the distribution proposal, which we believe overcomes many of the inherent weaknesses of the other methods of sale.

5

Distribution – the Best Way to Privatisise

The distribution idea was conceived by Portman Capital Partners LLP as a method of dealing with the Government overhang. The overhang is a function of the fact that the Government is the dominant shareholder in Lloyds and RBS and wants to sell the shares. That leads to investors who want to buy the shares having the upper hand because they can demand a discount. It also makes it easier for them to decide not to buy if the discount is not big enough, as they know that more shares will be for sale in the future. For Lloyds the situation is bad enough with the Government owning 39% of the stock but for RBS the situation is particularly severe with the Government owning 81%. Whether it is selling in tranches to institutions, or even a traditional privatisation, the Government is a forced seller of the shares. As a result it would have to offer a discount to ensure enough interest is generated to absorb the shares it wants to sell.

The idea behind distribution is to eliminate or dramatically reduce the overhang so that the Government, rather than selling at a discount, can actually sell at something approaching the fair value of the shares. It does this by turning a normal placing or privatisation on its head. Instead of the shares being paid for at the time of purchase, they are paid for at the time of sale. The shares are “distributed” to taxpayers who apply for them at zero initial cost, but with full rights to the shares. In other words once the taxpayer takes ownership of the distributed shares, they will have the voting rights to the shares and the right to receive dividends. This is important because with those rights the various bodies that determine index weightings like FTSE, Stoxx or MSCI should allow the shares to be counted as full shares. That in turn means that, unlike at the moment where the Government’s holding is excluded from calculating the weight of RBS or Lloyds in the index, post distribution the taxpayers shares should count. For RBS alone calculations show that this could trigger demand for around 25% of RBS stock by institutions, both those that directly track an index (like FTSE100 trackers) and fund managers who base their performance relative to an index.⁴⁴

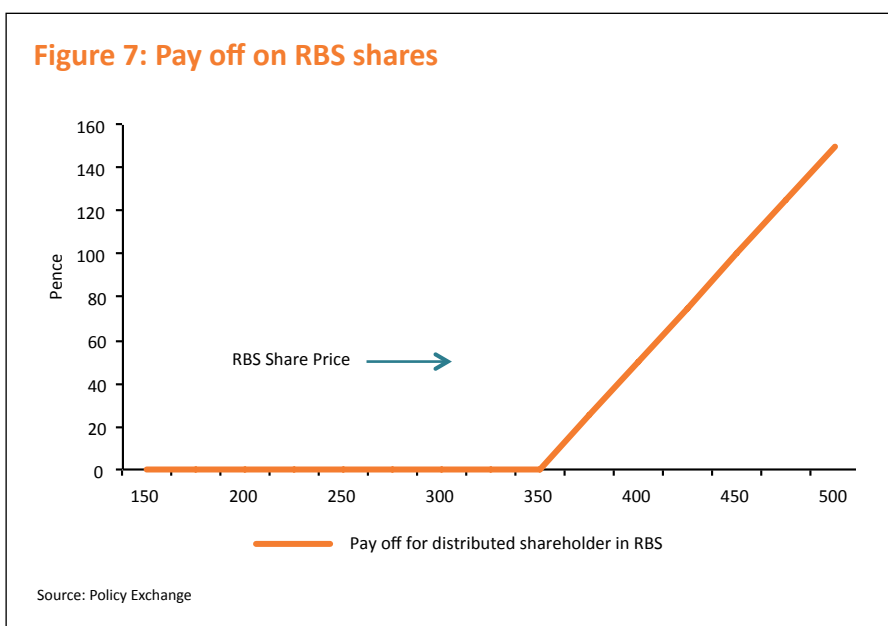
The more of its shares that the Government distributes to taxpayers the more shares that institutions would have to buy to bring them back in line with their index benchmark. Institutions, instead of demanding a discount to buy the shares, may even have to pay a premium to own them. This is similar to what happened in a number of the 1980s privatisations where the retail investor was favoured over the institutional investor to trigger a shortage of stock which the institutions then had to pay a premium to buy. This accounted for much of the

⁴⁴ Even those that do not directly track an index will likely have to buy some shares as most operate with what is called a tracking error, which limits their ability to deviate from the index by a specific amount, normally defined in percentage terms.

initial “success” of the privatisations, leading retail investors to cash in on quick profits. The beneficiaries in that case were the ones who had the money and time to apply for the shares. Structured correctly the distribution could benefit both taxpayers who receive the shares, since the share price should (other things being equal) rise after the placing and the Government who receive a higher price for the shares at the placing.

As we highlighted in the section looking at a traditional privatisation route for the bank shares, the key problems were likely to be one of encouraging enough retail investors to want to buy the shares, the discount you might have to offer to trigger that participation and the possibility that the shares might fall after the privatisation. We have already shown how you could turn a discount into a premium. The issues of attracting interest and preventing losses are interlinked.

Under the distribution scheme the government fixes the price it will receive when the individual taxpayer sells their shares. We will come back to the technicalities of that later on. For the moment let’s consider it in principle. If we assume that the share price of RBS shares is around 350p at the time of distribution and the Government sets 350p as the price it will receive when the shares are sold. This in effect creates a floor under all the shares held by the individual investors, since if the taxpayer has to pay the Government 350p back when they sell the shares no one is going to sell them below 350p. Hence you create a floor price.



Whilst extremely unlikely it is possible that after the distribution the shares never trade above 350p or indeed fall very quickly after the sale as in the case of the BP privatisation. Consequently under the distribution scheme you need to include a condition that if the shares are not sold within a certain amount of time (say ten years) they would revert to Government ownership. In other words the Government retains the downside in the shares distributed to the taxpayer until they are sold. From the Government’s perspective this is no different from the situation today in terms of the downside but the upside has been transferred to the individual taxpayer. The taxpayer/potential investor has no individual risk and so has much more confidence to participate in the distribution. If the shares fall

the taxpayer cannot lose money but if they rise they will make money. In financial market terms you this gives the taxpayer the economic equivalent of a free call option on the shares.⁴⁵ The payoff structure is shown clearly in figure 7.

That also reduces the political downside from distributing the shares to the public should something go wrong. This structure should ensure the share price has more upside than downside, other things being equal. However, no structure can guarantee that the share price does not react to an extreme external shock like a Eurozone blow up. Indeed, in this extreme case the Government might even have to put more capital into the banks in which case it would be better to have a structure where the shares could return to the Government. Under the distribution scheme this would not represent a loss to individual taxpayers – the same would not be true of a traditional privatisation.

The zero risk nature of the distribution structure should encourage participation by retail investors and because the shares are “nil paid” (i.e. it costs nothing to own them up front) it allows anyone to participate, whether you have the money to invest in shares or not. To us this is another sizeable political advantage for this

“The zero risk nature of the distribution structure should encourage participation by retail investors and because the shares are ‘nil paid’ it allows anyone to participate”

scheme – you can truly offer it to all taxpayers regardless of wealth or income. That marks it out in stark contrast to traditional privatisations where investors have normally had to pay money up front.

We also think it is important to ensure as wide a distribution as possible given that the shares are being sold below

the original “in-price”. That way taxpayers are getting the upside. Everyone remembers Gordon Brown’s disastrous sale of the gold reserves under the last Government. The current Chancellor does not want to be accused of doing the same with the banks. If you are going to sell them unintentionally cheap then at least do so predominantly to the people who notionally own them in the first place – the taxpayers.

This is why we like this scheme. It makes sense from a financial perspective in that it creates an environment where the shares can be sold for a better price than in a traditional privatisation or placing and does so by giving the upside to the taxpayer. The part of Nadhim Zahawi’s argument that we liked most was that you could use the privatisation of RBS (and Lloyds) to encourage a shareholding culture again. The distribution scheme provides a way of doing that without the downside of a huge cost to the Exchequer.

We also believe this scheme has two other key advantages. First it would allow a sizeable institutional placing alongside the distribution, since the distribution would generate institutional demand care of the re-weighting in the indices. Second, because of this factor should the banks need or want to raise capital⁴⁶ they would potentially be able to do so alongside any Government placing.

In a distribution form of privatisation there would be two main elements. First a distribution that would be open to any UK resident with a National Insurance number and who is on the electoral register. Second a retail and institutional offering at the same time that would allow institutions to buy some (but not all) of the stock they would likely need to match their index requirements and retail investors the chance to buy additional shares over and above what they will receive from the distribution.

45 A call option is the right to buy shares at a certain price (known as the strike price). You only exercise that right if the share price is above the strike price and by exercising it you will make a profit. If the price is below the strike price you do not exercise the option.

46 For example to accelerate meeting the eventual capital requirements that will be demanded by regulators. RBS is targeting a fully loaded tier 1 capital ratio of 10% by end 2014, it could use a capital raise to announce it had reached that target at the time of the privatisation.

The breakdown of that institutional and retail offering between sale of Government holding and any capital raise would be up to the banks and the Government.

Applying for the shares

We wanted to make the retail offering open to all taxpayers as it is the taxpayers that effectively bailed out and now own the banks. HMRC statistics show around 30 million people pay direct tax of some form. One option would be to limit the offering to them, but that obviously excludes people who have lost their jobs during the financial crisis, those who have not found one because the performance of the economy since the financial crisis and so on. Since pretty much everyone pays tax in one form or another, be it income tax, VAT, excise duty and so on it makes sense to have a broader qualifying factor. We have suggested that you would have to be in possession of a UK National Insurance Number and be on the UK electoral register for local elections. In that way you are restricting the scheme to those who are currently eligible for work and vote in the UK. It does not exclude EU citizens that are resident in the UK if they are on the UK electoral register and can legally work in the UK using a National Insurance number.

There are good reasons for this double check as there are more NI numbers in existence than the population of the UK.⁴⁷ That is in part due to NI numbers remaining in existence for a deceased spouse in order to receive benefits but there are also some inactive numbers too. In addition the total number of active National Insurance numbers in existence is around 55 million according to the DWP,⁴⁸ while the UK population over 16 is around 52 million according to the census. The number of people on the electoral register stood at 47.75 million at the end of 2012. From 2014 the Government is proposing that all registered voters will have to provide a date of birth and an NI number, so this system of eligibility would match what is being proposed for the electoral register from 2014.⁴⁹ We would also restrict eligibility to those over 18 at the time of the closing of the registration period to keep it to those able to vote.

For primarily logistical reasons we think the placing of the shares should not be automatic. This fits with the UK's approach to many other things including voting i.e. you have the right to vote but not the obligation. Similarly at Policy Exchange we are believers in equality of opportunity not outcome. So we think it is best that the offer is open to all, but only those who applied would actually get shares. To apply you would simply need a UK address, a National Insurance number and be on the electoral register. The logistics company overseeing the project could then cross check name and address with the electoral register and the NI number via the NI database. Given the large numbers involved logistics alone would suggest applications would have to be made via the internet, although clearly there could be alternatives such as a call centre or even in branches of the banks where people could have their details entered for them.

The individuals would be applying to receive shares that would cost nothing on receipt but with payment on sale. The way this might work would be for the shares to be given to the individual at no cost through a non-interest bearing, non-recourse loan from the Government. The shares would have to be held in a nominee account, with all share sales going through a centralised system. On sale of the shares the Government would be repaid at the floor price and the individual would have the profit from the sale paid into the nominee account.

47 <http://www.telegraph.co.uk/news/uknews/1550036/Fraud-fear-as-millions-of-NI-numbers-are-lost.html>

48 http://statistics.dwp.gov.uk/asd/asd1/adhoc_analysis/2011/ninostock.pdf

49 <http://www.electoralcommission.org.uk/voter-registration/individual-electoral-registration>

Money could either continue to be held in the nominee account or transferred to the individual's bank account. For those without bank accounts they could in theory take their details along to a participating bank or post office and withdraw any money sitting in their nominee account in cash (obviously subject to confirmation of identity). That way the scheme is not even dependent on individuals having bank accounts.

The nominee account would be structured in such a way that those who were interested could only apply for the account if they were UK residents with a National Insurance number, and were on the electoral register. This would circumvent the problem of having to offer all EU residents the scheme. We have confirmed with lawyers that such a mechanism would be unlikely to contravene any EU laws.⁵⁰ As additional assurance the floor price would have to be set at the same price as any placing into the market at the time of the privatisation. EU residents and institutions would of course still be able to take part in that placing at the same price.

For taxpayers you receive a free option to participate on the upside in the shares in exchange for a few minutes of effort in registering. Given the amount of press interest this idea has already generated⁵¹ we believe such a scheme would attract sizeable interest from individuals. Experience in the past of schemes where there is something available free of charge is that the take up tends to be quite high. Child Trust Funds for example had a 75% take up and offered £500 normally and £1000 for children in low income families.

There are no guaranteed returns from this scheme but publicity is likely to be high so we have assumed something between the 35-40% seen in local elections and the 65% average turnout seen at the last four elections. That would imply somewhere in the range of 17-30 million people applying for shares. We have deliberately pitched the range wide as in many of the privatisations in the 1980s actual applications came in lower than expected. Even at the bottom end of the range though it would be the biggest the UK has experienced by some distance. The Halifax de-mutualisation is the largest to date with 7.6 million people receiving shares.

One advantage of the scheme in comparison with a normal privatisation or share offering is that individuals would not have to decide at what price they were willing to buy the shares or how many they were likely to apply for. In the 1980s privatisations many people applied for multiples of the shares they actually wanted in order to try and get the best possible allocation. The way this scheme works is that the number of shares available would simply be divided by the number of applicants. The Government's current stake in RBS is worth around £30bn. If it distributed all of that and the top end estimate of 30 million individuals applied then they would receive roughly £1000 each of RBS shares. In terms of shares the Government holds 9,064.5 million shares, which divided by 30 million is a little over 300 shares per person. If only 15 million applied each person would get a little over 600 shares or £2000. The maths is relatively simple.

Since no payment is taken up front either there are no great complications about accepting people's credit cards, clearing cheques or ensuring bank transfers have arrived. Processing payments was of course a key problem that affected the Olympics tickets sales. So while it looks logistically difficult because of the numbers the simplicity of the system, at the outset removes some of the normal problems of a share issue. We are therefore simply dealing with numbers. And one thing the Olympics did show is that advance registering of millions of people is entirely workable.

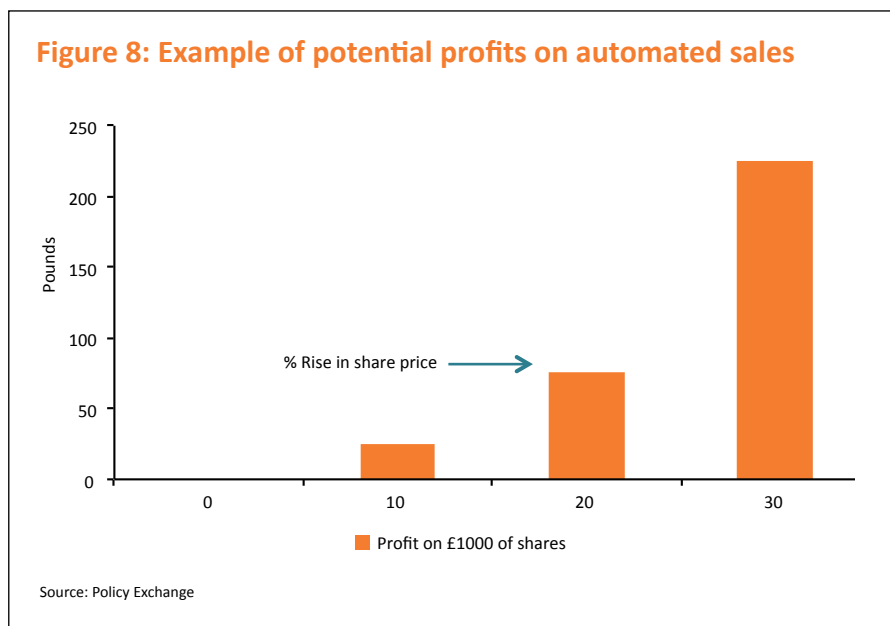
50 Paul Hastings, who are advising Portman Capital Partners in relation to certain elements of the distribution proposals, have determined that the qualifying criteria for participation is unlikely to offend EU laws on free movement of capital

51 See The Times 21/5/2013: Come and get 'em: plan to offer RBS shares at no risk

Selling the shares

If there is a complexity it is in the sale of the shares. This needs to be structured in a way that does not replace a Government overhang with a taxpayer overhang. The good news is that with the floor price having to be paid back at the time of sale no one is going to be interested in selling at the floor price or below. If we assume for arguments sake that the average share ownership starts at around £1000 then we doubt there are many people who would bother to sell for less than say a £50 gain as they would want some payback for having gone through the effort of registration. That would represent a 5% rise in the share price. Some might not want to take any profits before a 10% rise in the share price and others will be content to hold on for longer.

The evidence from the privatisations is that retail shareholders tend to either sell soon after receiving the shares or hold on for a long time. Some shareholders in the likes of Northern Rock never sold, seeing substantial gains turn into total losses. In part a failure to sell in situations like this tends to reflect the fact that people have forgotten they hold the shares, or that they know they have them but the fact is tucked away in the back of their mind, alongside “I will sell them when I get round to it”.



One proposal that Portman have suggested to deal with this is automated sales. Recipients of the shares would be able to opt to have their shares sold for them by an automated trading system. This has a number of advantages. First it takes away much of the hassle of having to sell shares from the retail investors. Ideally they would choose the levels above which they would be prepared to sell in advance and then let the computers do the work for them. As an example, an individual could choose to sell 25% of their stake once the share price had risen 10%, 25% more once it had risen 20% and the rest once the share price had risen by 30%. If we assume they have £1000 of shares then in this example they would see a total profit of at least £225 should the share price eventually reach and exceed a 30% premium to the floor price. The exact profit would not be known in advance as the shares would be grouped together and sold above the selling price, so in

all likelihood the profit would be more than £225. This example is shown in the chart above.

Alternatively they could just opt to sell the whole amount when the share price was more than 20% above the floor price. In that case, again assuming an initial £1000 of shares, they would receive a minimum gain of £200, providing the share price rose sufficiently. Another option might be to sell enough shares once the share price was 20% higher to repay the Government its floor price and then retain the rest of the shares. Instead of having £200 profit they would be left with £200 of shares.

There are a multitude of options but the key point is that these could be decided in advance leaving the individual happy that their shareholding is being dealt with as they want without them having to get back in touch with anybody. They could, of course, have the option of altering their preferences although you might want to limit the amount of times those preferences could be changed in any one month for example.

The second key advantage is that these sales could be aggregated together to enable economies of scale in trading. That would reduce execution costs for the individual holders and enable the brokers to join sales together to meet the larger size demanded by institutions. This is standard practice in today's markets and the shares would be sold at what is called the Volume Average Weighted Price (or VWAP). Simply put if 100,000 shares were sold over a day and 5,000 were sold for £1, 20,000 were sold at £1.10 and the remaining 75,000 were sold at £1.20, then the VWAP would be £1.17. In other words all shareholders whose shares were sold that day would receive £1.17. There would be no order of preference.

The third advantage is that other investors would have little or no idea of the preference of individual shareholders as to their selling price, as it would be an agglomeration of millions of individual decisions. So while there would be an overhang of sellers they would be above the floor price at unknown levels and unknown volumes at those levels.

The fourth advantage of this process is that the Government would likely (assuming the share price rises) receive a steady flow of receipts from the privatisation. And it would allow a steady flow of stock from retail investors back to institutional investors.

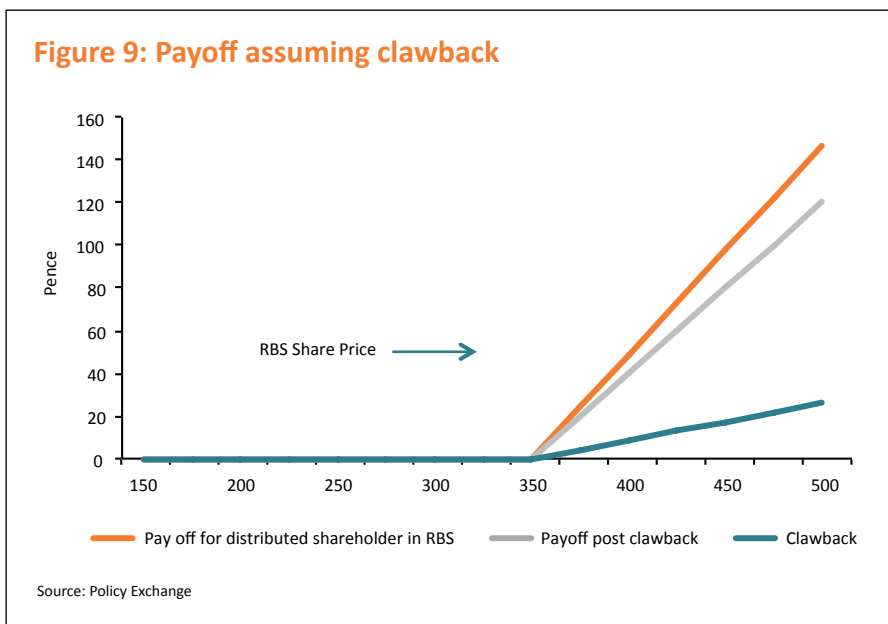
Finally it would reduce the chance of systems failing should everyone try and sell at the same time on the back of a press report or a particular surge in the share price.

Individual holders could, of course, decide to sell their shares themselves and there could be options through the internet account to execute either at the market price that day or with a fixed limit. Those orders could then be added into the mix with the other orders. They could also opt to own the shares at any point by repaying the Government its floor price, at which point the shares would need to be transferred from the nominee account to another account. We would expect brokers to offer such a service for those who wanted to do this.

All being well the shareholding structure of the banks would be shifted from retail to institutional over time, although hopefully some of the retail investors would opt to hold on to their shares having repaid the Government.

One other tweak to the system which we would suggest the Government considers would be for capital gains to be deducted directly on the sale of the

shares. Since the shares are being provided at no risk we think it is wrong for any gains to be offset against capital gains allowances. We would therefore suggest an 18% clawback to be introduced on any profits. The advantage of such a proposal is that the Government would benefit from any rise in the share price post the initial sale. This avoids some of the issues with the gold sale where it was deemed to have been sold too cheaply. This is most easily structured as a charge at the account level rather than a change in the tax code.



The alternative would be for the Government to hold on to a proportion of the shares to be sold later on should the price move higher. We would advise the Government to retain a small stake in case of any errors in the process or should the rise in the share price need to be smoothed in the aftermarket. In other words if for whatever reason there was not enough stock coming on to the market from individuals to meet institutional demand then the Government could supply that stock from its residual holding. Such a holding would probably need to be no more than 5% of RBS market capitalisation, although should the Government not decide to have a clawback it might want it to be higher. We would suggest though that any Government stake being held back be no more than 15%, simply because we want the Government to have no substantial ability to influence the affairs of the bank once privatised. Placing this final stake would not be problematic for the government and could be achieved at fair value.

How long would the scheme stay open for?

Of course there have to be back up plans should individuals fail to sell or repay the Government. This could happen for three main reasons. First the individuals opt to manage the share sale themselves and simply forget, second the share price fails to reach their trigger point for sale or third in the worst case the share price falls (perhaps because of an external shock) and fails to recover above the floor price.

The first two are dealt with simply by having an option for the Government to close the nominee accounts after a certain time period. Individuals would have the

option of selling any shares not already sold to repay the floor price in the ways detailed above or the shares would automatically be sold to repay the floor price with any surplus funds distributed to the individual after a certain date had passed.

Should the share price be well below the floor price the Government would have two options, either re-strike the floor price or to trigger a return of the shares to its ownership. The former would be possible, we think, only in the case where the share price had never really remained above the floor price for long enough to trigger sales. If a number of individual investors had repaid the floor price and made a profit it would seem wrong for those who had held on (presumably in the hope of a greater profit) to be bailed out. In such a situation it would seem better to return the shares to Government, as it could always carry out another distribution where everyone could reapply at the new floor price.

We would see the likely time period for keeping the system open to be a minimum of five years and a maximum of ten years. If the shares had not been sold over a ten year period then either a sale would need to be triggered or the shares taken back into Government ownership. With any luck the Government should be able to wrap the system up after five years.

The institutions

One of the key advantages of the distribution idea is that it facilitates a major institutional placing alongside the distribution to taxpayers. As we have highlighted above a distribution to taxpayers would increase the weight of the banks in the relevant indices. Analysis by a leading investment bank suggests that 35% or more of any large scale increase in RBS free float would need to be bought by institutions. For Lloyds given the larger existing free float, it is estimated that a distribution of the Government's stake would trigger demand for around 15% or more of its core of index re-weights. While some of the re-weighting might not take place immediately the institutions would likely see it as inevitable and act accordingly. Smaller placings though are estimated to trigger a smaller index shift. Accordingly it is estimated that if the Government were to do a £5bn placing in RBS, it would trigger a re-weight of only around 15%, so a mere £0.75bn of the placing. In contrast if the Government chooses to place its entire 81% holding in RBS then institutions would need to buy up to 28% of RBS shares in issue.

Even if the 19% currently held by private shareholders were to rise to 40% the institutions would still be around 7 percentage points short of the shareholding they would ideally have in RBS. They would need to buy it from the distributed shares. As no distributed shares would be sold until the price rose above the floor price institutions would be biased to participate in the offering that would take place alongside the distribution. This is exactly the same tactic used by the Government in the privatisations of the 1980s and 90s that we discussed in chapter 2, which proved very effective indeed.

That means three things. First and most importantly the Chancellor would be able to get a sizeable placing away to institutions and one that would be much bigger than a standalone placing. 21% of RBS currently would be around £8bn and 25% would be £10bn. Second the price he would likely get for that would be better since institutions would be prepared to pay up for it rather than demand a discount. And third it would provide a source of buying for those individuals who wanted to sell their distributed shares.

As highlighted above we would go one step further in allowing retail investors to participate in the institutional offering. Given the publicity there are likely to be retail investors who want to buy more than their allocation in the distribution. We would allow them to do so providing they agreed to pay the Government its floor price straight after the placing. This would be easily accomplished as their desired amount of shares in the offering would include their distributed amount which they would be guaranteed to get. We would like to include two incentives to do this. First we would make the shares where the floor price has been repaid ISA eligible, regardless of when the floor price is repaid. This would be over and above normal allowances, effectively meaning that any capital gain from the point that the floor price is paid would be tax free. Second any shares bought in the initial share sale would also be eligible for ISA treatment up to a maximum of a normal year's allowance.

Such a ploy would have two advantages. First, it would encourage people to pay the Government back up front, increasing Treasury receipts and second, it would add support to the placing. If, like in a traditional privatisation, there is a sizeable retail participation it would lead to the institutions potentially being scaled back more and having to buy more of the distributed shares in the aftermarket. Or it could simply allow the Government or the banks to place more stock in the initial offering.

Either way it allows HM Treasury to take control of the process in terms of the pricing of any sale through its ability to vary the book build process

Raising capital

One reason to do this might for example be to raise equity capital. The Financial Policy Committee of the Bank of England has been trying to encourage the banks to raise capital and in its recent analysis of the banks identified a £25bn shortfall, most of which was attributed to RBS and Lloyds. Although Lloyds has said that it has no need to raise capital and RBS is likely to try and avoid raising any more capital than it already planned, it might make sense to use any offering to strengthen their capital positions to the point that the markets could be convinced that the banks were fully capitalised to the satisfaction of the regulator. We saw recently how bank share prices can react positively to this when Deutsche Bank did a placing of shares and then declared that it needed no further capital.⁵² In addition that would probably accelerate the point at which the banks could pay a dividend again. Such a position would likely invite more demand from institutional investors.

For RBS in particular some form of capital raise would make sense since it would have to find the money to repay the dividend access share (DAS). This was put in place by the Government at the time of the implementation of the Asset Protection Scheme to bolster RBS' capital but also prevent it paying a dividend without incurring a significant penalty. Obviously if RBS wants to signal its ability to pay dividends, it needs to buy it back from the Government. The value of the DAS is put at between £1.5 and £2bn according to analysts we have spoken to.⁵³ So it would make sense for RBS to issue shares at the time of placement to, at a minimum, fund the repayment of the DAS.

The fact that you can raise capital at the same time is a big advantage of the distribution scheme over a staged sale and a traditional style privatisation. As for the option of the Government holding on to the shares to get a better price, that

52 Wall Street Journal 30/4/2013 – Deutsche Bank rallies on capital boost.

53 The exact valuation of the Dividend Access Share is a function of RBS share price and the redemption price for the Share would be a matter for negotiation between HM Treasury and RBS.

almost certainly prevents an equity capital raise in the foreseeable future as the Government has made it clear it has no desire to contribute to any such issue.

The allocation of shares

One of the key advantages of the distribution idea is that it allows the Government to control the allocation process in order to ensure that the offering is well supported. In terms of logistics we would propose asking the taxpayers to register for shares over a three month period after which the offer would close to allow the logistics firms to cross check the validity of the applications. The Government should know well in advance the number of applicants for the distributed shares.

It would then run a book build process for the public offering, which both institutional and retail shareholders would apply for. The Government would invite bids from institutions and retail investors within a range of pricing, built around where the shares were trading at the time. The Government would merely indicate the amount of shares likely to be on offer depending on the price.

The Government has (according to UKFI) 9.065 billion shares in RBS, which at a price of £3.50 would represent a holding of £31.73bn. Given that approximately 35% of this would be needed by institutions to top up their index weightings that represents £11.1bn. The Government would likely not want to allocate all of that £11.1bn to institutions at the placing as they would want some demand for the distributed shares post the offering. Then the Government also has to consider any retail demand from individuals.

As an example if the Government received say £3bn of demand from retail investors, it could allocate all of that. It could then issue a further £9bn to institutions taking the total raised from the offering to £12bn. In this example that would be enough to take the non-distributed shareholding to 50% of RBS. The remainder would then be distributed to taxpayers who had applied. If say 30 million taxpayers apply then they would receive around £660 of shares each. If only 20 million applied, then the number rises to a little under £1000.

Of course the key advantage of the structure is that it gives Government the flexibility to do what it wants within reason. It could announce that it has received 30 million applications ahead of the retail and institutional placing and that it intends to allocate a minimum of £750 per person. That would leave around £9bn for the retail and institutional placing. Given likely demand at that placing it could probably drive a higher price since institutions would know they were likely to be short of the stock. Given that the placing price would set the floor price for the distributed shares that would also drive that price higher.

The key is that the Government and its advisors would be able to control the process once they know how many individuals have applied for the distributed shares and should be able to ensure that the price is well supported after the placing by making institutions buy the distributed shares to top up their holdings. Again this is similar to the decision making process for the privatisations of the 1980s and 90s allowing the Government the flexibility to determine the allocation to adjust allocations to reflect both demand and its desire to give taxpayers a large amount of the upside.

The Government could of course also opt to retain a stake in RBS for sale later on. We would advocate them retaining a minimum stake of say 5% in order to allow them to supply stock into the market if needed post the placing and for any errors or omissions in the offering process.

Our advice to the Government would be to ensure that at least 40-45% of RBS was in the hands of traditional investors with 50-55% being distributed. Given institutions would likely be buyers post the placing and distributed shareholders sellers we would expect those ratios to swap over quite quickly after the distribution. Indeed, we would expect the distributed shareholding to fall steadily over time as any share price rise would trigger more of the automated sales we discussed above. Much depends on the path of the share price. The more it rises and the faster it does so then the more distributed shares would likely be sold. The fact that the distributed shareholders would be selling may provide something of a cap on the share price, but we would expect this to be mitigated by the gradual nature of the selling and by the volume-weighted approach we described above.

Were Lloyds to be floated in this way as well, the issues for the Government would be somewhat simpler. Lloyds is already majority owned by private investors so there is less need to think about the institutional allocation. That higher private ownership means that the institutional demand for Lloyds shares would only be around 15% of any offering. That is about £2.5-3bn depending on the share price. We think this is why the distribution offering also works well for Lloyds, since if the whole of the Government's remaining stake were put on the market in a normal privatisation it would not be clear in advance if there were enough buyers or whether the share price would need to fall to attract additional demand. If the Government instead offered say only £3-4bn to institutions and retail investors and the other £13-14bn to distributed shareholders we again think they could engineer a better price, while selling off the remainder of its stake, potentially in one go.

If we used the 30 million as the number of people applying for the shares we could have a situation where they would, in this example, receive around £660 of RBS shares and £450 of Lloyds shares. For the Government we think there are three advantages of this. First the public get a chance to participate in the upside in both banks and the amount of money involved is considerably more. Second you increase the chances of distributed shareholders being paid out on their application as you have two banks involved. Third, and arguably most importantly, it enables the Government to get both banks sold in one go before the election.

The risks

The key risks in this scheme are the logistics and what happens if the share price falls and remains below the floor price after distribution. On the logistics side we acknowledge that this would be the largest ever privatisation that the UK has seen. We believe there are likely to be between 20 and 30 million applications for the distributed shares making it three to four times as large as the Halifax de-mutualisation in 1997. It does though have several advantages.

First, advances in technology mean that the registration process and the management of the accounts can be done via the internet. In discussions we have had with logistics experts this dramatically simplifies the process and reduces risk. Of course, provisions will be needed for those uncomfortable with technology but through the banks' branches and call centres we believe this could be comfortably managed.

Second, the initial application process is quite simple. It is just an application for the shares. There is no money to be transferred and no prices to be entered at

which you would be prepared to buy the shares. There are the options for selling the shares that have to be entered but if the automatic sale options are entered that actually simplifies the selling process as it allows computer trading to do the hard work.

Third, as everything is to be held in a nominee account when the shares are sold the proceeds are held in this account. The applicant can either apply to have any funds transferred to their personal bank account, and supply the details accordingly, or they can be held in the nominee account. If the latter the individual could hold it until there is sufficient money in the account and ask for it to be transferred in one amount to their bank account or even arrange for it to be paid in cash at a bank if necessary. The nominee account serves as a buffer between the logistics firm and the individuals and allows for errors in things like account numbers.

Fourth, through the use of the NI database and the electoral register you can do a relatively straightforward cross check that can be used to capture incidents of fraud.

The IT we are looking at here is relatively simple. In fact it is little more than an advanced spreadsheet meaning that the risks of a breakdown are small. There are bigger issues once we get to trading and selling the shares but again we have been told these are not huge and with the nominee account system we do think it can be simplified enough to ensure it works smoothly. The key to the logistics working is for the Government to allow enough time to get the systems in place. Our discussions with the experts suggest a lead time of around 12 months from starting the process to the privatisation. That would mean that the Government needs to take the decision this summer for a second half 2014 privatisation.

Also on the logistics side shareholder voting has to be addressed. There has been some concern that there would be an enormous number of shareholders turning up at AGMs and lobbying groups encouraging shareholders to vote against the management on issues like remuneration. On the voting issue the terms of the nominee account would not give the right to attend the AGM but instead give the right to vote via the internet. As for the issue of lobby groups causing trouble there is not a great history of individual shareholders exercising those rights and more importantly by giving the benefits of owning the shares to the individuals we believe their interests and those of the bank will become more closely aligned. For a start both management and the distributed shareholder will want the share price to rise.

The other key risk is the share price falling below the floor price and staying there. Whilst unlikely this cannot be ruled out and we have seen how volatile bank shares have been in the last few years. They would be particularly susceptible to further problems in the Eurozone. Politically such an outcome would likely be deemed a failure of the scheme, but we think the downside is limited.

First, distributed shareholders would not incur any losses since they would not sell below the floor price.⁵⁴ This is the major upside of this scheme compared to a normal privatisation. There would not be the profits people had hoped for but no losses either. If needs be the Government could expire the scheme and re-strike the floor price. It could also wait. We have seen in recent years how shares have fallen sharply in the initial aftermath of a shock only to recover sometime later. If the scheme had a ten year lifetime we think the chances of the share prices remaining

54 There are various methods that can be employed to ensure that this is the case. The key one would be that anyone wanting to buy the shares when they were trading below the floor price would have to transfer money into the nominee account to effect the transaction. We doubt anyone would do this if they were warned that they would be incurring a loss to do so.

below the floor for the entire period are slim. And bear in mind both RBS and Lloyds will be much stronger banks in 2014 than they were in the earlier years.

Second, the Government would likely have got a much larger institutional placing away at the time of the privatisation than under almost any other scheme, particularly in the case of RBS. As we said above we would expect RBS to be 40-45% in the hands of non-distributed private investors compared to just 19% now. Lloyds would likely be more than two-thirds owned by private investors.

Third the risks of a major fall in the share price are actually reduced by the nature of this scheme. Since no distributed shareholders are sellers below the floor price, the price has an inbuilt stabiliser. Clearly that would not be enough on its own to ensure the share price did not fall but in comparison with other schemes it will, we believe, act as a dampener.

One final issue that has been highlighted is the ability of the banks to raise capital should they need to post a distribution. UK companies normally raise equity capital through a rights issue. This would mean offering the distributed shareholders the right to subscribe to additional shares. Some might want to do this, others would not. For those that chose not to the rights would be sold into the market as would be the case with any other rights issue. The distributed shareholders would have their holdings diluted, which would, other things being equal, lower the share price and impact on the amount of profit they could make. This would, however, be offset by the value received from the rights sold into the market. In reality, the ability of any company to raise money through a rights issue is driven by their ability to obtain underwriting. This is enhanced under the distribution scheme as the mechanism of the floor price already reduces downside risk.

In an extreme environment like a Eurozone breakup the Government would likely find itself subscribing to a new stake in the bank. As with the other examples we have discussed the outturn for the Government is better under the distribution scheme. If the Government had carried out a single isolated sale and still sat on the balance of its stake, it would have to subscribe for its share of the rights in any case. It would be in a worse position and, in the case of a traditional privatisation, would also be likely to face a raft of unhappy retail investors.

Overall, therefore, while the risks of this scheme are real we believe they are manageable. Moreover, this is not just our view, the investment banks and logistics firms we have spoken to believe the scheme to be workable. Given that the advantages of this scheme in terms of getting a better price for the Government, being able to float much if not all of the Government's stake in one go and, importantly, giving the taxpayers the majority of the upside in any rise in the share price we think it is the best all round solution.⁵⁵

⁵⁵ The whole process in terms of setting up nominee accounts for a large number of individuals might well create an asset in itself. Those accounts could be used for future privatisations, for example, or people could opt to use the money in the accounts to either support or invest in different causes like local infrastructure projects, which have little current ability to raise funds from individuals.

6

Conclusions

When the Government bought its stakes in RBS and Lloyds it was to support the financial system and give the banks the time and support they needed to rebuild themselves. Five years on the banks have made huge progress in improving their financial stability and by next year we believe both will be able to say that they have dealt the vast majority of their bad assets, have sufficient capital to meet the requirements of the regulatory authorities, be back in profit and be on the cusp of paying dividends again. As such they will be ready to return to the private sector as the then Chancellor, Alistair Darling, hoped when he made the decision to take the stakes in the banks.

We do not believe that banks should be state controlled as a matter of principle. The private sector is generally a better allocator of capital and while the errors of the banks in the run up to the financial crisis showed the private sector too has its flaws, both the banks and the regulatory system are better placed to deal with such issues in the future. We cannot support the ideas put forward to nationalise RBS and either break it up into regional banks or create a state owned business bank. Aside from the damage to the Government's fiscal position, which would be sizeable, neither in our view would have much to recommend it on a stand alone basis. Nor can we support nationalisation to create a good bank/bad bank structure. Again it would be expensive and not necessarily achieve the aims of those who support it. It would likely be conceived as state support for the good bank by the EU Commission which, we believe, would impose conditions on its operations that would limit the ability of the "good bank" to lend in the way its supporters envisage.

Even the idea of keeping the banks in state hands in order to get a better price later on has to be questioned. Governments do not make good holders of companies because they have a temptation to interfere. As we have pointed out, even the current Conservative Chancellor cannot resist saying what he wants the banks to do, and the Government's stake in RBS, in particular, allows all sorts of weird and wonderful ideas to emerge about what to do with the bank. That makes it difficult for the RBS management to recruit staff or manage the bank on truly commercial terms. Lloyds is less affected but it too is limited in what it can do, for example it cannot issue equity to boost its capital ratios should it find itself in a position to do so. Then there is the carry cost of not selling the banks, which we calculate at around £700m per year. In short we think holding on to the Government's stakes in the banks is more likely to be value destructive than value creative.

There are those who argue that the Government must wait to get the "in-price" for the shares before selling them. The price that the Government originally paid

was 502p for RBS and 73.6p for Lloyds according to UKFI figures. The current share prices are of course well below that. We believe that to insist on regaining these prices is both unwise and unnecessary. First of all the taxpayers' stake in RBS and Lloyds came about not from seeking an investment but rather to save the financial system. Second the price in the national accounts is probably a more accurate way to look at the "cost" of the stakes. This takes into account the share price on the day the shares were issued and any losses on that have already been taken in the national accounts. Adjusting for those moves gives 407p for RBS and 61p for Lloyds. Then there are the fees paid by the banks to the Government for the APS and in RBS' case the Dividend Access Shares. Deduct those and you can actually get to 53p for Lloyds and around 360p for RBS. In other words you can in theory sell the banks today for no net hit to the Government's accounts. For us this is the important fact, not what the Government originally paid for the stakes.

If the decision is made to return the banks to the private sector, which the Chancellor seems to have made,⁵⁶ then the question turns to how best to do so. The Treasury and UKFI's original strategy was to wait for the price to rise and then sell the banks back to institutional investors in stages. The problem is that it has taken longer than expected for the banks to return to full health and we are now less than two years from the General Election. Our discussion with investment banks suggests that no more than £5bn of Lloyds or RBS could be sold in a traditional placing in one go with the need to leave a gap between the placings probably of at least 12 months.

Such a method means that any stake would likely have to be priced lower in order to get it away for three reasons. Any placing of £5bn would not generate large institutional demand for re-weighting, so an incentive would need to be provided for them to buy it. Second, they would

know the Government had further stock to sell again reducing the demand to buy that particular issue. Third there would be a political risk premium for a new Government changing policy after the election. All three would require a discount, although the political risk premium would be lower for Lloyds.

Aside from the required discount the other key problem with a staged sale is that it would leave the Government a major shareholder into the election, particularly for RBS. There is simply no way that the Government could reduce itself to a minority shareholder through such a methodology. The increased uncertainty for the bank management teams alone would argue against this.

The traditional privatisation is an option for selling a much larger stake. It does, though, have substantial risks attached to it simply due to the size of any sale. It would be comparable to the biggest privatisations of the 1980s but banks being sold now are much more risky than the utilities sold then. A large retail sale would trigger an institutional re-weight but it would be unclear how much retail demand there would be. Any sizeable discount to encourage retail investors would have to be offered to all EU citizens as we understand it. Then there would be the risk of political fallout should the share price decline due to an external shock. With so much stock in issue the share price could be very volatile. We think it is simply too risky for RBS, although possible for Lloyds. The BP experience, which saw the share

“We do not believe that banks should be state controlled as a matter of principle. The private sector is generally a better allocator of capital”

⁵⁶ The Guardian – Osborne prepares grounds for RBS and Lloyds sell-off 22/5/2013

price collapse after the stock market crash and then the Kuwaiti Investment Office build a stake in the company is a salutary lesson in what could go wrong.

That leaves some form of distribution of the shares as the main alternative. We dislike the giveaway option for two main reasons. First the cost. The Government is in no position to write off close to £50bn at today's prices for Lloyds and RBS or even just £32bn for RBS. Second it would make the share price very volatile and potentially subject to other buyers like sovereign wealth funds building up substantial stakes on the cheap. We would expect large scale selling from taxpayers in the event of such a sale so that they could realise the money from the giveaway. In short we do not think it makes much sense.

The proposal we prefer is one where the shares are distributed to the taxpayer with a floor price that has to be repaid when the shares are sold. This particular method has the advantage that the individuals who receive the shares would not want to sell them below that floor price. That gives the share price a degree of support. Added to this a sizeable distribution like the one we are proposing would trigger a re-weight of the shares in the indices, and hence demand for the shares from institutional shareholders. The distribution could then be structured so that the institutional shareholders are not able to buy all the shares they need in the placing meaning they would have to buy any additional shares from those that had been distributed. We also believe a more traditional retail offering could take place alongside the institutional sale.

We would make the distributed shares available to anyone who has a National Insurance number and is on the electoral register. While there would be nearly 48 million people eligible, the fact that people would have to register for the shares means we would expect 20-30 million applicants. Should both Lloyds and RBS be included in a distribution as we suggest that could see somewhere between £1100 and £1650 worth of shares being distributed at current share prices.

What this method enables is a sale of a large tranche of the Government's shares to institutions while giving the taxpayer the bulk of the upside should the share price continue to rise. We believe the Government could operate a clawback at the capital gains tax rate of 18% if it wanted to take any of the upside in the share price post the placing. With or without this particular addition we believe this mechanism is the best to place a large portion (even all) of the Government's stake at the highest price ahead of the election.

While there are risks, both logistical and market wise should the share price fall, we believe distribution offers the best route to privatisation. We urge the Chancellor to take this method and apply it to both RBS and Lloyds giving the taxpayer an opportunity to profit from both and get the banks back into the private sector, where they belong.

When Alistair Darling decided to re-capitalise RBS he made a deliberate decision not to nationalise it so that it would be easier to privatise it in the future. It has taken much longer than expected, due to the Eurozone crisis, PPI mis-selling etc but RBS and Lloyds are now in the final stages of their financial rehabilitation. With both retuning to profitability this year we believe the time has arrived to start the process of privatisation.

We believe the right approach is for the Government to exit the vast majority of its shareholding in one go. We think that rules out a staged sale to institutions because it would simply take too long. A traditional privatisation would also be difficult to do in one step simply because of the size of the transaction. As for the idea of giving the shares away the cost to the Exchequer of close on £50bn makes it a non-starter.

We are therefore proposing the Chancellor uses a scheme that distributes the bulk of the shares to the taxpayer, around 70% of those shares in our proposal. This scheme would allow any taxpayer (those with an NI number and on the electoral register) to apply for shares in the banks. Those shares would be allocated equally amongst applicants for no up front payment, but with the Government receiving its money at the point of sale. If 30 million people applied we estimate they would get around £1100 of shares.

The price at which the Government would be repaid would be fixed at a normal offering of shares to both institutional and retail investors that would happen alongside the distribution. This immediately removes the Government overhang as no taxpayer would want to sell the shares below the repayment price.

That traditional placing can also be much larger because the distribution of the shares to taxpayers will produce a re-weighting of the shares in the key indices. We estimate that this could mean around 35% of the Government's stake in RBS and 15% of the stake in Lloyds would be required by institutional investors to meet the higher weightings. That should enable the government to place up to 30% of its stakes in the banks alongside the distribution, raising around £14bn at current prices.

We think the government should use this scheme for both Lloyds and RBS. It enables both privatisations to be done at the same time, well ahead of the election. It is the best mechanism for ensuring the highest price in the near term and a stable share price in the aftermarket. It also enables a sizable initial raise of money for the Treasury. Finally and most importantly it gives the taxpayer the chance to benefit properly from the recovery in both banks.

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