



Treasury Committee

Oral evidence: [UK Financial Investments Ltd Annual Report and Accounts 2014–15](#), HC 444

Tuesday 8 September 2015

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Members present: Andrew Tyrie (Chair); Mr Steve Baker, Bill Esterson, Mark Garnier, Helen Goodman, Stephen Hammond, George Kerevan, John Mann, Chris Philp, Mr Jacob Rees-Mogg, Wes Streeting

Questions 1-109

Examination of Witnesses

Witnesses: **James Leigh-Pemberton**, Executive Chairman, UKFI, and **Oliver Holbourn**, Head of Capital Markets, UKFI, gave evidence.

Q1 Chair: Thank you very much for coming to see us this morning. It is an important hearing; there is a lot of public money at stake in these banks for which you have oversight. Could I begin by asking: was the decision that you took and the advice that you gave on RBS decisive with the Chancellor, or did he take the decision and tell you?

James Leigh-Pemberton: We provided advice. We had been providing advice to the Chancellor and Treasury colleagues over quite an extended period of time, really since the time of the strategic review and the announcements made by management in February 2014. As we got closer to the point where the decision to make the sale was finally made, we had provided more and more advice. We made a recommendation.

Chair: But who triggered it?

James Leigh-Pemberton: I think it was our recommendation that they should proceed. We sent advice up prior to the completion of the Rothschild report, and the

Rothschild report was commissioned by Treasury probably to provide a second pair of eyes.

Q2 Chair: Can we see that advice, please?

James Leigh-Pemberton: Yes, by all means.

Q3 Chair: I think we should see the advice you put in prior to the Rothschilds report. Who commissioned the Rothschilds report?

James Leigh-Pemberton: HM Treasury commissioned the Rothschild report.

Q4 Chair: That is what it appears to say in the covering letter from Rothschilds. It is consistent with that. If you effectively initiated this with your advice, which I have the impression you were saying from your earlier remarks, why wasn't it you commissioning the Rothschilds report?

James Leigh-Pemberton: I presume that HM Treasury and Ministers, given the significance of that particular decision, wanted to get a second pair of eyes and some further advice on the topic, in addition to the advice that we had provided.

Chair: I see. They were second-guessing the advice being given by UKFI—checking that it was correct.

James Leigh-Pemberton: I think checking, yes.

Q5 Chair: Have you taken a look at the disclaimer on the Rothschilds report?

James Leigh-Pemberton: Yes.

Q6 Chair: I don't know how many of these passages I need to read out. "The information in this report has not been independently verified by Rothschild." They do not accept responsibility for any losses as a consequence. It goes on and on. It was written by a lawyer and you get used to these things in this litigious age, but it disclaims so much responsibility one wonders what the value of it is. It is pretty thin to start with. Do you think it has any value? What was paid for it?

James Leigh-Pemberton: It was commissioned by HM Treasury. I am not sure what the payment arrangements were, I am afraid. It is separate from us.

Q7 Chair: I think that might be worth having a look at too, don't you, so that we find out just what has been bought here from Rothschilds?

James Leigh-Pemberton: Yes.

Q8 Chair: This report calculated that there was a surplus on the holdings, if we get from the form now into the substance, that the Government had made—a profit—but that excluded the cost of funding. Is that the normal way of going about calculating whether you have made a profit or loss on an investment?

James Leigh-Pemberton: The OBR has published on two bases calculating whether there was a profit or loss. Probably both ways of thinking about it are right. Most fund management companies would report on the cost, today's mark-to-market price, make an assessment and deliver their analysis of whether their portfolio is in profit or loss without taking into account the cost of carry; but in this particular case, because of the opportunity cost associated with making the interventions, I can also understand very well that the cost of carry might want to be taken into consideration. As I said, there are two ways of thinking about it and they are both probably justifiable and right.

Q9 Chair: What is the number once cost of carry is included? You take us through the figures.

James Leigh-Pemberton: I think it would be a negative number. It depends on how you want to calculate the cost of carry. That is whether you use the real running gilt yields over the period or whether you take a single number. The OBR has taken a single figure and the OBR calculates that, after cost of carry, it is negative seven.

Oliver Holbourn: Mark-to-market based in July was a £14.9 billion gain pre financing costs and a £7.1 billion loss post financing costs.

Q10 Chair: You have heaps of commercial experience, both of you. If you were a commercial operation, how would you calculate cost of carry?

James Leigh-Pemberton: In a perfect world, you would calculate cost of carry by taking the real funding.

Chair: In the real world, not the perfect world, I am after.

James Leigh-Pemberton: In the real world also you would calculate by taking the cost of the real funding that was incurred and apply it against.

Chair: That is not quite the same as the OBR's calculation. Correct?

James Leigh-Pemberton: As taking a straightforward single number. Yes.

Q11 Chair: In that case, we had better have your assessment of the cost of carry, based on your best effort of the way it would be done in a commercial environment. Fees have also been included as a gain. Is this common practice in the private sector?

James Leigh-Pemberton: Yes. If you made an investment and you charged the investee company fees during the lifetime of that investment and they were paid by the company, they would be taken into account in the overall profit and loss account associated with making the investment.

Chair: But the fees have bought something. The fees are in exchange for risk transfer, are they not?

James Leigh-Pemberton: Correct, but those risks have been discharged. In the case of APS, the fees were charged; the risk was taken; the risks have been discharged and the fees were therefore realised in their entirety. In the case of the dividend access share, the first payment has been received and the second payment is contractually due. In a private sector context, it would be perfectly justified to include those in the overall return on the capital that was invested.

Q12 Chair: When this figure of a surplus on the bank bailouts of £14.3 billion was published, you already knew all about it. You had been through it very carefully and you thought it was correct, and not in any way misleading, to publish it as the central headline figure for the balance—the cost and benefit—of the bailout. Is that right?

James Leigh-Pemberton: No, it is not quite correct, because we do not, in our work, spend a significant amount of time thinking about the in prices and/or the fees that were charged at the time. When we do our valuation work and make our determinations about when appropriate opportunities to sell might materialise, we think about the current and future prospects of the assets that we have responsibility for and whether the market valuation reflects those and gives good value to the taxpayer. We do not think carefully about the in prices.

Chair: Just to let you know, if it is agreeable to you, we will drop you a line setting out what we would like you to supply us with, which I have already touched on in these exchanges.

James Leigh-Pemberton: Yes, by all means.

Q13 Helen Goodman: You told us something very interesting, in that you had already given advice to the Chancellor of the Exchequer. Did you have any further arguments, in addition to those that are in the Rothschilds report, for going ahead with the sale at this juncture?

James Leigh-Pemberton: We have our own valuation work, which we rely upon. We did not rely upon the valuation work set out in the Rothschild report. We have our own procedures for assessing whether the market price is good, fair or bad value for the taxpayer, relative to our own views on the current and future prospects of the bank. We had done all our own valuation work, so I think that would be supplementary to what was included in the Rothschild report. That is what we are required to do under the terms of our mandate.

Q14 Helen Goodman: The Rothschilds report set out a potential paper loss of £7.2 billion, but it also set out a number of public benefits. The weakness, it seems to me, is that those public benefits have not been quantified in any way at all. We do not know whether they are worth £100 million or £10 billion. Did you make any quantification of the public benefits?

James Leigh-Pemberton: The benefits of proceeding with this sale that we identified were, first, that, in the context of the size of the Government ownership in RBS, the disposal process will have to continue over quite an extended period of time. In order for that to be successfully executed, it is important to establish a liquid and actively traded market in RBS shares. The first benefit was indeed to do that and to prove that there was good, deep demand from the market for RBS stock. And secondly, to begin the process of signalling to the market that the Government overhang was going to diminish over time, which would enhance the marketability of the stock in future.

Q15 Helen Goodman: Why did you not use the system that you have used for Lloyds of deciding on a reasonable price and dribbling the stock out?

James Leigh-Pemberton: The key reason is that before this most recent placing only 20% of the issued share capital of RBS was traded in public markets. In order for those daily sales to be effective, there has to be a deep and liquid market with plenty of trading in the shares to enable our sales to be absorbed in that normal run-of-the-mill trading activity. With only 20% of the issued share capital traded in the market, there is not a liquid enough market for a trading plan like Lloyds to work well. The average daily volumes in RBS are very much smaller than the average daily volumes traded in Lloyds, and we have a restriction on the percentage of average daily volume that we can be in the Lloyds trading plan.

Q16 Helen Goodman: One of the arguments that was put forward in the Rothschilds report, which was what was given to Parliament—that is why we are relying on that rather a lot—was that “market conditions for financial assets and bank shares are currently good”. You sold the second, August tranche in the middle of the collapse in the Chinese stock market. Would you say that market conditions were still good at that moment?

James Leigh-Pemberton: If I may say so, we actually sold before that sell-off started. The material sell-off came only in the latter two weeks of August, and the first signs of it in the second week of August, but most indices had been pretty stable in the course of the last two weeks of July and the first week of August.

Q17 Helen Goodman: May I ask you some questions about your remit and about UKFI's objectives? One of the things that you are trying to do is promote high standards in the banks where the taxpayer has a big holding and be consistent with Government policy. That is right, is it not? I think that is No. 1 of four or something.

James Leigh-Pemberton: Yes. We are trying to ensure that the standards of governance and the standards of management are conducive to good conduct, which is conducive to good shareholder value.

Q18 Helen Goodman: Are you conscious of the inquiry that Coutts is having at the moment—Coutts is a subsidiary of RBS, just for the benefit of colleagues—into the marketing of tax avoidance schemes in Switzerland?

James Leigh-Pemberton: We are aware of all of the regulatory inquiries that are going on inside RBS, yes.

Q19 Helen Goodman: Does this raise any concern for you?

James Leigh-Pemberton: Yes.

Q20 Helen Goodman: What have you done about it?

James Leigh-Pemberton: We have regular meetings. We have regular engagement with RBS, both at the board level with the executive directors and also with those who are charged with legal and regulatory conduct affairs, to ensure that we are aware of the steps that they are taking to reduce the risk of any future material conduct issues.

Q21 Helen Goodman: Do you have concerns about the behaviour of Coutts in the time when RBS shares have been held by the taxpayer?

James Leigh-Pemberton: Yes, we do. That is one of the reasons publicly stated—and this was a decision that was made by the board and by management—why Coutts International, the non-UK part of Coutts, has been sold: because it falls outside the current risk appetite parameters of the board of RBS.

Helen Goodman: You are saying that the reason for selling is that the practices were controversial. Is that what you are telling me?

James Leigh-Pemberton: It is one of the reasons. It is not the primary reason. The primary reason is that RBS is refocusing its activities so that the vast bulk of its capital is devoted to serving clients in the UK. Therefore, it is natural as part of that strategy for Coutts International to be sold. Among the other reasons why Coutts International has been sold is that the risk appetite of RBS as a whole, which has been adjusted to take account of the fact that the risks of misconduct must be mitigated, no longer includes the type of activities that were being undertaken by Coutts International.

Q22 Helen Goodman: Okay, but since one of your objectives is to raise standards among the banks, why did you not sort out this issue before agreeing to the sale?

James Leigh-Pemberton: We do engage with the banks in relation to specific areas of conduct, but, because we are not engaged in the day-to-day management of the bank, it is very difficult for us to do so until those have emerged. We try to identify risks in the future but, most normally, as any institutional shareholder, what we will seek to do is to understand the implications of things that have happened in the past and what steps are being taken to mitigate the risks in the future.

Q23 Helen Goodman: One last question: did you report to Treasury Ministers when you discovered that this was going on?

James Leigh-Pemberton: We keep Treasury Ministers regularly informed of every conduct item that we find out about in our dialogue with both of the banks.

Q24 Stephen Hammond: Mr Leigh-Pemberton, in your evidence to the Chairman, you said that HMT commissioned the Rothschilds report but it was on your advice that the Treasury decided to sell the stake.

James Leigh-Pemberton: I think it is important to say that we provided advice and it was indeed on that advice that the action was finally taken, yes.

Q25 Stephen Hammond: You will have seen that the Minister, Harriett Baldwin, has said that Mr Osborne took the decision following advice from the Bank of England's Governor. I am trying to work out in my own mind what the balance of that advice is and how you fit into that triangle.

James Leigh-Pemberton: The only thing that I can say in relation to that is that we wrote a letter on behalf of the board of UKFI, on the afternoon of the sale, formally

confirming the board's recommendation that the sale represented good value to the taxpayer and could be successfully executed at a price that represented good value to the taxpayer. So far as we are concerned—I can only really speak from our perspective—that was the determinant that then allowed the sale to go forward. No doubt, given the seriousness of the decision, Treasury colleagues and Ministers will have taken the views of a number of others, but that is an activity that is separate from our own.

Q26 Stephen Hammond: Just returning to the remark about when is an apposite time to sell in terms of market conditions, I do take your point that the major sell-off was the latter two weeks of August, but if you look at the trends, certainly of indices, since that advice was given in June, there had been a consistent trend downwards. While it is a normal asset management practice to look at the current market price and the in price, can you tell us some of your thought processes? You see the market drifting. Was this just a panic sell—"we need to get some out at this price to create a free float later on"? Could you not have said, "This is a bit of a panic; it might correct itself, and therefore we should be waiting"?

James Leigh-Pemberton: I might ask Oliver to say a little bit more about that in a moment, but the key determinants of our decision-making are threefold. The first is whether the opportunity exists because of investor demand. This offering was well over-subscribed; there was deep investor demand on the day. The second is what the price point that is achievable in light of that investor demand represents in relation to the quoted market price. That is, "Is the relationship between the clearing price for the large parcel of shares and the current market price close enough to represent good value?" The third is what the price point represents relative to the fundamental valuation of the current and future prospects of the bank. All of those things were satisfactory from our point of view at the time that the sale was made. Overall, I think markets were satisfactory at that time. Oliver, I don't know whether you would like to add anything about market conditions at the time.

Oliver Holbourn: We just have to remember, in the context of overall markets, that we are in the sixth year of a bull run in equities. From a big-picture perspective, the market conditions for the sale of financial assets could be considered exceptional given what is going on and the amount of money that had been put into the system through quantitative easing. Notwithstanding your point that there was some weakness in the Chinese market specifically in June and July, European and US indices were at or very close to all-time highs.

Q27 Stephen Hammond: On a technical point, given that this was an institutional offer, did you consider any other instrument of sale?

Oliver Holbourn: We took advice from our privatisation adviser to consider all possible methods of sale. We decided for the first sale that this was the best way to maximise value for the taxpayer.

Stephen Hammond: You did not consider doing a mandatory convertible bond into RBS strike price 400p.

Oliver Holbourn: Equity-linked options are part of our toolkit. We had a long discussion as to whether an optional exchange or a mandatory exchange would be good value for the taxpayer. We decided for various reasons that it wasn't, and that a straight sale was the best way to go in this instance.

Stephen Hammond: If there is any view on that that you can share with us, it would be very helpful. It is an important point.

Q28 Chair: Can we have the various reasons on a piece of paper?

Oliver Holbourn: Absolutely.

Q29 Stephen Hammond: May I ask one last question in connection to the sale? Given what Philip Hampton had said on 30 July, how much weight did that have on your decision to proceed on 4 August?

James Leigh-Pemberton: Are you referring to the itemisation of the various risks?

Stephen Hammond: Yes, and the explicit remark that he thought that the share price would reach £4 at least in a year's time, once RBS had absorbed the expected fine from the US regulator for its subprime mortgage policies. He said that on 30 July and on 4 August you chose effectively to disregard that advice. I guess that is the answer.

James Leigh-Pemberton: I come back to the point that the value of the shareholding is very large and, following the sale that we made, it is still £28 billion. So there is significant taxpayer exposure to both upside and downside in the future. We are always careful not to make the assumption when we do our analysis and give our advice that things are only going to get better, because experience would tell us that that is far from the case.

Q30 Stephen Hammond: You say you speak to the management a lot and clearly that would be normal practice, but can you assure the Committee that you have taken the appropriate advice so that you do not become an insider, or become classified as such? There is clearly only a certain amount of information that management can give you, and you potentially are an insider both ways, if you are not careful.

James Leigh-Pemberton: I can give you absolutely that assurance. We have a very carefully designed protocol for information exchange with the management team of RBS, which has been developed by ourselves, our legal advisers, RBS and RBS's legal advisers.

It looks very much like a normal institutional investor's information exchange framework. We have the same in relation to Government as a whole, from the other side. There is information that HM Treasury comes into possession of from time to time, and we have a careful system to ensure that, when we make our sales, all the information that we have is in the public domain.

Chair: I think we had better see the documentation for that too, please. There is quite a bit of risk here associated with information that could lead to allegations of insider trading.

Q31 Stephen Hammond: Two last questions, if I may. Your objectives state that you maintain a dialogue with institutions. Could you give some flavour as to the breadth of those institutions, given that at least some of the trade organisations might be regarded as ineffective at the moment?

James Leigh-Pemberton: I will ask Oliver to give you some details in a moment, but it is worth saying that this dialogue goes on on a one-on-one basis; we will go and have meetings with individual institutions, or they will come to us and have meetings. We are not restricted just to trade bodies. We do talk to entities like the IMA, clearly, but we do have a lot of meetings with individual investors.

Oliver Holbourn: The process of gathering and obtaining market intelligence is one that is very important to us. We put together, shortly after we joined UKFI, a list of institutional investors that we thought it would be sensible to try to keep in contact with on a fairly regular basis. To date, I can tell the Committee that we have had more than 60 meetings with institutional investors of one sort or another during the course of this year. That number last year was closer to 80 or 90 meetings. We have a very regular dialogue on a one-on-one basis with these investors. It is very important to say that we do not actively solicit indications or orders in the assets that we own; it is just a process of gathering market intelligence and an exchange of views on a range of topics.

Q32 Stephen Hammond: Post 4 August, have you had any meetings? What are investors saying to you in terms of what they see as the future prospects?

Oliver Holbourn: We have had one or two meetings in the course of August. We have a discussion as to what is the art of the possible going forward. We always stick to publicly available information. The institution that we spoke with in August happened to congratulate us on what they thought was a first successful sale, and then we had a range of discussion around what the future sales format might look like. With the management teams at RBS and Lloyds, we had a discussion about the regulatory environment and various other things. It is always a broad range of topics that we seek to discuss.

Q33 Chair: Are you exempt or in any way protected from recourse in the courts by counterparties?

James Leigh-Pemberton: The entities with whom we contract are banks.

Chair: If it turns out that this information exchange framework is flawed, can you get sued in the normal way?

James Leigh-Pemberton: We, as an organisation and as individuals, are subject to the law. Insider trading is a matter of the law. Insider trading legislation is a matter of the law.

Chair: You are a company.

James Leigh-Pemberton: Yes, we are a company, but the law provides that individuals who have engaged in insider trading also are liable.

Chair: So you have a considerable interest in making sure you get this right.

James Leigh-Pemberton: Yes.

Chair: Beyond professional pride.

James Leigh-Pemberton: I was just going to say, before we get to that point, our *raison d'être* requires—the existence of the company requires—that we should meet the highest standards in all respects.

Q34 John Mann: Is one of your objectives to make RBS smaller and safer when it is fully privatised?

James Leigh-Pemberton: Yes, I think that is a—our objective is to enhance and protect the value associated with our shareholding. One of the principal ways of doing that is to ensure that the taxpayers' capital that is invested in the bank is allocated to businesses that produce a return above the cost of that capital. Any capital that is allocated to businesses that do not produce a return above the cost of capital is being lost slowly, over time. That overarching objective is also the objective of the management team and the board. If, as a result of that, there are businesses that they are exiting from and they are becoming smaller, and in the process safer, that becoming smaller and becoming safer is driven primarily by the desire to ensure that taxpayers' capital is applied to businesses in which RBS can generate a return for the taxpayer.

Q35 John Mann: Was the Rothschild report superfluous to need?

James Leigh-Pemberton: HM Treasury and the Ministers who commissioned the report will have made their own assessment.

John Mann: I am asking you.

James Leigh-Pemberton: From our point of view, we had done our own work and we had given our advice, and our work was approved by our board and our advice was approved by our board, so we had done what we were required to do.

John Mann: In your judgment, the Rothschild report was superfluous to need, then.

James Leigh-Pemberton: No. I—I think that given the seriousness of the decision and the importance of the decision, I can absolutely understand why getting confirmation and/or an alternative view is something that the final decision maker would want to do.

Q36 John Mann: Was the Goldman Sachs work they did for you on this, good value for money?

James Leigh-Pemberton: Yes. Goldman Sachs were paid £1 for their work.

Q37 John Mann: Are Goldman Sachs conflicted, considering that they are also bidding for UKAR mortgage assets?

James Leigh-Pemberton: No. We are absolutely satisfied with the arrangements for separation between the information flow in relation to Lloyds and RBS, which is what the Goldman Sachs privatisation advisory team are engaged by us to do. There is no flow of information from that team to any other part of the bank. They are two completely separate exercises. The UKAR disposal exercise is a separate exercise from what we are doing with Lloyds and RBS.

Q38 John Mann: Have you spoken to other shareholders in RBS about whether they have any concerns?

James Leigh-Pemberton: We have never asked the question explicitly, but in the 60 or so meetings to which Oliver referred I don't think the topic has ever come up.

Q39 John Mann: I am struggling to work out why you still exist. Why do you still exist? Are you needed?

James Leigh-Pemberton: We believe that the governance arrangement that we have in place, which is a very clearly defined mandate to operate at arm's length from Treasury and from Ministers and to include private sector experience of both managing investments in banks and executing transactions, is of value to colleagues in the Treasury and to the taxpayer.

Chair: We are going to come back to that later on in this session with another colleague.

Q40 John Mann: With that expertise, is it your judgment that the Government mistimed the sale?

James Leigh-Pemberton: No. We gave explicit advice, for the reasons that I described earlier, setting out our view that that was a good time to begin the process.

Q41 Bill Esterson: You said earlier you felt the sale demonstrated good value for the taxpayer. When you say “good value”, is that short-term good value or long-term good value?

James Leigh-Pemberton: It is good value in relation to our current assessment of the present and future prospects of the bank. The share price may go up, may go down, but relative to everything that we knew at the time and given the amount of demand that could be identified, the conditions that would realise good value for the taxpayer were satisfied at that time.

Q42 Bill Esterson: I also noticed earlier you said that investor demand was very high yet you had previously said that one of the reasons you felt this was the right thing to do was to create a proper market and liquidity. It seems to me, putting those two together, that liquidity was never going to be a problem if demand was so high.

James Leigh-Pemberton: No. I think that in fact it may—it is difficult; we will only know with the passage of time, but it may have been that one of the reasons why certain investors were prepared to commit themselves in the sale, not having been prepared to commit themselves to the stock in the open market previously, was precisely because the sale created a more liquid market in which they could trade more actively the investment that they had just made in the sale.

Q43 Bill Esterson: Is that because it was very cheap?

James Leigh-Pemberton: No. I don’t think it was cheap. On our valuation and analysis it was not cheap, nor was it cheap relative to the market price on the day. The principal reason for the investor demand was that the RBS management team had made significant progress in creating an investment case that was visible, understandable and capable of being valued by investors.

Q44 Bill Esterson: When do you think dividends will resume?

James Leigh-Pemberton: RBS gave guidance at their half-year results to the effect that they did not expect to be able to distribute surplus capital to shareholders prior to the first quarter of 2017. That guidance is the basis on which we are working in terms of expectations for when we might get capital out of RBS.

Bill Esterson: Your assumption is that that is when it will start.

James Leigh-Pemberton: We are just working on the assumption that that is the first point at which it could start.

Q45 Bill Esterson: Would it not have been better to delay the sale until dividends had restarted, because that would give a better value?

James Leigh-Pemberton: As I said, we certainly held the view that commencing the process and the creation of liquidity would allow more shares at potentially better prices, relative to the market, to be sold in the future, and that this process of exiting over time should be looked at in terms of a long-term strategy to effect the exit completely and create a platform through the first sale for further sales to be made to possibly a much broader range of investors, as we experienced in the case of Lloyds, once dividends start to be paid.

Bill Esterson: Your expectation is there will be a much higher price delivered later on.

James Leigh-Pemberton: Our expectation is that as capital is returned there will be a broader range of investors ready to buy. As I mentioned earlier, we should not try to predict what happens to absolute prices.

Q46 Bill Esterson: What do you think of the argument that there is merit in the Government retaining a stake longer term in RBS, in terms of income once dividends are generated; in terms of the opportunity to lend to business to help the economy; and, as happens in Germany, perhaps in directing infrastructure priorities?

James Leigh-Pemberton: We think about that in the context of what is written in our framework document and what is written in our mandate. In the framework document, which governs our activities and determines our decision-making, amongst other things, it says that it is not the intention of the Government to be a permanent investor in any of the banks that they invested in at the time of the 2008 interventions. It says that it is our responsibility to ensure that the banks are managed on a commercial basis, which we take to mean that the decisions in relation to how the business is managed should be made by the board on behalf of all of the shareholders, ourselves included. It also says that we should engage with management and the board to the highest standards of institutional investor behaviour. All of those things taken together define how we work with the banks

and how we make our decisions. Therefore, we do not really give any thought to things that are alternative to what is set out in our mandate, because we have to stick to the terms of our framework agreement.

Q47 Bill Esterson: Do you have a view?

James Leigh-Pemberton: I don't think I do, for the reasons I have just described. We have to spend most of our time worrying about discharging our mandate as it is written rather than thinking about what might happen.

Q48 Mr Rees-Mogg: May I draw attention to my declaration in the Register of Members' Interests? I am the chairman of an investment management company, although one that invests in emerging markets, so it does not particularly come in, but I had better put it on the record. Mr Leigh-Pemberton, to come on to the mortgage-backed securities fine that RBS is facing, are you encouraging the bank to go for an early settlement?

James Leigh-Pemberton: It is not for us to determine the details of any strategy that the bank may wish to adopt in this area or in any others. The day-to-day management of these affairs is very much a matter for the management team and for the board. From our point of view, certainty and resolution of this issue at the earliest possible opportunity is highly desirable, but certainty and resolution at any price is not. It is finding the right balance between getting it out of the way, on the one hand, and ensuring that taxpayer value is not adversely impacted by the timing of any settlement. That is the task of the management team that is dedicated to dealing with this issue inside RBS and we do have quite an active dialogue with them to understand how that is progressing.

Q49 Mr Rees-Mogg: As a shareholder, you are obviously entitled to your view and to express it to the board. What are you saying to the board? Are you saying that they are being a bit too slow? Are you saying they must be very careful on price?

James Leigh-Pemberton: It is important for us to understand that it is not a topic that is in the hands of RBS. There is a court date set for the litigation, and any settlement made ahead of that time will be the result of an initiative that will be taken by the FHFA, the DOJ and by other parties. RBS can make it known, if they choose, that they would like that to happen but, in the end, these are decisions that have to be made by the plaintiff rather than by RBS. What we have said is that from our point of view strategically, certainty and resolution is very desirable, but that it must be done—and we have to leave that to the management team and the board to determine how best to do that—it must be done in a way that does not give rise to sacrifice of shareholder value because the settlement has been too hasty.

Q50 Mr Rees-Mogg: Are you saying anything the other way round? Are you saying to the Treasury that they should use the Government's diplomatic efforts with our closest ally to avoid the British taxpayer being fined possibly \$8 billion by the American taxpayer?

James Leigh-Pemberton: That is really a matter for Treasury. These are policy and diplomatic matters that fall outside the remit of UKFI.

Q51 Mr Rees-Mogg: But they have a big effect on the share price, potentially. Certainly if I were in your position, I would be saying to the Treasury, "Come on, what is the British Embassy for if it is not trying to get RBS off this fine?" Our closest ally fining us \$8 billion is pretty stiff.

James Leigh-Pemberton: As I said, it is a matter for us to express our views to the RBS management team about how we would like to see this resolved, which we have done. Steps that they may take and any dialogue that they may have through their own channels—they have direct dialogue with HM Treasury and I have no doubt they have direct dialogue with other Government Departments—to enable that to happen, that is the mechanism through which any such initiative should be taken, rather than for us to go outside our remit of commercial management and engage in areas of activity in which we don't really have any expertise.

Q52 Mr Rees-Mogg: In terms of the level of the fine, do you have any current expectations? Following on from that, can we expect faster sales once it is out of the way? Obviously, if it is worse than expected, the price will go down; if it is lower than expected, the price will go up. It is probably pretty difficult for you to forecast which of those it will be but, once it is done, that is the last serious regulatory overhang you are aware of and therefore the opportunity to start sales more quickly would be there.

James Leigh-Pemberton: I might ask Oliver to say something about the first part of your question, if I may, in a moment, but in order to be clear, there are two parts to the potential liability arising from RMBS sales. The first is litigation brought by FHFA, but the second is what the Department of Justice and other attorneys-general in the States, where people have been affected, might wish to impose upon RBS. With respect to the first, Oliver, perhaps you might want to say what we have learned from other similar cases.

Oliver Holbourn: The provision that RBS has taken so far is £2.1 billion in relation to US RMBS, but the management team are quite explicit that they have only taken a provision in relation to FHFA; they have not taken a provision in relation to the DOJ. There is some triangulation that one can do in terms of what the notional value of mortgages that were originated or sold is and what the fine in the FHFA case is. The median tends to be around 10% to 11% of the notional value. For the DOJ there is no

correlation; it is random and it is very difficult to forecast what the number will be. Market estimates versus the £2.1 billion provision are that during the course of the settlements or outcome of litigation the total cost will be between £3 billion and £5 billion, roughly speaking, so in excess of the provision that RBS has taken but, as I say, RBS has been specific that that provision only relates at the moment to FHFA, rather than the DOJ.

Mr Rees-Mogg: Once it is out of the way, can we assume that sales will be faster?

James Leigh-Pemberton: The fact that we made the sale in August is indicative of the fact that there is a pretty deep market for RBS stock, notwithstanding the fact that these uncertainties are there. There are regulatory and legal uncertainties associated with the sector as a whole for us all the time. It is just a question of how precisely and clearly they can be measured by investors, which determines how much investor appetite there is. As I said, resolution and certainty may have the effect of broadening the market, because I think it is going to be a very important determinant of the market's assessment and ultimately the reality of how much surplus capital will be available for distribution for shareholders, starting on that timetable that I referred to earlier. It is a significant item in terms of determining what the future investment case for RBS looks like.

Q53 Wes Streeting: I want to ask about the recent court case involving Northern Rock Asset Management and the issue around compensation for those who borrowed from Northern Rock Asset Management whose mortgage documents were incorrectly worded. What was UKFI's involvement in this court case?

James Leigh-Pemberton: We were fully aware of the intention to bring the case and the rationale for it, which I would be very happy to explain. Unlike the quoted investments, UKFI has two nominated directors on the board of UKAR, so we have a very clear line of sight on all of their activities and we have an extremely regular and active dialogue with the management team and with the board, and we were fully aware. The reason for bringing the case was in order to provide certainty in relation to a specific legal question where there was a lot of uncertainty, so that the board could make a decision based on certainty whether remediation would be required in order to meet their obligations to treat customers fairly. It was a discovery process. It was initiated by UKAR. The decision was made to bring the case in order to achieve certainty on this difficult question of whether loans above £25,000 in principal amount were covered by the Consumer Credit Act.

Q54 Wes Streeting: In determining that certainty, do you think that UKAR has complied with its commitment to avoid "treating its customers unfairly and delivering inappropriate outcomes leading to customer detriment or impacting market integrity" with the outcome you have gained?

James Leigh-Pemberton: Yes, absolutely, because the certainty as to whether those who borrowed a principal amount greater than £25,000 have rights under the CCA has now been established by a legal process. That was exactly the reason for bringing the case.

Q55 Wes Streeting: I do not think that will be any comfort at all to the people who have lost out on compensation because of the certainty you have determined. I am struggling to see how you could possibly think it is fair that someone who has borrowed £24,999 would be entitled to compensation but someone who has borrowed £25,001 would not be entitled. How is that possibly a fair outcome?

James Leigh-Pemberton: Because that is what the law says. In the first instance—and I think we support their decision—the board of UKAR should be establishing what the legal rights are, and that was the reason for bringing the case at the outset. Having established the facts, then to take the appropriate action to either remediate or not in light of what those facts are, was the purpose of bringing the case. The case has now been completed, the facts have been established and the decisions have been made by the UKAR board accordingly.

Wes Streeting: To lots of observers, and certainly to me and possibly other members of the Committee, it looks like people have lost out on a legal technicality rather than a determination of fair treatment.

James Leigh-Pemberton: It could have been left and this uncertainty could have continued. UKAR would not have known whether to make provision or not for this uncertainty. It would not have been possible for UKAR to be clear with their customers, which they like to do, about what the position was. In order to meet one of the dominant requirements of the board of UKAR, which is to adhere to the need to treat customers fairly, this decision seemed to us to be an entirely appropriate decision so that the certainty that all of UKAR's customers deserved could be established.

Wes Streeting: A case of conflicts between certainty and fairness. There we are.

Q56 Chair: You said it is a fair decision because it is the law. Not all laws are fair, are they?

Mr Rees-Mogg: But that is our fault.

Chair: It may be or it may ultimately be the courts'. Courts tend to change their minds. Do you think this is fair only because somebody else has decided it is fair, or do you think it is fair yourself?

James Leigh-Pemberton: The notion of fairness, at least as discussed in the board, was to provide certainty. That was the most important thing that we were seeking to do through this exercise because, for as long as there was uncertainty, no one knew what the appropriate action was to take to treat customers fairly.

Q57 George Kerevan: You told us that the market in RBS shares is relatively liquid. Does that mean that you and your colleagues are alert to unusual or significant changes in the volume and price of the shares?

James Leigh-Pemberton: Yes. We look at price and volume on a daily basis.

George Kerevan: You personally.

James Leigh-Pemberton: Yes. I look at it daily.

Q58 George Kerevan: Did you notice anything unusual in the share price and trading volumes in the days before the 3 August sale?

James Leigh-Pemberton: Yes. There were higher-than-normal volumes. There was a lot of speculation in the market that, after the results, a placing would take place, which caused that spike in volumes and activity.

Q59 George Kerevan: You are confident that that was simply a normal market reaction to the RBS management saying that share prices would rise.

James Leigh-Pemberton: No, I think it was more a consequence of the Mansion House speech having been made; the results presentation having been given, which would then, for the various disclosure reasons that we were discussing earlier, clear the way for the placing; and a lot of accompanying speculation on the part of market participants—specialist sales commentary and research commentary—that said, “You can expect the placing shortly after the results.”

Q60 George Kerevan: Remind us what was happening to the share price in the few days before the sale.

James Leigh-Pemberton: Well, the share price itself was in a relatively narrow range—before the sale, I beg your pardon. On the day of the results, the share price went up sharply, to around the £3.60 level, first thing in the morning. The results presentation was given and management provided guidance on the timing of the return of surplus capital, which I referred to earlier, which was, I think, a disappointment. They also provided some detail on the composition of the operating profit and profit beat, which revealed that there were certain central office non-recurring items which were an

important contributor to that profitability beat. By the end of the day of the results, stock had drifted off that £3.60-ish high which it had made at the opening and closed much closer to £3.50. In the days subsequent to the results, stock traded at or around the £3.40 to £3.45 level, and on Monday it closed at £3.37.

Q61 George Kerevan: So apart from that one morning's spike, there had been a steady fall in the share price and in the latter week it had gone down to what normal people would say was a fair amount.

James Leigh-Pemberton: As I said, the stock had drifted off. RBS shares move 1% to 2% a day, because of their illiquidity, on a pretty regular basis, so that evolution in the share price in the days immediately following the day of the results announcement we did not regard as completely abnormal.

Q62 George Kerevan: They fell by 8% between the Thursday and the Monday. That is more than 1%.

James Leigh-Pemberton: Yes.

George Kerevan: We have a significant fall in the value of the shares, despite the bullish statements from RBS management, in an illiquid market. All that would suggest to your average first-year economics student that someone is shorting the shares. Did you have a discussion about that?

James Leigh-Pemberton: Yes, we did. We have done a considerable amount of work on that.

George Kerevan: Did you have a discussion about that before?

James Leigh-Pemberton: Yes, we did.

George Kerevan: What was your conclusion?

James Leigh-Pemberton: Our conclusion—and I think it was borne out by our subsequent analysis—was that the volume of short interest that was put on in the period following the results, on the Friday particularly, was not material in the context of the share sale as a whole. The headline figures are that the increase in short interest in that relevant period from the normal levels—the normal levels of short interest are 26 million to 28 million shares—that number increased by 12 million shares. A 12 million-share increase, in the context of a sale of 630 million shares, led us to believe that that increase in short selling was not a material factor in the final price that was achieved in the share sale.

Q63 George Kerevan: Could you quantify, or have you attempted to quantify, what the taxpayer has lost as a result of that short selling?

James Leigh-Pemberton: As I have said, the price of £3.30 was not, in our view, determined in any degree by the increase of 12 million shares in the short interest. The price of £3.30 would have been achieved in the sale whether there were 28 million shares of short interest or 40 million shares of short interest, because the size of that increase in short interest was not sufficient to alter the £3.30 final outcome.

Q64 George Kerevan: Do you think that any of that short selling was the result of a possible leakage of information from UKFI?

James Leigh-Pemberton: I can say with certainty that it was not. We have always, in the aftermath of these offerings, if there is a significant amount of speculation ahead of them, conducted our own inquiries to ensure that we have met all of our procedures and remain compliant with our compliance requirements. We have done that and we are satisfied that this speculation arose from the sequence of events that I have described: the Mansion House speech, the results presentation and a lot of speculation by market participants. There was even speculation that the placing would be done on the evening of the results day, so there was a widespread expectation that it would be coming to market.

Q65 George Kerevan: What was your priority in the sale—improving the liquidity of the market for RBS shares for subsequent sales or getting taxpayer value on that particular sale? In other words, were you prepared to trade taxpayer value in the short run?

James Leigh-Pemberton: No, because our mandate requires always that any sale should be good value at the time. We sized the offering in order to achieve good value and we sized the offering also for the purposes of proving the concept of the depth of market and the enhancement of liquidity in the shares, but it was also sized in order to achieve best value. The priorities were to achieve good value for the taxpayer but also to create a platform for further offerings in future which would achieve better value than would otherwise be achievable were the stocks still illiquid. That was our thinking.

Q66 Mark Garnier: Mr Leigh-Pemberton, can I move to Lloyds? You will probably be relieved. I wanted to talk about the strategy, to start off with, of how you are selling the shares. The first couple of tranches of shares were sold through an accelerated book-building process and now, since the back end of last year, there has been an arrangement whereby Morgan Stanley will trickle out a small tap of stock every time it trades above 73.6p, which I think the NAO has said is the in cost. Is that the case?

James Leigh-Pemberton: Yes. We have set a floor price in the trading plan of 73.6p. No shares can be sold below 73.6 p.

Q67 Mark Garnier: Does that not mean, though, that whoever interprets the flow of stock that is coming on to the market will recognise that it is not going to get much above 73.6p either, if there is going to be a 1% tap coming out every now and again?

James Leigh-Pemberton: I might ask Oliver to talk a little bit about how the price has behaved since the trading plan was put in place, but the headlines are that since the trading plan started, stock has traded at a high of 88p. Oliver, you might want to just talk about the volume limitations and things of that sort—the design features to ensure that we do not suppress the price.

Oliver Holbourn: What we have said to the market is that we will not sell more than 15% of the total volume that trades in Lloyds through the duration of the plan. The plan was originally intended to run until the end of June.

Mark Garnier: 15% of the market volume.

Oliver Holbourn: Yes. We will not have sold more than 15% of the total volume in Lloyds that has traded through the period from 17 December last year, when we started it, to whenever the trading plan finishes, which is no later than the end of this calendar year.

Mark Garnier: That is over an average of the whole period, so in a week you could potentially sell 100%, as long as you did not over the next five weeks or so.

Oliver Holbourn: We have put lots of parameters in the plan to safeguard good value for the taxpayer. We would never get close to selling 100% of the average daily trading volume.

Mark Garnier: I used hyperbole to illustrate that.

Oliver Holbourn: Absolutely. We have put sensible parameters in the plan to protect value. All other things being equal, we will try and sell more when the share price is higher and is well bid from investors; and, all other things being equal, we will sell less when the bid is not very active. We have been quite fortunate, I would say, in that we have been through periods, particularly in our trading plan, when volumes have been very, very good. When Lloyds announced its restarting of dividend payments at the full-year results, we saw a good tick-up in volume and a good tick-up in the price. Post the election we also saw a lot of trading in UK banks and in particular Lloyds, and that also allowed us to sell a good number of shares. There are lots of parameters; the key public ones are no sales below 73.6p and we will not sell more than 15% through the entire plan.

Q68 Mark Garnier: None the less, I believe the trading plan runs out in December this year and there is 13% still to go. Does that mean you may be trying to max out your 15% or, if you get to December and you still have, let us say, 12%, would you just start a new trading plan after that?

Oliver Holbourn: We have not made that decision yet. It is going well. We are pleased with how it is going. It will run no later than 30 December. I should add that the discretion is with Morgan Stanley. That is one of the reasons that we need to give them discretion from an insider-information perspective. They are handling exactly how much is sold, given the parameters that we have given to them.

Q69 Mark Garnier: Just to be clear, you do not have a dealer sitting in UKFI putting the orders on; Morgan Stanley has a discretion to sell up to 13%.

Oliver Holbourn: Morgan Stanley has two people who sit off the trading floor in a locked room who manage that order for us on a daily basis. That is right.

Q70 Mark Garnier: That is very interesting. So, come the end of December, if it has been their discretion that it is a bad thing to do to sell any more, you could still have 13% left.

Oliver Holbourn: Given the way that the parameters of the plan work, if the share price stays above 73.6p then there will be a certain amount of shares sold, but there is still too wide a variation of outcomes, depending on where the share price goes and how liquid the market is from now until December, for us to be able to sit here today and tell you what we think we will own if the plan continues until the end of December.

Q71 Mark Garnier: It puts you in quite an interesting position, because clearly Morgan Stanley could, at their discretion, sell the shares into quite difficult markets. For example, we have heard about the China moment during August. You have to come back and justify that to people like us, whereas they can sit quietly in their dealing room in Canary Wharf without having to worry too much about it. Does it not worry you that you are handing over too much discretion to them, given that you are having to deal with public opinion and the politics of all of this?

Oliver Holbourn: We thought long and hard, and we spoke with our US colleagues who have done this sort of exercise before, to benefit from their technical expertise. There are seven or eight pages of terms and conditions that we have put in place that allow Morgan Stanley a reasonable amount of discretion, but not so much discretion that we would not be comfortable sitting in front of you and justifying what has taken place.

Mark Garnier: Presumably you have regular conversations with them.

Oliver Holbourn: We get a daily update from them. We can monitor how much they are selling versus the daily volume. We can monitor how much they are selling versus the different exchanges. We can monitor the price that they achieve versus the volume-weighted average price.

Mark Garnier: That sounds like execution reporting as opposed to a discussion.

Oliver Holbourn: We have a weekly update call with them.

Q72 Mark Garnier: I completely appreciate you have to get an execution from them every day and they justify what they have done, but to what extent are you then inputting? Or are you not at all? Are you just literally handing it over to them?

James Leigh-Pemberton: It is important to understand that the mandate granted to them is an irrecoverable mandate for as long as the trading plan is running, so this current mandate runs from the renewal to 31 December.

Mark Garnier: So your input can only be renewed on 1 January.

James Leigh-Pemberton: We can decide whether the plan should continue. We can advise as to whether the plan should continue at that point. It will run until then and it will run in accordance with the quite detailed constraints that have been set out. Yes, we have very regular communication with Morgan Stanley, really for the purposes of ensuring that both the letter and, if you like, the spirit of those constraints are being properly observed by them.

Oliver Holbourn: It is probably worth saying as well that when we renewed the trading plan we did make certain small changes to the elements of discretion that Morgan Stanley had, based on the performance of the plan from 17 December until the middle of June when we renewed the plan.

Q73 Mark Garnier: I have a couple more quick questions, if I may. The 73.6p is cited as being the in cost for Lloyds, but the NAO comes out with a price of more like 80p, which would be break-even. Again, what is your view on this? We had the same discussion about RBS a bit earlier.

James Leigh-Pemberton: This is back to the two ways of looking at whether you include or do not include the cost of financing the position.

Mark Garnier: This is a clean price, as opposed to one with the cost of carry.

James Leigh-Pemberton: Yes.

Q74 Mark Garnier: So, again, it is slightly subjective. My final question is slightly more philosophical. It is to do with the fees that are being charged by your advisers. Have you worked out what fees are going to be paid on the sales of RBS and Lloyds in total?

James Leigh-Pemberton: At the moment, the fees for which the banks will act in the trading plan and the accelerated book-builds, and the fees for the advice that is given to us by capital markets advisers and privatisation advisers—in respect of all of those, these activities are being undertaken for a nominal sum—in each case £1.

Q75 Mark Garnier: What about the transaction? Are they charging commission?

James Leigh-Pemberton: No, they are not allowed to charge investors commissions. The outgoing, so far as the taxpayer is concerned, is £1 in each case.

Q76 Mark Garnier: Just to be absolutely clear, just so we are not missing anything, the total cost to the taxpayer of these pretty substantial corporate finance transactions—they are big transactions—is just £1.

James Leigh-Pemberton: Well, £1 each time. Rothschild charged us £1.

Oliver Holbourn: We had three banks on the first sale and an adviser, four banks on the second sale and an adviser, and then on RBS we had four banks and an adviser. On the trading plan, we have had a broker and an adviser. The total cost to the taxpayer is less than approximately £15.

Mark Garnier: That is a rare occasion when we can celebrate.

Q77 Chair: I am not sure. They will take their cut elsewhere, won't they?

James Leigh-Pemberton: I am bound to say that we are very cautious about how long this is going to continue, because I suppose it must be a reflection of overall conditions in the investment banking market and the importance of these transactions in terms of their size.

Mark Garnier: They are blue-riband transactions, so there is a lot of prestige that is attached to them.

James Leigh-Pemberton: Quite so.

Q78 Mark Garnier: Just to put it into context, which would be really helpful, were you not UKFI, were you not acting on behalf of the Government and

was there not a very big prestige transaction going on, what would you have expected the fees to have been?

James Leigh-Pemberton: 10 basis points.

Oliver Holbourn: We have sold £19 billion worth of stock in two years. You could imagine that fees were anywhere between 10 and 20 basis points, so somewhere between £19 million and £38 million, if my maths is correct.

Mark Garnier: Then there is obviously this subjective thing about how else you could use that flow of stock to make money elsewhere, but that would be the same were you spending £20 billion as opposed to the £15 that you have.

James Leigh-Pemberton: Yes. You are right that these are transactions which the banks wish to be associated with and they are ready to compete aggressively on the commercial terms in order to do that.

Mark Garnier: It is a very refreshing bit of good news.

Chair: It is extremely interesting and it would be helpful if you would jot down these arrangements in as much detail as you can and give us an expression of your caution and why you are cautious, in more detail, on paper. I am sorry to commission all these things today, but you have come to the Committee with quite a lot of important information for the taxpayer.

Q79 Chris Philp: Just to pick up on that last point, last time I checked, Goldman Sachs was certainly not a charitable organisation and I cannot believe they would do anything, no matter how prestigious, for no consideration. Could you comment to the Committee on how they are making money from these transactions? It seems quite clear to me that they must be making money somehow. If you don't know how they are making money, that is in itself slightly alarming.

James Leigh-Pemberton: As I say, we are very cautious about this. The assumption that we make is that the franchise value of being appointed to work for an agency of the UK Government, combined with the size of the transactions and therefore the level of engagement with a very wide range of investors that the size of those transactions involves, are the two things that are causing them to want to do this for that level of consideration.

Q80 Chris Philp: Are they making any spread when these shares are issued? Are they holding any shares on their own balance sheets and then selling them into the secondary market at a higher price in days subsequent?

James Leigh-Pemberton: Neither of those two things, I can confirm. When the shares were allocated, they were allocated in full. None were left on the books of any of the book runners, including Goldman Sachs, and there is no spread; there is a net price.

Q81 Chris Philp: Let me ask a different question. What is the manner of deciding which applicants get satisfied and which don't? The reason I am asking that is to determine whether favoured clients of the banks are given preferential treatment and that is the quid pro quo that Goldman and the likes are extracting. Do you have full transparency over that?

Oliver Holbourn: We have full transparency over the allocations. We are in complete control of the allocations. We decide the allocations.

Chris Philp: Do you?

Oliver Holbourn: Yes. We have a set of allocation principles, which is put together by our capital markets adviser, which determines on what basis we would like to see the shares allocated. It is very clear in that document—*[Interruption.]*

Chair: You can just keep going. It is a ritual bit of bell ringing that takes place, which I tried very hard to persuade the authorities to turn down when the Committee was in session, but they told me it would cost a lot more than it seems that it costs to sell this stock.

Chris Philp: Get Goldman to do it for £1 for the prestige. Sorry, you were answering the question.

Oliver Holbourn: There is a very clear point that is made in there that no consideration should be given to the client interests of the banks that are involved in the allocation process. As I say, we are the final determiners, with our capital markets adviser, of who gets the shares.

Chris Philp: So, the bank makes a recommendation and you rubber-stamp it.

Oliver Holbourn: No. The bank makes a recommendation. In terms of the timing of the last sale, the transaction was covered shortly after launch. The books were closed at 7.30. The banks went away and made a recommendation in terms of allocations. We met our capital markets advisers at 10 o'clock. We discussed it for two hours. We went back to the banks. We gave them the changes that we wanted to make. They put those forward. We then re-met again on a conference call at 6 in the morning, just with our capital markets adviser. We went through all of the allocations again, just to make sure that everything that should have been taken into account was taken into account, and, as James said, a full allocation process was then communicated to the market. No shares were left on any of the books of the investment banks.

Q82 Chris Philp: In terms of notifying potential subscribers to the issue, they were notified on the day. There was no advance notification given to any potential bidders.

Oliver Holbourn: No. They were all told between 7am and 8am, before the shares started trading.

Q83 Chris Philp: In the secondary market, were there any unusual-looking spreads as these stocks got traded in the aftermarket?

Oliver Holbourn: Spreads on FTSE 100 stocks tend to be relatively tight, notwithstanding the lack of liquidity.

Chris Philp: I have exhausted all the ideas I have as to how they can make money out of this. I am not sure if any colleagues can think of any other reasons.

Oliver Holbourn: On a sale of this type, the one way that they would normally make money is that they would charge commissions to the buyers. In this instance, we specifically said that they were not allowed to charge commission to the buyers and they accepted that.

Chris Philp: When I started working at McKinsey 15 years ago, the first thing I was taught was if something looks too good to be true, it probably is.

James Leigh-Pemberton: This is the reason why we feel so cautious about this. I come back to the point—and this is speculation on our part because, in the end, the only people who can really answer the question are the banks who are prepared to do this for no money.

Q84 Chris Philp: You used to run Credit Suisse in London. Would you have done this?

James Leigh-Pemberton: Prestige value and franchise value—it has been done. It has been done. It is done on quite a regular basis. Once the clearing price is established by the first sale in Lloyds, it is very difficult for anybody to make the decision that they wish to exclude themselves by going above that clearing price.

Chris Philp: Let me move on, because that was not the topic I intended to ask about.

Q85 Chair: Just before we move off this subject, if you don't mind, have you discussed this rather extraordinary arrangement with the Treasury?

James Leigh-Pemberton: They are fully aware of these things, yes.

Q86 Chair: Are you confident that the pressure to maintain these arrangements does not originate with the Treasury, who are quite happy, presumably, to be able to say this is great value for the taxpayer?

James Leigh-Pemberton: This procurement process for our book-runners and our advisers is done exclusively by us.

Chair: There is no involvement of the Treasury whatsoever.

James Leigh-Pemberton: No. We run the procurement process.

Q87 Chris Philp: I do urge you to keep a very close eye on this, because I have never encountered an alpha like Goldman Sachs or Morgan Stanley acting in a charitable manner. I am not sure if you have, but it seems rather extraordinary to me, so please be ultra-vigilant. I am sure they are making money somewhere, and if you do not know about it, that is a bit alarming.

Moving on to the PPI issues that Lloyds had, they received in June a £117 million fine, the largest retail fine ever handed out by the FCA, and their liabilities in relation to PPI are estimated at £12 billion. What steps have you taken to make sure that that is the extent of these issues and that all problems in this regard are now behind Lloyds? Can you assure the Committee that that is the case?

James Leigh-Pemberton: We have discussed at some length with Lloyds the lead-up to the findings that resulted in this fine and how that state of affairs came into existence but, most particularly, what changes have been made through the remediation process that was imposed on Lloyds by the enforcement action—what changes have been made to ensure that there will not be a recurrence of this failure to handle the complaints correctly. That is what has happened so far.

Q88 Chris Philp: And you are satisfied with what you have heard.

James Leigh-Pemberton: Yes. I think there has been a very thorough remediation process.

Q89 Chris Philp: Clearly the failing was very serious, yet the Chief Executive of Lloyds only lost 12% of his bonus. In your opinion, is that not a rather small punishment for such a serious catalogue of errors?

James Leigh-Pemberton: The steps that have been taken to date by Lloyds and that have been announced by Lloyds so far are that they have applied malus where they could apply malus to the relevant members of the group executive committee, and they

will make a deduction of £30 million from the bonus pool at year end. We haven't started the discussions yet with any of the banks, because it is a little too early in the year to do so, but one of the things that we will be doing is trying to get a detailed understanding of where that £30 million deduction is going to be applied.

Q90 Chris Philp: What is that as a proportion of the whole bonus pool, roughly?

James Leigh-Pemberton: The bonus pool last year was £370 million-odd.

Chris Philp: So it is a less than a 10% deduction. That is the lightest of raps over the knuckles, with respect.

James Leigh-Pemberton: As I said, what we will want to do is focus very carefully on where it is applied. It is important to remember that, given Lloyds' business model, the average bonus in Lloyds, which makes up the vast bulk of that pool, is about £4,500 per annum, so the key question in determining the effectiveness of these sanctions is where that deduction is made.

Q91 Chris Philp: Fair point. Just returning to the question of determining the appropriate valuation to maximise taxpayer return, which is quite rightly your mandate, you mentioned you have an internal model, which you no doubt keep updated continuously, which tells you what you think a fair selling price is. You also mentioned in previous remarks that, over the past four or five years, management at RBS—and I quote what you said—“has made significant progress” in making the investment case. Presumably it is fair to say that, over the last four or five-year period, the fair value that your model has produced has drifted upwards as the significant progress you refer to has been made.

James Leigh-Pemberton: You have to see the evolution of fair value for RBS shares in the context of a whole raft of things, but five years ago the share price was quite significantly lower than it is now. In 2009, it was higher than it is now, but markets were obviously wrong about that. This happened with all the banks. Generally speaking, what has happened with the valuation story in RBS is that the balance sheet has been shrunk and the highly capital-consumptive assets have been largely disposed of. RBS Capital Resolution has been run down to a very significant extent—about 80% of the gross assets in RCR have now been sold—and the Citizens sale is well under way. The capital position of RBS has improved dramatically. That was the first and most important thing that had to happen. In the process, the allocation of the taxpayers' capital—or all the shareholders' capital—to businesses where they can generate a return above the cost of capital has also been able to accelerate.

Oliver Holbourn: Maybe one thing to add—we sat in front of the Committee last year and said this—is that until quite recently we did not feel comfortable establishing what the fair value for RBS was, as a result of the width of outcomes on a number of

items. In particular, until they finalised their investment strategy for their investment bank, which was started in February 2013 and then firmed up in February 2014, they still had a third of their total risk-weighted assets allocated to businesses that were not generating above the cost of equity. It has only been recently that we have felt comfortable saying, on behalf of the taxpayer, “This is what we think fair value is” and comparing that.

Q92 Chris Philp: It is fair to say there has been an improvement in the certainty of outcome and there has been an improvement in the return on capital, as the poor assets have been disposed of. This really leads into my next question on this particular point. Clearly in June or July of this year, the market was at, say, 330p to 350p and your internal model was flashing, “It’s good value; time to sell.” Previously the stock has traded higher. It traded at 350p to 400p in the earlier part of this year and last year. Back in 2011, there were periods of time when it traded at 400p to 500p a share. If your model was flashing, “Sell this summer at 330p,” did it not also flash “sell” at those previous times I have just mentioned?

James Leigh-Pemberton: But we couldn’t because there was not enough investor demand, because there was no clarity on the end state of RBS.

Chris Philp: Even for a placing as small as £2 billion.

James Leigh-Pemberton: A placing of £2 billion needs £4 billion to £4.5 billion of gross demand. £4.5 billion of gross demand is an enormous number of very large orders from investors. These numbers are huge, in terms of market capacity. As I mentioned earlier, the point at which we could be satisfied that there was a sufficiently deep market and sufficient investor demand for RBS shares could only be reached when a broad enough range of investors had a clear enough picture of how to value the stock because the picture of the end state bank was clear enough. That was the only way that one could generate that demand.

Chris Philp: And you tested that with informal conversations over the last four or five years. You mentioned 60 conversations.

James Leigh-Pemberton: Absolutely. We get told, often quite explicitly, what investor attitudes are to RBS stock. They have changed over the years. Two years ago, many of them made some interesting hearing.

Q93 Chris Philp: I am sure. My final question really follows on from a point that John Mann raised earlier about the purpose of UKFI. You have said several times in your testimony so far that you view it as the job of the board to run the business, to take commercial decisions and to drive the business. The fact is you are a 70% to 80% shareholder in RBS and a circa 20% shareholder in Lloyds. In the last 15 years, I have run various businesses that have either been private equity backed or venture capital backed. Our investors have typically held between 30% and 80% of our businesses, depending on the business. I have to say that the attitude that the various private

equity houses and venture capital businesses that have invested in my companies have taken is not the attitude you have described. I understand if you are an institution holding 2% you might do what you are doing, but if you are holding 80%—they have typically put people on the board and they have been very clear about their views about strategy and about maximising shareholder value. Given the magnitude of your holdings, particularly in RBS, and given that you are the custodian of some tens of billions of pounds of public money—the entire MOD annual budget plus a bit—do you not think that a more involved role might be appropriate, including, for instance, board representation and a more active input into strategy, on issues such as the one that Mr Rees-Mogg referred to earlier?

James Leigh-Pemberton: I will take that in its different pieces, if I may. In terms of our engagement with the banks—I am talking now just about the quoted banks, not about UK Asset Resolution—our framework document, which is difficult to disagree with in this regard, requires us to conduct that engagement to the highest standards of institutional investor engagement. We do have a very high degree of dialogue with respect to current and future strategy, and we make our views known. We gather information from the senior management level and the next level down—the divisional heads. We have lots of discussion with them. Based on that information, we form views about whether what is being done is going in the right direction and we communicate those views in a way that is consistent with a large shareholder in a listed company. Our framework document and, as I understand it, the original policy decisions associated with these investments being made provide that the board and the management should be left free to act on behalf of all shareholders equally. It is an obligation of the directors of RBS under company law to represent the interests of all shareholders. Our engagement is one that is consistent with the highest standards of a large institutional holder, but it is not one where we can or should be giving instruction.

Q94 Chris Philp: I am not suggesting you ought to, but, at 80% or 70%, should you not have board representation? For example, Jitesh Gadhia is on your board and he will tell you that when Blackstone have a position in a company—I am speaking from personal experience—that is of the magnitude you have, they will not talk about engagement; they will be doing a lot more than being engaged. They will be on the board and they will be deeply involved in helping to guide the strategy. I would say that is an example of the highest standards of institutional management in the context of an 80% share. You are not a fund manager with a 2% holding; you are an 80% shareholder.

James Leigh-Pemberton: The framework document specifically provides that we not be represented on the board, at least by implication. That decision was made at the outset in order to allow the board of management to operate the business as a commercial entity. We spend all of our time thinking about whether the management teams and boards of the banks that we are responsible for are enabling the taxpayer to realise value. That is what we do all the time.

Chris Philp: Do you mean maximise value or realise value?

James Leigh-Pemberton: To realise value at the highest possible level. The fact that we are not represented on the board does not prevent us from carrying out the tasks associated with that objective.

Q95 Chair: Just to be clear, one of the central criticisms is that you might be stripping out long-term shareholder value by running down the investment bank. You are replying that it is by doing that, in conjunction with the Citizens sale, the Greenwich disposal and the Williams & Glyn operation in order to satisfy state aid requirements and all that, that you now get to the point where people are prepared to try and value the stock. That enables you to begin the process of creating the liquidity and depth in the market, and that is why those who argue that there is long-term value in the investment arm and that it should be held are mistaken.

James Leigh-Pemberton: The investment bank will continue its activities in those areas where it enjoys competitive advantage.

Chair: In a dramatically shrunk condition.

James Leigh-Pemberton: But very significantly shrunk. The areas of the business that they are exiting are areas of the business that were consuming significant amounts of capital and where the returns on that capital were in mid to low single-digit percentages per annum. That is daily value destruction, because the cost of our capital in a major bank like RBS is certainly in excess of 10% per annum.

Q96 Chair: Your response to those who say there is execution risk in getting out of the investment arm is, “Well, it is a price worth paying.”

James Leigh-Pemberton: There is significant execution risk. As it happens, today, given the overall market environment from a timing point of view, if one were going to undertake a project of this sort, this is as good a moment to do so as any in terms of market conditions.

Chair: It is helpful to have that on the record. Whether or not one agrees with the conclusions, it is very clear from what you have said now why you are taking the decisions you are on behalf of taxpayers who are following this. We are going to come back to a number of central issues that we have touched on through the hearing.

Q97 Mr Baker: May I begin by saying—I hope you will not mind me saying this—that I feel sure that many of my constituents would join me in regarding with the utmost astonishment the idea that the same organisations and individuals that have been fined repeatedly for rapacious misconduct are now the jolly good chaps we imagine from the past who are charging just £1 for their highly expert services. We have been to and fro over this a bit, but I think it would be a very good idea if UKFI

came back with a better answer for where they are making their money. Before we all have to read about it in *Private Eye*, it would be a jolly good idea to have a clear idea of where they are making their money and why they want to do this.

James Leigh-Pemberton: What I did want to add to what we were saying earlier is the following. In my previous experience, it is the case that if your bank is involved in a very large placing of this sort, in the days following such placings there tends to be a high level of activity in the stock itself involved in the placing. There also tends to be a significant amount of activity in the surrounding stocks, so other bank stocks, pan-European stocks and so forth. Those involved in those placings, if they are well organised, will have the opportunity to participate in that market-making activity that arises as a result of a major placing—something of a very large size—of this type. That, in our view—Oliver, correct me if I am wrong—is one of the reasons why banks like to be involved in these very large overnight trades and have established a clearing price so low for being involved on our behalf.

Q98 Chair: Have you considered charging them? Why should the correct price, if it is so beneficial to them, be zero? Why not charge them?

Oliver Holbourn: It is not possible under the Foreign Corrupt Practices Act.

Mr Baker: So it is so close to zero that it is meaningless.

Oliver Holbourn: A lot of banks have analysed whether or not they could pay us to do a transaction, and they feel that it falls foul of US legislation.

Q99 Mr Baker: The other thing is that I think we can take it as read that many members of the public regard the entire financial system, and indeed Government, with a very considerable degree of justified cynicism. Many people would look at the kinds of structures that are in place and the bailouts themselves and regard the whole thing as a stitch-up. Here we are sitting; you have been brought in because of your undoubted commercial experience and expertise, but you are, for example, not sitting on the board, for reasons that have been discussed. That is clearly not in line with normal commercial practice. We have touched on other areas that are not normal commercial practice. Mr Rees-Mogg brought up the issue of taxpayers in the US fining taxpayers in the UK. I am wondering what the UK is getting out of having UKFI, with all of your expertise. You employ capital markets advisers. The Treasury has to take second opinions. What are we getting for our money by having you do this job?

James Leigh-Pemberton: It is a difficult question to answer without sounding immodest, so forgive me if we sound, on behalf of the company and my colleagues, immodest. What the taxpayer gets is a group of people who have quite a lot of experience in transactions of the type that we have to undertake, who are able to ensure that they are executed to the required standards, at the right time and in the right way, so that the

taxpayer maximises the value associated with the exit, and who can be sure that, over the long term, the right steps are being taken, step by step, to build that taxpayer value over time. Because of our existence, we are able to dedicate all of our time and effort to doing that. To date, based on external assessment of the National Audit Office and others, we have accomplished that task in accordance with the mandate that is set out in our framework agreement.

Q100 Mr Baker: What functions do you exercise as UKFI that the Chancellor can evade responsibility for? What do you do for which he is not responsible?

James Leigh-Pemberton: The Chancellor makes the ultimate decisions on all these things. I can give you two examples: the trading plan and perhaps the sale of the Granite mortgages in UKAR. In the context of the trading plan, we developed a concept and then made a proposal to Treasury colleagues and to Ministers. We were rightly subjected to a high degree of scrutiny on that. They said, “What is this? How will it really work? Are you seriously asking us to delegate all these authorities to this broker?” etc. We went through some iterations and, in the end, we got approval for the execution of the trading plan. Again at the risk of sounding immodest, I think the trading plan has succeeded in delivering very good value for the taxpayer.

Q101 Mr Baker: The point here is that the Chancellor was ultimately responsible for that set of functions. Why do you need to be structured as you are, rather than simply being a body within the Treasury?

James Leigh-Pemberton: So that we have the benefit of a board of directors, to whom we are primarily responsible, ensuring that our activities are in accordance with our framework document and the mandate that we have, because that is the governance structure that keeps that discipline as imposed as it should be.

Mr Baker: I am trying to tease out this idea that the Chancellor is actually ultimately responsible for what you do and that he is responsible to Parliament and the public, and yet you seem to be functioning with an arm’s length arrangement that seems to get broken down quite frequently when ultimately you have to go to Treasury Ministers and the Chancellor for decisions.

James Leigh-Pemberton: In our perception, it is not broken down quite frequently. If I go to the second example, because of some particular characteristics of market conditions at the moment, together with UKAR we identified an opportunity to sell a very substantial pool of assets from UKAR’s balance sheet. That is a transaction that is in progress at the moment. We made a recommendation to Treasury colleagues and to Ministers that that should go forward and that recommendation was agreed. We have a process of what I would describe as origination and development of the means by which we may discharge our mandate that is set out in our framework document. As the

framework document requires, the ultimate decision is made by Ministers and the ultimate approval is given by Ministers, but it is a process that, if I can describe it as such, is originated and developed by us for approval by Ministers.

Q102 Mr Baker: Can you imagine a structure away from Government that would operate in a similar way, where a board and some executives do their usual job in a professional manner but then somebody else decides what is going to happen?

James Leigh-Pemberton: Yes, I can. If you are a non-executive director or executive director of a wholly-owned subsidiary, let us say of a motor company, of which the UK subsidiary will have its own board of directors, you are answerable to one shareholder. You are answerable, in that circumstance, to the board of the parent company. It is a very parallel situation. We have it under the regulatory framework amongst financial institutions all across the sector.

Mr Baker: That is the framework through which you would have us view your existence and your structure.

James Leigh-Pemberton: If I may say so, we regard ourselves as accountable to the taxpayer. Through the framework document, we see ourselves as accountable to the taxpayer and we therefore see that we are accountable ultimately to Parliament, through Ministers.

Q103 Mr Baker: With that in mind, I would like to return on this subject of value and accountability to the taxpayer to something Mr Holbourn said earlier. What I interpreted you to say was that you accept that all of these financial assets have had their prices pumped up by easy-money policies. Is that right?

Oliver Holbourn: No, I don't think that is right. I think what we said is that the market conditions for selling financial assets are good and that, in part, has been helped by the amount of liquidity that is currently in the system.

Chair: From QE.

Mr Baker: Yes, you said QE.

Oliver Holbourn: A large part of that is through quantitative easing.

Q104 Chair: What is the difference between the two statements?

Mr Baker: It is just a choice of words, is it not? You are saying that the prices are high because the central banks have pumped in new money.

Oliver Holbourn: It is not the only reason that the prices are high, but, as I said, we believe today that market conditions are favourable for the sale of financial assets and I do believe that part of the reasons that these markets conditions have come into being is because of quantitative easing.

Q105 Mr Baker: I think if we talked to most market participants, they would tell us just how important the central banks are in the course of their operations. It is good that you nod. I will just say that you are nodding for the sake of the record. But what do bubbles do, gentlemen? What do bubbles do? Come on: we know that bubbles burst, don't we?

James Leigh-Pemberton: I mentioned earlier that long experience tells us that you should not always think that things are going to get better. One of the reasons why, for example, we believe that this is an appropriate time to undertake a transaction like the Granite disposal is precisely because the market conditions for sellers in these assets at the moment are extremely favourable. It is our task to maximise value for the taxpayer and to take advantage of favourable market conditions.

Q106 Mr Baker: I don't wish to hold you to account for central bank policy, but I think we have established that, operating quite properly and professionally within the mandate you have been given, you are taking advantage of the conditions that have been created at least in part, as you have said, by the monetary policies of the Bank of England.

James Leigh-Pemberton: Yes.

Oliver Holbourn: Yes, I think that is correct.

Q107 Chair: Just to return briefly to this question of how brokers are making money, they make money by having the market advantage in the days after the disposal.

James Leigh-Pemberton: When I say having the market advantage, it is by being the natural call for a buyer or seller in those stocks.

Chair: Yes. Which is at the expense of brokers who are not.

James Leigh-Pemberton: Yes. That is the normal process of competition.

Q108 Chair: It may not be unusual these days that such practices are taking place and it may be what is going on in the US, but I am sure you understand that it is our job to maximise transparency for these transactions. I just want to be clear with

you that you are confident—you have mentioned your caution with respect to these arrangements—that you have taken every possible step to scrutinise these to ensure that nothing subsequently transpires that would be of concern to you, and that we are doing this in a manner that does maximise the return to the taxpayer.

James Leigh-Pemberton: Yes, we are.

Chair: And you are going to send us a note to this effect that sets it out in some detail.

James Leigh-Pemberton: Yes, we will.

Chair: If colleagues don't mind, I am not going to prolong the hearing at this point until we have had this note. We may want to recall you just on this point, if it turns out to be more interesting than on the basis of these exchanges we think it is. Everyone is chipping in now. They are a very demanding lot, my team. Very unusually, I am going to allow two very quick questions.

Q109 Mark Garnier: It is really following on from the note required. I gather that the precedent for this would be the AIG transaction—selling off that. When you prepare your note, could you include what you have learned from the AIG transaction and others—but specifically AIG?

Chair: I think I covered that point.

James Leigh-Pemberton: Yes.

Mr Rees-Mogg: Chairman, as a still semi-practising investment manager, it seems to be extremely easy. The broker provides something that the investment manager wants and is rewarded, over the next fortnight, with a succession of orders out of gratitude for getting a reasonable allocation, probably unaware that it has been made by you. The broker is going to say, "I have done incredibly well for you. I have got you 50% of the allocation you have asked for. Your position is now made up." You, as the fund manager, say, "Thank you so much."

Chair: My colleagues are answering questions that we are hoping you are going to answer rather than actually asking questions, but you are going to tell us, because you have told us you will. Thank you very much for giving evidence. It has been enlightening and thoughtful and gives us plenty more to look at.