

Preface

The banking crisis and economic recession of 2008 to 2009 formed the backdrop to the 2010 general election. The new Liberal Democrat-Conservative coalition government has now embarked on a course of radical reform in order to stabilise the nation's finances and restore sustainable economic growth.

While debate rages over changes to taxation and to the allocation of government spending, there is also a strong and growing undercurrent of discussion on the nature of our economic model. The banking crash was undoubtedly a crisis for capitalism but the policy response at home and abroad has averted disaster. It is right that people should question some of the economic policies and business practices that led us to the brink of disaster. Surely we can't return to business as usual? Are there alternative models of capitalism that can work in an open economy that deliver prosperity that is shared more fairly?

What to do about the banks and the bankers lies at the heart of this debate. But competition, lending decisions, bonuses and taxation are subjects for discussion in other pamphlets. This pamphlet focuses on the narrow but significant issue of what to do with the nation's shareholdings in two of the world's largest banks. We are the effective owners of Royal Bank of Scotland and the Lloyds Banking Group. Our taxes bailed out the banks and our government now owns two of them in our name.

The time will soon come for the state to divest itself of these enormous shareholdings. In my lifetime I've seen many state sell offs and privatisations. In my professional career I even worked on some of them!

An opportunity now arises for the coalition government to try a new model of privatisation. HM Treasury needs to recover the approximately £66 billion it spent bailing out the two banks. There is a general feeling in the country that we need to get something positive in return for the bail out. This pamphlet puts forward an idea for giving us all a stake in the banks, for HM Treasury to clear its debt and just maybe for an increase in confidence that capitalism can be popular and fair.

Executive Summary

As a result of the 2008 financial crisis, Royal Bank of Scotland (RBS) and Lloyds Banking Group (Lloyds) were rescued by a British taxpayer-funded recapitalisation, leaving the British government as the reluctant owner of 84 per cent of RBS and 43 per cent of Lloyds. Government should not be in the business of running banks. As the banks return to profitability, it is time to consider options

Getting your share of the banks: giving the banks back to the People

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CENTRE:FORUM

for returning them to the private sector. The bailout's extraordinary circumstances provide the government with an opportunity to implement a radical alternative to a conventional bank privatisation.

Any privatisation must meet the twin goals of recouping the taxpayers' investment in full, and equitably sharing the opportunity to benefit from RBS' and Lloyds' future profits and growth in value.

It is proposed that the government-owned bank shares are distributed to the British public, with no cash required of them up front. In order for the government to recoup the public's investment that rescued the banks, Portman Capital has developed a model that guarantees a fixed minimum price – known as the 'floor price' – for HM Treasury when individuals sell their shares, so citizens will benefit when the share price increases above the floor price.

This proposal is designed to maximise the likelihood of recouping the entirety of the government's 2008 investment in RBS and Lloyds. It would be considerably cheaper than a conventional privatisation, and it would

avoid the unfortunate experience of the US government's sale of half their General Motors' stake, (the US government expects to lose at least \$10 billion from the sale).

Overall, this innovative plan recoups the public's investment, is inclusive and equitable for the British people, and would allow *them* to benefit from any increased value in *their* banks.

Introduction

Buying and running commercial banks is not a normal role for the British government. The Bank of England is clearly a special case and the proposed Green Investment Bank could soon be another. Yet in 2011, the British public find themselves the reluctant owners of 84 per cent of Royal Bank of Scotland (RBS) and 43 per cent of Lloyds Banking Group (Lloyds) after rescuing them in the 2008 financial crisis. Coalition government ministers are thus stewards of these massive stakes, which have a most recent balance sheet value of £57.2 billion,¹ representing an £8.6 billion paper loss on the public's initial investment of £65.8 billion.

As they prepare to return two of the world's largest banks to the private sector, ministers need to ensure taxpayers get value for money, and that the privatisation process is fair and inclusive. This is a golden opportunity to do something radical that will capture the public mood, and demonstrate that the banks cannot return to business as usual. It will reward the public at a time when all that they see are the unwelcome consequences of the government's action to repair the national finances.

Why sell?

Our government should have no desire to be the largest single shareholder in the UK banking system. Not only does government need to recoup the £65.8 billion borrowed to rescue the banks, there is also an intrinsic tension between government's role as a regulator and its current role as a shareholder.² On the one hand government is seeking to maximise the value of the public stakes in the banks, whilst on the other attempting to rein in bankers' bonuses and increase the tax-take from the financial services sector.

Finally, the coalition looks ahead to the report from the Vickers Commission on banking this autumn. I know the government will consider the Commission's recommendations carefully, and will be keen to remove any suggestion of interference because of the public stakes in RBS and Lloyds. Divesting itself of the shares removes these actual and presentational conflicts for government.

1 £57.214 billion as at 31 Mar 10 per UKFI Annual Report and Accounts 2009-10, www.ukfi.co.uk

2 Portman Analysis of UKFI Annual Report and Accounts 2009-10.

How did we end up here?

It was never supposed to be like this. The 1986 'big bang' financial regulation reforms sparked a renaissance in UK financial services, with London becoming Europe's preeminent financial hub, rivalled as a global financial centre only by New York, Hong Kong and Tokyo. Government revenues have become particularly reliant on financial services, with 13.9 per cent of all tax revenue – one pound in every seven – coming from the financial services sector in 2006–07, the last full year before the financial crisis.³ Even after the financial crash the financial sector still provided 11.2 per cent of total government revenue in 2009-10. This dramatically underlines the need for the coalition's policy to rebalance the economy away from excessive reliance on financial services.⁴

As soon as they took office in 1997, Labour were enthusiastic proponents of 'light touch' financial regulation, carving out banking supervision from the Bank of England to the newly created Financial Services Authority (FSA). As Chancellor, Gordon Brown in his 2007 Mansion House Speech hailed the UK's "risk-based regulatory approach" as the key to the City's "Golden Age". Indeed, Brown went on to take credit for "resisting pressure" for firmer regulation of the City and its activities. The minister responsible for the regulation of the City at that time was Ed Balls, now the Shadow Chancellor.

Labour's 'light touch' regulation did nothing to curb excessive risk taking in the boom years. When faced with the run on Northern Rock – the first on a British retail bank in over a century – Labour's regulatory system wobbled and confidence was lost. When the recklessness of RBS and Halifax Bank of Scotland (HBOS) landed them in trouble, this already weakened system faced a much stiffer challenge.

The implications of letting RBS and HBOS go bust in 2008 for jobs and Britain's real economic health left the government no option but to rescue these stricken institutions: they were simply too big to be allowed to fail. So although it cost £45.5 billion to save RBS and £20.3 billion to save a forced merger of HBOS and LloydsTSB, I supported the bailout to safeguard jobs across the UK and in my Bristol constituency.

For all of Labour's regulatory mistakes, vital aid to the stricken banks was sensibly provided by purchasing new shares, rather than providing the banks with loans, as the Bush Administration did in the USA under the Troubled Asset Relief Programme (TARP). Buying shares not only immediately

3 Figure 2.1, p. 3 of "Total Tax Contribution PricewaterhouseCoopers LLP study of the UK Financial Services Sector for the City of London Corporation", February 2009, available from www.cityoflondon.gov.uk/Corporation/LGNL_Services/Business/Business_support_and_advice/Economic_information_and_analysis/Research_publications/#thecity

4 'The Total Contribution of UK Financial Services', City of London Corporation, December 2010.

improved the banks' capital ratios to support lending and ward off mass default, but British taxpayers gained a stake in the banks' future value – something a straightforward loan would not have provided. As the prime minister and deputy prime minister have repeatedly made clear, there is full agreement that in privatising the banks we must ensure that we recoup the £65.8 billion borrowed to fund the banks' rescues.

Lessons from the privatisations of the 1980s

When the sale of British Telecom was announced in May 1982, few could have appreciated the scale and impact that privatisations would have on the shape of the UK economy. From the time BT shares debuted on the London Stock Exchange in November 1984⁵ through to the end of the process with Railtrack in May 1996, three important elements remained constant.⁶

Cash up front limited participation

Focused on retail investors and those employed by the privatised companies in question, the UK privatisations required individuals to pay for the shares up front. Consequently, fewer than one in ten of the UK population purchased or received privatisation shares.⁷ Moreover, even after the building society demutualisations, only around one in five of the population have ever owned shares, even for a short period of time.

Assets were undervalued at the point of sale

The 1980s privatisations saw national assets sold well below their true value. BT shares rose from £1.30 to £1.70 on the first day – a 31 per cent return for investors – before reaching their maximum of £15 in 1999.⁸

The winners were small shareholders who could afford to participate and large institutional investors. The losers were the 90 per cent of the population who did not participate and thus saw no return, and the public finances which suffered as the government failed to maximise its receipts. There was certainly no transformation of Britain into a 'nation of shareholders'.

The negative impact on the public was compounded by the policy of using the receipts to hold down or reduce tax rates, meaning that there was no enduring benefit from the sales, for example through financing additional capital expenditure.

5 http://business.timesonline.co.uk/tol/business/industry_sectors/telecoms/article6924273.ece

6 <http://query.nytimes.com/gst/fullpage.html?res=940CE1D81739F931A35756C0A960958260>

7 Financial Times, 7 February 2001, available from <http://www.johnkay.com/2001/02/07/more-brickbats-than-bouquets>

8 http://business.timesonline.co.uk/tol/business/industry_sectors/telecoms/article6924273.ece

Private investors failed to realise the full benefits

Most of the private investors who bought shares in the privatisations made poor trading decisions, which limited the benefit they received. In 19 of the 21 privatisations conducted, the shares on average outperformed the FTSE 100 by 40 per cent in the first two years, and then underperformed the market by the same amount over the next fifteen.⁹ Unfortunately, the majority of private investors either sold their shares immediately – missing the over-performance – or never sold them at all, living with the underperformance.

Therefore the primary lesson to draw from the 1980s experience is that for a privatisation to benefit the whole of the British population, it has to be free at the point of distribution to ensure universal participation.

Second, we must be open to alternatives that do not require a 25 per cent discount or more on the true value as with previous privatisations from BT to Railtrack. Such a discount for the banks today would mean giving away approximately £15 billion worth of value.

Third, hand-in-hand with a major financial education effort, recipients should have the option of accessing the same trading strategies as used by market professionals to maximise the value of their shares. As it is proposed to include all UK adult citizens, there is a major opportunity to increase financial awareness and also for schools in citizenship or maths lessons to discuss the distribution.

Fourth, the return of RBS and Lloyds to the private sector should be structured in a way that minimises the transaction costs. The public would not look kindly on a sale that led to major corporate finance profits and huge executive bonuses.

Why a conventional privatisation should be rejected

Enthusiasts for the early privatisation of RBS and Lloyds have pointed out that after they returned to operating profit, their share price rose above the price the government paid for them, resulting in a paper profit, before subsequently falling away again. Consequently it is argued UK Financial Investments (UKFI), the government body that manages the ownership stakes in the banks, should start a conventional sale of the shares on the open market. Share sale advocates argue this is exactly what the market is expecting.

However, it is exactly the market's expectation of such a solution that caps the banks' share price in the market. The government in this case is widely anticipated to be preparing to sell its shares. This creates what the market describes as a 'share overhang'. Worse, as the

9 Financial Times, 7 February 2001, available from <http://www.johnkay.com/2001/02/07/more-brickbats-than-bouquets>

government owns such a large proportion of the banks, the market is unable to absorb all of the shares at once, requiring the staging of sales over a number of years. Thus the shares would have to be sold below market price, with the initial sales being the most heavily discounted, destroying value for British taxpayers.

Structural Overhang and Tracker Funds

A structural overhang occurs when the market knows that the owner of a significant proportion of a company's shares wants to sell them in a placing when they reach a certain price. As these shares will be sold at a discount to the market price, other shareholders sell in anticipation of the placing.

In the case of the UK banks, the high proportion of publicly owned shares means that the market currently anticipates significant discounts, especially for the earliest sales as investors know that future sales will follow. This means that when the shares trade at a price where the market anticipates the Government will sell, there will be significantly more sellers than buyers, capping the price. This is a structural overhang.

Not only does the proposal remove the overhang, but by transferring the shares to individual ownership, the free float in RBS and Lloyds is increased. Investment funds tracking the FTSE 100 index will be obliged to buy RBS and Lloyds shares to ensure that their fund correctly matches the index. Additionally, pension funds benchmarked against the index are likely to buy in order to maintain the relative weightings of shares in their portfolio to the index. This is likely to produce upward pressure on the share price.

There is another credible alternative to a heavily discounted sale. This would be a sale of a large proportion of the public's stake to a very long-term investor, such as foreign sovereign wealth funds from a country like China, Singapore, Norway or the Gulf emirates. Thus any increase in the current depressed share price as the banks return to profit would benefit foreign governments and their citizens, rather than the Britons who funded and underwrote the risk of the original bailout. It is for this reason that I hope that the government does not support this option.

Case Study: General Motors

There is a recent relevant example of a conventional privatisation following a government bail out, which I hope we can learn from. The Obama Administration recently made an Initial Public Offering (IPO) of General Motors (GM). Like the UK's

purchase of RBS and Lloyds shares, the US government never intended to own GM or Chrysler, but ended up owning 61 per cent of GM at a cost of \$49.5 billion.

The US Congress has created a Congressional Oversight Panel (COP) that publishes periodic reports on TARP.¹⁰ The Panel's latest report on the automotive bailout was published in January 2011 after the GM IPO. It makes for sobering reading.

As the COP report details, GM was relisted after a major restructuring of the company's balance sheet which significantly increased GM's intrinsic value. The IPO on 19 November 2010 was at \$33 per share, raising \$13.5 billion for the 27.5 per cent stake sold by the US government.¹¹ As the panel notes:

*"This sale represents a major recovery of taxpayer funds, but it is important to note that Treasury received a price of \$33.00 per share – well below the \$44.59 needed to be on track to recover fully taxpayers' money. By selling stock for less than this break-even price, Treasury essentially "locked in" a loss of billions of dollars and thus greatly reduced the likelihood that taxpayers will ever be repaid in full."*¹²

On the remaining 33 per cent of GM owned by the US government, the breakeven price has risen from \$44.59 to \$54.28 – a 22 per cent increase, with the new break even price now 64 per cent over the IPO price. On this basis, the US Treasury in September 2010 announced that it expected to lose some \$14.7 billion on the overall automakers bailout, with the majority of the loss coming from GM. The challenge facing the British government is to avoid similar loss of value when selling the public's shares in RBS and Lloyds.

Why a radical new solution is needed for Britain's banks

An ideal solution would both ensure that UK taxpayers recoup the money invested by their government in saving the banks, and that the nation has a chance to share in the banks' future profits and growth in value. This inclusive approach recognises that in a time of necessary national austerity, when we share the pain of the spending cuts and tax rises, so we should all share the profits from the sale of the bank shares. If we are 'all in it together', it is simply the right thing to do.

A model that meets these needs has been under development by Portman Capital since mid-2009. The model provides the distribution mechanism that maximises the return and increases the government's chance of ensuring that it recovers the

¹⁰ <http://cop.senate.gov/about/>

¹¹ COP Report.

¹² January Oversight Report: An Update on TARP Support for the Domestic Automotive Industry, 13 January 2011, available from <http://cop.senate.gov/reports/library/report-011311-cop.cfm>

public's money. It is for government to make the political judgements required to turn this into policy.

Under Portman's plan, the government would distribute approximately 75 per cent of the publicly owned shares to the population at no cost to the individual. This is a real transfer of ownership, and removes what the market refers to as the share's 'structural overhang'. When the shares are sold, a fixed nominal amount will go directly to the Treasury to repay the loans taken out to rescue the banks in the first place. Announced at the time of distribution, this minimum price – called the floor price – maximises the opportunity for the government to recoup at least the public's £65.8 billion investment in the banks. The floor price will be based on the prevailing market price, but will be at least the 51p per share we paid for RBS and the 74p per share we paid for Lloyds.

An essential element of the model is to minimise the incentive for an individual to immediately dispose of their shares. This will be a reversal of the experience of earlier privatisations or demutualisations, when quick profits were expected; large numbers of early sellers could drive the share price down, causing market instability. This disincentive is achieved by setting the floor price close to the market price on the day of distribution, reducing the intrinsic value – and therefore the incentive for – an immediate sale.

Once set, the floor price is fixed and will not change. For the individual, the floor price means that the shares provide the same economic value as what the City calls a "slightly in the money undated warrant". The substance of the transaction is that the individual has all the rights of a shareholder, in particular full dividend and voting rights.

How the Floor Price works

You have 1000 shares, which when distributed to you had a market price of say 100p with the Floor Price set at 85p. The intrinsic value of your shares – the value of your shares to you – at distribution is 15p per share (100p minus the 85p Floor Price) for the 1000 shares, a total of £150.

If in future, the share price rises from 100p to 150p, the new value of your shares to you would be 65p per share (150p minus the 85p Floor Price) times 1000 shares, a total of £650.

As the initial intrinsic value is comparatively small and the potential increase in value is large, this structure incentivises you to hold the shares and sell them over a longer period than the heavily discounted conventional privatisations of the 1980s which provided big share price increases on day one.

The Portman model removes the possibility of having to discount the share price by tackling the overhang. Also by transferring the shares to individual ownership, the free float in RBS and Lloyds is increased. Investment funds

tracking the FTSE 100 index will be obliged to buy RBS and Lloyds shares, to ensure that their fund correctly mimics the index. In addition, pension funds benchmarked against the index are likely to buy in order to maintain their portfolio's relative weightings of shares to the index. This is likely to produce upward pressure on the share price.

With the distribution, the Treasury passes control of events to the citizen. This is a fundamental shift and would signal that the Treasury, traditionally the most conservative of departments, has bought into the move from Big Government to Big Society that the coalition wishes to achieve.

Market Stability

To ensure that the stock market operates normally, Portman's plan sells just over 21 per cent of the stock to the market in two transactions: a Convertible Bond covering 6 per cent of the shares worth some £5 billion at the time of the announcement, and 15 per cent of the shares in institutional placings at the time of distribution. Selling the shares in this way ensures that the market will operate normally, whilst providing valuable early revenue for government. Demand is anticipated to be high, as the structural overhang on the shares will be removed, eliminating the need for the government to sell at a discount. Indicatively, these transactions should account for £15 billion, leaving nearly £50 billion of shares to be distributed, as detailed in Appendix B.

Who would qualify for the distribution?

There are many options for the coalition government when they come to decide who would be eligible to receive free shares. At one extreme would be the entire population as counted in the 2011 Census, somewhere in excess of 60 million people. This would throw up a huge number of social, economic and practical issues. Restricting the distribution to UK taxpayers has some attraction. But this would leave out the poorest households, undermining the notion that we are all in this age of austerity together. The simplest option would seem to be a distribution to all British adults.

Whatever the population set chosen, the sheer scale of the distribution, both in headcount and monetary terms, means that the government will need a robust dataset. Fortunately, the Electoral Roll provides a sound starting point. Updated monthly, the UK Electoral Roll holds the names and addresses of everyone who is eligible to vote in UK elections, currently about 45 million people aged over 18.¹³ A small number of British citizens are excluded from the Parliamentary franchise, notably peers and prisoners. Members of the upper house should not miss out on the share distribution, but the position of prisoners clearly needs careful consideration.

At the time of writing, voting rights for prisoners are likely to change. Whatever the outcome of the current debate, an option to consider might be the placing of offenders' shares in a trust for certain specified charities such as those working with the victims of crime or ex-offender rehabilitation.

Special provision will also have to be made for those individuals sectioned under the Mental Health Act (1983) and other incapacitated persons.

I recognise that this will require a data cleaning-up exercise to deal with the above points and other matters such as double registrations – e.g. for second home owners, MPs and students, all of whom will have two residences. The government would also need to decide what, if any, other eligibility criteria to apply to maximise fairness and equity. For example, it seems to me iniquitous to distribute shares to those who avoid paying their fair share in tax through non-domiciled status or other schemes of tax avoidance.

How would the scheme work?

The proposed distribution could bring share ownership to four in five Britons for the first time, making the banks' payback tangible to everyone. But this imposes a responsibility on government to make the process as straightforward as possible, and to support people in their investment choices through financial education. There would need to be a comprehensive array of measures in place, building on the valuable work of HM Treasury and the FSA's Consumer Financial Education Body (CFEB).¹⁴ Mass advertising also played a key role in the 1980s privatisations; to succeed, "Sid" will need to learn 21st century lessons in popular capitalism.

Once the register of eligible persons has been settled it would be used to circulate share distribution information. Each recipient might eventually need a username and password, if it is decided to give individual access to an electronic trading platform, perhaps run by UKFI in partnership with a paper-based solution available through Post Offices. There is considerable attraction in transferring ownership of the platform to the Post Office, allowing the Post Office to serve as a gateway to the stock market, increasing competition and providing access to the stock market for all.

At the time of distribution, the shares' legal ownership will transfer to recipients, and their shares will be held in their name in a nominee account, in line with standard industry practice. As owners, recipients will receive dividends and have the right to vote at Annual General Meetings, giving them a direct role in the running of the banks.

Importantly, this includes the right for individuals to vote on the election of directors, including the non-executive directors who sit on remuneration panels through the nominee account structure.

A nominee structure provides control to the public without presenting the banks with unmanageable logistical problems. There is enormous scope for not only returning real economic value to the citizen, but for also giving the public a say in the business practices of the banks that they saved and now own.

Share trading strategy is an individual decision, and government will provide two options. First, recipients may elect to trade the shares themselves, selling at a time of their choosing. That means that, when they do sell their shares, this group of recipients will receive a cheque for the sale proceeds less the floor price. An adjustment will need to be made to tax any capital gain. (The options are outlined in Appendix C). There would of course be a small broking fee to cover the cost of the service, set by government to cover the scheme's costs in accordance with existing Fees and Charges policy guidance.

What could this mean for me?

The Floor Price will not be below 51p per share for RBS and 74p per share for Lloyds. Given the floor price is fixed, the benefit of any increase in the share price passes to the individual. Therefore, if the RBS share price reaches 75p, and Lloyds rises to £1.10, well below their respective historic highs, then the individual's profit would be £520.

Learning from the 1980s privatisations, UKFI could offer to trade the shares for recipients using Volume Weighted Trading within preset price bands to maximise the total return. This means that the market knows that UKFI will never trade more than a fixed percentage of the trading volume, making it much harder for the market to anticipate when UKFI sales will take place, and therefore to profit at the public's expense.

Trading could be broken up into six-monthly blocks, called Trading Periods. Automatic trading will be the default option, and at the end of each trading period, recipients will receive a statement outlining how many shares were sold and at what price, along with the proceeds less the floor price, applicable Capital Gains Tax (CGT) and a single broking fee to cover the cost of the service in the relevant six months. It is expected to take two to three years to sell the shares, depending on market conditions and the banks' performance.

Recipients can opt out of automatic trading initially or at any point in the first five months of any Trading Period for the subsequent Trading Period. As it is likely to maximise a recipient's return, the automatic trading scheme is likely to be popular, as long as it is carefully explained.

What should happen next?

Both RBS and Lloyds have recently announced a return to operating profit, preparing the way for a return of both banks to the private sector.

HMTreasury will need to consider the options for recovering the £66bn used to rescue the banks, whilst ensuring that the public benefit from the bail out in the long run. I hope this pamphlet is a useful contribution to that debate.

Appendix A - Illustrative Timeline and Key Dates

Following Announcement Day (A-Day), the £5 billion Convertible Bond is issued to ensure the smooth operation of the market. These proceeds ensure an early start in debt reduction.

Shortly after announcement, on Qualification Day (Q-Day), those meeting the eligibility requirements will qualify to receive the share distribution.

Information Day (I-Day) follows after the list of eligible recipients has been prepared. Those eligible will receive an information pack outlining the process, electronic trading platform username and their sale and transfer options. Separately, recipients will receive their electronic trading platform password. Individual accounts on the electronic platform will be live at this point, and anyone who does not wish to participate can withdraw from the scheme, and their account will be cancelled.

Distribution Day (D-Day) is the date on which the shares are legally transferred to the recipients, and the market placing of the shares is made. The first six-month Trading Period (TP 1) begins.

'Payout days' will occur shortly after the end of each trading period, when those who elected to stay in the automatic trading mechanism will receive their share sale proceeds less the floor price, applicable CGT and a single broking fee to cover the cost of the service for that trading period.

Appendix B - How does government recover the money used to bail out the banks?

The government spent £65.8 billion acquiring new shares in Royal Bank of Scotland and Lloyds Banking Group. UK Finance and Investment now holds 90.645 billion RBS shares acquired for approximately 51p each and 27.618 billion shares in Lloyds acquired for approximately 74p each.

When the government decides that the time is right to return the shares to the private sector it will recover the investment in three stages, under the plan in this pamphlet. The government should only announce the timetable when the shares already in the market are trading near the acquisition prices of the UKFI held shares. This would determine the floor price.

The first stage at the time of announcement is to issue a £5 billion convertible bond, split £3.5 billion worth of RBS shares and £1.5 billion worth of Lloyds shares. If the bond is set at a 20 per cent premium over the floor price then approximately 5.7 billion RBS shares (6.3 per cent of the holding) and 1.68 billion Lloyds shares (6.1 per cent of the holding) will be in the bond.

What is a convertible bond?

A convertible bond is a loan that exchanges into shares at the option of the investor. As the investor converts into shares at their choice, this attracts a premium to the prevailing share price. In this case, this allows the government to sell up to £5 billion of RBS and Lloyds shares at a premium to the market price at the time of announcement.

When the government decides to make a distribution of the shares to the public it will first sell approximately £10 billion worth of shares directly to investors, in order to stimulate a market in the shares. It is envisaged that 15.1 per cent of the original holding of RBS would raise approximately £7 billion and 14.7 per cent of the Lloyds holding would raise approximately £3 billion.

The bond and market placement will have raised approximately £15 billion for UKFI which could now be used to repay the debt incurred to buy the shares in 2008.

Once a market in the banks' shares has been created the government could initiate the distribution of the vast majority of the remaining shares to the public, retaining a small number to deal with any problems or late claims. The floor price would be made clear at this point, most likely set at the 2008 acquisition prices of 51p for RBS and 74p for Lloyds. When the shares in the market are trading approximately 15 per cent above the floor then conditions will be right for the full public distribution.

At the time of the 2010 general election there were 45,597,461 people on the parliamentary electoral roll.¹⁵ A distribution of 95 per cent of the remaining shares would give each elector 1,484 shares in RBS and 456 shares in Lloyds.

After an interval of a few months the government could dispose of the retained 5 per cent holding. At this point it will have recovered about a fifth of the 2008 investment. Recovery of the remaining 80 per cent would depend on when the public sold their shares.

An individual may hold onto their shares, taking dividend income, from which the government will receive some income tax. It is likely that most individuals would sell their shares when they can see a clear profit above the floor price that has to be passed to the Treasury. For example, if the market price of RBS shares rose to 75p and Lloyds shares to £1.10 then an individual would be sitting on a profit of £520 above the floor price at distribution. Each time a disposal is made the Treasury would receive the floor price. An adjustment would also be needed for CGT.

Appendix C – Capital Gains Tax Treatment

Conceptually, there are three potential CGT treatments for the sales of the shares distributed to the population.

First, government could apply the existing rules, with each individual paying CGT on capital gains of more than £10,000 in each year at the applicable rate, currently 18 per cent for basic rate taxpayers and 28 per cent for higher rate taxpayers. As individuals would receive the shares in a personal investment capacity, Entrepreneurs' Relief at 10 per cent would not be applicable.

Second, government could elect to leave all of these windfall proceeds outside of the tax system, allowing all capital gains to be realised tax free.

Third, government could decide that the extraordinary nature of this distribution means that it should be considered outside of the existing CGT framework, collected from all recipients at the point of sale through the electronic trading platform.

¹⁵ House of Commons Library.

In revenue terms options one and two are likely to be very similar; given that a tiny proportion of UK taxpayers have capital gains near or over £10,000 p.a., the number who would pay CGT on the distributed share sales is very small. Option one would also impose a significant administrative burden on HM Revenue & Customs in processing the additional self-assessment paperwork.

The third option overcomes both drawbacks, and provides the state with an on-going interest in the performance of RBS and Lloyds through taking a proportion of the profits above the floor price. A common approach recognises the exceptional nature of the distribution, and underlines that 'we're all in this together'. Collection at source is straightforward and would ensure that there is no leakage of revenue.

It would be for government to decide on whether to levy CGT on these shares at a flat rate, or to extend the existing dual CGT of 18 per cent and 28 per cent for basic and higher rate taxpayers. There are clear policy and administrative attractions in a single rate, but either option is workable.

About the author

Stephen Williams was elected as Member of Parliament for Bristol West in 2005. He was appointed the chairman of the Liberal Democrat backbench committee for Treasury matters in 2010. He qualified as a Chartered Tax Adviser and, before becoming an MP, he worked for several large firms including PriceWaterhouseCoopers and Grant Thornton.

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