Centre for Policy Studies

Pointmaker

GIVE US OUR FAIR SHARES

HOW TO GET BEST VALUE FOR TAXPAYERS FROM REPRIVATISING THE BANKS

JAMES CONWAY, TOBY FENWICK AND MICHAEL O'CONNOR

SUMMARY

- Rescuing RBS and Lloyds in 2008 was a regrettable necessity, costing the UK taxpayer £66 billion.
- Long-term public ownership of RBS and Lloyds is not attractive. State ownership blunts banks' decision-making, depressing their value and hindering their long-term international competitiveness. The Coalition should do all it can to realise quickly the true value of its stakes in the banks.
- But the shareholdings in the banks are so large that the shares would, in a conventional privatisation, have to be sold at a large discount to their true value.
- However, by distributing shares to UK taxpayers and charging a fixed amount for each share when it is sold on (the "Floor Price"), this "share overhang" can be overcome. Better still, it gives any increase in value above this price to taxpayers.
- This proposal is a market-driven solution designed to maximise value for taxpayers. It balances three competing tensions: maximising returns to the Treasury; returning the banks to the private sector; and rewarding taxpayers for rescuing the banks.
- All onward shares sales by taxpayers will be subject to 18% Capital Gains Tax (CGT), irrespective of their CGT tax status. This will give the Treasury a share in the increased value of the rescued banks.
- To encourage early repayment, taxpayers should also be offered a CGT-free option if they pay the Floor Price up-front. This, along with £15 billion from an exchangeable bond and an institutional share placing, will generate early and high-value receipts to the Treasury.
- Importantly, this proposal would also increase popular appreciation of the financial sector. By creating universal share

ownership in the UK, the 80% of Britons with no current experience of share ownership would participate in the opportunities that savings and investment provides.

FOREWORD

Matthew Hancock MP

In 2008, as the boom turned to bust, every British taxpayer suddenly became a shareholder of two of the largest banks in the world. Whether we liked it or not, we spent £66 billion – over £3,000 for every family - to become the not-so-proud owners of 84% of RBS and 43% of Lloyds. What's more, we all continued to share in the wider economic misery of the recession that followed.

Now, three years later, although these banks are still worth less than taxpayers paid, they are gradually working their way back to health. It is a long, slow process, but we need to plan for when they get there. Because long term public ownership would be bad for the banks and bad for taxpayers. So now is the time to ask the question: how can the shares be distributed so that the taxpayers get their money back and are rewarded for the risk they ran in saving the banks?

This paper argues that those of us who rescued the banks – the public – should be given their fair share. Technicalities aside, the most powerful message of the proposal is the instinctive Conservative belief that those who took the hit should gain from the recovery.

The paper argues for an inclusive distribution, where the shares are given to all taxpayers. When the shares are then sold, a fixed amount – enough to recoup the original cost – would be paid back to the public purse, while any additional profit would be kept by individual taxpayers. This would put the returns back in the hands of the taxpayers who saved the banks.

There are several benefits. The sale of the state-owned banks will amount to one of the largest privatisations in history, anywhere in the world. The more people that participate, the greater the value that can be recouped and the greater the reward for the public. It will also involve everyone in Britai. All will be shareholders. All will have a say in how the financial sector works. It is an opportunity to encourage engagement between the finance sector and the general public, which would be a step towards closing the rift that persists after the crisis.

The power and profit would be with the new shareholders, the public, who could finally benefit from the risk they took in 2008.

It is a Conservative plan to empower individuals, help get the banks out of state hands, and maximise taxpayers' return for money. British taxpayers saved these banks, and have paid the price for their poor regulation and mismanagement. This plan would allow them to share in the reward as the banks return to health.

Matthew Hancock is MP for West Suffolk. He is a member of the House of Commons Public Accounts Committee. Before entering Parliament, he was an economist at the Bank of England and was later Chief of Staff to George Osborne.

INTRODUCTION

Given the scale of the financial crisis in 2008, the then Labour Government was right to stabilise the UK financial system through purchasing shares in RBS and Lloyds, as opposed to providing US-style loans.

Those who ran the risk of bailing out the banks should be those who benefit from their future performance: and that is the taxpayer, not the broader investment community (which passed up the opportunity to invest in the banks in the round of rights issues, which the taxpayer consequently had to underwrite). Indeed, the price which the taxpayer paid for its stakes in RBS and Lloyds is the price at which the investment community refused to share the risk. It is now for the Coalition to decide how to recoup the public's £66 billion investment.

WHY REPRIVATISE?

The economic benefits of privatisation are clear: public ownership is inherently inefficient, with nationalised industries typically overstaffed and undercapitalised. The private sector has the incentive to improve performance, with the greatest productivity gains in sectors where competition was fiercest. The 1980s privatisations – of companies such as British Aerospace, Associated British Ports and British Telecom – showed that, in market hands, profitability rather than consensus became the key driver, with efficiency gains for the whole economy.[1]

The negative consequences of state ownership are exacerbated in the case of the banks. It distorts competition by offering an explicit guarantee to some firms and not others and invariably leads to politically directed lending decisions: the underlying assumption of "Project Merlin", for example, is that it is the State that should direct lending targets.

Aims of Reprivatisation

The Coalition has stated that its aim in reprivatising RBS and Lloyds is to recover the £66 billion invested in 2008. Once RBS and Lloyds move into profit and start paying dividends, the shares could rise above the price the government paid. This could allow share

---

[1] For full details on the impact of privatisation, see the series of papers prepared for the CPS by NERA, in particular Privatisation and its Effect on the Exchequer Profit or Loss? (1997).

What is a Share Overhang?

A structural overhang occurs when the market knows that the owner of a significant proportion of a company's shares wants to sell them when they reach a certain price. As these shares will need to be sold at a discount to the market price, other shareholders sell in anticipation of the placing, depressing the share price. Investors will always be reluctant to own the shares above the level at which they know there is a large seller.

In the case of the UK banks, the high proportion of publicly owned shares means that the market currently anticipates sales at a significant discount. This is especially true for the earliest sales, as investors know that future sales will follow. In essence, why would you buy a car for £15,000 if you knew an identical one would be available at the dealer next door tomorrow for £13,000? 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 called a structural overhang.

sales to repay the debt. But that will depend on the government selling RBS for at least 51p per share and Lloyds for 74p per share.[2]

The second aim of reprivatisation should be for taxpayers to receive the full value of their stake in the banks. After all, £66 billion of taxpayers' money was put at risk to rescue the banks in the first place – all of which could have been lost if the banks failed. It is right that taxpayers should get a tangible share of the profits once their banks return to health.

The Coalition should also take this opportunity to increase popular understanding of economics and finance. Even after the 1980s privatisations and the 1990s demutualisations, only about 20% of the UK population has ever owned shares. The financial crisis of 2008, together with the less than ideal behaviour on the part of some in the City, has led to at best popular apathy and more often outright hostility to those working in financial services. Bridging the divide that has arisen between the world of finance and the public is necessary for the long-term health of the UK's most successful industry. An inclusive reprivatisation can begin this process.

OPTION ONE: A CONVENTIONAL REPRIVATISATION

Recovering the £66 billion invested in RBS and Lloyds will not be easy.[3] Advertising your intention to sell 84% of RBS and 43% of Lloyds[4] when the market is aware of the price you paid is like playing poker with an open hand. Simply put, there is little reason for an investor to pay more than 51p per share for RBS or 74p per share for Lloyds when they know that this is the government's break-even price.

As such, while the shares may approach the price that was paid in 2008, they are unlikely to move significantly beyond it. Investors are likely either to sell their holdings in the anticipation of the government selling their stakes or even to short-sell the shares with the view to buying them back more cheaply when the government sells its stake at a lower price.

This self-reinforcing effect – also known as a share overhang (see below) – provides an invisible ceiling, making it harder for the government to achieve value for money.

A dramatic example of this problem was the Obama Administration's sale of its General Motors shares last November. In selling 45% of the US government's stake at a discount, the Obama Administration locked in a $10 billion loss.[5] If this discount were repeated in the UK, it would equate to a £15 billion loss – the annual cost of policing England and Wales, or the entirety of the UK transport budget.

Some have argued that when RBS and Lloyds move into profit and start paying dividends, the shares will rise above the price the government paid. This would allow sales to repay the debt. Under optimistic scenarios, the Treasury could make a profit.

[2] Figures rounded up to the nearest whole penny. See UKFI, Annual Report and Accounts 2009-10, www.ukfi.co.uk

[3] Note that this paper does not consider the reprivatisation of either Northern Rock or Bradford and Bingley as the value of these companies is relatively small (Northern Rock would only be worth about £10 to £15 per head).

[4] At 31 March 2010. See UKFI, Annual Report and Accounts 2009-10, www.ukfi.co.uk

[5] January Oversight Report: An Update on TARP Support for the Domestic Automotive Industry, 13 January 2011.

But the structural overhang means that investors will demand a significant discount simply because the stakes are too large for the market to absorb. Therefore, irrespective of the price or timing of the sales, there will be a disconnect between price and value: whatever the price received for a conventional reprivatisation, UK taxpayers will not recoup the full value of their stake.

It is important to note that the better the banks perform, the greater the discount the market will demand as everyone knows the price the government paid. Having run all the risk in restoring the banks to health, it would be difficult to justify this discount – likely to be more than £15 billion – being presented to the City, hedge funds or a foreign sovereign wealth fund.

It is also argued that, with a conventional privatisation, the government could sell the shares at a time of its choosing. Narrowly, this is true. However, because of the discount generated by the overhang, the government has less control over the price it can achieve. In fact, because the government's stakes are so large, it finds itself in the invidious position where the more quickly it wants to sell its shares, the less control it has over pricing. For as long as the Government intends to fully recoup the £66 billion rescue cost, it is the market rather than the Government that has effective control over the timing of share sales.

How does the floor price work?

You have 1000 shares. When distributed to you, they had a market price of 52p with the Floor Price set at 50p. The value of your shares to you at distribution is 2p per share (52p minus the 50p Floor Price) for the 1000 shares, a total of £20.

If in future, the share price rises from 50p to 85p, the new value of the shares to you would be 35p per share (85p minus the 50p Floor Price) times 1000 shares, a total of £350.

OPTION TWO: HOLD INDEFINITELY AND SELL AT A PROFIT

Sweden fully nationalised Nordea Bank in 1992 after a housing bubble caused a Swedish banking crisis.[6] The Swedish Government decided to hold onto the shares, selling them slowly over time. Yet despite selling an additional stake of 6.3% in February 2011, nearly 20 years later, the Swedish state continues to own 13.5% of Nordea.[7]

Sweden's experience suggests that to extract the true value from RBS and Lloyds, sales will need to be phased over this *and* the next three Parliaments. With government ownership being less than optimal for the banks, the share price would continue to be depressed. Achieving real value for taxpayers would therefore be much more difficult, even over this time span.

OPTION THREE: DISTRIBUTION TO MAXIMISE TOTAL TAXPAYER RETURN

There is an alternative: a universal privatisation which distributes shares to all taxpayers free. If, in addition, a fixed amount goes back to the Treasury from every sale then the problem of the share overhang is overcome. This fixed amount – known as the Floor Price – would be at or above the amount that the government paid for the shares, ensuring that the £66 billion would be recouped over time. Any profit above the Floor Price would accrue to the individual shareholder. This has five benefits.

1. It puts a "floor" under the share price, as there are suddenly no sellers near or below the Floor Price, and an increasing number of sellers as the share price increases. It is the distribution itself that creates increased value over a conventional privatisation by inverting the dynamics of supply and demand. The market in the shares switches from one large known seller at an assumed price, to a broader group of owners with no rational economic reason to sell at that assumed price.

2. By relisting 84% of RBS and 43% of Lloyds at once, tracker funds and other funds which are benchmarked against the FTSE index will have fewer RBS and Lloyds shares than they need to replicate the index. Together, this creates demand at that same point at which there is now no supply. This produces a structural short in the market – which will ensure that the share price will initially stay above the "Floor".

3. To ensure that the market operates normally, a £5 billion bond, exchangeable into RBS and Lloyds shares, will be issued at announcement and £10 billion of shares will be placed at distribution. This returns £15 billion to the Treasury immediately, with the balance to accrue as sales take place. It should be noted that neither the share placing nor the exchangeable bond would be possible for fair market value unless the share overhang is removed by the distribution. The three elements come as a package – the distribution to unlock the overhang and the placings to restore normal market practice whilst accelerating receipts to the Treasury.

---

[6] See C Dougherty, "Stopping a Financial crisis, the Swedish Way", New York Times, 22 September 2008.

[7] See A Ward, "Sweden to sell more of Nordea stake", Financial Times, 4 February 2011.

4. These proposals could be implemented if it were decided to break the banks up. This means that the findings of the Vickers Commission can be considered and assessed in isolation from the question of bank ownership. The proposals also remove the risk of EU state aid actions against the UK.

5. The Coalition's plans to cut the deficit will take time. Enabling the banks to make a collective repayment to British taxpayers could be an important element of maintaining public support for the austerity package.

THE BENEFITS FOR THE TREASURY

The key benefit to the Treasury is that by removing the share overhang, the need for a discount is removed, allowing the Treasury to both recover the £66 billion and avoid giving excess profits to the market. Further, the proposal would ensure that the £15 billion in early receipts reflects fair value, which cannot be achieved through a conventional sale.

This method of distribution would also dramatically reduce the costs typically associated with a large placing. Investment banking fees for a conventional privatisation of this nature are cautiously estimated at around £1 billion (assuming fees of 1.5% on £66 billion).

However, distributing shares to all UK taxpayers would mean that no such investment banking fees for the share distribution would be necessary. Instead, it is proposed that an electronic trading platform would be developed, enabling shares to be distributed to, and traded by, all taxpayers online (see the box opposite for comments on the feasibility of establishing such a platform). A paper-based option would also be available through the Post Office for those without access to the internet. The costs incurred to develop the necessary infrastructure have been estimated at a maximum of £250 million.

This suggests a total saving for the Treasury of at least £750 million. In addition, the Treasury would then own a significant asset which could be used for future share distributions and ultimately privatised itself. This could also become an effective method of encouraging government-sponsored saving schemes such as NS&I. One option would be to merge the trading platform with the Post Office, thereby increasing its attraction to investors and therefore receipts to the Treasury upon privatisation.

THE BENEFITS TO INDIVIDUALS

For the 80% of taxpayers who have never directly owned shares, the distribution provides a valuable stake in two of the UK's largest companies, and a risk-free introduction to the benefits of investing. The shares are also valuable in their own right: over time, the value to the individual after deducting the Floor Price and CGT could be around £350 for the RBS shares and £150 for the Lloyds shares.

As shareholders, individuals will also be eligible for dividends, and have full AGM voting rights through a nominee company.

BROADER SOCIAL BENEFITS

The distribution should be carefully designed to protect the vulnerable and those with limited financial expertise. Most importantly, it should be impossible to transfer the shares without selling them, therefore avoiding the Russian oligarch experience in the 1990s.[8]

---

8 Note that detailed study of the universal privatisations of the 1990s in Latin America, Eastern Europe and the former Soviet Union will be necessary to ensure smooth and fair implementation.

In the light of the contribution that non-UK nationals who pay substantial UK taxes made to underwriting the banks' rescue, all UK taxpayers should be eligible for the share distribution.

Protections should be built into the trading platform, too: on an opt-out basis, the shares will be traded through an automated, value-maximising electronic platform. Empowerment and responsibility are key. Individuals would be free to trade the shares themselves, though the history of privatisation suggests that this is unlikely to maximise value. All of the services could also be available through the Post Office.

TAX TREATMENT AND INCENTIVES

The appropriate Capital Gains Tax treatment is essential to the success of these proposals.[9]

The correct CGT treatment recognises the exceptional nature of the distribution by taking the proceeds outside an individual's annual allowance, and levying a flat 18% rate on the profits. This has two important consequences.

1. It can offer CGT relief for those who pay the Floor Price within the first three months. This will drive early receipts to the Treasury, reducing the national debt.

2. For those who elect not to pay early, CGT provides the Treasury with a share of the profits above the Floor Price, increasing the total return to the Treasury.

[9] The inspiration for these proposals was an article by Lord Saatchi, "If banks make billions, I'd like my share" (The Times, 28 September 2009). This idea was also discussed by Stephen Williams MP, in Getting Your Share of the Banks: giving the banks back to the people (CentreForum, 2011). Steve Williams' paper is welcome but his implementation has areas that can be much improved, particularly in relation to tax treatment of shares.

CONCLUSION

These proposals focus on individual empowerment, actively reduce the State's activities and maximise the returns for both the UK taxpayer and the Treasury. They are both economically liberal and – as a side-effect of its value creation mechanism – likely to be extremely popular.

THE AUTHORS

James Conway is a partner of Portman Capital. He was previously a Portfolio Manager with Arrowgrass and at a subsidiary of Deutsche Bank.

Toby Fenwick is Public Sector partner at Portman Capital. He has a broad range of private and public sector experience, combining a background in commercial banking strategy at NatWest and Barclays with a range of positions at HM Treasury including European Financial Regulation, defence and foreign policy spending and practical preparations for the Euro.

Michael O'Connor is a founding partner of Portman Capital. He was previously a Portfolio Manager at GLG Partners and at Polygon Partners; and was Head of Convertible Bond Research at Deutsche Bank.

THE CENTRE FOR POLICY STUDIES

The Centre for Policy Studies is one of Britain's best-known and most respected think tanks. Independent from all political parties and pressure groups, it consistently advocates a distinctive case for smaller, less intrusive government, with greater freedom and responsibility for individuals, families, business and the voluntary sector.

Through our Associate Membership scheme, we welcome supporters who take an interest in our work. Associate Membership is available for £100 a year. Becoming an Associate will entitle you to all major CPS publications produced in a 12-month period; invitations to lectures and conferences; advance notice by e-mail of our publications, briefing papers and invitations to special events.

The aim of the Centre for Policy Studies is to develop and promote policies that provide freedom and encouragement for individuals to pursue the aspirations they have for themselves and their families, within the security and obligations of a stable and law-abiding nation. The views expressed in our publications are, however, the sole responsibility of the authors. Contributions are chosen for their value in informing public debate and should not be taken as representing a corporate view of the CPS or of its Directors. The CPS values its independence and does not carry on activities with the intention of affecting public support for any registered political party or for candidates at election, or to influence voters in a referendum.

978-1-906996-38-3