The UK investment in Royal Bank of Scotland

Rothschild report

10 June 2015

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1. Letter to the Chancellor

The Rt Hon George Osborne MP,
Chancellor of the Exchequer,
Her Majesty's Treasury,
1 Horse Guards Road,
London
SW1A 2HQ

10 June 2015

Dear Chancellor,

The government's shareholding in the Royal Bank of Scotland

You asked us to provide you with an assessment of whether or not it is appropriate and in the interests of taxpayers for the government to start to sell its stake in the Royal Bank of Scotland Group plc (RBS). This document summarises the analysis we have undertaken and sets out our resulting conclusions.

As of today, in the absence of unforeseen circumstances, taxpayers can comfortably expect to secure proceeds from their interventions in the banks that exceed the money put in. This contrasts with expectations at the time such interventions were made: in the 2009 Budget, HM Treasury estimated that the ultimate cost to the taxpayer of the financial sector interventions would be in the order of £20-50 billion. Alongside the United States, the UK will be one of the first countries that is able to demonstrate that it can comfortably expect to record a gain on its bank interventions.

As for RBS, it has made significant progress since the time of the government's interventions. It has removed more than £1 trillion of assets from its balance sheet, significantly improved its capital position and now has a much more robust funding and liquidity structure. It is shrinking RCR, the internal bad bank created after HM Treasury's review in 2013, and looks set to complete the wind-down ahead of schedule. The management team, led by Ross McEwan, has re-evaluated the Group's strategy and the bank is on course to be smaller and simpler, focused on serving its customers in businesses where it has real competitive advantage. While much remains to be done, in particular to improve customer service, reduce costs and shrink the investment bank, the new strategy is consistent with the new direction for the bank that was set out by RBS and HM Treasury at the conclusion of the government's bad bank review.

The returns on the government's interventions in RBS will be determined by the success of the whole of the selling programme, rather than the terms achieved on the first few disposals. Accordingly, as a precursor to a long-term programme, we believe that it is now in the interest of taxpayers for the government to set in train an initial small disposal of RBS shares for a number of reasons:

1. By starting to sell, the government will increase the free float which should in turn improve the marketability of the remainder of its shareholding. This will enable the government to execute larger sales on better terms than would otherwise have been the case;

2. We believe that sending a strong signal that RBS is on the road to recovery and that its reprivatisation has begun may also bring further benefits to the bank and therefore to the taxpayer as shareholder;

3. Market conditions for financial assets and bank shares are currently good;

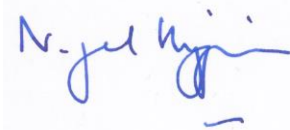
4. We believe that the current price of RBS shares reasonably reflects its future prospects based on its current strategy and the risks associated with this being achieved; and

5. We believe that RBS is ready to be sold and do not believe that there are other reasons that would preclude a share sale in the short term (i.e. in the next 12 months) or render it poor value for money for the taxpayer.

Given the current limited market for RBS shares, any sales in the short term would need to be carefully calibrated by reference to the depth of the market and the current size of RBS's free float and with a clear objective of maintaining an orderly aftermarket following any transaction.

Yours truly,

For and on behalf of Rothschild



Nigel Higgins, Chief Executive

2. Overview of Rothschild's analysis

2.1 The taxpayers' interventions in RBS

RBS benefitted from taxpayer support under the four principal programmes activated by the government to support the banking sector during the crisis[1]. The government's recapitalisation of the bank was ultimately made in three parts:

- RBS participated in the bank recapitalisation scheme announced in October 2008 when the government underwrote (and ultimately took up substantially all of) a £15bn share placing. The government also subscribed for £5bn in new RBS preference shares;
- Following the announcement of a large loss for 2008, the government converted its preference shares into new ordinary shares – a higher quality form of capital; and
- The government subscribed for £25.5bn of 'B' shares in RBS, which can convert into ordinary shares, to facilitate RBS's participation in the Asset Protection Scheme (APS). RBS also issued a Dividend Access Share to the government which it has subsequently agreed to retire for a total payment of £1.5bn. The government has no further exposure under the APS.

In total, the gross cost of the recapitalisation of RBS to the government was in excess of £45 billion.

2.2 Reasons for considering a sale of RBS shares

The government's shares in RBS were not intended to be an investment; instead, they were acquired as a result of a package of measures put in place to secure financial stability. It is also stated government policy that it should not be a permanent investor in UK financial institutions. Our analysis therefore has not sought to address the question of whether the government should sell its stake in RBS, but rather when it should do so.

We believe that it is now in the interest of taxpayers for the government to set in train an initial small disposal of RBS shares. In reaching this view we have made the following five key assessments.

2.2.1 Selling should improve the marketability of RBS shares

The overall return to taxpayers on the government's interventions in RBS will be determined by the success of the whole of the selling programme, which is likely to last a number of years, rather than on the terms achieved on the first few disposals.

At present, it is likely to be difficult to make a large sale of RBS shares on attractive terms, in particular because the shareholder register is concentrated and there is limited trading in RBS shares relative to the size of the bank.

[1] It also benefitted from covert emergency liquidity assistance from the Bank of England during the peak of the crisis

Table 1. Share trading information in selected banks (all exchanges)			
	RBS	**Lloyds**	**Barclays**
Market cap, £bn	41.2	62.2	44.5
Free float, %	22%	76%	95%
Average daily trading volume, £m	119	282	267
Average daily trading volume, % of market cap	0.29%	0.45%	0.60%

Source Bloomberg

While the relative lack of trading may in part be a function of the extent of restructuring still required at RBS, it is also likely to reflect the existence of the significant government shareholding; RBS's small free float and limited liquidity may deter investors from purchasing RBS stock. The limited liquidity in the shares will make it hard for them to buy in any material quantity without their buying pushing the price up, inflating their cost of ownership. Conversely, the opposite may be true when they come to sell.

The impact of this has been recognised by some analysts. For example, one equity research analyst recently wrote that:

> "We believe that any increase in the group's free float through a government share sale would improve liquidity for long-term shareholders and hence could be a positive… We believe that the low free float of the shares (c. 21%) is proving to be a deterrent to some potential shareholders. A government sale […] could encourage investment from value investors willing to back management's long-term plan to return cash to shareholders."

By selling some of its shareholding now, the government will improve the marketability of RBS shares and thereby the chances of it being able to make larger share sales in the future. The impact of even a small increase in the free float could be material: our analysis suggests that liquidity tends to increase rapidly as free float increases from low levels.

2.2.2 Selling may benefit RBS and the government as shareholder

There are plausible reasons to believe that by starting to sell down its stake in RBS the government can bring about broader benefits for the institution which could help accelerate its recovery and in turn benefit the share price.

These benefits might primarily derive from two sources. First, the start of a sale programme can send a strong signal that the bank is making strong progress in its restructuring and is well on the way to recovery. Secondly, any residual impression amongst investors that the bank may not be run for purely commercial purposes is likely to evaporate very quickly. There can be a fear amongst investors in companies with controlling shareholders that the business might be operated in the interests of the larger shareholder. However, once such a shareholder announces credibly that it intends to exit then this should not be a significant cause for concern: investors may assume that the larger shareholder is also focused on achieving the best value for money.

The signal that RBS is again becoming a normal commercial institution – rather than being the only large UK bank that continues to be supported financially by the government – may build the

confidence of potential clients and market counterparties. It may also increase the focus of management and employees on a shared objective, bringing broader benefits to the bank and to the government as a shareholder.

As Robert Talbut[2] told the Treasury Select Committee in 2012:

> "The overhang or the presence of a single government shareholder owning over 80% of the shares is an inhibiting factor on other commercial organisations wanting to own shares in the company."

We have reviewed a number of previous examples of the performance of the shares of banks when their respective government shareholders began to sell down. In each of these cases there was an improvement in the valuation of the investee banks when the government started to sell. This may also apply in the UK: Lloyds's share price rose by more than 9% on the news that it would not participate in the APS and would raise private rather than government capital; its shares also rose when the government began selling down its stake and when UKFI announced the extension of the trading plan. Similarly, RBS's share price rose by more than 6% when its intention to exit the APS was announced. However, the evidence is necessarily inconclusive: it cannot be proven that it was government selling that caused the increase in valuations, rather than an improvement in conditions that also boosted the share price.

Nevertheless, our judgment is that there is a reasonable prospect that the start of a sale programme by the government could change perceptions of RBS with consequent potential benefits for larger share sales in future.

2.2.3 Market conditions for financial assets and bank shares are good

Following the financial crisis, "risk-free" rates in many major economies around the world have fallen to very low levels. One result of this has been that yielding assets that are readily tradable have also increased in price with a corresponding fall in yield. These trends, which have been reinforced in the banking sector by the increased financial strength of the banks and other government actions (for example the Funding for Lending Scheme in the UK), are improving the availability of funding to banks while its cost has reduced.

These developments are in turn improving the value of legacy loan assets. Banks, which had been unable or unwilling to sell certain assets following the crisis, are now doing so in record volumes and at better pricing than was previously available. For example, in the commercial real estate market, record volumes of loan portfolio sales are being transacted, facilitating the accelerated de-risking of banks. In 2014, Deloitte recorded £33.6bn of direct and non-performing loan (NPL) portfolio sales, an increase of more than 80% on 2013 and reflecting a record number of transactions.[3] The benefits of this trend to RBS are visible in the results of RCR: asset sales have contributed more than £400m to RCR's operating profit in the six months to 31st March 2015.

These developments have been reflected in the market for bank shares, as investors have increasing clarity over the level of "normalised" earnings and are willing to pay an increasing multiple for such earnings. The EuroSTOXX banks index has increased by approximately one-third over the past year, and, measured on the basis of historic price/earnings multiples, UK banks are trading at a premium to long-term averages.

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[2] Mr Talbut was then the Chief Investment Officer of Royal London and the Chairman of the Investment Committee of the Association of British Insurers, one of the largest associations of UK institutional investors

[3] Deloitte Portfolio Investment Market Report, Spring 2015

In our assessment, market conditions are currently favourable for sellers of financial assets and, while it is impossible to predict the future, the potential for further material improvements needs to be balanced against the risks of a deterioration in market conditions.

2.2.4 The valuation of RBS shares

Since the onset of the financial crisis there has been a dramatic reduction in the market's assessment of the value of RBS. A number of factors have contributed to this loss. Most significantly, we believe that these include the more than £30 billion in losses that RBS has recognised to date; a significant increase in the amount of capital that markets and regulators require banks, including RBS, to hold to support a given level of business; and a reduction in the earnings generating capacity of RBS resulting both from the shrinkage of its business and changes in the markets in which it operates. We believe that a significant proportion of the reduction in value is likely to be permanent.

We have conducted a valuation of RBS using a number of different valuation methodologies which we summarise below:

- Our "steady state" valuation assesses how the market might value the "go forward" RBS once its restructuring is complete and takes into account the time this might take to achieve, the capital that could be released as RBS shrinks its balance sheet and makes an allowance for possible further litigation, conduct and restructuring charges that RBS might take. This methodology produces a result consistent with the current share price;
- A sum-of-the-parts analysis, based on comparable trading multiples, suggests that the market is consistent in its valuations of RBS and other banks;
- We have reviewed analysts' target prices for RBS shares and, where published, the valuations that in part underpin these targets. We have discounted these valuations to today where appropriate. RBS shares are currently trading towards the upper end of these ranges, as adjusted;
- We have considered how markets value RBS compared to other large European retail and commercial banks on a price/earnings and price/book regression basis. While RBS currently trades at a premium to its peers, we believe that this reflects depressed short term earnings expectations for RBS, relative to the bank's potential future profitability, rather than fundamental overvaluation. We do not therefore place much weight on these valuations; and
- We have sensitised our "steady state" valuations for a range of possible scenarios for the sustainable earnings capacity of "go forward" RBS and for different potential outcomes for the path of its deleveraging and future litigation and other expenses. The current share price lies firmly within the range of expected values and we see no reason to believe that there is any particular probability bias towards the positive or negative scenarios.

Based on our analysis we believe that the current RBS share price fairly reflects the fundamental value of the bank, taking into account its prospects and the possible future risks that it faces.

2.2.5 RBS's readiness for sale

2.2.5.1 RBS's strategy

Since Ross McEwan took over as Chief Executive the RBS Board has thoroughly re-evaluated the Group's strategy. Following the success of the previous management team in reducing the significant balance sheet risks that RBS faced, the company is now on a path to being a smaller

and simpler bank focused on businesses where it has a genuine and enduring competitive advantage. RBS's new strategy is consistent with the new direction for the bank that was set out by RBS and HM Treasury at the conclusion of the government's bad bank review.

While RBS has made a strong start in executing the strategy – for example achieving more than £1bn of cost savings in 2014 – much remains to be done. RBS anticipates incurring restructuring costs until 2017, with more than half of the overall expense occurring in 2015 and after. Nevertheless, in light of the progress to date there is no current reason to believe that the targets cannot be achieved.

2.2.5.2 Balance sheet risks

As well as the operational restructuring, RBS still needs to make further progress in reducing its balance sheet. The requirement for asset sales is primarily focused on completing the wind-down of RCR (which contains the vast bulk of RBS's higher risk assets) and reducing the size of the investment bank's balance sheet. These exit groups comprise £75bn of funded assets between them.

While the outcome of such a large disposal programme is inherently uncertain, we see no reason to believe that this programme is an impediment to selling RBS shares. Its track record in reducing assets is very strong – it has reduced the size of its balance sheet by more than £1.1 trillion since the end of 2008, including exiting the vast bulk of the c. £350bn funded assets initially held in the non-core division. In HM Treasury's bad bank review, BlackRock Solutions found that, "In aggregate, RBS's view of existing provisions and future impairments is realistic and in line with the lifetime loss projections calculated by BlackRock Solutions."[4]

In our assessment, although RBS's remaining programme of asset disposals is substantial in size, it should be within RBS's capability to manage and is no reason not to proceed with a share sale.

2.2.5.3 Litigation and conduct

In common with many other banks, RBS is subject to a number of regulatory and legal investigations, customer redress programmes and lawsuits, which some analysts expect will lead to RBS taking further provisions. The future financial impact of these on RBS is inherently uncertain. More broadly, new legal and conduct matters may arise over time and there can be no guarantee that there will ever be a position when there is absolute certainty as to RBS's exposure.

At present, analysts believe that there is significant risk in relation to a lawsuit brought by the FHFA in the United States and associated government investigations. There is an argument that the government should not sell shares until the outcome of this litigation is known. However, there seems little reason to believe that RBS's current share price does not reflect a reasonable assessment of the likely costs, and, based on our valuation work, there is no clear evidence that RBS's share price is discounting the possibility of materially higher losses than this. On this basis it is not clear that there is much value to the government in waiting until the outcome of the case is known: the outcome may be better, worse or in-line with market expectations and there is no reason to think that the government is better able to assess or manage this risk than potential purchasers of its RBS shares. Nevertheless, it may be that only smaller placements of RBS shares would be possible before this issue is resolved as some investors may be deterred from buying while this uncertainty remains.

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[4] HM Treasury, "RBS and the case for a bad bank: the Government's review," November 2013

We do not therefore see any reason why the government should not start to sell its RBS shares as a result of litigation risk.

2.3 Precedent sell-downs

We have analysed a number of precedent large-scale disposal programmes with which we are familiar having acted as independent adviser to either the company or the selling shareholder(s).

All these types of programmes follow a common pattern: typically they have taken a number of years to complete, involved a succession of trades (usually at increasingly high prices, or at least not significantly lower) and were carried out opportunistically.

The effect of each sale was to expand the free float, enhance liquidity and to broaden the institutional investor base in each company, paving the way for larger sales, often at tighter discounts, in the future. It is worth noting that it is very common for a government to execute disposals over a long period, particularly when the ultimate goal is to maximise value.

Therefore, in the case of RBS, our view is that any sales in the short and medium term would need to be carefully calibrated by reference to the current depth of the market for RBS shares, with a clear objective of maintaining an orderly aftermarket following any transaction.

2.4 UK taxpayers' recoveries from the financial sector interventions

As of today, in the absence of unforeseen circumstances, taxpayers can comfortably expect to secure proceeds from their interventions in the banks that exceed the money put in. This is a considerably better result for taxpayers than was considered likely at the time: at the 2009 Budget HM Treasury estimated that the ultimate cost to the taxpayer of the financial sector interventions would be in the order of £20-50 billion.

The table below sets out the total amount injected into the banks and the taxpayers' overall position as at 5 June 2015. It sets out for each of the largest bank interventions the amounts injected; loan repayments, share disposal proceeds and dividends received to date; the remaining amounts owed by the banks to the government (primarily loans to UKAR and the future retirement dividends on the RBS Dividend Access Share); and the current market value (or book value in the case of UKAR) of the government's remaining shares in the banks.

We follow the OBR in assuming that the remaining £1 billion of the government's £5.3 billion of interventions in smaller banks is recovered in full. We also take into account the fees received by the government under the Credit Guarantee Scheme and Special Liquidity Scheme (industry-wide funding and guarantee schemes) under which there is no remaining liability to the taxpayer and no payments were made. In line with the OBR's methodology, the table below is not a forecast of expected recoveries, but rather the government's net position on the financial sector interventions as at 5 June.

Many countries around the world were forced to intervene in their financial sectors during the crisis.

The United States made significant interventions, both in its financial sector and in the automotive industry. As is likely for the UK, gains on some interventions have been more than sufficient to offset losses on others: as set out in Table 3, the US is estimated to have made

gains of approximately $30 billion on its financial sector interventions under TARP, more than offsetting the estimated lifetime cost of $12 billion on the Automotive Industry Program, and leaving the US taxpayer with an overall estimated gain of $17.6bn. In addition, both Fannie Mae and Freddie Mac have reported paying cumulative dividends to the US Treasury significantly in excess of the cost of the preferred stock acquired by the Treasury.

In Europe, we are aware of 16 countries in addition to the UK that provided monetary support to their financial institutions. Our analysis suggests that of those countries that provided significant equity injections into their banks, the UK is one of the first to be able to demonstrate that its taxpayers can expect to record an overall surplus on their banking sector interventions.

Table 2. UK taxpayers' recoveries from financial sector interventions[5], £bn

	Lloyds	RBS	UKAR	Total
Amount injected	**20.5**	**45.8**	**41.3**	**107.6**
Repayments	11.1	0.5	21.2	32.8
Cash and fees received	2.9	4.5	3.7	11.0
Outstanding payment	-	1.2	19.1	20.3
Value of remaining shares as at 5 June 2015[6]	11.8	32.4	6.9	51.1
Implied net balance as at 5 June 2015	**5.3**	**(7.2)**	**9.6**	**7.7**
Other institutions				-
CGS fees				4.3
SLS fees				2.3
Overall surplus / (shortfall)				**14.3**

Source OBR, HM Treasury, company information, Factset, public disclosure

[5] Stated before the cost of funding the interventions. Figures may not cast due to rounding

[6] Stakes in RBS and Lloyds stated at market values as at 5 June; UKAR stated at last reported book value

Table 3. United States Financial Crisis interventions

in $bn	Obligation / Commitment	Estimated Lifetime Cost / (Gain) as of 28/02/2015
Bank Support Programs		
Capital Purchase Program (CPP)	204.9	(16.2)
Targeted Investment Program (TIP)	40.0	(4.0)
Asset Guarantee Program (AGP)	5.0	(4.0)
Community Development Capital Initiative (CDCI)	0.6	0.1
Credit Market Programs		
Public-Private Investment Program (PPIP)	18.6	(2.7)
Term Asset Backed Securities Lending Facility (TALF)	0.1	(0.6)
Purchase SBA 7(a) Securities (SBA)	0.4	(0.0)
Other Financial Institutions Programs		
American International Group (AIG)	67.8	(2.4)
Sub-total Investment Programs in financial institutions	**337.4**	**(29.9)**
Automotive Industry Program (AIFP)	79.7	12.3
Total for TARP and non-TARP AIG Shares[1,2]	**417.1**	**(17.6)**

Source Troubled Asset Relief Program U.S. Department of the Treasury – Monthly Report to Congress April 2015

Notes

1. The Treasury's investment in AIG common shares consisted of shares acquired in exchange for preferred stock purchased with TARP funds and shares received from the trust created by the Federal Reserve Bank of New York for the benefit of the Treasury as a result of its loan to AIG (non-TARP) shares. The Treasury disposed of both TARP and non-TARP shares and considered them together.
2. Excluding the Making Home Affordable, Hardest Hit Fund and FHA-Refinance economic support programmes which were not designed to generate any recoveries for the taxpayer.

3. Rothschild's recommendation

There is currently limited trading in RBS shares and its shareholder register is very concentrated by the standards of similar-sized companies. In part as a result of this, it would at present be challenging to make substantial sales of RBS shares that were material in the context of the government's overall shareholding, other than at disadvantageous pricing.

As a result, we believe that it would be in the interest of taxpayers for the government to set in train an initial small disposal of RBS shares. By increasing the free float now, the government will improve the marketability of the remainder of its shareholding, enabling it in future once the bank and the share price has fully recovered to execute larger sales on better terms than would otherwise have been the case. We believe that sending a strong signal that RBS is on the road to normality may also bring further benefits to the bank and to the government as a shareholder.

We believe that the current price of RBS shares reasonably reflects the prospects for future recovery and the risks associated with this being achieved. We do not believe that there are any other reasons that would preclude a share sale in the short term or render it poor value for money for the taxpayer.

Given the current limited market for RBS shares, any sales in the short term would need to be carefully calibrated by reference to the depth of the market and the current size of RBS's free float and with a clear objective of maintaining an orderly aftermarket following any transaction.