

UK Financial Investments Ltd

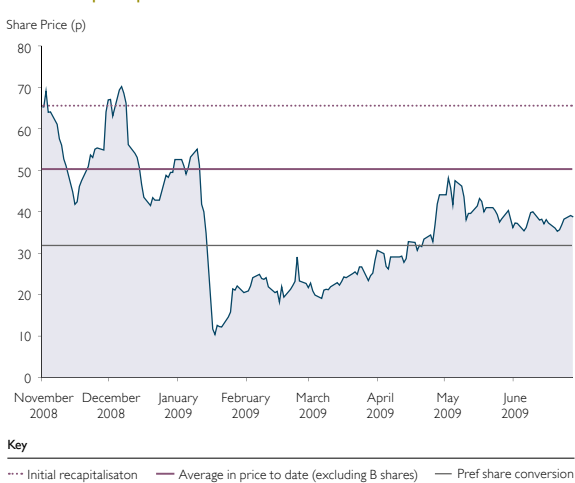
UK FINANCIAL INVESTMENTS LIMITED (UKFI)
UKFI STRATEGY: MARKET INVESTMENTS AND
ANNUAL REPORT AND ACCOUNTS 2008/09

UKFI manages the Government's investments in the Royal Bank of Scotland and Lloyds Banking Group.

The Government currently holds **39,645 million** ordinary shares in the Royal Bank of Scotland, equivalent to **70 percent** of voting share capital. The value of this investment on 30 June was **£15.3 billion**. In connection with the Asset Protection Scheme, the Government shareholding is due to increase by up to an additional 51,000 million non-voting B shares.

The Government currently holds **11,799 million** ordinary shares in the Lloyds Banking Group, equivalent to **43 percent** of voting share capital. The value of this investment on 30 June was **£8.3 billion**. In connection with the Asset Protection Scheme, the Government shareholding is due to increase by an additional 37,143 million non-voting B shares.

RBS share price performance



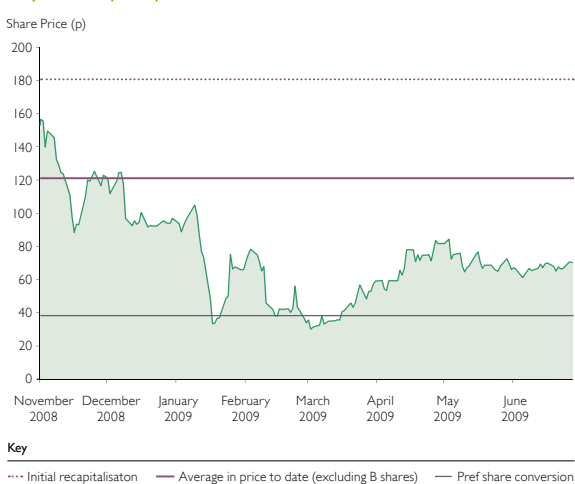
HM Treasury ordinary shareholdings in Royal Bank of Scotland (excluding B shares) ¹	Number of ordinary shares	In price	In price per share	Value as at 30/06/2009
	m	£m	p	£m
Initial recapitalisation	22,854	14,969	65.5	8,831
Preference shares conversion ²	16,791	5,058	31.75	6,488
TOTAL	39,645	20,027	50.5 (avg)	15,319

Notes

¹ UKFI will manage the B shares on completion of APS. See Box 2.5 for further details on the B shares.

² In price adjusted to include accrued dividends and redemption premiums of around £270 million.

Lloyds share price performance



HM Treasury ordinary shareholdings in Lloyds Banking Group (excluding B shares) ¹	Number of ordinary shares	In price	In price per share	Value as at 30/06/2009
	m	£m	p	£m
Initial recapitalisation ²	7,277	12,957	182.5	5,089
Preference shares conversion ³	4,521	1,508	38.43	3,162
TOTAL	11,799	14,465	122.6 (avg)	8,251

Notes

¹ UKFI will manage the B shares on completion of APS. See Box 2.5 for further details on the B shares.

² Includes Lloyds Banking Group capitalisation issue on 11 May 2009 (177 million shares).

³ In price adjusted to include accrued dividends and redemption premiums of around £230 million.

Performance of Investments ¹	As at 04/02/2009 ²	As at 30/06/2009 ³
	£m	£m
Unrealised Profit/(Loss) on HM Treasury ordinary shareholdings in RBS and Lloyds Banking Group	(18,137)	(10,923)

Notes

¹ Excludes B shares, which UKFI will manage on completion of APS. See Box 2.5 for further details on the B shares.

² 04 Feb 2009: Estimated unrealised loss on RBS and Lloyds ordinary shareholdings. HM Treasury impairment on financial investments published in Spring Supplementary Estimates 2008-09.

³ 30 June 2009: UK Financial Investments Strategy for Market Investments and Annual Report and Accounts 2008-09.

CONTENTS

ACTING CHAIRMAN'S FOREWORD	4
UKFI STRATEGY: MARKET INVESTMENTS	
01 UKFI's Role	6
02 Market Investments Strategy	12
03 Annex 1. Royal Bank of Scotland	30
04 Annex 2. Lloyds Banking Group	36
THE UKFI BOARD	41
THE UKFI TEAM	45
UKFI ANNUAL REPORT AND ACCOUNTS	
01 Chief Executive's Statement	46
02 Directors' Report	48
03 Directors' Remuneration Report	53
04 Statement on Internal Control	57
05 Independent Auditor's Report to the shareholders of UKFI	60
06 UKFI Financial statements	63
ANNEX 1: UKFI FRAMEWORK DOCUMENT	73

Forward-Looking Statements

This document, including information included in this document, contains "forward-looking statements" concerning UK Financial Investments Limited, Her Majesty's Government, Her Majesty's Treasury, the Bank of England, the Financial Services Authority as well as Lloyds Banking Group plc, The Royal Bank of Scotland Group plc, Northern Rock plc and Bradford & Bingley plc, that are subject to risks and uncertainties. Generally, the words "will", "may", "should", "continue", "believes", "expects", "intends", "plans", "anticipates" or similar expressions identify forward-looking statements. These forward-looking statements all include matters that are not historical facts and, by their nature, involve risks and uncertainties that could cause actual results to differ materially from those expressed in the forward-looking statements. Many of these risks and uncertainties relate to factors that are beyond UK Financial Investments Limited's ability to control or estimate precisely, such as changes in economic or market conditions, changes in regulatory environment and the outcome of litigation and UK Financial Investments Limited cannot give any assurance that such forward-looking statements will prove to have been correct. Nothing contained herein shall be deemed to be a guarantee, forecast, projection or estimate of future financial performance. The reader is cautioned not to place undue reliance on these forward-looking statements, which speak only as of the date of this document. UK Financial Investments Limited undertakes no obligation to update or revise publicly any of the forward-looking statements set out herein, whether as a result of new information, future events or otherwise, except to the extent legally required.

ACTING CHAIRMAN'S FOREWORD

The United Kingdom's decisive response to the financial crisis in the autumn of 2008 laid the framework for stabilising the British banking system. The recapitalisation programme and subsequent Asset Protection Scheme provided critical support for our troubled banks at a time of widespread disruption in the global financial system.

These programmes were designed to restore our banks to financial health and effective functioning in the UK economy, and fully to return the banks to private sector ownership. UK Financial Investments was created to help achieve these goals.

In our first few months of operation, much of UKFI's activity was devoted to assisting in stabilising the financial system.

As that situation has improved, we have turned our attention to our long-term goal of recovering the taxpayer's investments in our banks.

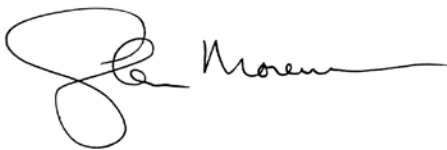
This Annual Report and Market Investments Strategy aims to provide Parliament, the public and other stakeholders with a clear view of how UKFI is approaching its task. It sets out why we believe our mission is achievable, and how we intend to deliver.

Our fundamental approach is to operate as an engaged institutional shareholder, operating on an arm's-length commercial basis. We believe that value will be re-established in the banks themselves, under the leadership of their own management and boards. Our role as shareholder is nevertheless to ensure that the banks have sound long-term strategies, and that they are effectively managed and properly governed.

Their task will not be easy. Our investee banks face significant legacy losses and the inevitable effects of the recession. Nevertheless, we believe they now have the capital resources to weather these difficulties and to emerge from the current environment with their strong franchises and profitability intact.

Our own task of returning these investments to the private sector is challenging. The amounts involved are very large, and a successful disposal of our holdings will require professionalism and patience.

We all have a stake in UKFI's success. Skilled disposal of these investments will recoup tens of billions of pounds for the taxpayer. At UKFI, we understand the importance of this challenge, and we are completely focused on achieving the objectives outlined in this report.



Glen Moreno
Acting Chairman

UKFI STRATEGY: MARKET INVESTMENTS

01

UK Financial Investments' Role

Creation and remit of UK Financial Investments

UK Financial Investments (UKFI) was created by the Government, as part of its response to the financial crisis, to manage the investments it has taken in UK financial institutions in the interests of maintaining financial stability.

At present, UKFI is responsible for Government investments in the Royal Bank of Scotland Group plc (RBS) and Lloyds Banking Group plc (Lloyds) – the company created by the Lloyds TSB Group plc acquisition of HBOS plc. These investments are managed by UKFI's Market Investments Team, and this document discusses the approach to ownership and our strategy for managing these investments. This year UKFI will also take responsibility for management of the Government's investment in Northern Rock plc, and Bradford & Bingley plc – together, the Wholly Owned Investments.

In discharging these responsibilities, UKFI's remit is to:

- manage these shareholdings commercially to create and protect value for the taxpayer as shareholder, with due regard to financial stability and competition;
- and
- devise and execute a strategy for disposing of the Government's investments in an orderly and active way over time.

These two roles are inextricably linked. Investors' willingness to buy shares in the banks will depend on their confidence that the banks are being managed to create value for shareholders. A commercial approach to the management of the Government's stakes in the banks will thus facilitate a return to full private ownership, and protect the taxpayer's position as investor. As set out in our Framework Document, the ultimate decision to proceed with any disposal transaction will rest with HM Treasury.

More detail on our remit can be found in our Framework Document with HM Treasury, in Annex I of the Annual Report.

UKFI's ownership approach

UKFI's role is to manage the Government's investments, not to manage the banks.

Our investee banks are run by their boards and management teams. As an engaged shareholder, UKFI is taking a close interest in the calibre and performance of the banks' boards and management teams – as well as in their financial incentives, which need to be fully aligned with the taxpayers' interests as shareholders.

UKFI is also working closely with the banks, again as an engaged shareholder, to assure ourselves of their approach to strategy and to hold them rigorously to account for performance. We are also taking a close interest in their approach to managing risk.

Within this overarching shareholder framework, operational management decisions are for the banks themselves, to be managed commercially without interference from shareholders including UKFI.

UKFI's ownership approach reflects the Statement of Principles of the Institutional Shareholders' Committee, which we aim to follow in full, including:

- **monitoring performance:** UKFI maintains an active and regular dialogue with investee companies' boards and senior management. We seek to satisfy ourselves that the boards are operating effectively, and that the companies' strategies protect and enhance shareholder value;
- **intervening where necessary:** should we have concerns, for instance about strategy, operational performance, acquisitions or disposals, we intervene with the board objectively and in an informed way;
- **voting:** we vote all Government's shares wherever practicable to do so, informing the company in advance of our intentions and rationale, and always disclosing how we have voted; and
- **evaluating and reporting:** we provide regular updates to HM Treasury on the performance of our investments and the effectiveness of our engagement with investee companies.

UKFI will not:

- intervene in **day-to-day operational management decisions** of our investee banks. This is explicitly prohibited by our Framework Agreement with HM Treasury. The banks retain their own independent boards, which manage the banks and determine their strategy and have clear legal obligations to all shareholders, not just UKFI;
- beyond the banks' binding legal obligations to HM Treasury on UK lending, which they must meet, seek to impose any **geographic bias** in the banks' activities;
- encourage the banks to make disposal on terms that **represent poor value**; or discourage them from operating efficiently;
- dictate the **scope** of our investee banks; UKFI believes the tests that any investment banking activities need to meet are whether they can generate sustainable returns through the economic cycle, and whether risks can genuinely be properly managed having regard to the lessons learned from the industry's experience in recent years; or
- generally be **insiders** in market investments, or directly represented on the banks' boards (see box 1.1)

BOX 1.1 DIRECTOR APPOINTMENTS

UKFI has specific rights to work with the banks' boards on the appointment of new independent non-executive directors – two in the case of Lloyds, and three in the case of RBS.

Two Lloyds directors, Tony Watson and Tim Ryan, have so far been appointed under these rights. One, Sir Sandy Crombie, has so far been appointed at RBS.

Under UK company law, directors cannot represent individual shareholders' interests. Accordingly, whilst these directors are appointed with the agreement of UKFI, they are not and cannot be UKFI's representatives and will not report directly to us.

UKFI is monitoring certain conditions attached to the Government's bank Recapitalisation Scheme such as remuneration and corporate governance conditions (which include no bonus payments for directors for 2008, compliance with ABI best practice on remuneration, and reward to incentivise long-term value creation and not encourage excessive risk taking, with no rewards for failure). However, the new **lending conditions** for RBS and Lloyds as part of participation in the Asset Protection Scheme are being monitored by HM Treasury, not UKFI. HM Treasury will provide an assessment of lending by the banks in due course.

Managing investments in RBS and Lloyds at arm's-length and commercially, rather than nationalising them, was a deliberate decision of Government to facilitate their return to private ownership. The Government has made it clear that it is not a permanent investor in UK banks, and that its intention, over time, is to dispose of all the investments it is making in an orderly way.

However, within this commercial relationship, an important part of UKFI's role will be to ensure that our investee banks are returned to the private sector as stronger, more resilient organisations. In particular, we expect our investee banks to have:

- **stronger and more robust strategies;**
- **more effective boards;**
- **more disciplined approaches to risk;**
- **sustainable balance sheet and funding structures;** and
- **better remuneration structures** that align reward with long-term value creation, adjusted for risk.

UKFI's resourcing

UKFI has deliberately decided to resource itself in a way that is consistent with the approach described above: as a small expert body. UKFI's size, currently 11 full-time employees, reflects this.

All UKFI's major strategic decisions are taken by our Board, which comprises our Chairman, Glen Moreno, our Chief Executive, John Kingman, and five other Non-Executive Directors. The UKFI Board operates to the highest standards of corporate governance, and its members have in total over 100 years of banking experience across a wide range of areas in the sector. UKFI's directors are drawn from senior positions in financial services and related industries with track records of board-level leadership in fund management, retail banking and other corporate or financial disciplines. More detail on the members of the UKFI Board can be found on page 41.

UKFI's executive team is currently made up of the Chief Executive, a Market Investments Team which manages investments in RBS and Lloyds and is working to devise an exit strategy, and a Policy and Operations Team. We will shortly be expanding to around 15 full-time staff, with the addition of a Wholly-Owned Investments Team to manage Government investments in Northern Rock and Bradford & Bingley. UKFI will then be fully staffed to discharge its existing remit.

John Kingman, Chief Executive, joined UKFI from HM Treasury, where he was Second Permanent Secretary, responsible for oversight and control of some £600 billion of public spending annually. John has previously worked on the Lex column of the Financial Times and in the Group Chief Executive's office at BP.

Sam Woods, Chief Operating Officer, joined UKFI in November 2008, having previously held a number of roles in HM Treasury and in the New Zealand Treasury. Before joining HM Treasury, Sam worked at Diageo and McKinsey & Company.

UKFI's Market Investments Team, and soon to be formed Wholly-Owned Investments Team, are staffed with employees with directly relevant experience from the private sector:

- John Crompton, Head of Market investments, has 22 years of banking experience: 20 with Morgan Stanley, and two with Merrill Lynch, and has been responsible for equity new issue business in Europe, the US and Asia.
- Keith Morgan, Head of Wholly-Owned Investments, will shortly join UKFI from Santander, bringing strong retail and commercial banking experience. He is currently a board director of Sovereign Bancorp in the U.S. focusing on the integration of Sovereign into Santander.
- Tim Sykes, Senior Banks Analyst, has spent 19 years working in the banking sector, including as Managing Director and Head of UK and Irish Banks equity research at UBS, and various management positions at Standard Chartered Bank.

More information on our Executive Team can be found on page 45.

When UKFI comes to make major transactions, we expect to make use of professional advisors to ensure that we maximise value for the taxpayer.

Assessing UKFI's performance

UKFI began operations against the backdrop of radical Government interventions to prevent systemic collapse in world financial markets. Following these interventions, the Government has made clear that it does not wish to be a permanent investor in UK financial institutions. Ultimately, our performance as an organisation in delivering our objective of protecting and creating value for the taxpayer will therefore be judged on the success of our investment and exit strategy, and the return we can secure for the taxpayer.

In meeting this objective, we are committed to being transparent to Parliament, the public, and other investors. The Chief Executive, Chairman and members of the senior management team have attended meetings of a number of relevant Parliamentary committees. These have included the Treasury Select Committee's hearings on the banking crisis, and the Lords Economic Affairs Committee's inquiry into banking supervision and regulation.

UKFI expects to be held to account for the performance of our activities and against our objectives on a day-to-day and month-to-month basis, including through quarterly meetings with HM Treasury.

The share price performance of our investee banks will clearly be closely watched. The Public Accounts Committee has carefully considered the use of share price targets and concluded that they are not, on their own, an adequate test of the Government's effectiveness in managing investments.¹ Share prices alone, whilst an important factor for us to monitor, are therefore not an ideal yardstick for measuring UKFI's overall performance, given the extent to which they are influenced by many factors outside UKFI's control.

We therefore intend to formulate, with HM Treasury and other interested parties, a broad and robust approach to measuring our performance, covering the conditions that need to be met to fulfil our objective of creating and protecting value for the taxpayer, paying due regard to the maintenance of financial stability and to acting in a way that promotes competition. Some of these conditions are largely exogenous to UKFI, for example improvements in the global economy and favourable developments in the wider banking sector. Some are indirectly affected by UKFI, for example the overall performance of our investee banks as organisations and the re-emergence of investor confidence. And some are directly influenced by UKFI, for example the board appointments we approve and the successful design and execution of an exit strategy.

We plan to measure our performance against a full range of indicators and benchmarks which can be used to measure progress on these conditions. We are still considering what would be the most robust qualitative and quantitative indicators to use, and will need to discuss these with a range of stakeholders before committing to them. However, the type of indicators we are considering include:

- in relation to **the banks' financial performance**:
 - share price;
 - profitability; and
 - capital adequacy ratios;
- in relation to **strategy in our investee banks**:
 - credible evidence of reform in their approach to managing risk;
 - meaningful reform in their approach to remuneration, allowing them to attract the best talent available but linking incentives to long-term sustainable value creation;
 - world-class board appointments, and highly effective boards; and
 - a strong track record for UKFI on engaging with our investee banks, including through exercise of our voting rights;
- in relation to **investor perceptions**, both of UKFI's effectiveness and of the attractiveness of our investee companies as investments, we intend to explore the scope for systematically assessing the market perceptions of:
 - UKFI's effectiveness as an active, engaged, commercial shareholder, operating at arm's-length from Government;
 - the quality of UKFI's engagement with other investors; and
 - our impact on the investee companies as investments.

We would welcome any views on this approach, which should be addressed to ukfienquiries@ukfi.gsi.gov.uk

¹The Shareholder Executive and Public Sector Businesses, House of Commons Committee of Public Accounts, Forty-second Report of Session 2006-07, 20 September 2007.

UKFI STRATEGY: MARKET INVESTMENTS

02

Market Investments Strategy

Disposal – at the heart of the Market Investments mission

UKFI's Market Investments remit is to dispose of the Government's shareholdings in RBS and Lloyds in an orderly and active way, with due regard to financial stability and the promotion of competition. While there are many possible approaches open to us, including strategic sales, our central assumption in thinking about our disposal programme is that we are likely to be selling shares to investors in the public equity markets.

This in turn means that we will need to do everything that we can to maximise the value of the two banks as publicly-traded entities, and to design and implement our exit strategy in the context of broader developments in the economy, financial sector and equity markets.

We see ourselves as having five principal tasks:

- understanding how the problems in the sector came about, learning the lessons and identifying the specific issues that our investee banks face;
- working with the boards and management at each bank to develop and implement an agenda to maximise value for shareholders;
- engaging with other investors and market participants to understand their views, and to seek to build confidence in our approach;
- developing and implementing a disposal strategy for the investments; and
- supporting Government (primarily HM Treasury) on their response to the crisis, from a shareholder perspective.

The purpose of this chapter is to describe how we are approaching these tasks and to set out our strategy for the future, dealing with each topic in turn.

Problems in the banking sector and implications for our investee banks

RBS and Lloyds have different business profiles and strategies, yet each has been profoundly affected by the financial crisis. In this section, we discuss the origins and development of the crisis, identify the key issues that banks, policy-makers and investors have had to address, and then examine the implications for each bank.

The pull-out exhibit identifies five key phases in the financial crisis as we see them, beginning in early 2007 with the first signs of concern about conditions in the US sub-prime sector, and highlights some of the main events while plotting the share prices of RBS, HBOS and Lloyds Banking Group, as the successor to Lloyds TSB and HBOS.

PLEASE FOLD OUT OPPOSITE PAGE AND REFER TO PHASES BELOW

Phases in the financial crisis

PHASE 1: STRUCTURED CREDIT BECOMES A GLOBAL ISSUE.

Beginning in spring 2007, concerns about the credit quality of securitised US “sub-prime” mortgage assets resulted in a sharp contraction of investor appetite for all “structured credit” securities, or for commercial paper issued by special purpose vehicles (SPVs) organised to invest in these assets. As a result, banks were forced to bring assets held in SPVs onto their balance sheets, and were unable to find buyers for securitisations of newly-originated assets. The problems spread to other types of asset including leveraged loans. Balance sheets expanded, demands on bank liquidity increased and capital was eroded as asset values fell.

PHASE 2: NEW CAPITAL, AND NEW CAPITAL TARGETS.

In response to the losses incurred in structured credit and the risks that these highlighted, regulators and many banks concluded that new capital was required to replenish structured credit losses, to establish new, more conservative benchmarks in the face of an impending recession, and to rebuild confidence in the sector. Between 2007 and 2009, over £129 billion in new bank equity was raised in Europe. Both RBS and HBOS had substantial structured credit exposure and undertook very large rights issues (£12 billion for RBS and £4 billion for HBOS), and these, together with other capital-raising exercises on both sides of the Atlantic, appeared for some months to have stabilised the sector.

PHASE 3: COUNTERPARTY CRISIS.

In early September 2008, market participants became increasingly concerned about their counterparties’ ability to meet their day-to-day obligations. Conventional measures of capitalisation and liquidity ceased to provide reassurance and pressures grew on affected institutions to find solutions. In the US, Bank of America acquired Merrill Lynch while Lehman Brothers went into bankruptcy on 15 September, and the following day the US government agreed to provide extensive financial support to AIG, and shortly afterwards announced several initiatives to support banks through the Troubled Asset Relief Program (TARP). In the UK, speculation centred on HBOS, which was heavily dependent on wholesale financing; on 18 September, after extreme volatility in its share price, HBOS agreed to be acquired by Lloyds TSB (see box 2.1).

PHASE 4: COLLAPSE OF CONFIDENCE LEADS TO GOVERNMENT INTERVENTION.

Investor confidence continued to decline and liquidity remained in short supply. In October, the UK government was the first to respond with a comprehensive set of measures addressing both capital and liquidity, and other European governments followed suit (see box 2.2). By early 2009, however, evidence was emerging of a slowdown in economic activity, raising further concerns about the viability of financial institutions and about the economic consequences of further financial sector bankruptcies. RBS issued a profit warning in January 2009, and the newly established Lloyds Banking Group followed suit in mid-February, reflecting deteriorating HBOS performance.

PHASE 5: BEGINNINGS OF EMERGING RECOVERY IN CONFIDENCE.

On 26 February 2009, HM Treasury announced its agreement with RBS on an Asset Protection Scheme providing insurance on £325 billion of assets; on 7 March a similar plan was announced for Lloyds Banking Group for £260 billion of assets (see box 2.3). This is expected to provide protection against credit risk associated with the assets protected by the scheme, complementing earlier support for capital and liquidity; it also indicated a strong commitment to avoid full nationalisation. Other broader policy initiatives – including Quantitative Easing undertaken by the Bank of England and the Federal Reserve – provided stimulus to credit markets and to the banking system. Indicators of economic activity and investor risk-aversion – for example, commodity prices, volatility measures and credit spreads – appear to suggest that fears of a deflationary recession have been abating, offering some relief to bank equities.

Milestones for UKFI's Investments

BOX 2.1 LLOYDS TSB ACQUISITION OF HBOS

Lloyds announced the acquisition of HBOS on 18 September 2008, creating the largest retail financial services provider in the UK with a consolidated balance sheet of £1.1 trillion and serving over 30 million customers.

Initial terms were that HBOS shareholders would receive 0.83 Lloyds TSB shares for each HBOS share.

Following the deterioration in market conditions, Lloyds announced revised terms on 13 October alongside participation in the Bank Recapitalisation Scheme. HBOS shareholders received 0.605 Lloyds TSB shares for each HBOS share. The acquisition closed on 16 January 2009.

BOX 2.2 OCTOBER RECAPITALISATION

On 13th October 2008, the Government announced the implementation of the Bank Recapitalisation Scheme. The Scheme aimed to provide temporary capital support to UK banks and building societies, enabling them to strengthen their capital positions and continue to lend to the real economy through the economic downturn.

As part of the Recapitalisation Scheme, the Government invested £37 billion in total in RBS, Lloyds TSB and HBOS. This was composed of:

- £20 billion in RBS, comprising £15 billion in ordinary shares and £5 billion in preference shares;
- £5.5 billion in Lloyds TSB, comprising £4.5 billion in ordinary shares and £1 billion in preference shares; and
- £11.5 billion in HBOS, comprising £8.5 billion in ordinary shares and £3 billion in preference shares.

In consultation with UKFI, the Government agreed in early 2009 to restructure the recapitalisation investment through redemption of the RBS and Lloyds preference shares financed by issues of ordinary shares, improving the banks' Core Tier 1 ratio which investors and regulators increasingly regard as genuine loss absorbing capital.

BOX 2.3 ASSET PROTECTION SCHEME

The Asset Protection Scheme (APS) is designed to provide protection against future credit losses on certain assets.

On 26 February 2009, **RBS** announced its intention to participate in the APS. RBS intends to protect £325 billion of assets. Key elements of the announcement include:

- RBS will pay a fee of £6.5 billion which may be funded by the issue of B shares (non-voting ordinary shares, which constitute Core Tier 1 capital) to HM Treasury. They have also agreed for a number of years not to claim certain UK tax losses and allowances.
- RBS will bear a first loss amount. Thereafter losses will be borne 90 percent by the Treasury and 10 percent by RBS.
- In addition, and conditional on RBS's participation in the Scheme, the Government has agreed to inject up to £19 billion more capital in the form of B shares – £13 billion on accession and up to £6 billion at RBS's option after the first anniversary of accession.

On 7 March 2009, **Lloyds** announced its intention to participate in the APS. Lloyds intends to protect £260 billion of assets. Key elements of the announcement include:

- Lloyds will pay a fee of £15.6 billion for participation in the Scheme. The fee may be funded by the issue of B shares (non-voting ordinary shares, which constitute Core Tier 1 capital) to HM Treasury.
- Lloyds will bear a first loss amount. Thereafter losses will be borne 90 percent by the Treasury and 10 percent by Lloyds.

UKFI will manage the B share investments in RBS and Lloyds on a commercial basis consistent with the approach and objectives set out in the UKFI Framework Agreement with the Treasury.

It is clear that many banks have faced similar issues over the past two years, relating to declines in asset values (or increases in expected losses on assets), access to liquidity, capital, and a developing recession. Investor anticipation of a stabilisation of economic conditions, accompanied by a reduction in the extreme levels of risk aversion that investors have shown in relation to bank investments, is a prerequisite for our investments to increase in value and for us to be able to implement a disposal programme.

However, while conditions have been challenging for all, the investment performance of individual banks has varied widely. To understand the best way forward for our investee banks we have sought to identify the factors that have differentiated bank performance in this very challenging environment and to highlight where changes are required. We set out the key issues below.

Investment banking versus traditional (retail or commercial) banking

This distinction, often made by commentators seeking to distinguish between “casino” and “utility” banking, has not been a good predictor of investment outcomes: there have been clear successes and failures amongst all categories of bank, whether “investment banks”, “traditional banks” or “universal banks” (combining both aspects of business). For example, within our portfolio RBS experienced extensive losses in its Global Banking and Markets (GBM) arm, but the RBS and Lloyds TSB retail banking business appear so far to be more resilient than that of HBOS. At the same time, investment banks typically have more exposure to assets which are “marked to market” – expected losses are realised up-front through the adjustment of market prices, rather than being realised over the multi-year life of a loan portfolio. Similarly, investment banks may be better able to capitalise on improvements in trading markets – as has been seen for RBS’s GBM business and other investment banks during the first few months of 2009.

“Risk” versus “growth” culture

Across all categories, it appears that banks which emphasised the pursuit of earnings growth over the pursuit of risk-adjusted returns (taking into account not just credit risk but also concentration, liquidity and operating risk) have been severely penalised. RBS’s wholesale lending strategy and HBOS’s pursuit of lending through its commercial arm and in certain mortgage categories are examples of this.

Strategy

Both our investee banks have made major strategic moves within the past two years, and these have shaped their current situations. In particular, with the benefit of hindsight, we consider RBS’s acquisition of ABN Amro to be a strategic error which compounded the challenges which the bank was to face over the subsequent 18 months. ABN Amro put RBS in a position of doubling up its exposure to risky asset classes, expanded its geographic footprint into regions where further expansion would be required in order to attain “critical mass”, and greatly increased the scale of its exposure to wholesale funding markets. Moreover, the acquisition was funded without the issue of additional equity, leaving the combined bank vulnerable to the forthcoming downturn.

Capitalisation

Our investee banks were characterised by low levels of capitalisation relative to the risks inherent in their asset books, exacerbated by strategic development. Capital shortfalls were identified by FSA stress tests and will be addressed through the pending APS.

Dependence on wholesale funding

Both RBS’s and HBOS’s expansion were predicated on continued availability of substantial volumes of wholesale funding – and both banks were therefore particularly vulnerable to general investor nervousness about the sector as well as to specific concerns about their own assets and capitalisation levels. Government stepped in to stabilise funding through its Bank Recapitalisation Scheme (see box 2.1 on the October Recapitalisation), but managing the size of the balance sheet, building the deposit base and restoring the confidence of wholesale funders remain key strategic issues for the banks.

Management and Governance

Under these difficult circumstances, the management and governance of banks have been tested to the full. It is clear that the boards of both RBS and HBOS failed to provide adequate leadership to their respective institutions.

Remuneration

Investors, regulators and legislators have identified remuneration structures that do not properly align shareholder and employee interests as contributing to the financial crisis, and to value destruction at certain banks, and we have focused on this issue at both banks, as discussed below.

We develop our views on the steps each bank needs to take to address these issues below.

Investment Agenda

In Chapter 1, we described the role we have been set as being “to manage the Government’s investments, not to manage the banks”. As such, we do not expect to receive insider information from the banks other than in certain unusual circumstances, such as while RBS was developing its February strategy announcement, or during the pre-announcement discussions relating to the Asset Protection Scheme. We have appropriate compliance measures in place to manage any inside information received from the banks.

With this important caveat, the purpose of this section is to describe the business issues which we are currently discussing with the banks, and which we expect to feature in our dialogue going forward.

We discuss these issues regularly with our own Board. We have regular meetings with the senior management teams of the two banks, and have also had meetings with the boards of the banks at which we have explained our mission and agenda and have invited their views on how we can best work with them to meet our goals.

Issues common to the two banks

As our discussion of sector-wide developments suggests, there are several issues which are common to both banks, despite the marked differences in their businesses. These include:

- **Financial results and outlook:** we are very interested in the banks’ public disclosures about the development of credit losses in their back books, in their indications of the profitability of the business that they are currently transacting, and in progress that they are making in managing costs. Together, these factors will determine the timing of their return to profitability, and the level of returns that they can be expected to generate in the future;
- **Implementation of the Asset Protection Scheme:** we regard this as being of crucial importance to the financial stability of the banks. The way in which the scheme operates in practice will have implications for the resources required to manage the assets and for the ongoing demands that the assets insured by the scheme will make on the banks’ funding resources;
- **Capital management and funding strategy:** both banks have undertaken substantial restructurings of their existing Tier 1 and Tier 2 capital, and in so doing have been able to capture gains for shareholders as well as strengthen their key Core Tier 1 ratios. We remain closely interested in this area. We are also very focused on their assessment of funding conditions, which we regard as essential to the long-term health of the banks; and

- **remuneration strategy:** UKFI has worked with both RBS and Lloyds to implement what are perhaps the most far reaching reforms to remuneration structures (see box 2.4) of any large banks in the world, in the context of their participation in the Asset Protection Scheme. Both banks are working on new long-term strategies in light of the forthcoming FSA guidance, and we will continue to work closely with them, as a major shareholder, in this area.

BOX 2.4 REMUNERATION

UKFI believes that the remuneration structures of the past were not in line with the long-term interests of shareholders, and contributed to excessive risk taking. Part of UKFI's role has been to work with our investee banks to ensure that incentives are much more strongly linked to long-term value creation. It is also essential however that remuneration in our investee banks is competitive with that in the rest of the banking sector, to ensure that the banks in which the taxpayer has investments attract and retain high calibre staff. We therefore welcome the finding of the Treasury Select Committee in their ninth report ("Banking Crisis Investigation: Reforming Corporate Governance and Pay in the City") that: "...we accept the argument put forward by the Government and UKFI that the position of banks would be worsened if they could not make bonus payments. We agree that unduly strict restrictions on bonuses to such staff would result in the banks struggling to recruit and retain talented staff and that this would be to the detriment of the taxpayer as a major shareholder in both institutions."

UKFI has worked with both RBS and Lloyds which have implemented what are perhaps the most far-reaching reforms to remuneration structures of any large banks in the world, in the context of their participation in the Asset Protection Scheme.

For instance, RBS has announced a new approach to remuneration which includes:

- No reward for failure: with no bonuses or pay increases made to staff associated with the major losses suffered in 2008.
- Bonuses: no discretionary cash bonuses will be paid in 2009 for 2008 performance. Total cash bonus payments of £175 million were made for legally binding guaranteed bonuses only, a reduction in total cash spend of over 90 percent. Any bonus earned in 2009 is intended to follow the same approach and deferral periods as outlined for 2008.
- 2009 pay: no "annual" pay increase for Directors and Executives, and for most staff in the US and Global Banking and Markets division, and below-inflation pay rises on average for other staff.

Lloyds has also with UKFI's agreement restructured remuneration, including no discretionary bonuses to be paid in 2009 except to more junior staff, and no annual free share award to anyone in the bank.

Looking forward, both banks have committed to fundamental reviews of their approach to future remuneration. We expect both banks to be at the forefront as banks globally rethink their approach; and changes will need to reflect the forthcoming FSA remuneration code, and the findings of the Walker Review in relation to the incentives in remuneration policy.

In addition, addressing the failings of governance at both RBS and HBOS has been a major focus for us in our dealings with the two banks:

- work with RBS has included a radical overhaul of the RBS board. This includes the appointment of a new Chairman (Sir Philip Hampton), the departure of seven non-executive directors, and plans to recruit three new directors to a smaller, more streamlined board. The first of these, Sir Sandy Crombie, retiring Chief Executive of Standard Life, became Senior Independent Director of RBS on 1 June 2009;

- for Lloyds, following the resignation of the HBOS board, we have worked with the board on two new director appointments with strong track records on governance (Tony Watson and Tim Ryan). A new Chairman is also being appointed to succeed Sir Victor Blank; and
- going forward, strong leadership will be essential to deal with the issues described above, to implement substantial restructurings in the operations of both banks, and to provide direction and motivation to employees.

Investor strategy

RBS's and Lloyds' shareholder registers have changed significantly during the past year as many shareholders have sold out of positions and all have experienced severe dilution. Rebuilding the confidence of existing and potential shareholders will be essential if the banks are to attain a full market valuation for their shares, and will be especially important for UKFI given our remit to exit from the Government's shareholdings. We are therefore encouraging the banks to make shareholder relations a strategic priority as they re-establish themselves in the capital markets.

RBS-specific issues

RBS is a diversified set of businesses comprising UK and US retail and commercial banking, a substantial global investment bank (GBM), a leading UK direct insurance business, and a wide range of geographically diversified businesses acquired through ABN Amro. Our current engagement with RBS includes:

- **Strategy:** RBS announced its new strategy in February 2009 alongside the APS announcement. UKFI had the opportunity to discuss this in advance of the announcement and has indicated its broad support. We are closely monitoring the implementation of this strategy, which includes:
 - scaling back of GBM activities and balance sheet use (a goal which will be greatly assisted by the Asset Protection Scheme); and
 - a programme for disposing of non-core businesses. We are very supportive of this initiative, whilst not wanting the bank to initiate disposals on terms that would destroy value for shareholders (for example, we supported the decision not to proceed with a sale of RBS Insurance). We would expect the bank to keep its disposal strategy under review as market conditions change;
- **Management and board:** we are working with Sir Philip Hampton and the Nominations Committee of the RBS Board as they recruit new directors;
- **Reforming risk management across RBS:** we regard this as essential to avoid the mistakes that resulted in value destruction at the bank in the past, welcome the priority that this is being given by the Board and will monitor progress closely in this area.

Lloyds-specific issues

At Lloyds, our current engagement includes:

- **Integration of HBOS:** our agenda for Lloyds Banking Group is primarily concerned with the integration of HBOS, both from an operational and cultural standpoint. We are very focused on metrics related to progress on merger integration, and expectations for value creation for shareholders;
- **Risk:** we place great importance on the roll-out of Lloyds' risk management standards and methods across HBOS and are focused on how the bank will communicate the progress and results of this initiative; and
- **Recruitment of new Chairman:** we are working with the Nominations Committee of the Lloyds Board as it seeks to identify a replacement for Sir Victor Blank, who recently announced his decision to step down before the 2010 Lloyds AGM.

Investor Engagement

Since the announcement of the Asset Protection Scheme we have had over 50 meetings with UK-based and global institutional investors, including current and potential shareholders in RBS and Lloyds. There are three reasons why we regard engagement with other investors in banks as central to our mission:

- we want to explain UKFI's objectives to other investors, and in particular to explain the arm's-length nature of our relationship with Government, and our objectives of improving the value of, and exiting from, our investments. We hope by doing this to help address any misunderstandings or fears about possible non-shareholder-oriented goals that we, as a Government-related entity, might be perceived to have;
- we want to hear other investors' views on the issues facing the banks, and what steps the banks should be taking to address these. Given the relative size of the Government's shareholdings in the two banks it is important that our views are well-informed; and
- by acting as responsible and responsive stewards of the taxpayer's investments, we hope to be able to promote the development of a broad group of investors who are comfortable with the direction that the banks are taking, and who are willing to step into our shoes over time.

We continue to build our relationships with other investors, and commit to continuing our policy of engagement with them around major business issues and in the deliberation on matters brought to vote at the banks' Annual General Meetings and all other meetings of shareholders.

Developing and implementing a disposal strategy

One of the most important issues facing our Board and Market Investments team is the question: under what circumstances might UKFI recommend the sale of shares in the banks? To address this, we need to take into account the value this would release for the taxpayer; the fact that exit from the position is an objective in itself; and the ongoing requirement for us to help maintain financial stability.

Because any decisions need to be taken in the context of changing economic and market conditions, we do not think that it is possible or desirable to state hard goals such as price or time that would drive our sales of the Government's shares. However, it is reasonable to consider scenarios in which share sales might be undertaken consistent with our objectives, to discuss the approach that we will take to evaluating and executing transactions, and to outline how this approach could translate into outcomes for the taxpayer. As set out in our Framework Document, the ultimate decision to proceed with any transaction will rest with HM Treasury.

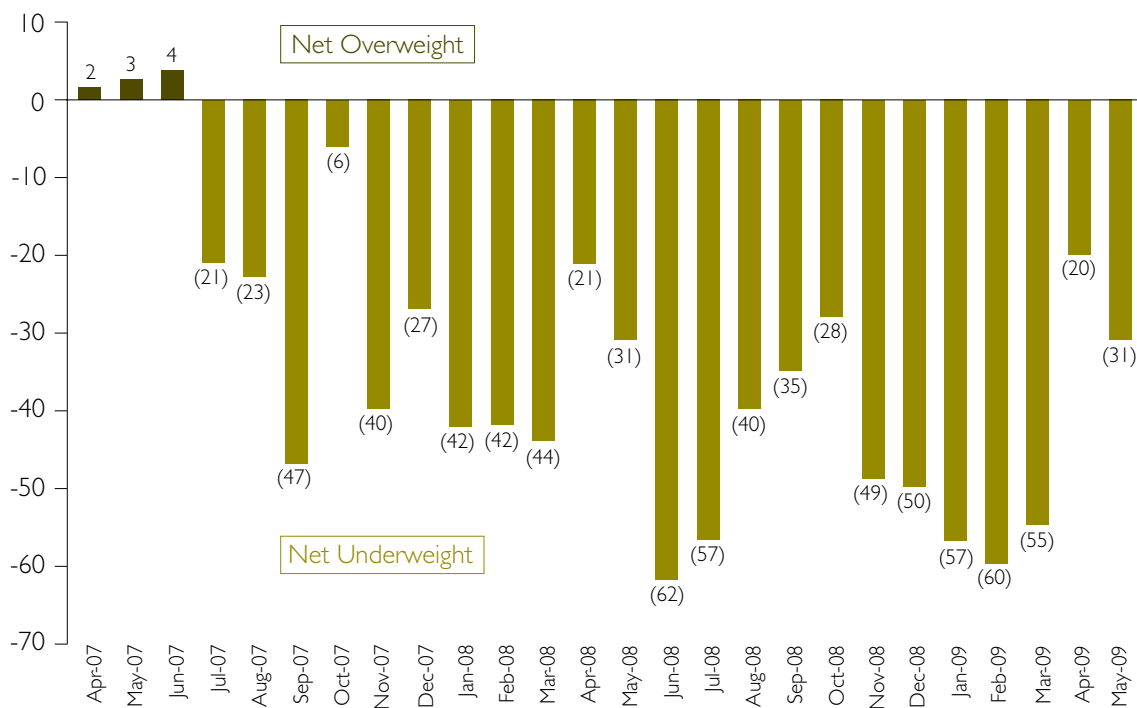
The Market Context: a current challenge, but future opportunity?

We note above that to execute share sales we will need to be comfortable not only that there is investor demand for shares, but also that our goals for value realisation and financial stability are met. Fortunately, these objectives are closely related: investor demand and higher valuations are likely to be consequences of greater financial stability. In the following paragraphs, we develop this point in more detail to illustrate how a hypothetical improvement in the economy and the sector could create selling opportunities.

As a starting point, we consider how public market investors in bank stocks have experienced severe value destruction in recent years, as evidenced by our chart tracking the development of the financial crisis. The Dow Jones STOXX 600 bank index (a broad measure of European bank performance) declined by over 80 percent from its April 2007 peak to March 2009 trough, while RBS experienced a peak-to-trough decline of 98 percent and Lloyds of 93 percent.

In our discussions with institutional investors it is very apparent that many decision-takers have withdrawn capital from the sector, and are waiting for clear signs that bank performance can be forecasted with some confidence before recommitting. The following chart illustrates that institutional investors predominantly say they are underweight in the banks sector.

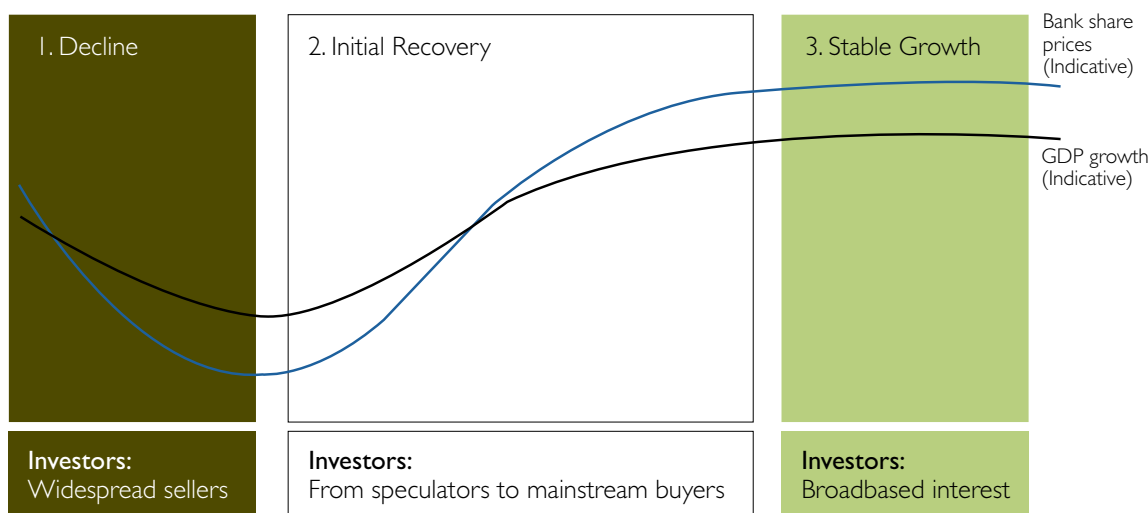
Figure I. Portfolio Managers Overweight vs. Underweight in the European Bank Sector



Source: BAS – ML Regional Fund Manager Survey, May 2009

At the same time, financial markets exist to put a value on the future, not to describe the present. So there is a risk for the investor who withdraws capital and waits for the return of profitability to the sector – other investors may move earlier, and prices rise. If we are comfortable that sales would be consistent with our financial stability goals, then this return of investor capital might create selling opportunities. We have illustrated this process in the following stylised chart:

Figure 2. Bank Sector Schematic



“Decline”: At first, bank shares decline sharply through a combination of deteriorating economic conditions magnified by concerns about the health of financial institutions. Investors lose confidence in the sector, and in their ability to make investment decisions about it, and are active sellers, taking markedly underweight positions. This mirrors events in the latter part of 2008 and early 2009 as illustrated in our pull-out chart. Valuation, lack of demand and stability concerns would clearly rule out sales under these circumstances.

“Initial recovery”: As conditions in the sector and the economy stabilise, this is reflected both in an increase in values, and in a return of investment capital to the sector. This cycle may be reinforcing; investors who are underweight may be inclined to chase share prices upward so as to avoid underperforming. Opportunities for us to sell the Government’s shares might emerge.

“Stable growth”: As the recovery matures, share price movements become less marked as investors are more fully invested. While capital flows into the sector under these conditions are less strong, we would expect to continue to be able to execute share sales.

Therefore, the circumstances under which we are likely to be able to sell shares are likely to be those in which the economy – and investor confidence – is recovering, and in which bank share prices have performed robustly. Sales under these circumstances seem likely to be consistent with our objectives of delivering value to the taxpayer and of maintaining financial stability.

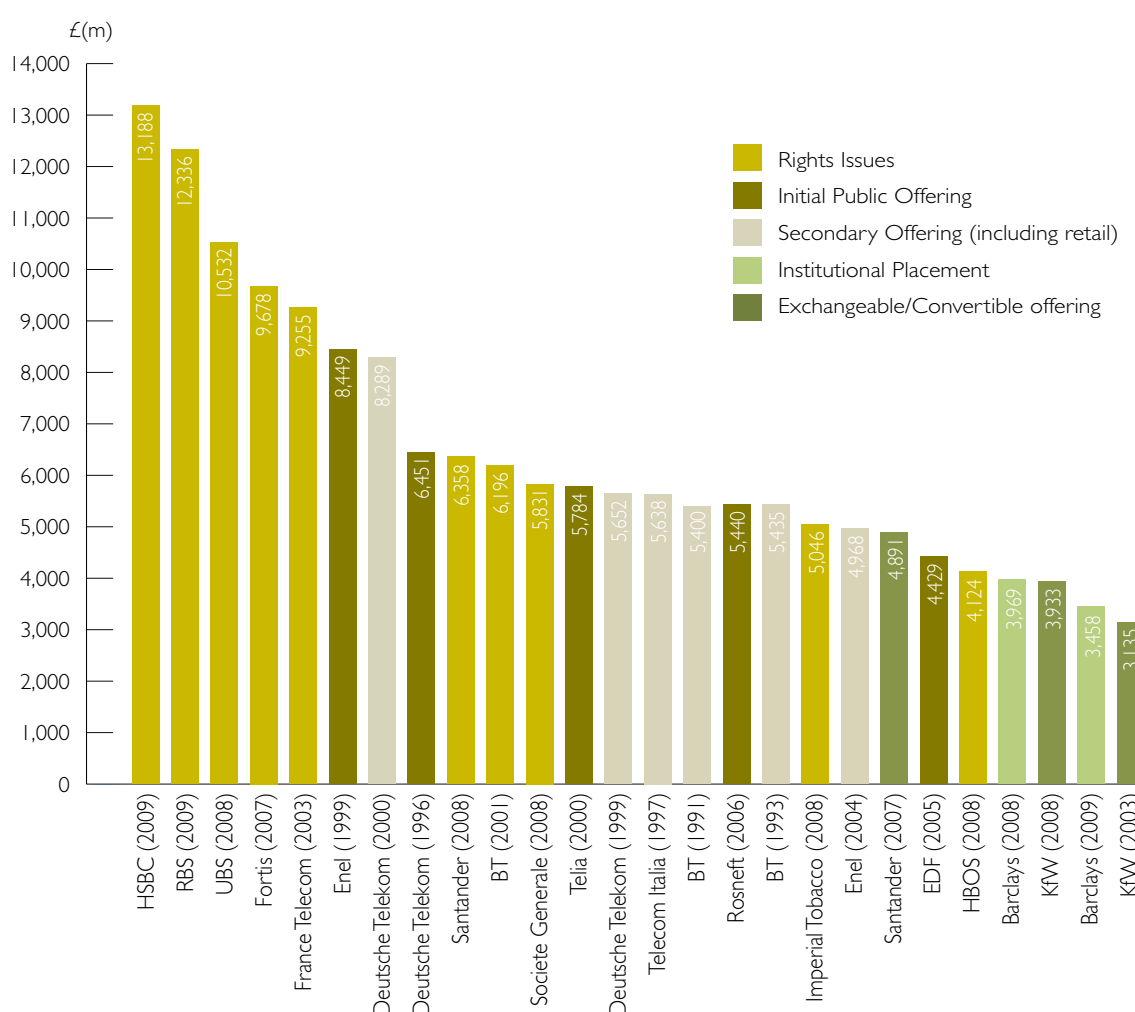
The challenge, however, will be to recognise whether a recovery in secondary market trading levels is adequately supported by evidence of underlying recovery in the economy, the banking sector as a whole, and in the prospects for our banks. While there have been some encouraging signs recently, it is in our view too early to make a judgement that the conditions are right for a share sale.

Disposal programme design – implications of scale and approach to transactions

Following the issue of B shares in connection with the Asset Protection Scheme, the value of the UKFI-managed investments in these banks will be around £60 billion at current market prices. This is a very large sum, and if, as seems likely, our opportunities to sell shares will emerge as conditions improve and share prices rise, the value of the investments we will be bringing to the market could be higher still.

We are also aware that there are practical limits on the size of individual capital markets transactions, and therefore that we may need to undertake several transactions in each bank's shares over a period of years to complete our exit. The following chart illustrates some of the largest equity market sales that have taken place in Europe in recent years.

Figure 3. Precedent large transactions since 1990



Source: Dealogic – data since 1990

The biggest have been rights issues; recent transactions for HSBC, RBS and UBS have demonstrated market capacity of over £10 billion, although since rights issues are priced at big discounts to prevailing share prices, they might not provide directly relevant precedents for transactions which are aimed at capturing a full market price for our investments.

Offerings sold at or close to the prevailing market price are typically somewhat smaller, although UK market capacity for this type of offering has not been fully tested since the BT sales in the early 1990s. There are three main types of transaction that might be available to us:

- **Institutional placements** require no prospectus and hence relatively little preparation time, and have been the standard method for executing disposals of shares in public companies (examples include UK Government sales of shares in British Energy in 2007 and QinetiQ in 2008).
- **Offerings targeted at retail** as well as institutional investors require the creation of a full prospectus (one to two months preparation time), and have been very rare in recent years (the last such transactions in Europe were for Deutsche Telekom in 2000 and Enel SpA in 2004).
- There may also be scope for **“structured transactions”** including exchangeable debt issues – employed by various European governments in recent years – in which shares are sold at a future date and at a predetermined premium to the current share price if that target price is reached or exceeded.

We will look at the full range of alternatives, and will make our decisions based on market conditions, on an assessment of investor demand, and on value for money considerations at the time when we are considering a transaction.

It is clear from this analysis that, given the size of our holdings and assuming that there might not be a strategic buyer for our stakes in these banks, we might expect to undertake several transactions in each bank's shares, and that these will take place over a sustained period. The fact that we are likely to be a very large, repeat user of the capital markets has several implications for our conduct of a sale programme, discussed below.

- If we can earn investor confidence in our approach to investment and in our sale processes, then we should expect to deliver better pricing for the taxpayer over the course of the disposal programme. Our approach to sales will need to reflect this. Conversely, if we were seen to act unreasonably as a general matter or in any given transaction we could face resistance from buyers in the future – in effect, investors might then seek a “risk premium” for taking part in a UKFI transaction, and the prices that we will generate for the taxpayer could suffer.
- There is a danger that our stakes may create “overhang” in the market – that the anticipation of a sale might affect the prevailing market price, to the detriment of proceeds. This problem has multiple aspects, and multiple potential solutions; one consequence, however, is that it is unlikely to be to the taxpayer's advantage to announce a specific predetermined sell-down strategy to the market.
- We will need to be especially careful that our dealings with intermediaries – including our selection processes for investment banking advisors – do not create undue risks of leaking our intentions to the market. In particular we will be wary of taking actions which incentivise banks to undertake unauthorised “pre-soundings” of investor appetite. We would expect prospective advisors to be firms in which we have a high degree of trust, and from whom we receive high levels of ongoing market advice and transactional idea-flow, which we regard as very important to our mission as an investor. Finally, we expect to secure demonstrable value for money, paying fees consistent with our status as a very large user of investment banking services, and will seek to ensure that fees are structured to reward successful outcomes for the taxpayer.

What will the consequences for the taxpayer be?

Government's stakes in RBS and Lloyds result from three sets of transactions:

- Ordinary shares acquired in RBS, Lloyds TSB and HBOS as a result of the October recapitalisations.
- Ordinary shares acquired in RBS and Lloyds Banking Group through the conversion of preference shares issued in the October recapitalisations.
- B shares to be acquired in RBS and Lloyds Banking Group as premium for the Asset Protection Scheme, and (in the case of RBS) to raise further capital.

Valuing the first two components is straightforward: the ordinary shares are quoted on the market. The B shares' value depends both on the ordinary share price and the value that is placed on the preferential dividend entitlement (see Box 2.5). We have engaged the services of a valuation agent who will provide a regular formal valuation of these securities once they are issued.

BOX 2.5. WHAT ARE B SHARES?

In connection with the Asset Protection Scheme (APS), the Government plans to subscribe for B shares in Lloyds and RBS. These are non-voting ordinary shares with preferential rights on dividends.

The B shares are perpetual, irredeemable securities that will form part of Core Tier I capital – and are expected to have the following terms:

- Loss absorbing on a pari passu basis with other ordinary shares and rank equally with ordinary shares in liquidation.
- Discretionary and non-cumulative dividends at the higher of 7 percent or a specified multiple of dividends on ordinary shares if paid. Dividends cannot be paid on ordinary shares unless a dividend is paid on the B shares.
- Convertible into ordinary shares at the holder's option at a specified conversion ratio of B shares to ordinary shares, and automatically convert at a certain trigger price.

For **RBS**, the expected specific terms as announced on 26 February 2009:

- Nominal value of 50 pence and issue price of 50 pence.
- If paid, dividends will be the higher of 7 percent or 2.5 x ordinary dividends.
- Convert at a ratio of 1 B share for 1 ordinary share and automatically if the share price of ordinary shares is above 65 pence for 20 out of 30 consecutive trading days.

For **Lloyds**, the expected specific terms as announced on 7 March 2009:

- Nominal value of 25 pence and issue price of 42 pence.
- If paid, dividends will be the higher of 7 percent or 1.25 x ordinary dividends.
- Convert at a ratio of approximately 2.7 B shares for 1 ordinary share and automatically if the share price of ordinary shares is above 150 pence for 20 out of 30 consecutive trading days.

The following charts illustrate how the share prices of the two banks have moved since the October recapitalisation issue terms were set, and compare them with the issue prices of the three tranches.

Figure 4. RBS share price performance



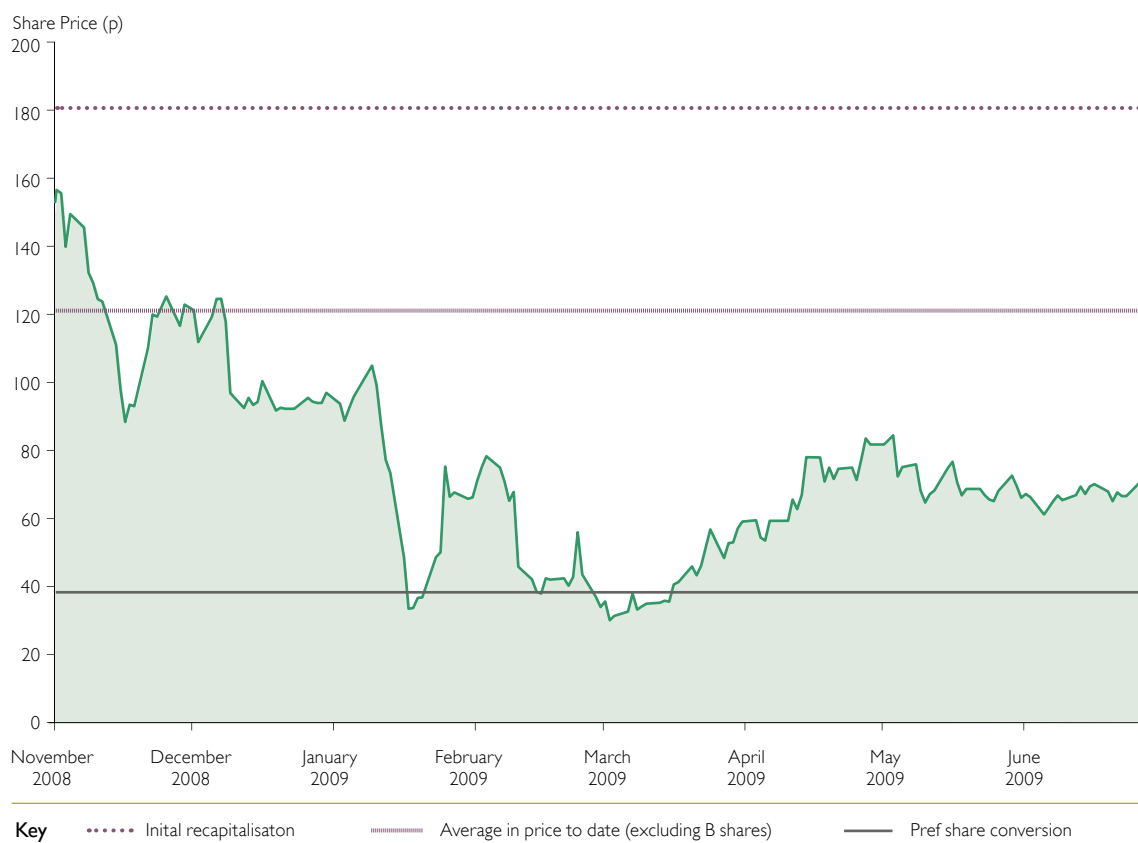
HM Treasury ordinary shareholdings in Royal Bank of Scotland (excluding B shares) ¹	Number of ordinary shares	In price	In price per share	Value as at 30/06/2009
	m	£m	p	£m
Initial recapitalisation	22,854	14,969	65.5	8,831
Preference shares conversion ²	16,791	5,058	31.75	6,488
TOTAL	39,645	20,027	50.5 (avg)	15,319

Notes

¹ UKFI will manage the B shares on completion of APS. See Box 2.5 for further details on the B shares.

² In price adjusted to include accrued dividends and redemption premiums of around £270 million.

Figure 5. Lloyds share price performance



HM Treasury ordinary shareholdings in Lloyds Banking Group (excluding B shares) ¹	Number of ordinary shares	In price	In price per share	Value as at 30/06/2009
	m	£m	p	£m
Initial recapitalisation ²	7,277	12,957	182.5	5,089
Preference shares conversion ³	4,521	1,508	38.43	3,162
TOTAL	11,799	14,465	122.6 (avg)	8,251

Notes

¹ UKFI will manage the B shares on completion of APS. See Box 2.5 for further details on the B shares.

² Includes Lloyds Banking Group capitalisation issue on 11 May 2009 (177 million shares).

³ In price adjusted to include accrued dividends and redemption premiums of around £230 million.

Performance of Investments ¹	As at 04/02/2009 ²	As at 30/06/2009 ³
	£m	£m
Unrealised Profit/(Loss) on HM Treasury ordinary shareholdings in RBS and Lloyds Banking Group	(18,137)	(10,923)

Notes

¹ Excludes B shares, which UKFI will manage on completion of APS. See Box 2.5 for further details on the B shares.

² 04 Feb 2009: Estimated unrealised loss on RBS and Lloyds ordinary shareholdings. HM Treasury impairment on financial investments published in Spring Supplementary Estimates 2008-09.

³ 30 June 2009: UK Financial Investments Strategy for Market Investments and Annual Report and Accounts 2008-09.

UKFI support to the Government response to the financial crisis

All public policy issues related to financial stability are matters for HM Treasury, which has defined our role as being an engaged, value-oriented shareholder, operating at arm's-length from Government. However, during the early months of UKFI's existence, financial stability and the need to maintain credit availability to the UK economy have remained important public policy issues, and have been the subjects of extensive engagement between Government and those banks which do business in the UK, including RBS and Lloyds. UKFI has not been a principal in these discussions, but HM Treasury has sought our advice from a shareholder standpoint on several areas, set out below.

- **Monitoring lending commitments** entered into under the October Recapitalisation arrangements. Originally, UKFI was charged with monitoring the banks' compliance with lending commitments made to HM Treasury. Following the Asset Protection Scheme, responsibility for monitoring the lending conditions has been consolidated into HM Treasury, to avoid duplication of effort and potential confusion, given that conditions would be attached to other possible Government schemes with which UKFI would not have direct involvement.
- **Redemption of preference shares** held by HM Treasury (and managed by UKFI) in RBS funded through a further issue of ordinary shares, in response to worsening business conditions for RBS which became evident in mid-January.
- **Structuring of Asset Protection Scheme arrangements**, including:
 - **design of "B shares"**, the securities which are to be issued in consideration for asset insurance. UKFI has focused on ensuring that from a shareholder's perspective these are seen as equivalent to ordinary share capital (important for avoiding concerns about future dilution and to establish an appropriate basis for valuation of the banks), and on ensuring that there will be reasonable arrangements for the taxpayer to exit from these holdings in the future (for example, the mechanisms by which these are convertible into ordinary shares if share price levels are exceeded); and
 - **working with the banks to identify measures** by which the banks can readily strengthen the key Core Tier 1 capital ratio and create shareholder value by improving Tangible Book Value per share. Examples include the liability management exercises through which RBS and Lloyds have repurchased or exchanged Tier 1 and Upper Tier 2 securities at a discount to book value, creating combined Core Tier 1 capital in excess of £5 billion.
- **Redemption of preference shares** issued by Lloyds Banking Group to HM Treasury, including terms of HM Treasury participation in the ordinary share offer to fund the redemption and acceleration of the offer to precede the closing of the Asset Protection Scheme.
 - Under this offer, Lloyds has raised an additional £4 billion of Core Tier 1 capital, of which 56.6 percent has been subscribed for by private sector shareholders (see box 2.6)
 - The taxpayer has received approximately £2.5 billion in cash for the redemption of preference shares and associated payments – the first repayment of capital provided by any government in the recent interventions.

As the financial system stabilises, we would expect that the need for new initiatives in the areas of financial stability or credit availability should diminish, but we will continue to offer shareholder input to HM Treasury as requested.

BOX 2.6 LLOYDS OPEN OFFER

In May 2009, Lloyds Banking Group (Lloyds) launched a placing and open offer, the proceeds of which were used to redeem the £4 billion preference shares held by HM Treasury.

Existing Lloyds shareholders were entitled to subscribe for 0.6213 new ordinary shares for every ordinary share through the Placing and Open Offer at an offer price of 38.43 pence per new ordinary share. On 8th June 2009, Lloyds announced that 9,043 million Open Offer Shares had been taken up, representing approximately 87 percent of the total number of Open Offer Shares.

HM Treasury subscribed for 4,521 million shares, maintaining the Government's ownership of Lloyds at 43 percent.

The remaining 1,365 million shares not taken up by existing shareholders were placed successfully in the market by the bookrunners at the conclusion of the open offer process in a "Rump Placing" at a price of 60 pence per share. The net proceeds raised in the Rump Placing in excess of the 38.43 pence open offer price (plus expenses) were distributed on a pro rata basis to those shareholders who did not participate in the Placing and Open Offer.

Lloyds used the proceeds of the open offer and rump placing, together with existing cash resources, to redeem the £4 billion preference shares held by HM Treasury at 101 percent of their issue price together with accrued dividends.

UKFI STRATEGY: MARKET INVESTMENTS

03

Annex I. Royal Bank of Scotland

UKFI manages the Government's investments in the Royal Bank of Scotland (RBS). This Chapter provides details of the Government's shareholdings in RBS and an overview of the RBS Group. It draws directly on the 2008 RBS Annual Report and Accounts.⁴

Government shareholding

The Government currently holds 39,645 million ordinary shares in RBS, equivalent to 70 percent of voting share capital. There are three stages to the Government investment in RBS:

- **October recapitalisation:** as part of the financial support for the banking industry announced in October 2008, the Government made a capital investment in RBS of £20 billion, £15 billion in the form of 22,854 million ordinary shares and £5 billion in preference shares.
- **Conversion of preference shares:** in January 2009, the Government, in consultation with UKFI, agreed to the redemption of its preference share investment, financed by a further offer of ordinary shares. The Government took up 16,791 million shares in the open offer, which increased the Government's ownership of ordinary voting shares to 70 percent.
- **Asset Protection Scheme:** in connection with the Asset Protection Scheme, the Government expects to receive a fee of £6.5 billion in the form of 13,000 million B shares. The Government has also agreed to subscribe for a further £13 billion (26,000 million B shares) on accession and up to a further £6 billion (12,000 million B shares) at RBS's option. In total, this would bring the Government's shareholding up to 84 percent of total share capital. The B shares are non-voting and the Government's voting shareholding would remain at 70 percent.

Company overview

The Royal Bank of Scotland Group plc is the holding company of a large global banking and financial services group. Headquartered in Edinburgh, the Group operates in the United Kingdom, the United States and internationally through its two principal subsidiaries, the Royal Bank and NatWest. Both the Royal Bank and NatWest are major long-established UK clearing banks. In the United States, the Group's subsidiary Citizens is a large commercial banking organisation.

The Group has a large and diversified customer base and provides a wide range of products and services to personal, commercial and large corporate and institutional customers in over 50 countries.

⁴The full RBS Annual Report can be found on the RBS Group website: www.rbs.com

Financial performance in 2008

The Royal Bank of Scotland (RBS) published its Annual Report and Accounts for 2008 in March 2009. The full RBS Annual Report can be found on the RBS Group website: www.rbs.com.

RBS Financial Performance ⁵ Pro forma results for year ended 31 December	2008
Underlying profit (1)	£80 million
Loss attributable to ordinary shareholders (2)	£7.9 billion
Total income (3)	£26.9 billion
Impairment losses (4)	£7.0 billion
Credit market losses (5)	£7.8 billion
Write-down of goodwill and other intangible assets (6)	£16.2 billion
Total capital ratio	14.2 percent
Core Tier I capital ratio (7)	7.0 percent
Tier I capital ratio	9.9 percent
Basic loss per ordinary share (8)	(61.0 pence)

Notes:

- (1) Profit before tax, credit market write-downs and one-off items, impairment losses on reclassified assets, purchased intangibles amortisation, write-down of goodwill and other intangible assets, integration costs, restructuring costs and share of ABN AMRO shared assets.
- (2) Before write-down of goodwill and other intangible assets, net of tax.
- (3) Excluding credit market write-downs and one-off items and share of shared assets.
- (4) Excluding impairment losses on reclassified assets.
- (5) Net of CDS hedging.
- (6) Net of tax.
- (7) Adjusted for the conversion of preference shares into ordinary shares.
- (8) Loss per ordinary share is based on the assumption that the rights issue and capitalisation issue were completed on 1 January 2008.

The following commentary on RBS's 2008 results is extracted directly from the RBS Annual Report 2008:

“While a downturn was anticipated, no one could have foretold the unprecedented market disruption and global economic downturn that we now experience. With roots in economic imbalances across the world, the downturn has weakened many. However, that is little consolation for the particular vulnerability that RBS has exhibited.

In 2008 the Group's overall results were bad, with net attributable losses, before goodwill impairments, of £7.9 billion. This is particularly disappointing since many parts of our business did well, serving customers and generating high-quality profitability. All our Divisions were profitable except Global Banking and Markets (GBM) and Asia Retail & Commercial Banking. Even in GBM, underlying income reached £10.2 billion on the back of many strong business performances. Unfortunately these profits were more than wiped out by credit and market losses in concentrated areas around proprietary trading, structured credit and counterparty exposures. Over 50 percent of these losses pertained to ABN AMRO-originated portfolios.

⁵RBS Annual Report, p. 1

In addition, the change in market outlook and our vulnerability thereto has required a £16.2 billion accounting write-down of goodwill and other intangibles relating to prior year acquisitions, most notably of ABN AMRO in 2007 and Charter One in the US in 2004. This non-cash item has minimal impact on capital but does highlight the risk of acquisitions if economic conditions change adversely.

From a capital perspective, successive capital raisings have substantially strengthened the Group's capital ratios. Reported losses have only partially eroded these, and our core Tier 1 ratio stood at 7.0 percent at the end of 2008, pro forma for the conversion of our preference shares, compared with 4.0 percent a year earlier. Additionally, the funded balance sheet was reduced by £93 billion, or 17 percent in constant currency terms. Unfortunately, the extreme dislocation of markets has impeded the risk reduction we target, leaving much still to do. Moreover, the fall in sterling exchange rates inflates our international balance sheet and this, plus extreme market movements, also increases the accounting value of our derivatives balances, albeit recording amounts that would be largely netted off under US GAAP.

RBS has strong businesses, and has taken steps to restore its capital base and benefits from clear Government support. It is our primary task to rebuild standalone strength in the coming years.”⁶

Corporate governance

The RBS Board is the principal decision-making forum for the company. It has overall responsibility for leading and controlling the company and is accountable to shareholders for financial and operational performance. The Board approves Group strategy and monitors performance.⁷

The RBS Board currently comprises the Chairman, three executive directors and five non-executive directors.

RBS Board of Directors 2008/09		Committee membership
Chairman		
Philip Hampton	Chairman	N (Chairman), R
Executive Directors		
Stephen Hester	Group Chief Executive	
Gordon Pell	Chairman, Regional Markets	
Guy Whittaker	Group Finance Director	
Non-executive Directors⁸		
Colin Buchan		A, N, R
Archie Hunter		A (Chairman), N
Joe MacHale		A, N
John McFarlane		N, R
Arthur Ryan		N

Note: Key to abbreviations: A (member of Audit Committee); N (member of Nominations Committee); R (member of Remuneration Committee).

⁶RBS Annual Report, p. 4

⁷RBS Annual Report, p. 153

⁸RBS also announced on 22 May that Sir Sandy Crombie would be appointed as a Non-executive Director and Senior Independent Director of the RBS board with effect from 1 June 2009.

Divisional review

The Group's activities are organised in the following business divisions:

- Global Markets (comprising Global Banking & Markets and Global Transaction Services)
- Regional Markets (comprising UK Retail & Commercial Banking, US Retail & Commercial Banking, Europe & Middle East Retail & Commercial Banking and Asia Retail & Commercial Banking)
- RBS Insurance and Group Manufacturing.

A description of each of the divisions, extracted from the 2008 RBS Annual Report, is given below⁹.

Global Markets

Global Banking & Markets is a leading banking partner to major corporations and financial institutions around the world, providing an extensive range of debt and equity financing, risk management and investment services to its customers. In 2008 the division was organised along four principal business lines: rates, currencies, and commodities, including RBS Sempra Commodities LLP (the commodities-marketing joint venture between RBS and Sempra Energy which was formed on 1 April 2008); equities; credit markets; and asset and portfolio management.

Global Transaction Services ranks among the top five global transaction services providers, offering global payments, cash and liquidity management, as well as trade finance, United Kingdom and international merchant acquiring and commercial card products and services. It includes the Group's corporate money transmission activities in the United Kingdom and the United States.

Regional Markets

UK Retail & Commercial Banking (RBS UK) comprises retail, corporate and commercial banking and wealth management services. It operates through a range of channels including on-line and fixed and mobile telephony, and through two of the largest networks of branches and ATMs in the UK.

In the Retail market, RBS UK serves over 15 million personal customers through the RBS and NatWest brands. It offers a full range of banking products and related financial services including mortgages, bancassurance products, deposit accounts, and credit and charge cards.

RBS UK holds a leading market share across all of the Business & Commercial and Corporate sectors. Through its network of relationship managers it distributes a full range of banking, finance and risk management services, including market-leading Invoice Finance and Asset Finance offerings.

The UK wealth management arm offers high quality private banking and investment services through the Coutts, Adam & Company, RBS International and NatWest Offshore brands.

US Retail & Commercial Banking provides financial services primarily through the Citizens and Charter One brands. Citizens is engaged in retail and corporate banking activities through its branch network in 13 states in the United States and through nonbranch offices in other states. Citizens was ranked the tenth-largest commercial banking organisation in the United States based on deposits as at 30 September 2008.

Europe & Middle East Retail & Commercial Banking comprises Ulster Bank and the Group's combined retail and commercial businesses in Europe and the Middle East. Ulster Bank provides a comprehensive range of financial services across the island of Ireland. Its retail banking arm has a network of branches and operates in the personal, commercial and wealth management sectors, while its corporate markets operations provides services in the corporate and institutional markets.

⁹RBS Annual Report, p. 26-27.

Asia Retail & Commercial Banking is present in markets including India, Pakistan, China, Taiwan, Hong Kong, Indonesia, Malaysia and Singapore. It provides financial services across four segments: affluent banking, cards and consumer finance, business banking and international wealth management, which offers private banking and investment services to clients in selected markets through the RBS Coutts brand.

RBS Insurance and Group Manufacturing

RBS Insurance sells and underwrites retail and SME insurance over the telephone and internet, as well as through brokers and partnerships. Its brands include Direct Line, Churchill and Privilege, which sell general insurance products direct to the customer, as well as Green Flag and NIG. Through its international division, RBS Insurance sells general insurance, mainly motor, in Spain, Germany and Italy. The Intermediary and Broker division sells general insurance products through independent brokers.

Group Manufacturing comprises the Group's worldwide manufacturing operations. It supports the customer-facing businesses and provides operational technology, customer support in telephony, account management, lending and money transmission, global purchasing, property and other services. Manufacturing drives efficiencies and supports income growth across multiple brands and channels by using a single, scalable platform and common processes wherever possible. It also leverages the Group's purchasing power and has become the centre of excellence for managing large-scale and complex change. The Centre comprises group and corporate functions, such as capital raising, finance, risk management, legal, communications and human resources. The Centre manages the Group's capital resources and Group-wide regulatory projects and provides services to the operating divisions.

UKFI STRATEGY: MARKET INVESTMENTS

04

Annex 2. Lloyds Banking Group

UKFI manages the Government's investments in the Lloyds Banking Group (Lloyds). This chapter provides an overview of the Government's shareholdings in Lloyds and an overview of the Lloyds Banking Group. It draws directly on the 2008 Lloyds Annual Report and Accounts.¹⁰

Government shareholding

The Government currently holds 11,799 million ordinary shares in Lloyds, equivalent to 43 percent of voting share capital. There are three stages to the Government investment in Lloyds:

- **October recapitalisation:** as part of the financial support for the banking industry announced in October 2008, the Government made capital investments in Lloyds TSB and HBOS totalling £17 billion, £13 billion in the form of 7,100 million ordinary shares and £4 billion in preference shares.¹¹
- **Conversion of preference shares:** in March 2009, the Government, in consultation with UKFI, agreed to the redemption of its preference share investment, financed by a further offer of ordinary shares. The Government subscribed for its pro rata share (4,521 million) of the ordinary shares on offer and maintained its holding of 43 percent of voting share capital.
- **Asset Protection Scheme:** in connection with the Asset Protection Scheme, the Government expects to receive a fee of £15.6 billion in the form of 37,143 million B shares. In total, this would bring the Government's shareholding up to 62 percent of total share capital. The B shares are non-voting and the Government's voting shareholding would remain at 43 percent.

Company overview

Lloyds Banking Group (Lloyds) is a leading UK based financial services group providing a wide range of banking and financial services, primarily in the UK, to personal and corporate customers.

Lloyds was formed in January 2009 following the acquisition of HBOS. The main business activities are retail, commercial and corporate banking, general insurance, and life, pensions and investment provision. The new Group also operates an international banking business with a global footprint in 40 countries.

The Group is the largest UK retail bank and has a large and diversified customer base. Services are offered through a number of well recognised brands including Lloyds TSB, Halifax, Bank of Scotland, Scottish Widows, Clerical Medical and Cheltenham & Gloucester, and via a unique distribution capability comprising the largest branch network in the UK and intermediary channels.

¹⁰The full Lloyds Annual Report can be found on the Lloyds Group website: www.lloydsbankinggroup.com

¹¹On 11 May, Lloyds Banking Group 1 for 40 capitalisation issue increased the Government's ordinary shareholding to 7,277 million shares.

Financial performance in 2008

Lloyds Banking Group published its Annual Report and Accounts for 2008 in April 2009. The full Lloyds Annual Report can be found on the Lloyds Group website: www.lloydsbankinggroup.com.

Lloyds Financial Performance ¹² Group Results Summary 2008 (£m)	2008
Net interest income	7,709
Other income	521
Total income	8,230
Insurance claims	2,859
Total income, net of insurance claims	11,089
Operating expenses	(5,651)
Trading Surplus	5,438
Impairment	(3,012)
Profit before tax – continuing businesses*	2,426
Volatility	
– Insurance	(746)
– Policyholder interests	(471)
Discontinued businesses	–
Profit on sale of businesses	–
Provision in respect of certain historic US dollar payments	(180)
Provision for Financial Services Compensation Scheme levy	(122)
Goodwill impairment	(100)
Settlement of overdraft claims	–
Profit before tax – statutory	807

* Excluding volatility, a provision in respect of certain historic US dollar payments, a provision for the Financial Services Compensation Scheme levy, goodwill impairment and, in 2007, results of discontinued businesses, profit on the sale of businesses and the settlement of overdraft claims.

The following commentary on Lloyds' 2008 results is extracted directly from the Lloyds Annual Report 2008:

“Statutory profit before tax reduced by 80 percent to £807 million. A resilient underlying business performance was offset by the impact of market dislocation and adverse volatility relating to the Group’s insurance businesses.

A resilient business performance. Profit before tax, on a continuing businesses basis, totalled £2,426 million, a decrease of 35 percent which reflected the impact of £1,270 million of market dislocation and higher impairment levels.

Robust income performance. Income, excluding market dislocation, grew by 9 percent reflecting strong revenue growth from the Group’s relationship banking businesses. On a statutory basis, income was 8 percent lower at £9,872 million.

Excellent cost management. The Group’s cost: income ratio, excluding market dislocation, improved by 1.1 percentage points to 47.0 percent.

¹²Lloyds Annual Report and Accounts, p.1

In a difficult economic environment, asset quality remains satisfactory. Impairment losses increased by 68 percent to £3,012 million, reflecting the impact of market dislocation, the slowdown in the UK economic environment and the impact of the falling house price index.

Strong liquidity and funding position maintained throughout the recent turbulence in global financial markets.

Robust capital ratios. Adjusting the year end capital ratios for the Government's recapitalisation of UK banks, completed in January 2009, and the estimated impact of the acquisition of HBOS, the enlarged Lloyds Banking Group's pro forma core tier 1 capital ratio stands at 6.4 percent, the tier 1 ratio at 9.8 percent and the total capital ratio at 12.5 percent¹³."

Corporate governance

The Group is led by the board comprising executive and non-executive directors with wide experience. The board usually meets at least nine times a year. It has a programme designed to enable the directors regularly to review corporate strategy and the operations and results of the businesses and discharge their duties within a framework of prudent and effective controls relating to the assessing and managing of risk¹⁴.

The Lloyds Board as at April 2009 comprises the Chairman, five executive directors and nine non-executive directors (with two additional non-executive directors joining from 1 March and 2 April 2009).

Lloyds Board of Directors 2008-09		Committee membership
Chairman		
Sir Victor Blank	Chairman	N (Chair), RO (Chair), R
Executive Directors		
J Eric Daniels	Group Chief Executive	
Archie G Kane	Group Executive Director Insurance	
G Truett Tate	Group Executive Director Wholesale	
Tim J W Tookey	Group Finance Director	
Helen A Weir CBE	Group Executive Director Retail	
Non-executive Directors		
Wolfgang C G Berndt		R (Chair), N
Ewan Brown CBE FRSE		A, RO
Jan P du Plessis		A (Chair), N, RO
Sir Julian Horn-Smith		N, R, RO
Lord Leitch		A, N, RO
Sir David Manning GCMG	CVO	N, R, RO
Philip N Green		A, R
Martin A Scicluna		A, RO
Carolyn J McCall OBE		R
Non-executive Directors joining the Board		
T Timothy Ryan, Jr	(from 1 March 2009)	A, RO
Anthony Watson CBE	(from 2 April 2009)	A, RO

Note: Key to abbreviations: A (member of Audit Committee); N (member of Nominations Committee); R (member of Remuneration Committee); RO (member of Risk Oversight Committee).

¹³Lloyds Annual Report, p. 10

¹⁴Lloyds Annual Report, p. 70

Divisional review

During 2008 Lloyds Banking Group has been organised along three primary operating divisions:

- UK Retail Banking;
- Insurance and Investments; and
- Wholesale and International Banking.

A description of each of the divisions, drawn from the Lloyds Annual Report, is given below¹⁵.

UK Retail Banking

During 2008, Lloyds UK Retail Banking provided a wide range of banking and financial services to some 16 million personal customers through over 1,950 branches across the UK. Following the acquisition of HBOS, the new "Retail" division now includes the HBOS branch operations and is the largest retail bank in the UK. UK Retail Banking continued to make substantial progress in each of its key strategic priorities: growing income from its existing customer base; expanding its customer franchise; and improving productivity and efficiency¹⁶.

Insurance and Investments

The Insurance and Investment division offers life assurance, pension and investment products, general insurance and fund management services. These products were delivered through a number of brands including Scottish Widows, Lloyds TSB General Insurance and Scottish Widows Investment Partnership. Following the acquisition of HBOS, the Insurance and Investments division has been renamed "Insurance" and now includes the Clerical Medical and HBOS General Insurance businesses which were previously part of the HBOS Insurance and Investments division.

Wholesale and International Banking¹⁷

During 2008, Lloyds businesses within the Wholesale and International Banking arena covered a broad scope, serving thousands of customers, ranging from start-ups and small enterprises to large organisations and global corporations.

Commercial Banking is a growing business with some 6,000 people serving nearly one million customers across the UK from one-person start-ups to large, established enterprises. Lloyds TSB has increased its lending to SMEs by nearly 20 percent in 2008. We also participate in specialist markets with a range of solutions including personal and international expatriate and private banking, motor and leisure finance and auto leasing.

Following the acquisition of HBOS, the Wholesale and International Banking division has been renamed 'Wholesale'. The new 'Wholesale' division operates a multi brand strategy primarily through the Lloyds TSB and Bank of Scotland brands but also trades through a number of more specialist brands including Lloyds TSB Development Capital and Black Horse.

¹⁵Lloyds Annual Report p. 10

¹⁶Lloyds Annual Report p. 20

¹⁷Lloyds Annual Report p. 30

THE UKFI BOARD



Glen Moreno – Acting Chairman.

Educated at Stanford University and Harvard Law School, Glen Moreno joined Citicorp in 1969. In the 1970s he was responsible for operations in Germany, Australia, South East Asia and India, including a wide range of corporate, retail and investment banking activities. In the 1980s he was Citi's senior officer in Europe and a member of the bank's policy committee.

In 1987 he joined Fidelity International as Chief Executive, recruited to lead its international expansion. In 1991 he retired from executive duties and held several board positions with banks and investment companies.

In 2005 Glen was appointed Chairman of Pearson plc, the world's leading education company with ownership interests in the Financial Times and The Economist. He remains a director of Fidelity International and chairs its audit committee. He is senior independent director at Man Group plc, a governor of the Ditchley Foundation and a director of the Royal Academy of Dramatic Art.



John Kingman – Chief Executive.

Prior to his appointment as Chief Executive of UKFI in November 2008, John Kingman was Second Permanent Secretary to the Treasury, where he was responsible for oversight and control of some £600 billion of public spending annually. He led negotiations with RBS, Lloyds TSB and HBOS on their recapitalisation and on the resolution process for Northern Rock. Earlier Treasury roles have included Managing Director, Finance and Industry – in which capacity he chaired, on the Chancellor's behalf, the tripartite standing Committee which oversees the stability of UK financial markets – Director, Enterprise & Growth Unit, and Press Secretary to the Chancellor.

John has also worked on the Lex column of the Financial Times and in the Group Chief Executive's office at BP, and has been a Board Director of the European Investment Bank, a non-executive director of Framestore CFC Ltd, and a Visiting Fellow at the Institute of Political and Economic Governance at Manchester University. John is a member of the Global Advisory Board of the Centre for Corporate Reputation, Oxford University.



Peter Gibbs

Peter Gibbs has a wealth of financial services experience in the Asset Management sector. Having begun his career at Brown Shipley, he joined Bankers Trust in 1985 as a Senior Portfolio Manager. In 1989 he joined Mercury Asset Management (MAM) where he rose to become Head of the International Equities Division. Following the acquisition of MAM by Merrill Lynch he was appointed Co-head of Equity Assets worldwide. In 2003 he became Chief Investment Officer for Merrill Lynch's Investment Management activities outside the US.

Peter retired from Merrill Lynch at the end of 2005. He currently serves as Non-Executive Director of Impax Group plc the environmental asset manager and as a Director of Merrill Lynch (UK) Pension Plan Trustees Ltd. Between June 2006 and August 2007 he was a Non-Executive Director of Bridgewater Group plc.



Michael Kirkwood

Michael Kirkwood was Citi's Chief Country Officer for the United Kingdom and Chairman of Corporate Banking until the end of 2008. He was recently appointed as Vice Chairman of the Advisory Board in the UK of PricewaterhouseCoopers. He has previously held management positions with Citi in New York, Switzerland and Scandinavia as well as the UK. Prior to joining Citi, Michael worked in Singapore for a number of years with Ralli International (subsequently part of the Bowater Group), as a Director of several group companies and latterly as founding Chief Executive of Temenggong Merchant Bankers Ltd. He has also worked for Ansbacher & Co and The Hongkong and Shanghai Banking Corporation.

In addition to his role with Citi, Michael served as a Non-Executive Director of Kidde plc from 2001 to 2005, was Vice Chairman of the British Bankers' Association, sat on the CBI's Financial Services Council and remains a member of the Advisory Board of the Association of Corporate Treasurers. He has held a variety of positions in trade bodies and the City of London, and is currently Chairman of Habitat for Humanity GB. He was appointed a Companion of the Order of St. Michael & St. George (CMG) in the Queen's 2003 Birthday Honours.



Lucinda Riches

Lucinda Riches is a senior equity capital markets banker with extensive experience in privatisations. After a brief spell at Chase Manhattan Bank, Lucinda joined SG Warburg in 1986 where she pursued a career spanning 21 years in SG Warburg and its successor firms, ultimately UBS. She became involved in the equity capital markets business in 1988. During the late 1980s and 1990s she worked on a large number of IPOs and equity sales for a range of clients, including privatisation for a number of governments around the world, including Deutsche Post, Telia, Statoil and Telestra.

Lucinda became European Head of Equity Capital Markets in 1995 and Global Head of Equity Capital Markets in 1999. In 2001 she joined the board of UBS Investment Bank, with personal responsibility for the equity capital markets strategy within the investment bank. She chose to step down from her UBS role in 2007. Lucinda has an MA in Philosophy, Politics and Economics from Brasenose College, Oxford and an MA in Political Science from the University of Pennsylvania.



Philip Remnant

Philip Remnant is Chairman of the Shareholder Executive, which was formed in 2003 to improve the Government's performance as a shareholder in government-owned businesses. He was appointed to the Northern Rock Board as a Non-Executive Director in February 2008, and is a Senior Advisor of Credit Suisse's investment banking division in Europe.

Previously, Philip was a Vice Chairman of Credit Suisse First Boston in Europe and was Director General of the Takeover Panel for two years between 2001 and 2003. He formerly held senior investment banking positions with BZW and Kleinwort Benson. He is a qualified chartered accountant and has an MA in Law from New College, Oxford.



Louise Tulett

Louise Tulett is HM Treasury's Group Director of Finance, Procurement and Operations. She joined HM Treasury in June 2000 following a 24-year career in public sector finance in local government and the Health Service. She is a member of the Chartered Institute of Public Finance and Accountancy (CIPFA).

Louise's first role at the Treasury was to introduce resource accounts to the Treasury itself, in line with the Central Treasury Initiative led by Sir Andrew Likierman for resource accounting and budgeting (RAB) across government departments. Following a short spell as department management accountant, Louise was promoted to Team Leader for Finance and Procurement in March 2004 and took responsibility for the merger of OGC/HMT Finance and Procurement function within Group Shared Services in August 2006. She was promoted to Group Director of Finance, Procurement and Operations in June 2007.

THE UKFI TEAM



John Crompton, Head of Market investments, has 22 years of banking experience: 20 with Morgan Stanley, and two with Merrill Lynch, and has been responsible for equity new issue business in Europe, the US and Asia. He also acted as HM Treasury's Senior Corporate Finance Advisor from 2005-2007. He has been registered with NASD (US), Hong Kong authorities, the FSA and predecessor organisations. John joined UKFI from Merrill Lynch, where he was Head of Equity Capital Markets EMEA, in December 2008.



Sam Woods, Chief Operating Officer, joined UKFI in November 2008. Sam previously held a number of roles in HM Treasury, and recently spent two years on secondment to the New Zealand Treasury as a Team Leader managing the Government's ownership interest in a number of state-owned enterprises. Before joining HM Treasury, Sam worked at Diageo on international strategy and as Finance Director of its UK subsidiary Translucis Limited. Prior to this, he worked at McKinsey & Company, mainly in financial services and M&A. In 1998 he spent a year at INSEAD gaining an MBA.



Keith Morgan, Head of Wholly-Owned Investments, will be responsible for managing the Government's shareholdings in Northern Rock and Bradford & Bingley. Keith, who joins UKFI from Banco Santander, has strong retail and commercial banking experience. He is currently a Board director of Sovereign Bancorp in the U.S. focusing on the integration of Sovereign into Santander. He was previously Director of Strategy & Planning at Abbey National, where he was a member of the Executive Committee, and was also Chairman of Santander's Asset Management and Credit Card businesses in the UK. Before joining Abbey in 2004, Keith spent 18 years at L.E.K. consulting, where he was a Partner specialising in financial services.



Tim Sykes, Senior Banks Analyst, has spent 19 years working in the banking sector, including as Co-head of European banks' equity research at Credit Suisse First Boston, and as Managing Director and Head of UK and Irish Banks equity research at UBS. From 2003 to 2007 he held various management positions at Standard Chartered Bank, most recently serving as deputy Group Treasurer. Tim joined UKFI in January 2009 from Execution Limited where he was Senior Banks Analyst covering the UK banks.

ANNUAL REPORT AND ACCOUNTS 2008 / 09

01

Chief Executive's statement

This is the first UK Financial Investments (UKFI) Annual Report and Accounts. Since commencing operations in November 2008, UKFI has taken on management of the Government's investments in financial institutions. This Annual Report covers the period from 10 October 2008, when UKFI was founded, to 31 March 2009.

For this annual reporting period, our investments comprised holdings in two investee banks: The Royal Bank of Scotland plc (RBS) and Lloyds Banking Group plc (Lloyds). Government investments in Bradford & Bingley (B&B) and Northern Rock (NR) were not managed by UKFI during this reporting period but are being taken on by UKFI during the 2009/2010 reporting period.

UKFI began operations against the backdrop of turmoil in the financial markets, and radical Government intervention, which saw the Government taking significant stakes in four of the UK's major financial institutions. Ultimately, our goal is to exit from the banks in which Government has investments, returning them to the private sector and protecting and creating value for the taxpayer.

Our remit

As a Limited Company, our activities are governed by our Board, which takes all major, strategic decisions for the Company.

We operate like any other active and engaged shareholder, on a commercial basis and at arm's-length from Government. We follow in full the Institutional Shareholders' Committee's Statement of Principles.

Our work complements that of HM Treasury which has responsibility for policy decisions for the financial sector as a whole, including economic growth and financial stability. UKFI has published a Framework Document with HM Treasury (included as an Annex to this Annual Report) which sets out our overarching objective and the key parameters for how we will conduct our business, including: a mandate to manage the investments commercially; a framework for monitoring and engaging with our investee companies; and robust institutional arrangements for keeping UKFI at arm's-length from Government.


We work closely with our investee banks, for example through strengthening their Boards. Our investee banks continue to be separate economic units with independent powers of decision and, in particular, will continue to have their own independent Boards and management teams, determining their own strategies and commercial policies.

Strategy, performance and accountability

In meeting our goal of protecting and creating value for the taxpayer, we are committed to being transparent to Parliament and the public. The Chairman and members of the senior management team have attended meetings of relevant Parliamentary committees where required. This has included the Treasury Select Committee's hearings on the banking crisis, and the Lords Economic Affairs Committee's inquiry into banking supervision and regulation.

The UKFI Strategy: Market Investments, published alongside this Annual Report, has been drawn up to provide the public and Parliament with a clear explanation of our strategy for disposing of the Government's investments in an orderly and active way while protecting and creating value for the taxpayer as shareholder, and with more information about the banks. The strategy includes details of our view of the banking crisis and the impact on our investee banks going forwards, our strategy for our investments, and summaries of key data on our investee companies. It also includes our plans for performance management.

I hope that this Annual Report and UKFI Strategy provide a useful update on our work on behalf of the Government and taxpayer as a shareholder in our investee banks.



John Kingman
Chief Executive
30 June 2009

ANNUAL REPORT AND ACCOUNTS
2008 / 09

02

Directors' Report

UKFI Board

The UKFI Board takes all major, strategic decisions for the Company. The principal activity of the Company is managing the Government's investments in financial institutions to protect and create value for the taxpayer as shareholder, through active engagement with the investee companies. The Company has a Framework Document with HM Treasury which sets out the key parameters for how we will conduct our business, including a clear mandate to manage the investments commercially, and robust institutional arrangements for keeping UKFI at arm's-length from Government.

The directors, set out below with their dates of appointment, provide the Company with the expertise, skills and experience required to manage the investments effectively.

Board membership		Committee membership
Glen Moreno (16.01.2009)	Acting Chairman	N (Chair), R
John Kingman (25.11.2008)	Chief Executive	
Peter Gibbs (18.01.2009)	Independent Non-Executive	N, R, A
Michael Kirkwood (18.01.2009)	Independent Non-Executive	N, R (Chair), A
Lucinda Riches (15.01.2009)	Independent Non-Executive	N, R, A
Philip Remnant (11.03.2009)	Treasury-Appointed Non-Executive	N
Louise Tulett (11.03.2009)	Treasury-Appointed Non-Executive	A (Chair)

Key to abbreviations: N=Nominations Committee, R=Remuneration Committee, A=Audit and Risk Committee.

During 2008/09 the membership of the Board changed as some members stepped down from the Board.

Former Board members ¹⁸	
Sir Philip Hampton (25.11.2008 – 16.01.2009)	Chairman
Tom Scholar (13.01.2009 – 02.03.2009)	Treasury-Appointed Non-Executive
Nicole Monir (10.10.2008 – 10.10.2008)	Director
Robin Ogle (10.10.2008 – 25.11.2008)	Director
Trusec Limited (10.10.2008 – 25.11.2008)	Director

The Board has considered and put in place arrangements to manage any conflicts of interest. As part of this, each director has disclosed, at the outset of their term as a director, any direct or indirect conflicts of interest they are aware of and may have in connection with being appointed a director of the Company.

The Board meets a minimum of nine times a year, and on an ad-hoc basis as required. The Board met 12 times in this reporting period.

¹⁸Nicole Monir, Robin Ogle and Trusec Limited were initial legal directors involved in the establishment of the Company, exercised no executive power during these periods, received no remuneration, and were not granted indemnities.

Board committees

The Board is supported by three sub-committees to provide effective oversight and leadership: the Audit and Risk Committee; the Remuneration Committee; and the Nominations Committee. The Board is also supported by the Executive Management Committee, which is not a Board Committee.

Audit and Risk Committee

The Audit and Risk Committee has met once in this reporting period.

All members of the Audit and Risk Committee are non-executive directors. The current members of the Audit and Risk Committee are Louise Tulett (Committee chair), Peter Gibbs, Lucinda Riches and Michael Kirkwood. Only members of the Audit and Risk Committee have the right to attend Audit and Risk Committee meetings. However, other individuals may be invited to attend for all or part of any meeting as and when appropriate. The Audit and Risk Committee meets a minimum of three times a year, and on an ad-hoc basis as required.

The Audit and Risk Committee is authorised by the Board to investigate any activity within its terms of reference and to seek any information it requires from any employee. The Board will ensure that employees co-operate fully with the Audit and Risk Committee. The detailed responsibilities of the Audit and Risk Committee include: considering the scope and planning of the audit, the audit fee and any questions of dismissal of the auditors; reviewing financial statements before submission to the Board; reviewing and considering reports from the auditors and the audit management letter and management response; and reviewing the Company's annual statement on internal control systems prior to endorsement by the Board and regularly reviewing the effectiveness of these systems.

Remuneration Committee

The membership, details and terms of reference for the Remuneration Committee are set out in the Directors' Remuneration Report.

Nominations Committee

The Nominations Committee did not meet during this reporting period.

All members of the Nominations Committee are non-executives. The current members of the Nominations Committee are Chair of the Board (Committee chair), Peter Gibbs, Lucinda Riches, Michael Kirkwood, and Philip Remnant. Only members of the Nominations Committee have the right to attend Nominations Committee meetings. However, other individuals may be invited to attend for all or part of any meeting as and when appropriate. Meetings are held when the chair of the Nominations Committee deems it necessary.

The Nominations Committee is responsible for adopting a formal, rigorous, and transparent procedure for the appointment of new directors to the Board. It is responsible for considering and recommending to the Board and, through the Board, to HM Treasury where required by the Framework Document, suitable candidates as directors, who have the time to commit to the Company and who are of appropriate experience, qualifications, background and reputation, so that any such appointment will enhance the Board's ability to discharge its functions and responsibilities as set out in the Framework Document.

Executive Management Committee

The Board is also supported by the Executive Management Committee which meets weekly. The current members of the Executive Management Committee are Chief Executive John Kingman, Head of Market Investments John Crompton, and Chief Operating Officer Sam Woods.

Corporate governance

Staff Profile

UKFI is a small organisation, with the number of full-time employees including the Chief Executive at 31 March 2009 being nine, with the average, excluding non-executive directors, being eight over the period. To allow the Company to manage the Government's investments in a commercial manner, the vast majority of our Market Investments Team (responsible for RBS and Lloyds) and soon to be formed Wholly-Owned Investments Team (responsible for NR and B&B) are, or will be, filled by candidates with directly relevant expertise from the private sector, and UKFI is not part of the Civil Service.

UKFI seeks to recruit and develop a diverse and talented workforce, and UKFI recruitment procedures are based on the principles of fair and open competition and selection on merit.

The total wage bill for UKFI including wages, salaries paid or payable, social security costs, and other pension costs is £388,000 for the period 10 October 2008 to 31 March 2009.

UKFI employees have taken a total of 0 days of sickness absence.

Professionalism and skills

UKFI has a rigorous internal compliance and financial control framework in place, which has been designed to allow us to operate to the same standards as FSA regulated firms. The UKFI Compliance Manual is followed by all UKFI staff at both board and executive level, and UKFI has a full-time Compliance Officer.

UKFI and HM Treasury have each provided the Directors, including two former directors, with a Deed of Indemnity. These indemnities are qualifying third-party indemnity provisions for the purposes of the Companies Act 2006 and indemnify directors to the fullest extent permitted by law against all losses suffered or incurred in respect of acts and omissions arising as a result of holding office and which do not arise as a result of dishonesty, fraud, or recklessness. The indemnities were in force throughout the period and are still in force.

Communication with the public and Parliament

UKFI remains accountable to Parliament and this Annual Report and Accounts will be laid before Parliament. The Chairman, Chief Executive and Chief Operating Officer of the Company have, where required, attended meetings for relevant Parliamentary committees (including the House of Commons Treasury Select Committee and House of Lords Economic Affairs Committee).

UKFI has responded to all requests for information under the Freedom of Information Act 2000 within the 20 days limit.

Disclosure of information to auditors

The directors who held office at the date of approval of this directors' report confirm that, so far as they are each aware, there is no relevant audit information of which the Company's auditors are unaware; and each director has taken all the steps that he/she ought to have taken as a director to make himself/herself aware of any relevant audit information and to establish that the Company's auditors are aware of that information.

This confirmation is given and should be interpreted in accordance with the provisions of section 418 of the Companies Act 2006.

UKFI has appointed the Comptroller and Auditor General as its external auditor. The National Audit Office carries out the audit for and on behalf of the Comptroller and Auditor General.

Statement of Directors' and Accounting Officer's responsibilities in respect of the Directors' Report and the financial statements

The directors are responsible for preparing the Directors' Report and the financial statements in accordance with applicable law and regulations. Company law requires the directors to prepare financial statements for each financial year. Under that law they have elected to prepare the financial statements in accordance with UK Accounting Standards and applicable law (UK Generally Accepted Accounting Practice). The financial statements are required by law to give a true and fair view of the state of affairs of the Company and of the profit or loss of the Company for that period.

In preparing these financial statements, the directors are required to:

- select suitable accounting policies and then apply them consistently;
- make judgements and estimates that are reasonable and prudent;
- state whether applicable UK Accounting Standards have been followed, subject to any material departures disclosed and explained in the financial statements; and
- prepare the financial statements on a going concern basis unless it is inappropriate to presume that the Company will continue in business.

The directors are responsible for keeping proper accounting records that disclose with reasonable accuracy at any time the financial position of the Company and enable them to ensure that its financial statements comply with the Companies Act 2006. They have general responsibility for taking such steps as are reasonably open to them to safeguard the assets of the Company and to prevent and detect fraud and other irregularities.

The Accounting Officer of HM Treasury has designated the Chief Executive as Accounting Officer of UK Financial Investments Limited. The responsibilities of an Accounting Officer, including responsibility for the propriety and regularity of the public finances for which the Accounting Officer is answerable, for keeping proper records and for safeguarding UK Financial Investment Limited's assets, are set out in Managing Public Money published by HM Treasury.

In preparing the accounts, the Accounting Officer is required to comply with the requirements of the Government Financial Reporting Manual and in particular to:

- observe the Accounts Direction issued by HM Treasury, including the relevant accounting and disclosure requirements, and apply suitable accounting policies on a consistent basis;
- make judgements and estimates on a reasonable basis;
- state whether applicable accounting standards as set out in the Government Financial Reporting Manual have been followed, and disclose and explain any material departures in the financial statements; and
- prepare the financial statements on a going concern basis.

This report has been prepared in accordance with the special provisions of the Small Companies and Groups (Accounts and Directors' Report) Regulations 2008 as set out in Statutory Instrument 2008/409.

This report has been approved by the board of directors and is signed by the Chief Executive on behalf of the board of directors.



John Kingman
Chief Executive
30 June 2009

ANNUAL REPORT AND ACCOUNTS
2008/09

03

Directors' Remuneration Report

The Remuneration Committee

The current members of the Remuneration Committee are Michael Kirkwood (Committee chair), the Chair of the Board, Peter Gibbs and Lucinda Riches. The Remuneration Committee met once in this reporting period. Only members of the Remuneration Committee have the right to attend Remuneration Committee meetings. However, other individuals may be invited to attend for all or part of any meeting as and when appropriate.

The Remuneration Committee operates as a sub-committee of the UKFI Board. The membership of the Committee comprises the Chair of the Board and non-executive directors and shall consist of not less than three members. The Board is responsible for any new appointments to the Remuneration Committee. The Remuneration committee meets a minimum of two times per year and on an ad hoc basis as required.

The Remuneration Committee's responsibilities are to:

- approve and agree with HM Treasury the remuneration levels for UKFI Directors;
- approve UKFI's broad policy relating to remuneration for all UKFI employees;
- ensure that the individuals for whom the Remuneration Committee is responsible are provided with appropriate incentives to encourage enhanced performance and are, in a fair and responsible manner, rewarded for their contributions to the success of UKFI;
- periodically review the broad policy and make recommendations to the Board for changes, as appropriate;
- review, and by reference to the broad policy applying from time-to-time, approve the terms of any contract of employment and remuneration arrangements, including any annual or longer-term incentive packages and pension rights of:
 - the Chairman of the Board;
 - the Chief Executive; and
 - any other Executive Director.
- review the executive recommendations on, and approve the remuneration of, any employee who is a direct report to the CEO;
- monitor against the agreed Board policy:
 - the level and structure of total remuneration for senior management; and
 - the application of the policy across the whole organisation to ensure transparency, fairness and consistency;
- approve both the policy for and any compensation packages or arrangements following the severance of the employment contract applicable to the Chairman of the Board, the CEO, any Executive Director or direct report to the CEO (plus any other member of staff where the terms proposed are unusual or exceptional) with a view to ensuring that the individual is treated fairly, but that failure is not rewarded.

UKFI operates a performance appraisal system and performance is reviewed semi-annually.

Performance-related pay takes the form of bonus payments.

Remuneration policy

In approving the remuneration for Board members and other UKFI employees, the Remuneration Committee takes into account all factors which it deems necessary, including that HM Treasury's interest is primarily in ensuring that remuneration levels:

- are sufficient to attract and motivate high-calibre individuals to drive the delivery of the activities and objectives set out in the Framework Document;
- are in line with the FSA code;
- are tied closely to performance, as measured by the implementation of and compliance with the Business Plan and Investment Mandate (once finalised);
- are aligned with the objectives set out in the Framework Document; and
- deliver value for money.

UKFI has a policy to recognise those staff that have performed well in their roles through the payment of bonuses. Bonuses are paid in relation to performance linked to the annual staff appraisal. Information on total UKFI remuneration can be found in the UKFI financial statements 2008/09 in chapter 6. Any UKFI bonuses are paid as a fraction rather than multiple of salary. Bonus payments are expected to make up between 0-20 percent of total staff costs. As no member of staff has been with the Company longer than five months, no bonuses have yet been paid.

Service contracts

UKFI policy on duration of contracts is that directors' contracts continue for a period of 36 months, unless terminated earlier by HM Treasury, in accordance with the Company's Articles of Association, or by either party giving written notice to the other. Upon termination of the appointment, subject to any fees outstanding, directors have no entitlement to compensation in respect to any loss.

Directors' remuneration

This information is subject to audit.

The table overleaf reports the remuneration of each director for the period ending 31 March 2009 and has been audited by the Company's Auditors. Salary includes gross salary, performance pay, expenses, and bonuses paid during the period.

Director	Salary and full year equivalent (FYE) (£000)	Estimated value of non-cash benefits
Glen Moreno*	0	0
John Kingman**	58 (143 FYE)	0
Peter Gibbs	6 (37.5 FYE)	0
Michael Kirkwood	6 (40 FYE)	0
Lucinda Riches	6 (37.5 FYE)	0
Philip Remnant	0 (32.5 FYE)	0
Louise Tulett	0	0
Philip Hampton	0	0
Tom Scholar	0	0
Total	0	0

*Glen Moreno has waived his entitlement to compensation.

**John Kingman is paid a salary through his employment contract with HM Treasury. The amount above reflects the salary recharged to UKFI in relation to his secondment for the period 3 November 2008 to 31 March 2009.

Directors' pension arrangements

None of the directors of UKFI receive a pension from the Company. John Kingman is a member of the Principal Civil Service Pension Scheme through his employment contract with HM Treasury. He is currently on secondment to UKFI, and has been since 3 November 2008. This information is provided for the purposes of clarity:

John Kingman; 3 November 2008 to 31 March 2009	£
Real increase in the accrued pension benefits and related lump sum at age 60 during the period	0-2,500
Value of the accrued pension benefits at the end of the reporting period and the related lump sum at age 60	20,000-25,000 plus lump sum of 70,000-75,000
Value of the cash equivalent transfer value at the beginning of the period	290,000
Value of the cash equivalent transfer value at the end of the period	310,000
Real increase in the cash equivalent transfer value during the period	6,000

Performance related pay

Performance pay is awarded in arrears. Therefore, the bonuses payable for performances during the 2008/09 financial year are not yet known and any directors' bonuses will be disclosed in next year's accounts. None of the non-executive directors of UKFI are eligible for UKFI performance related pay. Bonus figures for other UKFI staff are expected to be between 0-20 percent of total staff costs.

This report has been approved by the board of directors and is signed by the Chairman of the Remuneration Committee on behalf of the board of directors.



Michael Kirkwood

Chair of Remuneration Committee
30 June 2009

ANNUAL REPORT AND ACCOUNTS
2008/09

04

Statement on Internal Control

Scope of responsibility

The Board has responsibility for maintaining a sound system of internal control that supports the achievement of UKFI's policies, aims and objectives, whilst safeguarding the public funds and assets for which they are collectively responsible.

Context

This financial period has comprised the first five months of UKFI's existence, and from a control perspective much of our effort has therefore been focused on creating and putting in place appropriate systems and policies. In this work we have prioritised the formalisation of robust governance, compliance and risk procedures. A rigorous control framework has been developed with respect to these areas, and appropriate account of best practice has been taken. For instance, although UKFI's activities do not require FSA authorisation, the Board has decided that UKFI should adopt policies and procedures that would meet the standard expected of a wholesale market firm operating in the financial services market. For managing our resources, we are following the principles of Managing Public Money.

The purpose of the system of internal control

The system of internal control is designed to manage risk to a reasonable level rather than to eliminate all risk of failure to achieve policies, aims and objectives; it can therefore only provide reasonable and not absolute assurance of effectiveness. The system of internal control is based on an ongoing process designed to identify and prioritise the risks to the achievement of policies, aims and objectives, to evaluate the likelihood of those risks being realised and the impact should they be realised, and to manage them efficiently, effectively and economically. The system of internal control has been evolving in UKFI for the period ended 31 March 2009 and up to the date of approval of the annual report and accounts, and accords with central Treasury guidance.

The risk and control framework and the capacity to handle risk

As set out in Chapter 2 of this report, the UKFI Board is supported in its responsibility of managing risk by three sub-committees: the Audit and Risk Committee, the Remuneration Committee and the Nominations Committee. The Board is also supported by the Executive Management Committee.

The Audit and Risk Committee has responsibility for oversight of UKFI's governance, internal control, risk management processes and behaviours, agreeing internal and external audit work programmes and overseeing reports.

The Remuneration Committee has responsibility for approving and agreeing the remuneration levels for UKFI directors and approving UKFI's broad policy relating to remuneration for all UKFI employees.

The Nominations Committee has responsibility for adopting a formal, rigorous and transparent procedure for the appointment of new directors to the Board.

The Executive Management Committee provides operational leadership for the risk management process and is accountable to the Board. Every risk identified in UKFI's risk register has an owner from the Executive Committee who is responsible for ensuring that risks are dealt with appropriately.

All UKFI staff are required to undertake mandatory training which ensures awareness of the major risks associated with UKFI's environment. All existing staff had completed this by 2 June 2009.

Risks are managed and reviewed at three distinct levels: The Board; The Executive Committee; and individual business areas. Escalation procedures exist to ensure risks are addressed at the appropriate level. The risk management process is based on an Identify, Assess, Address, Review/Report cycle. During the "Assess" phase the risk event is evaluated in terms of the likelihood of it happening and the impact it would

have should it occur. From this assessment a numeric score is derived. The assessments are moderated by the Executive Committee with the output providing a baseline against which relative movement can be assessed. Every risk also has a risk actionee who is the nominated individual responsible for implementing the agreed control actions. On a monthly basis the Executive Committee reviews all risks on the register to ensure adequate coverage and appropriate prioritisation. The Board performs its review on a quarterly basis.

Risks to data and information held by UKFI are owned and managed by individuals and collectively by the Company as a whole. UKFI has appointed a Senior Risk Officer who is a member of the Executive Management Committee.

UKFI's relationship with HM Treasury is set out in the Framework Document published on 2 March 2009, and is available at www.ukfi.gov.uk

Review of effectiveness

As Accounting Officer, under terms of my appointment, I have responsibility for reviewing the effectiveness of the system of internal control. My review of the effectiveness of the system of internal control is informed by the work of the internal auditors and the executive managers within the Company who have responsibility for the development and maintenance of the internal control framework, and comments made by the external auditors in their management letter and other reports. I have been advised on the implications of the result of my review of the effectiveness of the system of internal control by the Board, the Audit Committee and a plan to address weaknesses and ensure continuous improvement of the system is in place.

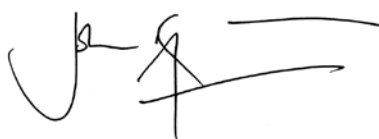
Ongoing review of the effectiveness of the control and risk management system of UKFI is provided by:

- The UKFI Board, which met 12 times during the period;
- The Audit and Risk Committee, which met once during the period;
- Internal Audit, who have thus far performed reviews of UKFI's governance arrangements and risk management arrangements;
- External Audit, who have considered UKFI's control framework during the course of the audit of this document;
- The Senior Risk Officer, who is responsible for maintaining UKFI's risk register; and
- The Senior Information Risk Officer who is the Chief Executive.

Significant control issues

UKFI's Framework Document was published in March but its Investment Mandate has not yet been finalised. In the absence of an agreed Investment Mandate there is a risk of uncertainty over the limits of UKFI's remit and the actions it should take.

We note that this has not presented a major obstacle to date as specific delegations have been provided for specific decisions. However, UKFI's management appreciate the need for the Investment Mandate to be finalised and put in place as soon as possible, and are currently in discussion with HM Treasury to address this.



John Kingman
Chief Executive
30 June 2009

ANNUAL REPORT AND ACCOUNTS
2008/09

05

Independent auditor's report to
the shareholders of UK Financial
Investments Limited

I have audited the financial statements of UK Financial Investments Limited for the period ended 31 March 2009 which comprise the Profit and Loss Account, the Balance Sheet, the Cash Flow Statement and the related notes. These financial statements have been prepared under the accounting policies set out therein. I have also audited the information in the Directors' Remuneration Report that is described as having been audited.

Respective responsibilities of directors and auditors

The directors' responsibilities for preparing the Annual Report, the Directors' Remuneration Report, and the financial statements in accordance with applicable law and United Kingdom Accounting Standards (United Kingdom Generally Accepted Accounting Practice), for being satisfied that the financial statements give a true and fair view and for ensuring the regularity of financial transactions are set out in the Statement of Directors' and Accounting Officer's Responsibilities.

My responsibility is to audit the financial statements and the part of the Directors' Remuneration Report to be audited in accordance with relevant legal and regulatory requirements and International Standards on Auditing (UK and Ireland).

I report to you my opinion as to whether the financial statements have been properly prepared in accordance with the United Kingdom Generally Accepted Accounting Practice, have been prepared in accordance with the Companies Act 2006, and give a true and fair view. I also report to you whether in my opinion the part of the Directors' Remuneration Report to be audited has been properly prepared in accordance with the Government Financial Reporting Manual and the information given in the Directors' Report is consistent with the financial statements.

In addition, I report to you whether in all material respects the expenditure and income in the financial statements have been applied to the purposes intended by Parliament and the financial transactions conform to the authorities which govern them.

I also report to you if, in my opinion, the Company has not kept adequate accounting records, if I have not received all the information and explanations I require for my audit, or if certain disclosures of directors' remuneration specified by law are not made.

I read other information contained in the Annual Report, and consider whether it is consistent with the audited financial statements. This other information comprises only the Chairman's foreword, UKFI Strategy: Market Investments, the Chief Executive's Statement, the unaudited part of the Directors' Report and the Statement on Internal Control. I consider the implications for my report if I become aware of any apparent misstatements or material inconsistencies with the financial statements. My responsibilities do not extend to any other information.

Basis of audit opinion

I conducted my audit in accordance with International Standards on Auditing (UK and Ireland) issued by the Auditing Practices Board. An audit includes examination, on a test basis, of evidence relevant to the amounts, disclosures and regularity of financial transactions in the financial statements. It also includes an assessment of the significant estimates and judgements made by the directors in the preparation of the financial statements, and of whether the accounting policies are appropriate to the Company's circumstances, consistently applied and adequately disclosed.

I planned and performed my audit so as to obtain all the information and explanations which I considered necessary in order to provide us with sufficient evidence to give reasonable assurance that the financial statements and the audited part of the Directors' Remuneration Report are free from material misstatement, whether caused by fraud or other irregularity or error and that in all material respects the expenditure and income have been applied to the purposes intended by Parliament and the financial transactions conform to the authorities which govern them. In forming my opinion I also evaluated the overall adequacy of the presentation of information in the financial statements.

Opinion

In my opinion:

- the financial statements have been properly prepared in accordance with United Kingdom Generally Accepted Accounting Practice;
- the financial statements have been prepared in accordance with the Companies Act 2006;
- the financial statements give a true and fair view of the state of the Company's affairs as at 31 March 2009 and of its profit for the period then ended;
- the audited part of the Directors' Remuneration Report has been properly prepared in accordance with the Government Financial Reporting Manual; and
- the information given in the Directors' Report is consistent with the financial statements.

Opinion on Regularity

In my opinion, in all material respects the expenditure and income have been applied to the purposes intended by Parliament and the financial transactions conform to the authorities which govern them.

Amanda Measures (Senior Statutory Auditor)

Date: 10 July 2009

for and on behalf of the
Comptroller and Auditor General (Statutory Auditor)

151 Buckingham Palace Road
Victoria
London
SW1W 9SS

ANNUAL REPORT AND ACCOUNTS
2008/09

06

UKFI Financial Statements

Profit and Loss Account for the period from 10 October 2008 to 31 March 2009

	Note	£000
Turnover	1(b)	1,242
Administrative expenses		<u>1,242</u>
Profit on ordinary activities before taxation	2-5	0
Taxation	1(g)	<u>0</u>
Profit for the financial period		<u>0</u>

The Company has no recognised gains or losses in the year other than those included in the profit and loss account and therefore no separate statement of total recognised gains or losses has been prepared.

All activities are classified as continuing.

The notes set out on pages 67 to 72 form part of these financial statements.

Balance sheet as at 31 March 2009

	Note	£000
Current Assets		
Debtors	6	677
Cash at bank and in hand	7	239
		<u>916</u>
Current Liabilities		
Creditors: amounts falling due within one year	8	916
		<u>0</u>
Net current assets		<u>0</u>
Total assets less current liabilities		<u>0</u>
Net assets		<u>0</u>
Capital and reserves		
Called-up share capital	9	0
		<u>0</u>
Equity shareholder's funds		<u>0</u>

These financial statements were approved by the Board of Directors on 30 June 2009 and were signed on its behalf by:



John Kingman
Chief Executive
30 June 2009

The notes set out on pages 67 to 72 form part of these financial statements.

Statement of cash flows for the period from 10 October 2008 to 31 March 2009

	£000
Reconciliation of operating profit to net cash flow from operating activities	
Operating profit	0
(Increase) in debtors	(677)
Increase in creditors	916
Net cash inflow from operating activities	<u>239</u>
Cash flow statement	
Cash flow from operating activities	239
Increase in cash in the period	<u>239</u>

The notes set out on pages 67 to 72 form part of these financial statements.

Notes to the financial statements

I. Significant accounting policies

UK Financial Investments Limited (“UKFI” or the “Company”) is a Company domiciled in the United Kingdom. The Company operates as an investment management business under the terms of the Companies Act 2006.

The financial statements were authorised for issue by the Directors on 30 June 2009.

The Companies Act 2006 requires accounts to be produced on an accruals basis and these accounts have been prepared on the basis of generally accepted accounting practice in the United Kingdom, i.e. the requirements of the Companies Act and the accounting standards issued or adopted by the Accounting Standards Board, including, where appropriate, Statements of Recommended Practice (SORPs).

These financial statements are prepared in accordance with the Government Financial Reporting Manual (FRoM) where this exceeds and does not conflict with the requirements of the Companies Act 2006.

International Financial Reporting Standards

The Government has indicated its intention that, from 2009-10, financial statements should be prepared using International Financial Reporting Standards (IFRS), adapted as relevant for the public sector. It is our view that the substitution of current IFRS for UK GAAP as the basis of the accounting policies applied in the Accounts of UKFI would not materially change the overall view of the Company's operations.

a) Basis of preparation

These accounts are prepared on a going concern basis.

The presentation currency for these financial statements is pounds Sterling, which is also the functional currency. Amounts are rounded to the nearest thousand.

The Directors have reviewed the accounting policies and believe that the accounting policies adopted are the most appropriate for the circumstances of the Company.

(b) Turnover

Turnover, which excludes value added tax, comprises of fees arising from investment management and other related services. Management fees are recognised in the income statement as they are earned.

(c) Foreign currency

Transactions which are denominated in foreign currencies are translated into Sterling at the foreign exchange rate ruling at the date of the transaction. Monetary assets and liabilities denominated in foreign currencies at the balance sheet date are translated to Sterling at the foreign exchange rate ruling at that date. Foreign exchange differences arising on translation are recognised in the income statement.

(d) Debtors

Debtors are stated at cost.

(e) Cash and cash equivalents

Cash and cash equivalents comprise solely of cash balances.

(f) Creditors

Creditors are stated at cost.

(g) Corporation tax

The Company is registered for the purposes of corporation tax. As the profit chargeable to corporation tax (PCTC) for the period is nil, the amount of corporation tax payable in respect of this period is nil.

(h) VAT

The Company is treated as carrying on a business for VAT purposes; services provided are standard-rated for VAT purposes.

(i) Financial Assets and Financial Liabilities

Recognition

Financial assets and financial liabilities which arise from contracts for the purchase of non-financial items (such as goods and services) which are entered into in accordance with UKFI's normal purchase or usage requirements, are recognised when, and to the extent which, performance occurs, i.e. when receipt or delivery of the goods or service is made.

De-recognition

All financial assets are de-recognised when the rights to receive cash flows from the assets have expired or UKFI has transferred substantially all of the risks and rewards of ownership.

Financial liabilities are de-recognised when the obligation is discharged, cancelled or expires.

Classification and Measurement

Financial assets are categorised as "Loans and receivables".

Financial liabilities are categorised as "Other financial liabilities".

Loans and receivables

Loans and receivables are non-derivative financial assets with fixed or determinable payments which are not quoted in an active market. They are included in current assets. UKFI's loans and receivables comprise: cash at bank and in hand, accrued income owed by group undertakings, prepayments and "other debtors".

Loans and receivables are recognised at cost; in accordance with FRS 29, the carrying values of short-term financial assets and liabilities (at amortised cost) are not considered different to fair value.

Other financial liabilities

All financial liabilities are recognised at cost; in accordance with FRS 29, the carrying values of short-term financial assets and liabilities (at amortised cost) are not considered different to fair value.

2. Turnover

	10 Oct 08 to 31 Mar 09
	£000
Investment management fees	1,242
	1,242
	1,242

3. Remuneration of directors

	10 Oct 08 to 31 Mar 09 £000
Directors' emoluments	76
	<u>76</u>

4. Personnel expenses

The average number of persons employed by the Company (including directors) during the period was nine.

The aggregate payroll costs of these persons were as follows:

	10 Oct 08 to 31 Mar 09 £000
Wages and salaries ¹⁹	369
Social Security Costs	13
Pension Costs	6
	<u>388</u>

The Company is due to commence operation of a defined contribution scheme; contributions are to be back-dated to the beginning of this financial period.

The pension cost charge for the period represents an estimate of contributions payable by the Company to this scheme and amounts to £6,000; this amount is included in creditors.

5. Profit before tax

	10 Oct 08 to 31 Mar 09 £000
Profit before tax is stated after charging:	
Auditors' remuneration: Audit of these financial statements	<u>18</u>

6. Debtors

	2009 £000
Amounts owed by group undertakings (note 13)	674
Other debtors	1
Prepayments	2
	<u>677</u>

7. Cash and cash equivalents

The period-end cash balance of £239,000 is held at the Office of the Paymaster General.

¹⁹Wages and salaries figure includes recharge costs for HM Treasury secondees, which are charged inclusive of social security and pension costs.

8. Creditors

	2009 £000
Trade Creditors	337
Amounts owed to group undertakings (note 13)	476
Taxation and social security	16
Accruals	87
	916

9. Called up share capital

	2009
Authorised	
Equity: Ordinary shares of £1 each	100
Allotted, called up and fully paid	
Equity: Ordinary shares of £1 each	1

During the period the Company issued 1 £1 ordinary share for a consideration of £1, settled in cash.

10. Dividends

No dividend was declared or paid during the period

11. Financial Instruments

FRS 25, 26 and 29, Financial Instruments, require disclosure of the role that financial instruments have had during the period in creating or changing the risks an entity faces in undertaking its activities.

UKFI is not exposed to significant financial risk factors arising from financial instruments. Financial assets and liabilities are generated by day-to-day operational activities rather than being held to change the risks facing UKFI in undertaking its activities.

Market Risk

Market risk is the possibility that financial loss might arise as a result of changes in such measures as interest rates and stock market movements. The vast majority of UKFI's transactions are undertaken in Sterling and so its exposure to foreign exchange risk is minimal. UKFI's income and operating cash flows are substantially independent of changes in market interest rates.

Credit Risk

Credit risk is the possibility that other parties might fail to pay amounts due to UKFI. Credit risk arises from deposits with banks as well as credit exposures to HM Treasury and other debtors. The credit risk exposure to HM Treasury is considered to be negligible: the Company's operating costs are recovered from HM Treasury, which is financed by resources voted by Parliament. Surplus operating cash is only held with the Office of the Paymaster General.

Liquidity Risk

Liquidity risk is the possibility that UKFI might not have funds available to meet its commitments to make payments. Prudent liquidity risk management includes maintaining sufficient cash to settle obligations.

11.1 Liquidity Risk

	2009 £000
At 31 March 2009	
Denominated in Sterling	916
Gross financial assets	916

11.2 Financial Liabilities

	2009 £000
At 31 March 2009	
Denominated in Sterling	916
Gross financial liabilities	916

11.3 Financial assets and liabilities by category

Financial assets	2009 £000	2009 £000
	Total	Loans & receivables
Amounts owed by group undertakings (note 13)	674	674
Other debtors	1	1
Denominated in Sterling	2	2
Cash at bank and in hand	239	239
Total at 31 March 2009	916	916

Financial liabilities	2009 £000	2009 £000
	Total	Other financial liabilities
Trade Creditors	337	337
Amounts owed to group undertakings (note 13)	476	476
Taxation and social security	16	16
Accruals	87	87
Total at 31 March 2009	916	916

11.4 Maturity of Financial Liabilities

	2009 £000
Less than one year	916
	<u>916</u>

In accordance with FRS 29, the carrying values of short-term financial assets and liabilities (at amortised cost) are not considered different to fair value.

12. Parent undertakings

As at 31 March 2009, the Company is a wholly owned subsidiary undertaking of HM Treasury, which is registered in England and Wales and operates in the United Kingdom.

13. Related parties

At the end of the period, the Company had the following balances with related parties:

	2009 £000
Debtors	
Group undertakings – HM Treasury	674
	<u>674</u>
Creditors	
Group undertakings – HM Treasury	476
	<u>476</u>

HM Treasury provided central services and staff secondments to the Company during the period.

During the period the Company received income from the following related parties for the provision of investment management services:

	2009 £000
Group undertakings – HM Treasury	1,242
	<u>1,242</u>

ANNEX I: UKFI FRAMEWORK DOCUMENT

UK Financial Investments Limited: Shareholder Relationship Framework Document

1. INTRODUCTION

This framework document ("Framework Document") has been drawn up by UK Financial Investments Limited (the "Company") and its shareholder, HM Treasury. It sets out the objectives for the Company and the framework within which the Company will pursue them.

2. ACTIVITIES OF THE COMPANY

- 2.1 The Company will manage HM Treasury's shareholdings in The Royal Bank of Scotland Group plc ("RBS") and Lloyds Banking Group plc ("Lloyds"). HM Treasury's shareholdings in RBS and Lloyds are held by the Treasury Solicitor as nominee for HM Treasury.
- 2.2 The Company will also manage HM Treasury's shareholdings in Northern Rock plc ("NR") and Bradford & Bingley plc ("B&B") once European Commission approval has been obtained for the relevant business plans (the "NR and B&B Plans"). The shareholdings of HM Treasury in NR and B&B are held by the Treasury Solicitor as nominee for HM Treasury. It is envisaged the Company will also manage the loan and guarantor arrangements with NR and B&B.
- 2.3 It is noted that some provisions of this Framework Document may need to be supplemented or amended to address the particular issues and objectives relating to NR and B&B, including those arising out of the NR and B&B Plans.
- 2.4 If HM Treasury (whether directly, through the Treasury Solicitor as nominee for HM Treasury or otherwise) acquires further holdings of securities (or acquires assets) of the above financial institutions, or other financial institutions, the Company will, following their acquisition by HM Treasury and if so requested by HM Treasury, manage those holdings or assets.
- 2.5 In this Framework Document:
- (A) the shares and other securities managed by the Company are referred to as the "Investments";
 - (B) the financial institutions in which such Investments are held are referred to as the "Investee Companies";
 - (C) the Investments in financial institutions the shares of which remain admitted to the Official List and admitted to trading on a recognised investment exchange are referred to as the "Listed Investee Companies"; and
 - (D) the Investments which constitute wholly-owned subsidiaries of HM Treasury are referred to as the "Wholly-Owned Investee Companies".
- 2.6 The Company will not, without the consent of HM Treasury, undertake any activity other than the activities envisaged by this Framework Document and activities incidental to them. As such, HM Treasury (and, where relevant, the other Tripartite Authorities) shall remain responsible for all other issues which are not, by virtue of this Framework Document, the responsibility of the Company, whether in relation to the Investee Companies, the Investments, the operation of the recapitalisation fund or otherwise.
- 2.7 The activities, roles and responsibilities of the Company as described in this Section 2 and the remainder of this Framework Document shall be conducted with propriety and otherwise in compliance with the publication entitled "Managing Public Money" issued by HM Treasury in October 2007 (as amended, updated or replaced from time to time).

3. OVERARCHING OBJECTIVE

The Company should, in compliance with the Investment Mandate described in Section 4, develop and execute an investment strategy for disposing of the Investments in an orderly and active way through sale, redemption, buy-back or other means within the context of an overarching objective of protecting and creating value for the taxpayer as shareholder; paying due regard to the maintenance of financial stability and to acting in a way that promotes competition. This objective includes:

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

The overarching objective described in the foregoing paragraphs of this Section 3 is referred to in the remainder of this Framework Document as the "Overarching Objective".

4. THE INVESTMENT MANDATE

- 4.1 HM Treasury will prepare an investment mandate which the Company is to comply with in respect of the management of the Investments and otherwise pursuing the objectives set out in this Framework Document. This document, as established and approved by HM Treasury, and as amended, updated or replaced from time to time, is referred to in this Framework Document as the "Investment Mandate".
- 4.2 The board of directors of the Company (the "Board") will review and comment on, and consult with HM Treasury as regards, the proposed Investment Mandate.
- 4.3 Prior to establishment of the initial Investment Mandate, the implementation of any decisions in respect of the Investments (including value realisation decisions) shall be subject to the prior consent of HM Treasury. After establishment of the initial investment mandate the implementation of value-realisation decisions (together with the other actions and decisions described in paragraph 9.25) shall be subject to the prior consent of HM Treasury.
- 4.4 The Company will comply with the Investment Mandate and take account of:
 - (A) the Overarching Objective;
 - (B) the need to ensure that, in order to meet the Overarching Objective, decisions in respect of the Investments will be taken in respect of each Investee Company individually rather than in respect of the portfolio of Investments which the Company is managing from time to time;
 - (C) the terms of the agreements and commitments entered into by HM Treasury with the Investee Companies and others relating to the Investments, as notified by HM Treasury to the Company;
 - (D) the conditions attaching to any decisions of the European Commission or national regulatory authorities in relation to state aid or merger control and any commitments given by HM Treasury in that context, as notified by HM Treasury to the Company; and
 - (E) the requirements relating to the boards and management of the Investee Companies, preservation of Investee Company independence and monitoring Investee Company compliance, as set out in Sections 6, 7 and 8.
- 4.5 HM Treasury will authorise the Treasury Solicitor to take instructions from the Company in relation to proxy forms, authorisations and other documents which need to be signed in order to give effect to the decisions made by the Company in compliance with this Framework Document and the Investment Mandate in relation to the Investments, including decisions as to voting.
- 4.6 The Company will be free to manage the investments and effect its investment strategy in its discretion in accordance with the Investment Mandate determined by the Treasury.
- 4.7 Neither HM Treasury nor the Company envisage that the Investment Mandate will, given its commercial sensitivity, be published.
- 4.8 HM Treasury will ensure that the Investment Mandate is consistent with this Framework Document, including Section 3 (Overarching Objective) and paragraph 7.1.

5. BUSINESS PLAN

- 5.1 The Board will, by no later than the end of February 2009, develop and recommend to HM Treasury a budget and funding plan for the Company which is appropriate to ensure the fulfilment by the Company of its role in relation to the Investments, and compliance with the associated obligations, as described in this Framework Document (this document will be subject to the approval of HM Treasury (the document, as so approved, being the "Business Plan")).
- 5.2 For the avoidance of doubt, the Business Plan and investment strategy referred to in section 3, shall pertain to the activities of the Company, and not to the business plans or budgets of the Investee Companies. The Business Plan will be prepared on the basis of:
- (A) an initial upfront payment being made to cover set-up costs and other incidental costs and expenses expected to be incurred in order to establish the Company in the manner contemplated by this Framework Document; and
 - (B) a periodical management fee to be paid to the Company as consideration for the performance of its ongoing obligations under this Framework Document in respect of the Investments, with such periodical management fee being representative of the anticipated costs and expenses to be incurred by the Company in effecting its investment strategy and otherwise fulfilling its responsibilities under this Framework Document.
- 5.3 The Business Plan will not allow the Company to incur any borrowings or enter into any similar financial transactions.

6. BOARD AND MANAGEMENT OF THE INVESTEE COMPANIES

- 6.1 Consistent with the agreements reached with RBS and Lloyds, the Company will work with the board of directors of each of these financial institutions to strengthen their membership through the appointment of suitably qualified, independent non-executives.
- 6.2 In relation to the Wholly-Owned Investee Companies, the Company will, on behalf of HM Treasury, exercise the rights in relation to the boards of those financial institutions conferred on HM Treasury by its Investments in those Wholly-Owned Investee Companies, including by virtue of the framework documents which apply to them, subject to the provisions of this Framework Document.
- 6.3 The Company will also engage with each Investee Company with respect to board composition more generally, consistent with the principles outlined in Section 7.

7. PRESERVATION OF INVESTEE COMPANY INDEPENDENCE

- 7.1 The Company will manage the Investments on a commercial basis and will not intervene in day-to-day management decisions of the Investee Companies (including with respect to individual lending or remuneration decisions). The Investee Companies will continue to be separate economic units with independent powers of decision and, in particular, will continue to have their own independent boards and management teams, determining their own strategies and commercial policies (including business plans and budgets).
- 7.2 The nature of the Company's engagement with the Investee Companies will be proportionate to HM Treasury's ownership interest:
- (A) Wholly-Owned Investee Companies: For these financial institutions, the board of the Investee Company will report to the Company, which will actively engage with the Wholly-Owned Investee Company in a manner similar to that in which a financial sponsor would engage with a wholly-owned portfolio company. The Company will, in addition to the rights attaching to the Investments in these companies, exercise all rights and discretions conferred on HM Treasury under the framework documents which apply to these companies, subject to the provisions of this Framework Document.
 - (B) Listed Investee Companies: For these financial institutions, the Company will engage actively with the Investee Company in accordance with best institutional shareholder practice. The Company will (subject

to the other provisions of this Framework Document) exercise the rights attaching to HM Treasury's Investments in these companies, including voting rights.

- 7.3 HM Treasury is determined to ensure that the Investments do not lead to a distortion or significant lessening of competition and that the Company adopts appropriate procedures for managing conflicts and inside information. The Company will:
- (A) ensure that there are no cross-directorships between the Investee Companies in relation to the appointments in which it has a specified role or between the Company and Listed Investee Companies;
 - (B) put in place robust barriers which are monitored and adhered to by Company personnel and enforced by the Board at all levels to ensure that commercial information relating to one Investee Company does not leak to, and is not exchanged with, another Investee Company;
 - (C) exercise its rights in relation to each Investee Company individually and will not co-ordinate its actions in relation to Investee Companies in a way that might distort competition between them; and
 - (D) develop, establish and apply policies and procedures to ensure that the Company (and its directors, officers and employees) abide by the Code of Market Conduct, and other rules and guidance laid down by the Financial Services Authority and recognised investment exchanges to which securities of the Investee Companies are admitted to trading (such policies and procedures to cover, in particular, insider dealing and market abuse) (the "Compliance Policies"). In this context, it is envisaged that the Company will normally act as other institutional shareholders would act, using published information in a structured dialogue with key members of the Investee Company's board. In considering whether it is necessary or appropriate for the Company (or any of its directors, offices or employees) to become an "insider" in relation to a Listed Investee Company (for example where it is necessary for the Company to receive price-sensitive information to enable it to perform its responsibilities under this Framework Document), the Company will pay due regard to the objective of implementing the Investment Mandate and manage the situation in accordance with the relevant elements of its Compliance Policies.

8. MONITORING INVESTEE COMPANY COMPLIANCE

- 8.1 The Company will (on behalf of HM Treasury) monitor and work to secure compliance with the following:
- (A) (i) the non-lending conditions attached to the accessing by RBS and Lloyds (including HBOS plc) of the Government's bank recapitalisation fund and any other financial institutions accessing the fund and (ii) the conditions attaching to any decisions of the European Commission or national regulatory authorities in relation to state aid or merger control and any commitments given by HM Treasury in that context, as notified by HM Treasury to the Company (together, the "Recapitalisation Conditions");
 - (B) the restructuring plans to be submitted to the European Commission in relation to RBS and Lloyds (including HBOS plc); and
 - (C) the NR and B&B Plans.

UKFI will develop a robust assurance regime for monitoring and securing compliance to these conditions, and will regularly discuss its approach with HM Treasury and report on compliance to HM Treasury. This work will include assisting HM Treasury to make appropriate submissions to the European Commission to determine the duration of Recapitalisation Conditions. The determination and establishment of conditions attaching to the access by any Investee Company of any financial support from the Government shall remain the responsibility of Government.

9. SHAREHOLDER RELATIONSHIP

General

- 9.1 Interactions between the Company and HM Treasury need to be underpinned by resolve on both sides to conduct affairs on the basis of a professional, efficient, trust-based dialogue:
- (A) professional: professional people engaged in dialogue relevant to delivering the Company's objectives, with commitments delivered on time and to specification;

- (B) efficient: both parties ensuring a joined-up and efficient approach amongst their constituent elements; and
 - (C) trust-based: open dialogue, based on a shared commitment to providing the Company with the ability to pursue its objectives effectively.
- 9.2 The success of the relationship depends on the nature and quality of the relationship between the Board and HM Treasury. The overall responsibility for ensuring that the intentions of this Framework Document are carried out in practice lies ultimately with the Chairman of the Board and the Chancellor of the Exchequer. The Chairman of the Board will maintain regular contact with the Chancellor of the Exchequer or an official nominated by the Chancellor. Below them, senior individuals within the Company and HM Treasury will be nominated who will have the responsibility to ensure that all contacts between the Company and HM Treasury are conducted at the right level, with the right people and in the right spirit.
- 9.3 The basic relationship between the Company and HM Treasury operates according to principles under which HM Treasury:
- (A) may appoint the Chairman of the Board and three senior Government officials as Directors;
 - (B) has authorisation over the appointment of other members of the Board proposed to be appointed by the Board's Nominations Committee and has authorisation over the terms on which each Director is appointed, remunerated and incentivised;
 - (C) through the establishment of this Framework Document and the Investment Mandate, determines the high level objectives that the Company is designed to achieve;
 - (D) must approve the Business Plan and any subsequent updates or amendments to it;
 - (E) requires that the Board is accountable to it for adhering to the Business Plan, complying with the Investment Mandate and delivering the objectives set out in this Framework Document;
 - (F) gives the Board the normal commercial freedom to take the action necessary to adhere to the Business Plan, comply with the Investment Mandate and deliver the objectives set out in this Framework Document;
 - (G) is able to monitor the Company's performance to satisfy itself that the Business Plan is being adhered to, the Investment Mandate is being complied with and the objectives set out in this Framework Document are being delivered and carried out; and
 - (H) must give its consent prior to certain significant actions being taken (as described in paragraph 9.26.)
- The following paragraphs of this Section 9 describe how these principles are to be put into practice.

Principles in practice

Board structure and governance

- 9.4 The Company will operate a corporate governance structure that provides a framework for the relationship between the Board and HM Treasury which, so far as practicable and in the light of the other provisions of this Framework Document (and, in the case of the Wholly-Owned Investee Companies, the existing framework documents applying to each of them) or as otherwise may be agreed with HM Treasury, takes appropriate account of best practice for a public sector company.
- 9.5 The Board will constitute the following committees of the Board:
- (A) Audit and Risk Committee;
 - (B) Remuneration Committee; and
 - (C) Nominations Committee.
- 9.6 The Board will notify HM Treasury of the delegated authorities it has granted to the Directors and senior management.

Board appointments; Senior management

- 9.7 The composition of the Board is a critical factor for HM Treasury. The aim is to secure an environment in which HM Treasury and the Chairman share a common view about Board composition (including balance of experience and background) and succession. To achieve this, the following will apply:
- (A) the Board will consist of seven Directors, comprising a private sector Chairman, three further non-executive private sector members and a Chief Executive, together with two senior Government officials nominated by HM Treasury (the "Treasury Directors");
 - (B) the Chief Executive will be the Accounting Officer for the Company;
 - (C) the Chairman will discuss and confirm with HM Treasury Board composition and succession initially, and regularly thereafter, in the light of performance and the requirements of the Investment Mandate, the Business Plan and this Framework Document;
 - (D) the Chairman will discuss with the Nominated Official any impending changes to Board membership;
 - (E) HM Treasury will meet the Chair of the Nominations Committee as necessary to discuss any proposed Board changes; and
 - (F) the Board will ensure that suitably rigorous appraisals are made of the effectiveness of the Chairman and Board.

- 9.8 The Board shall:
- (A) appoint to senior investment roles individuals with relevant financial experience, skills and appropriate qualifications, who shall (in addition to any other responsibilities determined by the Company) attend Board discussions relating to the Investments;
 - (B) appoint a professionally qualified financial controller to manage the Company's accounts and Business Plan, who shall (in addition to any other responsibilities determined by the Company) attend Board discussions relating to the Business Plan and the Company's financial statements and accounts; and
 - (C) appoint a suitably qualified individual to develop, establish and monitor compliance with the Compliance Policies, who shall (in addition to any other responsibilities determined by the Company) attend Board discussions relating to the Compliance Policies.

The Investment Mandate

- 9.9 Representatives of HM Treasury and the Board or other Company representatives will meet from time to time, as agreed, to review the strategic options available in formulating and implementing the Investment Mandate, and in delivering the objectives set out in this Framework Document.
- 9.10 A process of effective dialogue will be established between representatives of HM Treasury and the Board and other Company representatives to ensure that the Company fully understands the objectives set out in the Investment Mandate and its associated responsibilities pursuant to it.

The Business Plan

- 9.11 The Business Plan will be subject to review by, and the approval of, HM Treasury.
- 9.12 The Business Plan will cover a period of at least 12 months and will be reviewed by the Board on an annual basis.
- 9.13 The Company will inform HM Treasury of potential changes to the Business Plan that it considers are or may become necessary from time to time. Any proposed updates or amendments to the Budget, whether arising out of the annual review process or otherwise, will be subject to discussion with and approval by HM Treasury.

Remuneration and incentivisation

- 9.14 HM Treasury expects remuneration arrangements, including any incentivisation packages, to be developed and recommended by the Board's Remuneration Committee for Directors and senior management, and to be in line with the FSA's code. In the case of remuneration arrangements for Directors, the specific proposals for each individual will require approval by HM Treasury.

- 9.15 Prior to the appointment of the Company's non-executive directors and the establishment of the Board's Remuneration Committee, the role referred to in paragraph 9.15 will be fulfilled by the Chairman.
- 9.16 HMTreasury's interest is primarily in ensuring that remuneration levels:
- (A) are sufficient to attract and motivate high-calibre individuals to drive the delivery of the activities and objectives described or set out in this Framework Document.
 - (B) are tied closely to performance, as measured by compliance with the Investment Mandate (and implementation of the Company's investment strategy), adherence to the Business Plan and delivery of the objectives in this Framework Document;
 - (C) are aligned with the objectives set out in this Framework Document; and
 - (D) deliver value for money.
- 9.17 In addition, HMTreasury does not condone rewards for failure, and would expect the Board to support the removal of any Director or member of senior management responsible for a failure to adhere to the Business Plan, comply with the Investment Mandate or for any other serious failure.

The Board's freedom to act

- 9.18 HMTreasury is committed to giving the Board the commercial freedom to adhere to the Business Plan, comply with the Investment Mandate and fulfil and deliver the activities and objectives set out in this Framework Document. In that context, and save as provided in this Framework Document, HMTreasury will not interfere in day-to-day operational and commercial matters.
- 9.19 Subject to this Framework Document and the Company's memorandum and articles of association, decisions on the day-to-day running of the Company will rest with the Board in accordance with the Directors' statutory, common law and fiduciary responsibilities.

Monitoring the Company's performance

- 9.20 HMTreasury will regularly monitor the Company's performance of the activities, and performance against the objectives, set out in this Framework Document, by means of the following mechanisms:
- (A) quarterly shareholder meetings as the centrepiece of the formal reporting relationship between the Company and HMTreasury. The purpose of these meetings between the Chairman of the Company and senior representatives of HMTreasury (including the Nominated Official) is to provide a forum to review performance to date of the activities, and against the objectives set out in this Framework Document. Each meeting is primarily intended to be weighted towards being a forward-looking and risk-based analysis of progress against the Business Plan and Investment Mandate, including the Company's investment strategy (where appropriate);
 - (B) the Company will promptly and without delay disclose to HMTreasury any information regarding the Company that would have required public disclosure if it were listed on the Official List or which otherwise may have a significant bearing on the delivery of, or may have a significant impact on the assumptions or objectives set out in, this Framework Document or the Investment Mandate;
 - (C) in addition to the regular shareholder meetings, meetings between Directors and representatives of HMTreasury to discuss the affairs of the Company at HMTreasury's request; and
 - (D) in addition to the monitoring procedure described above, HMTreasury will be entitled on reasonable notice to such information in relation to the affairs of the Company, as it may consider necessary or desirable from time to time.
- 9.21 The Company will produce quarterly reports to facilitate effective shareholder meetings as referred to above, together with an annual report. The annual report (together with the Company's audited accounts) will be laid before Parliament. The quarterly and annual reports will contain such information as HMTreasury, in consultation with the Company, requires.

- 9.22 The Chairman and Chief Executive of the Company will, if required, attend meetings of relevant Parliamentary committees (including the Public Accounts Committee and the House of Commons Treasury Select Committee), for scrutiny and otherwise to answer questions about the Company.
- 9.23 The Company will:
- (A) appoint the Comptroller and Auditor General to audit its financial statements;
 - (B) permit audit procedures to be carried out by the National Audit Office (with or without the involvement of external professional advisors); and
 - (C) establish an internal audit function which shall be comprised of members of HM Treasury's internal audit team. The internal audit function will report to the Board's Audit and Risk Committee and will consider issues relating to the Company's adherence to the Business Plan, compliance with the Investment Mandate and delivery of the objectives set out in this Framework Document, covering (in particular) matters relating to strategy, performance and risk management.
- 9.24 The accounts to be produced by the Company will comply with any accounts direction issued by HM Treasury regarding the presentation or form of such accounts; and the timing for production of such accounts shall accord with "best practice" applicable to Government Departments and be laid before Parliament.

Approval rights

- 9.25 HM Treasury will have approval rights over:
- (A) any variation or waiver of the terms of any agreement between HM Treasury and an Investee Company or the grant of any consent or approval under such an agreement;
 - (B) any variation or waiver of the terms of any framework documents with NR or B&B;
 - (C) any disposals (including redemption prior to scheduled maturity) or acquisitions of Investments, or other strategic transactions, which are not in accordance with the objectives set out in this Framework Document or are not contemplated or permitted by the Investment Mandate;
 - (D) any action which may have a significant bearing on, or prejudice, HM Treasury's position as a creditor or contingent creditor of a Investee Company; and
 - (E) (without prejudice to paragraph 7.1) any other actions that fall outside of the scope of the Investment Mandate and the discretions vested in the Company by virtue of this Framework Document and which may have a significant bearing on or prejudice the delivery of, or compliance with, the activities and objectives set out in this Framework Document.

Power of Direction

- 9.26 In view of HM Treasury's broader functions, including its functions in relation to financial stability and financial and economic policy, it may be necessary for HM Treasury to give the Board directions of a general or specific nature from time to time. The Board will comply with such directions or resign. HM Treasury will, in making any such direction, have regard to the Overarching Objective and the requirement to preserve Investee Company independence (as outlined in Section 7).
- 9.27 Such directions will be given in writing and will be promptly published by HM Treasury unless financial stability requires that publication is delayed or withheld.

10. CONTINUATION OF THE COMPANY

- 10.1 The Company will continue in existence in and for so long as is required to carry out the activities envisaged by this Framework Document. Upon completion of such activities, it is envisaged that the Company will be wound up.

11. REVISION OF FRAMEWORK DOCUMENT

- 11.1 This Framework Document may be amended or supplemented from time to time where required by HM Treasury. In particular, it is noted that amendments and supplements may be required: (i) if the activities of the Company described in Section 2 are extended to cover other assets; and (ii) to reflect the NR and B&B Plans.
- 11.2 Any amendments or supplements to this Framework Document resulting from the provisions of this section 11 will be made: (i) having due regard to the need to preserve Investee Company independence (as outlined in Section 7); and (ii) the Overarching Objective, save in each case to the extent that these considerations are inappropriate when reflecting, or need not be taken into account in order to reflect, amendments or supplements arising out of the finalisation of the NR and B&B Plans.

12. STATUS OF FRAMEWORK DOCUMENT

- 12.1 In the event of any conflict or inconsistency, this Framework Document takes precedence over framework documents which are already in place in respect of the Wholly-Owned Investee Companies.
- 12.2 This Framework Document should be interpreted in the light of the Company's memorandum and articles of association and English company law and is without prejudice to the statutory and other rights and obligations of HM Treasury or the Company.

UKFI CONTACTS

This document can be found on our website at: www.ukfi.gov.uk

General enquiries should be addressed to:

Enquiries

UK Financial Investments Limited

1 Horse Guards Road

London

SW1A 2HQ

E-mail: enquiries@ukfi.gsi.gov.uk

Company Number 6720891

This document is printed on material comprising 75 percent recycled fibre.