



# **Annual Report and Accounts 2010-11**

of the Asset Protection Agency



**Asset Protection Agency  
Annual Report and Accounts 2010-11**

Accounts presented to the House of Commons pursuant to  
Section 7 of the Government Resources and Accounts Act 2000.

Annual Report presented to the House of Lords  
by Command of Her Majesty.

Annual Report and Accounts presented to  
Parliament by Command of Her Majesty.

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# 1 Chief Executive's Foreword

Welcome to the second Annual Report and Accounts of the Asset Protection Agency (APA or the Agency), the executive agency of HM Treasury which administers the Asset Protection Scheme (APS or the Scheme).

We live in a different world from the world we were in when RBS acceded to the Scheme in 2009. Improved market conditions and the passage of time have significantly diminished the risk to HM Treasury as an insurer of the APS assets. Instead of a payout being fifty-fifty likely under the Scheme, we are now well on course for HM Treasury to make an overall £5bn profit without having to pay out. So far we have already received cash payments of £2.5bn from Lloyds and £2.1bn from RBS.

We can take comfort from the following developments during the reporting period:

- The nominal amount of taxpayer exposure reduced from £234bn to £182bn of Covered Amount, relative to £286bn<sup>1</sup> at Scheme inception.
- The forecast Expected Loss outcome for RBS is now at £45bn, down from £57bn as reported in our previous Annual Report and Accounts. As a result the safety margin for the taxpayer (“overcollateralisation”) has increased from 10 per cent to 25 per cent during the year, up from 6 per cent at Scheme inception.

Key achievements of the Agency during the reporting period were as follows:

- The APA agreed with RBS a significant number of individual asset actions during the period which helped de-risk the portfolio and resulted in several hundred million pounds of increased cash recoveries from troubled assets.
- The APA agreed with RBS a series of measures which significantly improve the management and control environment of difficult assets. Together with ongoing initiatives which the APA is monitoring closely these measures should stand RBS in good stead beyond its eventual exit from the APS.
- The APA achieved all business plan targets while costs were kept significantly below budget.

Since the end of the reporting period, the APA has agreed with RBS a “simplification” of the APS which provides for the recognition of Losses and Recoveries to be aligned more closely with RBS’s normal accounting procedures. This is expected to improve overall operational efficiency and to provide operational savings to RBS for the duration of their participation in the Scheme.

<sup>1</sup> The figure originally reported at inception was £282bn. Following restatement of certain Structured Finance assets, Covered Amount at 31 December 2008 was revised to £286bn.

I would like to thank my staff for their significant contribution to these achievements and express my appreciation for our constructive relationships with RBS and HM Treasury senior management.

**Stephan Wilcke**

Chief Executive

12 July 2011



## 2 Business Review

### 2.1 Investment Management

#### 2.1.1 Functions

The Investment Management team fulfils its responsibility for oversight and monitoring of Covered Assets by:

- reviewing individual large credit exposures (i) presented to the APA and requiring a credit decision (credit reviews) and (ii) selected by the APA for review (asset reviews). Credit reviews are a priority for the APA as it is required to respond in a timely manner to requests by RBS for credit decisions; and
- reviewing RBS business divisions which manage significant numbers of Covered Assets, including assessing their strategies, operations and management capabilities.

As at 31 March 2011, the Investment Management team comprised 14 asset specialists focused on three broad asset classes<sup>2</sup> to which all large Covered Assets have been allocated: corporate and leveraged finance, commercial real estate, and structured products.

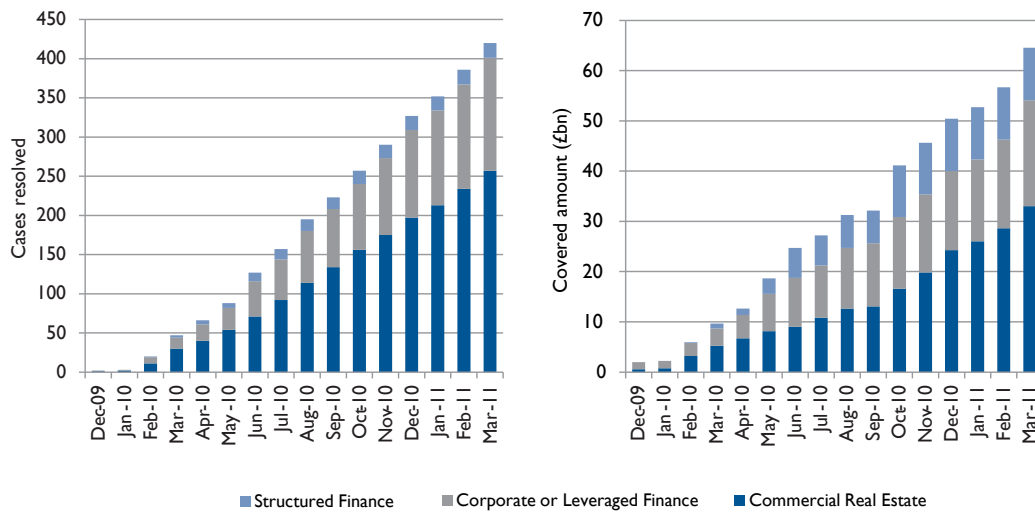
#### 2.1.2 Individual Assets

During the reporting period, we conducted 376 credit decision reviews<sup>3</sup> with an aggregate Covered Amount of £55.1bn at a steady rate of 5-10 per week. Figure 1 shows cumulative completed credit reviews by APA asset class by number of assets and Covered Amount from Scheme inception to 31 March 2011.

<sup>2</sup> These APA asset classes do not reconcile to the official Covered Asset Classes defined for EU state aid purposes in the APS as certain Covered Asset Classes such as Loans, Bonds and Derivatives have been reallocated for APA internal management purposes.

<sup>3</sup> For the avoidance of doubt the APA is not involved in granting new credit to borrowers, but rather in credit decisions on how large existing borrowings covered by the APS are amended, restructured, refinanced, or sold where the borrower is experiencing difficulty.

**Figure 1: Cumulative completed credit reviews by APA asset class by number of assets and Covered Amount**



Source: APA

One of our objectives for the reporting period was to complete asset reviews of all large Covered Assets (>£50m by borrower group) designated as the team’s “focus portfolio”. As at 31 March 2011, the focus portfolio comprised: 541 borrower groups representing £96.9bn Covered Amount as at 31 March 2011 (53 per cent of the total Covered Amount of all APS assets). Our objective was substantially achieved with 98 per cent reviewed. This was a significant achievement and has allowed the APA to understand in detail the risks in this part of the APS portfolio. As a result, we have been able to identify which assets, asset classes and business areas warrant further focused monitoring by the Investment Management team. During the 2011-12 financial year we expect to focus on assets undergoing restructurings and assets marked for sale in RBS’s Non-Core Division.

Figure 2 illustrates the Investment Management team’s focus portfolio as at 31 March 2011 analysed by priority status (Red, Amber, Green - red files being active restructurings/sales), Covered Amount and number of cases. In the reporting period the risk profile (according to our RAG categorisation) improved as assets were restructured, refinanced or sold.

**Figure 2: Investment Management team's focus portfolio analysed by number of borrower groups (#) and Covered Amount (£m) as at 31 March 2011**

	#	%	£m	%
Red	66	12%	17,683	18%
Amber	211	39%	34,169	35%
Green	264	49%	45,036	46%
Total	541	100%	96,888	100%

Source: APA

We closely monitored all large sales and debt restructurings in the APS portfolio and discussed these at the APA Credit Committee. As a result of these actions the APA agreed with RBS some modifications of individual asset actions during the period which have helped de-risk the portfolio and resulted in several hundred million pounds of increased cash recoveries from troubled assets.

### *2.1.3 General Asset Management and Business Reviews*

During the reporting period, the APA reviewed or initiated reviews of all RBS business divisions managing material portfolios of Covered Assets. In addition, a number of in-depth business reviews were initiated and in some cases completed by external consultants and/or by APA staff. The purpose of the reviews was to ensure that all Covered Assets in the relevant areas were receiving the best possible asset management. In some cases, reviews resulted in recommendations being made for changes in strategy, operations, reporting, controls or risk management which have been or are currently being implemented. In particular we focused on credit memos and analysis across the board, data gathering for commercial real estate assets, the medium-term strategy for the Non-Core Division, the appointment of an external valuation agent for structured finance and the development of an intrinsic value model. The APA continues to work with RBS to implement and maintain these changes.

As reported in our interim report we required RBS to appoint four SOC Special Advisers earlier in the reporting period; their work has been largely completed, and their recommendations accepted by RBS. The APA will continue to monitor the implementation of their recommendations in the period ahead.

## 2.2 Risk

The Risk team is responsible for monitoring and managing financial risks from the APS through:

- monitoring the evolution of incurred losses and portfolio credit quality;
- providing forecasts on loss evolution and stress testing adverse scenarios;
- providing an accounting valuation of the APS, the world's largest credit derivative contract;
- awarding Loss Credits where RBS disposes of assets before losses are formally incurred under the Conditions; and
- membership of the APA Credit Committee which makes asset-by-asset decisions on individual large credit exposures.

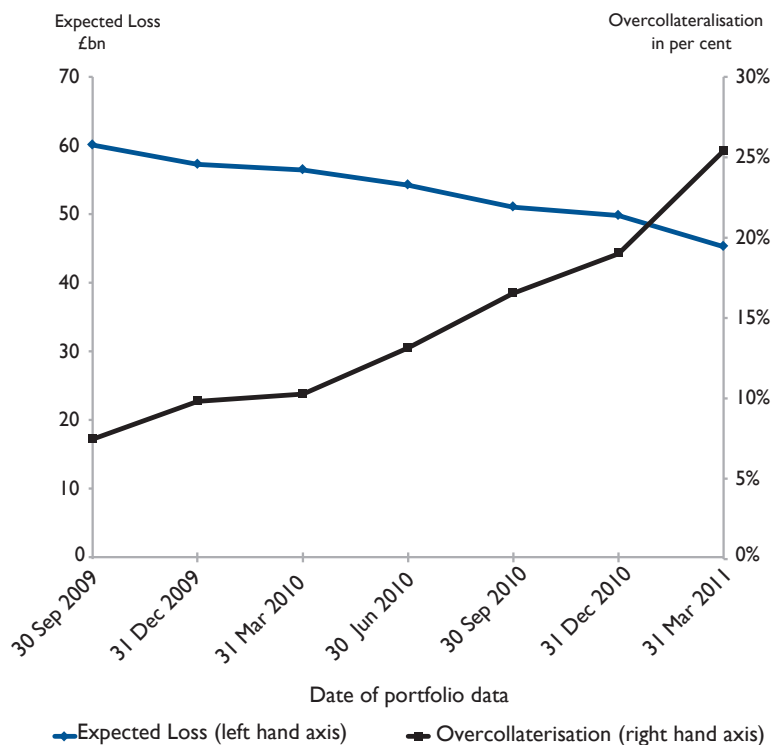
As at 31 March 2011, the Risk team comprised 14 staff.

### 2.2.1 Evolution of Taxpayer Risk Exposure

During the reporting period the incurred loss under the APS rose from £32bn to £38bn of Net Triggered Amount including awarded Loss Credits. Considerable amounts of future Recoveries from already Triggered Assets are expected. This is reflected in RBS' Interim Management Statements, which show that during the period cumulative credit impairment losses and adjustments to par value (including AFS reserve) relating to the Covered Assets moved only from £30.5bn to £31.7bn. Further detail can be found in RBS' Q1 2010 and Q1 2011 Interim Management Statements.<sup>4</sup>

Expected lifetime losses from APS assets are reforecast every quarter by the APA based on observed experience, refreshed portfolio data, and economic forecasts taken from the Office of Budget Responsibility (for the UK), the IMF (for the rest of the world) and other specialists (commercial and residential property prices for example). The cumulative lifetime Expected Loss forecasts have been declining over time as shown in Figure 3 and stood at £45bn at 31 March 2011, down from £57bn as reported in the APA's previous Annual Report. The downward trend reflects observed loss trends, better asset understanding, more granular data from RBS and a steady economic outlook.

<sup>4</sup>Links to relevant background documentation can be found in Annex D.

**Figure 3: Evolution of Expected Loss forecasts**

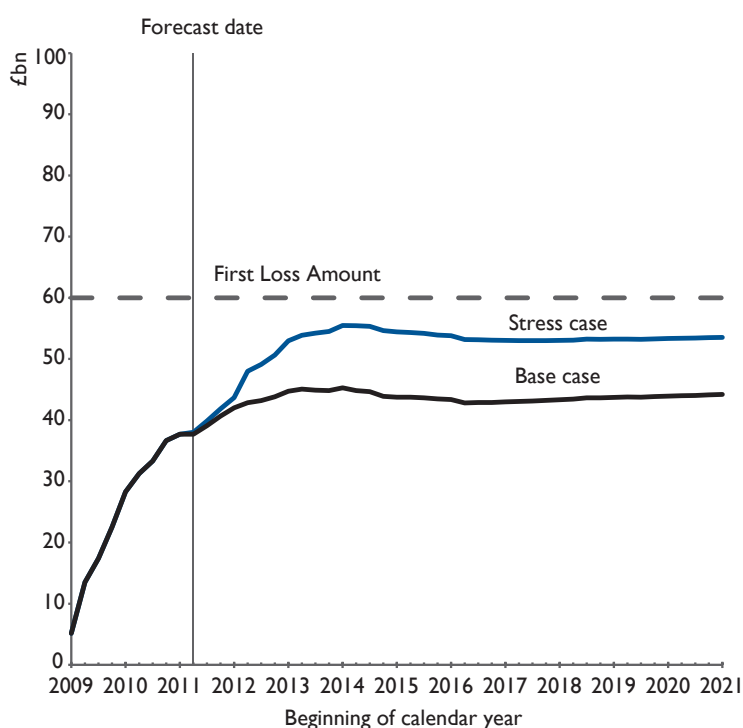
Source: APA analysis

A useful measure of the safety margin for the taxpayer is the concept of overcollateralisation, which measures the excess value of the Covered Assets relative to the amount of protection provided by HM Treasury (see Annex B for further detail on the definition). As seen in Figure 3, the safety margin continued its steady increase over the period since the Scheme's inception.

### 2.2.2 Stress testing and remaining factors

The Expected Loss forecast presented in the previous section is associated with significant uncertainty although this uncertainty is continuously reducing as Losses and Recoveries become fact rather than uncertain conjecture. To better understand the uncertainty inherent in the base case forecast set out in the previous section, the APA analyses a range of macroeconomic scenarios using its own proprietary macroeconomic model. Figure 4 shows the forecast Net Losses under the APA's base case and under a stress scenario, which is broadly consistent with the stress scenario set out in the FSA's Financial Risk Outlook 2010, shifted to initiate the stress scenario in Q2 2011.

**Figure 4: Base and stress case Net Loss forecasts based on portfolio data at 31 March 2011**



Source: APA analysis

Our current expectation, based on data as at 31 March 2011, is that Net Losses are not expected to go through the £60bn First Loss Amount. This extends to the assumed stress case, although this is not an absolute worst case scenario. A more severe stress scenario could result in a loss for HM Treasury as detailed in Annex B.

The biggest remaining vulnerability in the portfolio is to stresses in the commercial real estate portfolio from both declines in asset values and refinancing risks. The detailed results under base and stress by asset class and a profile of asset maturities are included in Annex B.

Direct sovereign risk was generally excluded in the APS asset selection process. Only a relatively small portion of APS assets are located in troubled Euro-zone countries (Ireland £13.9bn, Spain £4.3bn, Portugal £0.2bn, Greece £0.0bn), more details of which can be found in Annex B.

### 2.2.3 Awarding of Loss Credits on Disposal of Assets

To ensure that RBS's incentive to de-risk the APS portfolio is not unduly biased by the existence of the Scheme, a Loss Credit is generally awarded on the disposal of Non-Triggered Assets. The Loss Credit is based on the expected Net Loss that would have been incurred on the asset had it remained within the Scheme.

The withdrawal of a Non-Triggered Asset reduces the total amount of assets in the Scheme and thereby reduces the level of potential Losses covered by the Scheme. If no Loss Credits were awarded, RBS would extract less benefit from the Scheme as the asset was no longer covered, but its payments for being in the Scheme would remain unchanged; this could discourage RBS from selling assets covered by the Scheme. The award of a Loss Credit redresses the balance and ensures that RBS gains at least some of the benefit it would have had if it retained the asset within the Scheme while de-risking the Scheme and the bank overall.

As at 31 March 2011 the APA had awarded Loss Credits of £1.5bn on £7bn of Covered Amount including for individual disposals as well as number of portfolio disposals. HM Treasury reviewed the functioning of the Loss Credit mechanism in the reporting period and decided to continue it, with a further review in a year's time or, if earlier, when awarded Loss Credits exceed £10bn.

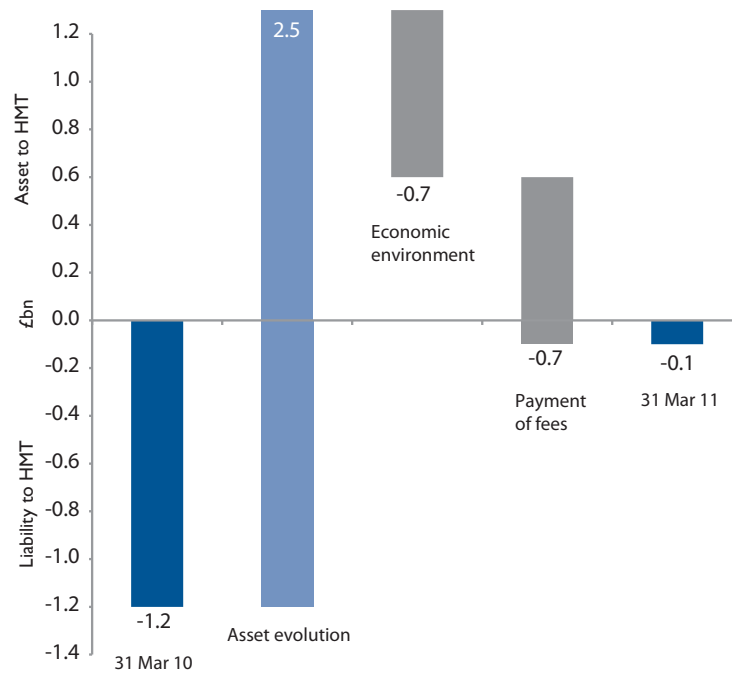
### 2.2.4 Valuation of the APS

For the purposes of HM Treasury's Annual Report and Accounts, the APS is accounted for as a derivative. In accordance with IFRS, the APS is marked-to-market, with the result reflecting movements in credit spreads, exchange rates, interest rates, and the quality of the underlying portfolio.

As at 31 March 2011, the fair value of the APS was a £0.1bn liability to HM Treasury. This is a mark-to-market profit to HM Treasury of £2.0bn since inception, £0.2bn in the year to 31 March 2010 and £1.8bn in the year to 31 March 2011. The fair value of the APS liability represents the statistical expectation, or weighted probability, of the difference between cash paid and cash received under different scenarios.

Figure 5 breaks down the drivers of change in the valuation since 31 March 2010 into three components:

- asset evolution (amortisation, rating migrations, elapse of time etc.);
- changes to the economic environment (credit spread and exchange rate movements); and
- payment of fees.

**Figure 5: Attribution of P&L since 31 March 2010 (£bn)**

Source: APA analysis

While asset evolution has reduced the APS liability considerably due to amortisation, favourable migration, and realised losses that have been lower than expected at inception, this was partially offset by widening of credit spreads in the market associated with the problems of peripheral EU sovereigns from the second quarter of 2010. While there was some recovery in the market, the environment is still not back to where it was at the beginning of the reporting period. More details on the valuation can be found in Annex C.



## 2.3 Finance and Operations

The Finance and Operations team is responsible for the oversight of data reported under the Scheme, Scheme Ledger reporting, IT and other infrastructure, as well as the APA's HR and finance function. Section 3.2 of this report contains management commentary for the APA's financial results for the period 1 April 2010 to 31 March 2011.

As at 31 March 2011, the Finance and Operations team comprised 12 staff.

### 2.3.1 Data Management and Validation

During the reporting period, the APA's Data Validation team ran a series of validation tests which assessed the quality of the data supplied by RBS, including checks against certain aspects of the Conditions. Validation test results were shared with RBS and formed the basis of discussions where further clarification was required. The quality of the data received from RBS improved significantly in the reporting period.

In the reporting period, the Data Validation team significantly reduced the time taken to approve data since the roll out of its new asset database system – TAPAS.

### 2.3.2 Verification

Verification provides assurance over the data RBS submits to the APA and supplements the due diligence exercises carried out on assets prior to the formation of the APA.

At the APA's request and in keeping with the APA's desire to place as much reliance as possible on RBS internal systems, RBS Group Internal Audit (GIA) performed a number of asset testing procedures on APS assets during the period. PricewaterhouseCoopers (PwC) performed an oversight role on behalf of the APA which included assessing the independence, competence and objectivity of GIA and carrying out re-performance of a selection of the tests performed by GIA. PwC concluded the APA could rely on the work undertaken by the GIA testing team. The work of GIA was performed to a high standard, for example GIA applied stringent protocols and developed well thought out workflow processes in their performance of verification procedures.

In addition to the asset testing referred to above, the APA gained assurance and evidence over the quality of the data reported to the APA by RBS from a number of other sources that include:

- overseeing the reconciliation of the APS data to the audited financial accounts;
- reviewing RBS's internal APS Annual Assurance Plan and Report; and
- attending the RBS APS Senior Oversight Committee.

Over the course of the period RBS implemented system and process improvements that have improved the quality of the data reported to the APA. As a consequence, the APA has reduced the assessed impact of known or suspected data issues on the APS financial instrument valuation disclosed in HM Treasury's financial statements from £250 million at 31 March 2010 to £150 million at 31 March 2011, as noted in Annex C.

### *2.3.3 Changes to Scheme Documentation*

The Scheme documentation is highly complex due to the complexity and scale of the Scheme. This has given rise to a number of interpretation and application issues, including issues that were not able to be resolved fully before the Accession Date. As at 31 March 2011, RBS and the APA had agreed in principle on virtually all priority issues.

During the period RBS and HM Treasury had a difference of opinion as to the status of certain structured credit assets for the purposes of the Scheme. RBS paid HM Treasury a £2.8m additional fee in order to extend the time available for discussion between the parties. Subsequently the determination of the treatment of the relevant assets for the purposes of the Scheme was resolved and a supplemental agreement documenting changes to the implied write-down trigger for long dated assets was entered into.

RBS and the APA also entered into a number of other legal documents during the period tailoring the Conditions on which RBS participates in the Scheme. These relate to revised arrangements for the assessment of APS performance-related remuneration for relevant RBS staff, a move from annual to quarterly fee payments and a number of operational matters.

Since the end of the reporting period, the APA and RBS have entered into legal documentation to align the operation of the Scheme more closely with RBS's regular "business as usual" finance and risk management processes and are finalising an agreement to move the focus of its asset management provisions to the riskiest assets in the Scheme.

For a general background relating to the APS and the APA please refer to Annex A of this document.

## 3 Performance and Results

### 3.1 Performance against targets

This section of the document provides an assessment of APA performance against the targets that were included in the Agency's 2010-11 Business Plan.

- 1 To conduct reviews of all individual APS assets with a covered amount exceeding £50m by 31 March 2011; to provide RBS with timely decisions where required minimising delays; to avoid occasions (target > 95%) in connection Conduct Requiring Approval where, through lack of APA response within 5 business days, RBS is able to invoke the "snooze/lose" provision.

Substantially achieved. As at 31 March 2011, the APA had reviewed 521 files with £94.7bn Covered Amount. This represents 96 per cent by number and 98 per cent by amount of APS borrower groups with Covered Amount >£50m. The APA provided timely responses to RBS in all cases.

- 2 To provide robust APS loss forecasts to HM Treasury, both on a quarterly basis by no later than 6 weeks after receipt of Quarterly Statement data from RBS, and also in line with agreed timetables for fiscal events. During the year to commission Government Actuarial Department to conduct a review of the fitness for purpose of the loss forecast modelling assumptions and methodology.

Achieved. The APA provided quarterly loss forecasts in the reporting period within the timelines stated. In the period, the Expected Loss outcome decreased significantly from £57bn to £45bn.

The Government Actuary's Department reviewed the APA's loss forecasting model during the reporting period and concluded that it was fit for purpose in the context of supporting the statement that the central expectation that there will be a net benefit to the taxpayer of at least £5bn from the APS.

- 3 To produce an auditable valuation of the APS that complies with International Financial Reporting Standards and in line with appropriate accounting policies, in accordance with agreed timelines for inclusion in HM Treasury's Annual Report and Accounts and Parliamentary Estimates.

Achieved. As at 31 March 2011, the fair value of the APS was a £0.1bn liability to HM Treasury. This is a mark-to-market profit to HM Treasury of £2.0bn since inception, £0.2bn in the year to 31 March 2010 and £1.8bn in the year to 31 March 2011.

- 4 To commence the rolling programme of verification data reported by RBS to provide evidence to support losses claimed, the data used to prepare the loss forecasts and determine whether a selection of Scheme rules have been complied with. In addition, by 31 December 2010 to have performed loss testing on a selection of losses from each business division of RBS that reported losses to 30 June 2010.

Achieved. The APA's independent verification agent (PwC) developed and assisted with the implementation of policies and procedures for the achievement of accurate, valid and appropriate loss verification over the life of the APS and to determine RBS's compliance with its non-data related obligations under the Conditions.

Initial loss testing on a selection of losses for each business division of RBS that reported losses to 30 June 2010 was followed in the reporting period by asset testing by RBS's Group Internal Audit function, with PwC performing an oversight role on behalf of the APA.

- 5 To complete reviews of the RBS business units managing covered assets by 31 March 2011.

Substantially achieved. As at 31 March 2011, the APA had reviewed or initiated reviews of all RBS business divisions managing material portfolios of APS assets.

- 6 To process all loss credits for disposal of non-triggered assets within one month of receipt of all relevant information.

Substantially achieved. As at 31 March 2011, 30 Loss Credits had been processed, of which over 90% had been processed within one month.

- 7 To provide full and accurate reporting to HM Treasury's APS Team and HM Treasury Group Finance, within agreed timelines and taking account of Parliamentary reporting requirements and targets agreed with HM Treasury.

Achieved. In the reporting period, the APA met all of its reporting requirements to HM Treasury.

- 8 To complete the build, test and implementation of the APA's IT Data System, which enables the APA to store and manage APS data received from RBS, by 30<sup>th</sup> July 2010 and in line with specification and budget. Also, to conduct APA operations in accordance with Government data handling, IT use and security policies.

Achieved. The reporting period saw the APA successfully deliver its data management IT system (TAPAS) which has automated much of the APA's data validation activity.

APA operations were conducted in accordance with Government data handling, IT use and security policies, including submission of all required information security returns within the relevant timescales.

**9 To operate within budget and in line with HM Treasury Group policies including on financial and commercial management.**

Achieved. The APA operated within its budget for the reporting period.

**10 In line with HM Treasury Group policies to provide HM Treasury with relevant information in a timely manner to enable HM Treasury to meet operational, contractual and statutory deadlines when responding to Parliamentary Questions and Freedom of Information requests.**

Achieved. In the reporting period, the APA responded to all Parliamentary Questions and Freedom of Information requests within the required timeframes. All statutory and other deadlines in relation to the provision of requested information were met.

### **3.2 APA financial results**

The APA's financial results for the period from 1 April 2010 to 31 March 2011 were £14.7m of revenue and £14.7m of costs, as costs incurred by the APA in managing and administering the APS are passed on to RBS under the terms of the Scheme.

The Parliamentary control totals were income of £36.5m and costs of £36.5m.

The most significant factor in the actual costs, and hence revenue, of the APA being lower than the amount originally budgeted was that RBS incurred costs directly that APA had anticipated incurring on its own account. This outcome is at APA's instigation as it enables the impact of the APA's work to be more effectively embedded into RBS' operating environment. The actual net operating costs of nil were the same as that budgeted.

At 31 March 2011, the APA's Statement of Financial Position showed total assets less liabilities surplus compared to a deficit at 31 March 2010. The APA's Statement of Financial Position is a product of the relationship between the APA and HM Treasury as its parent department. The APA is an executive agency operating at arm's length from Ministers, but its funding is an allocation of the total voted by Parliament to HM Treasury. The APA has no operating capital or cash of its own; its liabilities are paid by HM Treasury. The cash funding thus provided by HM Treasury to the APA does not equate to the net operating cost recorded by the APA on an accrual basis. As required by the Government Financial Reporting Manual, funding is recorded in the general fund within Taxpayers' Equity, along with net operating cost. The balance of Taxpayers' Equity can therefore be particularly affected by unpaid and accrued liabilities recognised as an expense by the APA but not yet funded by HM Treasury and outstanding receivables.

### **3.3 APA supplier payment policy**

All of the APA's supplier invoices are processed for payment by HM Treasury, which is committed to the prompt payment of all invoices not in dispute. In May 2010, the government introduced a five day payment

target for SME suppliers to receive payment which accelerated payment from the 10 day target set for SME suppliers in November 2008. For 2010-11, Treasury Group achieved 83 per cent (80 per cent being the set target) for the 5 day target and 96 per cent (95 per cent being the set target) for the 10 day target which Treasury Group extended to all suppliers rather than restricting it to SMEs.

The APA's trade creditor days for the period, calculated as the proportion that is the aggregate amount owed to trade creditors at 31 March 2011 compared with the aggregate amount invoiced by suppliers during the year, expressed as a number of days when compared with the one year period of account, was 3.2 days (2009-10: 12.5 days for the 115 day period of account).

### **3.4 Staff sickness absence**

In 2010-11 there were 1.7 average working days lost per staff year (2009-10: 0 days). The proportion of staff with no sickness absence recorded was 77 per cent (2009-10: 100 per cent).

#### **Stephan Wilcke**

Chief Executive and Accounting Officer  
12 July 2011

## 4 Statement of Accounting Officer's Responsibilities

Under the Government Resources and Accounts Act 2000, HM Treasury has directed the APA to prepare, for each financial year, the resource accounts detailing the resources acquired, held or disposed of during the year and the use of resources by the Agency during the year. The accounts are prepared on an accruals basis and must give a true and fair view of the state of affairs of the Agency, recognised gains and losses and cash flows for the financial year.

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 accounts; and
- prepare the accounts on a going concern basis.

HM Treasury has appointed the Chief Executive as the Accounting Officer of the APA.

The responsibilities of an Accounting Officer, which include responsibility for the propriety and regularity of the public finances for which the Accounting Officer is answerable, for keeping proper records and for safeguarding the APA's assets, are set out in Chapter 3 of Managing Public Money published by HM Treasury.





## 5 Statement on Internal Control

### 5.1 Scope of responsibility

As the Accounting Officer for the APA, I have responsibility for maintaining a sound system of internal control that supports the achievement of APA policies, aims and objectives, whilst safeguarding the public funds and APA's assets for which I am personally responsible, in accordance with the responsibilities assigned to me in Managing Public Money.

The APA is legally and constitutionally part of HM Treasury; however, as an executive agency, it operates at arm's length from Ministers. Oversight and approval for policy, strategic objectives and the financial framework of the APA rests with the Chancellor of the Exchequer. This oversight and approval is delegated to the Permanent Secretary of HM Treasury who in turn delegates operational decisions and day to day management of the APA to me in my role as Chief Executive. The Permanent Secretary has also designated me as the Accounting Officer for the APA.

As Chief Executive and Accounting Officer of the APA I am responsible for ensuring that the APA carries out its functions in accordance with the Framework Document, the APA annual Business Plan, and the Accounting Officer delegation letter from the Permanent Secretary to me. In addition to my responsibilities relating to the APA, the Accounting Officer delegation letter makes me responsible for managing and measuring the Government's liability under the APS, including by producing a robust independent estimate of expected losses, expected recoveries, and the expected future value of the protection issued under the APS to be incorporated into HM Treasury's resource accounts, and an accurate report of any sums to be paid out by HM Treasury as a result of the protection offered under the APS. These responsibilities are to be discharged in a way that will deliver value for money and in line with the Conditions.

### 5.2 The purpose of the system of internal control

The APA's 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 provide only reasonable and not absolute assurance of effectiveness. The system of internal control is based on the ongoing identification of risks that could affect the APA's ability to achieve its aims and objectives; evaluation of the likelihood and impact of those risks being realised; and the efficient, effective and economic management of those risks.

The system of internal control continued to develop and improve over the course of this reporting period as the Agency and the understanding of our risks matured.

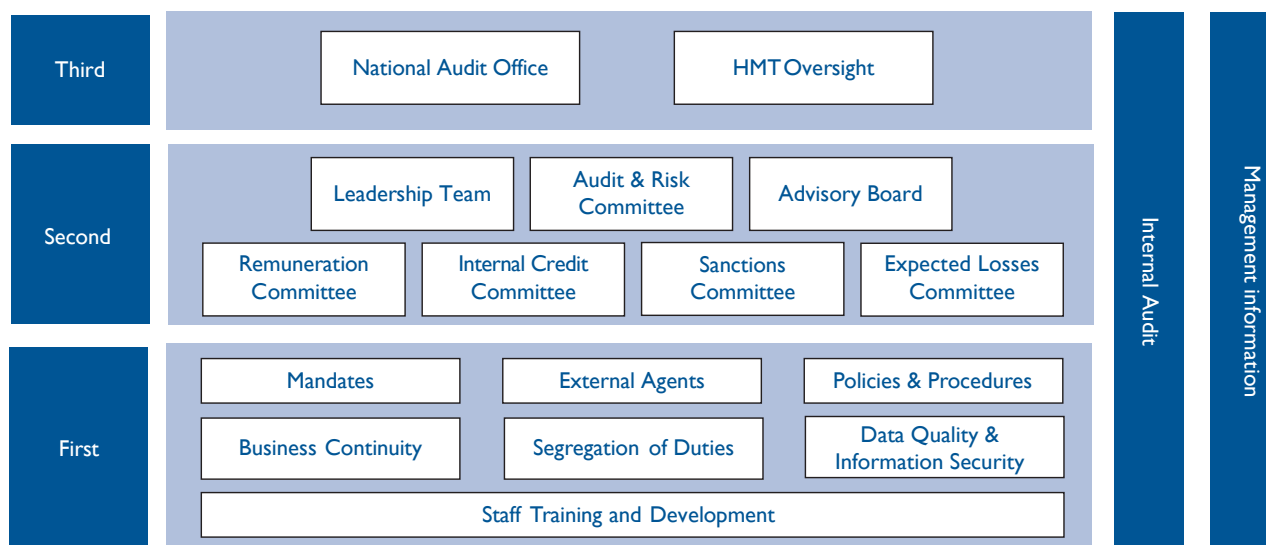
### 5.3 Capacity to handle risk

As at 31 March 2011, the APA employed a total of 43 permanent and fixed term staff on contracts greater than one year.

The APA is a finite life organisation of uncertain duration. RBS has publicly stated that “Our baseline planning scenario is to exit [the APS] once our fees are fully amortized in late 2012.” The operating model of the APA has been designed to rely heavily on external advisors and contractors. The degree of reliance receded in the period as the APA has now reached a steady state; however this may increase again in the future. The APA’s ability to manage and control risk is dependent on having effective relationships with external advisors and being able to attract contractors in addition to retaining existing employees.

Figure 6 illustrates the three lines of defence incorporating within each line the significant control components. The second and third lines are further explained below.

**Figure 6: APA lines of defence**



Source: APA

The third line of defence includes oversight from external audit together with an oversight function from HM Treasury.

The second line of defence consists of the following forums: the Advisory Board, the Audit and Risk Committee, the Remuneration Committee and a number of management committees without non-executive members, namely the Internal Credit Committee, the Expected Loss Committee, the Leadership Team and the Sanctions Committee.

- The Advisory Board advises me and other members of the executive management. The Advisory Board consists of the Leadership Team, non-executive members and representatives of HM Treasury. The board meets at least quarterly to consider strategic, operational and management issues related to the achievement of the APA's objectives and the fulfilment of its responsibilities.
- The Audit and Risk Committee's role is to support me in my responsibilities as Accounting Officer and Chief Executive for risk control and governance by reviewing the effectiveness, reliability and integrity of the APA's risk assurance framework. The Audit and Risk Committee meets at least quarterly and is chaired by a member of HM Treasury's Group Audit and Risk Committee; other members include one of HM Treasury's representatives and a non-executive member of the Advisory Board. The National Audit Office, APA internal auditors and HM Treasury internal auditors are all invited to attend Audit and Risk Committee meetings.
- The Internal Credit Committee serves as a consultative body to enable views and knowledge to be shared on both credit decisions required to be taken by the APA and *ad hoc* credit reviews. The Internal Credit Committee meets as required. Attendees include myself, the Chief Risk Officer, the Chief Investment Officer, the Chair of the Expected Loss Committee, and the Chief Credit Officer Real Estate on a standing basis. However, authority to approve or decline credit decisions rests with a hierarchy of authorised individuals as specified in the Procura Framework (see below).
- The Expected Loss Committee serves as a consultative body to discuss loss forecasts on large Covered Assets and Loss Credits in connection with disposals of Non-Triggered Assets. The Expected Loss Committee meets as required. Meetings are chaired by the Risk Director responsible for individual Expected Loss assessments and include relevant representatives from the Risk and Investment Management teams.
- The primary body in the APA for identifying and mitigating risk at a day-to-day level is the Leadership Team, which comprises the heads of each division of the APA, General Counsel and myself. The Leadership Team generally meets twice weekly and each division is regularly required to report on any new risks identified in the areas for which they have responsibility and on any changes in the status of existing risks. Each head meets with his or her own team on a weekly basis.
- The Sanctions Committee comprises the Leadership Team and the Chief Credit Officer Real Estate and exists to support me in decision-making relating to any use of APS sanctions against RBS. The Sanctions Committee first met on 28 April 2010 and met a number of times during the reporting period.

- To advise me in respect of my responsibility for the APA's risk and control framework, the APA has appointed Ernst & Young to act as its internal auditors. The role of the internal auditors is to offer guidance on effective risk management and control and to provide systematic, objective and disciplined approaches for evaluating the effectiveness of internal control, risk management and governance processes. The internal auditors carry out their work in accordance with the internal audit plan and regularly report on their work to the Audit and Risk Committee.

#### 5.4 The risk and control framework

The risk and control framework has evolved since the launch of the APA. It gains assurance from a wide ranging suite of controls that individually are evolving to give better assurance and collectively form the bedrock of our framework.

The APA maintains a risk management framework to identify, mitigate and review APA's strategic, reputational and operational risks. It also maintains a risk register that is monitored and reviewed by senior management on an *ad hoc* basis. This risk register highlights and prioritises key risks and is used to monitor the effectiveness of the control environment and to strengthen controls where required. Underpinning the risk and control framework the APA has focused its efforts to identify and mitigate risks on priority areas and has taken a proportionate, risk-based approach to the set-up of its evolving control framework. In particular the APA has developed and maintained the following key control components:

1. Controls and safeguards in response to data risks have been put in place to ensure security and integrity of data is maintained at all times. In May 2010 the APA completed and submitted the Security Risk Management Overview 2010-11 to HM Treasury. Policies are set out in Knowledge Management guidance documents available and distributed to all staff. Mandatory compliance training and a related compliance assessment is required for all APA staff to address Government Data Handling Review and information assurance requirements. The APA complies with Cabinet Office and HM Treasury reporting requirements in relation to security and information assurance. The APA had no personal data related incident over the reporting period which was required to be reported to the Information Commissioner's Office.
2. Policies on anti-fraud measures and whistle-blowing have been implemented. The APA has its own Conflicts of Interest Policy which covers standards of propriety and conduct, dealing in securities and other assets, confidentiality and official information, gifts and hospitality and the Business Appointment Rules.
3. Segregation of duties controls are in place to promote independent checking and reconciliation, and to avoid concentration of key activities or related controls in the hands of individuals or small groups of staff. The APA has a Service Level Agreement (SLA) with the Debt Management Office (DMO) and HM Treasury which provides various levels of segregations of duties. In particular segregation of duties takes place between front and back office activities, though it is recognised that, in a relatively small organisation such as the APA, segregation of duties can be a challenge.

4. Policies and procedures have been applied to mitigate risks in business critical areas including financial control, personnel management and data assurance. The policies and procedures have been documented for all main activities and include:
  - monthly balance sheet reconciliation and certification procedures and quarterly agreement of all balances and accruals with suppliers;
  - procurement controls that have been put in place to ensure only genuine expenditure is incurred on behalf of the APA;
  - appropriate financial controls to ensure the APA operates within its organisational budget as agreed with HM Treasury; and
  - an internal framework (Procura Framework) to delegate authority from the CEO to staff for specific approval decisions and procedures for recording key decisions.
5. The Procura Framework controls the internal delegation of authority and specifies approval levels in such areas as credit decisions, operational decision-making, spending, contracts, stakeholder communication, and internal policy-making. With regard to credit decisions, the framework sets out the hierarchy of individuals who are authorised to approve transactions, for example Prohibited Conduct requests from RBS, depending on the size of the relevant transaction.
6. Following agreement between the APA and RBS of a timetable for the delivery of data and the specific information to be included in each data submission, arrangements are in place to validate data delivered by RBS before it is distributed for use by the Investment Management, Finance and Risk teams. Key elements of these arrangements include: a series of data validation tests to assess the data quality; discussion with RBS of exceptions identified during validation testing; and frequent, often bi-weekly conference calls between the APA validation team and the relevant RBS data team.
7. The APA has an independent verification agent to develop and carry out policy and procedures for the achievement of accurate, valid and appropriate data verification, including loss verification over the life of the APS.
8. The APA has set up a Business Continuity Plan (BCP) which leverages the SLA with HM Treasury and the DMO, whereby the DMO provide IT related recovery services to the APA.
9. Staff undertake training in areas which pose particular risks. All new staff receive compliance training and receive copies of the APA's Conflicts of Interest Policy and the APA Compliance Commandments as part of their induction packs. Subsequent to this, all staff undertake an annual compliance test. The results are assessed by General Counsel and followed up as necessary with staff. Where required to enable them to fulfil their role, staff also undertake training on the APA's

Insider Dealing and Market Abuse Policy which covers procedures designed to avoid the APA and its staff breaching insider dealing and market abuse legislation.

## 5.5 Review of effectiveness

As Accounting Officer, I have responsibility for reviewing the effectiveness of the system of internal control. My review is informed by the work of the internal auditors, the APA managers who have responsibility for assessing and maintaining the system, and the comments of the National Audit Office in their management letter and other reports. In relation to the review, I benefit from the advice of the Leadership Team, the Advisory Board and the Audit and Risk Committee. Subsequent to the review, a plan is in place to address weaknesses and ensure continuous improvement of the system.

There are a number of activities that form the basis of my review of the effectiveness of the APA system of internal control. Annually, I formally review the key outcomes and findings of the following:

- the proceedings of the Leadership Team, which met regularly, usually twice a week, during the reporting period. I have used this forum to discuss risk and internal control systems;
- the proceedings of the Advisory Board;
- the proceedings of the Audit and Risk Committee, which reviews the effectiveness of the risk management and internal control framework; and
- the output of the APA's internal audit function, performed by Ernst & Young.

The APA's internal auditors performed a review of the APA's key processes in January and May 2011. The findings and related management action points were agreed with management and subsequently reported to the Audit and Risk Committee in February 2011 and 14 June 2011. The review by the internal auditors covered the APA's controls and processes for the period 1 April 2010 to 31 March 2011. The internal auditors' strategy was to take a risk-based approach and accordingly key processes were chosen across the business to be tested. The APA as an organisation has matured since its last assessment, and controls and processes have successfully been embedded over the reporting period. Our internal auditors have concluded that management is operating a control environment generally adequate for an organisation of the APA's size and maturity. Accordingly, our internal auditors have reported to the Audit and Risk Committee that this Statement on Internal Control in their opinion is a true and fair reflection of the material aspects of the control environment of the APA. External audit is performed by the National Audit Office. So far as I am aware, there is no relevant audit information of which the APA's external auditors are unaware, and I have taken all the steps that ought to have been taken to make myself aware of any relevant audit information and to establish that the APA's external auditors are aware of that information. "Relevant audit information" means information needed by the external auditors in connection with preparing their audit report.

Whilst both the internal and external audit reports give assurance that the majority of controls the APA has developed are well designed and will give good assurance in the future, the APA continues to acknowledge and implement their recommendations, where appropriate, to ensure that the framework for risk and financial management continues to evolve.

### **5.6 Significant internal control issues 2010-2011**

No significant internal control issues in the APA were identified for the reporting period.

In my opinion, the APA's system of internal control was effective in response to the changing risk environment faced by the APA in the reporting period, and remains so on the date I sign this statement.

**Stephan Wilcke**

Chief Executive and Accounting Officer

12 July 2011





## 6 The Certificate and Report of the Comptroller and Auditor General to the House of Commons

I certify that I have audited the financial statements of the Asset Protection Agency for the year ended 31 March 2011 under the Government Resources and Accounts Act 2000. These comprise the Statement of Comprehensive Net Income, the Statement of Financial Position, the Statement of Changes in Taxpayers' Equity, the Statement of Cash Flows and the related Notes. These financial statements have been prepared under the accounting policies set out within them. I have also audited the information in the Remuneration Report that is described in that report as having been audited.

### **Respective responsibilities of the Accounting Officer and auditor**

As explained more fully in the Statement of Accounting Officer's Responsibilities, the Accounting Officer is responsible for the preparation of the financial statements and for being satisfied that they give a true and fair view. My responsibility is to audit the financial statements in accordance with the Government Resources and Accounts Act 2000. I conducted my audit in accordance with International Standards on Auditing (UK and Ireland). Those standards require me and my staff to comply with the Auditing Practices Board's Ethical Standards for Auditors.

### **Scope of the Audit of the Financial Statements**

An audit involves obtaining evidence about the amounts and disclosures in the financial statements sufficient to give reasonable assurance that the financial statements are free from material misstatement, whether caused by fraud or error. This includes an assessment of: whether the accounting policies are appropriate to the Asset Protection Agency's circumstances and have been consistently applied and adequately disclosed; the reasonableness of significant accounting estimates made by the Asset Protection Agency; and the overall presentation of the financial statements. In addition I read all the financial and non-financial information in the annual report to identify material inconsistencies with the audited financial statements. If I become aware of any apparent material misstatements or inconsistencies I consider the implications for my certificate.

In addition, I am required to obtain evidence sufficient to give reasonable assurance that the expenditure and income reported in the financial statements have been applied to the purposes intended by Parliament and the financial transactions conform to the authorities which govern them.

### **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.

### **Opinion on financial statements**

In my opinion:

- the financial statements give a true and fair view of the state of the Asset Protection Agency's affairs as at 31 March 2011 and of its net operating costs for the year then ended; and
- the financial statements have been properly prepared in accordance with the Government Resources and Accounts Act 2000 and HM Treasury directions issued thereunder.

### **Opinion on other matters**

In my opinion:

- the part of the Remuneration Report to be audited has been properly prepared in accordance with HM Treasury directions issued under the Government Resources and Accounts Act 2000; and
- the information given in the Business Review and Performance and Results for the financial year for which the financial statements are prepared is consistent with the financial statements.

### **Matters on which I report by exception**

I have nothing to report in respect of the following matters which I report to you if, in my opinion:

- adequate accounting records have not been kept; or
- the financial statements and the part of the Remuneration Report to be audited are not in agreement with the accounting records or returns; or
- I have not received all of the information and explanations I require for my audit; or
- the Statement on Internal Control does not reflect compliance with HM Treasury's guidance.

### **Report**

I have no observations to make on these financial statements.

*Amyas C E Morse  
Comptroller and Auditor General  
National Audit Office  
157-197 Buckingham Palace Road  
Victoria, London, SW1W 9SP*

*14 July 2011*

## 7 Accounts of the APA

### Primary Financial Statements

#### Statement of Comprehensive Net Income

*For the year ended 31 March 2011*

		2010-11	2009-10 <sup>a</sup>
	Note	£000	£000
<b>Administration costs</b>			
Staff costs	3	6,377	1,425
Other administration costs	4	8,366	2,418
<b>Gross administration costs</b>		14,743	3,843
Operating income	5	(14,743)	(3,843)
<b>Net administration costs</b>		-	-
<b>Total net operating costs</b>		-	-

<sup>a</sup> The comparative accounting period commenced on launch of the APA on 7 December 2009. The comparative accounting period end is 31 March 2010. The duration of the comparative period is 3 months and 25 days.

All expenditure is classified as administration. No programme expenditure has been incurred.

The Notes on pages 35 - 55 form part of these Accounts.

## Statement of Financial Position

*As at 31 March 2011*

	Note	2011 £000	2010 £000
<b>Non-current assets</b>			
Property, plant and equipment	7	200	309
Intangible assets	8	3,025	2,540
<b>Total non-current assets</b>		<b>3,225</b>	<b>2,849</b>
<b>Current assets</b>			
Trade and other receivables due within one year	9	3,062	320
Cash and cash equivalents		-	-
<b>Total current assets</b>		<b>3,062</b>	<b>320</b>
<b>Total assets</b>		<b>6,287</b>	<b>3,169</b>
<b>Current liabilities</b>			
Trade and other payables falling due within one year	10	(2,968)	(5,061)
<b>Total current liabilities</b>		<b>(2,968)</b>	<b>(5,061)</b>
<b>Non-current assets plus/less net current assets/(liabilities)</b>		<b>3,319</b>	<b>(1,892)</b>
<b>Non-current liabilities</b>			
Other payables: amounts falling due after more than one year	10	(1,711)	(3,159)
<b>Total non-current liabilities</b>		<b>(1,711)</b>	<b>(3,159)</b>
<b>Assets less liabilities</b>		<b>1,608</b>	<b>(5,051)</b>
<b>Taxpayers' equity</b>			
General fund		1,608	(5,051)
<b>Total taxpayers' equity</b>		<b>1,608</b>	<b>(5,051)</b>

### Stephan Wilcke

Chief Executive and Accounting Officer

12 July 2011

The Notes on pages 35 - 55 form part of these Accounts.

## Statement of Changes in Taxpayers' Equity

*For the year ended 31 March 2011*

	Notes	General Fund £000	Total Reserves £000
<b>Balance at 1 April 2010</b>		(5,051)	(5,051)
<b>Changes in taxpayers' equity for 2010-11</b>			
Non-cash charges - cost of capital	4	27	27
Non-cash charges - auditor's remuneration	4	23	23
Net operating cost for the period		-	-
<b>Total recognised income and expense for 2010-11</b>		<b>50</b>	<b>50</b>
Net parliamentary funding drawn down		6,609	6,609
<b>Balance at 31 March 2011</b>		<b>1,608</b>	<b>1,608</b>

The Notes on pages 35 - 55 form part of these Accounts.

## Statement of Cash Flows

*For the year ended 31 March 2011*

	Note	2010-11 £000	2009-10 £000
<b>Cash flows from operating activities</b>			
Net operating cost		-	-
Adjustments for non-cash transactions	4	1,259	118
Changes in working capital other than cash	14	(5,449)	7,065
<b>Net cash inflow/(outflow) from operating activities</b>		<b>(4,190)</b>	<b>7,183</b>
<b>Cash flows from investing activities</b>			
Purchase of property, plant and equipment	7	(9)	(339)
Purchase of intangible assets	8	(2,410)	(1,778)
<b>Net cash outflow from investing</b>		<b>(2,419)</b>	<b>(2,117)</b>
<b>Cash flow from financing activities</b>			
Net parliamentary funding drawn down		6,609	(5,066)
<b>Net cash inflow/(outflow) from financing activities</b>		<b>6,609</b>	<b>(5,066)</b>
<b>Net increase/(decrease) in cash and cash equivalents in the period before adjusting for receipts and payments to the Consolidated Fund</b>			
		-	-
Receipts due to the Consolidated Fund		-	-
Payments of amounts due to the Consolidated Fund		-	-
<b>Net increase/(decrease) in cash and cash equivalents in the period after adjustment for receipts and payments to the Consolidated Fund</b>		<b>-</b>	<b>-</b>

The Notes on pages 35 - 55 form part of these Accounts.

## Notes to the Accounts

### 1. Statement of accounting policies

These financial statements have been prepared in accordance with the 2010-11 Government Financial Reporting Manual (FRoM) issued by HM Treasury. The accounting policies contained in the FRoM follow International Financial Reporting Standards (IFRS) to the extent that it is meaningful and appropriate to the public sector. Where the FRoM permits a choice of accounting policy, the accounting policy which has been judged to be most appropriate to the particular circumstances of the APA for the purpose of giving a true and fair view has been selected. The Agency's accounting policies have been applied consistently in dealing with items considered material in relation to the Accounts.

The comparative accounting period commenced on launch of the APA on 7 December 2009. The accounting period end is 31 March 2010. Reference to the comparative period refers to the 3 months and 25 days accounting period for 2009-10.

#### 1.1 Changes in accounting policy and disclosures

##### *1.1.1 New and amended standards adopted by the Agency*

The Agency has adopted all existing standards and amendments applicable to the activities of the Agency in accordance with the FRoM from the start of the accounting period dated 1 April 2010.

The FRoM has removed the requirement to record a notional cost of capital for accounting periods beginning 1 April 2010. Actual costs may be charged by HM Treasury as they determine to be appropriate. The amendment has not resulted in a material impact on the Agency's resource accounts. See Note 1.13 below.

##### *1.1.2 Standards, amendments to and interpretations of existing standards that are not yet effective and have not been early adopted by the Agency*

There are no new standards or amendments to existing standards that have been published and are mandatory for the Agency's accounting period beginning 1 April 2011 and later periods.

#### 1.2 Accounting convention

These Accounts have been prepared under the historical cost convention modified to account for the revaluation of fixed assets.

## 1.3 Property, plant and equipment and intangible non-current assets

### 1.3.1 Measurement

Property, plant and equipment and intangible non-current assets are carried at cost on initial recognition. Cost includes all expenditure which is directly attributable to the acquisition of the items.

Subsequent costs are included in the asset's carrying amount or recognised as a separate asset, as appropriate, only when it is probable that future economic benefits associated with the item will flow to the APA and the cost of the item can be measured reliably. The carrying amount of the replaced part is derecognised. All other repairs and maintenance are charged to the Statement of Comprehensive Net Income during the period in which they are incurred.

All non-current assets are carried at historical cost less depreciation, with the exception of intangible assets. Intangible assets are carried at fair value in line with FReM which has adapted IAS 38 "Intangible Assets" to take into account considerations for not-for-profit entities. The lower of depreciated replacement cost and value in use is used as a proxy for fair value.

### 1.3.2 Recognition

The threshold for capitalising non-current assets is £5,000.

Development costs of computer software are recognised as intangible assets when they exceed the capitalisation threshold above and meet the following criteria:

- it is technically feasible to complete the software so that it will be available for use;
- management intends to complete the software and use or sell it;
- there is an ability to use or sell the software;
- it can be demonstrated how the software will generate probable future economic benefits;
- adequate technical, financial and other resources to complete the development and to use or sell the software are available; and
- the expenditure attributable to the software during its development can be reliably measured.

When the computer software is under development and meets the above criteria, it is classified as Asset Under Construction until launch, when it is transferred to Software.



## 1.4 Depreciation

The charge for depreciation is calculated to write down the cost or valuation of property, plant and equipment to their estimated residual values by equal instalments over their estimated useful lives, which are as follows:

Furniture, fixtures and fittings	3 years
Office and other non-IT equipment	3 years
Leasehold improvements	3 years
Computer and telecom hardware, software and licences	3 years
Other plant and machinery	3 years

Depreciation is charged in the month following acquisition up to the month prior to disposal.

The assets' residual values and useful lives are reviewed, and adjusted if appropriate, at the end of each reporting period.

Assets are assessed at each reporting date to determine if there is any indication that an asset may be impaired. If an indication exists and an asset's carrying amount is greater than its estimated recoverable amount, it is written down immediately to its recoverable amount.

## 1.5 Cash and cash equivalents

The APA does not hold any cash or cash equivalent balances. All cash transactions are processed by HM Treasury using HM Treasury's bank accounts.

## 1.6 Trade receivables and other current assets

Trade receivables and other current assets primarily consist of amounts due from participants within the APS and represent the recharge of the costs of the Agency. For the 31 March 2010 period end, participants had already paid for the recharge of costs of the Agency to 31 March 2010 and hence trade receivables and other current assets consisted primarily of prepayments. If collection is expected in one year or less, they are classified as current assets. If not, they are presented as non-current assets.

Trade receivables, except for those with public bodies, are recognised initially at fair value on initial recognition and subsequently measured at amortised cost using the effective interest method, less provision for impairment. In accordance with the FReM, trade receivables with public bodies are carried at historical cost less any impairment.

The Agency assesses at each balance sheet date whether there is objective evidence that a trade receivable or other current asset is impaired. An asset is impaired and impairment losses are incurred only if there

is objective evidence of impairment as a result of one or more events that occurred after the initial recognition of the asset (a “loss event”) and that loss event (or events) has an impact on the estimated future cash flows of the asset that can be reliably estimated.

The criteria that the Agency uses to determine whether there is objective evidence of an impairment loss include:

- delinquency in contractual payments of principal or interest;
- cash flow difficulties experienced by the counterparty (for example, equity ratio, net income percentage of sales);
- breach of loan covenants or conditions; and
- deterioration in the value of collateral.

The Agency first assesses whether objective evidence of impairment exists.

The amount of the loss is measured as the difference between the asset’s carrying amount and the present value of estimated future cash flows (excluding future credit losses that have not been incurred) discounted at the asset’s original effective interest rate. The carrying amount of the asset is reduced through the use of an allowance account in the Statement of Financial Position and the amount of the loss is recognised in the Statement of Comprehensive Net Income. If a loan has a variable interest rate, the discount rate for measuring any impairment loss is the current effective interest rate determined under the contract.

When an asset is uncollectible, it is written off against the related provision for asset impairment. Such assets are written off after all the necessary procedures have been completed and the amount of the loss has been determined.

If, in a subsequent reporting period, the amount of the impairment loss decreases and the decrease can be related objectively to an event occurring after the impairment was recognised (such as an improvement in the counterparty’s credit rating), the previously recognised impairment loss is reversed by adjusting the allowance account in the Statement of Financial Position and the amount of the reversal is recognised in the Statement of Comprehensive Net Income.

Trade receivables and other current assets are recognised when the rights to receive the cash flows from the asset or substantially all risks and rewards of ownership fall to the Agency.

Trade receivables and other current assets are de-recognised when the rights to receive cash flows from the asset have expired or where the Agency has transferred substantially all risks and rewards of ownership.

The fair value of trade receivables with a maturity of less than one year is assumed to approximate their book values.

### 1.7 Trade payables and other current liabilities

Trade payables and other current liabilities are obligations to pay for goods or services that have been acquired in the ordinary course of business from suppliers. Payables are classified as current liabilities if payment is due within one year or less. If not, they are presented as non-current liabilities.

Trade payables and other current liabilities are recognised initially at fair value and subsequently measured at amortised cost using the effective interest method.

Trade payables and other current liabilities are recognised when the Agency enters into an obligation.

Trade payables and other current liabilities are de-recognised when they are extinguished, that is, when the obligation is discharged, cancelled or expires.

The fair value of trade payables and other current liabilities with a maturity of less than one year is assumed to approximate their book values.

### 1.8 Financial instruments

The Agency recognises, measures and discloses financial instruments following guidance in the FReM and IFRS.

#### 1.8.1 Definition of financial instruments

A financial instrument is any contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity.

A financial asset is any asset that is cash, an equity instrument of another entity, a contractual right to receive cash or another financial asset from another entity, or a contractual right to exchange financial instruments with another entity under conditions that are potentially favourable.

A financial liability is any liability that is a contractual obligation to deliver cash or another financial asset to another entity, or a contractual obligation to exchange financial instruments with another entity under conditions that are potentially unfavourable.

An equity instrument is any contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities.

### *1.8.2 Categories of Financial Instruments*

Based upon the guidance in IFRS, financial instruments have been classified into the following three categories, which are determined at initial recognition:

- derivatives at fair value through Statement of Comprehensive Net Income;
- loans and receivables; and
- available-for-sale financial assets.

#### *Derivatives at fair value through Statement of Comprehensive Net Income*

A derivative is a financial instrument or other contract within the scope of IAS 39 if it has all three of the following characteristics:

- its value changes in response to a change in the value of the underlying;
- it requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors; and
- it is settled at a future date.

The Agency does not hold any derivatives.

#### *Loans and receivables*

Loans and receivables are non-derivative financial assets with fixed or determinable payments that are not quoted in an active market, other than those that the Agency upon initial recognition designates as available-for-sale financial assets.

The Agency does not hold any loans and receivables, other than those classified under trade receivables; see Note 9.

#### *Available-for-sale financial assets*

Available-for-sale financial assets are non-derivative financial assets that are either designated in this category or not classified in any other categories and are intended to be held for an indefinite period of time and may be sold in response to needs for liquidity or changes in interest rates, FX rates or equity prices.

The Agency does not hold any available-for-sale financial assets.

### 1.9 Provisions, contingent liabilities and contingent assets

A provision is recognised when the following three criteria are met in line with IAS 37 – Provisions, Contingent Liabilities and Contingent Assets:

- there is a present obligation (either legal or constructive) as a result of a past event;
- it is probable that a transfer of economic benefits will be required to settle the obligation; and
- a reliable estimate can be made of the amount of the obligation.

The amount recognised as a provision is the best estimate of the expenditure required to settle the present obligation at the balance sheet date.

The discount rate applied to general provisions is 2.2 per cent, which is in line with the guidance issued by Public Expenditure System paper PES(2004) 04.

In accordance with IAS 1 Presentation of Financial Statements, provisions are separated into current and non-current.

Generally, contingent liabilities and contingent assets are not recognised as liabilities or assets in the Statement of Financial Position, but are shown as a separate note. A contingent liability is disclosed in the Notes to the Accounts when the possibility of an outflow of economic benefit to settle the obligation is more than remote. A contingent asset is disclosed in the Notes to the Accounts when an inflow of economic benefit is probable.

In addition to contingent liabilities disclosed in accordance with IAS 37, the Agency discloses for parliamentary reporting and accountability purposes certain statutory and non-statutory contingent liabilities where the likelihood of a transfer of economic benefit is remote, but which have been reported to Parliament in accordance with the requirements of Managing Public Money.

Where the time value of money is material, the contingent liabilities and assets which are required to be disclosed under IAS 37 are stated at discounted amounts and the amount reported to Parliament separately noted. Contingent liabilities that are not required to be disclosed by IAS 37 are stated at the amounts reported to Parliament.

### 1.10 Revenue recognition and operating income

Revenue is recognised when the amount of revenue can be reliably measured and it is probable that future economic benefits will flow to the Agency. Revenue comprises the fair value of consideration received or receivable and is shown net of VAT.

Operating income relates directly to the operating activities of the Agency. It includes recharges to participants in the APS for the cost for services incurred by the Agency.

### 1.11 Deferred income

Income is recognised by reference to the stage of completion of a transaction or asset at the end of the reporting period in line with IAS 18. Where payment has been received which is greater than the income to be recognised by reference to the stage of completion of the transaction or asset, this is deferred within the Statement of Financial Position. The deferred income is released to the Statement of Comprehensive Net Income as income to match the expense of the transaction or asset.

### 1.12 Administration and programme expenditure

All expenditure is classified as administration. Net administration costs reflect the costs of running the Agency. No programme costs have been incurred.

### 1.13 Capital charge

A non-cash credit, reflecting the cost of capital utilised by the Agency, was included in operating costs for the period to 31 March 2010. As noted in 1.1.1 above, from 1 April 2010 onwards the Agency is not required to record a notional cost of capital charge. However, an expense adjustment was made in 2010-11 to offset the Cost of Capital credit in 2009-10. This change in accounting policy has not affected the net operating costs or reserves.

### 1.14 Pensions

The provisions of the Civil Service pension schemes, which are described in Note 3.2, cover some employees. The defined benefit schemes are unfunded and are contributory. The Agency recognises the expected cost of these elements on a systematic and rational basis over the period during which it benefits from employees' services, by payment to the defined benefit schemes of amounts calculated on an accruing basis. Liability for payment of future benefits is a charge on the defined benefit schemes. In respect of the defined contribution schemes, which cover some employees, the Agency recognises the contributions payable for the year.

### 1.15 Early departure costs

The Agency is required to meet the additional costs of benefits beyond the normal Principal Civil Service Pension Scheme (described in Note 3.2) benefits in respect of employees who retire early. The Agency provides for the costs when the early retirement is agreed and binding on the Agency, effectively charging the full cost at the time of the decision and holding this in a provision. There have been no early retirements to date.

### 1.16 Employee benefits

The Agency has provided for the cost of accumulating compensated absences. This is accounted for when an employee renders services that increase their entitlement to future compensated absences. This accrual is monitored on a yearly basis.

### 1.17 Leases

Leases in which a significant proportion of the risks and rewards of ownership are retained by the lessor are classified as operating leases. Operating leases are charged to the Statement of Comprehensive Net Income on a straight-line basis over the term of the lease.

### 1.18 VAT

Many activities of the Agency are outside the scope of VAT and, in general, output tax does not apply and input tax on purchases is not recoverable. Where VAT is recoverable in respect of APA expenditure, it is recovered by HM Treasury. Irrecoverable VAT is charged to the relevant expenditure category or included in the capitalised purchase cost of non-current assets. Where output tax is charged or input VAT is recoverable, the amounts are stated net of VAT.

## 2. Critical accounting estimates and judgements

Estimates and judgements are continually evaluated and are based on historical experience and other factors, including expectations of future events that are believed to be reasonable under the circumstances.

### 2.1 Critical accounting estimates and assumptions

No estimates or assumptions have been identified which have a significant risk of causing a material adjustment to the carrying amounts of assets and liabilities within the next financial year.

### 2.2 Critical judgements in applying the Agency's accounting policies

There are no critical judgements identified in applying the Agency's accounting policies.

### 3. Staff numbers and costs

#### 3.1 Analysis of total costs over categories

	2010-11	2010-11	2010-11	2009-10
	Permanent staff	Others	Total	Total
	£000	£000	£000	£000
Wages and salaries	322	5,358	5,680	1,338
Social security costs	39	421	460	53
Accrued employee benefits	7	116	123	15
Other pension costs	65	49	114	19
<b>Total costs</b>	<b>433</b>	<b>5,944</b>	<b>6,377</b>	<b>1,425</b>
Less recoveries (income) in respect of outward secondments	-	-	-	-
<b>Total net costs</b>	<b>433</b>	<b>5,944</b>	<b>6,377</b>	<b>1,425</b>

Permanent staff includes those on a permanent contract of employment with the Agency, either on part-time or full-time contracts. Others include those who are on fixed term contracts with the Agency and also those who are seconded or contracted to the Agency. The Agency is not liable to social security costs, pension costs or other accrued employee benefits for those seconded or contracted to the Agency and hence their full cost is recorded within the wages and salaries row above.

#### 3.2 Pension schemes

The Principal Civil Service Pension Scheme is an unfunded multi-employer defined benefit scheme but the Agency is unable to identify its share of the underlying assets and liabilities. The Scheme Actuary (Hewitt Bacon Woodrow) valued the scheme as at 31 March 2007. Details can be found in the Resource Accounts of the Cabinet Office: Civil Superannuation [www.civilservice-pensions.gov.uk](http://www.civilservice-pensions.gov.uk).

For 2010-11, employer's contributions of £51,288 were payable to the unfunded multi-employer defined benefit scheme at one of four rates in the range 16.7 to 24.3 per cent of pensionable pay, based on salary bands. For 2009-10, employer's contributions of £12,834 were payable to the unfunded multi-employer defined benefit scheme at one of four rates in the range 16.7 to 24.3 per cent of pensionable pay, based on salary bands. The Scheme Actuary reviews employer contributions every four years following a full scheme valuation. The contribution rates are set to meet the cost of the benefits accruing during 2010-11 to be paid when the member retires, and not the benefits paid during this period to existing pensioners.

Employees can opt to open a partnership pension account, which is a stakeholder pension with an employer contribution. Employer's contributions were paid to one or more of a panel of three appointed stakeholder pension providers for the period of £10,413 (2009-10: nil). Employer contributions are age-related and range from 3.0 to 12.5 per cent of pensionable pay. Employers also match employee contributions up to 3 per cent of pensionable pay.



One employee, Stephan Wilcke the APA's Chief Executive, has opted to have employer pension contributions at 20 percent of pensionable pay paid into a private pension outside the civil service pension scheme. Total employer contributions for the period were £30,000 (2009-10 : £15,250).

In addition, employer contributions of £22,146, being 0.8 per cent of pensionable pay, were payable to the partnership pension providers to cover the cost of the future provision of lump sum benefits on death in service and ill health retirement of all employees.

Contributions due to the partnership pension providers at the balance sheet date were £13,046 (31 March 2010: £2,085). Contributions prepaid at that date were nil (31 March 2010: nil).

### 3.3 Average number of persons employed

The average number of full-time equivalent persons employed during the year was as follows:

	<b>2010-11</b>	<b>2009-10</b>
	<b>Number</b>	<b>Number</b>
Permanent staff	2.0	1.3
Others	42.6	36.5
<b>Total</b>	<b>44.6</b>	<b>37.8</b>

Permanent staff includes those on a permanent contract of employment with the Agency, either on part-time or full-time contracts. Others include those who are on fixed term contracts with the Agency and also those who are seconded or contracted to the Agency.

**4. Other administration costs**

	<b>2010-11</b>	<b>2009-10</b>
	<b>£000</b>	<b>£000</b>
Consultancy costs	5,517	1,856
Accommodation costs	98	51
Office services	801	183
Staff-related costs, including recruitment, training and travel	248	66
Rentals under operating leases	443	144
<b>Total</b>	<b>7,107</b>	<b>2,300</b>
<b>Non cash items</b>		
Depreciation and similar charges:		
Auditor's remuneration and expenses	23	15
Cost of capital reversal	27	-
Depreciation	1,209	103
<b>Total non cash items</b>	<b>1,259</b>	<b>118</b>
<b>Total</b>	<b>8,366</b>	<b>2,418</b>

No payments were made to the auditor in respect of non-audit services.

Within consulting costs for 2009-10, £317,765 was expensed as research and development costs of APA software which did not meet the criteria for capitalisation under IAS 38. Nil in 2010-11.

## 5. Income

### Operating income analysed by activities:

	<b>2010-11</b>		<b>2009-10</b>
	<b>Appropriated in Aid</b>	<b>Payable to Consolidated Fund</b>	<b>Income included in SCNI</b>
	<b>£000</b>	<b>£000</b>	<b>£000</b>
Fee income	<b>(14,743)</b>	-	<b>(14,743)</b>
			<b>(3,816)</b>

Fee income relates solely to the recharge of total operating costs to RBS.

## 6. Analysis of operating segments and fees and charges for the period to 31 March 2011

The Agency applies IFRS 8 and considers it has one operating segment. The segment's income and expenses are stated in the Statement of Comprehensive Net Income, and the segment's assets and liabilities are stated in the Statement of Financial Position.

All fee income disclosed in Note 5 arises in relation to the APA's function of operating the APS. All costs included within Note 4 are incurred to enable the APA to meet that function.

## 7. Property, plant and equipment

	Leasehold Improvement £000	Furniture & Equipment £000	IT Equipment £000	Total £000
<b>Cost/valuation</b>				
At 1 April 2010	28	100	211	339
Transfers	-	-	-	-
Additions	-	-	9	9
Impairments	-	-	-	-
Disposals	-	-	-	-
<b>At 31 March 2011</b>	<b>28</b>	<b>100</b>	<b>220</b>	<b>348</b>
<b>Accumulated depreciation</b>				
At 1 April 2010	(3)	(16)	(11)	(30)
Transfers	-	-	-	-
Charge in period	(10)	(34)	(74)	(118)
Impairments	-	-	-	-
Released on disposal	-	-	-	-
<b>At 31 March 2011</b>	<b>(13)</b>	<b>(50)</b>	<b>(85)</b>	<b>(148)</b>
Net book value 31 March 2010	25	84	200	309
<b>Net book value 31 March 2011</b>	<b>15</b>	<b>50</b>	<b>135</b>	<b>200</b>

All assets above are owned by the Agency.

## 8. Intangible assets

	<b>Asset Under Construction</b>	<b>Software</b>	<b>Total</b>
	<b>£000</b>	<b>£000</b>	<b>£000</b>
<b>Cost/valuation</b>			
At 1 April 2010	1,055	1,559	2,614
Additions	1,576	-	1,576
Transfers	(2,631)	2,631	-
Disposals	-	-	-
<b>As at 31 March 2011</b>	<b>-</b>	<b>4,190</b>	<b>4,190</b>
<b>Accumulated depreciation</b>			
At 1 April 2010	-	(73)	(73)
Charge in period	-	(1,092)	(1,092)
Disposals	-	-	-
<b>As at 31 March 2011</b>	<b>-</b>	<b>(1,165)</b>	<b>(1,165)</b>
Net book value as at 31 March 2010	1,055	1,485	2,540
<b>Net book value as at 31 March 2011</b>	<b>-</b>	<b>3,025</b>	<b>3,025</b>

All assets above are owned by the Agency.

The Asset Under Construction at 1 April 2010 included £835,486 of accruals which were invoiced and paid in 2010-11. There were no capital accruals in 2010-11.

## 9. Trade receivables and other current assets

### 9.1 Analysis by type

	2011	2010
	£000	£000
<b>Amounts falling due within one year</b>		
Trade receivables	-	-
Deposits and advances	2	22
Prepayments and accrued income	3,060	298
	<u>3,062</u>	<u>320</u>
<b>Amounts falling due after more than one year</b>		
Other receivables	-	-
	-	-
<b>Total</b>	<u>3,062</u>	<u>320</u>

The prepayments and accrued income balance has increased from 31 March 2010 to 31 March 2011 as a result of RBS having paid HM Treasury in advance for APA expenses at 31 March 2010 and that not being the case at 31 March 2011. This results in an accrued income balance due from RBS at 31 March 2011 of £2,480,000 for which there is no comparative balance at 31 March 2010.

### 9.2 Intra government balances

	Amounts falling due within one year	Amounts falling due after more than one year	Amounts falling due within one year	Amounts falling due after more than one year
	2011	2011	2010	2010
	£000	£000	£000	£000
Balances with other central government bodies	-	-	-	-
Balances with public corporations and trading funds	-	-	-	-
<b>Sub total: intra government balances</b>	-	-	-	-
Balances with bodies external to government	3,062	-	320	-
<b>Total receivables as at 31 March</b>	<u>3,062</u>	-	<u>320</u>	-

## 10. Trade payables and other current liabilities

### 10.1 Analysis by type

<b>Amounts falling due within one year</b>		
	<b>2011</b>	<b>2010</b>
	<b>£000</b>	<b>£000</b>
Trade payables	(62)	(246)
Other payables	-	-
Other taxation and social security	(164)	(70)
Accruals	(1,105)	(3,429)
Deferred income	(1,514)	(1,301)
Accrued annual leave	(123)	(15)
<b>Total</b>	<b>(2,968)</b>	<b>(5,061)</b>

Within accruals as at 31 March 2010. £835,486 relates to accruals for software to be capitalised as an Asset Under Construction, see Note 8. There were no capital accruals in 2010-11.

<b>Amounts falling due after more than one year</b>		
	<b>2011</b>	<b>2010</b>
	<b>£000</b>	<b>£000</b>
Deferred income	(1,711)	(3,159)
<b>Total</b>	<b>(1,711)</b>	<b>(3,159)</b>

#### *Deferred income:*

During 2009, RBS and Lloyds Banking Group (LBG) paid for the set-up costs of the APS and the APA. Payment for the acquisition of capital assets was not taken to the Statement of Comprehensive Net Income as income but deferred as deferred income. A portion of these set-up costs related to the software build costs. The software build costs were spread over 2009 and 2010, and hence a portion of the fee paid by RBS and LBG related to expenses yet to be incurred as at 31 March 2010. That portion of the fee was deferred as deferred income. These costs were substantially all incurred in 2010-11 as capital purchases (see Note 8). The deferred income is released to the Statement of Comprehensive Net Income to match the expense to which it relates. The deferred income relating to capitalised assets is released to the Statement of Comprehensive Net Income to match depreciation of the software asset.

## 10.2 Intra-government balances

	Amounts falling due within one year 2011 £000	Amounts falling due after more than one year 2011 £000	Amounts falling due within one year 2010 £000	Amounts falling due after more than one year 2010 £000
Balances with other central government bodies	(298)	-	(111)	-
Balances with public corporations and trading funds	-	-	-	-
<b>Sub total: intra-government balances</b>	<b>(298)</b>	<b>-</b>	<b>(111)</b>	<b>-</b>
Balances with bodies external to government	(2,670)	(1,711)	(4,950)	(3,159)
<b>Total payables as at 31 March</b>	<b>(2,968)</b>	<b>(1,711)</b>	<b>(5,061)</b>	<b>(3,159)</b>

## 11. Provisions for liabilities and charges

The Agency meets the additional costs of benefits beyond the normal benefits in respect of employees who retire early by paying the required amounts annually to the relevant scheme over the period between early departure and normal retirement date. The Agency provides for this in full when the early retirement programme becomes binding by establishing a provision for the estimated payments discounted by the HM Treasury discount rate. As at 31 March 2011 there were no early retirements and hence no provision recognised.

There were no other provisions for liabilities and charges as at 31 March 2011.

## 12. Capital commitments

There were no capital commitments as at 31 March 2011.



### 13. Commitments under operating leases

The table below states the Agency's operating lease rental commitments within the time periods set out below.

	2011	2010
	£000	£000
<b>Buildings:</b>		
Within one year	337	331
Two to five years	786	1,103
More than five years	-	-
	<b>1,123</b>	<b>1,434</b>
<b>Other:</b>		
Within one year	78	71
Two to five years	35	75
More than five years	0	0
	<b>113</b>	<b>146</b>

The building lease has a six month break clause, where the Agency is only liable to pay for the six month notice period at a cost of £169,000.

### 14. Reconciliation of working capital other than cash for the cash flow statement

	2011	2010
	£000	£000
<b>Movements in working capital other than cash:</b>		
(Increase) in current trade receivables	(2,742)	(320)
(Decrease)/Increase in current trade payables	(1,259)	4,226
(Decrease)/Increase in non-current trade payables	(1,448)	3,159
Changes in working capital other than cash	<b>(5,449)</b>	<b>7,065</b>

## 15. Financial instruments

As the cash requirements of the Agency are met through the Estimate process and managed by HM Treasury, financial instruments play a more limited role in creating and managing risk than would apply to a non-public sector body. The majority of financial instruments relate to contracts to buy non-financial items in line with the Agency's expected purchase and usage requirements and the Agency is therefore exposed to little credit, liquidity or market risk.

## 16. Contingent assets and liabilities

The Agency had no contingent assets as at 31 March 2011.

The APA is a finite life organisation of uncertain duration. RBS has publicly stated that "Our baseline planning scenario is to exit [the APS] once our fees are fully amortized in late 2012. This will, of course, be subject to regulatory approval." APA management have determined that no provisions are required at 31 March 2011 in respect of the finite life of the Agency. The Agency has no other contingent liabilities as at 31 March 2011.

## 17. Related party transactions

The Asset Protection Agency is an executive agency of HM Treasury. HM Treasury is regarded as a related party. During the reporting period, the Agency had a number of material transactions with HM Treasury and with other entities for which HM Treasury is regarded as the parent Department. The principal transaction was a Service Level Agreement that was entered into between HM Treasury, the Debt Management Office (DMO) and the Agency. The DMO is an executive agency of HM Treasury and is a related party of the Agency. Under this Service Level Agreement the DMO provides IT support and facilities services to the Agency. All costs are recharged to the Agency on a commercial basis.

### *Royal Bank of Scotland*

HM Treasury has a 67 per cent stake in the voting share capital of RBS, and as such RBS is a related party of the Agency. During the reporting period RBS made payments to the Agency in respect of the recharge of the Agency's costs. Before commencement of the Agency, RBS also made payments to HM Treasury in respect of the recharge of HM Treasury's costs in setting up the Agency.

### *Lloyds Banking Group*

HM Treasury has a 43 per cent stake in the voting share capital of LBG, and as such LBG is a related party of the Agency. Before commencement of the Agency, LBG made payments to HM Treasury in respect of the recharge of HM Treasury's costs in setting up the Agency.

In addition, the Agency had a small number of transactions during the reporting period with other government departments and other central government bodies, and entities included within the Whole of Government Accounts. Most of these transactions have been with the Financial Services Authority, the Government Actuary's Department and the Government Car and Dispatch Agency.

Senior management have confirmed to the Agency's Chief Executive Officer that they have not entered into any transaction with related parties which are not in the ordinary course of business, or which are at preferential rates. The Chief Executive Officer has also confirmed that he has not entered into any transaction with related parties which were not in the ordinary course of business or which are at preferential rates.

There were no transactions with LBG in the reporting period.

### **Post balance sheet events**

The financial statements were authorised for issue on 14 July 2011.



## 8 Remuneration Report

### 8.1 Remuneration policy

The APA requires staff with specialist financial and technical expertise. Before the APA's launch, HM Treasury ran a compensation bench-marking exercise to determine the level of remuneration and benefits needed to attract candidates with the requisite skills. On the basis of the bench-marking exercise, HM Treasury Operations Committee approved the pay principles to be adopted in setting salary ranges and the packages for the senior APA staff disclosed below were approved by the Cabinet Office.

### 8.2 Remuneration Committee

The APA Remuneration Committee exists to advise the Chief Executive and Advisory Board on remuneration for APA staff and to give HM Treasury such advice as they may seek on pay and bonus recommendations in respect of the Chief Executive. The members of the Remuneration Committee are John B. Caouette and Hamish Buckland. The Chief Executive also attends meetings of the Remuneration Committee except where his own performance is being discussed.

### 8.3 Service contracts

Civil service appointments are made in accordance with the Civil Service Commissioners' Recruitment Code, which requires appointments to be on merit and on the basis of fair and open competition, but also includes details of the circumstances when appointments may otherwise be made. Further information about the work of the Civil Service Commissioners can be found at [www.civilservicecommissioners.gov.uk](http://www.civilservicecommissioners.gov.uk).

The majority of the employees at the APA are appointed on fixed term appointment basis, receive a basic salary, and are eligible to be considered for bonuses based on performance. However, due to the modified terms and conditions of their employment, they are not eligible for any employer pension contributions to their salary. Employees on secondment from other Government departments retain the terms and conditions of their home department.

As permanent staff members, the Chief Executive and Chief Financial and Operating Officer are eligible for pension contributions as detailed below. Independent members of the Advisory Board are appointed in accordance with Cabinet Office guidance and paid on a fee arrangement only.

### 8.4 Remuneration received

The following sections provide details of the salaries and pension entitlements of the most senior civil servants as a result of their employment by APA and their influence on managing or controlling the activities of the APA. This report is based on payments made by the APA and subsequently recorded in the Accounts of the APA. These disclosures have been subject to external audit.

Table I sets out the salary paid by the APA to senior APA staff and fees paid to members of the Advisory Board for their services to the APA. Salary includes gross salary or fees, performance pay or bonuses,

overtime and any other allowance to the extent that it is subject to UK taxation for the year ended 31 March 2011.

There were no pay increases awarded during the reporting period in accordance with the Civil Service freeze in pay.

**Table 1 APA senior staff salaries and Advisory Board fees**

	Note	2010-11 £000 Salary	2009-10 £000 Salary (Full Year Equivalent (FYE))
<b>Senior APA staff</b>			
Stephan Wilcke - Chief Executive	(1)	145 - 150	45 -50 (145 - 150)
Bill Dickinson - Chief Financial and Operating Officer (from 1 March 2010)	(2)	135 - 140	10 - 15 (135 - 140)
Jens Bech – Chief Risk Officer	(3)	160 - 165	50 – 55 (160 - 165)
Ion Dagtoglou – Chief Investment Officer	(3)	160 - 165	50 – 55 (160- 165)
Brian Scammell	(4)	130 - 135	30 - 35 (130 – 135)
<b>Advisory Board members</b>			
John B. Caouette	(5)	10 - 15	0 - 5 (10 – 15)
Hamish Buckland	(6)	65 - 70	10 - 15 (80 – 85)

Notes:

(1) Stephan Wilcke is employed on a permanent contract from 28 September 2009 and has been the APA's Chief Executive since the APA's launch on 7 December 2009. He has opted to have employer pension contributions at 20 per cent of pensionable pay paid into a private pension outside the civil service pension scheme. Total employer contributions for the period were £30,000 (2009-10: £15,250).

(2) Bill Dickinson is employed on a permanent contract from 22 February 2010, taking up his office as Chief Financial and Operating Officer from 1 March 2010. The APA makes employer contributions to the Nuvos scheme. As at 31 March 2011, the accrued pension and related lump sum (as at the age of 65) was within the banding £2,501-5,000 (2009-10: within the banding £0-£2,500). The CETV of his pensions as at 31 March 2011 was £37,651 (31 March 2010: £10,315). The actuarial factors used to calculate CETV were changed in 2010-11. The CETVs at 31 March 2010 and 31 March 2011 have both been calculated using the new factors, for consistency. The CETV at 31 March 2010 therefore differs from the corresponding figure in last year's report, which was calculated using the previous factors.

(3) Jens Bech and Ion Dagtoglou were employed on 30 November 2009 on four year fixed term contracts. They are not eligible for employer pension contributions.

(4) Brian Scammell was employed from 4 January 2010 as a Chief Credit Officer on a two year fixed term contract on a 4 day week basis. His salary disclosed above (including FYE) is on a 4 day week basis. He is not eligible for employer pension contributions.

(5) John B. Caouette was appointed as a member of the Advisory Board on 18 March 2010 on a one year fixed term contract. The APA exercised an option to extend this contract for the 12 months to 17 March 2012. He receives a fee within the banding £10,000 - £15,000 per annum.

(6) Hamish Buckland was employed as a Chief Credit Officer until 31 January 2011, for which his salary fell in the banding £55,000 - £60,000. During this financial period he also served as a member of the Advisory Board on the basis of a one year fixed term contract. This fixed term contract ended on 17 March 2011 and the APA exercised its option to extend the contract for a further 12 months to 17 March 2012. He receives a fee within the banding £10,000 - £15,000 per annum for his services as a member of the Advisory Board

### *Performance bonuses*

At the end of the reporting period, performance appraisals were undertaken in line with Civil Service appraisal and performance award policies. Stephan Wilcke has waived any bonus for the period. To date, no bonus awards have been made to members of the Leadership Team in respect of the period to 31 March 2011 (£26,000 for the period to 31 March 2010, details of which are disclosed in the 2009-10 APA Annual Report). The extent of any bonus to members of the Leadership Team is the subject of further discussion with HM Treasury. The APA financial statements, for the year to 31 March 2011 include an accrual of £120,400 for the estimate of the bonus that may be paid to members of the Leadership Team for the year to 31 March 2011. Individual performance bonus awards to other members of APA staff of £179,398 were approved by the Remuneration Committee on 13 May 2011 in respect of the period to 31 March 2011 (£4,535 for the period to 31 March 2010).

### *Chairman of the Audit and Risk Committee and other senior APA staff*

Michael Ashley was appointed as Chairman of the Audit and Risk Committee in March 2010. He does not receive remuneration from the APA.

Lucy Wylde acted as General Counsel throughout the reporting period whilst on secondment from Slaughter and May. Slaughter and May were paid a fee of £79,476 (2009-10: £25,340), excluding VAT, for her services.

## **8.5 Notice periods**

Senior APA staff (excluding Advisory Board members and Chief Credit Officers) are entitled to give three months' notice to terminate their employment.

For all senior APA staff, the APA is entitled to give five weeks' notice (extended by one week per year over four years of continuous service) if retired on age grounds, if dismissed on grounds of inefficiency, or if dismissal is the result of disciplinary proceedings in circumstances where summary dismissal is not justified. If retired on medical grounds, the period of notice is up to nine weeks. If employment is terminated compulsorily on any other grounds, unless such grounds justify summary dismissal at common law or summary dismissal is the result of disciplinary proceedings, six months' notice must be given, other than for Stephan Wilcke for whom the notice period was 12 months if notice had been given before 28 March 2011 and is now six months.

If employment is terminated without the notice periods above, having regard to the reason for such termination, compensation will be paid in accordance with the relevant provisions of the Civil Service Compensation Scheme.

Members of the Advisory Board and Chief Credit Officers are entitled to give one month's notice. The APA is entitled to give one month's notice.

## 8.6 Civil Service pensions

Pension benefits are provided through the Civil Service pension arrangements. Further details about the Civil Service pension arrangements can be found at the website [www.civilservice-pensions.gov.uk](http://www.civilservice-pensions.gov.uk).

### 8.6.1 Cash Equivalent Transfer Value

A Cash Equivalent Transfer Value (CETV) is the actuarially assessed capitalised value of the pension scheme benefits accrued by a member at a particular point in time. The benefits valued are the member's accrued benefits and any contingent spouse's pension payable from the scheme. A CETV is a payment made by a pension scheme or arrangement to secure pension benefits in another pension scheme or arrangement when the member leaves a scheme and chooses to transfer the benefits accrued in their former scheme. For the senior management's pension entitlements from the Civil Service Pension Scheme, the pension figures shown relate to the benefits that the individual has accrued as a consequence of their total membership of the pension scheme, not just their service in a senior capacity to which disclosure applies. The CETV figures include the value of any pension benefit in another scheme or arrangement which the individual has transferred to the Civil Service Pension Scheme arrangements and for which the Cabinet Office's Civil Superannuation Vote has received a transfer payment commensurate with the additional pension liabilities being assumed. They also include any additional pension benefit accrued to the member as a result of their purchasing additional years of pension service in the scheme at their own cost. CETVs are calculated in accordance with the Occupational Pension Scheme (Transfer Values) (Amendment) Regulations and do not take account of any actual or potential reduction to benefits resulting from Lifetime Allowance Tax which may be due when pension benefits are taken.

### 8.6.2 Real increase in CETV

This reflects the increase in CETV effectively funded by the employer. It does not include the increase in accrued pension due to inflation, contributions paid by the employee (including the value of any benefits transferred from another pension scheme or arrangement) and uses common market valuation factors for the start and end of the period.

#### **Stephan Wilcke**

Chief Executive

12 July 2011



The contents of this section have not been audited

## Annex A – The APA and the APS

### A.1 The APA

The APA is an executive agency of HM Treasury, which was established to operate the APS.

#### A.1.1 Responsibilities and objectives

The APA has three principal responsibilities, which are set out in the APA's Framework Document:

1. ensuring that each participating financial institution complies with the terms and conditions attaching to its participation in the Scheme, including through:
  - proactive and timely exercise of HM Treasury's rights under the Scheme; and
  - engagement with participating financial institutions to determine appropriate asset management strategies for Covered Assets;
2. forecasting potential future payouts under the Scheme; and
3. verifying losses and recoveries on Covered Assets and advising HM Treasury on any payments to be made under the Scheme.

RBS is currently the only participating financial institution.

The APA's overriding objective is to protect the taxpayer's interest. This breaks down into more specific operational objectives. The operational objectives for the period this report covers were set out in the APA's Business Plan for 2010-11.

#### A.1.2 Structure and operations

The APA's operating model is a small core of permanent in-house staff, supported as necessary by external experts. This model was adopted in light of the complexity and unprecedented nature of the APS, as well as the likely short-term duration of the Scheme, which will depend on such factors as the success of RBS management strategies and the rate of sustainable recovery in the UK and global economies.

All costs incurred by the APA in managing and administering the APS, including fees for external professional support and staff costs, are passed on to RBS under the terms of its participation in the Scheme.

As an executive agency, the APA operates at arm's length from Ministers despite being legally and constitutionally part of HM Treasury. The Chancellor of the Exchequer determines the policy and financial framework within which the Agency operates, but delegates operational decision and day-to-day management of the Agency to the Chief Executive. This governance structure allows the APA to act purely

in furtherance of the specified Asset Management Objective (AMO) or to reduce risk to the taxpayer, and enables RBS to continue to conduct its daily operations along free-market principles.

## A.2 The APS

### A.2.1 Background

Announced in January 2009, the APS was created to enable the Government to provide participating institutions with protection against future credit losses on defined portfolios of assets in exchange for a fee. By limiting potential losses in this way, the Government aimed to support the stability of the UK financial system by:

- increasing confidence in the participating financial institutions; and
- improving their capacity to lend to creditworthy businesses and individuals.

The confidence provided by the APS, and improved market conditions allowed LBG to exit the APS after raising sufficient capital privately. RBS remains the sole participant of the APS.

### A.2.2 How the Scheme works

At inception of the Scheme HM Treasury agreed to provide protection for £286bn of assets (Covered Assets) which were on the consolidated balance sheet of The Royal Bank of Scotland Group plc (RBSG) as at 31 December 2008. Protection is provided to the extent that overall Losses on these assets, net of Recoveries, exceed a First Loss Amount of £60bn.

Under the Conditions, RBS bears all Losses on the Covered Assets up to the First Loss Amount. If total Losses net of Recoveries exceed the First Loss Amount, then HM Treasury will pay to RBS 90 per cent of the excess amount above net £60bn.

The Conditions were originally developed for more than one participant and were therefore kept relatively generic, objective and applicable to different banks. Specifically, this meant that they were not aligned with RBS's internal "business-as-usual" processes and will not benefit RBS upon its eventual exit from the APS. Recently, the APA has entered into a legal agreement to align the operation of the Scheme more closely with RBS's regular "business-as-usual" finance and risk management processes whilst maintaining economic equivalence to the existing Scheme.

A Loss arises when a Covered Asset is the subject of a Trigger. Bespoke arrangements are in place where appropriate, but in broad terms the Triggers are:

- Failure to Pay, i.e. an Obligor has failed to pay an amount due on the Covered Asset (after a specified grace period);

- Bankruptcy, i.e. an Obligor in respect of a Covered Asset has become bankrupt or insolvent, has winding-up or liquidation proceedings instigated against it, has been subject to the appointment of a liquidator or administrator, has a secured party take possession of any of its assets or has a legal process enforced against it in connection with the enforcement of Security for that Covered Asset; and
- Restructuring, i.e. a Covered Asset is restructured (such as, for example, through the implementation of a debt for equity swap) and it was or thereby becomes (or accounting rules would require it to be or become) the subject of a specific accounting impairment;

or for most portfolios of Covered Assets in RBS's Global Banking & Markets Division and the Corporate and Commercial business within its Corporate Banking Division:

- occurrence of an adverse credit event (impairment or its equivalent or default status for regulatory purposes) (the "AV Trigger").

When a Covered Asset is the subject of a Trigger, HM Treasury is entitled to receive 90 per cent of any Recoveries relating to that asset. Any payments due from HM Treasury to RBS in respect of Losses on Covered Assets are deferred for at least two years from the time that the Loss occurs. This deferral period allows the APA to verify Loss claims and, where applicable, gives time for Recoveries on the assets to have been realised before payment is made. For Covered Assets subject to the AV Trigger and certain other Long Dated Assets, however, calculation of Losses and Recoveries is measured on a "net" impairment (or equivalent) approach taking into account future expected recoveries in respect of the relevant asset rather than on the basis of a gross loss followed by subsequent recognition of recoveries on a "cash" basis.

Both measures of Losses and Recoveries are expected to trend to the same economic outcomes. The change to the AV Trigger and impairment (or equivalent) measure of Loss for certain Covered Assets has made it less likely, however, that a situation will arise in which RBS receives temporary cash payments from HM Treasury which it will subsequently have to repay.

RBS is obliged to pay fees to HM Treasury for so long as it receives protection under the Scheme. For the first three years of the APS (from 2009), these fees are £700m per year; thereafter they are £500m per year until 31 December 2099. RBS paid £1.4bn of fees on 31 December 2009 in respect of the years 2009 and 2010 and a further £700m on 31 December 2010 in respect of 2011; thereafter fees are payable quarterly.

To leave the APS before 31 December 2099, RBS must pay back any payments it has received under the Scheme, plus a minimum of £2.5bn, less any APS fees already paid. RBS will also require the approval of the FSA.

### A.2.3 Oversight and monitoring by the APA

RBS is required to manage Covered Assets in accordance with a combination of overarching and detailed requirements. The primary overarching requirement is to manage and administer the Covered Assets in accordance with the Asset Management Objective (AMO), which is broadly to maximise their expected net present value (NPV) including by minimising the losses and maximising the recoveries in respect of such assets. The discount rate to be used in such NPV analysis is based on rates regularly published by the Public Works Loan Board. In managing Covered Assets, all other objectives of RBS, except for its legal obligations, must be subordinated to the AMO. The APA may grant approval for particular transactions that do not comply with the AMO where doing so would reduce the risk to the taxpayer. A further requirement, subordinate to the AMO, is for RBS to manage the Covered Assets in accordance with its ordinary course business and banking policies, practices and procedures to the extent that these are consistent with good industry practice.

The APA is responsible for ensuring that RBS complies with the Conditions in its management of Covered Assets. The APA has powers to monitor asset performance and is able to influence the management of the assets in furtherance of the AMO or to reduce risk to the taxpayer. In certain circumstances, the APA can intervene directly by, for example, requiring alternative asset managers to be appointed or by stopping the sale of Triggered Assets to third parties at prices that the APA considers do not comply with the AMO or reduce risk appropriately.

The Conditions also include certain monitoring and reporting provisions, which ensure that the APA has visibility over RBS's management of the assets included in the APS. These provisions include:

- a requirement for RBS to provide regular, detailed data on the Covered Assets, including data on Triggers, Losses and Recoveries;
- a requirement for RBS to provide a wide range of other information and other reports as requested by the APA; and
- a right for the APA at any time to conduct an audit, investigation or review of any aspect of the business, financial condition and affairs of the RBS Group in connection with the APS.

The APA's daily interactions with RBS fall into two broad categories: responding to requests from RBS to approve particular transactions and ongoing governance and oversight.

### A.2.4 Credit reviews

The Conditions set out a number of actions for which RBS is required to obtain approval from the APA. The APA grants such approval in furtherance of the AMO or to reduce risk to the taxpayer. The main types of approval granted by the APA pursuant to credit reviews are as follows:

### *Prohibited Conduct*

The Conditions specify a number of actions in relation to Covered Assets (Prohibited Conduct) that RBS is not generally permitted to carry out unless approved in accordance with a specified Conduct Approvals Hierarchy.

Prohibited Conduct broadly comprises:

- the release of any security, guarantee, indemnity or collateral in respect of a Covered Asset;
- any return of value on equity by any Obligor to a member of the RBS Group, for example by way of payment on a dividend, to the extent that it does not give rise to a Recovery;
- the sale, transfer or other disposal of the whole or any part of any Triggered Asset and/or any Non-Cash Realisation; or
- the amendment, replacement or termination of any Closely Related Hedge.

A Closely Related Hedge is, broadly, an asset, agreement, instrument or arrangement that was a hedging arrangement in existence as at 31 December 2008 and resulted in a reduction in the credit risk or an increase in the credit line with respect to a Covered Asset.

Where the action concerned is the amendment, replacement, or termination of a Closely Related Hedge or is other Prohibited Conduct in respect of large Covered Assets, RBS is required under the Conduct Approvals Hierarchy to submit a formal request and receive approval from the APA in advance of carrying out the relevant action. Unless further information is requested, the APA has five Business Days to consider such requests before either approving or declining them.

### *Additional lending*

In certain circumstances, compliance with the AMO might require RBS to provide additional, or to extend existing, financing to an Obligor. RBS may apply prospectively or retrospectively to the APA for this additional or extended financing to become an Extended Protection Asset (EPA) covered by the APS. RBS has no right to require the granting of EPA status, which is at the discretion of the APA.

### *Loss Credits*

The Conditions require RBS to seek to identify potential disposals of Covered Assets and to discuss them with the APA although they do not restrict the disposal by RBS of Non-Triggered Assets. In consideration of the risk reduction associated with disposing of Non-Triggered Assets, however, the APA will, at its sole discretion, consider granting a "Loss Credit", i.e. crediting the APS loss ledger with an amount based on the future expected losses of Non-Triggered Assets that RBS disposes of.

The APA works closely with RBS to understand potential disposals and determines appropriate Loss Credits to the ledger accordingly.

#### **A.2.5 Ongoing governance and oversight**

The Conditions contain a number of provisions which are designed to ensure that RBS has at all times an appropriate governance framework in place to ensure that the Covered Assets are managed in accordance with the Conditions and in a way that gives the APA sufficient visibility of their management.

These governance and oversight conditions include the requirement for RBS to establish a Senior Oversight Committee (SOC). The SOC meets on a monthly and ad-hoc basis and consists of senior management personnel and a non-executive director of RBS. The SOC is charged with developing a strategy for, and providing oversight and supervision of, compliance with the APS and reviewing the business strategies and governance arrangements of RBS in connection with the APS. The Conduct Approvals Hierarchy also requires certain decisions affecting Covered Assets to be elevated to the SOC for approval. The Leadership Team attends SOC meetings as non-voting observers. The APA's SOC observer role is one of the ways by which the APA monitors compliance with the Scheme.

RBS has also appointed a Scheme Head dedicated to the APS and as the APA's primary senior point of contact in RBS. The Scheme Head manages and administers RBS's participation in the APS, including day-to-day oversight of compliance with the Conditions (including the AMO). The Scheme Head manages a team within RBS, supported by the Scheme Executive Team. The Scheme Executive Team members all report directly to the Scheme Head and are responsible for liaising with relevant personnel to ensure those personnel comply with the Scheme Documents.

The APA also has rights under the APS to attend meetings of any credit or risk committee (or equivalent) of any member of the RBS Group on a sample basis for the purpose of monitoring RBS's compliance with the Asset Management Conditions.

## Annex B – Loss Forecast

The overall Expected Loss forecast consists of Expected Losses on already Triggered Assets, Non-Triggered Assets and Loss Credits. This breakdown as at 31 March 2011 is shown in Table 2.

**Table 2: Triggered Amount, Recoveries and Expected Loss by already and yet to trigger assets (£bn)**

	Triggered Amount (£bn)	Recoveries	Expected Loss	Expected Loss in per cent of Triggered Amount
Triggered Assets	46	19	27	59%
Non-Triggered Assets	30	13	16	55%
Loss Credits	1.5	0	1.5	100%
<b>Total</b>	<b>78</b>	<b>32</b>	<b>45</b>	<b>58%</b>

Note: Loss Credits are reported on a Net Loss basis.

Source: APA analysis

HM Treasury benefits from substantial overcollateralisation in the Scheme. The first layer of overcollateralisation is provided by the First Loss Amount of £60bn. The second layer is due to the fact that RBS is required to pay fees on a quarterly basis to remain in the Scheme.<sup>5</sup> Only if Losses are over approximately £73bn, the effective attachment point of the second loss tranche, will the value of the Scheme payments be greater than the fees, and so only at that level would RBS rationally stay in and an ultimate payout be made. It is worth highlighting, however, that the future fee payments are associated with RBS counterparty credit risk.

The degree of overcollateralisation can be measured as the expected value of performing assets and expected Recoveries (which equals Covered Amount minus Expected Loss) relative to the size of the effective second loss tranche as shown below.

$$\text{Overcollateralisation in per cent} = \frac{90\% \times (\text{Covered Amount} - \text{Expected Loss})}{90\% \times \text{Effective second loss tranche}} - 1$$

Since the Scheme's inception to 31 March 2011, the degree of overcollateralisation has increased from 6 to 25 per cent.

<sup>5</sup> If RBS exits the Scheme, any payouts received by RBS must be paid back to HM Treasury with interest.

Although the Expected Loss forecast has been declining over time, significant downside risk remains in the APS portfolio. To better understand the extent of this downside risk, the APA analyses a number of stress case scenarios.

The main stress case is broadly consistent with that set out in the FSA's Financial Risk Outlook 2010, shifted to initiate the stress scenario in Q2 2011 and with some adaptation to fit the structure of the APA's forecasting model.

In summary, the main stress scenario assumes a severe downturn in the macroeconomic environment from the middle of 2011. UK GDP growth is assumed to stall, turning negative in Q4 2011 and eventually declining by 2.3 per cent to a trough in Q4 2013 with gradual recovery thereafter. Alongside this fall in GDP, the scenario includes a rise in unemployment to a peak of 13 per cent and allows for a "double-dip" in property prices, with house prices falling by 25 per cent from current levels and commercial property by nearly 40 per cent. The stress scenario assumes that interest rates are kept relatively low in response to the reduction in real output. The APA has used similar magnitude stress assumptions outside the UK. Under this stress case scenario, the APA predicts an Expected Loss on the APS portfolio of £55bn, which is 21 per cent higher than in the base case scenario. Table 3 shows Expected Loss across asset classes for the APA's base and stress case forecasts based on portfolio data as at 31 March 2011.

It is important to emphasise that the main stress scenario just described is by no means a worst case scenario, for example it assumes that interest rates are maintained at relatively low levels. The APA has also performed a "reverse" stress test to identify a scenario under which total Net Loss would reach £73bn, the level at which RBS would be expected to stay in the Scheme and HM Treasury would pay out more than was received in fees. This scenario includes a substantially deeper and more prolonged decline in GDP than the primary stress scenario, dropping by as much as 8 per cent year-on-year and eventually declining nearly 25 per cent from current levels. Unemployment peaks at 23 per cent, residential property values decline by 40 per cent, and commercial real estate drops by nearly 60 per cent. In addition, this scenario envisages sterling falling by 25 per cent while short term interest rates climb to almost 20 per cent. This extremely severe scenario has been informed by the experience of the 1930s and of countries that have gone through sovereign debt and currency crises.

During the reporting period, there has been significant focus on sovereign risk with pressure on a number of Euro-zone countries. Figure 8 shows the top ten countries by initial Covered Amount as at 31 December 2008, and how that breaks down into Non-Triggered Amount, Triggered Amount and cover that has run-off or has expired due to disposals or withdrawals from the Scheme as at 31 March 2011. Ireland exposure has reduced considerably over the life of the Scheme, and there is limited exposure to the other, most vulnerable Euro-zone countries.



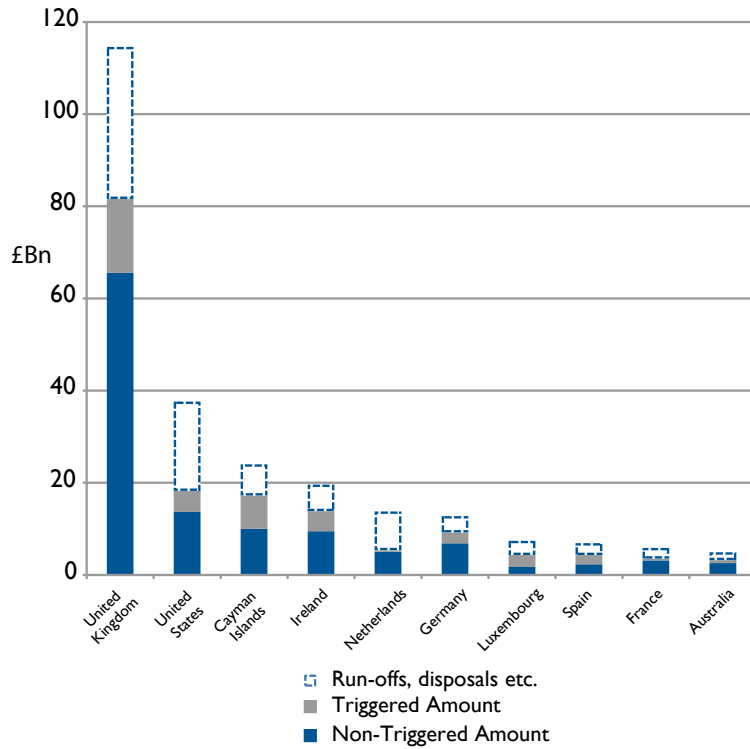
**Table 3: Base and stress case loss forecasts based on portfolio data as at 31 March 2011**

APS Asset Classes	Initial Covered Amount at 31/12/2008	Covered Amount at 31/03/2011	Net Triggered Amount incl. Loss Credits	Base case Expected Loss	% of initial Covered Amount	Stress case Expected Loss	% of initial Covered Amount
Residential mortgages	15	14	1	2	12%	2	16%
Consumer finance	55	45	10	11	20%	12	22%
Bonds	2	1	0.05	0.1	9%	0.2	12%
Loan	80	38	5	6	8%	6	8%
Lease finance	2	1	0.4	0.3	14%	0.3	14%
Project finance	2	2	0.1	0.1	7%	0.2	7%
Leveraged finance	28	15	3	4	15%	4	16%
Commercial real estate	40	27	7	7	19%	12	29%
Structured finance	36	23	11	12	34%	14	38%
Derivatives	26	17	1	2	7%	4	14%
<b>Total (£bn)</b>	<b>286</b>	<b>182</b>	<b>38</b>	<b>45</b>	<b>16%</b>	<b>55</b>	<b>19%</b>

Source: APA analysis

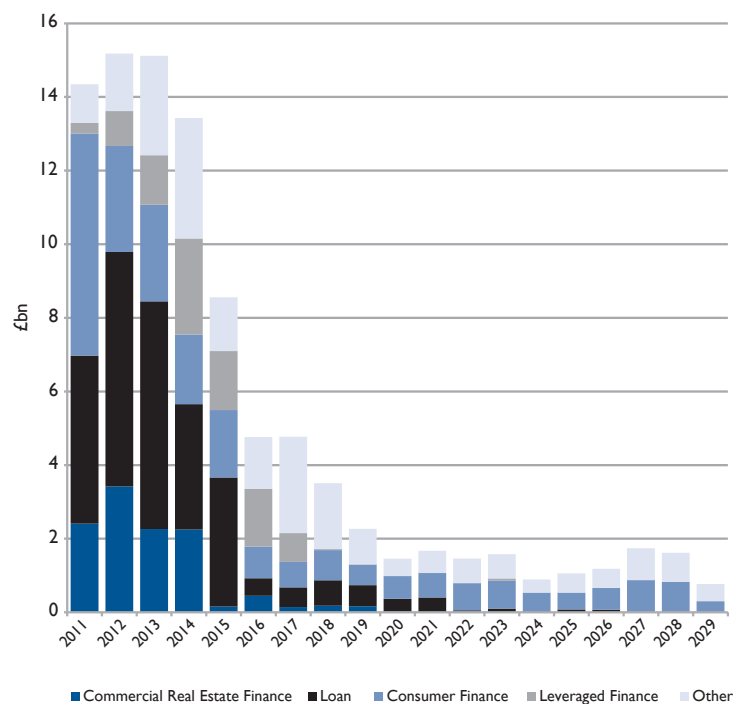
Some of the APS portfolio will require re-financing. The peak is expected to occur in the period 2011-2014. Figure 9 shows the original maturity profile of Non-Triggered Assets as at 31 March 2011. RBS will dispose of some of these assets. Others will re-finance under normal commercial terms with RBS or other lenders. The remainder will either become Triggered Assets or RBS may decide to maintain exposure by re-financing existing loans on terms less favourable than new business. Should RBS decide to do the latter APS cover will lapse.

**Figure 8: Top ten countries by initial Covered Amount**



Source: RBS data, APA analysis

**Figure 9: Maturity profile of Non-Triggered Assets**



Source: APA analysis

## Annex C – APS Valuation

The APS is accounted for as a derivative. HM Treasury considered alternative options under IFRS, in particular whether the APS could be accounted for as an insurance contract or a financial guarantee. The APS is not considered an insurance contract primarily because it relates to a financial risk.<sup>6</sup> Furthermore, because certain “limited recourse assets” in the pool are only obligated to pay if funds are available, they cannot technically default, and so HM Treasury do not consider the APS a financial guarantee. HM Treasury assessed whether the APS meets the requirements to be defined as a derivative. The standard requires a derivative to have all three of the following characteristics:

- its value changes in response to the change in a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other variable, provided in the case of a non-financial variable that the variable is not specific to a party to the contract (sometimes called the “underlying”);
- it requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors; and
- it is settled at a future date.

HM Treasury is of the opinion that the APS meets all of these requirements for the following reasons:

- the value of the APS is driven by the underlying credit risk of the assets in the Scheme, very much like a synthetic collateralised debt obligation (CDO). The credit risk of those underlying assets is therefore the “underlying” in the APS;
- in order for HM Treasury to get exposure to that underlying risk without using a derivative it would have had to purchase the underlying assets/risk in a funded transaction, i.e. an asset purchase scheme. Clearly when compared to that alternative the APS requires no such initial net investment; and
- the APS is settled at a future date: potential payouts will occur at future dates should the first loss be exceeded and it has a contractual maturity of 2099.

While the best assessment of both RBS and HM Treasury is that the APS was agreed at fair value, this conclusion involved management judgement, and it is possible that the fair value was not zero. If this was the case, the fair value at 31 March 2011 would also differ from the figure reported to HM Treasury. The valuation of the APS is sensitive to assumptions in relation to inputs that are not observable in the market. The impact of the following reasonably possible alternative assumptions has been tested:

<sup>6</sup> Credit insurance can be accounted for under IFRS 4 only if an issuer of financial guarantee contracts has previously asserted explicitly that it regards such contracts as insurance contracts and has used accounting applicable to insurance contracts. As HM Treasury has not previously made any such assertion, IFRS 4 cannot be applied to this transaction.

- asset correlation: +/- 10 per cent (absolute);
- recovery uncertainty factor for non-triggered assets: +/- 10 per cent (absolute);
- mapped credit spreads: +/- 10 bp (absolute);
- expected loss given default: +/- 10 per cent (relative).

Under these reasonably possible alternative assumptions, the fair value of the APS at 31 March 2011 could be a liability of up to £0.9bn or an asset of up to £0.3bn. However, this would have only a limited effect on income reported by HM Treasury in the Statement of Comprehensive Net Expenditure, as circumstances affecting these assumptions are not believed to have changed since inception, and it would therefore be appropriate to apply them to the initial valuation as well.

The expectation is also that despite these uncertainties, the current assumptions will remain unchanged. However, they are reviewed periodically and will be changed if there is sufficient evidence that such action is appropriate. The uncertainty due to these assumptions is likely to exist throughout the life of the APS. As the Scheme progresses, the size of the covered asset pool within the Scheme will decrease, which will reduce exposure to uncertainties over expected losses and recoveries. However, as the Scheme progresses, future valuations will be further from the initial calibration at the start of the Scheme and the risk of cumulative differences over time increases uncertainty of valuations.

An additional source of uncertainty is the quality of the portfolio data underlying the valuation, for example assets that are the subject of rule interpretation discussions, rating information that may be out of date, cover termination dates that may be subject to change, and proxies being used to estimate Covered Amount for some asset classes. The potential impact of known or suspected data issues is in the order of +/- £150 million, though the current best estimate is that there will be no net effect. There is a potential for additional impact from data issues that are currently unknown.

Valuation results are subject to numerical uncertainty arising from the simulation-based approach to valuation. The uncertainty is in the order of +/- £25 million.

The model incorporates several simplifications:

- amortisation and prepayments are not recognised;
- foreign exchange (FX) volatility is not modelled;
- a single asset correlation is used for all asset pairs;
- generic credit curves based on geography and ratings have been used for most assets in the portfolio; and

- Triggered Assets are treated as having a deterministic recovery rate rather than the random recovery applied to Non-Triggered Assets.

The first four simplifications are not expected to have a significant impact on the valuation as they would in general be absorbed by a change in the initial calibration, and the impact on subsequent changes in valuation would likely be trivial.

The impact of the fifth simplification will not be fully counteracted by a similar change in the initial calibration. As the amount of Triggered Assets increases over time the impact will increase and as Recoveries are realised the impact will tend to shrink. As the amount of Triggered Assets increased in the period to 31 March 2011 the impact as at the reporting date will be greater than it was at 22 December 2009 (the day on which RBS acceded to the APS). The difference in the impact at these two dates is not considered to be significant.

### *Fair value of the APS*

As a derivative, the APS is measured at fair value, as determined using a valuation model. The APS is a unique financial instrument, but the common instrument it most closely resembles is a synthetic CDO, an instrument which transfers credit risk, in whole or in part, on a pool of assets without transferring ownership of the assets themselves. The valuation model used to determine the fair value of the APS is a Gaussian copula model with stochastic recovery, which is an industry standard model for valuing CDO instruments. Further details on the design of the valuation model can be found in HM Treasury's 2009-10 Resource Accounts.

The APS valuation as at 31 March 2011 was a liability of £0.1 billion. This represents the payment of fees received of £2.1 billion and changes since inception in remaining life to maturity, credit spreads, foreign exchange rates, interest rates, and the portfolio. Consequently, HM Treasury has made a mark-to-market gain of £2.0 billion since inception of the APS on 22 December 2009 (£1.8 billion in the year ended 31 March 2011), with shortened time to maturity and portfolio changes (e.g. migration, amortisation, prepayments) leading to a gain that was partially offset by moves in credit spreads. There was negligible movement due to foreign exchange or interest rates.

### *Market risk and sensitivity analysis relating to APS derivative*

The value of the APS is subject to changes in market factors, primarily credit spreads, foreign exchange rates (in particular USD and EUR) and interest rates. Changes in credit spread impact the implied loss in the asset pool and thus the value of the APS protection. Changes in foreign exchange rates impact the GBP value of potential losses that are denominated in foreign currencies. Changes in interest rate impact the present value of future cash flows due to both fees and protection payments.

The sensitivity of the APS value to the specified changes in these market factors is summarised below.

Risk Factor	Increase in APS liability		Decrease in APS liability	
	Factor	£m	Factor	£m
Credit spreads (absolute moves)	+10bps	29	-10 bps	(29)
Credit spreads (relative moves)	+10%	57	-10%	(54)
Foreign exchange rates (positive for strengthening GBP)	-1%	13	+1%	(12)
Interest rate (LIBOR)	-10bps	1	+10bps	(1)

## Annex D      Glossary and Background Documentation

### *Abbreviation*

<b>AMO</b>	Asset Management Objective
<b>APA</b>	Asset Protection Agency
<b>APS</b>	Asset Protection Scheme
<b>bps</b>	Basis Points
<b>CDO</b>	Collateralised Debt Obligation
<b>CETV</b>	Cash Equivalent Transfer Value
<b>DMO</b>	UK Debt Management Office
<b>EPA</b>	Extended Protection Asset
<b>EUR</b>	Euro
<b>FReM</b>	Financial Reporting Manual
<b>FSA</b>	Financial Services Authority
<b>FX</b>	Foreign Exchange
<b>GDP</b>	Gross Domestic Product
<b>HMT</b>	Her Majesty's Treasury
<b>IAS</b>	International Accounting Standards
<b>IFRS</b>	International Financial Reporting Standards
<b>LBG</b>	Lloyds Banking Group
<b>NPV</b>	Net Present Value
<b>PwC</b>	PricewaterhouseCoopers
<b>RBS</b>	The Royal Bank of Scotland plc
<b>RBSG</b>	The Royal Bank of Scotland Group plc
<b>SOC</b>	Senior Oversight Committee
<b>SCNI</b>	Statement of Comprehensive Net Income
<b>SLA</b>	Service Level Agreement
<b>SME</b>	Small or Medium-sized Enterprise
<b>USD</b>	United States' Dollar
<b>VAT</b>	Value Added Tax

## *Definitions*

Capitalised expressions used in this document that are not otherwise defined have the same meanings as in the legal documents that set out the terms of RBS's participation in the Scheme. These documents, which include the terms and conditions of the APS (the "Conditions"), have been published on HM Treasury's website at [http://www.hm-treasury.gov.uk/financial\\_stability\\_agreements.htm](http://www.hm-treasury.gov.uk/financial_stability_agreements.htm)

In addition, the following capitalised expressions have the meanings ascribed to them below:

<b>Expected Loss</b>	the estimated life-time Net Losses of the Covered Assets
<b>Loss Credit</b>	the benefit, if any, which the APA agreed to make available to RBS as a result of a disposal of a Non-Triggered Asset
<b>Net Losses</b>	at any date, Losses less Recoveries at that date
<b>Net Triggered Amount</b>	as with Net Losses
<b>Triggered Amount</b>	as with Losses

## *Background documentation*

RBS Interim Management Statement Q1 2010

[http://www.investors.rbs.com/download/announcements/RBS\\_Final\\_Q1\\_2010.pdf](http://www.investors.rbs.com/download/announcements/RBS_Final_Q1_2010.pdf)

RBS Interim Management Statement Q1 2011

[http://www.investors.rbs.com/download/announcements/Q1\\_IMS\\_2011.pdf](http://www.investors.rbs.com/download/announcements/Q1_IMS_2011.pdf)

RBS Annual Results 2010

[http://www.investors.rbs.com/download/announcements/Announcement\\_RBS\\_Annual\\_Results\\_2010.pdf](http://www.investors.rbs.com/download/announcements/Announcement_RBS_Annual_Results_2010.pdf)

Royal Bank of Scotland: details of Asset Protection Scheme and launch of the Asset Protection Agency

[http://www.hm-treasury.gov.uk/d/rbs\\_aps\\_apa.pdf](http://www.hm-treasury.gov.uk/d/rbs_aps_apa.pdf)

APA Interim Report February 2011

[http://www.hm-treasury.gov.uk/d/apa\\_interimreport\\_150211.pdf](http://www.hm-treasury.gov.uk/d/apa_interimreport_150211.pdf)

Annual Report and Accounts 2009-10 of the Asset Protection Agency

[http://www.hm-treasury.gov.uk/d/apa\\_annual\\_report\\_0910.pdf](http://www.hm-treasury.gov.uk/d/apa_annual_report_0910.pdf)









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