HM TREASURY

TREASURY MINUTES

Government responses on the Twenty Ninth to the Thirty Second Reports from the Committee of Public Accounts: Session 2010-12

Cm 8110

June 2011

HM TREASURY

Treasury Minutes on the Twenty Ninth to the Thirty Second Reports from the Committee of Public Accounts Session 2010-12

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Twenty Ninth Report

Department for Culture, Media and Sport (DCMS)

The BBC's management of its Digital Media Initiative

Report Summary from the Committee

The Digital Media Initiative (the Programme) is designed to transform the way in which BBC staff create, use and share video and audio material. It involves the development of new technology to allow staff to manage content efficiently on their desktops, in order to give greater accessibility of digital content for audiences on TV, online and radio.

Successful implementation of the Programme has a wider strategic importance for the BBC, including supporting the BBC's move to Salford from May 2011. After a difficult start, which resulted in the original delivery contract being terminated, the BBC brought the Programme in-house and has since made good progress in delivering it. The Programme is, however, no longer expected to deliver the overall net financial benefit of £17.9 million originally anticipated. The BBC approved the Programme on the basis that it would cost £81.7 million and deliver benefits of £99.6 million, but now forecasts costs of £133.6 million and benefits of £95.4 million – a net cost of £38.2 million.

In February 2008, under its Technology Framework Contract, the BBC let a £79 million contract to Siemens without open competition. The contract covered the delivery of the technology and the operation of the Programme until March 2015. The technology was not delivered and the BBC and Siemens agreed a no-fault termination of the contract with effect from July 2009.

Despite the scale and technological innovation of the Programme, the BBC chose not to test through competition the capacity and capability of potential suppliers to take on such a challenge. The contract with Siemens transferred too much financial risk to the contractor, such that the BBC felt unable to intervene proactively in the development of the Programme until it was too late. The contract was terminated and the Programme taken in-house, but by then the BBC had suffered two years of delay and lost £26 million in benefits as a result. To cover the costs of delay and completing the Digital Media Initiative in-house, the BBC found £26 million of efficiencies within BBC Divisions, and negotiated £24.5 million of new efficiencies in the Siemens Framework Contract. The Committee questioned whether these savings could and should have been identified earlier.

The BBC has made a strong start on the in-house development of the Programme. It has successfully delivered four technology releases and it is on course to deliver the complete technology for the Programme by Summer 2011 and within the new budget of £133.6 million. The Committee welcomes the BBC's success to date in developing this technology and look to the BBC to share lessons with the wider public sector.

The Comptroller and Auditor General told the Committee that he did not have full and unfettered access to all the information he required to carry out his review, delaying the start of his work. This is not satisfactory. The Committee expects the BBC and BBC Trust to ensure that full access is given promptly in the future.

On the basis of a report from the Comptroller and Auditor General, the Committee took evidence from the BBC Trust and BBC on the management of the contract with Siemens and the BBC's in-house development of the Programme.

Government responses to the Committee's conclusions and recommendations

PAC CONCLUSION AND RECOMMENDATION 6

So far the BBC has made good progress in delivering the Programme in-house.

Since taking the Programme in-house, the BBC has successfully delivered four technology releases and is currently on course to deliver the complete technology for the Programme by Summer 2011, although this is five months later than planned. The BBC attributes its success to date to a strong supplier management team and to the creation of an in-house software development team. The Office of Government Commerce should work with the BBC to identify practical lessons to be shared across the wider public sector.

6.1 The Government agrees with the Committee's recommendation.

6.2 To date, the Cabinet Office's focus has been to embed the efficiency and reform agenda within central government. The Cabinet Office recognises that it can learn from best practice in the wider public sector, private and third sectors, and overseas, and that it has a role to play in disseminating this learning.

PAC CONCLUSION AND RECOMMENDATION 7

The BBC's confidential settlement with the contractor delayed the C&AG's access to relevant information, and led to the National Audit Office's review being held up for eight months.

The Committee is pleased that the Trust agrees that there should be speedy access to all the information that is required when the C&AG decides to do a study. The C&AG should have full and unfettered access to the information he considers necessary and discretion over what is published.

7.1 The Government agrees with the Committee's recommendation.

7.2 The Government is committed to giving the National Audit Office (NAO) full access to the BBC's accounts to ensure transparency. In September 2010, the Government announced that the NAO was to have full access to the BBC accounts for the first time. The Secretary of State had agreed with the BBC Trust that the NAO can decide which value for money studies to undertake and when; and that the NAO would have rights of access to BBC information.

7.3 The new arrangements will include:

- NAO routine access to BBC management information;
- NAO right of access to any information it needs to identify and carry out its studies;
- NAO access to confidential BBC contracts with third parties; and
- agreement that the NAO will not question the BBC's editorial policy.

7.4 Since this was agreed with the BBC Trust, the Department for Culture, Media and Sport (DCMS) has been in discussion with the BBC Trust about the detail of the new arrangements. The changes will be implemented by amending the BBC Agreement, which is where the BBC's present value for-money provisions are set out. Amendments to the BBC Agreement require the consent of the BBC. The Secretary of State has consulted the Comptroller and Auditor General about the changes.

7.5 The DCMS Structural Reform Plan commits the Department to implementing the new arrangements by November 2011.

Thirtieth Report

Ministry of Defence (MOD)

Management of the Typhoon Project

Report Summary from the Committee

Typhoon is a multi-role aircraft capable of both air defence and ground attack. The Ministry of Defence (the Department) entered into a contract for the first 53 aircraft in 1998, and is buying Typhoon in collaboration with Germany, Italy and Spain. The total cost to the United Kingdom of buying the aircraft and supporting them in service over the next 20 years is estimated to be £37 billion.

Typhoon is a highly capable air defence fighter and is now being used to defend United Kingdom and Falkland Islands airspace, as well as being part of recent efforts to impose a no fly zone in Libya. However, Typhoon was commissioned during the Cold War and it took 20 years, and a higher budget, from the start of development to the aircraft being deployed operationally.

The Department originally planned to buy 232 aircraft. However, in light of changed operational requirements and significant funding constraints arising from the pressures of the defence budget, it is now ordering 160 aircraft and will retire the 53 oldest aircraft by 2019, leaving a long-term fleet of 107 aircraft. It is unclear as to whether the acquisition of the third phase in this contract, for the last 16 aircraft, was driven by contractual obligations or by operational need.

The project began in the 1980s and the Department was over-optimistic on costs. In particular, it failed to anticipate significant cost increases and delays from the rigid and complex collaborative arrangements. Overall, it is costing the Department £20.2 billion, £3.5 billion more than it first expected to buy a third fewer aircraft. This is equivalent to the purchase cost of each aircraft rising by 75%, from £72 million to £126 million.

In 2004, the Department decided to retire the ground attack Jaguar aircraft early and to spend £119 million to install ground attack upgrades on early Typhoons to cover the resulting capability gap. These upgrades were ready for use by 2008. A year later, the Department decided to retire the air defence Tornado F3 aircraft early to save money and therefore re-prioritised Typhoon away from ground attack missions to air defence tasks. It is now not using Typhoon's ground attack capability.

Problems with the availability of spares mean that Typhoons are not flying the hours required and the Department is forced to cannibalise parts from other aircraft to maximise the number of aircraft available on a given day. As a result, it is not fully training all its pilots, and only eight of the 48 Typhoon pilots were capable of undertaking ground attack missions on Typhoon. In addition, the Department had to ground five pilots temporarily in 2010. The problem is likely to be exacerbated as the number of Typhoons in-service increases and they are used in a wider range of operational roles.

Support costs are budgeted at £13.1 billion, but reviews by the Department have suggested costs could be as high as £16.6 billion across the life of the aircraft. The Department has identified potential savings of £3.5 billion to keep support costs within budget, albeit that this budget was meant to cover 232 aircraft not the 160 now being bought. The Committee is concerned that the Department has budgeted for cuts to meet overall expenditure targets and that, over time, the costs will creep up again.

To ensure good value from this expenditure, the Department will need to both reduce the cost and increase the timeliness of future collaborative spares and repairs contracts. At present, the contracts do little to incentivise better industry performance and to penalise failure.

The Department has appointed a Senior Responsible Owner (SRO) to be the person accountable for delivering each major procurement project. However the SRO on Typhoon has limited decision making powers and merely co-ordinates activity. That is not good enough.

On the basis of a report by the Comptroller and Auditor General, the Committee took evidence from witnesses from the Ministry of Defence on the past decisions taken on Typhoon, and on the improvements that the Department can make to the delivery model to get more from industry in terms of reduced costs and better performance in the future.

Government responses to the Committee's conclusions and recommendations

PAC CONCLUSION AND RECOMMENDATION 1

Despite buying 30% fewer Typhoons than originally planned, the cost of production and development has risen to £20.2 billion, £3.5 billion more than the Department first expected.

This reflects the accumulated effect of over optimism on costs. The Committee has commented on this issue in previous reports. Typhoon will be in-service for another twenty years and, given the Department's assurance that it has learned the lessons, our recommendations in this report focus on how the Department can secure best value on the project going forward. Good decisions are based on good information. If the Department is to make more realistic and achievable investment decisions in future, it needs to have a comprehensive understanding of the balance between costs, number of aircraft kept in service and the operational capability which the aircraft provide.

1.1 The Government partially agrees with the Committee's conclusion and recommendation.

1.2 The cost data specified by the Committee was taken from the Major Projects Report 2010. A recent change to Government accounting policy, involving the removal of the cost of capital charge, together with a programming change, have led to the estimated cost of production and development reducing to £17.7 billion. The Department understands and acknowledges that good investment decisions are informed by good information, and is working to ensure this is the case for all investment decisions. The Secretary of State for Defence will be chairing regular major project review boards to ensure the Armed Forces are well equipped and taxpayers get value for money.

PAC CONCLUSION AND RECOMMENDATION 2

The Department's calculation of unit cost per aircraft does not include all relevant costs.

The Department calculates a unit cost of £73 million, based on production costs alone. However, the inclusion of development costs and the cost of capital take the total unit cost to £126 million. In order to provide a full picture of costs and enable comparison across projects, the Department should calculate and report its unit cost on a basis that includes all expenditure, including development and production costs.

2.1 The Government disagrees with the Committee's conclusion and recommendation.

2.2 The method and calculation of unit cost made by the Department has been reported within the Major Projects Report and validated by the National Audit Office for many years. Development costs are not related to the number of aircraft that the Department buys, and are therefore considered to be fixed, a point previously established with the National Audit Office. The unit price of the Typhoon aircraft, based on the method of calculation used within the Major Projects Report, has proven to be comparable with similar types of aircraft.

2.3 The Department has provided a full picture of costs – fixed (independent of the number of aircraft units ordered) and variable (dependent on the number of aircraft units ordered). However, including fixed costs, which are not related to aircraft numbers/units, in the case of Typhoon, distorts the impact of reductions in the number of aircraft to be purchased. At this stage in Typhoon's development, the fixed cost element has largely been spent. Therefore cost control is now focussed primarily on the production element. It is also unhelpful and misleading when trying to make meaningful comparisons against other aircraft, especially where we are competing in export markets where the unit cost based on numbers of aircraft units produced is the cost most often quoted by their national governments.

2.4 Currently accepted methodologies for calculation of unit price also exclude through life support and eventual disposal costs. It would therefore be inappropriate to include all expenditure as recommended by the Committee.

PAC CONCLUSION AND RECOMMENDATION 3

The Department was not able to demonstrate that it had conducted a thorough cost-benefit analysis to support its original decision to equip Typhoon with ground attack capability, or its subsequent decision not to use it.

The Department spent £119 million giving Typhoon a ground attack capability to replace the capability previously provided by the Jaguar aircraft. However, in 2009 the Department decided to retire the air defence Tornado F3 aircraft early to save costs and re-prioritised Typhoon in air defence roles. This has meant that Typhoon's ground attack capability is not being used. This is an all too familiar pattern of decision making, reflecting the overall failure to control defence spending; balancing the books in the short term without taking into account long term value for money. The Department should treat decisions about major changes to the operational use of key equipment most seriously and conduct thorough cost-benefit analyses to ensure value for money is achieved.

3.1 The Government disagrees with the Committee's conclusion and recommendation.

3.2 The investment decision went through the Department's budgetary process and was approved only after formal investment appraisal. Typhoon's ground attack capability was formally declared in 2008, since when both ground attack and air defence capabilities have been maintained at a level to meet operational requirements. Because a capability is not currently in use does not mean that it is not prudent to have it available. Indeed, the ground attack capability is being used successfully in operations over Libya. When the decision was taken to join this international operation, the Typhoon element was able to deploy against a wide spectrum of target sets from the tactical to strategic. Notably this included the first operational use by Typhoon of the Enhanced Paveway II bombs, four of which were released in a strike against a large military vehicle depot, with all hitting their intended target points.

PAC CONCLUSION AND RECOMMENDATION 4

In settling on the number of aircraft to be ordered, the Department had to make difficult judgements on the balance between affordability and operational risk.

The net result will be the number of aircraft being bought falling from the planned 232 to 160 and 53 of these aircraft being taken out of use by 2019; leaving a fleet size of 107. It is also unclear whether the third phase of acquisitions was determined by contractual commitments as opposed to operational imperatives. In future we expect the Department to offer us a clearer explanation as to why it has reached such judgements on individual capabilities and for these judgements to be underpinned by robust cost and operational analyses.

4.1 The Government partially agrees with the Committee's conclusion and recommendation.

4.2 The Department agrees that it has to take difficult judgements on the balance between affordability and operational risk. The investment decision for the third phase of acquisitions reflected the increased capability of the platform as a result of weapons and technology improvements – it will be more capable than originally foreseen, to meet operational requirements and to meet international commitments. The Department therefore balanced its obligations to Partner Nations under the collaborative Memoranda of Understanding whilst procuring sufficient aircraft to meet its operational requirements.

PAC CONCLUSION AND RECOMMENDATION 5

Major defence procurement contracts are often lengthy and therefore carry an inherent risk that elements become obsolete before projects are completed and operational.

The risk of obsolescence was exacerbated in the case of Typhoon, which was not operational until two decades after the project started. The Department needs to find ways to actively manage this risk to achieve best value for money. It should consider, for example, how to oblige contractors to manage the risk of obsolescence throughout the life of a project, which might include in-built flexibility for aircraft and other equipment to accommodate upgrades.

5.1 The Government partially agrees with the Committee's conclusion and recommendation.

5.2 The nature of the threat and environment in which aircraft have to operate is continually changing and equipment is often at the cutting edge of technology in order to maintain operational advantage. Consequently, major military equipment projects are extremely technically challenging, with the inherent risk of time delays and cost increases. This is no different for other technologically advanced Nations with similar projects. For Typhoon, however, the result has been a highly agile and effective aircraft, responding in an exemplary way with high levels of readiness, low operational costs, and excellent accuracy in the air to ground role. It also has significant further growth potential, successful overseas sales, and considerable further international interest with potential benefit to UK industry.

5.3 It is agreed that obsolescence is a risk that needs to be managed rigorously (as it does on any major high-technology project). Indeed, on the Typhoon project, the support contracts the Department has in place do require contractors to manage obsolescence risk on a through life basis.

5.4 Further evidence of managing obsolescence on Typhoon has been the incremental acquisition through the purchase of separate tranches of aircraft as part of the Procurement Strategy.

PAC CONCLUSION AND RECOMMENDATION 6

The Department relies on a small group of key industrial suppliers who have the technical and design capability to build, upgrade and support Typhoon.

In the absence of competition, the Department needs to demonstrate it is achieving value for money from its single source supply contracts but did not supply specific evidence that it is doing so. We expect the Department to generate robust cost and performance data, potentially drawing on its independent United Kingdom support contracts with BAE Systems and Rolls Royce, to assess the value for money of future contracts.

6.1 The Government partially agrees with the Committee's conclusion and recommendation.

6.2 The Department is alert to the risk of cost growth within non-competitive procurement, and in the air sector has developed a range of analytical tools, benchmarks and cost models to drive the continuous improvement and efficiency agendas.

6.3 All non-competitive contracts follow the principles included in the 2010 General Review, a report of the Review Board for Government Contracts (also known as the Yellow Book), including application of the Government Profit Formula, used to determine the profit included in the price of non-competitive contracts. The Department is currently undertaking the first ever independent review of single source pricing under the Yellow Book to ensure it is still efficient, relevant to today's industrial landscape and represents value for money to the taxpayer. As a particularly high value project, Typhoon proposals are subject to scrutiny by the Department's Investment Approvals Board and HM Treasury prior to contractual commitments being made.

6.4 The main support contracts with BAE Systems and Rolls Royce were both subject to Public Sector comparator exercises and full Cost Assurance and Analysis Service (CAAS) investigation prior to being placed. This provided a robust baseline for the original contracts, and each subsequent (preplanned) re-negotiation of the contracts has resulted in both increased contractor productivity and decreased cost to the Department. These support contracts, as with all the Department's non-competitive contracts, contain conditions giving the Department rights to price-fixing and post-costing investigations, as well as arrangements to refer contracts to the Independent Review Board for Government Contracts for arbitration or possible price adjustment.

PAC CONCLUSION AND RECOMMENDATION 7

Problems with the availability of spare parts have meant that Typhoons are not flying as many hours as the Department requires.

As a result, the RAF only had eight of its 48 Typhoon pilots capable of undertaking ground attack missions. This has also led to five pilots being grounded and the Department regularly taking parts from some aircraft to ensure it has a sufficient number to meet immediate operational needs.

a) The Department must negotiate future contracts so that industry delivers spare parts on time; and

b) A limited amount of 'cannibalisation', for example, from aircraft undergoing maintenance, may be better than incurring the additional cost of purchasing and storing large amounts of spares, but we question whether it can be cost effective to have three planes with a total value of £ 378 million sitting on the ground. The Department should undertake more robust analysis to determine the most cost effective balance between cannibalising aircraft, buying more spares and accepting increased operational risks.

7.1 The Government partially agrees with the Committee's conclusion and recommendation.

7.2 Flying hours may not be achieved for a number of reasons, an example being the disruption caused by the volcanic ash cloud in 2010. It is also the case that the mix between live and synthetic training needs to be able to respond to changing requirements, including factors such as practicality and danger, where initially simulation may take precedence. Availability of spare parts is one reason why Typhoons have not flown as many hours as the Department would like. To give the impression that that is the sole reason would be wrong.

7.3 Some pilots will only be trained to operate in air defence, some pilots will also be ground attack qualified, i.e. multi-role. Whilst the Committee highlighted a perceived shortfall in the number of pilots trained for ground attack, it is important to recognise that the eight pilots trained in this role represented the operational need at that time. The mix of training by role has been sufficiently flexible to allow the Department to meet all operational requirements. This continues to be the case including operations over Libya.

7.4 There is a fine balance between the number of spares to be purchased and operational availability. The Department carries out extensive modelling and analysis to ensure purchase of the optimum number of spares to meet operational requirements. The Department accepted that two aircraft and a ground test rig had been used to supply spare parts, but that position was a snapshot in time, the aircraft were not part of the forward fleet, and it is not Departmental policy to keep aircraft on the ground unnecessarily. Cannibalisation to satisfy urgent requirements is however an accepted maintenance practice across all military aircraft fleets, and avoids holding large and expensive stockpiles of spares. It is also important to recognise that the Department's work with industry on critical spares has resulted in spares delivery targets largely being met.

PAC CONCLUSION AND RECOMMENDATION 8

The Senior Responsible Owner (SRO) on Typhoon is not involved in key decisions, for example, those related to exports of the aircraft.

Good practice suggests there should be one person with full responsibility leading the delivery of key capabilities such as Typhoon. The SRO role as applied by the Department on capabilities like Typhoon does not have appropriate responsibilities and cannot therefore be held to proper account. The Department should consider, as part of the work of the Defence Reform Unit, how to give SRO's the authority they need to manage the delivery of the equipment for which they are accountable.

8.1 The Government partially agrees with the Committee's conclusion and recommendation.

8.2 It is the Department's policy that all programmes should have a Senior Responsible Owner. This role is accountable for realising the expected benefits of the programme, though it is acknowledged that in practice they do not always have the full authority needed to deliver their responsibilities. Nonetheless, for Typhoon the Senior Responsible Owner continues to be involved in all major decision making.

8.3 A key theme of the Government's current Defence Reform work is to ensure that accountability for delivery is aligned with the authority and levers necessary to ensure delivery. Lord Levene is due to publish his findings this summer.

PAC CONCLUSION AND RECOMMENDATION 9

The form of collaboration underpinning the Typhoon project has added cost growth and delay to the project.

Decision making within the collaboration is a lengthy process and it can take several years for key upgrades to be agreed and delivered. The arrangements were agreed in the 1980s and driven by political considerations rather than by commercial or military imperatives. Done well, collaboration offers significant potential benefits from sharing costs and developing common capabilities with allies. To enable it to make the most of on-going and potential new collaborative opportunities, the Department should evaluate its portfolio of collaborative projects to establish what has worked well, or failed, and why this has happened.

9.1 The Government partially agrees with the Committee's conclusion and recommendation.

9.2 The Department fully recognises the significance of potential benefits from collaboration, and the need to learn lessons from current and past collaborations. It has conducted evaluations of a number of significant collaborative projects, and has already identified factors which can contribute to the success and failure of a project.

9.3 The Department agrees that the international decision making and architecture in the early years of the Typhoon project was not optimised for the in-service phase. However, this has improved significantly through the growing maturity of the project and a series of specific initiatives. For example, the aim of one of these initiatives is to reduce elements of in-service support costs by some 50%. These improvements reflect that the platform is now in operational service, its significant growth potential, and the need for rapid exploitation of new technologies.

9.4 In 2008, the Department undertook a review of six collaborative projects in order to identify areas which would increase the likelihood of future multinational project success. The case study projects were chosen to represent examples of different collaborative models, with varying challenges and levels of performance. The review identified a set of guiding principles to be applied when establishing future collaborative projects.

9.5 More recently, at the request of the Defence Committee, the Department commissioned a study to establish the lessons learned from the A400M aircraft project which could be applied to future collaborative projects. The report was issued in December 2010 and adds to the body of evidence on collaborative lessons learned. The Department is also working with NATO to identify lessons learned and best practices for acquisition, as well as pooling and sharing at national, regional and multinational level.

9.6 Whatever the history of the project, the fact remains that we now have an exceptionally capable aircraft, flying successfully in combat missions, being manufactured at predictable unit cost and with significantly improved in-service support costs, high levels of availability, good fuel efficiency, and excellent prospects for further capability growth.

Thirty First Report

HM Treasury (HMT)

Asset Protection Scheme

Report Summary from the Committee

In October 2008, the Government put in place measures to support UK banks, including purchases of shares in the Royal Bank of Scotland (RBS) and Lloyds Banking Group (Lloyds). The economic downturn continued to intensify, however, further undermining market confidence in the value of banks' assets.

To restore confidence, the Government launched an Asset Protection Scheme (the Scheme) in January 2009 to protect banks against further exceptional losses on their assets. During negotiations to finalise the Scheme, the Treasury remained alert to developments in the market throughout 2009 and made changes to the Scheme to better protect the taxpayer. As part of the Scheme, Lloyds and RBS agreed to meet published targets for lending to households and businesses.

Following the Scheme's announcement, market sentiment towards the banks stabilised, helping to achieve the Treasury's overriding aim to maintain financial stability. The development and implementation of the Scheme is a noteworthy achievement in which the commitment and skills of Treasury staff played a central part. Against this positive overall picture, there are a number of areas where further work could be undertaken.

It is alarming that two of the UK's major banks were simply unable to provide sufficient data to assure the Treasury that their assets were not linked to fraud or other criminal activity. It raises questions on the management controls within the banks and the quality of audit provided to the banks. The lack of certainty on the nature of the assets put the Treasury in a difficult position and the Accounting Officer had to ask for a Direction from Ministers before proceeding with the Scheme.

While mortgage lending targets have been met, first year lending targets for businesses were not, despite assurances given by the banks to the Treasury. In part this was because many businesses chose to repay existing borrowers. But subsequent research has indicated that tight credit supply is likely to have been the dominant influence on the level of lending in the economy. With few mechanisms through the Scheme to encourage banks to help credit-worthy businesses in need of finance, the Treasury needs to develop other means of influencing banks' behaviour. Simply changing the lending targets from a net to a gross basis risks reducing the pressure on the supported banks to increase credit.

The prospect of the Treasury having to bail out RBS under the Scheme has receded, but there is a small risk that any future recession may change this. The Treasury now needs to make sure that it retains the knowledge and experience it has built up over the past three years so that it can act to protect the taxpayer if interventions to support UK banks are needed in the future.

On the basis of a report from the Comptroller and Auditor General, the Committee took evidence from the Treasury, and separately from RBS and Lloyds, on the maintenance of financial stability and protection of the taxpayer.

Government responses to the Committee's conclusions and recommendations

PAC CONCLUSION AND RECOMMENDATION 1

In challenging circumstances, the Treasury achieved its overriding aim to maintain financial stability.

By avoiding the huge economic and social consequences of the failure of a major bank, the Asset Protection Scheme (the Scheme) was an important part of a wider package of measures to support the UK's financial system.

1.1 The Government agrees with the Committee's analysis.

PAC CONCLUSION AND RECOMMENDATION 2

The Treasury conducted extensive investigations of the assets put forward for inclusion in the Scheme, but both banks encountered major difficulties in providing all the data requested.

Two of the UK's major banks could not provide basic information on their assets and sufficient assurance that their assets were not linked to fraud or other criminal activity. As the Treasury did not have a complete picture of the risks the taxpayer would be taking on, it was put in a difficult position and the Accounting Officer had to ask for a Direction from Ministers before proceeding with the Scheme. The Treasury should take steps to ensure the banks address these gross deficiencies in basic data and, when considering the future role of financial services regulators, make sure that arrangements are in place to test whether this has been done.

2.1 The Government agrees with the Committee's recommendation.

2.2 The Financial Services Authority is responsible for ensuring that banks have the appropriate internal management systems in place. They have outlined their expectations that banks should have robust, complete and accurate data gathering across their organisations in order to comply with regulations.

2.3 In addition, the Asset Protection Agency continues to verify losses and recoveries on assets covered by the Asset Protection Scheme.

PAC CONCLUSION AND RECOMMENDATION 3

The gaps in information on the banks' assets also begs questions about the role played by the auditors of banks ahead of 2008, when the full impact of the financial crisis became apparent.

The Treasury and the Department for Business, Innovation and Skills have been working with organisations in the banking sector to improve the audit framework. They should now expand discussions to include the major professional audit and accountancy bodies. The Treasury should report back to us within a year on specific actions to ensure that professional audit standards and practices are up to the task of providing robust assurance on the internal control and governance of financial institutions, and on the valuation of assets.

3.1 The Government partially agrees with the Committee's recommendation.

3.2 The Government agrees with the Committee on the need for robust assurance on internal controls, governance and asset valuation, and will continue to work with organisations in the banking sector to improve audit quality. However, the Government believes it is the responsibility of the auditing profession to ensure auditors robustly challenge banks' internal control and governance systems. In addition, the Financial Services Authority is responsible for supervisory oversight of the effectiveness of firms' risk management and governance, the Department for Business, Innovation and Skills for audit policy, and the Financial Reporting Council (FRC) for the development of audit standards and practice, and oversight of auditor regulation.

3.3 The FRC is considering how to enhance both audit and company stewardship through more effective corporate reporting, in light of the experience of the financial crisis. This broad initiative is intended to improve assurance in the areas above, where the committee has raised concerns. It includes: enhanced dialogue on the role of assurance; the adequacy, timeliness and reliability of information to monitor going concern and liquidity risks; and board accountability for systems and processes. The FRC will be reporting on these through their Effective Company Stewardship and Sharman inquiries.

3.4 The Treasury will submit these reports to the Committee, with an update on progress in this area.

PAC CONCLUSION AND RECOMMENDATION 4

The Treasury lacked effective sanctions against RBS and Lloyds when they failed to meet their lending targets.

In the first year, the mortgage lending targets were met but lending to businesses fell short of the targets by £30 billion. Under the lending commitment the Treasury considered a range of sanctions against RBS and Lloyds, should the second year target be missed, but decided that each sanction had a downside that outweighed the benefits. This is not satisfactory, and the Treasury should consider the precise mechanisms by which it will exert influence, including assessing progress and the application of appropriate sanctions. In giving the lending commitment, the banks wanted to highlight the constraints of demand and risk. Nevertheless there appears to be a reduction in the supply of credit, and we expect the lending commitment to be met, and a determination to achieve it to be shown by the banks.

4.1 The Government agrees with the Committee's recommendation that lending commitments should be met, and that the Treasury should consider the mechanisms by which it will exert influence.

4.2 On 9 February 2011, the Chancellor announced a new commitment by the UK's biggest high street banks on lending expectations and capacity. The commitment to make available new lending to SMEs is part of the performance metrics of each bank's chief executive and those senior managers responsible for lending to SMEs.

4.3 The Chancellor has stated that he will use every means available to him to hold these banks to their published lending commitments. The Government reserves the right to return to this issue and take further measures if the banks fail to meet their commitments.

PAC CONCLUSION AND RECOMMENDATION 5

There were gaps in the Treasury's analysis of how much RBS should pay for the Scheme.

The Treasury accepted that more could have been done to analyse the range of possible fees. However, the Treasury considered that such an analysis would not have resulted in a higher fee as that could have risked the viability of the scheme in providing assurance to the financial markets. Given the huge sums at stake, however, it remains unsatisfactory that a comprehensive analysis was not undertaken and we expect to see such analyses in the future where there is a significant exposure to the taxpayer.

5.1 The Government agrees with the Committee's recommendation that, in the future, any scheme involving significant exposure to the taxpayer should be subjected to a comprehensive analysis.

5.2 The APS achieved its objective to achieve financial stability, and part of that success was the terms and conditions including the price charged to RBS for the insurance. The Treasury did a very considerable amount of careful analysis of the different aspects of the terms, including the due diligence that determined the first loss amounts and overall asset pool.

5.3 The Treasury accepts that it could have performed more analysis to underpin its decision on the fee. However, this further analysis would not have changed the decision. The Treasury charged the highest fee possible, consistent with leaving RBS sufficiently well capitalised in the event of a further deterioration in economic and market conditions. In the light of the advice of the NAO and the Committee, the Treasury has re-examined its decision. It continues to believe that the fee set was appropriate.

PAC CONCLUSION AND RECOMMENDATION 6

Following the announcement of the Scheme in January 2009, the Treasury retained flexibility to make changes and revisited earlier decisions to check whether they still provided value for money.

Just ahead of signing the deal in November 2009, the Treasury reconsidered its options in the light of market changes, but considered that the Scheme remained the best way to ensure financial stability. Lloyds was allowed to leave the Scheme and raise capital in the markets and the terms of RBS's participation were recast. Reviewing decisions in the context of changing circumstances was good practice and the Treasury should ensure its guidance to departments requires this in all cases.

6.1 The Government agrees with the Committee's recommendation.

6.2 The Treasury did monitor developments in the market and allowed Lloyds to withdraw from the APS due to improving market sentiment to the bank and in order to minimise the overall fiscal exposure to financial institutions. However, Lloyds Banking Group did still pay £2.5 billion in fees for the coverage that the Scheme gave them between January and November 2009.

6.3 *Managing Public Money* requires Departments to take stock and continuously evaluate projects and policies that they undertake to ensure that they are appropriate and represent value for money.

PAC CONCLUSION AND RECOMMENDATION 7

While the prospect of the Treasury making payments to RBS has receded since 2009, there remains a risk that a further and severe economic downturn might result in RBS remaining in the Scheme for the foreseeable future.

Such an outcome would lead to significant and long-term costs for the taxpayer. The Treasury, through the Asset Protection Agency, must make sure that RBS properly prioritises and complies with the requirements of the Scheme to maximise the returns on the insured assets in the interests of the taxpayer, its largest shareholder. The interests of the taxpayer must not in any way be sacrificed for the interests of the bank.

7.1 The Government agrees with the Committee's recommendation.

7.2 The Asset Protection Agency's (APA) published framework document outlines its key responsibilities to protect the taxpayer's interest by ensuring that RBS complies with the terms and conditions attaching to its participation in the APS and that the objectives of the APS are achieved by exercising the Treasury's rights in such a way as to maximise the net present value of the assets in the APS and to reduce the probability of payouts. The Government is bearing the advice of the Committee in mind whilst managing the APS.

PAC CONCLUSION AND RECOMMENDATION 8

The Treasury took the lead role in developing the Scheme and has accumulated valuable knowledge and experience in doing so.

When Northern Rock got into difficulty in 2007 and had to be nationalised, the Treasury was severely stretched in terms of resources and experience but its capacity and capability have since grown. Current changes in the regulatory landscape mean that much of the day to day management of any future banking crisis will fall to the Bank of England. The involvement of public funds will, however, require the Treasury's prior approval. The Treasury will therefore need to make sure that in reducing its staffing it retains sufficient capability to understand and challenge proposed interventions should its approval be sought in the future.

8.1 The Government agrees with the Committee's recommendation.

8.2 The Treasury, like all other central Government Departments has had to make budget cuts in the light of the tight departmental settlements outlined at Spending Review 2010. The Department undertook a strategic review to identify the key areas where it would need to maintain resources and expertise in future. A new Financial Stability Group has been established to retain knowledge captured during the recent crisis and to provide expertise and challenge in any future interventions in the financial sector.

8.3 As with any other policy area the department is active in, the Treasury will continue to review its staffing levels and capabilities as the policy and financial environment changes.

Thirty Second Report

HM Treasury (HMT)

Maintaining financial stability of UK banks: update on the support schemes

Report Summary from the Committee

In 2007, following a period of instability in the financial markets, the Treasury intervened to protect depositors and stop instability spreading. This included nationalisation and lending to troubled institutions and to the Financial Services Compensation Scheme, the purchase of a large number of shares in RBS and Lloyds, establishing sector-wide schemes to guarantee banks' debt-funding and protect their assets, and indemnifying the Bank of England against losses for providing temporary liquidity.

This was justified at the time to protect taxpayers, but the peak of the financial crisis has passed, and banks must not remain dependent on taxpayer support indefinitely. Although the level of explicit support has decreased from nearly £1 trillion to £512 billion, the Treasury still retains the ultimate risk of supporting banks should they threaten the stability of the overall financial system. The options available to deal with a failing bank are still not able to pass the costs of failure to the shareholders and creditors instead of to the public purse.

Taxpayer support for the banks, both explicit and implicit, provides a subsidy to the banking sector as a whole. Estimates of the size of the implicit subsidy vary - from as high as £100 billion to just below £10 billion in 2009 alone. But regardless of the size, the Bank of England, Treasury, and RBS all agreed the implicit subsidy needed to be removed. The explicit subsidy includes the fees paid by banks for their use of the Credit Guarantee Scheme which, to date, have been at least £1 billion less than the benefit received by the banks. These subsidies enable private gains to be made at the expense of public risk. Contracts entered into when state support was put in place have allowed some of these gains to be used to pay bonuses to certain bank staff, and dividends to shareholders, rather than enhancing the financial sustainability of the sector.

Although the banks' progress to date on reducing their reliance on the explicit taxpayer support is encouraging, the Treasury must continue to encourage the banks to manage the transition from reliance on the support schemes to private funding in an orderly and smooth way. Whether or not the taxpayer obtains value for money from exiting from the support depends heavily on a successful sale of the shares in RBS and Lloyds. The value of the shares at the time we took evidence was still some £8.4 billion below the price paid by the taxpayer.

The scale of the Government shareholding is far greater than in previous share sales and will require extraordinarily careful handling. When developing its strategy for the sale, the Treasury will need to balance the legitimate desire to maximise proceeds against its other objectives of preserving financial stability and enhancing competition. Considerable regulatory and political uncertainty over the Government's intentions for the banking sector will remain until the Government has responded to the recommendations from the Independent Commission on Banking, expected to report in September 2011.

On the basis of a report from the Comptroller and Auditor General, the Committee took evidence from the Treasury, the Bank of England, and separately from RBS and Lloyds, on the progress on repaying the taxpayer support and maintenance of financial stability. The Committee are grateful to the Bank of England for its evidence at the first hearing, and the Committee hopes the Bank's senior officials will be able to support the Committee's future hearings on this and related subjects.

Government responses to the Committee's conclusions and recommendations

PAC CONCLUSION AND RECOMMENDATION 1

Banks should not be dependent on taxpayer support.

The Committee are encouraged that the level of explicit support provided to the banks has decreased from nearly £1 trillion to £512 billion by December 2010. The Treasury must continue to manage down the explicit support and work towards a financial system where risk is borne solely by investors.

1.1 The Government agrees with the Committee's recommendation.

1.2 The previous Government intervened to avoid a collapse of the financial sector. The various measures, such as recapitalisation of RBS and LBG, the interventions relating to Northern Rock or the Credit Guarantee Scheme were temporary and are not intended to be permanent.

1.3 The Treasury regularly evaluates the interventions made during the crisis and has been developing exit plans for the various schemes.

PAC CONCLUSION AND RECOMMENDATION 2

Whilst parts of the banking industry believe that the time for remorse is over, so long as banks are "too big to fail" there remains an implicit expectation of taxpayer support.

This provides a very significant implicit subsidy for important banks, which, the Bank of England has estimated, could be as high as £100 billion. Currently the options available for winding-up failing banks would still not be able to cope with the failure of a major bank, and there is no way to avoid the cost of such a failure being borne by the taxpayer. Although the risk of such a failure has reduced since 2008, the Treasury must maintain momentum for international reform in this area. It should also continue to work with the Bank of England to develop a credible resolution regime capable of handling the failure of a systemically important bank.

2.1 The Government agrees with the Committee's recommendation.

2.2 The Government supports the ongoing work by the G20 and the Financial Stability Board to develop a robust, internationally consistent policy framework to address the risks posed by systemically important financial institutions (SIFIs), while taking into account the cumulative impact of reform on the economy. An internationally consistent approach is crucial to ensure level playing field and it will be important that G20 countries support the FSB in fleshing out and ensuring consistent implementation of its recommendations.

2.3 The Chancellor of the Exchequer has recently endorsed the principles of bail-in and a retail ring fence, as proposed by the Independent Commission on Banking (ICB) interim report. This is to ensure that private investors, not taxpayers, bear the losses if banks fail and to protect the vital retail services that banks provide in the event of another financial crisis. The final proposals of the ICB on these issues will be judged against the following conditions:

- all banks should be allowed to fail safely without affecting vital banking services;
- without imposing costs on the taxpayer;
- in a manner applicable across our diverse sector; and
- consistent with EU and international law.

PAC CONCLUSION AND RECOMMENDATION 3

The Treasury is providing a subsidy of at least £1 billion through the Credit Guarantee Scheme.

The Committee accepts that such subsidies were initially necessary to support the banks, but it is now time to ensure the taxpayer is adequately compensated for the support provided. The Treasury should look for ways to ensure that banks are not paying bonuses or dividends at the expense of repaying the subsidy. The fees for the Credit Guarantee Scheme should be reassessed and revised upwards where necessary.

3.1 The Government agrees with the Committee's recommendation that the taxpayer must be adequately compensated for the support provided.

3.2 Under the state aid term sheets, Lloyds Banking Group (LBG) and Royal Bank of Scotland (RBS), the major banks which were recapitalised during the crisis, are not allowed to pay dividends until January and April 2012 respectively..Banks are already beginning to reduce their reliance on the Credit Guarantee Scheme. The Government recently announced a buyback facility, where participating institutions can smooth their refinancing profile over the next 12-18 months by replacing short maturity government- guaranteed debt with private unguaranteed funding. This change to the CGS will reduce the public exposure to the banks as well strengthening the funding of these institutions as they begin move away from public support.

3.3 The institutions involved will be charged a fee for this buyback facility. The fee is designed to ensure the taxpayer receives a fair return for the support given through the CGS but also at a level that make it attractive to the institutions involved to begin withdrawing from the Scheme, which is ultimately in the taxpayers' best interest.

PAC CONCLUSION AND RECOMMENDATION 4

Unless banks can replace taxpayer funding with alternative sustainable funding over the next two years, the Government may still be called on to provide additional support.

Stability depends on banks exiting the support schemes in an orderly fashion. Banks are on track to achieve this, but the next two years may be challenging. The Treasury, working with the Bank of England, must continue to encourage a smooth and timely run-down of the Credit Guarantee and Special Liquidity Schemes. In addition it should continue to develop its contingency plans for managing an orderly transition to full private funding.

4.1 The Government agrees with the Committee's recommendation.

4.2 The Government is continuing to plan for the exit of banks from support schemes. In addition to the voluntary Special Liquidity Scheme repayment plans a number of banks have agreed with Bank of England, the Government has recently amended the Rules of the Credit Guarantee Scheme to allow early repayment of debt guaranteed under the Scheme. The authorities are already monitoring funding plans of users of the SLS and CGS at an aggregate and individual level.

PAC CONCLUSION AND RECOMMENDATION 5

Despite our previous recommendations, the Treasury has not yet captured the experience and lessons they have learned from the interventions.

The Treasury should therefore conduct an interim lessons learned exercise now, to ensure that institutional knowledge is retained.

5.1 The Government agrees with the Committee's recommendation.

5.2 The Treasury will conduct an interim lessons learned exercise on the various financial interventions made during the crisis and will report in due course.

PAC CONCLUSION AND RECOMMENDATION 6

The value for money of removing the explicit taxpayer support will be highly dependent on the Treasury's handling of the sale of the shares in RBS and Lloyds, a sale far greater than any previous privatisation.

The Treasury also has to balance the need to make a profit for the taxpayer with its wider responsibilities for financial stability and promoting competition. The Treasury has not yet set out its plans for the sale but should continue to work with UK Financial Investments to ensure an orderly programme of disposals.

6.1 The Government agrees with the Committee's analysis.

6.2 As set out in the UKFI Framework Document, representatives of the Treasury and UKFI meet regularly to review the strategic options available for managing the investments and devising and executing a disposal strategy.

6.3 The Chancellor of the Exchequer has announced that the sale process for Northern Rock has begun.

PAC CONCLUSION AND RECOMMENDATION 7

It is inappropriate for a bank dependent on taxpayer support to be generating excessive incomes or dividends at the expense of exiting public support.

The Committee recognises that banks with significant state ownership still need to pay competitive remuneration to retain their staff, but only if this contributes to the value realised on exit from taxpayer support. The Treasury must explore all avenues to ensure that the remuneration packages for the part-nationalised banks provide value for money for the taxpayer, and properly reflect the burden on the taxpayer of continuing support.

7.1 The Government agrees with the Committee's recommendation.

7.2 As the majority shareholder in the RBS and the largest shareholder in LBG, the Government has made clear that it expects these banks to be back-markers and not market leaders on bonuses.

7.3 The Government is determined that the taxpayers' investment in the banking system is recovered and therefore RBS and LBG must be able to attract and retain staff in order to protect and create value for the taxpayer. The Government believes that these banks' remuneration policies strike the right balance.

PAC CONCLUSION AND RECOMMENDATION 8

It is still not clear how the Treasury will manage its competing objectives of maintaining financial stability, promoting competition and realising the value of the taxpayers' investments.

Until the Government has responded to the Independent Commission on Banking, this uncertainty will remain. In formulating its response to the Commission, the Treasury will need an explicit framework for how it will manage these competing objectives. It should analyse the costs and benefits of options for the size and shape of the banking industry, and quantify the value it places on each of its objectives.

8.1 The Government agrees with the Committee's recommendation.

8.2 The Government agrees that it will be important to consider all competing objectives such as maintaining financial stability, competition and ensuring value for money of taxpayer interventions. However, it may not be possible to quantify every element of the various options available for the size and shape of the banking industry as the Committee suggests.

8.3 The Chancellor of the Exchequer has recently endorsed the principle of two of the key ICB interim proposals on bail-in and a retail ring fence. The Government will consider the final report of the ICB in September and issue its response after this, and will reflect the Committee's advice in its response.

PAC CONCLUSION AND RECOMMENDATION 9

The taxpayer will have to pay £5 billion a year in interest on the money borrowed to finance the support.

This is a material amount, and should be reflected in future assessments of the total cost of the interventions.

9.1 The Government agrees with the Committee's recommendation.

9.2 The Government takes into account financing costs when making policy decisions, including those in the financial sector.

9.3 The Office for Budget Responsibility has certified the Treasury's methodology for estimating the expected direct costs of the financial stability interventions. The OBR now publish the official estimate of the total cost of these interventions twice yearly in their Economic and Fiscal Outlook. The methodology they use is a matter for them.

9.4 Once all the support schemes have been un-wound, an overall assessment will be made of the net cost and benefit to the Exchequer. The Treasury agrees that this should take account of the financing cost.

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