UK Financial Investments Ltd

UK FINANCIAL INVESTMENTS LIMITED (UKFI)
ANNUAL REPORT AND ACCOUNTS 2011/12

UK FINANCIAL INVESTMENTS LTD ANNUAL REPORT AND ACCOUNTS 2011/12

Presented to the House of Commons pursuant to section 7 of the Government Resources and Accounts Act 2000.

Ordered by the House of Commons to be printed on 3 July 2012.

HC 363 LONDON: THE STATIONERY OFFICE £16.00

Any enquiries regarding this document should be sent to us at enquiries@ukfi.co.uk.

This publication is available for download at www.official-documents.gov.uk.

This document is also available from our website at www.ukfi.co.uk/publications.

ISBN: 9780102978520

Printed in the UK for The Stationery Office Limited
on behalf of the Controller of Her Majesty's Stationery Office

ID 2493690 07/12

Printed on paper containing 75% recycled fibre content minimum.

UKFI CONTACTS

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

General enquiries should be addressed to:
Enquiries
UK Financial Investments Limited
Oceanic House
1a Cockspur Street
London
SW1Y 5BG

Email: enquiries@ukfi.co.uk

Company Number 6720891

CONTENTS

UKFI'S REMIT

UK Financial Investments (UKFI) was created in November 2008 as part of the UK's response to the financial crisis.

UKFI is responsible for managing the Government's shareholdings in Lloyds Banking Group plc and The Royal Bank of Scotland Group plc. UKFI is also responsible for managing the Government's 100 per cent shareholding and loans in UK Asset Resolution Ltd (UKAR). UKAR was formed during 2010 to integrate the activities of Northern Rock (Asset Management) plc and Bradford & Bingley plc. UKFI managed the Government's 100 per cent shareholding in Northern Rock plc from Northern Rock plc's formation on 1 January 2010 and up to its sale to Virgin Money on 1 January 2012.

UKFI's overarching objective is to manage these shareholdings commercially to create and protect value for the taxpayer as shareholder and to devise and execute a strategy for realising value for the Government's investments in an orderly and active way over time within the context of protecting and creating value for the taxpayer as shareholder, paying due regard to the maintenance of financial stability and acting in a way that promotes competition.

More detail on UKFI's role, remit and ownership approach is set out in our Framework Document and Investment Mandate with HM Treasury, which can be found on our website www.ukfi.co.uk.

CHAIRMAN'S FOREWORD

Set against the backdrop of the intensifying Eurozone crisis and deteriorating market conditions, 2011/12 was a mixed year for UKFI's mission to return the state owned banks to the private sector.

Across Europe bank share prices are being hampered by the profound uncertainties arising from the market and economic environment and the ongoing programme of regulatory reform at the domestic, European and international level. The long-term impact of these developments is far from clear at this stage. While the economic headwinds should subside in time, banks are facing structural changes such as more expensive wholesale funding costs and much higher capital and liquidity requirements, which are likely to have a permanent impact on their profitability and shareholder returns. This is especially true of large and complex banks like Lloyds Banking Group (Lloyds) and The Royal Bank of Scotland Group (RBS) – although of course any cost to the taxpayers' stakes needs to be evaluated against the wider benefits to the UK economy and public finances of a safer and more resilient banking sector.

Until some of the major sources of investor uncertainty start to subside, we are unlikely to be able to recommend that the Government commences a broad-based offering of its shares in Lloyds and RBS. While we would have liked to have seen faster progress towards the initiation of the disposals programme, it is important not to lose sight of the substantial progress that both banks are making in rebuilding investor confidence. The scale of the restructuring challenge is enormous. Since the start of 2009, Lloyds and RBS have reduced non-core legacy assets by over £350 billion in total – a remarkable achievement in controlled de-risking, which could easily have precipitated large losses if not carefully managed.

In relation to our wholly owned investments, 2011 marked a major milestone with the announcement in November of the sale of Northern Rock plc to Virgin Money Holdings (UK) Limited (Virgin Money). The transaction delivers good value for taxpayers, strengthens competition in UK banking and secures jobs in the North East. In its recent evaluation the National Audit Office reported positivity on the disposal and UKFI's handling of it.

UK Asset Resolution Ltd (UKAR) also made good progress in managing the orderly run-down of Northern Rock (Asset Management) plc (NRAM) and Bradford & Bingley plc (B&B) during its first full year of operation, reducing customer balances from £83.5 billion to £75.3 billion and repaying over £2 billion of Government loans. The successful completion of the integration programme has created an entity with the right capabilities to manage the needs of customers over the long-term. Building on the successful repurchase of subordinated debt over the past two years which, generated total gains for the taxpayer of over £2 billion, UKFI will continue to work with UKAR to assess opportunities for further value creation.

Clearly the job of rebuilding Lloyds and RBS is far from complete, and we will continue to engage actively with the Boards and management teams in tackling the remaining obstacles to broad-based investor appeal. There will also need to be a full investigation into the causes of the recent major technical disruption in NatWest, RBS and Ulster Bank. However, I believe that the substantial progress that has already been made in addressing the legacy of balance sheet and funding weaknesses is evidence that the Government's framework for managing the investments on an arm's length basis is broadly working. The best way to re-establish shareholder value and financial stability in the banks is under the leadership of their own Boards. While Lloyds and RBS need to be sensitive to the political and social environment in which they operate, this needs to be framed within the context of a clear commercial focus if taxpayers' interests are to be protected. The intense media and Parliamentary debate in relation to Stephen Hester's bonus was a clear reminder of how difficult it can be at times to uphold this balance. Lloyds and RBS must stay at the forefront of best practice and restraint in their remuneration policies, but it is also critical that they are able to attract, motivate and retain staff of the calibre needed to protect and build the value of the taxpayers' investment, ultimately facilitating their return to full private sector ownership.

I am very grateful to all the team at UKFI and to my Board colleagues for their continued dedication and work in pursuing our objectives. In particular I would like to thank Sir David Cooksey who stepped down as Chairman of UKFI in January 2012. Sir David provided strong leadership during a challenging period for UKFI and its investments, and I am extremely grateful for his sage advice and counsel while I was Chief Executive. I would also like to thank Keith Morgan, who will be leaving UKFI having successfully restructured the wholly owned portfolio. The sale of Northern Rock plc and the total payments by UKAR to the Exchequer of £4.4 billion over the last two years are a testament to the hard work of Keith and his team.

Robin Rudenberg
Chairman

28 June 2012

01

Review of the past year and objectives for 2012/13

Introduction

This opening chapter provides an overview of UKFI's activities in managing the Government's shareholdings in the banks, structured around the following three sections:

- a summary of how we have approached our role as an active and engaged shareholder over the past year, with the aim of building sustainable value for taxpayers;
- an update on our strategy for disposing of the shareholdings, including the progress we have made in selling Northern Rock; and
- a description of UKFI's objectives for the year ahead, as agreed with HM Treasury.

More detailed information on the financial performance of each of the investee banks over the past year is provided in Chapters 2 to 5.

Chapters 6 and 7 provide further information on UKFI's internal governance and remuneration policies. The UKFI Board, supported by three sub-committees, takes all major strategic decisions for the company. The directors provide the company with the appropriate experience and expertise to manage the Government's investments on a commercial basis.

Chapters 8 and 9 provide the independent auditor's report and UKFI's financial statements for 2011/12. UKFI has produced an unqualified set of accounts for the four years of its operation. Our direct administration expenditure for the year under review was £2.5 million (down from £2.7 million in 2010/11), of which staff costs were £1.8 million.

UKFI's role as an active and engaged shareholder

Under the framework set by the Government, UKFI is required to manage the shareholdings on a commercial basis, actively engaging at a strategic level rather than intervening in day-to-day management decisions. This approach aims to ensure that value is re-established in the banks under the leadership of their own Boards and management teams, to the ultimate benefit of taxpayers. Our level of involvement varies between the partly and wholly owned institutions:

- in the case of the banks in which the Government is a 100 per cent shareholder (currently UKAR and previously Northern Rock plc before it was sold), UKFI works with the Boards and management teams in a manner similar to that in which a financial sponsor would engage with a wholly owned portfolio company. For example, UKFI appoints the Chairman of the Board, is required to approve Board nominations, is represented at Board meetings, and has approval rights over the companies' business plans;
- in contrast, UKFI takes a more arm's length approach to its interactions with Lloyds and RBS, recognising that, as listed companies, their directors have fiduciary duties under the Companies Act 2006 to act in the commercial interests of all shareholders, not just the largest one. UKFI therefore operates in line with best practice for institutional shareholders, exercising its voting rights and engaging actively with the Boards and senior management on key strategic issues, while preserving their independence and freedom to determine their own commercial policies and business plans.

For all the investee companies our engagement is focussed on ensuring that their business strategies, performance, governance and risk management processes are aligned to build sustainable value for the taxpayer as shareholder. This approach is consistent with the best practice set out in the Financial Reporting

Council's Stewardship Code for Institutional Investors, which aims to enhance the quality of engagement between shareholders and companies. Further details of how we act in accordance with this Code are available on our website.

UKFI's approach to the stewardship of the shareholdings is also informed by active dialogue with a wide range of other institutional investors, with whom UKFI holds regular meetings.

Engagement with the wholly owned companies

UKFI is either represented or is in attendance at Board meetings of all the wholly owned companies. Keith Morgan was a member of the Board of Northern Rock plc up until the point it was sold. He is also a member of the UKAR Board, and after his departure UKFI will continue to be represented through Jim O'Neil.

From the beginning of 2011, UKFI worked closely with the Board of Northern Rock plc to evaluate strategic options to realise value for the taxpayer from its investment, while also focusing on enhancing the commercial performance of the business. This culminated in the sale of the business to Virgin Money on 1 January 2012.

During this period, UKFI also worked closely with the Board of UKAR to develop a strategy for accelerating and enhancing the value of the run-down of the balance sheets of its combined businesses. Working with the company, we developed a detailed assessment of the likely cash flows to the taxpayer as the run-down of the balance sheets progresses, and the value this represented under different risk scenarios.

We published a separate report[1] in February 2012 providing further information on our strategy and process for realising value from Northern Rock plc, together with an assessment of the value of the cash flows from UKAR.

Engagement with Lloyds and RBS

Over the past year the focus of our engagement with both Lloyds and RBS has been on ensuring that the shape and pace of balance sheet restructuring is appropriate to secure sustainable shareholder value in the evolving market and regulatory environment. Given the context of weak and deteriorating conditions, we have supported the actions taken by both management teams to accelerate the run-down of non-core assets, reduce risk concentrations and strengthen their liquidity and funding positions. In particular, we engaged closely with RBS in the reshaping of its international wholesale business announced in January 2012, and with Lloyds in the development and implementation of its Group strategic review. Over the coming year we will continue to work with both banks to ensure that they are responding appropriately and proactively to further developments in the regulatory environment, including the implementation of the measures set out in the Governments white paper on banking reform published in June.

We have also continued to engage with the risk officers and Board Risk Committees of both banks to ensure that they remain focussed on improving the risk management processes used to underpin business decisions.

Over this financial year UKFI has exercised its voting rights in relation to all resolutions put to shareholders. We inform the relevant bank in advance of our voting intentions and rationale, and we disclose on our website how we have voted on the resolutions at Lloyds and RBS. Many of these votes follow consultations by the Boards with us and other shareholders in relation to individual resolutions.

While it is for the Boards of Lloyds and RBS to make decisions on the appointment of directors, as a large shareholder we are consulted and seek to ensure that suitably qualified, independent non-executives are

[1] *'Publication on the sale of Northern Rock plc', February 2012, available at www.ukfi.co.uk/publications*

recruited to maintain the strength and balance of the Boards. During the reporting year we were consulted on the non-executive appointments announced at both Lloyds (Sara Weller) and RBS (Alison Davis, Baroness Noakes and Tony Di Lorio), which followed the retirement of some existing Board members.

At the end of 2011 António Horta-Osório took a short leave of medical absence from Lloyds. During that period UKFI engaged closely with the Board to ensure that appropriate procedures were put in place for the continued leadership of the bank, together with robust arrangements for assessing and managing his return.

Remuneration

Remuneration in the banking sector remains a high profile issue. UKFI's Framework Document states we should not intervene in relation to individual remuneration decisions within Lloyds and RBS, except in relation to directors through our vote on the Directors' Remuneration Report at the Annual General Meeting. As the largest shareholder in Lloyds and RBS, UKFI has worked closely with the Boards to ensure that pay is aligned with the interests of shareholders, and appropriately focussed on long-term performance. While both banks need to be sensitive to the wider economic and political environment in which they operate, it is also essential that they are able to offer remuneration packages that are adequate to attract and retain staff with the talent and experience needed to oversee the complex restructuring challenges they face, in order to protect shareholder value.

Following a process of thorough engagement with the Lloyds and RBS Remuneration Committees, UKFI concluded that both Committees had exercised reasonable judgement in relation to their approach to total variable remuneration this year, both in relation to the financial performance and the retention of key employees. This resulted in significant reductions in total variable pay. UKFI voted in favour of the Directors' Remuneration Reports at both the Lloyds and RBS Annual General Meetings.

The RBS Board consulted UKFI on its decision to award a bonus to its Chief Executive, Stephen Hester, which recognised his role in leading the substantial restructuring and de-risking of the bank over the course of 2011. While we note that he ultimately elected to waive this award, this was a personal decision. Overall we believe it is critical for both taxpayer value and financial stability that key employees are able to be appropriately rewarded in line with their contribution to long-term performance.

Disposals strategy

UKFI is responsible for devising and recommending to HM Treasury a strategy for returning the banks to private ownership, and for executing the chosen strategy. Further details of how we are approaching this task for each of the investee institutions are set out below.

Northern Rock plc

In June 2011 the Chancellor of the Exchequer announced the launch of an open and transparent sales process for Northern Rock plc, based on advice provided by UKFI that this timing and approach was likely to be the best way to maximise value for taxpayers, and should therefore be pursued as the first option. We assessed the full range of disposal options in reaching this conclusion.

The sale process attracted interest from a number of parties, and concluded with the sale of Northern Rock plc to Virgin Money on 1 January 2012. The transaction consideration comprised £747 million cash on completion with the potential in the future to receive up to c.£1 billion in total.

The value range of this transaction was assessed to be higher than all other options for returning Northern Rock plc to the private sector, including an initial public offering (IPO), a stand-alone remutualisation, a deposit sale and loan book run-down, and a later exit from temporary public ownership in 2013.

The National Audit Office published a detailed evaluation of the sales process in May 2012[2], which concluded that the sale to Virgin Money was the best available option to minimise future losses and on this basis value for money was preserved. It also concluded that UKFI handled the sales process well, noting that "bidders were positive about the sale process, describing it as transparent and fair. Competitive tension was maintained with two final bidders who remained aware that UKFI had alternative means of disposing of Northern Rock plc. In final negotiations, UKFI improved the overall offer from Virgin Money."

UKAR

The integration of NRAM and B&B into UKAR has created a larger operating entity able to deliver synergies and economies of scale. In particular, increased efficiency and shared capability in arrears management and treasury functions will enhance the future repayment of Government loans. Alongside this we have worked closely with the company to develop a strategy to accelerate and enhance the value of the rundown of the balance sheets of the combined business.

At 31 December 2011 UKAR owed HM Treasury £46.6 billion, an amount the company expects to repay in full. Total payments from UKAR to the taxpayer, including repayments, interest, fees and corporation tax, increased from £1.6 billion in 2010 to £2.8 billion in 2011. In August 2011, UKFI and HM Treasury secured increased interest payments from UKAR by requesting an increase in the margin over Bank Base Rate on the Working Capital Facility that HM Treasury provides to B&B. In May 2012, the margin over Bank Base Rate on the Government loan to NRAM was also increased.

In November 2011, tender offers were made to repurchase up to £1.3 billion of B&B and NRAM capital instruments. As a result, £1,159 million of notes were repurchased, generating a gain of £382 million. This takes the total pre-tax gains generated for the taxpayer to over £2.1 billion from liability management programmes undertaken by UKAR over the last two years.

Our separate report in February 2012 set out UKFI's assessment of the expected cash flows from the Government's intervention in B&B, NRAM and the creation and sale of Northern Rock plc.

In cash terms these companies are collectively expected to more than repay the original funding provided by the taxpayer. The cash is expected to be returned over a period of around 10 to 15 years from 2012 as NRAM and B&B are run-down and the remaining Government loans are repaid. The cash-flows from the companies are estimated to yield an overall positive annual rate of return of between 4.0 and 5.0 per cent to HM Treasury, higher than the Government's estimated notional annual funding costs during the period of intervention of 3.9 per cent.

[2] *'The creation and sale of Northern Rock plc', National Audit Office, May 2012. Available at www.nao.org.uk/publications*

Lloyds and RBS disposals

As discussed above, Lloyds and RBS have continued to make steady progress in de-risking their balance sheets and rebuilding the profitability of their core businesses over the past year, thereby laying the foundations for the future realisation of value from the taxpayers' stakes in both banks. However, there remain significant obstacles to the initiation of the share disposals programme in the short term. In common with many banks across Europe, both Lloyds and RBS are currently trading at a substantial discount to their book values, reflecting the market turmoil arising from the Eurozone crisis, the uncertain outlook for economic recovery and the major programme of domestic and international regulatory reform currently underway. The long-term impact of these developments on the taxpayers' investments is highly uncertain at this stage, but it is clear that any structural changes in funding costs, capital and liquidity requirements will have permanent repercussions for the banks' profitability and shareholder returns. Until there is greater clarity in the long-term operating environment, it is likely to be difficult to commence a broad-based sell-down of the shareholdings.

Nonetheless, the Government remains committed to the return of Lloyds and RBS to full private sector ownership at the earliest appropriate opportunity. In the current environment, UKFI's focus is therefore on working with the banks to ensure their performance, leadership and strategy are evolving in a way which builds the confidence and willingness of private investors to participate in future share sales, either in the public equity markets or through strategic placements.

The ultimate decision to proceed with any share sale rests with HM Treasury. Consistent with UKFI's Investment Mandate, any transaction recommendations that we make to Ministers will be based on value, and not the cost of investment, paying due regard to financial stability and competition issues (although the latter is only likely to be a relevant factor in this context if another incumbent bank was seeking to acquire a controlling stake in one of the businesses).

In particular, our assessment of the value for money of individual transaction proposals will focus on two primary considerations:

- whether it secures fair value for the shares based on a realistic assessment of the banks' future earnings prospects, taking into account any long-term changes in their existing operating environment arising from the regulatory and market developments noted above; and
- the likely impact on the value achieved in the overall disposals programme, recognising that it is likely to require multiple transactions over a number of years to dispose fully of the Government's substantial shareholdings, and that a well-executed sale can boost the prospects for subsequent offerings by building investor momentum and increasing the trading liquidity of the shares.

We will continue to monitor market developments so we are ready to capitalise on suitable disposal opportunities as they emerge, and will also continue to maintain a dialogue with a wide range of investors, to inform both our stewardship function and our approach to future share sales.

UKFI's 2012/13 objectives

The key objectives which UKFI has agreed with HM Treasury for the 2012/13 reporting year are set out below.

Lloyds and RBS

1. To engage with the Boards and management teams of both banks to ensure their strategies, performance and leadership remain appropriate to build sustainable shareholder value in the context of the evolving operating environment, underpinned by high standards of customer conduct, risk management and regulatory compliance.
2. To develop and maintain a strategy for the effective disposal of the shareholdings, taking into account relevant market developments; and to work with HM Treasury to ensure we have robust analytical frameworks in place to assess the value for money and wider policy, operational and legal implications of individual transaction proposals.
3. To maintain an ongoing dialogue and communication with both existing and prospective investors in Lloyds and RBS, to inform our approach to both the stewardship and disposal of the shareholdings.

UKAR

4. To actively engage with UKAR in the orderly ongoing run-down of its closed mortgage books with a focus on maximising value for the taxpayer. This includes:
   - ongoing review of its business plan and balance sheet optimisation strategy;
   - working with the company to execute balance sheet transactions as appropriate; and
   - monitoring its approach to arrears management, impairment and cost efficiency.

All investee banks

5. To ensure that strong governance and leadership are maintained at the investee institutions to oversee the successful development and implementation of the agreed strategies.
6. To engage actively with the remuneration committees of the investee institutions in striking an appropriate balance between incentives and restraint.
7. To provide input and expertise where appropriate to support the HM Treasury's wider policy interests in relation to the banking sector, for example in relation to financial stability and competition.

ANNUAL REPORT AND ACCOUNTS
2011/12

02

The Royal Bank of Scotland Group plc

Summary of Government shareholding

As at the end of March 2012, the Government held a total of 90.6 billion shares in RBS, including 51 billion non-voting B shares and the enhanced Dividend Access Share (see Box 2.1 on page 20), equivalent to 66 per cent of voting share capital and 82 per cent economic ownership.

Company overview

The Royal Bank of Scotland Group plc is a global banking group, providing services to personal, commercial and large corporate and institutional customers in over 30 countries. Headquartered in Edinburgh, the Group operates in the United Kingdom, the United States and internationally.

Company performance

The table below provides an overview of the key financial results for RBS from 2009 to 2011. Full details of the results, including for the first quarter of 2012, can be found on the company's website: www.investors.rbs.com/results_presentations.

Table 2.1: Key financial performance metrics

	2011	2010	2009
Risk measures (Group)			
Core tier 1 ratio	10.6%	10.7%	11.0%
Loan: deposit ratio	108%	118%	135%
Short-term wholesale funding	£102bn	£130bn	£216bn
Liquidity portfolio[1]	£155bn	£155bn	£171bn
Leverage ratio[2]	16.9x	16.8x	17.0x
Value drivers (Core Bank)			
Return on Equity	10.5%	13.3%	13.5%
Cost: income ratio[3]	60%	56%	53%

Notes: (All figures from statutory accounts)

1. *Eligible assets held for contingent liquidity purposes including cash, Government-issued securities, and other eligible securities with central banks.*
2. *Funded tangible assets divided by total tier 1 capital.*
3. *Net of insurance claims.*

Commenting on the Group's performance in 2011, Stephen Hester, Chief Executive said:

"2011 saw good progress across all measures of risk reduction and increased financial soundness; important given the much tougher market conditions. Customer service and support was sustained well.

However, RBS has reported a pre-tax loss of £766 million overall and, in common with others, has seen a share price fall, albeit still at levels much higher than the 10p starting point in January 2009. These outcomes reflect the stage of our recovery and the external environment. They mask real and important accomplishments, however.

Core bank operating profits were £6.1 billion. Within this total, operating profits in 2011 across RBS's Retail and Commercial business (excluding Ulster Bank) were up 9 per cent to £4.9 billion. RBS Insurance turned loss into profit, a £749 million improvement on 2010. GBM suffered a 54 per cent fall in profit to £1.6 billion, reflecting tough market conditions, but still a substantial result and one generally in line with other investment banking businesses. Non-Core losses declined 24 per cent to £4.2 billion as the risk run-off continued ahead of schedule. Exceptional charges for past business associated with PPI and Greek write-downs were also taken. £3.8 billion was handed over to HMT/HMRC/Bank of England in fees for APS/Credit Guarantee Scheme, taxes (both on our behalf and on that of our employees) and capital support schemes.

We all understand that a company that is making losses at the bottom line tests the patience of those who depend on it. However, the restructuring task we have undertaken at RBS is unique in its scale and complexity, and needs to be phased in line with our ability to fund and execute it. In dealing with these legacy losses we expect to put the company on a sustainable footing for generations to come. 2011 proved what we already knew: that there are no shortcuts to this endpoint."

Investment in RBS

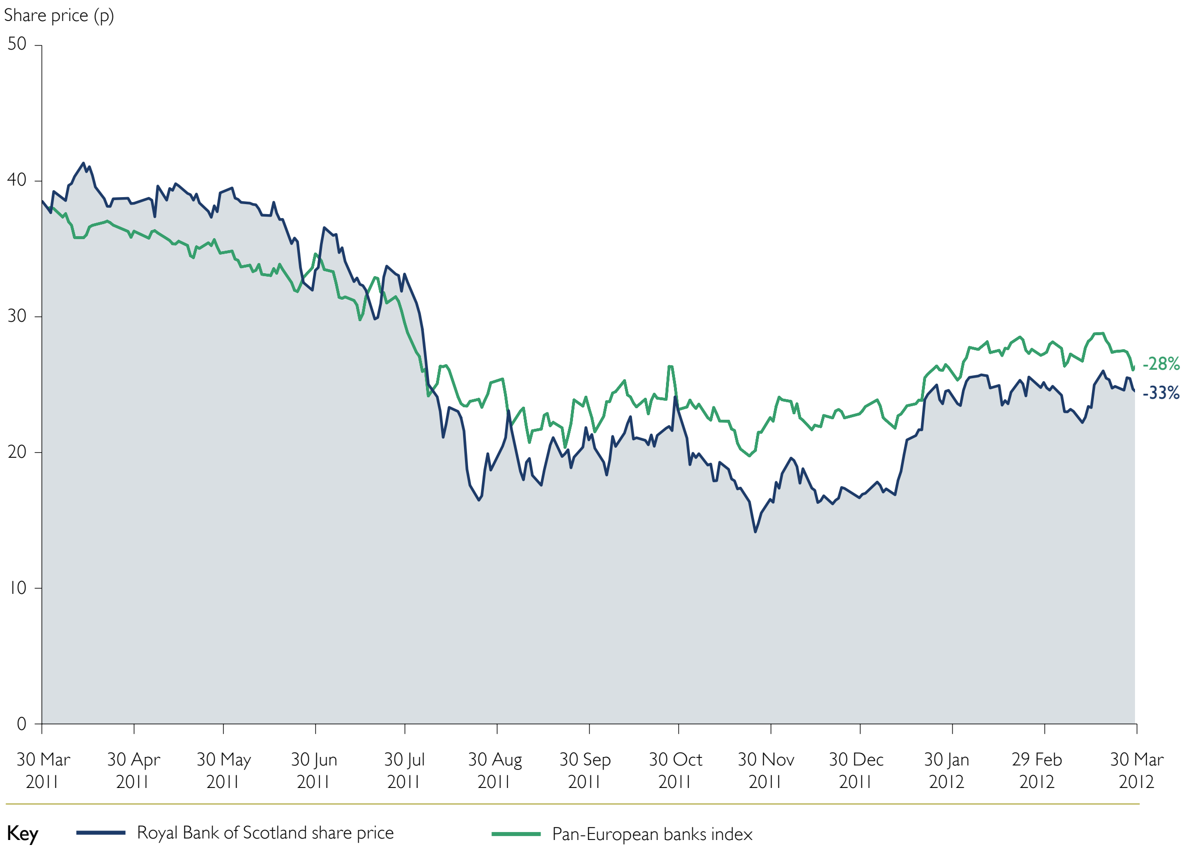
The Government's investment in RBS has been made in three different tranches, as summarised in the table below. Taking into account fees received, the net cost of the Government's investment in RBS is £45,222 million, equivalent to an average of 49.89p per share.

HM Treasury shareholdings in RBS		Shares	Total investment	Investment per share	Value at 31 March[1]
		m	£m	p	£m
Initial recapitalisation	December 2008	22,854	14,969	65.50	6,317
Preference share conversion[2]	April 2009	16,791	5,058	31.75	4,641
APS B shares[3]	December 2009	51,000	25,500	50.00	14,096
Total investment		**90,645**	**45,527**	**50.23 (avg)**	**25,054**
Fees received[4]			(305)		
Total net investment		**90,645**	**45,222**	**49.89 (avg)**	

Notes

1. *Based on RBS share price of 27.64p as at 30 March 2012.*
2. *Total investment includes accrued dividends and redemption premiums received of around £270 million.*
3. *Excludes theoretical valuation of the enhanced dividend access share, valued as £1.8 billion as at 31 March 2012. See Box 2.1.*
4. *Underwriting fees on transactions paid to HM Treasury, including the recapitalisation and preference share conversion. Excludes annual fees paid to HM Treasury in relation to the Asset Protection Scheme (APS) and contingent capital facility.*
5. *On 6 June 2012 RBS executed a share consolidation exercise, the effect of which is to divide the ordinary share count by 10 and multiply the unit price by the same factor. The impact of this exercise is not factored into the figures provided in this table.*

Figure 2.1: RBS share price performance



BOX 2.1: B SHARES AND THE DIVIDEND ACCESS SHARE

As part of the arrangements for RBS' participation in the Asset Protection Scheme (APS) in 2009, the Government subscribed to 51 billion B shares, together with one enhanced Dividend Access Share (DAS). The £25.5 billion investment in the form of B shares counts towards the bank's core tier 1 capital. B shares do not confer voting rights, but otherwise rank pari passu with ordinary shares. The market value of each B share is therefore assumed to be equivalent to the value of an ordinary share.

The B shares are convertible into ordinary shares at the Government's option (subject to certain parameters agreed with the European Commission). However, the Government has agreed not to convert B shares to the extent that its holding of ordinary shares would represent more than 75 per cent of the bank's total ordinary share capital.

Alongside the APS agreement, the Government also provided an £8 billion contingent capital facility, under which it would acquire further B shares in the event that RBS' core tier 1 ratio falls below 5 per cent.

The single DAS confers the right to an enhanced dividend over and above the dividend entitlement of each ordinary and B share, providing the greater of 7 per cent of the B share nominal amount of £25.5 billion, or 250 per cent of the ordinary share dividend. DAS dividends are payable at the discretion of the RBS Board, but must be paid if a dividend is awarded on ordinary shares. The DAS expires when the RBS ordinary share price equals or exceeds 65p for 20 days in any 30-day period.

There is no market price for the DAS. However, its value can be estimated using an option-based valuation model on the basis of market-observable and non-observable data and assumptions.

Using this financial model, the DAS value was estimated at £1.8 billion at 31 March 2012. It should be noted that this theoretical valuation does not necessarily reflect the ultimate value that may be realised from the DAS. The value estimate is highly sensitive to underlying assumptions, which are very uncertain. Further details are provided in HM Treasury's latest Annual Report and Accounts (available at www.hm-treasury.gov.uk).

ANNUAL REPORT AND ACCOUNTS 2011/12

03

Lloyds Banking Group plc

Summary of Government shareholding

As at the end of March 2012, the Government held a total of 27.6 billion ordinary shares in Lloyds, equivalent to 40 per cent of total share capital.

Company overview

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

Lloyds Banking Group plc was formed in January 2009 following the acquisition of Halifax Bank of Scotland by Lloyds TSB. The main business activities are retail, commercial and corporate banking, general insurance, and life, pensions and investment provision.

The Group has a large and diversified customer base in the UK, providing services through a number of recognised brands including Lloyds TSB, Halifax, Bank of Scotland, Scottish Widows, Clerical Medical and Cheltenham & Gloucester.

Company performance

The table below provides an overview of the key financial results for Lloyds from 2009 to 2011.
Full details of the results, including for the first quarter of 2012, can be found on the company's website: www.lloydsbankinggroup.com.

Table 3.1: Key financial performance metrics

	2011	2010	2009
Risk measures			
Core tier 1 ratio	10.8%	10.2%	8.1%
Loan: deposit ratio	135%	154%	169%
Short term wholesale funding (<1 year)	£113bn	£149bn	£162bn
Liquidity portfolio[1]	£202bn	£160bn	£151bn
Leverage ratio	17x	17x	18x
Value drivers			
Return on equity	-6.2%	-0.7%	8.8%
Cost: income ratio	50%	47%	48%

Note: (All figures from statutory accounts)

1. *Eligible assets held for contingent liquidity purposes including cash, Government-issued securities, and other eligible securities with central banks.*

Commenting on the Group's performance over 2011, António Horta-Osório, Chief Executive, said:

"In 2011, we established our longer term strategy for the Group, acted quickly and decisively to mitigate the effects of a challenging environment and put in place the right foundations to deliver on our objectives over the next 3-5 years, whilst continuing to support the UK economy. Using the framework set out in our Strategic Review, we accelerated strengthening our balance sheet, decreasing risk and reducing costs. The investments we made behind our brands, distribution, customer relationships and people have strengthened our franchise, and created new opportunities which will enable us to realise over time the Group's full potential for growth. We also made good progress on the EC mandated business disposal (Project Verde), and saw greater clarity emerge on the future UK regulatory framework following the publication of the Independent Commission on Banking's (ICB's) final report and the Government's response on 19 December 2011.

As a result, in 2011, we delivered a resilient performance and made good progress against the key elements of our strategic plan to become the best bank for our customers, despite a weakening UK economy, ongoing financial market volatility, continued high levels of regulatory scrutiny and competitive markets. We are now better positioned to adapt to the changing economic environment and to realise over time the full potential of our franchise, brands and capabilities, and therefore to deliver strong, stable and sustainable returns for our shareholders."

Investment in Lloyds

The Government's investment in Lloyds has been made in three different tranches, as summarised in the table below. The gross cost of these investments is £20,313 million, at an average cost per share of 73.58p. Taking into account the fees received from Lloyds, including £2.5 billion in relation to the implicit capital support provided by the APS in 2009, the net cost is £17,433 million, equivalent to 63.14p per ordinary share.

HM Treasury shareholdings in Lloyds		Shares	Total investment	Investment per share	Value at 31 March[1]
		m	£m	p	£m
Initial recapitalisation[2]	January 2009	7,277	12,957	182.50	2,445
Preference share conversion[3]	June 2009	4,521	1,506	38.43	1,519
Rights issue	December 2009	15,810	5,850	37.00	5,313
Total investment		**27,609**	**20,313**	**73.58 (avg)**	**9,278**
Fees received[4]			(381)		
Total investment net of fees		**27,609**	**19,933**	**72.20 (avg)**	
APS exit fee[5]			(2,500)		
Total investment net of all fees		**27,609**	**17,433**	**63.14 (avg)**	

Notes: (All figures from statutory accounts)

1. *Based on Lloyds share price of 33.61p as at 31 March 2012.*
2. *Includes Lloyds capitalisation issue on 11 May 2009 (177 million shares).*
3. *Investment adjusted to include accrued dividends and redemption premiums of around £230 million.*
4. *Underwriting and commitment fees on transactions paid to HM Treasury, including in relation to the recapitalisation, preference share conversion and rights issue.*
5. *£2,500 million paid by Lloyds for the implicit capital support provided by the APS in 2009.*

Figure 3.1 Lloyds Banking Group share price performance

ANNUAL REPORT AND ACCOUNTS 2011/12

04

Northern Rock plc

Summary of Government shareholding

UKFI managed the Government's 100 per cent shareholding in Northern Rock plc from Northern Rock plc's formation on 1 January 2010 up to its sale to Virgin Money on 1 January 2012.

Company overview

The former Northern Rock was taken into temporary public ownership in February 2008 before being split into two legal entities, Northern Rock plc and NRAM, on 1 January 2010. From this point the shareholdings in both companies were managed by UKFI as part of the Government's wholly owned portfolio of financial services investments.

- Northern Rock plc was created as a smaller, well capitalised, deposit-taking and mortgage-providing bank which would be returned to the private sector; and
- NRAM was formed from the residual former Northern Rock balance sheet and, as a capital-efficient financial institution, would run down the remaining closed mortgage book and repay the Government loans and other creditors.

During 2010 and 2011, UKFI worked with Northern Rock plc to release the Government guarantees on deposits, operationally separate the two companies, and restructure the cost base that Northern Rock plc inherited from the former Northern Rock.

In June 2011 the Chancellor of the Exchequer announced that he had decided to launch an open and transparent sale process for Northern Rock plc in line with state aid rules, allowing any interested parties to bid, including mutuals.

The sale process attracted interest from a number of parties and the process concluded with the sale of Northern Rock plc to Virgin Money on 1 January 2012.

The transaction consideration comprised £747 million cash on completion with the potential in the future to receive up to c.£1 billion in total.

Company performance

Table 4.1: Northern Rock plc key financials[1]

£ million	6 months to 30 June 2011	6 months to 30 June 2010	12 months to 31 December 2010
Total income	41	29	105
Operating expenses	(107)	(171)	(327)
Loan impairment loss	(2)	(1)	(2)
Profit/(loss) before tax	(68)	(143)	(224)
Total equity (period end)	1,122	1,266	1,188

Note:

1. *Northern Rock plc: Half Year Results 2011*
(Full year results for 2011 have not been published at the time of writing this report)

The half year results to 30 June 2011 were the first set of results for Northern Rock plc following the operational separation of Northern Rock plc from NRAM in late 2010. Prior to this, the accounts included both income and costs relating to a broad set of operational services provided to NRAM, which has an effect on some comparisons.

Northern Rock plc made good progress in the first half of 2011, despite tough trading conditions. As expected, it continued to be loss-making but losses were reduced significantly compared with the loss in the first half of 2010. Total income was £41 million compared with £29 million in the first half of 2010. This included improved net interest income reflecting growth in the mortgage book, an improvement in funding margins, higher returns on liquid assets and reduced retail deposit guarantee fees. Operating expenses were £107 million compared with £171 million in the first half of 2010 as Northern Rock plc continued to take steps to align the cost base with the income-generating capacity of the company.

Northern Rock plc grew its mortgage book to £12.5 billion during the first half of 2011 although tough trading conditions and the deterioration in the macro-economic environment continued. The quality of lending remained high, with mortgage accounts more than three months in arrears at 30 June 2011 representing 0.26 per cent of the book, and the average loan to value for new lending completed in the first half of 2011 was 69 per cent.

BOX 4.1: SALE OF NORTHERN ROCK PLC

Sale process launched after full review of options

In June 2011 the Chancellor of the Exchequer announced that he had decided to launch an open and transparent sale process for Northern Rock plc in line with state aid rules, allowing any interested parties to bid, including mutuals. This did not mean that other options to return Northern Rock plc to the private sector had been ruled out. However, the independent advice provided by UKFI was that a sale process was likely to maximise potential value for the taxpayer and should be explored as a first option. This was based on an assessment of the full range of options for returning Northern Rock plc to the private sector which was led by UKFI. Deutsche Bank AG (Deutsche Bank) provided independent corporate finance advice to UKFI and Northern Rock plc on the assessment of the options.

During the assessment of options to return Northern Rock plc to the private sector and the subsequent sale process, UKFI consulted with the Board of Northern Rock plc which, having considered its specific responsibilities, agreed with the conclusions that UKFI reached on the best option to return the company to the private sector. In providing its corporate finance advice, Deutsche Bank took into account UKFI and Northern Rock plc's commercial assessment of the options for the company.

Sale to Virgin Money maximises value for the taxpayer

The sale process attracted interest from a number of parties, including mutuals, although no mutual submitted a final bid. The process concluded with the sale of Northern Rock plc to Virgin Money on 1 January 2012.

The transaction consideration comprised £747 million cash on completion, plus other cash and non-cash elements such that the taxpayer can receive up to c.£1 billion in total. Deutsche Bank estimated that the value of the transaction consideration to taxpayers was in the range of £863 million to £977 million. UKFI, having taken advice from Deutsche Bank, concluded that a sale to Virgin Money was the option that would maximise value for the taxpayer. The transaction met UKFI's mandated objectives to create and protect value for the taxpayer as shareholder, paying due regard to financial stability and competition, and it met the European Commission sale deadline of 31 December 2013.

The value range of the sale to Virgin Money was assessed to be higher than all other options to return Northern Rock plc to the private sector, namely an IPO, a stand-alone remutualisation, a deposit sale and loan book run-down, and a later exit from temporary public ownership in 2013.

Attractive competition outcome

The Virgin Money offer was also more attractive than the IPO, remutualisation and deposit sale and loan book run-down options from a competition perspective. Virgin Money and Northern Rock plc combined has £19 billion total assets, 75 branches and 4 million customers, bringing together two entities with complementary product sets and distribution channels with the potential to develop into a challenger bank in the future.

Virgin Money has plans to expand into the personal current account market and make a staged entry into offering products to small and medium-sized enterprises. Customers will see the existing branch distribution retained and rebranded as Virgin Money, with the cross-sale of new products.

Optimal timing for the sale

UKFI considered carefully the issue of timing and recommended to the Chancellor that a sale to Virgin Money at the end of 2011 was in the best interests of taxpayers. The sale fulfilled the European Commission state aid requirement to exit majority ownership of Northern Rock plc by 31 December 2013. It could not be guaranteed that market conditions and associated valuations would improve before the European Commission sale deadline. Neither was there any certainty that the two parties who had made offers at the end of the sale process would still be interested in the future, especially as Virgin Money had made it clear that their valuation of Northern Rock plc would decrease as they made further significant investment in their own organic plan, and the other party's offer was conditional on events that had a high degree of risk.

In considering the issue of timing, UKFI took into full account that valuations in the UK banking sector had declined significantly. UKFI recognised that Northern Rock plc faced significant challenges as a small bank operating in a difficult economic environment and that by selling now, HM Treasury would no longer be exposed to these risks impacting the value achieved.

Against this background, the significant premium that Virgin Money's offer represented versus trading multiples at the time, the uncertain outlook for Northern Rock plc and the economy, and the European Commission State aid deadline, all supported the decision to accept Virgin Money's offer.

National Audit Office

The National Audit Office conducted a study on the creation and sale of Northern Rock plc during the first half of 2012, such studies being typical practice following the sales of Government-owned companies. The National Audit Office report, which was published in May 2012, examined: HM Treasury's decision to create Northern Rock plc; the financial performance of Northern Rock plc while in public ownership; whether the sale of Northern Rock plc was the best available option; and whether the sale process was handled well.

The National Audit Office confirmed that, although the sale to Virgin Money generated a loss for the taxpayer, it was the best available option to minimise future losses and on this basis, value for money was preserved.

It also concluded that UKFI handled the sale process well. It reported that bidders were positive about the sale process, describing it as transparent and fair, and explained that in final negotiations UKFI improved the overall offer from Virgin Money.

The National Audit Office said that in two years of public ownership, Northern Rock plc failed to meet fully its lending targets or deliver the financial performance expected. However, it explained that poorer financial performance was largely the result of worse than expected economic conditions and concluded that no alternative was likely to have been significantly better either in financial terms or in supporting mortgage lending.

Further information

Further information on 'The sale of Northern Rock plc' can be found in UKFI's February 2012 publication on The sale of Northern Rock plc which is available at www.ukfi.co.uk/publications.

05

UK Asset Resolution Ltd

30

Summary of Government shareholding

UKFI is responsible for managing the Government's 100 per cent shareholding in UKAR, and its subsidiaries, B&B and NRAM, on behalf of HM Treasury.

Company overview

On 1 October 2010 UKFI announced the establishment of UK Asset Resolution Ltd as the single holding company to manage, on an integrated basis, the closed mortgage books of both Northern Rock (Asset Management) plc and Bradford & Bingley plc.

Following the split of Northern Rock on 1 January 2010, NRAM holds and services the closed mortgage book of the original Northern Rock. As of 31 December 2011, total assets of the company were £55.3 billion, of which £41.2 billion were loans and advances to customers.

B&B was brought into public ownership by way of a Transfer Order on 29 September 2008. The Transfer Order also facilitated the sale of the UK and Isle of Man retail deposit business to Abbey National plc, part of the Santander Group, including all of B&B's retail deposit accounts and its branch network. As of 31 December 2011, total assets of the company were £40.1 billion, of which £34.1 billion were loans and advances to customers.

The ongoing focus of these businesses is an orderly run down of their closed mortgage books and the repayment of Government funds. Neither of the companies holds deposits or offers additional mortgage lending.

UKAR provides common governance, management and operations to both subsidiaries, although both remain as separate legal entities with their own balance sheet and Government support arrangements. The integration of the two companies has created a larger entity, enjoying economies of scale. Increased efficiency and shared capability in arrears management and treasury functions will enhance future repayment of Government loans.

The year ending 31 December 2011 is the first full financial year for UKAR and the first year in which it produced consolidated results for the group.

At 31 December 2011 UKAR owed HM Treasury £46.6 billion, an amount which the company expects to repay in full.

Company performance

Table 5.1: UKAR key financials[1]

£ million	2011	2010
Underlying net operating income	1,759	1,812
Operating expenses	(221)	(278)
Loan impairment loss	(390)	(1,089)
Underlying profit before tax	1,089	444
Statutory profit for the year	1,375	1,487
Loans from HM Treasury (year end)[2]	46,582	48,708
Total equity (year end)	4,676	3,035

Notes

1. *UK Asset Resolution Ltd Annual Report and Accounts 2011.*
2. *Loans from HM Treasury at 31 December 2011 comprise: £19,726 million HM Treasury Loan to NRAM, £18,416 million B&B Statutory Debt to HM Treasury (of which £15,655 million is owed to the Financial Services Compensation Scheme) and £8,440 million HM Treasury Working Capital Facility to B&B.*

The underlying profit of the combined UKAR businesses increased from £444 million in 2010 to £1,089 million in 2011. Total payments to the taxpayer, including repayments, interest, fees and corporation tax, increased from £1.6 billion to £2.8 billion. In August 2011 UKFI and HM Treasury requested an increase in the margin over Bank Base Rate on the Working Capital Facility that HM Treasury provides to B&B, from 1.50 per cent to 5.00 per cent. In May 2012 UKFI and HM Treasury requested an increase in the margin over Bank Base Rate on the Government loan that HM Treasury provides to NRAM, from 0.25 per cent to 1.00 per cent. These increases reflected the improved balance sheet strengths of B&B and NRAM and result in an additional interest payment to HM Treasury.

The number of customers in arrears by three months or more reduced from 38,500 to 33,200 as a direct consequence of proactive arrears management coupled with the continued benign interest environment in 2011. This contributed to the new provisions for loan impairment falling from £1,089 million to £390 million. UKAR reduced customer balances from £83.5 billion to £75.3 billion which enabled it to repay £2.15 billion of Government loans. Costs are being well controlled with ongoing operating expenses £57 million lower than 2010 at £221 million, and UKAR has successfully integrated many of the B&B and NRAM operations in 2011 including telephony, financial systems and the commercial loan books. Since the year end it has also completed the migration of the NRAM mortgages to the UKAR mortgage platform.

In November 2011, tender offers were made to repurchase up to £1.3 billion of B&B and NRAM capital instruments. As a result, £1,159 million of notes were repurchased, generating a pre-tax gain of £382 million. This takes the total gains generated for the taxpayer to over £2.1 billion from liability management programmes undertaken by UKAR over the last two years. These have resulted in the majority of the original subordinated debt of B&B and NRAM being purchased for an average of 46 per cent of the face value of the securities.

THE UKFI BOARD AND SENIOR MANAGEMENT

Robin Budenberg – Chairman

Robin Budenberg joined UKFI on 1 January 2010 from UBS where he was responsible for senior UK client relationships. He was Chief Executive of UKFI until January 2012 when he became Chairman. He was involved in the Government Bank Recapitalisation Scheme in October 2008. He qualified as a Chartered Accountant with Price Waterhouse before joining SG Warburg in 1984. He subsequently worked at the successor firms – SBC Warburg, UBS Warburg and latterly UBS. During this time, he carried out various management roles and he also advised a number of the UK's largest companies on major projects.

Jim O'Neil – Chief Executive

Jim O'Neil joined UKFI in October 2010 as Head of Market Investments and became Chief Executive on 2 April 2012. He is responsible for managing the Government's shareholdings in Lloyds and RBS. He joined UKFI from Bank of America Merrill Lynch where he spent 17 years. He has extensive experience of both the capital markets and the banking industry. He joined Merrill Lynch in 1993 in New York and relocated to London in 1999. Most recently he was Head of International Corporate Finance. He holds a BSc from the University of Virginia and an MBA from the University of Chicago Graduate School of Business.

Peter Gibbs – Non-Executive Director

Peter Gibbs has a wealth of financial services experience in the Asset Management sector. Having begun his career at Brown Shipley, he joined Bankers Trust in 1985, and in 1989 he joined Mercury Asset Management where, following the acquisition by Merrill Lynch, he rose to become Chief Investment Officer for Merrill Lynch's Investment Management activities outside the US.

Peter retired from Merrill Lynch at the end of 2005. He currently serves as Non-Executive Director Friends Life Group plc, Non-Executive Director of Intermediate Capital Group plc, Non-Executive Director of Impax Asset Management Group plc, and as a Director of Merrill Lynch (UK) Pension Plan Trustees Ltd.

Julian Kelly – Non-Executive Director

Julian Kelly was appointed Group Director of HM Treasury Finance and Commercial in January 2011. Previously, Julian has been the Director of Finance, Commercial and Estates at the UK Border Agency since 2009, and Director of Finance there since 2007. Julian is a qualified Chartered Accountant and a member of the Chartered Institute of Management Accountants.

Before that he held various roles in HM Treasury, including leading the spending team covering the Home Office and Criminal Justice Department as Head of the Home, Legal and Communities team between 2003 and 2007, and roles in the Prime Minister's Strategy Unit and at HSBC in their Treasury and Capital Markets team. Julian has a wealth of experience from both in and out of HM Treasury, and from corporate and policy roles.

Michael Kirkwood – Non-Executive Director

Michael Kirkwood is currently Chairman of Ondra Partners LLP, Chairman of Circle Holdings plc, and a Non-Executive Director AngloGold Ashanti Limited and of Eros International plc. Michael retired from a 31-year career with Citicorp at the end of 2008. Schooled in Scotland and a graduate of Stanford University, he initially worked for HSBC and the Bowater-Ralli Group. His career has taken him to Asia, the USA, continental Europe, and Scandinavia, as well as the UK.

Michael served on the Board of Kidde plc for four years prior to its acquisition by United Technologies in 2005. Until June 2011 he was Deputy Chairman of PwC's Advisory Board. During his City career Michael served as Vice Chairman of the British Bankers Association, President of the Chartered Institute of Bankers, Chairman of the Association of Foreign Banks, Chairman of British American Business, Master of the Worshipful Company of International Bankers, and a member of the CBI's Financial Services Council, and he remains a member of the Advisory Board of the Association of Corporate Treasurers. A former HM Lieutenant for the City of London, Michael was appointed a Companion of the Order of St Michael & St George (CMG) in the Queen's 2003 birthday honours.

Keith Morgan – Head of Wholly Owned Companies

Keith Morgan is responsible for managing the Government's shareholdings in NRAM and B&B. Keith, who joined UKFI from Banco Santander, has strong retail and commercial banking experience. Before joining UKFI he was a Board Director of Sovereign Bancorp in the US focusing on the integration of Sovereign into Santander. Keith sits on the Board of B&B, NRAM and UKAR. He was previously Director of Strategy & Planning at Abbey National, where he was a member of the Executive Committee, and was also Chairman of Santander's Asset Management and Credit Card businesses in the UK. Before joining Abbey in 2004, Keith spent 18 years at LEK Consulting, where he was a partner specialising in financial services.

Philip Remnant – Non-Executive Director

Philip Remnant is a Senior Adviser of Credit Suisse's investment banking division in Europe, Chairman of City of London Investment Trust plc, and Deputy Chairman of the Takeover Panel. Between 2007 and 2012 he was Chairman of the Shareholder Executive.

Previously, Philip was a Vice Chairman of Credit Suisse First Boston in Europe, and was Director General of the Takeover Panel for two years between 2001 and 2003, and again in 2010. He formerly held senior investment banking positions with BZW and Kleinwort Benson. He is a qualified chartered accountant and has an MA in Law from New College, Oxford.

He was appointed a Commander of the Order of the British Empire (CBE) in 2011.

Lucinda Riches – Non-Executive Director

Lucinda Riches is a Non-Executive Director of The Diverse Income Trust plc (appointed March 2011), a Non-Executive Director of The Graphite Enterprise Trust PLC (appointed July 2011), a Non-Executive Director of the partnership Board of SJ Berwin LLP (appointed March 2012), a Non-Executive Director of The British Standards Institution (appointed May 2012), having been an adviser to the Board since May 2011, and a Trustee of Sue Ryder (since 2008).

Lucinda was formerly an investment banker, and has extensive experience in capital markets and privatisations. She began her career at Chase Manhattan Bank. Lucinda worked at UBS and its predecessor firms for 21 years until 2007. At UBS, she was Managing Director, Global Head of Equity Capital Markets and a member of the Board of the Investment Bank.

Lucinda has an MA in Philosophy, Politics and Economics from Brasenose College, Oxford, and an MA in Political Science from the University of Pennsylvania.

06

Directors' Report & Governance Statement

UKFI Board

The UKFI Board takes all major strategic decisions for the company. The principal activity of the company is managing the Government's investments in financial institutions to protect and create value for the taxpayer as shareholder, and where applicable, as provider of financial support, through active engagement with the investee companies. The company has a Framework Document and Investment Mandate with HM Treasury appropriate for an arm's length body. This sets out the key parameters for how UKFI will conduct its business, including a clear mandate to manage the investments commercially.

The directors, as set out below with their dates of appointment, provide the company with the appropriate expertise, skills and experience required to manage the investments effectively. The UKFI Board operates to the highest standards of corporate governance and its members have over 100 years' banking experience across a wide range of areas in the sector.

Board membership	Current position	Committee membership
Robin Budenberg (01.01.2010)	Chairman	N (Chair), R
Jim O'Neil (31.01.2012)	Chief Executive	
Peter Gibbs (18.01.2009)	Independent Non-Executive	N, R, A
Julian Kelly (27.01.2011)	Treasury-Appointed Non-Executive	A (Chair)
Michael Kirkwood (18.01.2009)	Independent Non-Executive	N, R (Chair), A
Keith Morgan (31.01.2012)	Executive Director – Head of Wholly Owned Investments	
Philip Remnant (11.03.2009)	Treasury-Appointed Non-Executive	N
Lucinda Riches (15.01.2009)	Independent Non-Executive	N, R, A
Former Board members		**Committee Membership**
Sir David Cooksey (01.08.2009 to 11.01.2012)	Chairman	N (Chair), R

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

During 2011/12 the membership of the Board changed, with Sir David Cooksey stepping down as Chairman and Robin Budenberg being appointed Chairman in his place and Jim O'Neil succeeding Robin as Chief Executive. Alongside this Keith Morgan was appointed as a director of the company.

In accordance with the corporate governance code, the UKFI Board carefully considered the implications of appointing the current Chief Executive to the role of Chairman and considered it to be in the best interests of UKFI and its stakeholders, given the size of the company and the benefits of continuity.

During the year the terms of appointment for Peter Gibbs, Michael Kirkwood, Lucinda Riches and Philip Remnant expired, and these were all extended for a further 12 months.

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

The Board meets a minimum of nine times a year and on an ad-hoc basis as required. The Board met 19 times during this reporting period.

The Chairman considers the effectiveness of the Board on a regular basis, and also reviews compliance with the Corporate Governance Code. Other than the item mentioned above, UKFI has complied with all relevant provisions on the code.

Board Committees

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

Audit and Risk Committee

The Audit and Risk Committee has met three times during this reporting period.

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

The Audit and Risk Committee is authorised by the Board to investigate any activity within its terms of reference and to seek any information it requires from any employee. The Board will ensure that employees co-operate fully with the Audit and Risk Committee. The Committee has worked over the year to fulfil its detailed responsibilities including: considering the scope and planning of the audit, the audit fee and any questions of dismissal of the auditors; reviewing financial statements before submission to the Board; agreeing the internal audit plan, and reviewing and considering the associated reports; reviewing and considering reports from the auditors and the audit management letter and management response; and reviewing the operation and effectiveness of the company's internal control systems.

Remuneration Committee

The Remuneration Committee has met twice during this reporting period. The membership, details and terms of reference for the Remuneration Committee are set out in the Directors' Remuneration Report (Chapter 7).

Nominations Committee

The Nominations Committee has met once during this reporting period.

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

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

The Nominations Committee is not required to meet to approve the appointment of senior Government officials nominated by HM Treasury.

Meetings

The number of meetings of the Board and the Audit, Remuneration and Nominations Committees and individual attendance at these meetings by members in the reporting period is shown in the table below.

	Board	Audit	Remuneration	Nomination
Total number of meetings held in 2011/12	19	3	2	1
Number of meetings attended in 2011/12				
Robin Budenberg	19		2	1
Jim O'Neil[1]	4			
Peter Gibbs	17	3	2	1
Julian Kelly	18	3	1	
Michael Kirkwood[2]	13	1	2	1
Keith Morgan[3]	4			
Philip Remnant	17		1	1
Lucinda Riches	16	3	2	1
Former Directors				
Sir David Cooksey[4]	14		1	1

Notes

1. *Jim O'Neil was appointed a director on 31 January 2012 and became Chief Executive on 2 April 2012.*
2. *By mutual consent with the Chairman, Michael Kirkwood absented himself from five Board meetings during the year to avoid any actual or perceived conflict of interest relating to discussions on matters where he had previously declared an interest.*
3. *Keith Morgan was appointed a director on 31 January 2012.*
4. *Sir David Cooksey resigned as Chairman on 11 January 2012.*

Risk & Internal Control Framework

The Board has responsibility for maintaining a sound system of governance and internal control that supports UKFI's policies and the achievements of its objectives, while safeguarding the public funds and assets for which the Board is collectively responsible.

UKFI actively manages risks faced as an organisation and has therefore put in place business and operational risk management arrangements so that the Board, and through it, UKFI's stakeholders, can be reassured that UKFI is operating within the risk parameters set by the Framework Document and the Investment Mandate in place between UKFI and HM Treasury.

As part of this, UKFI maintains a risk register to record the risks faced both by UKFI as an organisation and the risks posed by having shareholdings in the banking sector. This document is maintained by the Chief Executive and reviewed and discussed by the UKFI Board on a regular basis.

The system of governance and internal control is designed to manage risk to a reasonable level rather than to eliminate all risk of failure to achieve policies, aims and objectives; it can therefore only provide reasonable and not absolute assurance of effectiveness.

The following events were potential risk events during the year. UKFI identified these and took action to mitigate that risk.

1. During 2011 fears around a sovereign debt crisis continued to impact countries within the Eurozone and the wider banking sector, leading to concerns about the ability of banks to fund themselves. Throughout this period UKFI monitored the banks' funding positions and engaged regularly with the banks' management on the issue.
2. During 2011 UKFI launched and completed a sales process for Northern Rock plc. UKFI undertook a review of all the options for Northern Rock plc before launching the sales process, which took full account of the risks associated with the sale. UKFI recognised that Northern Rock plc faced significant challenges as a small bank operating in a difficult economic environment and that by selling now, HM Treasury would no longer be exposed to these risks impacting the value achieved. The process concluded on 1 January 2012 with the sale of Northern Rock plc to Virgin Money.
3. Throughout the year the regulatory environment in which the banks operate continued to change, including in the UK, the Government's response to the Independent Commission on Banking. UKFI reviewed the impact of proposed regulatory changes and discussed with the banks in which the Government is a shareholder how proposed regulatory changes would impact upon their operations.
4. During the year the CEO of Lloyds was absent for a short period of time due to illness. Throughout that time UKFI engaged closely the Board of Lloyds to ensure the procedures put in place were appropriate for the continued management of the bank and that the transition arrangements put in place for his return were successful.
5. Remuneration in the banking sector remains a high profile issue, with the UKFI banks continuing to attract a high degree of attention and scrutiny. UKFI worked with the banks' Remuneration Committees on their approach to remuneration, ensuring they pursue policies that promote long-term sustainable performance.
6. During the year there were changes to the UKFI leadership, with a change of Chairman and Chief Executive and the announcement that the Head of Wholly Owned Investments would be stepping down in 2012 following the completion of his role in restructuring UKFI's wholly owned portfolio. UKFI ensured processes were in place to manage effectively the succession risk associated with operating a small team.

The requirements for credit-risk policies, processes and controls have been considered and it has been determined that they would have very limited impact on UKFI delivering its business plan because our operations will be backed and supported by the company's parent, HM Treasury.

Risks to data and information held by UKFI are owned and managed by individuals and collectively by the company as a whole. There were no personal data related incidents during the year.

UKFI has policies and procedures which set out how staff are expected to operate in discharging their duties. These cover the operation of the UKFI Board, compliance, risk management, procurement, finance and human resources. In addition, all UKFI staff are required to undertake mandatory training which ensures awareness of the major risks associated with UKFI's day-to-day operating environment.

Sustainability

UKFI is committed to its contribution to sustainable development. UKFI is based on the Government estate in a Department for Culture, Media and Sport (DCMS) building. We use recycled paper for day-to-day use and UKFI publications, have segregated waste streams collected for recycling, and purchase all electricity and gas through the central Cabinet Office negotiated contracts which include 10 per cent renewable energy. We share DCMS's facilities management and mail service contractors. and both contractors hold their own ISO14001 accreditation.

Transparency

UKFI adheres to the Government's Transparency Agenda and publishes a range of data, either on our own website or on data.gov.uk, including:

- senior staff's hospitality and expenses;
- salaries greater than the Prime Minister's;
- transactions over £25,000;
- corporate credit card transactions over £500; and,
- awarded contracts.

Payment of suppliers

In May 2010, the Government introduced a five-day target for small and medium enterprise suppliers to receive payment. This accelerated payment from the previous 10-day target set in November 2008. During 2011/12, UKFI made 98 per cent of all supplier payments within five days.

Review of effectiveness

The new Head of Finance and Oversight has carried out a review of all internal processes during the year. This included a review of HR, procurement and finance processes. Minor weaknesses were found in the recording of information, but no significant internal control issues were identified. The internal procedures have been reviewed and the reporting processes updated.

As Accounting Officer, under the terms of my appointment, I have responsibility for maintaining and reviewing the effectiveness of the system of internal control. There were no significant control issues in the year under review.

Disclosure of information to auditors

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

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

UKFI has appointed the Comptroller and Auditor General as its external auditor. The National Audit Office carries out the audit for and on behalf of the Comptroller and Auditor General. The remuneration paid to the auditors is disclosed in the financial statements. No non-audit work was undertaken by the auditors.

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

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

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

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

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

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

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

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

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

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

Jim O'Neil
Chief Executive

28 June 2012

07

Directors' Remuneration Report

Remuneration Committee

The Remuneration Committee operates as a sub-committee of the UKFI Board. The membership of the Committee comprises the Chair of the Board and non-executive directors and shall consist of not less than three members. The Board is responsible for any new appointments to the Remuneration Committee. The current members of the Remuneration Committee are Michael Kirkwood (Committee Chair), the Chair of the Board, Peter Gibbs, and Lucinda Riches.

The Remuneration Committee meets a minimum of two times per year and on an ad-hoc basis as required. The Remuneration Committee met twice in this reporting period. Only members of the Remuneration Committee have the right to attend Remuneration Committee meetings. However, other individuals may be invited to attend for all or part of any meeting as and when appropriate.

The Remuneration Committee has worked over the year to fulfil its responsibilities to:

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

UKFI operates a performance appraisal system and performance is reviewed semi-annually. Performance related pay takes the form of bonus payments.

Remuneration policy

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

- deliver value for money;
- are sufficient to attract and motivate high-calibre individuals to drive the delivery of the activities and objectives set out in the framework document;
- are in line with the FSA code: linked to performance, with no reward for failure or excessive risk-taking; and
- are aligned with the objectives set out in the Framework Document, Business Plan, and Investment Mandate.

UKFI has a policy to recognise those staff that have performed well in their roles through the payment of bonuses. Performance-related pay is awarded in relation to performance linked to the annual staff appraisal. Information on UKFI remuneration can be found in the UKFI financial statements 2011/12 in Chapter 9.

Any UKFI performance-related pay is calculated as a fraction rather than multiple of salary. A total of £85,294 was awarded for the performance year 1 December 2010 to 30 November 2011, of which £36,171 was paid out and £49,123 was retained because UKFI bonuses are deferred over three years and subject to clawback in line with the arrangements now in place at the investee banks. The total award represents 4.7 per cent of staff costs incurred over the same period.

In the previous performance year (1 December 2009 to 30 November 2010) a total of £84,712 was awarded, representing 4.5 per cent of staff costs for the same period, of which £35,566 was paid out and £49,146 retained. This year £89,423 was paid out relating to deferred bonuses.

Staff profile

UKFI is a small organisation. At 31 March 2012, the number of full-time employees' including the Chief Executive, was 12. The average over the 2011/12 period was 14, excluding non-executive directors, and 20 including non-executive directors. UKFI is not part of the Civil Service and the majority of posts are occupied by staff with directly relevant expertise from the private sector. UKFI recruitment procedures are based on the principles of fair and open competition and selection on merit.

Due to the small number of staff in post throughout the year, this report does not include detailed statistics on the UKFI workforce. The release of such data would enable personal information on individual staff to be identified which individual staff would have no reasonable expectation of being disclosed.

During the year UKFI staff took an average of 4.8 (2010/11: 8.4) days of sickness absence.

Directors' information

Service contracts

UKFI policy on duration of contracts is that directors' contracts continue for a period of 12 months, unless terminated earlier by HM Treasury, in accordance with the company's Articles of Association, or by either party giving written notice to the other. Upon termination of the appointment, subject to any fees outstanding, directors have no entitlement to compensation in respect to any loss.

Changes in year

UKFI's Chairman, Sir David Cooksey resigned on 11 January 2012. Robin Budenberg became Chairman, and Jim O'Neil and Keith Morgan both joined the Board on 31 January 2012.

Changes after the reporting period

From 1 April 2012 Jim O'Neil became Chief Executive of UKFI. His salary will remain constant.

Robin Budenberg is entitled to a salary of £95,000 as Chairman. However, he has requested that he be paid £75,000 reflecting the current economic environment and therefore from 1 April 2012 his salary was reduced from £147,251 to £75,000.

Directors' remuneration – salary

The table below reports the remuneration of each director for the period ending 31 March 2012 and has been audited by the company's Auditors. The value of non-cash benefits is zero, and salary therefore includes only gross salary.

Each non-executive director is paid a fee of £28,500 for their attendance at the Board, plus £4,750 for each Board Committee Chairmanship held, plus £2,375 for each Board Committee membership for which they are not Chairman.

Director	Salary (£) Year ended 31 Mar 2012	Salary (£) Year ended 31 Mar 2011
Sir David Cooksey	74,059 (Full year equivalent: £95,000)	96,250
Robin Budenberg	147,251	147,896
Jim O'Neil	30,000 (Full year equivalent: 180,000)	0
Peter Gibbs	35,625	36,094
Julian Kelly[1]	0	0
Michael Kirkwood	38,000	38,500
Keith Morgan	33,333 (Full year equivalent: 200,000)	0
Philip Remnant	30,875	31,281
Lucinda Riches	35,625	36,094

Note

1. *Julian Kelly is appointed to the Board as an employee of HM Treasury and does not receive remuneration for his services.*

In accordance with the Hutton Review of Fair Pay, we have disclosed the top to median staff pay multiples. The ratio between the highest paid director and the median pay of UKFI is 4.3 (2010/11: 3.6).

Directors' remuneration – performance-related pay

Neither the UKFI non-executive directors, nor the Chairman, are eligible for UKFI performance-related pay. Jim O'Neil, the Chief Executive, has waived his right to performance-related pay for the current period.

The appraisal year for UKFI runs from December to November. Any awards made for the period December 2011 to November 2012 will be determined by the Remuneration Committee in line with the annual performance timetable in January 2013. Keith Morgan has not received any bonus relating to the time he was a director in 2011/12.

Expenses

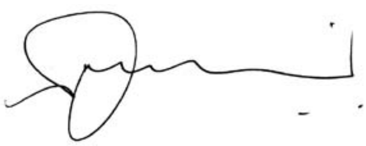
Director	Expenses (£) Year ended 31 Mar 2012	Expenses (£) Year ended 31 Mar 2011
Sir David Cooksey	0	0
Robin Budenberg	482	453
Jim O'Neil	77	0
Peter Gibbs	0	0
Julian Kelly	0	0
Michael Kirkwood	0	0
Keith Morgan	10	0
Philip Remnant	0	0
Lucinda Riches	0	0

Directors' pension arrangements

None of the non-executive directors nor Robin Budenberg receives a pension from the company.

Jim O'Neil and Keith Morgan participate in the UKFI pension scheme which is provided by Standard Life. UKFI match individual contributions up to 15 per cent of salary. The following employer contributions were made relating to the period they were Board members:

Director	Employer pension contributions (£) (31 Jan to 31 Mar 2012)	Employer pension contributions (£) (Full year equivalent)
Jim O'Neil	4,500	27,000
Keith Morgan	5,000	30,000



Michael Kirkwood
Chair of Remuneration Committee

28 June 2012

08

Independent Auditor's Report to the Shareholders of UK Financial Investments Limited

I have audited the financial statements of UK Financial Investments Limited for the year ended 31 March 2012 which comprise the Income Statement, the Statement of Financial Position, the Statement of Cash Flows and the related notes. The financial reporting framework that has been applied in their preparation is applicable law and International Financial Reporting Standards as adopted by the European Union.

Respective responsibilities of the directors and the auditor

As explained more fully in the Directors' Responsibilities Statement, the directors are 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 and express an opinion on the financial statements in accordance with applicable law and International Standards on Auditing (UK and Ireland). Those standards require me and my staff to comply with the Auditing Practice 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 company's circumstances and have been consistently applied and adequately disclosed; the reasonableness of significant accounting estimates made by the directors; 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 report.

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 recorded in the financial statements 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 company's affairs as at 31 March 2012 and of its results for the year then ended;
- the financial statements have been properly prepared in accordance with International Financial Reporting Standards as adopted by the European Union; and
- the financial statements have been prepared in accordance with the Companies Act 2006.

Opinion on regularity

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

Opinion on other matters prescribed by the Companies Act 2006

In my opinion, the information given in the Directors' Report 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 where the Companies Act 2006 requires me to report to you if, in my opinion:

- adequate accounting records have not been kept; or
- the financial statements are not in agreement with the accounting records and returns; or
- certain disclosures of directors' remuneration specified by law are not made; or
- I have not received all of the information and explanations I require for my audit.

Bryan Ingleby (Senior Statutory Auditor) **Date: 28 June 2012**

For and on behalf of the Comptroller and Auditor General (Statutory Auditor)
National Audit Office
157-197 Buckingham Palace Road
London
SW1W 9SP

09

UKFI Financial Statements

Income statement for the year ended 31 March 2012

	Note	2011/12 £000	2010/11 £000
Revenue	3(e)	5,693	2,702
Other operating income – amounts recharged to investee companies	3(f)	0	215
		5,693	**2,917**
Expenses and fees incurred on sale of Northern Rock plc		3,170	0
UKFI administrative expenses		2,523	2,702
Amounts incurred on behalf of investee companies		0	215
		5,693	**2,917**
Profit/(loss) before corporation tax	2-7	**0**	**0**
Taxation	3(g)	0	0
Profit/(loss) for the period		**0**	**0**

The company had no recognised gains or losses in the year other than those included in the income statement and therefore no separate statement of comprehensive income has been prepared.

All activities are classified as continuing.

The notes on pages 58 to 67 are an integral part of these financial statements.

Statement of financial position as at 31 March 2012

	Note	31 Mar 2012 £000	31 Mar 2011 £000
Non-current assets			
Property, plant and equipment	8	81	142
Intangible assets	9	8	17
Total non-current assets		**89**	**159**
Current assets			
Trade and other receivables	10	354	288
Cash and cash equivalents	11	292	113
Total current assets		**646**	**401**
Total assets		**735**	**560**
Equity			
Share capital	12	0	0
Retained earnings		0	0
Total equity		**0**	**0**
Liabilities			
Current liabilities			
Trade and other payables	13	669	488
Total current liabilities		**669**	**488**
Non-current liabilities			
Trade and other payables	14	66	72
Total non-current liabilities		**66**	**72**
Total liabilities		**735**	**560**
Total equity plus liabilities		**735**	**560**

These financial statements were approved by the Board of Directors on 26 June 2012 and were signed on its behalf by:

Robin Budenberg
Director

28 June 2012

Jim O'Neil
Director

28 June 2012

UKFI Company Number 6720891

The notes on pages 58 to 67 are an integral part of these financial statements.

Statement of cash flows for the year ended 31 March 2012

	Note	31 Mar 2012 £000	31 Mar 2011 £000
Cash flows from operating activities			
Profit/(loss) for the period		0	0
Adjustments for:			
Depreciation	8	67	67
Amortisation	9	9	8
		76	**75**
Decrease/(increase) in trade and other receivables	10	(66)	193
(Decrease)/increase in trade and other payables	13, 14	175	(290)
Net cash from operating activities		**185**	**(22)**
Cash flows from investing activities			
Acquisition of property, plant and equipment		(6)	0
Acquisition of intangible assets		0	0
Proceeds of disposal of property, plant and equipment		0	6
Net cash used in investing activities		**(6)**	**6**
Net increase/(decrease) in cash and cash equivalents		**179**	**(16)**
Cash and cash equivalents at 1 April		113	129
Cash and cash equivalents at 31 March		**292**	**113**

The notes on pages 58 to 67 are an integral part of these financial statements.

Notes to the financial statements

1. Reporting entity

UK Financial Investments Limited (the "company") is a company domiciled in the United Kingdom. The address of the company's registered office is 2 Lambs Passage, London EC1Y 8BB. The company operates as an investment management business under the terms of the Companies Act 2006.

2. Basis of preparation

(a) Statement of Compliance

The financial statements have been prepared in accordance with International Financial Reporting Standards (IFRS).

These financial statements are prepared in accordance with the Government Financial Reporting Manual (FReM) where this exceeds the requirements of the Companies Act 2006.

The financial statements were authorised for issue by the Board of directors on 26 June 2012.

(b) Basis of measurement

The financial statements have been prepared on the historical cost basis.

The going concern of UKFI is dependent on successfully funding its balance sheet and maintaining adequate resources to continue to operate for the foreseeable future. HM Treasury has stated that it will fund UKFI's operations for the next financial year.

The directors have considered a number of key risk factors which could adversely affect UKFI's future results, as set out in note 17 to these annual accounts.

Having considered the above, the directors have a reasonable expectation that UKFI will continue in operational existence for the foreseeable future. Accordingly, the financial statements have been prepared on a going concern basis.

(c) Functional and presentation currency

These financial statements are presented in pounds Sterling, which is the company's function currency. All financial information has been rounded to the nearest thousand.

(d) Use of estimates and judgements

The preparation of the financial statements in conformity with IFRS requires management to make judgements, estimates and assumptions that affect the application of accounting policies and the reported amounts of assets, liabilities, income and expenses. Actual results may differ from these estimates.

Estimates and underlying assumptions are reviewed on an ongoing basis. Revisions to accounting estimates are recognised in the period in which the estimates are revised, and in any future periods affected.

Notes to the financial statements (continued)

3. Significant accounting policies

The accounting policies set out below have been applied consistently to all periods presented in these financial statements.

(a) Foreign currency

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

(b) Property, plant and equipment and intangible assets

(i) Recognition and measurement

Items of property, plant and equipment are measured at cost less accumulated depreciation. Intangible assets are measured at cost less accumulated amortisation. In line with HM Treasury Group policy, the company does not capitalise items with a cost less than £5,000.

(ii) Subsequent costs

The cost of replacing a part of an item of property, plant and equipment is recognised in the carrying amount of the item if it is probable that the future economic benefits embodied within the part will flow to the company, and its cost can be measured reliably. The carrying amount of the replaced part is derecognised. The costs of the day-to-day servicing of property, plant and equipment are recognised in profit or loss as incurred.

(iii) Depreciation and amortisation

Depreciation and amortisation are calculated over the depreciable amount, which is the cost of an asset, or other amount substituted for cost, less its residual value.

Depreciation and amortisation are recognised in profit or loss on a straight-line basis over the estimated useful lives of each part of an item of property, plant and equipment and intangible assets, since this most closely reflects the expected pattern of consumption of the future economic benefits embodied in the asset.

The estimated useful lives for the current and comparative periods are as follows:

Furniture, fixtures and fittings	3 to 10 years
Computer and telecom hardware, software and licences	3 to 10 years

Depreciation and amortisation methods, useful lives and residual values are reviewed at each financial year-end and adjusted if appropriate.

(c) Leased assets

All of the company's leases are classified as operating leases, and the leased assets are not recognised in the company's statement of financial position. Payments made under operating leases are recognised in profit or loss on a straight-line basis over the term of the lease.

(d) Employee benefits

(i) Defined contribution plans

A defined contribution plan is a post-employment benefit plan under which an entity pays fixed contributions into a separate entity and will have no legal or constructive obligation to pay further amounts. Obligations for contributions to defined contribution pension plans are recognised as an employee benefit expense in profit or loss in the periods during which services are rendered by employees. Prepaid contributions are recognised as an asset to the extent that a cash refund or a reduction in future payments is available.

(ii) Short-term employee benefits

Short-term employee benefit obligations are measured on an undiscounted basis and are expensed as the related service is provided. A liability is recognised for the amount expected to be paid under short-term cash bonus plans if the company has a present legal or constructive obligation to pay this amount as a result of past service provided by the employee, and the obligation can be estimated reliably.

(e) Revenue

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

(f) Other operating income

Other operating income, which excludes value added tax (VAT), comprises adviser fees recharged to the investee companies.

(g) Corporation tax

The company is registered for the purposes of corporation tax. The amount of corporation tax payable in respect of this period is nil.

(h) VAT

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

(i) Trade receivables

Trade and other payables are stated at cost.

(j) Cash and cash equivalents

Cash and cash equivalents comprise solely of cash balances.

(k) Financial assets and financial liabilities

(i) Recognition

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

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

(ii) De-recognition

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

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

Notes to the financial statements (continued)

(iii) Classification and measurement

Financial assets are categorised as 'Loans and receivables'.

Financial liabilities are categorised as 'Other financial liabilities'.

(iv) Loans and receivables

Loans and receivables are non-derivative financial assets with fixed or determinable payments which are not quoted in an active market. UKFI has no loans, however it has the following receivables included in the current assets: cash at bank and in hand, and accrued income owed by group undertaking.

Receivables are recognised at cost; in accordance with IFRS 7, the carrying values of short-term financial assets and liabilities (at amortised cost) are not considered different from fair value.

(v) Other financial liabilities

All financial liabilities are recognised at cost; in accordance with IFRS 7, the carrying values of short-term financial assets and liabilities (at amortised cost) are not considered different from fair value.

(l) New standards and interpretations not yet adopted

A number of new standards, amendments to standards and interpretations are not yet effective for the year ended 31 March 2012, and have not been applied in preparing these financial statements. None of these is expected to have an effect on the financial statements of the company.

(m) Segmental Reporting

UKFI has two reportable segments: the operation of UKFI, and the sale of Northern Rock plc. The budget updates are provided to the Chief Operating Decision Maker, which is UKFI's Board. Expenses associated with the Northern Rock plc sale are disclosed in the income statement.

The main activity of the company is managing, from its London headquarters, the Government's investments in financial institutions.

4. Income

	2011/12 £000	2010/11 £000
Investment management fees	2,524	2,702
Reimbursement of fees relating to the sale of Northern Rock plc	3,169	0
Adviser fees recharged to investee companies	0	215
Total	**5,693**	**2,917**

5. Remuneration of directors

	2011/12 £000	2010/11 £000
Directors' emoluments	425	387
Total	**425**	**387**

6. Personnel expenses

The average number of people working at the company during the period was 20 (2010/11: 20). This figure includes directors and long-term inward secondees.

The aggregate payroll costs of these people were as follows:

	2011/12 £000	2010/11 £000
Wages and salaries	1,465	1,513
Social security contributions	177	184
Defined contributions	103	60
Contributions to other pension plans	55	64
Agency staff	32	0
Total	**1,832**	**1,821**

Wages and salaries include Board fees and the costs of long-term inward secondees.

Contributions to other pension plans are included in the amount recharged for HM Treasury, the Cabinet Office and Home Office secondees. UKFI has no ongoing liability in respect of the underlying pension schemes.

A bonus amount of £85,294 was awarded in respect of the period 1 December 2010 to 30 November 2011, representing 4.7% of staff costs incurred over the same period. In respect of the previous performance year, £89,423 was paid out this year in deferred bonuses.

7. Profit before tax

	2011/12 £000	2010/11 £000
Profit before tax is stated after charging:		
Auditors' remuneration: audit of these financial statements	16	18

Notes to the financial statements (continued)

8. Property, plant and equipment

2011/12	IT £000	Furniture & Fittings £000	Total £000
Cost or valuation			
At 1 April 2011	103	119	222
Additions	0	6	6
Disposals	0	0	0
At 31 March 2012	**103**	**125**	**228**
Depreciation			
At 1 April 2011	(37)	(43)	(80)
Charged in year	(34)	(33)	(67)
At 31 March 2012	**(71)**	**(76)**	**(147)**
Carrying value at 31 March 2012	**32**	**49**	**81**
Carrying value at 31 March 2011	66	76	142

2010/11	IT £000	Furniture & Fittings £000	Total £000
Cost or valuation			
At 1 April 2010	109	119	228
Additions	0	0	0
Disposals	(6)	0	(6)
At 31 March 2011	**103**	**119**	**222**
Depreciation			
At 1 April 2010	(3)	(10)	(13)
Charged in year	(34)	(33)	(67)
At 31 March 2011	**(37)**	**(43)**	**(80)**
Carrying value at 31 March 2011	**66**	**76**	**142**
Carrying value at 31 March 2010	106	109	215

9. Intangible assets

2011/12	Software £000	Total £000
Cost or valuation		
At 1 April 2011	26	26
Additions	0	0
At 31 March 2012	**26**	**26**
Amortisation		
At 1 April 2011	(9)	(9)
Charged in year	(9)	(9)
At 31 March 2012	**(18)**	**(18)**
Carrying value at 31 March 2012	**8**	**8**
Carrying value at 31 March 2011	17	17

2010/11	Software £000	Total £000
Cost or valuation		
At 1 April 2010	26	26
Additions	0	0
At 31 March 2011	**26**	**26**
Amortisation		
At 1 April 2010	(1)	(1)
Charged in year	(8)	(8)
At 31 March 2011	**(9)**	**(9)**
Carrying value at 31 March 2011	**17**	**17**
Carrying value at 31 March 2010	25	25

10. Trade receivables and other current assets

	31 Mar 2012 £000	31 Mar 2011 £000
Prepayments	11	0
Trade receivables due from related parties	343	288
Other trade receivables	0	0
Total	**354**	**288**

Notes to the financial statements (continued)

11. Cash and cash equivalents

	31 Mar 2012 £000	31 Mar 2011 £000
Government Banking Service, Commercial Banks	292	113
Cash in hand	0	0
Total	**292**	**113**

12. Called up share capital

	31 Mar 2012 £	31 Mar 2011 £
Authorised		
Equity: ordinary shares of £1 each	**100**	**100**
Allotted, called up and fully paid		
Equity: ordinary shares of £1 each	**1**	**1**

13. Trade payables and other current liabilities

	31 Mar 2012 £000	31 Mar 2011 £000
Amounts falling due within one year		
Trade and other payables due to related parties	2	2
Other trade payables	66	26
Non-trade payables and accrued expenses	177	350
Taxation and social security	424	110
Total	**669**	**488**

14. Non-current liabilities

	31 Mar 2012 £000	31 Mar 2011 £000
Amounts falling due after more than one year		
Trade and other payables due to related parties	0	5
Non-trade payables and accrued expenses	58	59
Taxation and social security	8	8
Total	**66**	**72**

15. Operating leases

Operating lease rentals are payable as follows:

	31 Mar 2012 £000	31 Mar 2011 £000
Less than one year	180	219
Between two and five years	0	154
More than five years	0	0
Total	**180**	**373**

16. Dividends

UKFI has no intention of making a profit at any point, and does not intend to declare a dividend at any point. No dividend was declared or paid during the period (2010/11: Nil).

17. Financial instruments

IFRS 7 and IAS 39, financial instruments, require disclosure of the role that financial instruments have had during the period in creating or changing the risks an entity faces in undertaking its activities.

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

UKFI holds the following financial assets: trade receivables due from related parties, other trade receivables, and cash at bank and in hand. All are classified as 'Loans and Receivables' and denominated in pounds Sterling (notes 10 and 11).

UKFI's financial liabilities are: trade and other payables due to related parties, other trade payables, non-trade payables and accrued expenses and taxation and social security. All are classified as 'Other Financial Liabilities' and denominated in pounds Sterling. The maturity analysis of the financial liabilities is less than one year (note 13) and more than one year (note 14).

In accordance with IFRS 7, the carrying values of short-term financial assets and liabilities (at amortised cost) are not considered different from fair value.

Market risk

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

Credit risk

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

Liquidity risk

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

Notes to the financial statements (continued)

18. Contingent liabilities

UKFI continues to indemnify its directors against liabilities and losses incurred in the course of their actions as directors, and these in turn are guaranteed by HM Treasury. The potential liabilities in relation to these indemnities are considered unquantifiable.

19. Related parties

As at 31 March 2012, the company is a wholly owned subsidiary undertaking of HM Treasury, which is registered in England and Wales and operates in the United Kingdom.

Keith Morgan, UKFI's Head of Wholly Owned Investments is a non-executive director of Bradford & Bingley plc, Northern Rock (Asset Management) plus UK Asset Resolution Ltd.

Keith Morgan was also a non-executive director of the former Northern Rock plc before it was sold to Virgin Money on 1 January 2012.

Details of the salary and other remuneration payable to senior management are provided in the Remuneration Report.

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

	31 Mar 2012 £000	31 Mar 2011 £000
Trade receivables due from related parties		
HM Treasury	343	285
Salary adjustment	0	3
Total	**343**	**288**

	31 Mar 2012 £000	31 Mar 2011 £000
Trade and other payables due to related parties		
HM Treasury less than one year	2	50
HM Treasury more than one year	0	5
Total	**2**	**55**

During the period, the company received income from the following related parties:

	31 Mar 2012 £000	31 Mar 2011 £000
HM Treasury – provision of investment management services	2,524	2,702
HM Treasury – expenses and fees for the sale of Northern Rock plc	3,169	0
Northern Rock (Asset Management) plc – recharge of adviser fees	0	21
Bradford & Bingley plc – recharge of adviser fees	0	194
Total	**5,693**	**2,917**

Published by TSO (The Stationery Office) and available from:

Online
www.tsoshop.co.uk

Mail, telephone, fax and email
TSO
PO Box 29, Norwich NR3 1GN
Telephone orders/general enquiries: 0870 600 5522
Order through the Parliamentary Hotline Lo-Call 0845 702 3474
Fax orders: 0870 600 5533
Email: customer.services@tso.co.uk
Textphone: 0870 240 3701

The Parliamentary Bookshop
12 Bridge Street, Parliament Square,
London SW1A 2JX
Telephone orders/general enquiries: 020 7219 3890
Fax orders: 020 7219 3866
Email: bookshop@parliament.uk
Internet: http://www.bookshop.parliament.uk

TSO@Blackwell and other accredited agents

Company Number 6720891

Design www.bluegoose.co.uk

ISBN 978-0-10-297852-0