



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

**Asset Protection Agency
Report and Accounts 2009-10**

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

Accounts presented to the House of Lords by
Command of Her Majesty.

Report presented to Parliament by
command of Her Majesty.

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1 Chief Executive's Foreword

Welcome to the first Report and Accounts of the Asset Protection Agency, the executive agency of HM Treasury which administers the UK Government's Asset Protection Scheme. I am deeply grateful to our team for their considerable achievements over a short period of time which are detailed in this report. They have turned a project into an organisation and, together with RBS, implemented a complicated contract in minimal time.

When we published our business plan for 2009/10 I laid out the following tests for judging whether the APS (and APA) had been successful:

1. The role the APS had played in restoring financial stability to the UK banking sector which supports the real economy without implicit or explicit government help.
2. The Government would have been remunerated for its risk in respect of the APS, RBS will have exited the Scheme successfully and any losses paid out would have been reimbursed by RBS on exit.
3. The APA would have played its part in reducing potential losses on APS covered assets and in protecting the public interest in the way it exercises its functions.

The first two points are clearly still work in progress. The acuteness of the global banking crisis may have abated somewhat, and we are nearer to our goals than we were in 2009. Still, the recovery is extremely fragile and the recent travails of the Eurozone and its banks serve as a salutary reminder that it would be too early to declare our task over. The pool of insured assets remains vulnerable due to high leverage and significant refinancing risks, and it is largely thanks to the extremely low interest rate environment that we have been spared the early realisation of larger losses. However I am pleased to report that in my opinion we have been travelling in the right direction during the reporting period and continue to do so at the time of writing.

On the third point we have also made progress. I want to explicitly pay tribute to the extremely challenging task the RBS senior management team have taken on in turning around the bank and returning it to viability. It is a multi-year journey with a massive amount of change required in almost all areas: culture, systems, capability and financials to name a few. We wouldn't be on this journey together if the starting point were a happy one. It follows that there are many aspects of how APS covered assets are managed, controlled, documented and processed that can be improved, and often improved significantly. But we also recognise that these improvements cannot happen overnight, which is why the APA has been considered in exercising its formal powers so far and has instead focused on establishing a multi-layered dialogue with RBS designed to flush out issues and seek ways to address them together. In addition in some areas APA has required RBS to appoint external advisors in order to speed up resolution of problem areas and benefit from third party expertise.

The rally across asset classes during the latter half of 2009 and continuing into the first quarter of 2010 was an opportunity to de-risk some APS portfolios through sales and hedges which was recognised by both RBS management and the APA. The APA therefore consented to the overwhelming majority of RBS disposal

requests during this period and in some instances encouraged RBS to sell even more exposure of certain assets. At the time of writing, the market environment is somewhat less favourable to de-risking and sales, which presents a challenge to both RBS and the APA in finding ways to continue to maximise the long term value of recoveries and continue to de-risk the APS portfolio.

As this report details, our current best expectation remains that the taxpayer will not bear any ultimate losses from the APS and instead make a profit of £5bn (£2.5bn each from Lloyds and RBS). The cover provided for RBS remains important should we find ourselves in a stressed environment. However our current expectations are that the broad trend of recovery will continue. Still, the remaining imbalances in the global economy are so significant that we are not counting on a smooth ride. There are plenty of “known unknowns” to worry about at the moment, never mind the “unknown unknowns”. Protection against the unknown is the essence of the APS which underpins our central financial stability objective.

Stephan Wilcke

Chief Executive

30 June 2010

2 Introduction

2.1 Scope of this document

The Asset Protection Agency (APA or the Agency) is an executive agency of HM Treasury (HMT). The APA has been established to operate the Asset Protection Scheme (APS or the Scheme). The objectives of the Scheme are to support the stability of the UK financial system, increase confidence and capacity to lend, and thus support the economy by protecting financial institutions participating in the Scheme against exceptional credit losses on certain portfolios of assets.

This is the APA's first Annual Report and covers the period from the Agency's launch on 7 December 2009 to 31 March 2010.

The APA's Framework Document requires that the APA's Annual Report contains the following (relevant sections of this report):

- details of the APA's performance against targets for the year (Section 6.1)
- details of the APA's progress towards its strategic objectives (Sections 1 and 5)
- a summary of the APA's activities during the year (Sections 5 and 6)
- an update on compliance by participating financial institutions with the terms and conditions of the Scheme (Section 5.2.2)
- financial information about the operation of the APA and the Scheme (Sections 4, 6.2 and 11)
- any other issues that the Treasury or the APA deem appropriate.

2.2 The APA

The APA's main function is to operate the APS on behalf of HMT. To this end, the APA has three principal responsibilities, which are set out in the APA's Framework Document:

- I. ensuring that each participating financial institution complies with the terms and conditions attaching to its participation in the Scheme, including through:
 - proactive and timely exercise of HMT's rights under the Scheme; and
 - engagement with participating financial institutions to determine appropriate asset management strategies for Covered Assets;

- 2 forecasting potential future payouts under the Scheme; and
- 3 verifying losses and recoveries on Covered Assets and advising HMT on any payments to be made under the Scheme.

RBS is the only participating financial institution at present.

The APA's overriding objective is to protect the taxpayer's interest. This breaks down into more specific operational objectives. The operational objectives for the period this report covers were set out in the APA's Business Plan for 2009-10 and are reproduced below:

1. To be proactive and timely in exercising of HMT rights to maximise the value of the assets in the Scheme and reduce the probability of payouts under the Scheme.
- 2 To provide timely, robust and independent forecasts of anticipated losses on covered assets.
- 3 To achieve accurate, valid and complete verification of losses on covered assets.
- 4 To engage with RBS to determine appropriate asset management strategies for covered assets.
- 5 To ensure consistent and prudent determination of expected loss credits for disposal of Non-Triggered Assets.
- 6 To provide timely and accurate reporting to HMT.
- 7 To ensure effective Agency setup and smooth transition to "business as usual".
- 8 To communicate clearly and openly with all stakeholders.
- 9 To ensure operating within budget, with a strong focus on efficiency and value for money.
- 10 To provide swift and helpful responses to public enquiries.
- 11 To foster a supportive organisational culture with an emphasis on personal development.

2.2.1 The Agency's target operating model

The APA's target operating model is based on a small core of permanent in-house staff, supported as necessary by external experts. This model has been chosen in light of the complexity and unprecedented nature of the APS, and significant uncertainty over the Scheme's duration, which will depend on such factors as the success of RBS management strategies and the rate of sustainable recovery in the UK and global economies. The APA has worked towards becoming a lean and flexible organisation and wherever

appropriate bases its work on RBS's own processes and systems to minimise duplication and ensure maximum value for money.

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

2.2.2 Advisory Board and committees

The Chief Executive is supported by the Advisory Board, the meetings of which are chaired by a non-executive member. The Advisory Board meets at least quarterly to consider strategic, operational and management issues related to the achievement of the APA's objectives and fulfilment of its responsibilities. The Advisory Board exists purely to advise the Chief Executive and other members of the Leadership Team; accountability for all decisions remains with the Chief Executive. Lucy Wylde is a member of the Advisory Board and is a partner at Slaughter and May, which provides legal advice to the APA, and appropriate arrangements are in place to manage that conflict. Subject thereto, none of the members of the Advisory Board hold any company directorships or other significant interests that might conflict with their management responsibilities. The Advisory Board is supported by the Audit and Risk, Credit and Remuneration Committees.

2.2.3 Relationship with HM Treasury

The APA is legally and constitutionally part of HMT but, as an executive agency, operates at arm's length from Ministers. The Chancellor of the Exchequer determines the policy and financial framework within which the Agency operates, but delegates to the Chief Executive operational decisions and day-to-day management of the Agency. The APA's Framework Document, which is available on the APA website at www.hm-treasury.gov.uk/apa, sets out the respective responsibilities in relation to the APS of Ministers, HMT and the Chief Executive.

The Chief Executive reports to HMT's Second Permanent Secretary. Two senior representatives of HMT – the head of the APS/RBS Team and the Director of Financial Stability - are members of the Advisory Board.

2.2.4 The arm's length principle

While APS policy matters remain the prerogative of HMT Ministers, the arm's length nature of the APA means that operational decisions relating to the APS are delegated to the Chief Executive. This governance structure allows the APA to act purely in furtherance of the specified Asset Management Objective (AMO) or to reduce risk to the taxpayer, and enables RBS to continue to conduct its daily operations along free-market principles.

2.2.5 Relationship with Parliament

The Chief Executive has been designated by HMT's Permanent Secretary as an Agency Accounting Officer of HMT. As the Accounting Officer, he is personally responsible for safeguarding the APA's funds; for ensuring propriety and regularity in the handling of these funds; and for assuring HMT's Principal Accounting Officer that the funds authorised by Parliament for which he has responsibility are used for the purposes intended by Parliament, and that these funds and any receipts are properly accounted for. Responsibility for the Government's liability under the APS remains with HMT's Permanent Secretary in his capacity as Principal Accounting Officer.

As an Accounting Officer, the Chief Executive may be summoned to a hearing of the Committee of Public Accounts (PAC) to account for the discharge of his responsibilities.

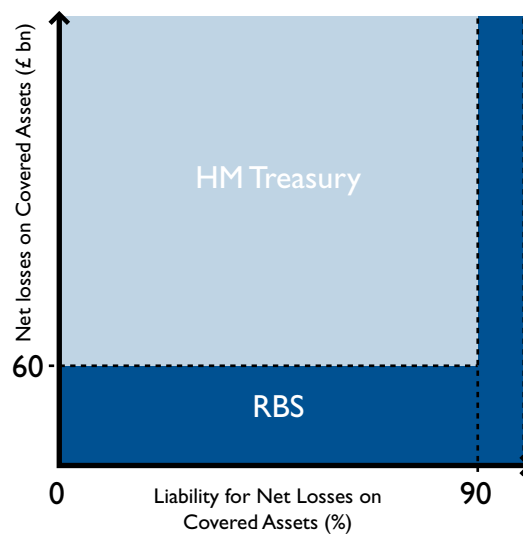
2.3 Background to the APS

The APS, announced in January 2009, was created to enable the UK Government to provide participating institutions with protection against future credit losses on defined portfolios of assets in exchange for a fee. By limiting potential losses in this way, the Government aimed to support the stability of the UK financial system; to increase confidence in the participating financial institutions; and to improve their capacity to lend to creditworthy businesses and individuals. As stated in Section 2.2, RBS is the only participating financial institution at present.

2.3.1 How the Scheme works

All of the £282bn of assets against which HMT provides protection (Covered Assets) were on the consolidated balance sheet of The Royal Bank of Scotland Group plc (RBSG) on 31 December 2008. Protection is provided to the extent that overall eventual Losses on these assets, net of Recoveries, exceed a first loss amount of £60bn – the equivalent of the “excess” under a conventional insurance policy.

RBS therefore bears all Losses on the Covered Assets up to the First Loss Amount of £60bn. If total Losses net of Recoveries should exceed the First Loss Amount, then HMT will pay to RBS 90% of the excess amount above £60bn, as illustrated in Figure 1 below.

Figure 1: Liability for Losses on Covered Assets

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

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

When a Covered Asset is the subject of a Trigger, HMT is entitled to receive 90% of any Recoveries relating to that asset. Any payments due from HMT to RBS in respect of Losses on Covered Assets are deferred for at least two years from the time that the Loss occurs. This deferral period allows the APA to verify Loss claims and gives time for Recoveries on the assets to have been realised before payment is made.

RBS is obliged to pay fees to HMT for so long as it receives protection under the Scheme. For the first three years of the APS (from 2009), these fees are £700m per year; thereafter they are £500m per year until

31 December 2009. RBS paid £1.4bn of fees on 31 December 2009 in respect of the years 2009 and 2010; thereafter fees are payable annually in advance.

To leave the APS before 31 December 2009, RBS must pay back any payments it has received under the Scheme, plus a minimum of £2.5bn, less any APS fees already paid. RBS will also require the approval of the FSA.

2.3.2 Oversight and monitoring by the APA

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

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

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

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

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

2.3.3 Credit reviews

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

Prohibited Conduct

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

Prohibited Conduct broadly comprises:

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

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

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

Additional lending

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

Loss Credits

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

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

2.3.4 Ongoing governance and oversight

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

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

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

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

3 People

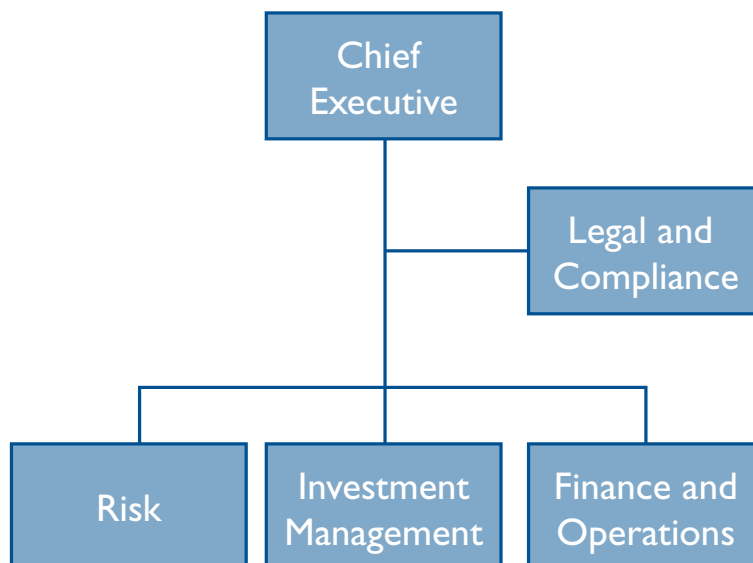
3.1 Organisational structure

The APA is organised in three main teams, which are illustrated in Figure 2 below. These correspond to the Agency's three principal responsibilities as set out in the Framework Document. The head of each division reports to the Chief Executive.

- The Investment Management team is responsible for working with RBS to ensure that Protected Assets are appropriately managed and for handling asset-related requests from RBS in connection with the Scheme.
- The Risk team is responsible for forecasting losses under the Scheme to enable HMT to predict any fiscal impact, for valuing the APS for the purposes of HMT's Annual Report and Accounts and for determining appropriate Loss Credits associated with RBS's disposal of Non-Triggered Assets.
- The Finance and Operations team is responsible for the verification of any payments to be made under the Scheme, as well as for data validation, IT and other infrastructure, and the APA's finance and HR functions.

Supporting the three main teams is a Legal and Compliance team which provides advice on legal matters connected with the operation of the Scheme, compliance with the law and the APA's governance as a public body.

Figure 2: APA organisational structure



3.2 Senior management and non-executives

The senior management team and non-executives who have served for all or part of the reporting period or since then are:

Stephan Wilcke, Chief Executive

Jens Bech, Chief Risk Officer

Ion Dagtoglou, Chief Investment Officer

James Hewer, interim Chief Financial and Operating Officer

Bill Dickinson, Chief Financial and Operating Officer

Lucy Wylde, General Counsel

Cynthia Parker, Chief Credit Officer (structured finance)

Brian Scammell, Chief Credit Officer (commercial real estate)

Hamish Buckland interim Chief Credit Officer (corporate and leveraged finance) and Advisory Board member

John B. Caouette, non-executive Chairman of Advisory Board

Lowri Khan CBE, non-executive member of Advisory Board

Elizabeth Dymond, non-executive member of Advisory Board

Michael Ashley, non-executive Chairman of Audit and Risk Committee

Biographies and Advisory Board and Committee memberships are set out in Annex I.

3.3 Recruitment and induction

At launch, the APA was staffed primarily by secondees. By the end of March 2010, the numbers of permanent staff and fixed term appointments greater than one year working at the APA had been increased to 16. By the end of June this number had risen to 32. In addition, during the reporting period the composition of the Advisory Board and associated committees was agreed and all members were appointed.

Actual and projected total numbers for APA staff are given in Table I below.

Table I: APA staff numbers

Category	Dec 2009	March 2010	June 2010	Sept 2010 (projected)	Dec 2010 (projected)
Investment Management/CCOs	6	12	16	16	18
Risk	5	7	11	13	14
Legal and Compliance	4	4	3	4	4
Finance and Operations (inc. CEO)	17	18	20	15	15
Total	32	41	50	48	51
Permanent/fixed term appointments greater than one year	4	16	32	39	42
Interim staff (inc. secondments/temp/fixed term appointments of one year or less)	28	25	18	9	9

Source: APA

Induction arrangements have been developed and implemented for all personnel working at the APA and knowledge management systems are being put in place to ensure the teams can optimise and share their experience.

Details of the APA's remuneration and appointments policies including pension arrangements can be found in the Remuneration Report in Section 9.

4 Overview of Covered Assets

The information set out in Tables 2 to 6 below, including the notes to those tables, has been extracted from information published by RBSG as specified therein. This information has not been independently verified by or on behalf of the APA and is therefore not determinative of any payouts that HMT may be required to make under the Scheme. The APA's business review, which contains further information about the operation of the APS and relevant commentary, is set out in Section 5.

RBS included assets in the Scheme with a total par value as at 31 December 2008 of £282bn. The Covered Assets were generally selected in terms of adverse credit quality as reflected by high Probability of Default and high Loss Given Default. Table 2 below summarises the criteria applied by RBS during 2009 for identifying candidate assets for inclusion in the APS.

Table 2: Selection of the APS portfolio

Contributing divisions ⁽¹⁾	Selection criteria
UK Retail	<ul style="list-style-type: none"> • Mortgages: assets with a higher loan-to-value (LTV) and in higher risk segments (e.g. LTV >97% on general book, LTV >85% on buy-to-let book), and those assets in arrears (at 31 December 2008). • Loans and overdrafts: higher risk customers based on internal bandings, and those assets in arrears (at 31 December 2008).
UK Corporate	<ul style="list-style-type: none"> • Commercial & corporate real estate: all defaulted assets in the work-out/restructuring unit, and those assets in high risk bands. • Corporate: all defaulted assets in the work-out/restructuring unit. Corporate banking clients in high risk sectors or with high concentration risk. • Business Banking: portfolios in the work out/restructuring unit and those in high risk bands.
Global Banking & Markets	<ul style="list-style-type: none"> • Banking book: selection by individual assets (corporate loans, real estate finance, and leveraged finance), Global Restructuring Group work-out unit counterparties/assets and high risk counterparties/assets. • Additional counterparties/assets were selected through an individual risk review of the total portfolio. • Trading book: selection by individual assets (monolines, derivatives, mortgage trading).
Ulster Bank (Corporate and Retail)	<ul style="list-style-type: none"> • Mortgages: assets with greater than 85% LTV, broker mortgages and interest only with a higher probability of default. • Retail: portfolios of accounts in default, >1 month arrears, <2 years old and a higher probability of default. • Corporate: counterparties/assets in work-out/restructuring groups or in high risk bands, and other assets identified as part of an individual review of cases.

Note:

(1) Including assets transferred to Non-Core Division

Source: RBSG Annual Report 2009, page 175

Table 3 below details the movement in Covered Assets between 31 December 2008 and 31 March 2010.

Table 3: Covered Asset

Changes to Covered Assets	£ bn
Covered Assets at 31st December 2008	282.0
Disposals	(3.0)
Non-contractual early repayments	(8.9)
Amortisations	(9.4)
Maturities	(16.7)
Rollovers and Covered Amount cap adjustments	(1.7)
Effect of foreign currency movements	(11.8)
Covered Assets at 31 December 2009⁽¹⁾	230.5
Disposals	(1.7)
Maturities, repayments, amortisations and other movements	(2.6)
Effect of foreign currency movements	4.7
Covered Assets at 31 March 2010⁽²⁾	230.9

Notes:

(1) The covered amount at 31 December 2009 above includes approximately £2.1 billion of assets in the derivatives and structured finance asset classes which, for technical reasons, do not currently satisfy, or are anticipated at some stage not to satisfy the eligibility requirements of the Scheme. HMT and the Group continue to negotiate in good faith whether (and, if so, to what extent) coverage should extend to these assets. Also, the Group and HMT are in discussion over the HMT classifications of some structured credit assets and this may result in adjustments to amounts for some asset classes; however underlying risks will be unchanged.

(2) The covered amount at 31 March 2010 includes approximately £2.0 billion of assets in the derivatives and structured finance asset classes which, for technical reasons, do not currently satisfy, or are anticipated at some stage not to satisfy, the eligibility requirements of the APS. The APA and RBS continue to negotiate in good faith whether (and if so, to what extent) coverage should extend to these assets. Also, the APA and RBS are in discussion over the classifications of some structured credit assets and this may result in adjustments to amounts for some asset classes; however underlying risks will be unchanged. Whilst good progress is being made, the final outcome is dependent on RBS and the APA reaching an agreement by the due date on various areas of interpretation. Should this not be achieved and the APA does not grant an extension to RBS, cover on these assets may be restricted.

Source: RBSG Annual Report 2009, page 175 and RBSG Q1 2010 Interim Management Statement, Appendix 3, page 2

Table 4 below summarises the total Triggered Amount and related Recoveries by division as at 31 December 2009 and compares it to credit impairments and write-downs for the same divisions. The Non-Core division is the operating division of RBS Group that manages separately the assets that the RBS Group intends to run off or dispose.

Table 4: Triggered Amount, Recoveries and impairments as at 31 December 2009 (£m)

Contributing Divisions	Triggered Amount	Recoveries	Net Triggered Amount	Credit Impairments and Write Downs
UK Retail	3,340	129	3,211	2,431
UK Corporate	3,570	604	2,966	1,007
GBM	1,748	108	1,640	1,628
Ulster Bank (Corporate and Retail)	704	47	657	486
Non-Core	18,905	777	18,128	23,338
Total at 31 December 2009	28,267	1,665	26,602	28,890

Note:

(1) The triggered amount on a covered asset is calculated when an asset is triggered (due to bankruptcy, failure to pay after a grace period, and restructuring after an impairment) and is the lower of the covered amount and the outstanding amount for each covered asset. Given the grace period for triggering assets, the Group expects additional assets to trigger based on the current risk rating and level of impairments on covered assets.

Source: RBSG Annual Report 2009, pages 176-177

Table 5 below sets out cumulative credit impairment losses (including available-for-sale reserves) and adjustments to par value relating to Covered Assets at 31 March 2010 and 31 December 2009.

Table 5: Cumulative credit impairment losses (£m)

	31 March 2010	31 December 2009
Loans and advances	15,848	14,240
Debt securities	7,795	7,816
Derivatives	6,890	6,834
	30,533	28,890
By division		
UK Retail	2,618	2,431
UK Corporate	1,231	1,007
GBM	1,473	1,628
Ulster Bank	683	486
Non-Core	24,528	23,338
	30,533	28,890

Source: RBSG Q1 2010 Interim Management Statement, Appendix 3, page 2

Table 6 below details the total Triggered Amount by division at 31 March 2010 and 31 December 2009. These exclude Recoveries.

Table 6: Total Triggered Amount by division (£m)

	31 March 2010	31 December 2009
UK Retail	3,517	3,340
UK Corporate	3,843	3,570
GBM	2,378	1,748
Ulster Bank	769	704
Non-Core	22,665	18,905
	33,172	28,267

Source: RBSG Q1 2010 Interim Management Statement, Appendix 3, page 3

Notes:

(1) The Triggered Amount on a Covered Asset is calculated when an asset is Triggered and is the lower of the Covered Amount on the Initial Event Date and the Outstanding Amount on the Trigger Date for each Covered Asset.

(2) There are a number of Scheme rule interpretation issues being discussed between RBS and the APA, the most significant of which is in relation to the interpretation of certain loss Triggers. Table 6 is based on RBS published data, using RBS's understanding of the Triggers.

Further information on the Covered Assets can be found in can be found in the RBSG Annual Report 2009 (in particular pages 178 to 182) and in RBSG Quarter 1 2010 Interim Management Statement, Appendix 3.

5 Business Review

5.1 Overview of activities since launch

In the period that this report covers, the APA has focused much of its resource on putting in place the systems and procedures necessary to enable it to meet the challenges involved in implementing and operating the APS. This period has been characterised by rapid change and short-term projects. As procedures are established and bedded down, it is envisaged that the APA will continue its move from a project-focused operating model to an increasingly programme-oriented, “business as usual” state.

A major focus for the APA since its launch has been to build teams with the necessary skills and expertise to carry out the Agency’s responsibilities. Having received over a thousand applications for the roles on offer, recruitment has by necessity absorbed significant management time during this period. The result, however, is that the majority of core positions are now filled.

Concurrently with the drive to recruit staff, the APA has been working on designing and implementing the necessary technical infrastructure for running the APS. The development of a bespoke IT system for handling and processing the data flows that are a fundamental element of the Scheme’s workings will improve the effective and efficient operation of the APS. Wherever possible, APA systems are being designed to leverage off RBS’s systems to prevent duplication and ensure value for money. More details can be found in the Chief Financial and Operating Officer’s report in Section 5.4.

One of the APA’s main responsibilities is the forecasting of losses under the Scheme with a view to enabling HMT to manage any future impact on the public finances. The APA has developed a model – which will continue to be refined – to forecast APS losses under a wide range of possible economic scenarios. The APA has also produced a valuation of the Scheme for HMT’s Annual Report and Accounts which is compliant with International Financial Reporting Standards (IFRS). More details can be found in the Chief Risk Officer’s report in Section 5.3.

The APA has established working relationships with RBS and has designed and implemented processes for the interactions between RBS and the APA that are required by the Conditions, particularly with regard to RBS approval requests in relation to Prohibited Conduct. These processes will continue to develop and be refined.

Consistent with the APA’s target operating model, the Agency has been building relationships with a range of third party advisers across a range of disciplines within financial, accounting, advisory and legal services. During the reporting period the APA appointed PricewaterhouseCoopers to act as its verification agent to ensure that only appropriate payments are made under the Scheme and to monitor compliance by RBS with the terms of its participation in the APS.

A significant part of the APA’s work during the reporting period has been the creation of internal governance and control systems to support strategic decision-making and to ensure risks are adequately identified and managed. The Advisory Board with committees has been instituted to support the Chief Executive. Their composition includes external members who have been appointed to bring an independent

perspective and to offer constructive criticism of APA management. The APA has also appointed internal auditors to analyse and test the ways of working that are being developed.

While observing the arm's length principle, the APA has maintained close and constructive relationships during the reporting period with HMT, its parent department. Since its launch, the Agency's relationship with HMT has been characterised by frequent informal communication. A regime of formal reporting from the APA to HMT also exists, which includes mostly management information and summaries and analysis of Quarterly Statements, loss forecasts and this Annual Report.

5.2 Chief Investment Officer's review

5.2.1 Oversight and monitoring of Covered Assets

During the period under review, the APA has focused on hiring specialist teams and developing business-as-usual operations. The Investment Management team is targeted to comprise 18 people: three asset specialist teams and a credit administration team. In addition, the three Chief Credit Officers (CCOs, see Section 3) support the Chief Investment Officer and provide senior asset expertise. The 13 asset specialists and three CCOs recruited to date all have significant sell-side, buy-side and credit expertise from a range of investment banking backgrounds.

The Investment Management asset specialists are focused on three broad asset classes to which all large Covered Assets have been allocated: corporate and leveraged finance, commercial real estate, and structured products. These APA asset classes do not reconcile to the Covered Asset Classes defined in the APS as certain Covered Asset Classes such as Loans, Bonds and Derivatives have been reallocated for APA management purposes.

The Investment Management team reviews files (i) presented to the APA and requiring a credit decision (credit reviews) and (ii) selected by the APA for review (asset reviews). The credit reviews are a priority for the APA as it is required to respond in a timely manner to requests by RBS for credit decisions (within five Business Days unless further information is required but often more quickly).

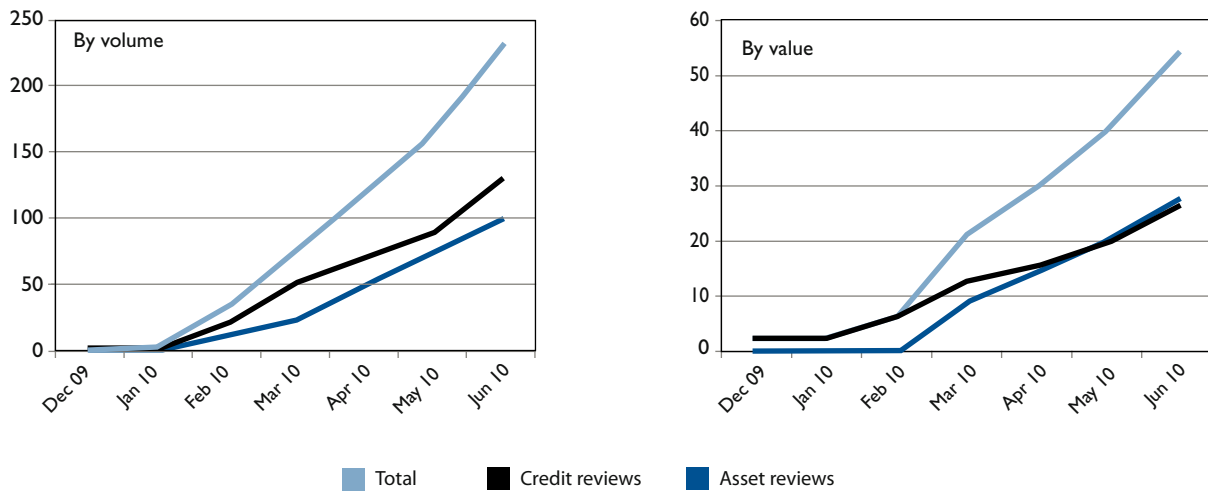
The APA has begun a programme of asset reviews to enhance monitoring and oversight of asset management of Covered Assets, in particular where credit decisions or debt restructurings are imminent. These asset reviews are selected to cover the larger and riskiest Covered Assets.

The team's objective for the 2010/11 financial year is to complete reviews of all large Covered Assets (currently 589 grouped by ultimate borrower) representing £124bn Covered Amount or 54% of the 31 March 2010 aggregate Covered Amount.

Figure 3 below shows cumulative files reviewed by the APA by volume and value as at 30 June 2010. As at that date, the APA had reviewed or was in the process of reviewing 231 RBS files representing £53bn of Covered Amount (23% of the 31 March 2010 Covered Amount). 130 of these files (£26bn of Covered

Amount) were credit reviews requiring credit decisions by the APA and 101 files (£27bn of Covered Amount) were asset reviews selected for review by the APA.

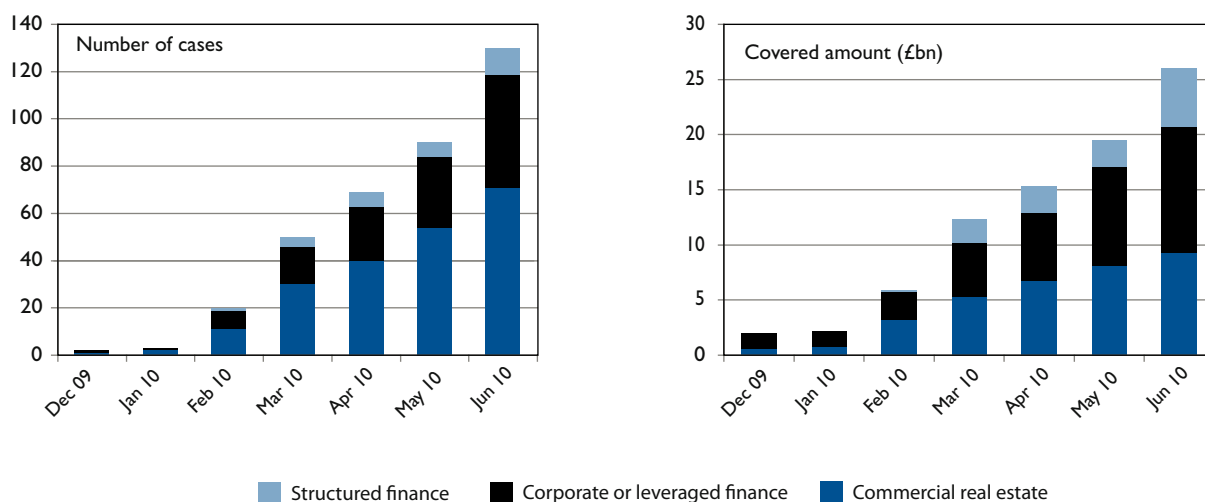
Figure 3: Cumulative files reviewed by volume and value (£bn)



Source: APA

Note: Credit reviews are files presented to the APA by RBS which require a credit decision; asset reviews are files selected by the APA for review. The data for asset reviews in Figure 3 includes assets both under review and reviewed.

Figure 4 below shows cumulative completed credit reviews by APA asset class by volume and value as at 30 June 2010. Of the 130 credit reviews completed as at that date, 71 related to commercial real estate, 48 to corporate or leveraged finance, and 11 to structured finance (using the APA asset classes). However, the average size of files reviewed in the commercial real estate asset class has been relatively smaller than the other asset classes.

Figure 4: Cumulative completed credit reviews by APA asset class by volume and value (£bn)

Source: APA

Note: the asset classes used in Figure 4 reflect the asset classes defined by the APA for management purposes and not the Covered Asset Classes defined in the APS.

5.2.2 RBS performance and compliance

APS Oversight

The APA has sought to develop working relationships with senior RBS managers to ensure proper oversight, monitoring and governance of Covered Assets. In addition, whenever a Covered Asset is reviewed by the APA, direct contact is usually established with the appropriate RBS asset managers.

The APA has expressed concern over the quality of credit memos and financial analysis received from RBS and the consistency with which RBS manages the Covered Assets in accordance with the AMO. The APA continues to discuss this with RBS and to monitor the position.

The APA has begun a process of reviewing the major RBS businesses managing Covered Assets in order to ensure that the Covered Assets receive the best possible asset management including outsourced asset management if appropriate. Some changes to operations and practices have been discussed and the APA expects further interaction with RBS in this area.

The Leadership Team has attended all meetings of the Senior Oversight Committee to date and has sought to monitor and influence discussions at those meetings as well as using the meetings to report to RBS on its own views and experiences of operating the Scheme.

Negotiations on Scheme Documents

At the Accession Date, RBS and HMT agreed to negotiate in good faith to resolve certain interpretation and application issues that were not able to be resolved fully before then due to the complexity and scale of the Scheme. RBS and the APA continue to work to resolve these and other emerging issues, some of which may ultimately require amendments to the Conditions or Practice Statements.

Restructuring Trigger

As noted in Section 2.3.1, a Covered Asset is the subject of Restructuring Trigger only if a dual test is satisfied. First, the asset must be the subject of one or more specified restructuring events. Secondly, the asset must be or as a result of the restructuring event become (or IFRS as at 31 December 2008 would require it to be or become) the subject of a specific accounting impairment. RBS and the APA have different interpretations on how the specific impairment test should be applied, which has led to different views as to whether certain Covered Assets have been the subject of a Restructuring Trigger. As at 30 June 2010, this issue is the subject of ongoing discussions between RBS and the APA and is as yet unresolved.

Covered Asset restatement

RBS and HMT have a difference of opinion as to the status of certain structured credit assets for the purposes of the Scheme and have been discussing the relevant areas of interpretation and how they might be resolved. As at 30 June 2010, the determination of the treatment of those assets for the purposes of the Scheme is dependent on the progress of negotiations and how the relevant matters are resolved.

Compliance

Since the Accession Date, a number of breaches of the Scheme Documents have occurred, in part because of the complexity of the Scheme and the need for RBS to accommodate the requirements of the APS at an operational level. The APA has generally sought to address compliance issues through discussions with RBS and also the use of its investigative and reporting powers. In addition, the Agency has more recently asked RBS to appoint a number of specialist advisers (SOC Special Advisers) in relation to certain assets and business areas in order to provide additional support to the Senior Oversight Committee.

5.2.3 Market overview

The APA monitors the markets relating to the following asset classes: corporate and leveraged finance, commercial real estate and structured products. These APA asset classes are not the same as the Covered Asset Classes defined in the Conditions. For management purposes, the APA has allocated all large Covered Assets to these three asset classes. The APA's commentary on the markets for these three asset classes is set out in Annex 2.

5.3 Chief Risk Officer's review

During the reporting period, the focus has been on staffing up the Risk team, developing risk management capabilities and producing a number of key outputs including a loss forecast for inclusion in the Budget in March 2010. At the end of the reporting period, the Risk team had seven staff coming from a diverse range of backgrounds including banking, asset management, rating agencies and management consulting. The target size of the Risk team is 14.

The APA has a range of risk policies and supporting processes in place to identify and manage its risks and to promote a strong culture of risk awareness throughout its operations. The risks associated with running the APS fall into two broad categories:

- financial risks associated with HMT's potential liability under the APS; and
- operational risks of running the APS and the APA.

This section focuses on the first category, i.e. the financial risks associated with HMT's potential liability under the APS. The APA's internal structures and processes used to manage operational risk are described in the Statement on Internal Control included in Section 8.

The remainder of this section is structured as follows:

- Section 5.3.1 describes the financial risks associated with HMT's potential liability under the APS.
- Section 5.3.2 sets out the APA's approach to measuring these financial risks including the:
 - Expected Loss on the Covered Assets and potential HMT payouts; and
 - fair value of the APS in accordance with IFRS for inclusion in HMT's Annual Report and Accounts.
- Section 5.3.3 briefly describes responsibilities for risk mitigation.

5.3.1 *Financial risks of the APS*

In broad terms, the APS exposes HMT to the following financial risks:

- credit risk associated with the Covered Assets, which in turn is driven by a number of underlying factors including:
 - adverse portfolio selection (high borrower leverage, limited debt service capacity etc.);
 - economic environment (GDP growth, employment etc.);

- interest rates as a driver of debt service costs; and
- collateral valuations, which drive the likelihood of Triggers occurring and the level of Recoveries;
- foreign exchange (FX) rate movements affecting Covered Amounts measured in pounds sterling (GBP); and
- RBS counterparty credit risk.

Credit risk

The economic outlook is a key driver of the uncertainty surrounding future Losses and Recoveries under the APS. An economic rebound would lead to lower Losses as fewer Covered Assets would be the subject of a Trigger and the Recoveries on Triggered Assets would increase due to higher collateral valuations and higher exit values from debt-for-equity restructurings. Conversely, economic stagnation or worse, a new recession, would lead to significantly higher Net Losses than are currently expected.

The selection criteria for APS exposures, which are summarised in Section 4, show that Obligors covered by the APS tend to be highly leveraged, which implies that relatively small shocks to cash generating capacity or required debt service can result in an Obligor defaulting. Since interest rate levels drive debt service requirements for borrowers holding floating rate debt or for borrowers that need to refinance existing debt, rising interest rates may dampen the positive effect of an economic recovery.

Some of the Obligors covered in the APS borrowed money at relatively low rates during the boom years, often with limited covenants (popularly referred to as “covenant-lite”). Some of these borrowers are experiencing economic difficulties, but have not yet defaulted as current required interest service is minimal. Instead, these borrowers cling onto the hope that the situation will have changed materially when the debt reaches maturity. There are also cases where equity owners or management are able to extract substantial value from a company through dividends or management fees in the period running up to a refinancing date even though it is seemingly evident that the company will never be able to refinance its entire debt load. These types of issues are particularly prominent in the leveraged finance and CRE asset classes.

Residential and commercial property prices are key drivers of Losses and Recoveries on the APS portfolio. Property values drive borrowers' propensity to default as well as the level of potential recoveries. Once LTV goes significantly above the 100% mark, the incentive for borrowers to continue to service debt – even if they are able to do so – is reduced. Moreover, once in default the loan amount outstrips the recovery value increasing the likelihood of a Net Loss.

Foreign exchange rate risk

The APS portfolio includes a large proportion of non-sterling-denominated assets as shown in Table 7 below.

Table 7: Currency analysis by Covered Amount (£m) as at 31 December 2009

Currency	Covered Amount	% of total
GBP	107,731	47%
Euro	56,586	25%
USD	58,489	25%
AUD	3,276	1%
JPY	1,725	1%
Other	2,723	1%
Total	230,530	100%

Source: RBSG Annual Report 2009, page 182

The protection provided by the APS is generally in the currency of the Covered Asset meaning FX rate movements change the GBP equivalent Covered Amounts and consequently Losses and Recoveries are sensitive to exchange rate fluctuations. The sensitivity to exchange rate movements of Expected Loss and the fair value of the APS is discussed in Section 5.3.2.

RBS counterparty credit risk

The APS exposes HMT to RBS counterparty credit risk, specifically the risk that RBS will default on annual fee payments or on any other payments required by the APS. There is no requirement for RBS to post collateral to mitigate this risk, and, in the event of default, HMT will have no priority claim over the Covered Assets or any other assets of RBS. However, the APS itself improves the financial strength of RBS, particularly in any extreme downturn scenarios. In such circumstances, payments under the Scheme would be due to RBS rather than to HMT and RBS counterparty credit risk is therefore considered to be immaterial and is not actively managed.

5.3.2 Risk measurement

The APA has developed two primary management processes and is using two distinct models for portfolio evaluation and APS risk management: a loss forecasting process and a valuation process. Both processes work with the same source data and perform similar analysis. They are, however, designed to address different questions and employ different methodologies, which needs to be borne in mind when making any direct comparisons of the outputs of the two models.

The loss forecasting model is used for HMT fiscal budgeting and as a risk management tool within the APA. It models in detail the expected level of Losses, Recoveries and potential HMT payouts over the life of the APS under a single economic scenario. It can be used to examine the effect of alternative assumptions and economic scenarios. The forecast remains subject to uncertainty as the overall economy may be stronger or weaker than expected and individual Covered Assets may perform better or worse than expected. The loss forecasting model is also used in the process for determining Loss Credits in relation to disposals of Non-Triggered Assets.

The valuation model is primarily used for valuing the APS in accordance with IFRS for inclusion in HMT's Annual Report and Accounts. The model estimates the fair value of the APS in the way the market would be expected to price the instrument and makes use of inputs that reflect market expectations and measures of the risk-return factors inherent in the instrument. The valuation model is discussed in more detail below.

Loss and payout forecasting

The APA's loss forecasting model is fully operational, although some aspects of it were simplified to ensure that the demanding schedule for its initial development could be met. The Risk team continues to refine the model to improve on these simplified areas. Moreover, the model-based prediction of Expected Loss will, for some of the larger assets, begin to be superseded by more detailed case-by-case assessments of individual assets.

Any forecast of credit losses is affected by uncertainty. The APA's projections of Losses, Recoveries and potential HMT payout are subject to various sources of uncertainty:

- there is inherent uncertainty in the macroeconomic outlook;
- APS exposures are more risky than typical bank exposures. It is not clear to what extent historical expectations of performance are reasonable for the pool of assets in the APS;
- the Trigger definition used in the Conditions does not fully align with commonly used default definitions such as the Basel II definition of default. Consequently, empirical evidence on Trigger probabilities and Loss Given Trigger is very limited; and
- the APA has had limited time to develop the current version of the loss forecasting model, although enhancements are being worked on.

The loss forecasting model takes as its starting point asset-level data provided by RBS, including Basel II risk parameters such as Probability of Default and Loss Given Default where available. A range of assumptions are made based on the APA's view of the economic outlook in order to generate a multi-year forecast of future Losses, Recoveries and potential HMT payouts. The model is capable of running a range of stress tests and scenario analyses.

Table 8 below provides a summary of the APA's base case loss forecasts across APS asset classes, which was based on portfolio data as at 31 December 2009 as provided by RBS. It is important to emphasise that these loss forecasts are not deemed to be generally representative of the risks across these asset classes in the wider economy. This is for two reasons: first, the Covered Assets were originated by RBS at a time when the bank was aggressively seeking to increase market share, and secondly they were deliberately adversely selected as described in Section 4.

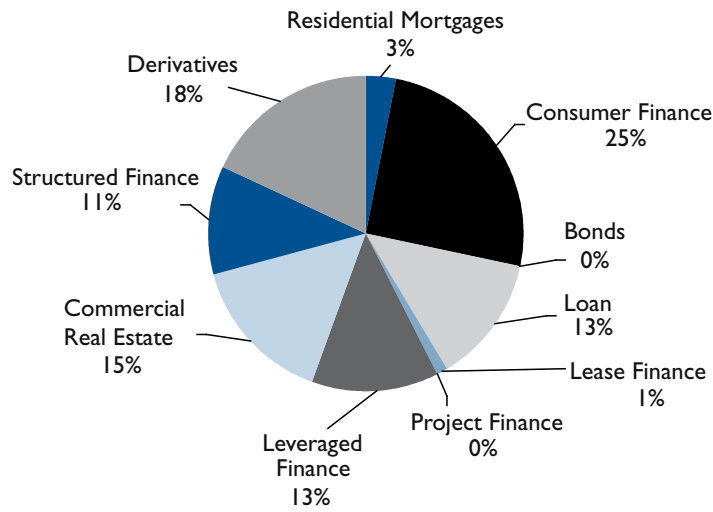
Table 8: APA estimate of life-time Expected Loss based on portfolio data as at 31 December 2009

APS Asset Classes	Initial Covered Amount as at 31 December 2008 (£bn)	Covered Amount as at 31 December 2009 (£bn)	Expected Loss (£bn)	Expected Loss as a % of Initial Covered Amount
Residential Mortgages	15	14	2	13%
Consumer Finance	55	53	15	27%
Bonds	2	1	0.1	5%
Loans	80	55	8	10%
Lease Finance	2	2	0.4	18%
Project Finance	2	2	0.2	8%
Leveraged Finance	28	23	7	26%
Commercial Real Estate	40	32	9	22%
Structured Finance	19	15	6	33%
Derivatives	39	34	10	26%
Total	282	231	57	20%

Source: APA

Figure 5 below shows the breakdown of Expected Loss by Covered Asset Class.

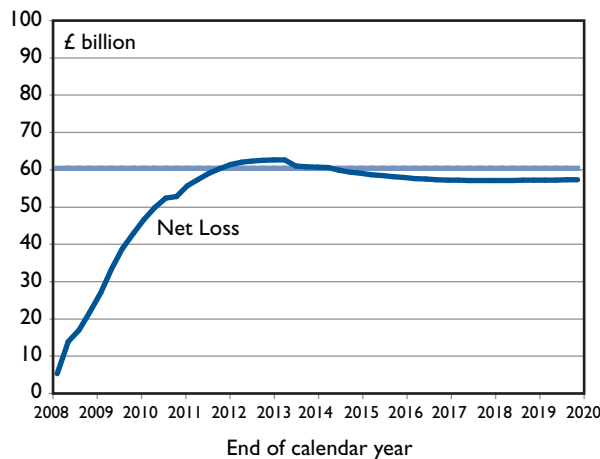
Figure 5: Expected Loss by segment as a percentage of total based on portfolio data as at 31 December 2009



Source: APA

The APA’s loss forecasting model not only estimates lifetime Expected Loss, but also predicts the timing of Triggers and Recoveries and thus potential HMT payouts. For the APA’s current base case, Figure 6 below shows Net Losses and cumulative HMT payout across time assuming that RBS does not exit the APS during the period shown. As mentioned already, it is important to recognise that these forecasts are associated with significant uncertainty, and thus the APA’s forward-looking predictions may change substantially over time.

Figure 6: APS ledger under the base case scenario based on portfolio data as at 31 December 2009



Source: APA

The APA's best estimate as at 30 June 2010 is that Net Losses will exceed the £60bn First Loss Amount temporarily between Q4 2012 and Q1 2015. From Q1 2017, Net Losses are expected to stabilise around the APA's estimate of life-time Expected Loss of £57bn as Recoveries pick up.

As noted in Section 2.3.1, a key feature of the APS is that there is a two year delay between Loss claims and any potential payout in order to allow Recoveries to be realised before any potential payout from HMT to RBS. The APA's assumptions about the actual delay between Triggers and subsequent Recoveries indicate that there is a reasonable chance that HMT will temporarily have to pay out a relatively small amount in 2015, which will subsequently be recovered in full, including accrued interest, leading to HMT experiencing zero losses. The temporary payout is deemed to be within the error bound of the predictions and may change in future forecasts.

In summary, it is the APA's current expectation that overall Net Losses on the Covered Assets will not exceed the £60bn First Loss Amount. Consequently, the central expectation remains that there will be a net benefit to the taxpayer of at least £5bn from the APS reflecting the fees already received from Lloyds Banking Group (£2.5bn) and RBS as well as future fees due from RBS. RBS is obliged to pay at least £2.5bn in total fees prior to exiting the APS and has already paid fees of £1.4bn for 2009 and 2010.

RBS will have an incentive to exit the APS and repay HMT any payouts even if Net Losses exceed £60bn. This is because even if RBS receives a payout from HMT it will have to pay an annual fee for continued protection under the Scheme of £500m until 2099 (£700m for the first three years) unless otherwise agreed with HMT. It will therefore be economically attractive for RBS to remain in the APS only if Net Losses on the Covered Assets exceed £60bn plus the present value of those future fees. Depending on the exact discount factor and the timing of exit, it can be shown that the First Loss Amount plus the present value of future fees is between £70-75bn (£74bn using a zero coupon yield curve of 1% in 2010, 2% in 2011, 3% in 2012 and 4% from 2013 to 2099). In other words, there is a significant additional buffer for HMT built into the APS in the form of future fees and the requirements to repay any future payout if exit occurs prior to 2099.

Stress testing and scenario analysis

The APA produces a range of stress testing and scenario analyses to test the impact on the APS ledger of various risks. Table 9 below summarises some of the sensitivity and scenario analyses that the APA has generated.

Table 9: Sensitivity and scenario analyses based on portfolio data as at 31 December 2009

Type	Description	Expected Loss (£bn)	
Base scenario	APA's best estimate based on current economic outlook	57	
Sensitivity	1. Occurrence of immediate Triggers of entire leveraged finance and structured credit portfolios	70	
	2. FX sensitivity	Appreciation by 25%	53
		Depreciation by 25%	65
	3. CRE price sensitivity	Increase by 25%	52
		Decrease by 25%	59
	4. Delayed Recoveries	12 months	57
		24 months	57
	5. Reduced Recoveries	Decrease by 5%	59
		Decrease by 10%	61
		Decrease by 15%	62
Decrease by 20%		64	
	Decrease by 25%	66	
Scenario analysis	6. Severe stress Moody's Cumulative Default Rates for 1920-1940 Downturn in UK CRE prices Lower than expected Recoveries	74	

Source: APA analysis

Key insights that can be drawn from the preceding table are set out below:

- The occurrence of immediate Triggers of the entire leveraged finance and structured credit portfolios increases Net Losses significantly. In other words, Net Losses could increase significantly if these portfolios perform worse than currently assumed in the APA base case. However, full triggering of these portfolios is unlikely.
- FX rates are an important risk driver – depreciation of GBP increases Expected Loss as cover is written in the currency of the Covered Asset.
- CRE prices are a key driver of Expected Loss on the CRE portfolio – and due to its relative size – a major driver of Expected Loss on the APS pool.

- Expected Loss is insensitive to the assumed delay between Trigger events and the occurrence of Recoveries as long as the levels of Losses and Recoveries are kept constant. This is because Expected Loss is not measured in terms of present value, i.e. no discounting is carried out. Having said that, it is likely that the level of Expected Loss will be linked to the actual time delay between Losses and Recoveries. On one hand, a short delay may signify that collateral is sold at “fire-sale” prices leading to a lower quantum of Recoveries. On the other, a long delay may say something about the efficiency of the work-out process, resulting in lower overall Recoveries. At this stage, the APA does not have sufficient empirical evidence to model the link between the delay in Recoveries and the quantum of Recoveries. Regardless of these observations, it is important to recognise that a long delay in Recoveries increases the likelihood that HMT will have to payout temporarily under the APS even though life-time Expected Loss does not exceed £60bn.
- The Expected Loss estimates are highly sensitive to the recovery rate assumptions that are used in the loss forecasting model. As more empirical evidence is collected, the APA will seek to corroborate these assumptions.
- Finally, fairly severe assumptions as shown in the severe stress case have to be made in order to bring Net Losses to the £74bn threshold at which RBS would benefit economically from staying in the APS until 2099, which potentially could lead to an ultimate loss to HMT. The APA estimates the likelihood of Net Losses exceeding £74bn to be in the order of 1:10 to 1:20.

APS valuation for HMT's Annual Report and Accounts

The APA is responsible for valuing the APS in accordance with IFRS for inclusion in HMT's Annual Report and Accounts.

The APS is accounted for as a derivative. The APA considered alternative options under IFRS, in particular whether the APS could be accounted for as an insurance contract or a financial guarantee. The APS is not considered an insurance contract broadly because it relates to a financial risk¹. Further, because Obligors in respect of certain “limited recourse assets” in the pool are obligated to pay only if funds are available, they cannot technically default, and so the APS is not considered a financial guarantee.

The APA assessed whether the APS meets the requirements to be defined as a derivative. The standard requires a derivative to have all three of the following characteristics:

- its value changes in response to the change in a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or

¹ Credit insurance can be accounted for under IFRS 4 only if an issuer of financial guarantee contracts has previously asserted explicitly that it regards such contracts as insurance contracts and has used accounting applicable to insurance contracts. As HMT has not previously made any such assertion, IFRS 4 cannot be applied to this transaction.

other variable, provided in the case of a non-financial variable that the variable is not specific to a party to the contract (sometimes called the 'underlying');

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

The APA is of the opinion that the APS meets all of these requirements for the following reasons:

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

As a derivative, the APS is measured at fair value, as determined using a valuation model. The APS is a unique financial instrument, but the common instrument it most closely resembles is a synthetic CDO, an instrument which transfers credit risk, in whole or in part, on a pool of assets without transferring ownership of the assets themselves. The valuation model used to determine the fair value of the APS is a Gaussian copula model with stochastic recovery, which is an industry standard model for valuing CDO instruments.

The assets covered by the APS are mapped to credit default swap curves derived from observable market information, which are used to derive default probabilities. The Gaussian copula models the joint default behaviour of the underlying assets. Stochastic recovery modelling, a relatively recent innovation developed in response to the recent market turmoil and now a broadly accepted industry standard, allows the model to be calibrated to the market prices of traded CDO tranches.

A Monte Carlo engine simulates default times for each asset and recoveries in different scenarios. Cash flows due to each party in each scenario are discounted and the results averaged to determine the net present value of the position.

The valuation model reflects the delay incorporated into the APS from the time that a loss is incurred on an asset to any protection payment by discounting protection cash flows. It also reflects the exit option, which is not a standard feature of CDOs. It assumes that RBS will not exit the APS before four years have elapsed,

which corresponds to total fee payments of £2.6bn, which is £100m higher than the minimum required payment of £2.5bn. At that point, it will remain in the APS only if the expected value of future protection is greater than the value of future payments. In effect, it is assumed that RBS will have perfect foresight at that point.

The model uses three types of inputs: portfolio data, observable market data and unobservable data. Portfolio data is obtained for each individual asset and includes Covered Amount, Triggered Amount, maturity, internal rating, and Loss Given Default. Observable market data includes credit spreads, FX rates, and interest rates. Unobservable data consists of the correlation between underlying assets and the uncertainty in recoveries. The APA determined levels for these unobservable inputs by calibrating them to the contract initial fair value of zero and found that the results were in the credible ranges of correlation values derived from observable market values of traded liquid instruments and market practice recovery uncertainties.

Valuation result, uncertainty and market risk

The fair value of the APS financial instrument as at 31 March 2010, including assessments of uncertainty and market risk as at that date, will be disclosed in HMT's Annual Report and Accounts. Once published, HMT's Annual Report and Accounts 2009/10 will be made available on www.hm-treasury.gov.uk.

5.3.3 Risk mitigation

Credit risk on individual assets is managed by RBS and overseen by the Investment Management team, Risk team and Credit Committees. However, there are a number of broad risk drivers such as FX rates and macroeconomic variables which affect the risks to HMT that arise from the Scheme. Any decision to hedge these risks would be the responsibility of HMT. The APA will continue to advise HMT in this area.

5.4 Chief Financial and Operating Officer's review

5.4.1 Financial performance and results

Information about the financial performance of the Covered Assets during the period to 31 December 2009 and the three months to 31 March 2010 is set out in Section 4.²

Section 6.2 contains the management commentary for the APA's financial results for the period from 7 December 2009 to 31 March 2010.

²This does not include the performance of the APS financial instrument itself, which is reflected in HMT's Annual Report and Accounts

5.4.2 Data management and validation

RBS and the APA have agreed a timetable for the delivery to the APA of data relating to the Covered Assets and the specific information to be included in each data submission. Following receipt of data, the APA validation team runs a series of validation tests, in line with the terms of the APS, to assess the data quality. These tests produce exception reports that are shared with RBS and form the basis of discussions where further clarification is required. Once the APA validation team are satisfied that the data meets the APA's requirements, it is made available to the Investment Management, Finance and Risk teams to allow them to complete their different models and reports.

There are bi-weekly conference calls between the APA validation team and the relevant RBS data team that provide a forum for RBS to explain the exceptions reported and also allow both parties to agree how anomalies are to be addressed. The tone of these meetings has been positive and constructive. RBS have complied with the delivery timetable and the quality of data provided to the APA continues to improve.

5.4.3 Verification

The APA has appointed an independent verification agent to develop policies and procedures and then implement such policies and procedures for the achievement of accurate, valid and appropriate loss verification over the life of the APS and to determine RBS's compliance with its non-data related obligations under the Conditions. Verification activities commenced in April 2010 and a paper setting out the approach and initial six month plan for verification was tabled at the Audit and Risk Committee on 21 May 2010.

The intention is that verification will form part of the APA's 'toolkit' to provide assurance over RBS's compliance with the terms and conditions of its participation in the Scheme. This will supplement the work of the APA validation team and the due diligence exercises carried out prior to the formation of the APA.

Verification will follow a risk-based sampling approach, driven primarily by an assessment of the APS governance structure within RBS, materiality and the work and findings of RBS Global Internal Audit. The core verification programme will focus on the verification of data contained in the Post-Accession Data and Quarterly Statement submissions, with the former seeking to provide evidence primarily to assist the APA in assessing the Expected Loss and the latter to provide evidence in relation to actual Net Losses. The core verification programme will then be supplemented through ad-hoc reviews into areas of particular concern to the APA.

5.4.4 APA environmental policies

The APA is committed to contributing to the Government's objectives on sustainable development as contained in the Sustainable Development in Government framework published in March 2010 and its predecessor, the Sustainable Operations on the Government Estate framework.

During the reporting period, representatives from the APA have attended Property Asset Management Board meetings led by HMT, where matters such as Sustainable Development in Government are discussed. APA representatives have also attended bi-monthly meetings led by the HMT Sustainability Manager and attended by representatives from HMT, the UK Debt Management Office (DMO) and the APA to explore how the APA will contribute to meeting the Government's objectives on sustainable development.

The APA's offices are sub-let from the DMO, and through this relationship the DMO have initially been including the APA within their reporting of metrics over items such as waste, recycling and energy. Now that it has appointed the necessary staff, the APA is exploring with HMT and the DMO how the APA can take on a more active role going forward.

6 Performance and Results

6.1 Performance against targets

This section of the document provides an assessment of APA performance against the targets that were included in the Agency's 2009/10 Business Plan.

- 1 To pro-actively review the largest and most complex individual Covered Assets during the next 3 months; to provide RBS with timely decisions where required minimising delays; to avoid occasions where through lack of APA response RBS is able to invoke the "snooze/lose" provision

The APA was initially constrained by a lack of expert resources and so focused on its contractual obligation to respond to Prohibited Conduct approval requests. During the period under review the APA considered requests relating to Covered Assets with an aggregate Covered Amount of £12bn representing 5% of the total Covered Amount as at 31 March 2010. The APA provided timely responses to RBS in all cases. As it has expanded, the APA has begun a broader programme of asset reviews which it expects will enable it to enhance its review coverage of the APS portfolio.

- 2 To internalise the HMT loss forecasting diligence and provide a first preliminary independent APA portfolio loss forecast by the end of March 2010.

During the period under review, the APA established its Risk team, which has responsibility for portfolio loss forecasting, APS valuation and Loss Credit calculation. The team has developed a loss forecasting model able to project future Losses, Recoveries and potential HMT payouts, which fed into the Government's calculations for the Budget in March 2010. The team has also carried out a valuation of the APS.

- 3 To appoint an independent verification agent and agree procedures to achieve accurate, valid and complete loss verification in future.

PricewaterhouseCoopers were appointed during the reporting period to act as the APA's verification agent and the development of policies and detailed plans for carrying out verification began.

- 4 To engage with RBS to determine first-cut asset management strategies for Covered Assets by Asset Class and RBS business unit.

The APA has focused on three primary asset classes: commercial real estate, corporate and leveraged finance, and structured products, which represent almost all of the larger Covered Assets. Specialist staff have been hired to monitor Covered Assets in these asset classes. Through reviews of individual assets the APA is influencing asset management strategies for these asset classes. The APA has engaged with RBS business managers responsible for all the Covered Asset Classes and has begun or plans reviews of RBS's most significant business units.

- 5 To establish a process and test initial precedents for awarding expected Loss Credits for disposal of Non-Triggered Assets to RBS.

A methodology and process for awarding Loss Credits for disposal of Non-Triggered Assets has been established and initial Loss Credits have been awarded.

- 6 To continue the good working relationship with the APS/RBS Team at HMT and provide timely reports as required.

The APA continues to enjoy constructive working relationships with the HMT team responsible for sponsoring the Agency. The team leader regularly attended the APA's Leadership Team meetings in the period, though this has been phased out in the first quarter of 2010/11 and replaced with meetings focused on HMT's requirements. All reporting and data requested by HMT from the APA in the reporting period was provided within the agreed deadlines.

- 7 To have received enough acceptances from candidates so that these, plus existing employees, would amount to at least 15 employees by 31 March 2010.

By the end of March 2010, the APA had been able to increase the number of employees to 22 (16 permanent staff and fixed term appointments of greater than one year and six fixed term appointments of less than one year).

- 8 To establish clear and open lines of communications with the APS Steering Committee at HMT and the Senior Oversight Committee at RBS.

During the reporting period, the APA instigated and maintained channels for regular and constructive formal and informal communication with relevant bodies within HMT. Through effective use of its position as observer on the Senior Oversight Committee at RBS, the APA has monitored and influenced the discussions of the Senior Oversight Committee.

- 9 To operate within budget and establish internal controls procedures for "business as usual" operations.

The APA operated within its budget for the reporting period. A control framework has been developed and embedded to govern the internal delegation of authority for spending and operational decisions.

10 To establish a process to respond to FOI and other public and parliamentary enquiries effectively.

Appropriate processes to handle Freedom of Information Act (FOI) and other requests for information have been implemented. The APA is considered as part of HMT for the purposes of FOI and all FOI requests concerning the APS are therefore handled by HMT, liaising closely with the APA to ensure clear, accurate and timely responses. Parliamentary questions are handled in a similar fashion. The APA is registered as a data controller under the Data Protection Act. All statutory and other deadlines in relation to the provision of requested information have been met.

11 To continue our journey of building a team of good people who enjoy working with each other and identify with our mission and values.

The APA has recruited a core team of high calibre staff that are committed to the APA's objectives. Senior management have instigated regular internal communication and social events to promote knowledge sharing and effective working relationships.

6.2 APA financial results

The APA's financial results for the period from 7 December 2009 to 31 March 2010 were £3.8m of revenue and £3.8m of costs, as costs incurred by the APA in managing and administering the APS are passed on to RBS under the terms of the Scheme.

The Parliamentary control totals were income of £11.7m and costs of £11.7m.

The budget that the APA originally submitted for 2009/2010 was based on estimates given the understanding of the set up of the APA at the time. The actual costs, and hence revenue, of the APA as its operations evolved were less than budget. The actual net operating costs of nil were the same as that budgeted.

In future periods, the APA will operate with nil net operating costs, unless costs are incurred as a result of a legal dispute with RBS.

At 31 March 2010, APA's statement of financial position showed a deficit. This is a product of the relationship between the APA and HMT as its parent department. The APA is an executive agency operating at arm's length from ministers, but its funding is an allocation of the total voted by Parliament to HMT. The APA has no operating capital or cash of its own; its liabilities are paid by HMT. The cash funding thus provided by HMT to the APA does not equate to the net operating cost recorded by the APA on an accrual basis. As required by the Government Financial Reporting Manual, funding is recorded in the general fund within Taxpayers' Equity, along with net operating cost.

The balance of Taxpayers' Equity can therefore be particularly affected by:

- unpaid and accrued liabilities recognised as an expense by the APA but not yet funded by HMT; and
- outstanding receivables.

The statement of financial position deficit at 31 March 2010 therefore reflects the APA's net operating funding requirement at that date rather than operating performance or solvency.

6.3 APA supplier payment policy

All the APA's supplier invoices are processed for payment by HMT, which is committed to the prompt payment of all invoices not in dispute. Following an enhancement to government policy, the prompt payment target was reduced from 30 calendar days to 10 working days with effect from 1 December 2008. As announced in the Budget in March 2010, all central government departments are also expected to aim to pay 80% of all undisputed invoices within five days. HMT achieved payment of 92% of invoices within 10 days.

The APA's trade creditor days, calculated as the proportion that is the aggregate amount owed to trade creditors at 31 March 2010 compared with the aggregate amount invoiced by suppliers during the period, expressed as a number of days when compared with the 115 day period of account, is 12.5 days.

6.4 Staff sickness absence

There were no recorded working days lost to sickness absence in the reporting period.

Stephan Wilcke

Chief Executive and Accounting Officer

14 July 2010

7 Statement of Accounting Officer's Responsibilities

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

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

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

HMT has appointed the Chief Executive as the Accounting Officer of the APA.

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 the APA's assets, are set out in Chapter 3 of Managing Public Money published by HMT.

8 Statement on Internal Control

8.1 Scope of responsibility

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

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

The Framework Document dealing with the operation of the APA, which is available at http://www.hm-treasury.gov.uk/d/apa_framework_document.pdf, sets out:

- the status and structure of the APA;
- the objectives and overall responsibilities of the APA;
- my responsibilities as Chief Executive and Accounting Officer of the APA;
- the relationship between the APA and HMT (including the Chancellor of the Exchequer, HMT Ministers and the Principal Accounting Officer) and Parliament; and
- other ancillary matters relating to the operation of the APA.

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

I report regularly to the Second Permanent Secretary of HM Treasury on compliance by RBS with its obligations under the Scheme, on HMT's exposure under the Scheme, and on the APA's performance. I am also required, when summoned, to appear before the Committee of Public Accounts or other Parliamentary Select Committees at hearings at which matters concerning the APA are discussed.

8.2 The purpose of the system of internal control

The APA system of internal control is designed to manage risk to a reasonable level rather than to eliminate all risk of failure to achieve policies, aims and objectives; it can therefore provide only reasonable and not absolute assurance of effectiveness. The system of internal control is based on the ongoing identification of risks that could affect the APA's ability to achieve its aims and objectives; evaluation of the likelihood and impact of those risks being realised; and the efficient, effective and economic management of those risks.

The system of internal control described here has been developed during the period from the date the APA was launched and I was appointed as its Accounting Officer (7 December 2009) and up to the date of approval of the Annual Report and Accounts, and accords with HMT guidance.

8.3 Capacity to handle risk

When the APA was launched on 7 December 2009, the Leadership Team consisted of the Chief Executive, interim Chief Financial and Operating Officer, Chief Investment Officer, General Counsel and Chief Risk Officer. At that time all other staff, bar one, were secondees from professional services firms or contractors. From the outset the focus of the Leadership Team was to ensure that the key objectives of the APA were met whilst also building a platform from which the APA could further develop processes and controls.

After the formation of the APA, efforts were focused on priority areas using a proportionate, risk-based approach to the setup-up of the APA's control framework. The APA's system of internal controls has evolved in stages. RBS acceded to the APS on 22 December 2009. Priority areas included the following:

- controls and safeguards were developed and implemented to ensure security and integrity of data;
- appropriate financial controls were put in place to ensure the APA operates within its organisational budget, as agreed with HM Treasury;
- the APA set up an internal framework to delegate authority for specific approval decisions and procedures for recording key decisions;
- a data reconciliation and tie back exercise was undertaken to reconcile covered asset data obtained during the due diligence exercise earlier in 2009 to the Covered Asset Initial Data provided by RBS for their accession to the APS on 22 December 2009;
- a loss forecasting model and related model build controls were developed. Further improvements to the loss forecasting model and quality assurance processes are planned over the coming months;
- processes were put in place for performing credit reviews; and

- a risk management framework to identify, mitigate and review APA's strategic, reputational and operational risks evolved over the course of the reporting period.

Subsequent to the initial focus on priority areas, further work was performed to strengthen processes and controls.

As of 31 March 2010, APA employed a total of 16 permanent and fixed term staff on contracts greater than one year, six on short term fixed contracts, and 19 secondees and contractors.

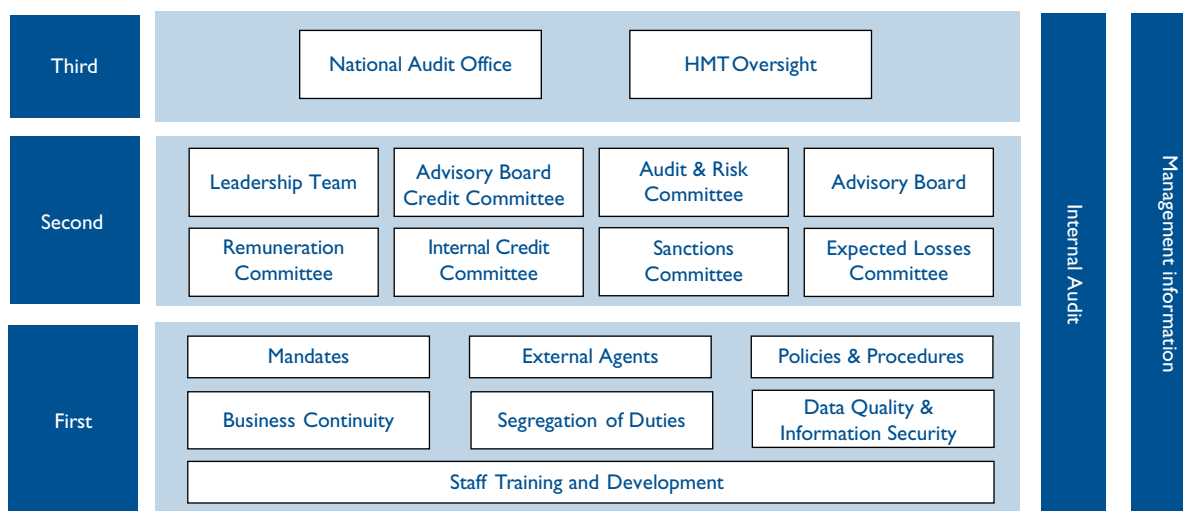
The APA's operating model is, by design, heavily reliant on external advisors and consultants, and the APA's ability to manage and control risk is partially dependant on having effective advisory relationships in place. During the period the APA made significant progress in putting advisors in place, and the process is now nearing completion at the time of writing this statement. However, the process was significantly slower than I would have ideally liked, hampered by two factors outside the APA's control. First, the unique nature of the APS within the context of the public sector combined with government procurement requirements led to very long lead times before advisors could be appointed and panels established. Secondly, we suffered significant delays addressing conflicts of interests with our advisors due to their extensive commercial relationships with RBS. In some instances advisors were reluctant to work with the APA for fear of losing business from RBS as a result.

8.4 The risk and control framework

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

Figure 7 below illustrates the three lines of defence incorporating within each line the significant control components. The second and third lines are further explained below.

Figure 7: APA lines of defence



Source: APA

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

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

- The Advisory Board advises me and other members of the executive management. The Advisory Board consists of the Leadership Team, non-executive members and representatives of HMT. It first met on 18 March 2010 and more recently on 14 and 15 June 2010 and, going forward, will meet at least on a quarterly basis to consider strategic, operational and management issues related to the achievement of the APA’s objectives and the fulfilment of its responsibilities.
- The Audit and Risk Committee’s role is to support me in my responsibilities as Accounting Officer and Chief Executive for risk control and governance by reviewing the effectiveness, reliability and integrity of the APA’s risk assurance framework. The Audit and Risk Committee first met on 25 March 2010 and subsequently on 21 May 2010, 14 June 2010, 24 June 2010 and 9 July 2010 and will continue to meet at least quarterly, reporting its findings to the Advisory Board. The Audit and Risk Committee is chaired by a member of HMT’s Group Audit and Risk Committee; other members include one of HMT’s representatives and a non-executive member of the Advisory Board. The National Audit Office, APA Internal Audit and HMT Group Internal Audit are all invited to attend Audit and Risk Committee meetings.

- The Advisory Board Credit Committee advises me on all credit related issues affecting the APA, including but not limited to, credit processes and policies, credit performance and trends within the Covered Assets and selected individual RBS approval requests. The Committee is chaired by me and other attendees include the Chief Investment Officer, Chief Risk Officer, non-executive members of the Advisory Board and the Chief Credit Officers. The Committee meets at least quarterly and ad hoc as required. Its first meeting was on 27 May 2010 and more recently it met on 15 June 2010.
- The Internal Credit Committee serves as a consultative body to enable views and knowledge to be shared on both credit decisions required to be taken by the APA and ad hoc credit reviews. The Internal Credit Committee was established on 2 February 2010 to meet three times a week. It is chaired by the relevant Chief Credit Officer for the deal being discussed and other attendees include myself, the Chief Risk Officer, the Chief Investment Officer and the other Chief Credit Officers. However, authority to approve or decline credit decisions rests with a hierarchy of authorised individuals as defined in the Procura Framework (see below).
- The Expected Loss Committee serves as a consultative body to discuss loss forecasts on large Covered Assets and Loss Credits in connection with disposals of Non-Triggered Assets. The Expected Loss Committee was established on 27 May 2010 and meets weekly and ad hoc as required. Meetings are chaired by the Chief Risk Officer or the Risk Director responsible for individual Expected Loss assessments. Other attendees include myself and relevant representatives from the Risk and Investment Management teams.
- The primary body in the APA for identifying and mitigating risk at a day-to-day level is the Leadership Team, which comprises the heads of each division of the APA, General Counsel and myself. The Leadership Team meets twice weekly and each division is regularly required to report on any new risks identified in the areas for which they have responsibility and on any changes in the status of existing risks. Each head meets with his or her own team on a weekly basis.
- The Sanctions Committee comprises the Leadership Team, the Chief Credit Officers and General Counsel and exists to support me in decision-making relating to any use of APS sanctions against RBS. The Sanctions Committee first met on 28 April 2010 and has met a number of times since.

To advise me in respect of my responsibility for the APA's risk and control framework, the APA appointed Ernst & Young on 23 March 2010 to act as internal auditors. The role of the internal auditors is to offer guidance on effective risk management and control and to provide systematic, objective and disciplined approaches for evaluating the effectiveness of internal control, risk management and governance processes. The internal auditors regularly report on their work to the Audit and Risk Committee.

Risk registers are the principal management tools used for identifying and tracking risks. A central Strategic Risk Register, which is maintained by the Chief Financial and Operating Officer, seeks to identify the strategic risks faced by the APA as a whole. Each team head is responsible for risks assigned to their team and for instilling a culture and process within their team to allow for identification and escalation of risks.

The register is available to all staff working at the APA. The Leadership Team review this Strategic Risk Register on a regular basis with a focus on new risks, the completeness and accuracy of the register, and those risks which require action. Existing policies and procedures are revisited to ensure that the identified risks are mitigated appropriately and that residual risk is of an acceptable level. The Leadership Team reassesses their risk appetite upon each review of the risk register.

Consideration of the Strategic Risk Register is a regular item on the Advisory Board's agenda. The Chairman of the Audit and Risk Committee is invited to attend Advisory Board meetings at which the Risk Register is discussed.

Underpinning the risk and control framework the APA has focused its efforts to identify and mitigate risks on priority areas and has taken a proportionate, risk-based approach to the set-up of its evolving control framework. In particular the APA has developed and implemented the following key control components:

1. Controls and safeguards in response to data risks were put in place to ensure security and integrity of data is maintained at all times. In May 2010 the APA completed and submitted Annex A of the Security Policy Framework and Information Assurance Maturity Model to HMT. This exercise highlighted further improvements to be made to the policies over data security. Existing policies are set out in Knowledge Management guidance documents available and distributed to all staff. Mandatory compliance training and a related compliance assessment has been introduced for all APA staff to address Government Data Handling Review and information assurance requirements. The APA complies with Cabinet Office and HMT reporting requirements in relation to security and information assurance. The APA had no personal data related incidents over the financial reporting period which were required to be reported to the Information Commissioner's Office.
2. Policies on anti-fraud measures and whistle-blowing have been implemented. The APA has its own Conflicts of Interest Policy which covers standards of propriety and conduct, dealing in securities and other assets, confidentiality and official information, gifts and hospitality and the Business Appointment Rules.
3. Segregation of duties controls are in place to promote independent checking and reconciliation, and to avoid concentration of key activities or related controls in the hands of individuals or small groups of staff. The APA has entered into a Service Level Agreement (SLA) with the DMO and HMT which provides various levels of segregations of duties. In particular segregation of duties takes place between front and back office activities, though it is recognised that, in a relatively small organisation such as the APA, segregation of duties can be a challenge.
4. Policies and procedures have been applied to mitigate risks in business critical areas including financial control, personnel management, and data assurance. The policies and procedures have been documented, or are in the process of being documented, for all main activities. For remaining activities, teams have identified timeframes and dependencies to enable timely documentation.

- 5 A framework (Procura Framework) is in place which controls the internal delegation of authority and specifies approval levels in such areas as credit decisions, operational decision-making, spending, contracts, stakeholder communication, and internal policy-making. With regard to credit decisions, the framework sets out the hierarchy of individuals who are authorised to approve transactions, for example Prohibited Conduct requests from RBS, depending on the size of the relevant transaction.
- 6 Following agreement between the APA and RBS of a timetable for the delivery of data and the specific information to be included in each data submission, arrangements have been put in place to validate data delivered by RBS before it is distributed for use by the Investment Management, Finance and Risk teams. Key elements of these arrangements include: a series of data validation tests to assess the data quality; discussion with RBS of exceptions identified during validation testing; and bi-weekly conference calls between the APA validation team and the relevant RBS data team.
- 7 The APA has appointed an independent verification agent to develop and carry out policy and procedures for the achievement of accurate, valid and appropriate loss verification over the life of the APS. Verification activities commenced after the end of the reporting period.
- 8 The APA set up a Business Continuity Plan (BCP) which leverages the SLA with HMT and the DMO, whereby the DMO provide IT related recovery services. The APA completed the HMT Annual Business Continuity Assurance Certification for the period to 31 December 2009, setting out key elements of the BCP and actions for improvement. Further work is required to bring the BCP up to a robust level to improve, for example, the scope and level of service provided by the DMO.
- 9 Staff undertake training in areas which pose particular risks. All new staff receive compliance training and receive copies of the APA's Conflicts of Interest Policy and the APA Compliance Commandments as part of their induction packs. Subsequent to this, they undertake a compliance assessment. Where required to enable them to fulfil their role, staff also undertake training on the terms and conditions of RBS's participation in the APS.

During the initial set up phase, the monitoring of performance of the APA was more informal in nature and the targets more qualitative. In May 2010 APA management submitted to HMT proposed APA 2010/11 objectives and targets which included more quantitative measures.

8.5 Review of effectiveness

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

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

- the proceedings of the Leadership Team, which has met regularly, usually twice a week, since the launch of the APA. I have used this forum to discuss risk and internal control systems;
- the proceedings of the Advisory Board, which receives reports from the Audit and Risk Committee and reviews the system of internal control;
- the proceedings of the Audit and Risk Committee, which reviews the effectiveness of the risk management and internal control framework. The APA's internal and external auditors and HMT Group Internal Auditors are invited to all meetings; and
- the output of the APA's internal audit function, which is performed by Ernst & Young. Internal Audit work is carried out in accordance with the internal audit plan, a draft of which was presented and discussed by the Audit and Risk Committee on 25 March 2010.

Internal Audit performed a review of APA's key processes in April – May 2010. The findings and related management action points were agreed with management and subsequently reported to the Audit and Risk Committee on 21 May 2010 and 14 June 2010.

The review by the internal auditors largely focused on the latter part of the reporting period. Certain key payment authorisation controls were tested throughout the period. As the control and risk environment has evolved, management have used assurances from the second line of defence to make the assertion to the internal auditors that there have been no significant shortcomings in the control environment other than those described in this document. Accordingly, Internal Audit has reported to the Audit and Risk Committee that this document in their opinion is a true and fair reflection of the material aspects of the control environment of the APA.

External audit is performed by the National Audit Office. So far as I am aware, there is no relevant audit information of which the APA's external auditors are unaware, and I have taken all the steps that ought to have been taken to make myself aware of any relevant audit information and to establish that the APA's external auditors are aware of that information. 'Relevant audit information' means information needed by the external auditors in connection with preparing the audit report.

Whilst both the internal and external audit reports give assurance that the majority of controls the APA has developed (or is continuing to develop) are well designed and will give good assurance in the future, the APA is working to embed further these systems and procedures and to ensure that the framework for risk and financial management continues to evolve.

8.6 Significant internal control issues 2009-2010

No significant internal control issues in the APA were identified for the period from 7 December 2009 to 31 March 2010.

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

Stephan Wilcke

Chief Executive and Accounting Officer

14 July 2010

9 Remuneration Report

9.1 Remuneration policy

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

9.2 Remuneration Committee

The APA Remuneration Committee exists to advise the Chief Executive and Advisory Board on remuneration for APA staff and to give HMT such advice as they may seek on pay and bonus recommendations in respect of the Chief Executive. The members of the Remuneration Committee are John B. Caouette and Hamish Buckland. The Chief Executive also attends meetings of the Remuneration Committee except where his own performance is being discussed. The Remuneration Committee held its first meeting on 15 June 2010.

9.3 Service contracts

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

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

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

9.4 Remuneration received

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

Table 10 below sets out the salary paid by the APA to senior APA staff and fees paid to members of the Advisory Board for their services to the APA. Salary includes gross salary or fees, performance pay or bonuses, overtime and any other allowance to the extent that it is subject to UK taxation for the period from 7 December 2009 to 31 March 2010. No bonuses were paid in the period.

Table 10: APA senior staff salaries and Advisory Board fees

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

Notes:

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

(2) Bill Dickinson was employed on a permanent contract from 22 February 2010, taking up his office as Chief Financial and Operating Officer from 1 March 2010. Bill was previously working with the DWP where he joined the Novos scheme; the APA continues to make employer contributions to this scheme. As at 31 March 2010, the accrued pension and related lump sum (as at the age of 65) was within the banding £0-£2,500. The CETV of his pensions as at 31 March 2010 was £3,000.

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

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

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

(6) Hamish Buckland was employed from 1 February 2010 as a Chief Credit Officer on a six month fixed term contract on a 2 day week basis for which his salary on a 2 day week pro rated basis is within the banding £65,000 - £70,000 per annum. With effect from 18 March 2010 he was additionally appointed as a member of the Advisory Board on the basis of a one year fixed term contract with an option for the APA to extend the contract. He receives a fee within the banding £10,000 - £15,000 per annum for his services as a member of the Advisory Board.

Performance bonuses

At the end of the 2009/10 reporting period performance appraisals were undertaken in line with Civil Service appraisal and performance award policies. Stephan Wilcke waived any bonus for the period. Individual performance bonus awards were approved by the Remuneration Committee on 15 June 2010 and payments made to the following members of the Leadership Team:

Jens Bech, Chief Risk Officer	£11,000
Ion Dagtolou, Chief Investment Officer	£11,000
Bill Dickinson	£4,000 ³

A very few other APA staff were eligible, due to the period of service, for performance bonuses for the period to 31 March 2010. Bonus payments of £4,535 were approved in respect of the period to 31 March 2010.

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

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

James Hewer acted as Interim Chief Financial & Operating Officer from launch of the APA on 7 December 2009 until 1 March 2010 whilst on secondment from PricewaterhouseCoopers. His secondment ended on 12 March 2010. PricewaterhouseCoopers were paid a fee of £55,200 (excluding VAT) for James' services during the reporting period as part of their support of the APS project.

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

9.5 Notice periods

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

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

³ This bonus payment will be recharged to the Department for Work and Pensions (DWP) as Bill Dickinson was an employee of this department for the majority of the period to which the bonus relates.

Stephan Wilcke for whom the notice period is 12 months if notice is given before 28 March 2011 and six months if it is given on or after 28 March 2011.

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

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

9.6 Civil Service pensions

Pension benefits are provided through the Civil Service pension arrangements. Further details about the Civil Service pension arrangements can be found at the website www.civilservice-pensions.gov.uk.

9.6.1 Cash Equivalent Transfer Value

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

9.6.2 Real increase in CETV

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

Stephan Wilcke

Chief Executive

14 July 2010

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

I certify that I have audited the financial statements of the Asset Protection Agency for the period ended 31 March 2010 under the Government Resources and Accounts Act 2000. These comprise the Operating Cost Statement, the Statement of Changes in Taxpayers' Equity, the Statement of Financial Position, the Statement of Cash Flows and the related notes. These financial statements have been prepared under the accounting policies set out within them. I have also audited the information in the Remuneration Report that is described in that report as having been audited.

10.1 Respective responsibilities of the Accounting Officer and auditor

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

10.2 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 Agency's circumstances and have been consistently applied and adequately disclosed; the reasonableness of significant accounting estimates made by the Agency; and the overall presentation of the financial statements.

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

10.3 Opinion on regularity

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

10.4 Opinion on the financial statements

In my opinion:

- the financial statements give a true and fair view of the state of the Agency's affairs as at 31 March 2010 and of the net operating cost, changes in taxpayers' equity and cash flows for the period then ended; and
- the financial statements have been properly prepared in accordance with the Government Resources and Accounts Act 2000 and HM Treasury directions issued thereunder.

10.5 Opinion on other matters

In my opinion:

- the part of the Remuneration Report to be audited has been properly prepared in accordance with HM Treasury directions made under the Government Resources and Accounts Act 2000; and
- the information given in sections 3, 5.1, 5.4 and 6 of the Annual Report for the financial period for which the financial statements are prepared is consistent with the financial statements.

10.6 Matters on which I report by exception

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

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

10.7 Report

I have no observations to make on these financial statements.

Amyas C E Morse

Comptroller and Auditor General

National Audit Office
157-197 Buckingham Palace Road
Victoria
London
SW1W 9SP

16 July 2010

11 Accounts of the APA

Primary Financial Statements

Operating Cost Statement

for the period⁴ ended 31 March 2010

	Note	2009-10 £000 Income
Administration costs		
Staff costs	3	1,425
Other administration costs	4	2,391
Gross administration costs		3,816
Operating income	5	(3,816)
Net administration costs		0
Total net operating costs		0

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

The notes on pages 67 - 89 form part of these accounts.

⁴The accounting period commenced on launch of the APA on 7 December 2009. The accounting period end is 31 March 2010. Reference to the 'period' refers to the 3 month and 25 day accounting period for 2009/2010.

Statement of Financial Position

as at 31 March 2010

	Note	31 Mar 2010 £000
Non current assets		
Property, plant and equipment	7	309
Intangible assets	8	2,540
Total non-current assets		2,849
Current assets		
Trade and other receivables due within one year	9	320
Cash and cash equivalents		0
Total current assets		320
Total assets		3,169
Current liabilities		
Trade and other payables falling due within one year	10	(5,061)
Total current liabilities		(5,061)
Non-current assets plus/less net current assets/(liabilities)		(1,892)
Non current liabilities		
Other payables: amounts falling due after more than one year	10	(3,159)
Total non-current liabilities		(3,159)
Assets less liabilities		(5,051)
Taxpayers' equity		
General fund		(5,051)
Total taxpayers' equity		(5,051)

Stephan Wilcke

Chief Executive and Accounting Officer

14 July 2010

The notes on pages 67 - 89 form part of these accounts.

Statement of Changes in Taxpayers' Equity

for the period ended 31 March 2010

	Notes	General Fund £000	Total Reserves £000
Balance at 7 December 2009			
Changes in taxpayers' equity for 2009-10			
Non-cash charges – cost of capital	4	(27)	(27)
Non-cash charges – auditor's remuneration	4	15	15
Net operating cost for the period		0	0
Total recognised income and expense for 2009-10		(12)	(12)
Net parliamentary funding drawn down		(5,039)	(5,039)
Balance at 31 March 2010		(5,051)	(5,051)

The notes on pages 67 - 89 form part of these accounts.

Statement of Cash Flows

for the period ended 31 March 2010

	Notes	2009 - 10 £000
Cash flows from operating activities		
Net operating cost		0
Adjustments for non-cash transactions	4	91
Changes in working capital other than cash	14	7,065
Net cash inflow/(outflow) from operating activities		7,156
Cash flows from investing activities		
Purchase of property, plant and equipment	7	(339)
Purchase of intangible assets	8	(1,778)
Net cash (outflow)/inflow from investing		(2,117)
Cash flow from financing activities		
Net parliamentary funding drawn down		(5,039)
Net cash (outflow) from financing activities		(5,039)
Net increase/(decrease) in cash and cash equivalents in the period before adjusting for receipts and payments to the Consolidated Fund		0
Receipts due to the Consolidated Fund		0
Payments of amounts due to the Consolidated Fund		0
Net increase/(decrease) in cash and cash equivalents in the period after adjustment for receipts and payments to the Consolidated Fund		0

The notes on pages 67 - 89 form part of these accounts.

Notes to the APA Accounts

1. Statement of accounting policies

These financial statements have been prepared in accordance with the 2009-10 Government Financial Reporting Manual (FReM) issued by HMT. The accounting policies contained in the FReM follow International Financial Reporting Standards (IFRS) to the extent that it is meaningful and appropriate to the public sector. Where the FReM permits a choice of accounting policy, the accounting policy which has been judged to be most appropriate to the particular circumstances of the APA for the purpose of giving a true and fair view has been selected. The Agency's accounting policies have been applied consistently in dealing with items considered material in relation to the accounts.

The accounting period commenced on launch of the APA on 7 December 2009. The accounting period end is 31 March 2010. Reference to the 'period' refers to the 3 month and 25 day accounting period for 2009-2010.

1.1 Changes in accounting policy and disclosures

1.1.1 New and amended standards adopted by the Agency

The Agency adopted all existing standards and amendments applicable to the activities of the Agency in accordance with the FReM at the start of its first accounting period dated 7 December 2009.

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

The following standards and amendments to existing standards have been published and are mandatory for the Agency's accounting period beginning 1 April 2010 and later periods, but the Agency has not early adopted them:

IFRS 3 (revised), 'Business combinations' (effective from 1 July 2009). The revised standard continues to apply the acquisition method to business combinations, with some significant changes. For example, all payments to purchase a business are to be recorded at fair value at the acquisition date, with contingent payments classified as debt subsequently re-measured through the income statement. There is a choice on an acquisition-by-acquisition basis to measure the non-controlling interest in the acquiree either at fair value or at the non-controlling interest's proportionate share of the acquiree's net assets. All acquisition-related costs should be expensed. The Agency will apply IFRS 3 (revised) prospectively to all business combinations from 1 January 2010. The amendment will not result in a material impact on the Agency's resource accounts.

IAS 38 (amendment), 'Intangible Assets'. The amendment is part of the IASB's annual improvements project published in April 2009 and the Agency will apply IAS 38 (amendment) from the date IFRS 3 (revised) is adopted. The amendment clarifies guidance in measuring the fair value of an intangible asset acquired in a

business combination and it permits the grouping of intangible assets as a single asset if each asset has a similar useful economic life. The amendment will not result in a material impact on the Agency's resource accounts.

IAS 17 (amendment), 'Leases'. The amendment deletes specific guidance regarding classification of leases of land, so as to eliminate inconsistency with the general guidance on lease classification. As a result, leases of land should be classified as either finance or operating, using the general principles of IAS 17. The amendment is to be applied retrospectively to existing leases if the necessary information is available at the inception of the lease. Otherwise, land leases should be reassessed on the date of adoption of the amendment. The Agency will apply the amendment to all land leases from 1 January 2010. The amendment will not result in a material impact on the Agency's resource accounts.

IAS 7 (amendment), 'Cash Flow Statements'. The amendment requires that only expenditures that result in a recognised asset in the statement of financial position can be classified as investing activities. The amendment is to be applied retrospectively for accounting periods beginning after 1 January 2010. The Agency will apply the amendment for the accounting period ending 31 March 2011 and later periods. The amendment will not result in a material impact on the Agency's resource accounts.

The following sections of the FReM have been amended and are mandatory for the Agency's accounting period beginning 1 April 2010 and later periods, but the Agency has not early adopted them:

Chapter 8, 'Impairment of Assets'. IAS 36 required impairments of revalued assets to be taken to the revaluation reserve in line with the IAS that required the revaluation. FReM requires such impairment losses to be taken to the Operating Cost Statement (OCS), where the impairment is caused by a clear consumption of economic benefit. The amendment will not result in a material impact on the Agency's resource accounts.

Chapter 11, Income and Expenditure. The FReM has removed the requirement to record a notional cost of capital for accounting periods beginning 1 April 2010. Actual costs may be charged by HMT as they determine to be appropriate. The amendment will not result in a material impact on the Agency's resource accounts.

1.2 Accounting convention

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

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

1.3.1 Measurement

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

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

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

1.3.2 Recognition

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

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

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

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

1.4 Depreciation

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

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

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

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

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

1.5 Cash and cash equivalents

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

1.6 Trade receivables and other current assets

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

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

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

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

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

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

The Agency first assess whether objective evidence of impairment exists.

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

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

If, in a subsequent period, the amount of the impairment loss decreases and the decrease can be related objectively to an event occurring after the impairment was recognised (such as an improvement in the counterparty's credit rating), the previously recognised impairment loss is reversed by adjusting the allowance account in the statement of financial position and the amount of the reversal is recognised in the OCS.

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

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

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

1.7 Trade payables and other current liabilities

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

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

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

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

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

1.8 Financial instruments

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

1.8.1 *Definition of financial instruments*

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

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

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

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

1.8.2 *Categories of financial instruments*

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

- derivatives at fair value through OCS;
- loans and receivables; and
- available-for-sale financial assets.

Derivatives at fair value through OCS

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

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

The Agency does not hold any derivatives.

Loans and receivables

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

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

Available-for-sale financial assets

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

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

1.9 Provisions, contingent liabilities and contingent assets

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

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

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

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

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

Generally, contingent liabilities and contingent assets are not recognised as liabilities or assets in the statement of financial position, but are shown as a separate note. A contingent liability is disclosed in the notes to the accounts when the possibility of an outflow of economic benefit to settle the obligation is more than remote. A contingent asset is disclosed in the notes to the accounts when an inflow of economic benefit is probable.

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

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

1.10 Revenue recognition and operating income

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

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

1.11 Deferred income

Income is recognised by reference to the stage of completion of a transaction or asset at the end of the reporting period in line with IAS 18. Where payment has been received which is greater than the income to be recognised by reference to the stage of completion of the transaction or asset, this is deferred within the Statement of Financial Position. The deferred income is released to the OCS as income to match the expense of the transaction or asset. Note 2.1 refers to the application of this accounting policy.

1.12 Administration and programme expenditure

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

1.13 Capital charge

A non-cash charge, reflecting the cost of capital utilised by the Agency, is included in operating costs. The charge is calculated at the real rate set by HMT, currently 3.5 per cent on the average carrying amount of all assets less liabilities except for:

- property, plant and equipment where the cost of capital charge is based on opening values, adjusted pro rata for in-year:
 - additions at cost;
 - disposals as valued in the opening statement of financial position (plus any subsequent capital expenditure prior to disposal);
 - impairments at the amount of the reduction of the opening statement of financial position value (plus any subsequent capital expenditure); and
 - depreciation of property, plant and equipment and amortisation of intangible assets;
- donated assets, and cash balances with the Office of the Paymaster General, where the charge is nil; and
- assets and liabilities in respect of amounts due from, or due to be surrendered to, the Consolidated Fund and liabilities in respect of advances outstanding from the Contingencies Fund, where the charge is nil.

1.14 Pensions

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

1.15 Early departure costs

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

1.16 Employee benefits

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

1.17 Leases

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

1.18 VAT

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

2. Critical accounting estimates and judgements

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

2.1 Critical accounting estimates and assumptions

The Agency makes estimates and assumptions concerning the future. The resulting accounting estimates will, by definition, seldom equal the related actual results. The estimates and assumptions that have a significant risk of causing a material adjustment to the carrying amounts of assets and liabilities within the next financial year are addressed below.

Deferred income is recognised by reference to the stage of completion of the software asset. RBS and LBG paid for the set-up costs of the APS and the APA in 2009. A portion of these set-up costs related to the software build costs. The software build is spread over 2009 and 2010, and hence a portion of the fee paid by RBS and LBG relates to expenses yet to be incurred at year end. That portion of the fee is deferred as deferred income. The deferred income is released to the OCS to match the expense to which it relates. The software asset is capitalised, and hence the deferred income is released to the OCS to match depreciation of the software asset. However, there is an element of estimation in calculation of the expected costs to complete the software asset which may have a material impact on the carrying amount of the deferred income asset within the next financial year.

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

2.2 Critical judgements in applying the Agency's accounting policies

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

3. Staff numbers and costs

3.1 Analysis of total costs over categories

			2009-10
	Permanent staff	Others	Total
	£000	£000	£000
Wages and salaries	66	1,272	1,338
Social security costs	8	45	53
Accrued employee benefits	3	12	15
Other pension costs	9	10	19
Total costs	86	1,339	1,425
Less recoveries (income) in respect of outward secondments	0	0	0
Total net costs	86	1,339	1,425

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

3.2 Pension schemes

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

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

Employees can opt to open a partnership pension account, which is a stakeholder pension with an employer contribution. No employer's contributions were paid to one or more of a panel of three appointed stakeholder pension providers for the period. Employer contributions are age-related and range from 3.0

to 12.5 per cent of pensionable pay. Employers also match employee contributions up to 3 per cent of pensionable pay.

In addition, employer contributions of £2,587, being 0.8 per cent of pensionable pay, were payable to the partnership pension providers to cover the cost of the future provision of lump sum benefits on death in service and ill health retirement of all employees.

Contributions due to the partnership pension providers at the balance sheet date were £2,085. Contributions prepaid at that date were nil.

3.3 Average number of persons employed

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

	Number 2009-10
Permanent staff	1.25
Others	36.5
Total	37.75

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

4. Other administration costs

	2009-10
	£000
Consultancy costs	1,856
Accommodation costs	80
Office services	206
Staff-related costs, including training and travel	66
Rentals under operating leases	92
Other	0
Total	2,300
Non cash items	
Depreciation and similar charges:	
Auditor's remuneration and expenses	15
Cost of capital charges	(27)
Depreciation	103
Total non cash items	91
Total	2,391

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

Within consulting costs above £317,765 has been expensed as research and development costs of APA software which did not meet the criteria for capitalisation under IAS 38.

5. Income

Operating income analysed by activities:

	Appropriated in Aid	2009-10 Payable to Consolidated Fund	Income included in OCS
	£000	£000	£000
Fee Income	(3,816)	0	(3,816)

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

6. Analysis of operating segments and fees and charges for the period to 31 March 2010

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

The following analysis of the services for which a fee is charged is provided for fees and charges purposes, and not to meet the disclosure requirements of IFRS 8.

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

7. Property, plant and equipment

	Leasehold Improvement £000	Furniture & Equipment £000	IT Equipment £000	Total £000
Cost/valuation				
At 7 December 2009	0	0	0	0
Transfers	0	0	0	0
Additions	28	100	211	339
Impairments	0	0	0	0
Disposals	0	0	0	0
At 31 March 2010	28	100	211	339
Accumulated depreciation				
At 7 December 2009	0	0	0	0
Transfers	0	0	0	0
Charge in period	(3)	(16)	(11)	(30)
Impairments	0	0	0	0
Released on disposal	0	0	0	0
At 31 March 2010	(3)	(16)	(11)	(30)
Net book value 7 December 2009	0	0	0	0
Net book value 31 March 2010	25	84	200	309

All assets above are owned by the Agency.

8. Intangible assets

	Asset Under Construction	Software	2009-10 Total
	£000	£000	£000
Cost/valuation			
As at 7 December 2009	0	0	0
Transfers	0	0	0
Additions	1,055	1,558	2,613
Disposals	0	0	0
As at 31 March 2010	1,055	1,558	2,613
Accumulated depreciation			
At 7 December 2009	0	0	0
Charge in period	0	(73)	(73)
Disposals	0	0	0
As at 31 March 2010	0	(73)	(73)
Net book value as at 7 December 2009	0	0	0
Net book value as at 31 March 2010	1,055	1,485	2,540

Of the Asset Under Construction Additions above £835,486 is accrued as at period end; see Note 10.1. All assets above are owned by the Agency.

9. Trade receivables and other current assets

9.1 Analysis by type

	2010 £000
Amounts falling due within one year	
Deposits and advances	22
Prepayments and accrued income	298
	320
Amounts falling due after more than one year	
Other receivables	0
	0
Total	320

9.2 Intra government balances

	Amounts falling due within one year 2010 £000	Amounts falling due after more than one year 2010 £000
Balances with other central government bodies	0	0
Balances with public corporations and trading funds	0	0
Sub total: intra government balances	0	0
Balances with bodies external to government	320	0
Total receivables as at 31 March	320	0

10. Trade payables and other current liabilities

10.1 Analysis by type

Amounts falling due within one year	
	2010
	£000
Trade payables	(246)
Other payables	0
Other taxation and social security	(70)
Accruals	(3,429)
Deferred income	(1,301)
Accrued annual leave	(15)
Total	(5,061)

Within Accruals above, £835,486 relates to accruals for software to be capitalised as Asset Under Construction; see Note 8.

Amounts falling due after more than one year	
	2010
	£000
Deferred income	(3,159)
Total	(3,159)

Deferred income:

RBS and LBG paid for the set-up costs of the APS and the APA in 2009. A portion of these set-up costs related to the software build costs. The software build is spread over 2009 and 2010, and hence a portion of the fee paid by RBS and LBG relates to expenses yet to be incurred at period end. That portion of the fee is deferred as deferred income. The deferred income is released to the OCS to match the expense to which it relates. The deferred income relating to capitalised assets is released to the OCS to match depreciation of the software asset.

10.2 Intra-government balances

	Amounts falling due within one year 2010 £000	Amounts falling due after more than one year 2010 £000
Balances with other central government bodies	(111)	0
Balances with public corporations and trading funds	0	0
Sub total: intra government balances	(111)	0
Balances with bodies external to government	(4,950)	(3,159)
Total payables as at 31 March	(5,061)	(3,159)

11. Provisions for liabilities and charges

The Agency meets the additional costs of benefits beyond the normal benefits in respect of employees who retire early by paying the required amounts annually to the relevant scheme over the period between early departure and normal retirement date. The Agency provides for this in full when the early retirement programme becomes binding by establishing a provision for the estimated payments discounted by the HMT discount rate. As at 31 March 2010 there were no early retirements and hence no provision recognised.

There were no other provisions for liabilities and charges as at 31 March 2010.

12. Capital commitments

The APA entered into a contract with a third party to extend the functionality of software used by the Agency to meet its obligations under the APS on 25 March 2010. The total expected costs are £1,309,080, which are invoiced monthly in arrear on a time and materials basis. Delivery of the final phase of the software is expected in August 2010.

13. Commitments under operating leases

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

	2010 £000
Buildings:	
2010/11	331
2011/12 to 2014/15	1,103
Due April 2015 onwards	0
	<u>1,434</u>
Other:	
2010/11	71
2011/12 to 2014/15	75
Due April 2015 onwards	0
	<u>146</u>

The building lease has a six month break clause, where the Agency is only liable to pay for the six month notice period at a cost of £165k.

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

	2010 £000
Movements in working capital other than cash:	
(Increase) in current trade receivables	(320)
Increase in current trade payables	4,226
Increase in non-current trade payables	3,159
Increase in working capital other than cash	<u>7,065</u>

15. Financial instruments

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

16. Contingent assets and liabilities

The Agency had no contingent assets or liabilities as at 31 March 2010.

17. Related party transactions

The Asset Protection Agency is an executive agency of HMT. HMT is regarded as a related party. During the period, the Agency has had a number of material transactions with HMT and with other entities for which HMT is regarded as the parent Department. The principal such transaction was a SLA that was entered into between HMT, the DMO and the Agency. The DMO is an executive agency of HMT and is a related party of the Agency. Under this SLA the DMO provides information technology support and facilities services to the APA. All costs are recharged to the Agency on a commercial basis.

Royal Bank of Scotland (RBS)

HMT, through its ownership of UK Financial Investments Limited, has a 70% stake in the voting share capital of RBS, and as such RBS is a related party of the Agency. During the year RBS made payments to the Agency in respect of the recharge of the Agency's costs. Before commencement of the Agency, RBS also made payments to HMT in respect of the recharge of HMT's costs in setting up the Agency.

Lloyds Banking Group (LBG)

HMT, through its ownership of UK Financial Investments Limited, has a 43% stake in the voting share capital of LBG, and as such LBG is a related party of the Agency. Before commencement of the Agency, LBG made payments to HMT in respect of the recharge of HMT's costs in setting up the Agency.

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

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

CEO has also confirmed that he has not entered into any transaction with related parties which were not in the ordinary course of business or which are at preferential rates.

18. Post balance sheet events

The APA instructed the DMO under the SLA between the DMO, HMT and APA to build and maintain a secure dataline between the APA and RBS for an estimated cost of £28,000 with running costs of £1,000 per month. The build phase of the system was completed in June 2010, with rollout to APA and RBS following shortly thereafter.

19. Date authorised for issue

The financial statements were authorised for issue on 16 July 2010.

Annex 1 – Senior management team and non-executives

Stephan Wilcke, Chief Executive

Member of:

- Advisory Board
- Advisory Board Credit Committee
- Leadership Team
- Internal Credit Committee
- Expected Loss Committee
- Sanctions Committee

Stephan was appointed as Chief Executive Officer of the APA in September 2009. Most recently he held Senior Adviser positions with Cairn Capital and AgFe Limited focusing on special situations created by the credit crunch, most notably advising a range of central banks on the credit work-outs of their exposures to Lehman, Landsbanki and Glitnir, where he led negotiations with the Resolution Committees of the Icelandic banks and the Administrators of the various Lehman Estates.

He joined Apax Partners in 2000 as the first financial services specialist and went on to become a partner and Head of European Financial Services. He started his career at management consultancy Oliver Wyman in London where he focused on banking strategy and credit risk management, and was elected a partner in 1998.

Stephan has been a non-executive director of many regulated financial institutions in the UK and Europe, including membership of audit, risk and remuneration committees. He played a pivotal role in many innovative financial transactions including the introduction of Actuarial Credit Risk Accounting at SBC, Europe's first CLO, Europe's first private equity backed asset management buy-out and subsequent IPO, and the largest private equity deal in 2005 in the financial sector (Travelex). He has worked across all the asset classes included in the APS in various previous roles.

Jens Bech, Chief Risk Officer

Member of:

- Advisory Board
- Advisory Board Credit Committee
- Leadership Team
- Internal Credit Committee
- Expected Loss Committee
- Sanctions Committee

Jens has ten years of experience at leading management consulting firms where he focused on financial services. He has extensive technical expertise in financial and risk management.

Jens joined the APA from Oliver Wyman's Finance & Risk practice. He has originated and led a wide range of high-profile projects covering finance, risk management, restructuring and strategic planning for clients located throughout Europe, North America, Asia and Australia.

Jens led Oliver Wyman's support of Iceland during the financial crisis, undertaking a valuation of the assets and liabilities of the failed banks that served as an input into the settlement negotiations with creditors, including the UK and Dutch governments. Jens also advised the Financial Supervisory Authority – Iceland (FME) on restructuring the failed Icelandic banks. Jens' educational background is in economics, with master's degrees from the University of California at Santa Barbara and the University of Copenhagen.

Ion Dagtoglou, Chief Investment Officer

Member of:

- Advisory Board
- Advisory Board Credit Committee
- Leadership Team
- Internal Credit Committee
- Sanctions Committee

During his 17 year investment banking career, begun in the last UK recession, Ion became a distressed debt expert across global economic cycles with a focus on corporate debt restructuring and acquiring and managing large portfolios of non-performing loans.

For six years at Goldman Sachs and two years previously at Citigroup Ion co-led acquisitions of large portfolios of non-performing loans across Europe.

Ion joined Schroders, the merchant bank, in 1992 and was immediately involved in restructuring UK corporate debts. After the Asian financial crisis Ion led a team in Singapore to restructure and realise a portfolio of debts across South East Asia leading many multi-creditor restructuring negotiations both as principal and agent. During his career Ion has also been involved in bilateral and syndicated lending, leasing and mid-market private equity.

James Hewer, interim Chief Financial and Operating Officer (until 1 March 2010)

Member of Leadership Team

James is a structuring and financial services expert with over 13 years of experience and with a wide range of experience across both assurance and advisory services to a variety of financial services institutions. He is a leading expert in accounting and financial instruments.

James has been involved with the APS, and subsequently the APA, since January 2009 on secondment from PriceWaterhouseCoopers LLP until 12 March 2010. He was a key member of the Scheme design team, leading on accounting, regulation and tax analysis. He has a deep understanding of the APS, its design and the unique challenges it presents from an operations and control perspective.

Bill Dickinson, Chief Financial and Operating Officer (from 1 March 2010)

Member of:

- **Advisory Board**
- **Leadership Team**
- **Sanctions Committee**

Bill joined the APA in March 2010. Bill had over 20 years' auditing, financial and regulatory reporting and advisory experience at KPMG. As a partner in KPMG's Financial Services practice he led engagements across a wide range of financial services sectors, working with FTSE 100 and major US listed retail, commercial and investment banks, insurance companies and their private banking, asset management and treasury operations and securitisation special purpose vehicles.

More recently Bill was Director General of Finance and Corporate Services at the UK Government's Department for Innovation, Universities and Skills and Financial Risk Director at the Department for Work and Pensions.

Lucy Wylde, General Counsel

Member of:

- [Advisory Board](#)
- [Leadership Team](#)
- [Sanctions Committee](#)

Lucy acts as General Counsel to the APA on secondment from Slaughter and May, which she joined in 1984 and where she became a partner in 1993. She has experience of a wide range of corporate and finance transactions. She has acted in particular for asset management groups, investment funds, banks, building societies, insurance companies and other financial institutions. She has regularly advised on the structuring and reconstruction of funds and investment vehicles in varying forms and on an ongoing basis for a number of listed investment companies and their advisers.

She has acted for long-term insurance company and fund management clients on M&A transactions, outsourcing and other projects. Her practice also includes advising on developments affecting the asset management sector generally, most recently in relation to the impact of the collapse of Lehmans and liquidity issues.

Cynthia Parker, Chief Credit Officer (structured finance)

Member of:

- [Sanctions Committee](#)
- [Internal Credit Committee](#)

Cynthia joined the APA on 1 April 2010 and has over 25 years' experience in a wide array of financial services. She began her career at Chase Manhattan in corporate credit and moved into syndicated loans and interest rate swap trading. She traded interest rate swaps for eight years at Chase, Barclays and Svenska Handelsbanken.

She moved into credit derivatives in 1998 at Nationsbank and then set up Ambac's credit platform in 1999. At Ambac, she ran European CDOs and credit derivatives globally in a diverse range of asset classes. She has also been an active participant in ISDA working committees. Her last position at Ambac was working out ABS CDOs.

Brian Scammell, Chief Credit Officer (commercial real estate)

Member of:

- Sanctions Committee
- Internal Credit Committee

Before joining the APA, Brian was a Managing Director and Credit Executive for J.P. Morgan's EMEA real estate structured finance and real estate investment banking businesses. His role included the risk assessment and approval of complex secured loans for syndication and securitisation, derivatives transactions, investment and management decisions relating to acquired distressed debt portfolios and the oversight of retained credit exposures.

Brian had previously built and led the J.P. Morgan team which negotiated with major financial sponsor firms to structure and execute large syndicated leveraged loan transactions.

Hamish Buckland, interim Chief Credit Officer (corporate and leveraged finance)

Member of:

- Advisory Board
- Audit and Risk Committee
- Advisory Board Credit Committee
- Remuneration Committee
- Internal Credit Committee
- Sanctions Committee

Hamish is a highly experienced investment banker, with particular expertise in the debt markets and M&A financing. After five years at Williams & Glyn International, he spent the majority of his career at J.P. Morgan, including as Co-Head of European Leveraged Finance and finally as Vice Chairman of Investment Banking until he left in December 2009.

John B. Caouette

Member of:

- [Advisory Board \(non-executive Chairman\)](#)
- [Advisory Board Credit Committee \(non-executive\)](#)
- [Remuneration Committee \(non-executive\)](#)

John was Founder, Chairman, President and CEO of CapMAC, a triple-A rated financial guarantor that focused on the global market for structured finance. He subsequently led the MBO of the business from Citigroup, followed by an IPO and sale to MBIA. In 2004 he retired as Vice Chairman of MBIA Insurance Corporation, where he oversaw the company's international financial guarantee business and new business development. He was senior independent director of LCH Clearent and is currently Chairman of Channel Capital. He is an advisory board member to the Haas School of Business, University of California at Berkeley and a published author on risk management.

Michael Ashley

Member of the Audit and Risk Committee (non-executive Chairman)

Michael is a non-executive member of Treasury Audit Committee. He is a senior bank audit partner with over 30 years' experience at KPMG and Head of Quality and Risk Management and a member of the Board of KPMG Europe LLP. He is also vice chair of the Technical Expert Group of the European Financial Reporting Advisory Group which has responsibility for advising the European Commission on adoption of IFRS in Europe.

Elizabeth Dymond

Member of:

- [Advisory Board \(non-executive\)](#)
- [Audit and Risk Committee \(non-executive\)](#)

Elizabeth is the APS / RBS Team Leader at HMT and has led the work to set up the APA for HMT. She joined the Financial Stability part of the International and Finance directorate of the Treasury to work on the Asset Protection Scheme in 2009, having been on secondment to the Bank of England in 2008. She had previously been Chief Financial and Accounting Adviser at the Competition Commission, which she joined in 2001 from the Office of Fair Trading, where she had worked as a financial analyst since 1999. She is a chartered accountant who qualified with Coopers & Lybrand. She subsequently worked at Mercury Asset Management and at 3i plc where she was group management accountant.

Lowri Khan CBE

Member of Advisory Board (non-executive)

Lowri is Director of Financial Stability at HMT, and is responsible for financial stability policy and oversight of the government's financial sector interventions. She is a career civil servant, with considerable experience of financial sector policy, including most recently as head of the Treasury's Debt and Reserves Management Team, and then the Intervention Strategy and Markets Team.

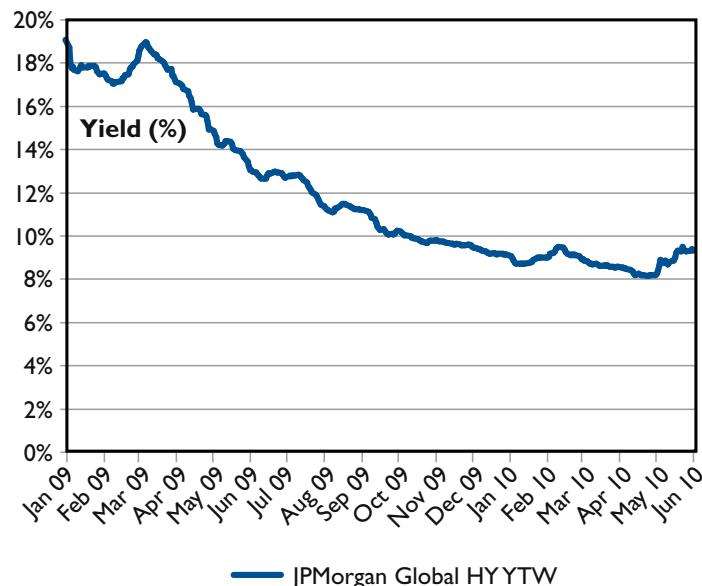
Annex 2 – Market overview of asset classes monitored by APA

Corporate and leveraged finance

In early 2009 the outlook for the global corporate credit markets was pessimistic. The financial crisis was at a critical stage, spreads were at historic highs, defaults were accelerating and availability of capital was limited to all but the strongest borrowers. Many corporates faced an environment of rapidly deteriorating business conditions and operating performance, coupled with tightening covenants, excessive debt loads and declining business valuations. It was clear that many faced major balance sheet restructurings or bankruptcy over the short to medium term.

The nadir was reached during the first quarter of 2009. Key market indicators such as the JPMorgan Global High Yield Index started the year at a yield of 18.94% and the leveraged loan index, iTraxx Europe LevX, slumped to a low of 69.05 on 10 March 2009 (see Figures 8 and 9 below). Rating Agencies were predicting default rates reaching over 10% through the rest of the year and well into 2010/11. Liquidity was dire as the structured credit markets remained firmly closed and lending banks focused on their own issues and capital adequacy.

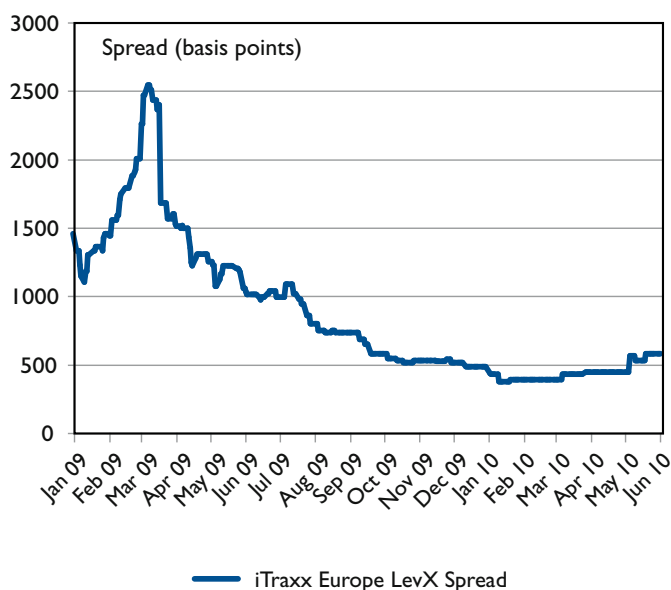
Figure 8: JPMorgan Global High Yield Index



Source: J.P. Morgan

The JPMorgan Global High Yield Index (yield to worst –YTW) is a tradeable index referencing a global portfolio of high yield corporate bonds.

Figure 9: iTraxx Europe LevX Spread



Source: J.P. Morgan

The iTraxx Europe LevX is a tradeable index consisting of credit default swaps (CDS) on 40 European senior debt issuances. The spread represents an underlying risk premium on the referenced portfolio.

Many predictions did turn out to be correct. A significant number of borrowers found themselves in acute distress and 2009 proved to be a year of widespread restructurings and bankruptcy filings which inevitably led to many losses for credit providers. Default rates rose from 5.15% to 10.27%⁵ during the year. Pain was particularly felt by subordinated debt lenders, but also spread to providers of senior loans as the excesses of lending in the 2006-7 period produced predictable results. Many of these restructurings are ongoing with outcomes uncertain.

The unprecedented level of government intervention in the global economy and financial system in the first half of 2009 did, however, start to have a beneficial impact. The business environment seemed to bottom out and gradually start to improve. The financial markets rallied as liquidity flowed from low-earning cash holdings into higher risk and heavily sold asset classes. In the credit markets, the rebound started in the high-grade markets, but spread into non-investment grade and continued throughout the year as optimism returned. By the end of 2009, the JPMorgan Global High Yield index had rallied to yield 9.01% and LEVX had similarly improved to 91.34.

⁵ US LTM Default rates: US High Yield Bond. Source J.P. Morgan

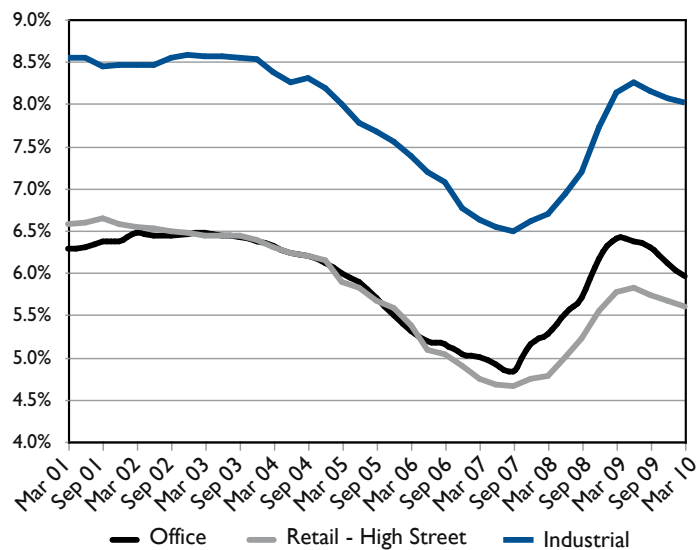
This rally in the credit markets continued with strong momentum well into 2010, with the markets reaching their recent high points at the end of April. Crucially, improved investor optimism and liquidity allowed the new issue market to re-open, particularly for high yield bonds in the US and Europe. Access to capital predictably started for the stronger BB rated credits, but spread to include weaker single B and even CCC borrowers. This access to long-term capital enabled corporate borrowers to start terming out debt and to mitigate the refinancing issues posed by debt maturities over the next few years.

The combination of improved capital market conditions and gradual economic recovery led to revised expectations that default rates will decline significantly by the end of 2010. The APA is seeing this in relation to the Covered Assets in this asset class, with a reduction in the rate of new problem loans emerging from the corporate and leveraged portfolios and increased opportunities to reduce exposures through refinancings and secondary market sales.

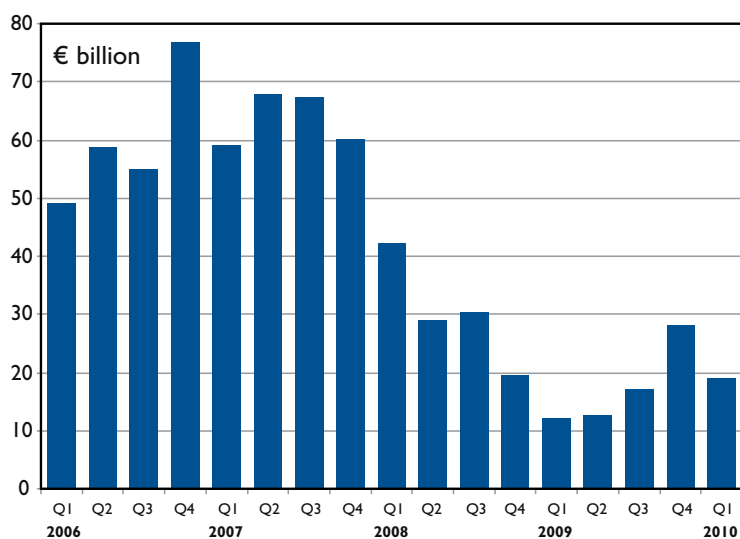
Commercial real estate

Commercial real estate (CRE) investment markets strengthened across most of the EU last year, with yields tightening and transaction volumes rising. The CB Richard Ellis All Property Average Prime Yield in Q1 2010 was 6.03%, 33 bps lower than its peak in Q2 2009, with the steepest yield decline being in offices (see Figure 10 below). Transaction volumes rose significantly during 2009, although they remained well below the levels of 2007 and 2008 (see Figure 11 below). Occupier markets lagged during the early stages of economic recovery with rents continuing to fall. Modest yield compression looks set to continue during 2010 although rental levels seem likely to decline further.

Figure 10: CB Richard Ellis EU-27 Weighted Average Yield Index



Source: CB Richard Ellis

Figure 11: Aggregate European commercial real estate investment activity

Source: CB Richard Ellis

In the UK, which contains the largest concentration of APS-covered real estate assets, capital value improvements during 2009 were largely driven by prime real estate. A large part of secondary and tertiary real estate did not benefit from the upturn. Although yield declines may come to an end, and perhaps temporarily reverse, the impact on real estate capital values should be mitigated by a return to rental growth over 2010-2011. Within the hotel sector, London performed more strongly in 2009 but many regional hotel markets did not. In residential real estate, published price forecasts during the first half of 2010 ranged from moderate growth to significant falls despite the recovery over the year to May 2010 noted by Nationwide Building Society and Halifax.

Against this background, maximising value from the real estate portfolio in the APS in line with the AMO will often require exposure to be retained for the medium term. Large value declines in real estate values since origination may also mean that, in some cases, restructurings will need to compensate RBS for its increased risk position with instruments giving equity-like returns.

Structured finance

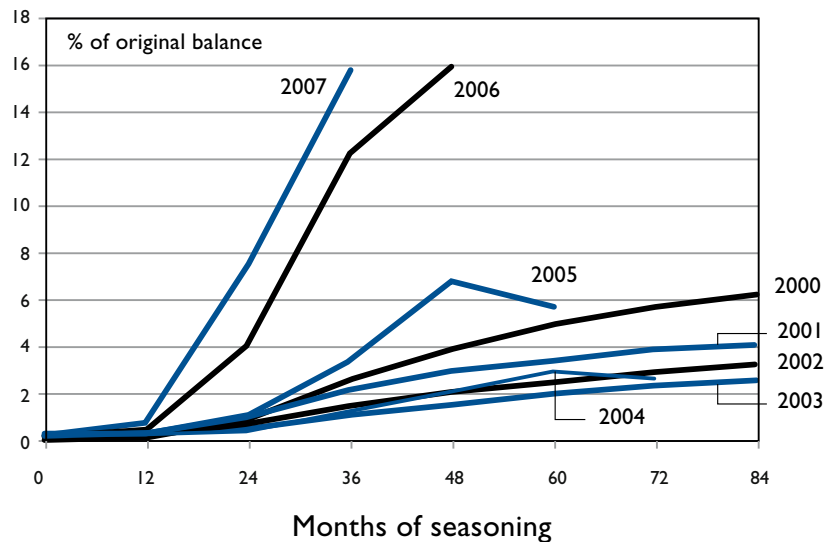
All sectors showed impressive spread tightening with the exception of US vintage residential mortgage-backed securities (RMBS) and European commercial mortgage-backed securities (CMBS). The underperformance of European CMBS is due to smaller pools / larger obligor concentrations, poor rental conditions in many markets and the lack of available refinancing.

Performance of 2005, 2006 and 2007 US RMBS vintages (the majority of the RMBS collateral in the asset-backed security (ABS) collateralised debt obligations (CDOs) in the Scheme) was negatively impacted by the drop in US house prices which began in 2007 and has still not stabilised. In February 2010 Moody's

estimated that over 56% of US subprime loans (rated by Moody's) exceeded the value of the underlying mortgaged property. This is translating into large losses upon foreclosure.

A graph of cumulative losses by subprime vintages is shown in Figure 12 below.

Figure 12: Subprime - cumulative loss comparison by RMBS vintages



Source: Standard & Poor's Financial Services LLC – "U.S. Subprime RMBS Performance" (24 June 2010, Cesar Romero)

The 2006-I and 2007-I US ABS Indices (see Table 11 below) can be used as a proxy for US sub-prime RMBS performance. Each index comprises 20 US subprime bonds. At inception, the pools were tranching into equity up through AAA tranches and all tranches were launched at a price of 100%. It is clear from the prices listed as of 10 June 2010 that the 2006-I Index has performed better than the 2007-I Index; however, losses are expected in the AA tranches downward in both the 2006-I and 2007-I Indices and perhaps in the AAA tranche of the 2007-I Index. The prices of the 2007-I tranches barely moved from 1 January 2009 as compared to 10 June 2010 indicating that the 2007 collateral impairment was already anticipated in 2009.

Table 11: US ABX prices

US ABX Prices (US RMBS Indices)	1 January 2009	10 June 2010
2006-1 AAA	80	86
2007-1 AAA	39	41
2006-1 AA	33	42
2007-1 AA	6	5
2006-1 A	12	16
2007-1 A	4	4
2006-1 BBB	6	6
2007-1 BBB	3	4

Source: J.P.Morgan

Over the same period, all other ABS sectors have shown dramatic spread compression based on falling corporate default rates, better macroeconomic conditions in Europe through this period and structurally sound securitisations (see Table 12 below).

Table 12: Spread compression in other ABS sectors

Europe	1 January 2009	10 June 2010
UK Non Conforming RMBS 3Y AAA	900	370
UK Buy to Let RMBS 3Y AAA	950	250
UK Credit Cards 5Y AAA	625	175
Europe CMBS 5Y AAA EUR	775	700

Corporate Loans CDS Levels	1 January 2009	10 June 2010
DJ CDX: IG	195	126
DJ CDX: BB	616	429
DJ CDX: B	1064	666
JPM USD HY Index/ Swap	1677	713

US ABS (All Floating)	1 January 2009	10 June 2010
Credit Card AAA	500	25
Prime Auto AAA	500	15
Private Student Loans AAA	900	300
CMBS /Swaps AAA	1375	280

US HY CLOs	1 January 2009	10 June 2010
AAA spreads	500	220
AA prices	40	77
A prices	20	62
BBB prices	15	52

AUS RMBS	500	175
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Source: J.P. Morgan. Figures are quoted as spreads unless noted otherwise.

Annex 3 – Market overview of asset classes monitored by APA

Abbreviations

ABS	Asset-Backed Security
AMO	Asset Management Objective
APA	Asset Protection Agency
APS	Asset Protection Scheme
AUD	Australian Dollars
BCP	Business Continuity Plan
bps	Basis Points
CCO	Chief Credit Officer
CDO	Collateralised Debt Obligation
CDS	Credit Default Swap
CETV	Cash Equivalent Transfer Value
CLO	Collateralised Loan Obligation
CMBS	Commercial Mortgage-Backed Security
CRE	Commercial Real Estate
DMO	UK Debt Management Office
EPA	Extended Protection Asset
FOI	Freedom of Information Act (2000)
FReM	Financial Reporting Manual
FSA	Financial Services Authority
FX	Foreign Exchange
GBM	Global Banking Markets (a division of RBS)
GBP	Pounds Sterling
GDP	Gross Domestic Product
HMT	Her Majesty's Treasury
IAS	International Accounting Standards
IFRS	International Financial Reporting Standards
JPY	Japanese Yen
LBG	Lloyds Banking Group
LTV	Loan-to-Value
NPV	Net Present Value

OCS	Operating Cost Statement
RBS	The Royal Bank of Scotland plc
RBSG	The Royal Bank of Scotland Group plc
RMBS	Residential Mortgage-Backed Security
SOC	Senior Oversight Committee
SLA	Service Level Agreement
SME	Small or Medium-sized Enterprise
TMT	Technology, Media and Telecommunications
USD	United States' Dollars
VAT	Value Added Tax

Definitions

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

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

Expected Loss	means the estimated life-time Net Losses of the Covered Assets.
Expected Net Payout	means the expected life-time cumulative cash payout to be made, if any, by HMT to RBS over the lifetime of the Scheme.
Loss Credit	means the benefit, if any, which the APA agrees to make available to RBS as a result of a disposal of a Non-Triggered Asset.
Loss Given Trigger	means the expected Loss less Recoveries on a Triggered Asset.
Net Losses	means, at any date, Losses less Recoveries at that date.
Net Triggered Amount	has the same meaning as Net Losses
Triggered Amount	has the same meaning as Losses.



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