NATIONAL AUDIT OFFICE

REPORT BY THE
COMPTROLLER AND
AUDITOR GENERAL

The Sale of Girobank plc

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John Bourn
Comptroller and Auditor General

National Audit Office
29 January 1993

The Comptroller and Auditor General is the head of the National Audit Office employing some 900 staff. He, and the NAO, are totally independent of Government. He certifies the accounts of all Government departments and a wide range of other public sector bodies; and he has statutory authority to report to Parliament on the economy, efficiency and effectiveness with which departments and other bodies have used their resources.

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Introduction

1 Girobank opened for business in 1968 and was incorporated as a wholly owned subsidiary of the Post Office in 1985. In 1987-88 Girobank's operating profit was £23.5 million on net income of £361 million; it had gross assets of £1,865 million and liabilities of £1,773 million. In June 1988 the Government and the Post Office announced their agreement that the Post Office should offer Girobank for sale to a financial institution or other suitable company in the private sector. They believed it could then best achieve the vigorous expansion it needed, freed from public sector constraints, and provide increased competition in the banking sector. After fifteen months of exclusive negotiations, Girobank was sold to the Alliance & Leicester Building Society on 2 July 1990 for £111.8 million; this included £39 million for repayment of subordinated debt. The Secretary of State for Trade and Industry consented to the sale.

2 For legal reasons Girobank could not be sold in its entirety to a building society. Secondary legislation was passed to allow a building society to acquire Girobank as a deposit-taking subsidiary. However, a society would still not, under the legislative framework governing building societies, be permitted to carry out all the activities in which Girobank was engaged. Therefore, to allow the sale to the Alliance & Leicester to go ahead, the Post Office, with the consent of the Secretary of State, transferred out of Girobank those activities which the Alliance & Leicester could not undertake, to dispose of them at their own risk. The transfers to the Post Office were at their net book value of £428 million, in return for cash of the same amount thereby avoiding any overall effect on Girobank's published net worth. Some of these assets remain with the Post Office. The most significant asset, the leasing business, was sold to The Norwich Union Life Insurance Society in March 1990 for net proceeds of £339 million.

3 This sale was of a subsidiary of a nationalised industry. This had two main consequences. Firstly, the proceeds of the sale did not accrue directly to the Exchequer, but instead offset the Post Office's borrowing requirement for the financial year. Secondly, the sale was conducted by the Post Office, not the Department of Trade and Industry (the Department). The Department's function was to advise Ministers on the exercise of the powers under Section 61(3) of the British Telecommunications Act 1981, whereby their consent is a pre-condition to the Post Office's transfer of any of its interests in a wholly owned subsidiary. To enable the Department to carry out this duty and to satisfy the Accounting Officer and Secretary of State that the sale had been properly conducted and that the terms were defensible, officials kept closely in touch with the Post Office on developments in the sale, and advised Ministers of the key decisions which the Post Office were proposing to take. The Department were independently advised throughout by a merchant bank (Hambros).

4 Guidance issued by the Treasury requires departments to secure the best possible price in disposing of assets. Sales should be on the open market, by public auction or tender where appropriate. In July 1990, shortly after the Girobank sale, the Treasury advised departments contemplating trade sales to obtain sealed bids; thereafter any period of exclusive negotiation was to be as short as possible.

5 Against this background the National Audit Office examined the performance of the Department in the sale. This Report sets out the Department's monitoring and other roles in relation to events in the main sale to the Alliance & Leicester; the steps taken to dispose of the other activities; and assesses the outcome against the criteria for the sale agreed between the Department and the Post Office.

6 The National Audit Office were assisted in this work by consultants from Price Waterhouse. In addition to examining the Department's papers, the National Audit Office interviewed and received information from representatives of the Post Office and their merchant bank advisers (Schroders), the Department's merchant bank advisers (Hambros), the Alliance & Leicester, the Co-operative Wholesale Society and The Norwich Union. The National Audit Office appreciate the co-operation and assistance received.

Background and preparations for the sale

7 Before 1988 the Department and the Post Office had been considering the future of Girobank. Both the Department and the Post Office sought the views of their merchant bank advisers as to the method by which a sale could be achieved. In recommending a trade sale (in March 1988), Hambros advised the Department that in their view there were sufficient potential purchasers to make for a genuine auction. Hambros considered that for prudential reasons, to protect Girobank's depositors, a management buyout was untenable because it would need to borrow extensively and was likely to be restricted in its role as a lender. Ministers also considered that a share flotation would have made Girobank vulnerable to an early takeover, and they concluded that a trade sale to a strong financial institution would present fewer difficulties and would give Girobank greater strength.

8 Hambros also advised the Department that the sale proceeds might be doubled by deferring the sale until 1990, by which time Girobank would have benefited from the implementation of a new computerised account ledgering system and its new business plan. However, they identified some risks attached to the delay, in particular the possible over-optimism of the business plan, the potential for delays to the new accounting system, the effect on management of a continuation under the constraints imposed in public sector ownership, and the possibility of a deterioration in the overall market. Ministers concluded that, as Girobank was both successful and profitable, there was no reason in principle why it should remain in the public sector.

9 In evidence to the Select Committee on Trade and Industry in January 1988 (HC 273) the Post Office said that their preference up to then had been for their four separate businesses — counters, letters, parcels, as well as Girobank — to be kept together because of their close interdependence. However, the Post Office also said they always recognised that decisions as

to privatisation were for the Government. In June 1988 the Post Office Board agreed with the Government that taking Girobank out of the public sector was the best way to give it the freedom to trade on equal terms in a highly competitive market.

10 The Department and the Post Office agreed the criteria against which bids would be assessed. The price offered would be a major determinant, but in addition the following considerations would be taken into account:

(i) the prospective purchaser's plans for the future development of Girobank and in particular their likely impact on the Post Office's continuing operations, especially those of Post Office Counters Limited;

(ii) the arrangements proposed by any prospective purchaser to enable management and staff to share directly in the success of the business;

(iii) the promise any purchaser brought of widening customer choice in the market place in which Girobank operates; and

(iv) the need for any prospective purchaser to be approved in due course by the Bank of England.

Proper regard would also be paid to the interests of employees.

11 Clearing banks and foreign businesses were not ruled out as potential purchasers, but the Minister told the House of Commons in June 1988 that a major clearing bank would have considerable difficulty in meeting the sale objective of widening consumer choice in banking services in this country.

12 At the time the sale was announced Girobank provided a range of cash transmission and other banking services to over two million personal and business customers, and was the country's sixth largest bank in terms of personal current accounts. As a bank it is unusual because it depends upon Post Office Counters Ltd for its retail outlets and, unlike other banks, most of its earnings comes from fees for cash transmission services rather than from interest on loans. Between 1983 and 1989 Girobank developed a leasing business which became the eighth largest in the United Kingdom, with more than 500 corporate and public sector customers.

13 The Post Office had been taking steps to improve Girobank's overall performance, irrespective of any ownership considerations, and these contributed to improving the attractiveness of Girobank as a whole. These measures included Girobank's incorporation separately from the Post Office, the appointment of new and more commercially minded senior management from the private sector, and the introduction of more sophisticated management systems.

14 Once the decision had been taken to sell Girobank, the Department and the Post Office took no specific steps to prepare it for sale. They told the National Audit Office that they considered Girobank to be an integrated business which was being offered for sale as an entity. They did not therefore consider whether some of its businesses should be sold separately; nor, as the aim was to attract as wide a field of potential purchasers as possible, did they consider taking steps to make it more attractive to specific bodies.

The Sale

The first bidding exercise

15 In July 1988 Schroders produced an information memorandum for those who had registered an interest. As part of this process independent accountants (Arthur Andersen) produced for the Post Office the required confidential long form report on Girobank for issue to short-listed potential purchasers. This indicated, amongst other problems, that the existing computer systems would be inadequate to manage the business in the future and that forecast delays in implementing the new system would cost Girobank £1.5 million each month in lost profit opportunity after September 1988. The Post Office told the National Audit Office that everything possible was done to bring the system live as fast as possible commensurate with the safety and security required of a critical banking system. The Department were aware of the problems identified in the long form report, and that remedial action was being taken as a matter of urgency. However, they judged that the advantages of early privatisation outweighed any benefit to proceeds which might have flowed from delay until the problems had been fully resolved.

16 The marketing strategy implemented by Schroders on behalf of the Post Office was designed to elicit interest from as broad a range of potential purchasers as possible. Building societies were not excluded but, because of legal restrictions at that time on societies' powers to acquire Girobank as a subsidiary, Schroders did not specifically target them in the initial sale process. The sale was advertised widely, in the press and elsewhere, at home and overseas.

17 Over 90 organisations, including banks, financial services organisations, retailers, local authorities and six building societies, expressed interest in the sale of Girobank and were sent information by Schroders. Seven indicative bids were subsequently received. The Department asked the Post Office to reject the highest indicative bid, in the range £170 million to £200 million, because it was submitted by a body (a foreign bank) which was in the public sector. Ministers considered that the sale of Girobank to a company in the public sector would not be compatible with the objective of privatising Girobank. The Post Office rejected some of the other indicative bids because they did not represent fair value. The Post Office shortlisted three bidders, and invited them to submit final bids.

18 By October 1988 all potential bidders had withdrawn. The Post Office Chairman advised the Department that the reasons might include the circumstances within the bidders' own organisations, the continued delay in implementing Girobank's new computer system, the industrial relations situation in Post Office Counters, Girobank's dependence for profits upon a few corporate customers, and the investment needed to improve the bank's technology. The Post Office did not believe there was any evidence that potential buyers had been deterred by shortage of information or the timescale.

19 On 10 November 1988 the Minister told the House of Commons that the original timescale may not have allowed prospective purchasers adequate time for assessing and understanding Girobank's special features, their potential and how it might fit their future strategy. The Government and the Post Office had therefore decided to allow more time for bids to be submitted. No new deadline was set. Proposals from clearing banks,

consortia or a management buy-out were not ruled out if they satisfied the criteria set out in paragraph 10. The long form report was updated and showed that work was being done on the problems identified in the original report but that more remained to be done.

20 In their Sixth Report of Session 1988–89 (HC 559) the Trade and Industry Select Committee noted their belief that the Post Office and the Government had not given enough consideration to the unusual nature of Girobank's activities. The Committee pointed out that the subsequent failure to achieve a quick sale had resulted in a period of uncertainty for Girobank's business and employees which might have been avoided had a more realistic timescale been set. The Government's response to the report did not comment on this point.

The second bidding exercise

21 The Department asked their merchant bank advisers (Hambros) to work alongside the Post Office's advisers (Schroders) in identifying potential purchasers. Several organisations expressed an interest in Girobank and detailed confidential discussions, starting in January 1989, were subsequently held with four of these — none of whom had submitted indicative bids after the first exercise. Schroders advised all four bidders at the end of February that the Post Office's intention, assuming a suitable offer was received, was to conclude a sale as soon as practicable after the middle of March.

22 On 5 April 1989 the Alliance & Leicester submitted a bid which had a face value of £120 million. The Post Office then allowed a further nine days for the receipt of other bids. Although they said they were surprised at the sudden introduction of this deadline, the Co-operative Wholesale Society submitted a bid with a face value of £124 million on 14 April 1989. Both bids needed to be adjusted to take account of the detailed conditions attached to them (see paragraph 28 and Table 1); both bids allowed for £39 million to repay Girobank's debt capital to the Post Office.

23 Schroders told the National Office that they spoke to both the bidders and to their intermediaries to clarify certain aspects of each bid. Because the two bids were so close they also spoke to the intermediaries acting for the bidders telling them that a competitive situation had arisen. They did not explicitly invite revised bids but they sought to establish whether the bids represented their final offers. No additional information or assurances were provided to either party. J P Morgan, the Alliance & Leicester's advisers, said that their client's offer might be capable of improvement and were told by Schroders that this should be done if at all possible. The Alliance & Leicester increased their offer to £130 million in the light of their own expectation that certain issues, about which they had some concerns, would be resolved satisfactorily.

24 Chase Investment Bank, who were acting on behalf of the Co-operative Wholesale Society, told the National Audit Office that they were aware that the Co-operative Wholesale Society were prepared to increase their bid in certain circumstances and that they had expected further negotiations with the Post Office and Schroders, to include price, before the Post Office decided on a preferred purchaser. They did not believe they were asked by Schroders whether their bid was final, and they did not at any time tell

Schroders that their bid of £124 million was final. The Co-operative Bank, on behalf of the Co-operative Wholesale Society, clarified certain aspects of their bid. Given that these clarifications did not alter the relative position of the two bidders, Schroders considered them to be minor, and to put both bids on a more comparable basis. They also said they were of the view, as a result of their telephone consultations with both the Chase Investment Bank and the Co-operative Bank, that the Co-operative Wholesale Society's bid, amended as above, represented the final negotiating position. Schroders considered that it ws now right to bring the matter to a conclusion. They advised the Post Office accordingly.

25 In their assessment of the bids (Table 1), on the basis of advice from the Post Office, the Department had raised the effective value of the Alliance & Leicester's offer price by £9.5 million on the grounds that the Post Office would retain this increase arising from unquoted securities. One of the clarifications made by the Co-operative Bank on behalf of the Co-operative Wholesale Society in a letter of 18 April was that they would likewise allow the Post Office to retain such an increase. This letter was therefore not available to the Post Office Board when they met to consider the bids on 17 April, nor was it available to the Department when they submitted the analysis of the bids to Ministers on 18 April. On 19 April Post Office Board members met and concluded that the Alliance & Leicester bid remained preferable to the bid from the Co-operative Wholesale Society. The National Audit Office note that adding this £9.5 million to the Co-operative Wholesale Society's bid would have raised it effectively to £106 million. The Alliance & Leicester's bid, on this basis, would have been worth £3.9 million more than the bid from the Co-operative Wholesale Society.

Table 1: Department of Trade and Industry's financial evaluation of bids received for Girobank plc

	Alliance & Leicester Building Society's revised bid £ million	Cooperative Wholesale Society's bid £ million
1. Offer prices		
share capital	91.0	85.0
debt capital	39.0	39.0
	130.0	124.0
2. Price adjustments contained in these bids:		
dividends proposed by Girobank since March 1988	(2.1)	not applicable*
difference between book and "market" values:		
(a) quoted securities	(2.5)	(2.5)
(b) unquoted securities	9.5	not applicable*
(c) leasing book	(16.0)	(16.0)
other quantified adjustments	(9.0)	(9.0)
3. Effective offer prices at 17 April 1989	109.9	96.5

Source: Department of Trade and Industry

Note: The purpose of this evaluation prepared on 18 April 1989 was to compare the two bids on as equal a basis as possible and on standard assumptions about the values of certain aspects of each bid at the time of the evaluation.

This table shows that in terms of adjusted prices the Alliance & Leicester's revised bid was estimated by the Department (on the basis of advice from the Post Office) to be worth £13.4 million more than the bid from the Co-operative Wholesale Society.

* The Co-operative Wholesale Society's bid did not seek to adjust their offer price for the asterisked items. However, following a telephone request from Schroders for clarification on 14 April 1989, the Co-operative Bank indicated that any surplus of market value over book value for Girobank's quoted and unquoted securities could be retained by the Post Office. The Co-operative Bank confirmed this in writing on 18 April 1989, after the above evaluation had been carried out.

26 The Co-operative Wholesale Society and Chase Investment Bank said that they were surprised when the announcement was made that the Alliance & Leicester had obtained sole negotiating rights (paragraph 33). In May 1989 they advised Schroders that they would remain interested if the negotiations with the Alliance & Leicester broke down.

Consideration of the bids

27 The Department and the Post Office separately evaluated the two bids against their agreed criteria for the sale. Although the Department had not set a minimum price, their advice from Hambros was that offers in excess of £90 million to £100 million should not be rejected as too low (Appendix 1).

28 In evaluating the bids the Department and the Post Office considered the effect on the offer prices of the associated terms and conditions (Table 1). The principal adjustments were to reflect differences between the book and market values of Girobank's investments and leasing assets. The Department estimated, on the basis of advice from the Post Office, that the adjusted value of the Alliance & Leicester's revised bid of £130 million was £109.9 million, whereas the adjusted value of the Co-operative Wholesale Society's bid of £124 million was estimated to be £96.5 million.

29 Both bids were subject to similar warranties and conditions. For example, they both called for a re-negotiation of Girobank's contract with Post Office Counters, and sought assurances about the implementation of Girobank's new computer system.

30 Schroders advised the Post Office that both bidders appeared to meet the sale criteria; however there were major uncertainties relating to the ability of either bidder to complete the transaction. In their view there was a more immediate risk of job losses with the Co-operative Wholesale Society's bid because they had greater overlap of operations with Girobank. Also the Co-operative Wholesale Society's offer was conditional upon a satisfactory shareholders' agreement being reached with a foreign bank, though the Co-operative Wholesale Society had confirmed to Schroders that they would provide the required funding from their own resources, should there not be an agreement with their potential partner. Further in April 1989 discussions between the Post Office and the Co-operative Wholesale Society were progressing at a very slow rate. The major uncertainty with the Alliance & Leicester's bid was the treatment of those activities which were outside the powers of a building society, and the need for secondary legislation to enable them to acquire Girobank.

31 Schroders also advised the Post Office that both potential purchasers appeared to have the management commitment to overcome possible difficulties, and it would be essential to grant exclusivity to one or other of them to progress the sale to a conclusion. Both bidders had envisaged a period of exclusive negotiation, with a view to its conclusion by the end of June 1989.

32 The Post Office Board met on 17 April 1989, and agreed to accept the revised offer from the Alliance & Leicester received that day; they considered that this offer was preferable to that from the Co-operative Wholesale Society against each of the criteria on which the offers were assessed. The Post Office Board therefore proposed, subject to the views of the Department, to grant the Alliance & Leicester Building Society exclusive negotiating rights for a period to be agreed.

33 The Department recognised that to grant exclusivity to one preferred bidder could result in a sale to that bidder or no sale at all. Nevertheless, they concluded that a period of exclusivity was necessary to resolve the outstanding conditions, and told the Post Office Chairman that they were content with the Board's decision in respect of the Alliance & Leicester. Hambros' advice to the Department was that the three month period of exclusivity requested by the Alliance & Leicester was excessive. The Post Office and the Alliance & Leicester subsequently agreed to a two month period of exclusivity. The Post Office Board's decision was announced to Parliament on 20 April 1989 by the Minister who added that he endorsed the decision, which he was satisfied took full account of the criteria for the sale.

The difficulty of sale to a building society

34 As soon as the Alliance & Leicester became a potential purchaser in November 1988 the Department proceeded rapidly to explore whether the Building Societies Commission could be persuaded to relax their initial advice, given in June 1988, that Girobank would not be eligible for investment by a building society. In January 1989 the Commission advised the Department that building societies did not have the powers to undertake significant elements of Girobank's business, including corporate unsecured lending and leasing. However, that power could be made available by secondary legislation.

35 Accordingly, in February 1989 the Treasury sought Parliamentary approval of an order under section 19 of the Building Societies Act 1986 to give societies power to provide temporary or occasional overdrafts for corporate customers connected solely with their money transmission activities, and to act as agents for unsecured loans for corporate clients (SI 730 of 1989, which came into force on 1 July 1989). Further detailed work had to be done before the Building Societies Commission were able to make the further requisite order designating Girobank as a suitable investment for a building society. In May 1990 the Commission, with Treasury consent, made an order under section 18 of the Act which enabled building societies to invest in Girobank, including its money transmission business, but subject to the disposal or rundown of its corporate unsecured lending and leasing business (SI 1089 of 1990). The effect of these orders was that large building societies could bid for Girobank, as well as develop their money transmission services in competition with Girobank.

36 Some of Girobank's activities, such as corporate lending, leasing and hire purchase, would still be outside a building society's powers as principal. The Government proposed that this business should be transferred to the Post Office, as the best solution in terms of maximising the return, but on the basis that the Post Office should:

- sell as many of the leasing assets as possible in 1989–90, subject to securing a good price, and not arrange any new leases;
- not give undertakings either to hold on to the assets which the Alliance & Leicester were not empowered to hold, or to sell them back to the Alliance & Leicester at a later date; and
- closely restrict the amount of new corporate loans that the Post Office offered via Girobank after the sale, and arrange for a third party to take over this new lending as soon as possible in 1989–90.

Progress of negotiations

37 The extent of the detailed work that needed to be undertaken in respect of the sale led to the Post Office maintaining their exclusive negotiations with the Alliance & Leicester for about a year longer than originally agreed. During this period both sides ran the risk of the other withdrawing from the sale. At each stage of the negotiations however the Post Office and the Alliance & Leicester agreed revised dates for completion of the task in hand or of the negotiations as a whole, but these were repeatedly missed and reset. The Post Office also considered at all times whether they should break off negotiations with the Alliance & Leicester and seek to resume negotiations with the Co-operative Wholesale Society. However they judged on each occasion that the best hope of a successful sale lay in discussions with the Alliance & Leicester; and they wished to continue negotiations as long as progress was being made and a successful sale was eventually achieved. The Post Office were also concerned about the impact on Girobank's credibility if it appeared that negotiations were running into insuperable difficulties.

38 Schroders told the National Audit Office that, as the sale process continued, they maintained contact with the other previous potential bidders and with the Co-operative Wholesale Society. Hambros told the National Audit Office that they had also kept in touch informally with the Co-operative Bank's representatives in the course of contacts about other matters.

39 The Department monitored the sale process closely and told the National Audit Office that they would have intervened had they ever thought that those involved in the sale were not acting properly or moving as quickly as they could to resolve the various matters.

40 A main factor which contributed to the lengthy period of exclusive negotiations was the fact that Girobank had never been prepared for a sale to a building society. The Department informed the National Audit Office that this was to avoid closing off any options in the initial stages of the sale. But they were aware of the many complexities involved in the sale to a building society; and they encouraged and contributed to the constructive assessment of methods to deal with the problems as they were identified (paragraphs 34–36). However, because the sale of a bank to a building society was breaking totally new ground, neither the Department nor others involved were able to anticipate from the outset all the complexities that arose in ensuring that the sale complied with the requirements of the legislation governing building societies.

41 Other problems which emerged during negotiations mainly concerned the identification, funding and future management of those activities which would continue to be outside the legal powers of a building society as principal. Contributing problems arose from Girobank's existing management information systems which had not been designed to comply with Building Societies Act requirements. No estimate was made of the time it would take to resolve these difficulties once the first two months had expired. The Department told the National Audit Office that they did not consider this would have served any practical purpose while the negotiations were continuing to make progress.

Completion of the sale to the Alliance & Leicester

42 The Secretary of State gave his consent for the sale of Girobank to the Alliance & Leicester Building Society on 31 May 1990. An order designating Girobank as a suitable investment for a building society came into force on 22 June 1990 (SI 1089 of 1990). The Post Office and the Alliance & Leicester completed the sale ten days later.

43 The sale agreement included an undertaking by the Alliance & Leicester not to sell Girobank for two years. It also included undertakings by the Post Office:

- to extend their banking contract with Girobank from one to three years (at a lost opportunity cost which the Post Office estimate at £3.6 million);
- not to engage in specified lending for four years;
- not to sell Post Office Finance Limited (the remaining corporate lending assets) for four years or, if the Alliance & Leicester became entitled to acquire it within that time, not to sell it within that time without offering it first to the Alliance & Leicester;
- in respect of future capital gains tax liability (recently agreed with the Inland Revenue to be nil); and

Table 2: The Post Office's losses on disposal of Girobank and Giroleasing

	£ million	£ million	£ million
1. **Sale of Girobank to Alliance & Leicester**			
Net asset value[(a)]		170	
Offer	130		
Adjustments for:			
retained earnings	13		
loss on gilt investments	(19)		
loss on interest rate swops	(1)		
1988–89 dividend	(2)		
cost of Department of Social Security contract	(9)		
Sale proceeds		112	
Loss on disposal[(a)]		(58)	
Post Office expenses		(3)	
Tax		(2)	
Loss on disposal after expenses and tax[(a)]			(63)
2. **Sale of Giroleasing[(b)] to The Norwich Union**			
Net asset value		338	
Offer	342		
Adjustments	(3)		
Net sale proceeds		339	
Profit on disposal		1	
Post-completion adjustments		5	
Tax		(7)	
Loss on disposal, after tax			(1)
Total loss on disposal of Girobank and Giroleasing[(a)]			(64)

Source: The Post Office (figures adjusted for rounding)

Notes: (a) *The net asset value for Girobank is stated at a modified historical cost of £170 million. The Post Office estimate that on an historical cost basis the net asset value would have been £156 million, and hence the loss on disposal would have been £14 million smaller.*

(b) *Figures relate to the sale of both the leasing and the hire purchase businesses to The Norwich Union and include £5 million late receipts not shown separately in the Post Office's Accounts for 1989-90.*

This table shows that the Post Office's combined losses on the sales of Girobank and Giroleasing amounted to £64 million. However, the above figures exclude the extra cost to the Post Office of the Nippon loan (up to £2 million — paragraph 62), the extension to the Post Office's banking contract with Girobank (£3.6 million) and unquantified potential costs arising from the retention of some businesses and assets in the Post Office (paragraph 59).

- in respect of an actuarial assessment of the transfer required from the Post Office's pension funds (the actuaries' latest assessment of this is about £100 million).

44 £39 million of the sale proceeds were used by the Post Office to repay subordinated loans from them to Girobank. The Post Office's published external financing limit for 1990–91 was for borrowing of £38 million, after taking into account net receipts from the sale of Girobank of £35 million. As the actual net receipts of the sale were £72.8 million, the Department reset the Post Office's external financing limit for the financial year to zero. The Post Office's 1989–90 accounts show that they incurred a £63 million loss on the sale of Girobank to the Alliance & Leicester, as against the book value of the assets (Table 2). This includes the £3 million cost of the sale to the Post Office.

45 The Alliance & Leicester's accounts for 1990 show that the value to them of Girobank's revalued net assets was £21 million greater than the price they paid for them, after taking account of capitalised acquisition costs. However, against this, the Society have set aside £20 million for expenditure on information systems, promotion of a brand image and internal reorganisation, to achieve the strategic fit they wanted for Girobank.

Businesses not sold to the Alliance & Leicester

46 In order to dispose separately of the remaining activities and allow the sale to a building society to go ahead (paragraph 36), between July 1989 and July 1990 the Post Office acquired those parts of Girobank's business which a building society was not empowered to own and which had not been transferred elsewhere. This was done, with the consent of the Department, by the exchange of cash for the assets etc at their net book value of £428 million, thereby avoiding any effect on the published net worth of Girobank — gross assets of £1,865 million and liabilities of £1,773 million (Figure 1 and paragraph 64).

Giroleasing

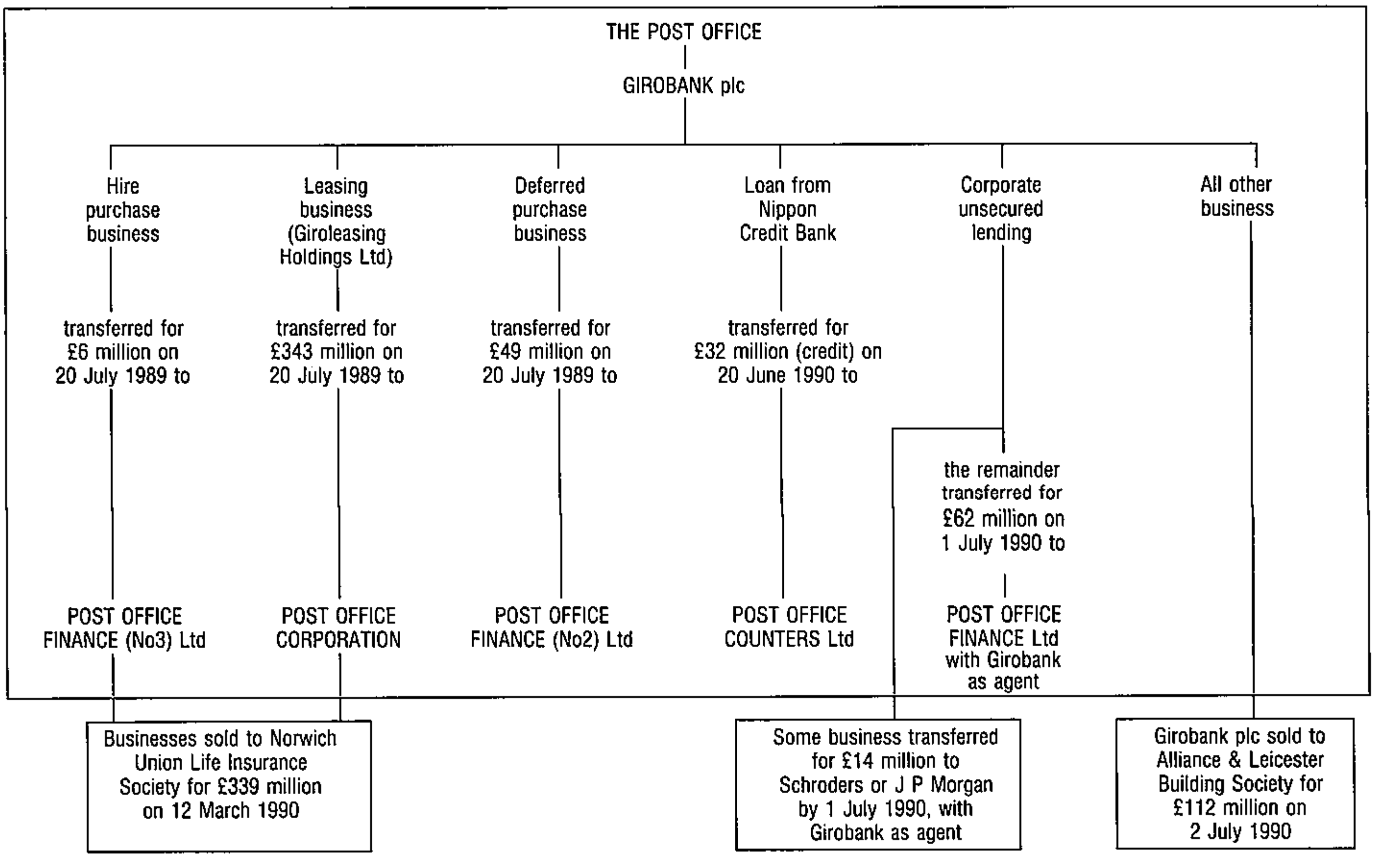
47 Giroleasing was the collective name for the corporate leasing and hire purchase businesses which the Post Office acquired from Girobank in July 1989 at their book value of £349 million. Through Schroders the Post Office advertised Giroleasing for sale in September 1989 and received 31 expressions of interest. They subsequently received nine indicative bids ranging from £285 million to £367 million. Price was the main criterion applied in the assessment of bids as these were purely financial assets. Other factors taken into consideration were the ability of the bidder to complete the transaction, and the legal terms required by the bidder. The Post Office invited the six highest bidders to submit final bids based on further information.

48 Price Waterhouse advised the National Audit Office that a group of purchasers might have paid more in total for Giroleasing if the Post Office had fragmented the business and offered it for sale as a number of smaller entities, each with distinct tax advantages for its potential purchaser. The Post Office assured the Department that they had considered this approach, but said they had rejected it because it would have pushed completion of the sale beyond the end of the financial year without necessarily achieving a higher price. The Post Office had been asked by the Treasury to conclude the sale by 31 March 1990, if this was possible without giving an undue number of warranties.

49 Four final bids were received ranging from £313 million to £375 million. Because the bid from The Norwich Union Life Insurance Society Limited was by far the highest, the Post Office decided to give them preferred bidder status; they then informed the Department and the other bidders. On the basis of the updated financial information provided to them as preferred bidder about the portfolio, and to take into account movements in market interest rates, The Norwich Union recalculated their offer from £375 million to £378 million. The Norwich Union's offer compared very favourably with Schroder's valuation of between £310 million and £320 million as the value to the Post Office of the future cash flows of the business.

50 Regardless of who purchased the business the price was to be adjusted after completion. These adjustments were mainly to take account of differences between the forecast balance sheet as at 31 January 1990 and the final audited balance sheet. They also allowed for any discrepancies in the financial information used by The Norwich Union for their valuation which

Figure 1: The restructuring and disposal of Girobank's businesses



Source: The National Audit Office

This figure shows the restructuring of Girobank and that, although the major businesses were subsequently sold, several businesses were retained by the Post Office.

were identified during Ernst and Young's post-completion review of the portfolio on behalf of the Post Office and The Norwich Union. In order to make the calculation of the post-completion adjustments as mechanical and non-controversial as possible, The Norwich Union agreed to reveal the calculations backing their offer.

51 On 30 January 1990 — the day before the sale agreement was due to be signed — Girobank identified a clerical error in the detailed taxation calculations. This resulted in taxation payable being included as income, and tax relief receivable as expenditure, effectively overstating The Norwich Union's bid by £55 million. Following discussions with The Norwich Union, the National Audit Office are satisfied that this was a genuine mistake. The Post Office were advised by their solicitors that their knowledge of the mistake made by The Norwich Union could render a sale contract null and void if not communicated to the purchaser. The Post Office were certain that the mistake would have come to light during the calculation of the post-completion adjustments.

52 The corrected Norwich Union offer had a value of £323 million which meant that another company, whose offer was for £342 million, was now offering more than The Norwich Union. The Post Office decided to allow The Norwich Union until 5 February to consider their position and whether they wished to maintain their offer at £323 million; the Post Office agreed not to solicit other bids until this date.

53 Schroders spoke on several occasions to The Norwich Union during this period; they told them that the second highest offer which the Post Office had received was of the order of £340 million; and succeeded in persuading The Norwich Union to increase their offer to £342 million, on 5 February. Also on this day, Schroders spoke to the company which had submitted the other highest final bid. Schroders did not specifically invite this company to re-bid but they did seek to confirm whether they were still interested and to explore how real their offer was, in terms of available finance and of the need for warranties. The company said that they were still interested, that they would need 7 to 10 days to confirm that their offer was real, but that if no warranties were to be offered by the Post Office then they would expect the final price to be lower. No other bidders were contacted.

54 The Post Office and Schroders were therefore able to compare two offers at £342 million:

(a) a firm one from The Norwich Union, which was ready for signature, with few and fully discussed warranties associated with the offer, and with the finance readily available; and

(b) a bid from a much smaller company which still needed time to consider the purchase and raise the finance, and which was likely to be reduced as the Post Office wished to sell with as few warranties as possible.

Finally, the Post Office were aware that time was short if the sale were to be completed before the end of the financial year. Schroders' advice, which the Post Office accepted, was that the sale should be concluded with The Norwich Union. The agreement was signed on 9 February 1990 and the details were publicised shortly afterwards. The Post Office told the National Audit Office that there was no reason to abandon the sale process and start again, as The Norwich Union's revised bid was now as high as the next best offer and because The Norwich Union were considered to be a very acceptable purchaser.

55 The sale to The Norwich Union was concluded in March 1990, with the consent of the Department. The latest book value was £338 million at the time of the sale as the result of transactions conducted during the sale period. However the final sale valuation was £339 million, following the outcome of the review by Ernst and Young, referred to in paragraph 50. A further adjustment (mainly interest accrued between the signing of the contract and completion) later increased the proceeds of the sale by £5 million. Both adjustments would have been of the same order of magnitude whichever was the winning bid. The result was a profit for the Post Office of approximately £6 million over the latest book value, before £7 million capital gains tax on the sale (Table 2).

56 The Department were kept informed of these developments and told the National Audit Office that they were satisfied that the taxpayers' position had been adequately safeguarded by selling to The Norwich Union at their revised offer of £342 million. They did not believe that there was any guarantee that a reopened auction would have bettered what was considered to be a good price for the financial assets involved.

Corporate lending

57 The corporate lending business comprised unsecured loans and overdrafts to companies and other corporate bodies. Although they could not own this bussiness, the Alliance & Leicester considered it essential for the commercial benefit of the money transmission business for Girobank to continue to deal with its corporate lending customers.

58 Accordingly, Girobank sought out other banks in the United Kingdom and overseas, to take on the loans, with Girobank managing them on an agency basis. These approaches were unsuccessful. To allow the sale to go ahead, the banking departments of J P Morgan (advisers to the Alliance & Leicester) and Schroders agreed to take on loan facilities relating to those corporate clients who gave their agreement to the transfer. Lengthy negotiations ensued but by June 1990, when the sale of Girobank was imminent, some customers had not signed the necessary loan transfer agreements. With the Department's consent, the Post Office transferred the remaining corporate and other small loans and their associated liabilities to Post Office Finance Limited at their book value of £61.6 million.

59 The Department informed the National Audit Office that this loan book continues to show a profit; as a prudential measure the Post Office have established a provision against any bad debts which may arise on any of the transactions transferred to Post Office Finance Limited. The total loan facilities involved, and the amounts actually drawn down at the time of the transfer, were as follows:

	Limit £ million	Usage £ million
J P Morgan	100	10
Schroders	109	4
Post Office Finance Ltd	160	62
	369	76

60 Under these arrangements, Girobank, as a subsidiary of the Alliance & Leicester, secured access to the corporate lending customers by acting as agent for J P Morgan, Schroders and Post Office Finance Limited.

Nippon loan

61 Girobank had a loan agreement for 8 billion yen (£32.2 million) and two associated currency swap arrangements with the Nippon Credit Bank. These required consultation with the lenders if Girobank ceased to be controlled by the Government, with the lenders having the right to require payment of the loan in the absence of a successful conclusion to the consultation process. The Alliance & Leicester's offer required the Post Office's assistance in the renegotiations with the Nippon Credit Bank. It proved impossible to agree terms acceptable to both the lenders and the Alliance & Leicester.

62 The Department agreed with the Post Office that rather than terminate the loan at a cost of £2.5 million, it would be more economical to transfer it to the Post Office at a cost of £1 million to £2 million. Therefore, with the lenders' approval and the consent of the Department and the Treasury, the Post Office transferred the loan and associated rights and liabilities from Girobank to Post Office Counters in June 1990. Girobank paid Post Office Counters £32.2 million in return. The Post Office do not expect any liability to arise on this loan or the contracts up to or beyond their maturity in 1994.

Deferred purchase agreements

63 Girobank had eight deferred purchase agreements with local authorities under which it provided funds for the construction of buildings to be used by the local authorities, in return for fees and reimbursement of the construction costs. The business, with a book value of £49 million, has been retained by the Post Office with the agreement of the Department, and it remains profitable.

Summary

64 This restructuring has resulted in the transfer of assets from Girobank at their book value in exchange for cash of £442 million from the Post Office and others as follows:

	£ million	£ million
From/(To) the Post Office:		
Giroleasing	349	
Corporate lending	62	
Deferred purchase agreements	49	
	460	
Nippon loan	(32)	
Net payment by the Post Office		428
(see paragraph 46)		
Corporate Lending:		
Schroders	4	
J P Morgan	10	
Payments by others		14
Total		442

Achievement of the sale criteria

Price

65 Although the Alliance & Leicester's final offer for Girobank in April 1989 was £130 million, the eventual sale price was £111.8 million. The National Audit Office note that this was within the minimum valuation range (£95 million to £100 million) provided by the Department's advisers after allowing for an improvement in the value of gilts (Appendix 1, paragraphs 14 and 15). The difference of £18.2 million reflected the following reductions:

(a) £18.7 million in respect of the July 1990 market values of Girobank's quoted securities (mainly gilts) compared with book value (paragraph 67 refers);

(b) £8.8 million to compensate the Alliance & Leicester for diminished profit on Girobank's revised contract with the Department of Social Security; and

(c) £4 million other agreed adjustments;

partly offset by a negotiated price increase of £13.3 million for additional earnings retained in Girobank from the time of the offer up to the completion of sale.

66 No adjustment was made to the price paid by the Alliance & Leicester to take account of the potential increase in Girobank's *future* earnings arising from the restructuring. This may have been significant because the Post Office estimated that the cash received by Girobank for Giroleasing etc, had generated £6 million more in profits than the activities it had replaced. In the course of the final negotiations concerning price, the Post Office decided it would be inappropriate to seek an increase to the price on this account because the Alliance & Leicester's bid explicitly referred to their inability to retain these assets; the Post Office therefore concentrated their efforts in negotiation on securing the negotiated price increase of £13.3 million referred to in paragraph 65 above. The Department were not involved in the detailed negotiations concerning price.

67 Part of Girobank's liquid asset base was a holding of quoted securities — mainly gilts. The price of gilts was volatile at the time of the sale, and, while they might have risen, there was also a risk that their value would fall during the period of exclusive negotiations, thereby reducing proceeds. The Post Office recognised that it would have been normal commercial practice to hedge the portfolio but, after consulting the Treasury, the Department advised that it was inappropriate for a public sector body to hedge securities which had been issued by the Government.

68 The Alliance & Leicester agreed in negotiation that no adjustment needed to be made to the sale price to reflect a reduction in the market value of unquoted securities from a premium of £9.5 million to a discount of £950,000. The Alliance & Leicester paid for these securities at their book value. Adjusting the sale price to reflect the higher market value of these unquoted securities had originally been assessed by the Department in April 1989, on advice from the Post Office, to be a significant element of the differences between the Alliance & Leicester's offer and that from the Co-operative Wholesale Society (Table 1).

Impact on Post Office operations

69 The Alliance & Leicester's plans for the development of Girobank do not appear to have had a significant impact on the Post Office's continuing operations. The link between Girobank and Post Office Counters, which is regarded as beneficial by both parties, has been safeguarded by a contract renegotiated during the sale process.

Impact on Girobank management and staff

70 Girobank employees have a voice on the board and their salaries are partly performance-related. The Alliance & Leicester are not empowered to give share options and have no scheme for profit sharing. The Department accepted the Post Office view that the bid from the Alliance & Leicester posed a smaller risk of redundancies than a sale to the Co-operative Wholesale Society; and the sale agreement protected the existing pension benefits of Girobank employees.

Impact on customer choice

71 Since the Alliance & Leicester's branch network offers Girobank additional outlets, the increased accessibility has widened the choice to the public and should help to expand Girobank's business. However, the scale of Girobank's services for corporate clients is now smaller as the result of the disposal of businesses not acquired by the Alliance & Leicester.

Bank of England approval

72 The Bank of England were content for the ownership of Girobank to be transferred to the Alliance & Leicester.

General

73 The Select Committee on Trade and Industry (Sixth report, Session 1988–89, paragraph 28) expected the Department to monitor the operation of Girobank to ensure that the conditions originally set by Ministers for the sale were met. However, they have not done so, and the Department told the National Audit Office that they considered the criteria related only to the sale process and were not intended to encompass Girobank's future activities in the private sector.

National Audit Office conclusions

74 The National Audit Office's main findings and conclusions from their examination were as follows:

On the preparations for sale

(a) Before 1988 the Post Office had taken some steps to improve Girobank, but significant problems remained, such as the delayed improvement of the computerised account ledgering system. These were receiving urgent attention but had not been resolved at the time of the launch of the sale. The advantages of early privatisation were judged to outweigh any benefit to proceeds which might flow from delay until the problems were fully resolved. Had it been possible to resolve them earlier, Girobank may have been more attractive to potential bidders (paragraphs 13 and 15).

(b) Following their decision to sell Girobank, the Department and the Post Office took the view that it should be offered for sale as an integrated entity so as to attract as wide a field of potential purchasers as possible; therefore they did not initially take any steps to make it more attractive to specific bodies (paragraphs 7 and 14).

(c) The Department and the Post Office did not analyse in advance the implications of a sale to any particular class of purchaser, such as a building society; and they made no contingency plans for such a sale in case these plans closed off any options. Because the sale of a bank to a building society was breaking totally new ground neither the Department nor others involved were able to anticipate from the outset all the complexities that arose. Nevertheless, the Department took early action in 1988 in seeking the Building Societies Commission's approval for a sale of Girobank to a building society. However, the sale would have been progressed more quickly and the receipt of the purchase price would have been earlier had the Department and the Post Office been able to resolve the complexities and legal requirements of a sale to a building society sooner (paragraphs 34 and 40–41).

(d) The initial publicity of the sale generated over 90 expressions of interest from around the world. However, four of the seven indicative bids which followed were from parties considered unsuitable in terms of the nature and objectives of the sale. The three other bidders decide not to pursue their interest. The Department and the Post Office considered it was right to advertise widely in the first instance in the interest of fairness and in order to generate the maximum amount of competition. The results were however disappointing, and a more focused approach to identifying particular purchasers was then followed (paragraphs 16–18, 21).

On marketing and competition

(e) In order to realise the best price for the sale of publicly owned assets it is essential for there to be fully effective competition on equal terms. In the case of Girobank exclusive negotiations were prolonged from two to 15 months. Although some progress was being made during this period, there was a risk of no sale at all or one which represented poor value for money. The value of Girobank's quoted and unquoted securities fell by some £29 million during the negotiating period. It was therefore appropriate that the Post Office did at all times consider whether they should break off negotiations with the Alliance & Leicester and seek to resume negotiations with the Co-operative Wholesale Society (paragraphs 37 and 68).

On achievement of the sale criteria

(f) The delay in completion of the sale led to a reduction in proceeds compared to the offer price, mainly due to an £18.7 million fall in the value of Girobank's gilt investments and a reduction of £9.5 million in the value of unquoted securities. Both bids provided for the price to be re-adjusted in respect of the market value on the completion of the sale process of Girobank's holding of gilts and unquoted securities (paragraphs 65–68 and Table 1).

(g) It is not yet possible to confirm whether all the sale criteria have been achieved and, in particular, how far the sale to the Alliance & Leicester has widened choice to the public or helped expand Girobank's business. Since they consider the criteria relate only to the sale itself, the Department have not conducted and do not intend to conduct any after-sale monitoring (paragraph 73).

General conclusion

75 Girobank was a unique bank, apparently unattractive to many bidders and hence difficult to sell. Nevertheless, the Department achieved their aim to the extent of selling off the banking, hire purchase and leasing businesses, although the deferred purchase, Nippon Loan and most of the corporate lending business remain in public ownership. The Department and the Post Office faced novel problems in transferring Girobank to a building society. In the event, because of these problems, the period of exclusive negotiations had to be prolonged from two to 15 months. But a successful sale was eventually achieved.

Appendix 1
Valuations of Girobank —a summary

Introduction

1 Before and during the sale process separate valuations of Girobank were carried out for the Department of Trade and Industry and the Post Office by two merchant banks, Hambros and Schroders respectively.

Methodology

2 The standard method of valuation was based on a price-earnings ratio with the addition of a takeover premium as considered appropriate at the time. For comparison the valuations also assessed Girobank's break-up value, derived from its latest balance sheet and adjusted for the difference between the book and market values of the gilts portfolio.

3 The earnings figures used were derived from Girobank's latest reported profits, adjusted for items which were likely to materially change the bank's future profitability. It was difficult to quantify these adjustments because deficiencies in Girobank's management accounting system made it difficult to apportion the bank's earnings to specific activities.

4 The price-earnings ratios were taken from the range of ratios of United Kingdom clearing banks, and were selected from the lower end of the range, as this approach reflected the relative quality of Girobank's business. Girobank was an unusual bank so comparisons with other banks would have to be treated with caution. All the valuations referred to equity plus debt. Hambros and Schroders told the Department that they analysed recent transactions involving sales of banks and used this information to inform their valuation reports, although the information itself was not appended to the reports.

Hambros September 1987 valuation

5 Hambros, acting for the Department, assessed the value of Girobank for various sale options as follows:

	£ million
Trade sale	139
A management buyout	75–100

Hambros estimated that, if Girobank achieved the profit growth implied by its business plan, which Hambros regarded as ambitious, the bank could be valued at between **£200 million and £230 million** by March 1989. (These planned profits were not achieved.) Hambros said that, whilst proceeds might be maximised by deferring the sale, Girobank's management argued strongly for the bank to leave the public sector without delay.

Schroders February 1988 valuation

6 Schroders, acting for the Post Office, assessed the value of Girobank for various sale options as follows:

	£ million
A share flotation	95–105
A sale to a management buyout consortium	110–120
A sale to a corporate purchaser	120–130

Hambros March 1989 minimum valuation

7 Hambros assessed the likely proceeds of assets which might be sold on a break-up to be between **£87 million and £90 million.** This was based on a book net asset value of £140 million plus £6 million for the unrealised gain on Girobank's gilts, less costs and adjustments to other asset values.

8 On a going concern basis they assessed the value to be between **£67 million and £70 million,** plus a modest premium for control. This value was derived from post-tax profits for 1989 of £14 million and a price-earnings ratio at the bottom of the range for clearing banks.

9 They concluded that offers in excess of **£90 million to £100 million** should not be rejected as too low.

Schroders May 1990 valuation

10 Schroders advised that a price-earnings ratio at the bottom, or below, the range for other banks (5.5 to 7.8) was currently appropriate for Girobank, and this implied a valuation of no more than **£110 million.** Lack of interest shown during the sale meant that any premium to be added for control was likely to be negligible. Schroders said they had no reason to advise the Post Office that the current price negotiated with the Alliance & Leicester was unfair.

Hambros May 1990 minimum valuation

11 Hambros assessed the break-up value to be **£75 million,** based on a book net asset value of £154 million at March 1990, less £31.3 million for the unrealised loss on the market value of gilts at that time, and less costs and other adjustments.

12 Hambros final valuation updated their 1989 report to take account of Girobank's 1989–90 trading results. Although operating profits had risen to £28.8 million and post-tax profits had risen from £14 million to some £18.8 million, these included profits of some £6–8 million gross (£4–5 million net of tax) which Hambros discounted on the basis that these would no longer arise in future years now that Girobank's contracts with the Department of Social Security and the Post Office had been renegotiated onto a more commercial basis.

13 Girobank had failed to achieve its target profit and Hambros considered that a price-earnings ratio of 6 was appropriate, compared to the banking industry's range of 5.5 to 7.2. Hambros applied this multiplier to the adjusted profit to derive a valuation of between **£86 million and £95 million** on a going concern basis, to which a buyer might be expected to add a modest premium.

14 They now concluded that their 1989 minimum valuation should be marginally revised and that offers in excess of **£95 million to £100 million** should not be rejected as too low.

15 The National Audit Office note that allowing for the improvement in the value of the gilts by the time the sale was concluded (+£12 million from that at paragraph 11 above), the sale proceeds of £111.8 million were within this range.

Appendix 2
Chronology of Events

		Paragraph in Report
7 June 1988	Government announcement of sale	1
10 November 1988	Parliament informed no buyer found within the original timescale	19
February 1989	Building Societies Commission published guidance note setting out the conditions under which it would make the necessary Order to allow a building society to acquire Girobank	34
13–17 March 1989	Receipt of statements of interest from the four potential bidders	21
23 March 1989	The Post Office told bidders that they intended to conclude a sale as soon as possible and to accept the first satisfactory offer to be received	21
5 April 1989	The Alliance & Leicester Building Society offered £120 million	22
14 April 1989	The Co-operative Wholesale Society offered £124 million	22
	Schroders sought to establish if both bidders' offers were final	23, 24
17 April 1989	The Alliance & Leicester revised their offer to £130 million	23
	The Government set out conditions for sale to a building society	36
	Post Office Board decided to accept the Alliance & Leicester offer	32
18 April 1989	The Co-operative Wholesale Society's subsidiary (The Co-operative Bank) sent a letter confirming clarification of the Society's bid	24
19 April 1989	Secretary of State informed Post Office he was content with their decision	33
20 April 1989	Parliament informed that the Alliance & Leicester were the preferred bidder and that exclusive negotiating rights had been granted	33
20 July 1989	Leasing, deferred purchase and hire purchase businesses transferred from Girobank to the Post Office	46
9 February 1990	Agreement signed for sale of Giroleasing to The Norwich Union for £342 million	54
5 March 1990	Sale of Giroleasing approved by the Department	55
12 March 1990	Sale of Giroleasing completed	55
18 May 1990	Order by the Building Societies Commission was laid, designating Girobank a suitable investment for a building society	42
31 May 1990	Secretary of State formally approved sale of Girobank to the Alliance & Leicester	42

1 June 1990	Girobank sale agreement signed	43
20 June 1990	Foreign currency (Nippon) loan transferred to Post Office Counters Ltd	62
22 June 1990	Building Societies Order came into effect	42
25 June 1990–1 July 1990	Transfer of corporate lending business to Schroders and J P Morgan for £14 million	58
30 June 1990	Repayment of subordinated debt by Girobank	44
1 July 1990	Residual corporate lending transferred to Post Office Finance Ltd for £62 million	58
2 July 1990	Sale of Girobank to the Alliance & Leicester completed for £111.8 million	42