

To Bank Shareholders

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Bank Investors Campaign – Update No. 8

Treasury Committee Revelations

The Parliamentary Treasury Committee interviewed a number of the senior executives of banks recently about the financial crisis in the banking sector. Videos of the two sessions are present at: www.parliamentlive.tv/Main/VideoPlayer.aspx?meetingId=3401 and www.parliamentlive.tv/Main/VideoPlayer.aspx?meetingId=3422. They had clearly taken legal advice on what they would say, because they managed to avoid admitting any actual mistakes whilst apologising profusely for recent events.

Revelations on Lloyds Banking Group

There were two particularly interesting comments by Eric Daniels, Chief Executive of Lloyds Banking Group, on the acquisition of HBOS. Firstly he said that the due diligence done on the acquisition was substantially less than they would normally expect to do on such a large deal. The need to complete the deal quickly was obviously a factor here.

But he also stated that LloydsTSB would not have had to take funding from the Government if the merger had not taken place. This is surprising bearing in mind what was said in the merger offer document. This is what it said on page 9:

"If the Acquisition and Placing and Open Offer do not complete, HM Treasury has stated that it would expect Lloyds TSB to take appropriate action to strengthen its capital position. The FSA has advised Lloyds TSB that if the Acquisition were not to occur, it would require Lloyds TSB to raise £7 billion of additional capital, made up of £5 billion of Core Tier 1 equity and £2 billion of Tier 1 instruments. Whilst Lloyds TSB would be able to seek to raise such additional new capital in the public markets, there can be no certainty that Lloyds TSB would be able to successfully raise such capital or as to the terms on which such capital could be raised, including the terms of any participation by HM Treasury in any such capital raising, or as to whether any such fundraising would be on a pre-emptive basis".

Many shareholders in LloydsTSB were opposed to the merger with HBOS and UKSA issued a press release questioning whether it was in the interests of shareholders to vote in favour at the time. We particularly expressed concerns about the risks associated with the HBOS loan book. But the above statement may well have persuaded some shareholders to vote in favour because it suggested that the company may have needed to take Government funding anyway.

It is of course clear from Mr Daniels statement that LloydsTSB could have stayed independent and out of the embrace of the Government, much to the dismay of shareholders, now that subsequent events have shown the folly of this merger.

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Lloyds Trading Statement

Subsequent to the above revelations, Lloyds Banking Group issued a trading statement which disclosed that additional write-offs in HBOS meant that the group was likely to report an underlying loss of some £8.5 billion for the year. Although this meant that such write-offs had only risen from something over £8 billion to £10 billion, the share price immediately collapsed by as much as 40%, although it recovered somewhat later in the day.

The Risk of Nationalisation

What shareholders fear is no doubt that more write-offs will be required in future, as loans continue to default, with the result that the Government will have to provide more funding. This could result in them taking more than 50% of the equity, diluting shareholders substantially and giving the Government control. Or it could mean total nationalisation.

The Northern Rock Precedent

On the same day as the announcement of the Lloyds trading statement, the judgment in the Northern Rock judicial review was announced. If this judgment stands, and it will almost certainly be challenged in an appeal, then if nationalisation of Lloyds did take place the shareholders would almost certainly get no compensation whatsoever. The judgment effectively states that where any company has received funding from the Government then that funding has to be ignored or taken to be withdrawn for the purposes of valuation. This instantly turns any such bank into an insolvent and worthless business. This would of course also be relevant to Royal Bank of Scotland, and any other bank that might be nationalised.

Perhaps one should compliment the directors of Barclays Bank in avoiding such Government support, and of course, LloydsTSB could have also as stated by Mr Daniels.

Incidentally the "Banking Bill" that is going through Parliament contains very dangerous wording that replicates the actions of the Government in respect of Northern Rock and that could undermine the rights of shareholders. A partner in lawyers Allen & Overy said the bill threatened "*the erosion of English legal certainty*" and opened up the possibility of "*banana republic-style expropriation*" of assets by the authorities. But unfortunately this Bill has not received much public notice.

Allocating Blame

Who is to blame for the debacle of the LloydsTSB/HBOS merger? Or as one writer in the FT put it "*when black horse meets black hole*". HBOS was clearly a company in some difficulties, which is why many shareholders, particularly institutions, who often held shares in both companies voted in favour. HBOS was facing nationalisation if the merger did not take place and this also encouraged HBOS shareholders to vote in favour because the actions of the Government in respect of Northern Rock and Bradford & Bingley had made it clear that any payment of compensation would be avoided by the Government.

The Government encouraged this merger as a way out of the problem, and the necessity to avoid full nationalisation, and indeed were so keen to do so that they gave a whitewash under competition law. As a result they now risk the prospect of having to nationalise the merged company, plus have lost billions of pounds on their investment in the equity.

Why did the directors of LloydsTSB think this proposal was in the interest of their shareholders? Sir Victor Blank, the Chairman, must surely take a lot of the blame, along with the other directors.

They turned an investment in a stable, some say even boring, diversified bank with a high quality balance sheet, and which paid high dividends to shareholders, into a risky investment with no dividends.

Other HBOS Revelations

Other revelations that came out of the Treasury Committee were that HBOS directors had been warned about the risks they were taking by one of their staff, who subsequently got sacked for his pains. The FSA had also investigated the affairs of the company but had not taken any action. Sir James Crosby, the former chief executive of HBOS, who had become deputy chairman of the FSA, resigned the same day that these matters became public.

What To Do?

What should Lloyds Banking Group shareholders do now? A difficult question indeed. All they can hope and ask for is that the directors take vigorous steps to avoid the necessity to raise more capital. On the political front, you probably need to oppose the creeping nationalisation of the UK banking sector by requesting other measures are taken to strengthen the balance sheets of UK banks other than by equity stake building by the Government.

Note that we do get numerous calls for us to take legal action against the former directors of the various UK banks who have got into these recent difficulties. But this is easier said than done. Such cases are exceedingly difficult under UK law, and potentially very expensive so are generally not a practical proposition unless a very specific basis can be identified. Such cases are also unlikely to restore the value of your shareholding or gain you compensation. The difficulty of pursuing such actions in a legal and political climate that is prejudicial to the rights of shareholders should not be underestimated, as recent events have shown. Action in venues other than the courts of law is probably easier, but you can be assured we will do all we can where possible.

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Note that all previous information issued by UKSA in respect of our campaign on banks is present on the following web site page: www.uksa.org.uk/Bank_Investors_Campaign.htm