

Our Chief Executive's review

I'm sure I won't be the only Chief Executive who sees 2008–09 as a year of two halves. Like many others, our year started in relative stability. Even allowing for the backdrop of an emerging downturn, the first few months saw us on track towards all our key targets. Then in September the world changed.



A new economic environment

With the financial crisis, the global economic climate was transformed and, overnight, demand for our products increased dramatically. As the full implications of what had happened became clear, demand rose still higher.

Our experience dealing with the events of the previous year, and the contingency plans put in place as a result of them, proved vital. We were able not only to cope with the surge in demand but also to maintain our high levels of customer service, whether dealing with new investors or helping allay the many and varied concerns of our existing customers.

Power of partnership

That we were able to do this is an enormous credit to our partner – Siemens – whose flexibility and dedication meant not only that our call centres dealt with the call volumes but also that the full range of customer service processing was managed with pace and accuracy. Our main distributor, the Post Office®, also had to cope with increased volumes on our behalf and did so very well. (Pages 19 to 21 cover their roles in more detail.)

But it's also an enormous credit to our own staff, particularly those involved in managing the Siemens relationship. The fact that our partnership score is now at its highest level ever demonstrates just how well the two teams communicated and supported each other during this testing time.

Striking a balance

It was clear even at this stage that several of our business targets for the year were no longer relevant. Inflows in the third quarter alone were sufficient to ensure we would exceed our original Net Financing target for the whole year and we raised our target from £4 billion to £11 billion with a margin of £2 billion either side. The final Net Financing figure, of £12.5 billion, is within this range. While we wanted to remain a safe option for customers, we were also acutely aware of the need to maintain an appropriate competitive position which did not take advantage of our ability to guarantee 100% security in an uncertain environment.

We worked with HM Treasury to establish a balanced way forward for NS&I, and agreed that in the interests of financial stability we would stay open to new customers and not take any products off sale. But we would adopt – as best we could – a low profile by stopping all discretionary marketing during the autumn and winter.

For the remainder of the year, our decision-making was driven by a need to maintain a balance between:

- the interests of our customers
- delivering on our core remit of raising cost-effective finance for Government, and
- the need to support financial stability by maintaining an appropriate competitive position

As the base rate fell to unprecedented lows, that balance became all the harder to achieve – and all the more important.

Focusing on our customers

For our customers, the key issue was ensuring that our products continued to meet their needs. Traditionally, the interest rates on most of our variable rate products have been below, or close to, the Bank of England base rate. When that rate fell to 0.5%, reducing our rates below it for every variable rate product we offer would have been unfair to customers.

We have balanced the need not to distort the competitive position with maintaining a savings offer that still delivers a reasonable return.

A good example is the change we have made to Premium Bonds from April 2009. We introduced a new £25 prize category and removed one of the two monthly £1 million jackpot prizes; both measures will help us to maintain the frequency of prizes, something our customers have told us is particularly important to them. We also worked to minimise the frequency of changes to the prize fund rate, helping to maintain a degree of stability for Premium Bond holders.

This essentially reflects what we have always sought to do throughout our 148-year history: provide a stable, dependable corner of the savings market where customers can invest without any worries. But within that scope, we have continued to make progress on our five-year strategy to simplify and modernise our infrastructure and product range. One change in the last year was the announcement to close our Cash ISA to new customers, removing any confusion or crossover with our more popular Direct ISA. (This is covered in more depth in 'Our products' on pages 16 and 17.)

Premium Bonds: the ERNIE and Colossus connection

Premium Bonds of course retain a special affection among the UK public and the unveiling of ERNIE 1 in a permanent exhibition at the Science Museum in June 2008 really underlined that for me. The exhibition also features a range of memorabilia, including valentine cards and poems sent to 'him' in years gone by. I was delighted to have the opportunity to meet one of the original engineering team, Jack Armitage, who built the first ERNIE all those years ago at Dollis Hill, London. He joined a team, many of whom had worked at Bletchley Park in the Second World War on Colossus, the code-breaking machine and the world's first electronic computer.

Retuning our strategy

Product evolution is a key part of our **NS&I adding value** strategy, alongside the increased promotion of direct channels and other steps to further our efficiency. I'm delighted to be able to report that even under the pressure of the demand we faced, we were still able to complete a number of strategic initiatives in the back office which contribute to these goals. These are discussed in more detail in the next section, 'Our strategy'.

While we continued to make sound progress against our strategic programmes, one aspect of the strategy has had to be substantially revised: the measure of Value Add. As many readers of this report will know, NS&I has been measured for some time on how cost-effective we are at raising finance for the Government, compared to the alternative methods of raising finance primarily through gilts. The changing economic landscape throughout the year has meant this measure is, temporarily, not an accurate or meaningful comparison.

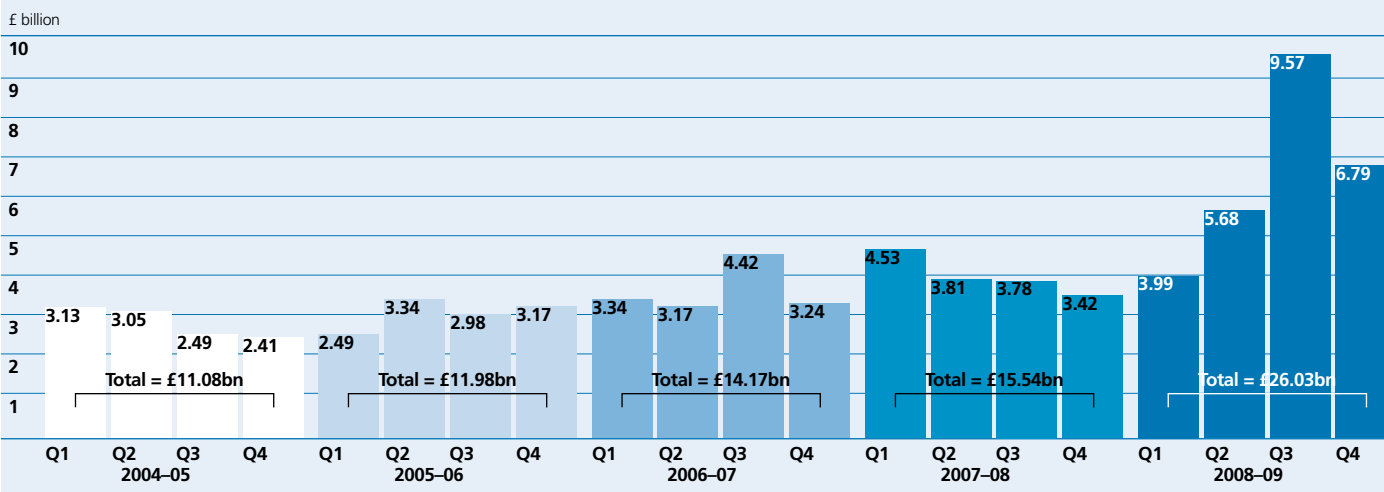
Nor do the comparators used to calculate Value Add (base rate for variable rate products and comparable gilt yields for fixed rate products) enable us to provide fair rates to customers in this period of exceptionally low interest rates. The low base rate has led many of our competitors to price their savings products off LIBOR or their loan books, while financial markets have been unusually volatile. There is also now an increased differential between LIBOR and the Bank of England base rate, whereas previously the two had tracked each other closely. The result is that both are currently no longer reliable comparators to measure our cost-effectiveness or to set price levels.

As a result, we agreed with the HM Treasury to formally suspend the Value Add target for 2008–09 and set no Value Add target for 2009–10. While we remain committed to the concept over the longer term, in the short term there are alternative ways of assessing our effectiveness – for example the well-established measure of comparing our administrative costs to the average funds invested by customers.

We also worked with HM Treasury to agree a revised Net Financing target for the coming year. Given the exceptional levels of Net Financing we have delivered over the last two years when we have delivered more Net Financing than we had planned to contribute over the five-year strategic period, the target for NS&I in 2009–10 will be to maintain broadly the existing level of stock. This means we can focus on the core elements of our modernisation programme, while preserving our long-term ability to raise Net Financing for Government, and aiding wider financial stability by maintaining an appropriate competitive position after the exceptional events of last year. Looking longer term, we are re-planning our financial strategy to accommodate the changed economic environment.

Essentially, our challenge for 2009–10 is to make sure we continue to deliver sustainable cost-effective Net Financing while keeping administrative costs low – no mean feat given the volume of inward and outward transactions we anticipate. We will still need to deliver gross inflows of some £14 billion in 2009–10 to maintain a broad Net Financing balance. The **NS&I adding value** strategy is vital to achieving those efficiencies through modernising the infrastructure of the business over the next few years to the benefit of customers and the taxpayer. So even though the financial metrics have changed, the underlying strategic goals remain the same.

Gross inflows into NS&I (including reinvestments)



Looking forward

As I said at the outset, this really has been a year of two halves. But even as the markets and economic landscape have shifted, one thing has – I believe – remained constant: the dedication of our people and partners to providing customers with the service they deserve. That for me is the biggest achievement of the year. It's also one I feel we are well equipped to repeat in 2009–10, as we face up to the challenge of operating in a very difficult savings landscape.

Finally, I would like to extend my personal thanks to Paul Spencer who is stepping down as NS&I's Chairman. Paul has contributed an enormous amount to NS&I over his six years on our board, first as a Non-executive Director and latterly as Chairman. I look forward to building on these achievements with his successor Martin Gray.

Jane Platt

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