

Landscape Review of NS&I: Stakeholder summary

July 2007



HM TREASURY



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EXECUTIVE SUMMARY

National Savings and Investments (NS&I) is a Government Department and Executive Agency of the Chancellor of the Exchequer. Its sole objective is the delivery of cost effective financing for the Government through the sale of savings and investments products in the retail market. This report presents the findings of a Landscape Review of NS&I that was commissioned by HM Treasury (HMT) Ministers in 2005 and completed in 2006. Landscape Reviews are the process for assessing the effectiveness of the framework for delivering policy within the Agency structure.

This report gives some background to NS&I, and discusses NS&I's performance since 2000, the future of NS&I in the retail savings market, NS&I's impact on wider Treasury objectives, corporate governance and risk management, and how NS&I will deliver future Government objectives.

INTRODUCTION

ABOUT NATIONAL SAVINGS AND INVESTMENTS

1.1 NS&I became an Executive Agency of the Chancellor of the Exchequer in 1996. Its origins can be traced back to the National Savings Bank in the 1860s.

1.2 NS&I is an integral part of the UK's debt management arrangements. Its sole aim is to help reduce the cost to the taxpayer of Government borrowing now and in the future, through the sale of savings and investment products to the retail market. It does this in accordance with an annual Financing Remit, set by Treasury Ministers, which is published at the same time as the Budget each year.

1.3 The Chief Executive of NS&I is accountable to Treasury Ministers for the performance of the Agency and, as Accounting Officer, to Parliament for the proper, effective and efficient use of public funds.

1.4 Accountability to Treasury Ministers is achieved via a governance framework, which includes a Framework Document, Corporate Plan, Service Delivery Measures and the annual Financing Remit. Further information is available on the NS&I website, www.nsandi.com.

1.5 The NS&I Board supports the Chief Executive in ensuring good governance, setting corporate policy and monitoring the Agency's performance. The NS&I Board is comprised of the Executive Management Team, four Non-Executive Directors and two representatives of the Treasury. Full details of the roles and responsibilities of Ministers, Treasury officials, the Board, and the Chief Executive are set out in the Framework Document.

KEY MEASURES

1.6 Customers deposit cash on a regular basis into new and existing products, but also withdraw cash on a regular basis as products reach maturity and when cash is required for other needs. Net Finance (NF) is the measure of the net change of funds, that is, total inflows from new deposits and retention of maturing monies, less the total outflows from withdrawals and interest payments. A positive Net Finance figure represents a positive contribution to government financing.

1.7 Value Added (VA) is the principal measure of cost effectiveness of raising debt finance through NS&I at a lower cost than through wholesale borrowing such as gilts and Treasury bills. It is calculated by subtracting NS&I's total operating costs from the costs of comparable alternative sources of debt finance.

KEY FACTS ABOUT NATIONAL SAVINGS & INVESTMENTS

At the end of 2006-07 more than £78 billion had been invested by over 26 million customers through NS&I.

Mission: To help reduce the cost to the taxpayer of Government borrowing now and in the future.

Single strategic objective: To provide retail funds for the Government that are cost effective in relation to funds raised in the wholesale market.

Strategy: “Direction 2007” was NS&I’s five year strategy which ended in March 2007. It has been replaced by “NS&I Adding Value” which has been developed in line with the findings of this Review.

Products: NS&I offers 12 products. Five are offered on a “tax free” basis¹. Premium Bonds are by far the most popular, with over £35bn stock at the end of March 2007.

Tax free: Premium Bonds, Index Linked Savings Certificates; Fixed Interest Savings Certificates; Cash Mini ISA; Children’s Bonus Bond; Direct ISA;

Taxable: Easy Access Savings Account; Guaranteed Equity Bond; Capital Bonds; Fixed Rate Savings Bonds; Income Bonds; Investment Account; Pensioners Guaranteed Income Bonds.

Staff and Partnerships: NS&I directly employed 135 staff at the end of 2006-07. The Agency relies on a public private partnership with Siemens for the c. 1,700 staff who run its operations. Partnership costs absorb the majority of NS&I’s budget. In 2006-07 the Siemens contract cost £101.1m in a total budget of £179m.

¹ When deciding the returns to offer savers on its tax free products, NS&I calculates the tax foregone (lost) to the Exchequer. This means that NS&I’s tax free products are cost neutral to the Exchequer.

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THE LANDSCAPE REVIEW

2.1 The Review's objectives were to:

- describe the existing NS&I service delivery framework;
- assess the alignment between HM Treasury and NS&I objectives;
- assess NS&I's capability to deliver against these objectives; and
- assess the effectiveness of NS&I governance.

Review Structure

2.2 The NS&I Landscape Review was directed by a Steering Group consisting of officials from the Treasury and NS&I, together with an independent member. It was led by a project team within the Treasury's Debt and Reserves Management team, with support from NS&I.

Key themes

2.3 The Review focussed on five key themes, which are discussed in more detail later in this report.

NS&I's performance since 2000

2.4 The Review evaluated NS&I's performance since 2000, in order to inform consideration of the potential future role of NS&I as part of the government's debt finance activities, and ensure that consideration of any changes was set in the context of recent performance.

The Future of NS&I in the Retail Savings Market

2.5 A strategic review of the market in which NS&I operates was undertaken. This included an assessment of NS&I's strengths and weaknesses, together with the external opportunities and threats that NS&I faces now and will face in the future.

Impact on Wider Treasury Objectives

2.6 The Review assessed the impact of NS&I on wider Treasury objectives, with the aim of informing decisions regarding the appropriate role for NS&I in meeting them. Treasury objectives examined included the delivery of fair, efficient and stable financial markets and provision of incentives to work, save and invest.

Corporate Governance and Risk Management

2.7 The Review examined the effectiveness of corporate governance, performance and risk management processes in relation to NS&I's business activities.

Delivering future Government objectives

2.8 The Review investigated NS&I's future role in the wider context of Government debt finance.

Consultation

2.9 As part of the Review, the Review team consulted the following stakeholders, whose responses informed the analysis presented within the main body of the report:

- Association of British Insurers
- British Bankers' Association
- Building Societies Association
- Consumers' Association
- Financial Services Authority
- National Consumer Council

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NS&I's PERFORMANCE SINCE 2000

3.1 Direction 2007 was NS&I's five year strategic plan, which was approved by Treasury Ministers in 2003, and which placed a greater emphasis than before on NS&I customers. Under the plan, NS&I aimed to raise a total of £15 billion in NF and £1.3 billion in VA between 2003-04 and 2007-08. By the end of 2006/07 NS&I had delivered all the NF and most of the VA targeted. HM Treasury Ministers therefore agreed to close the strategy a year early on the basis that any residual targets were carried over into the new plan. The replacement strategy, "NS&I Adding Value" was launched on 1st April 2007 and is in line with the findings of this Review.

3.2 The total stock of debt raised by NS&I had grown during this period in support of Government Net Financing requirements. This growth was possible due in particular to:

- the Public Private Partnership (PPP) with Siemens (signed in 1999 and due to run until 2014), under which NS&I outsourced its operations. This has facilitated the modernisation of the business and improved customer service; and
- market conditions favourable to NS&I's brand strengths.

3.3 A 2000 Review of NS&I concluded that NS&I should enhance the 'value adding' elements of its portfolio (ie. those which enable NS&I to raise cost-effective finance) and reduce barriers to future strategic change. By 2005, its corporate strategy "Direction 2007" had gone some way to delivering this through:

- better customer segmentation, improved operational efficiency, and some product rationalisation; and
- increasing the ratio of direct to indirect costs, thereby increasing flexibility and cost effectiveness.

3.4 NS&I also improved customer service under "Direction 2007", consistently meeting customer service targets. Key achievements include:

- voluntarily subscribing to and complying with the Banking Code, which sets standards of good banking practice across the industry for the benefit of customers;
- joining the jurisdiction of the Financial Ombudsman Service to offer customers the same arbitration process the rest of the industry offers; and
- launching a free "tracing service" for forgotten funds which had returned £38million to customers at March 2007.

3.5 However, NS&I continues to face challenges and risks to its long-term funding capacity. Across its product line, it remains heavily dependent on sales of Premium Bonds (which in 2005 accounted for nearly 40% of the total stock of NS&I debt). Premium Bond stocks grew by 116% between 2000 and 2005 (underpinning a 14% increase in total stocks).

3.6 In addition, NS&I faces challenges in distribution. It remains heavily dependent on the Post Office, which accounts for approximately 60% of total sales and is also an important distribution channel. NS&I has sought to mitigate this strategic risk by seeking new distribution partners and building up direct sales channels. Whilst it has had initial success with this strategy, the ongoing dependency requires continued focus.

3.7 NS&I's partnership with Siemens is central to its success. However, the partnership also creates operational and strategic risks. NS&I must continue to manage ongoing operational risks, particularly the potential difficulty of reducing stocks in the event that public finances returned to surplus. It must also retain the capability to manage the business in the event of hand back at the end of the contract in 2014.

4

THE FUTURE OF NS&I IN THE RETAIL SAVINGS MARKET

4.1 The Review noted that most independent forecasters expected the retail savings market to grow over the next five years, primarily driven by benign macro economic conditions.

4.2 NS&I is expected to deliver most of its value from unique and tax free products (Premium Bonds and Savings Certificates) in the long run. Non-differentiated products should continue to generate some VA since there is a margin between the retail and the wholesale markets. However, competition in the market is likely to intensify, placing downward pressure on margins. This is driven partly by competition from new entrants with low cost business models. NS&I is less able to compete on price than its competitors due to the need to price below gilt yields. Furthermore, NS&I have concluded that current account flows are too volatile as a source of debt finance.

4.3 Given doubts over the long-term value adding potential of many of its non-differentiated products, NS&I should continue with its strategy to rationalise low or non value-adding products, increasing its focus on those which offer the most cost effective financing. This will require further business transformation. Any decision to develop new products or to extend the scope of NS&I's activities must demonstrate clear capacity to deliver value.

5

IMPACT ON WIDER TREASURY OBJECTIVES

5.1 The Review considered the impact of NS&I on wider Treasury objectives, in particular:

- Objective III: Provide efficient, stable and fair financial markets, for their users and the economy; and
- Objective IV: Promote a fair, efficient and integrated tax and benefit system with incentives to work, save and invest.

Efficient, stable and fair financial markets

5.2 The Review found that the existence of a number of natural, strategic, and legal barriers to entry does prevent other firms from competing with NS&I on level terms. NS&I is also subject to differences in its regulatory and accountability frameworks. However, the Review's assessment was that any advantage gained from these differences are partially offset by the fact that NS&I operates within extensive strategic, operational, financial and governance constraints to which its competitors are not subject.

5.3 NS&I customers choose products on a combination of price and non-price criteria. Analysis of demand for NS&I's unique tax-free products indicates that many customers substitute between these and alternative financial products (including cash based and direct equity products). The existence of substitutes suggests that demand for NS&I products is responsive to competition. The Review therefore considered whether NS&I is likely to "crowd out" competitors.

5.4 When considering the impact of NS&I on competitors it is useful to consider funding patterns relative to the rest of the market. Although NS&I's stock grew from £63.3bn to £71.4bn between 2000-2005, its market share has actually declined over the period from 10.8% to 8.6% of the total cash deposits market. This is because NS&I:

- is not a major player in the instant access section of the deposits market; and
- faces increased competition in the deposits market from low cost providers.

5.5 The Review therefore found that NS&I was not having a significant competitive impact at its current relative size to the market. However, it nonetheless recognised that the impact on an individual participant could potentially be significant, though whether this was the case in practice was difficult to assess. The Review therefore noted that the Treasury should keep market impact in view when setting financing targets for NS&I. The Review concluded that NS&I should therefore target Value Added subject to delivering the agreed level of Net Financing. This is a change consistent with limiting NS&I's impact on the financial services market.

5.6 The Review also found that NS&I could mitigate its impact on the wider financial services market by increasing the availability of public information that would enable its competitors to analyse its direction and intent.

Regulation

5.7 NS&I is not directly regulated by the Financial Services Authority (FSA). The reasons for this exemption are:

- as the Government’s retail debt finance arm, NS&I is governed by specific legislation that regulates the way in which its products are managed¹;
- although NS&I accepts funds from the public, it holds no assets: all assets are passed directly to the Exchequer, and NS&I’s liabilities are therefore “guaranteed” by Government;
- NS&I sells only simple cash products. It does not conduct investment business.

5.8 NS&I is also subject to unique constraints due to its status as part of Government. Not only do strategic decisions require Ministerial consent, but NS&I is also accountable to Parliament for the proper use of public funds.

5.9 In providing comments to the Landscape Review, the FSA stated that “...it is difficult to see how FSA regulation would (materially) enhance consumer protection for NS&I customers”. The Review supported this view, concluding that compulsory regulation would add to the costs of NS&I without clearly adding to consumer protection. It also concluded that the differences in the regulatory and accountability framework are unlikely to have a material impact on competition.

5.10 However, the Review did highlight a number of specific areas where the case for extending compliance should be considered, highlighting full compliance with rules on financial promotions as being of particular importance.

5.11 NS&I has voluntarily adopted the Banking Code and Advertising Standards Code, and moved from having its own adjudicator to using the Financial Ombudsman Service to deal with customer complaints. NS&I is also working to comply on a voluntary basis with relevant FSA regulations that relate to its dealings with customers. This approach has realised real benefits for customers, while enabling Government to continue to derive value from NS&I’s operations. It also brings NS&I further into line with retail financial services best practice.

5.12 NS&I will update the FSA biannually on progress against its plans, monitor and respond to relevant changes in FSA regulation and report on progress in its annual reports. This approach has been agreed with the FSA.

¹ In particular, NS&I products are governed by the National Savings Bank Act 1971, the National Debt Act 1972, and secondary legislation passed under those acts.

Incentives to save and invest

5.13 NS&I's single strategic objective is to reduce the cost to the taxpayer of Government borrowing. The review considered whether NS&I should specifically pursue any of the Government's current savings objectives as part of its core purpose.

5.14 Having examined a number of specific policies, the Review concluded that NS&I should not be required to promote savings as an end in its own right, as it would be unlikely to be cost-effective and could lead to adverse effects on the competitiveness of the retail savings market. However, NS&I should support future Government policy initiatives in cases where that is consistent with its core debt financing objective. The Review noted in particular that the current remit should not preclude NS&I allocating resources to fulfil corporate and social responsibilities appropriate to a major savings provider, such as support for financial capability.

5.15 The Review also examined the effects of the tax-treatment of NS&I's products. Unique tax-free products are a central element of NS&I's capacity to raise cost effective finance. However, the rates offered on these products take into account the tax the Government has foregone, so that the products are in fact cost neutral to the Exchequer. This means that lower rate taxpayers receive the same net returns as higher rate taxpayers, and that as a result higher rate taxpayers pay less in tax foregone than their individual tax-rate would require. The Review concluded that the scale of the effect on the taxation of lower rate compared to higher rate taxpayers was small both in absolute terms and in comparison to the impact of other tax-exempt savings policies. Furthermore, it was justified by the overall benefits in terms of lower debt finance costs to Government.

5.16 NS&I's differentiated product offerings may also encourage some additional savings at the margin and thus create incentives to save. The Government guarantee of NS&I products may also encourage some additional saving. The most differentiated product, Premium Bonds, is likely to create the greatest incentives since its uniqueness means that it may encourage people to save money that would otherwise have been consumed. The extent of any additional saving will be more limited the more people see Premium Bonds as substitutes for alternative savings products. The Review recognised that any incentive to save was a positive externality of NS&I pursuing its existing remit.

6

CORPORATE GOVERNANCE AND RISK MANAGEMENT

6.1 NS&I's governance arrangements combine relevant best practice from the corporate sector with fundamental practices of public accountability. In this context, the Review was able to identify two main areas for potential improvement:

- increased clarity over roles and responsibilities between the Treasury and NS&I; and
- stronger internal governance processes, in particular, stronger control of partnership agreements and the strengthening of the NS&I risk management function.

6.2 The Review found that NS&I's performance management systems and strategic planning processes operate effectively. NS&I has developed systems for provision of performance information to management, to the Board and to the Treasury. In addition, there is a structured business planning framework which is increasingly synchronised with that of the Treasury.

6.3 The Review noted that there was room for further development of NS&I's business continuity planning, and noted the importance of managing the risks around its controls over its business partners.

7

DELIVERING FUTURE GOVERNMENT OBJECTIVES

7.1 NS&I and the Debt Management Office (the DMO, which raises finance in the wholesale market) operate effectively together to deliver the Government’s financing requirements. NS&I currently makes annual financing projections which are updated in year where necessary. The Treasury sets NS&I annual Net Finance and Value Added targets at the start of each financial year. These are designed to deliver against cumulative five-year targets. This framework ensures that:

- agency performance is optimised through challenging but achievable short term targets while retaining a medium term strategic focus; and
- the Treasury can form clear expectations of debt finance contributions and costs over the medium term.

The Review concluded that this framework of annual and cumulative five-year targets should be retained.

7.2 The Review noted that the requirement to deliver Net Financing and an agreed level of sustainable Value Added did not provide a clear guide to NS&I of the Government’s preferences between the two targets. Government should therefore prioritise Value Added over Net Financing at the margin and the Treasury should set targets in future which make it clear that NS&I should target Value Added subject to an agreed amount of Net Financing. This change in emphasis should:

- achieve greater cost-effectiveness in the medium term by placing increased responsibility on NS&I for ensuring all financing is “value adding”;
- reduce variance in Net Financing outturn against targets, to facilitate the overall coordination of debt finance with the DMO; and
- reduce the risk of NS&I having a negative impact on individual competitors and the competitiveness of the retail savings and investments market as a whole, by de-emphasising growth.

7.3 The Treasury should retain the responsibility for setting interest rates on products, based on recommendations from NS&I.

7.4 The Value Added measure could be improved to more accurately reflect the cost effectiveness of NS&I finance.

7.5 The Review also considered the case for NS&I to introduce the Tax Deduction Scheme for Interest (TDSI), as the Exchequer faces a risk of tax going unpaid because NS&I does not operate the TDSI scheme on its taxable products. The Review concluded that NS&I should develop a business case for the implementation of the TDSI scheme.

8

LANDSCAPE REVIEW RECOMMENDATIONS

8.1 The Economic Secretary to the Treasury agreed the following recommendations:

- NS&I should maximise Value Added, subject to an agreed level of Net Financing and the delivery of fair value to customers, as part of its annual targets and next five-year strategy.
- NS&I should retain as its sole purpose a remit to raise cost effective debt finance. However, the Treasury recognises that NS&I should allocate appropriate resources to meet broader corporate social responsibilities in line with private sector practice in the financial services industry, drawing on partners where relevant.
- NS&I should retain its ability to offer unique tax free products.
- The Treasury expects NS&I to comply fully with FSA requirements where applicable and NS&I should extend compliance with FSA requirements on a voluntary basis.
- The Treasury should ensure that it is aware of the impact of NS&I on the wider retail financial savings market when setting financing targets. NS&I should ensure that it mitigates its impact through more transparent communication and reporting of overall aims and objectives, tax forgone, all key future targets, and a public quarterly business update.
- NS&I and the Treasury should review issues of corporate governance, performance and risk management, both internally to NS&I and between NS&I and the Treasury.
- NS&I should amend the measurement of Value Added in consultation with Treasury in order to present as accurate a measurement as possible.
- NS&I should develop a business case to evaluate adoption of the Tax Deduction Scheme for Interest.
- NS&I should develop a revised corporate strategy to deliver the Government's debt finance objectives to 2010-11, incorporating the conclusions of this Review.

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