Pointmaker

NO TO UNDERWRITING

HOW THE COALITION CAN AVOID BEING RIPPED OFF

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SUMMARY

- The Coalition is expected to sell some or all of the Government's £66 billion holdings in RBS and Lloyds TSB once stock market conditions recover and once the banks themselves are restored to reasonable health.
- Particularly at a time of general distrust, the Coalition must ensure that any sale is handled in a way which maximises benefits to the taxpayer, either as direct proceeds or partly by the issue of free or favourably priced shares to the general public.
- Privatisation was a great idea. It had a huge success in its intended primary aim of converting bureaucracies into successful competitive businesses. However, about 15% of the potential proceeds were lost through under-pricing, and half of this (£2.5 billion) was creamed off by an underwriting cartel.
- Some in the financial community will be hoping that a traditional sale of the bank shares will yield similarly lucrative opportunities.
- This paper suggests a way of ensuring that the Coalition maximises the proceeds from an orthodox sale and explains how some part of this potential could be given to individual shareholders. Over £3 billion could be saved for HM Treasury.
- Self-seeking actions by a few members of the financial community must take much of the blame for the financial crisis. In some cases, the most guilty institutions have proved to be the major beneficiaries of the remedial actions taken. The British public, already understandably cynical about the banks, will not forgive the Coalition if this happens with the sale of the bank shares.
- The distribution process must therefore be transparent and not open to exploitation by financial intermediaries. Above all, unnecessarily expensive underwriting practices should be avoided.

1. INTRODUCTION

Traditionally in the UK, there have been three methods of making an Initial Public Offering, namely:

- “Placings”, where the shares are offered at a fixed price to investors, usually fixed by the sponsoring bank or broker;
- “Offers for sale”, made publicly and at a fixed price, and generally underwritten; and
- “Tenders”, where the shares are offered to the highest bidder.

Placings give profitable patronage opportunities to intermediaries, and therefore tend to be under-priced. Generally, placings give the worst outcome for the client and regulators have tried to prohibit them. Offers for sale seem more open but the sponsors take great care to make sure that they are under-priced so that their underwriting commissions are unlikely to result in a loss. Although these opportunities need to appear widely spread, a proportion can be allocated to `friends,’ as discussed below. Tenders are normally the best option (at least for major vendors) but, being hated by financial intermediaries, have been rare.

2. EARLIER UK PRIVATISATIONS

British Telecom, although theoretically an `offer for sale’, was in fact a disguised partial `placing’. The Government raised £3.9 billion, before disclosed expenses, for shares valued by the market on opening at £5.2 billion. The shares were therefore under-priced by an astonishing (for those days) 33%. Only about 35% of this windfall went to the general investing public: existing private investors, who received only a trivial holding, were effectively excluded from the issue. The rest had been either quietly pre-placed with "Priority Applicants" (City Institutions) or offered as part of a separate international offering. These between them pocketed about £800 million in addition to disclosed fees.

This was a substantial and an unnecessary loss to the Government. Advice on both structure and under-pricing was given by the very institutions which benefited at the expense of the Government, their client. Following the later damning experience of the `Water’ issue, and thanks to the support of John (later Lord) Wakeham, the Minister, and John (later Sir John) Guinness, his Permanent Secretary, the procedures were handled much more carefully from the Electricity issues onwards.

Meanwhile the loss to the `government as vendor’ from a blatant conflict of interest had risen threefold. Overall, the public purse received £30.7 billion (again, *before* disclosed expenses) but the value of the shares sold in initial dealings was £36.0 billion, the offers being underpriced by £5.3 billion (15%). Of this, £2.6 billion went to individual public applicants (contributing to wider share ownership) but slightly more, £2.7 billion, went to the `priority applicants’.

These issue procedures were in breach of Stock Exchange rules, designed to prohibit placings for all but the smallest issues. When this was pointed out, the Stock Exchange set up the Ross Russell Committee. Taking the side of the financial institutions, this proposed that the rules be changed to meet the practice.

3. AN ALTERNATIVE

The following procedure would enable the Coalition to benefit from all the advantages of tenders, while avoiding the dangers of placings.

1. Treat the (substantial) work of drawing up the prospectus as a professional

assignment to be carried out for negotiated fees. This already happens in the present practice and is not normally a deduction from the percentage charged by intermediaries. Negotiations should be handled on a competitive basis directly by the Coalition and should not be allowed to be yet another source of patronage for intermediaries.

2. Take advice on the conceptual aspects of the issue, such as the capital structure, from independent fee-paid advisers (which might include academic economists) and of course the expertise available within the Treasury, the Bank of England, and the Select Committees in both Houses of Parliament. The investment community would of course be asked for their views, but these should not dominate.

3. A political decision would be needed on how much of the issue is to be offered to investors at the maximum available price and how much would be retained on favourable terms for small individual investors. The Coalition may also wish to consider the cogent recommendations made in an earlier CPS paper and give a large proportion of shares directly to the public in order to avoid the dangers of an overhang in the share price.[1]

4. The Coalition or its agent would advertise, seeking tender offers from *all* investors, domestic and foreign, institutional and private, with the minimum application set above the maximum likely allocation to small investors. This would do away with the problem of the early privatisation procedures which effectively excluded substantial private investors, not on the underwriting list, from obtaining more than for what was, for them, a trivial holding at the offer price. Private investors would normally apply through banks or brokers (who could be offered a modest commission) but might also be encouraged to make a direct application accompanied by a returnable deposit.

5. Following this, the general public would be offered an opportunity to acquire fairly small holdings at a discount conditional upon the shares being held for a minimum period. There are a wide range of possibilities here that could be considered.

The cost from underpricing, to the government as vendors, of the privatisations discussed was about 15%. Recent activities in the new issue market suggest that the ambitions of the banks likely to be advising the Government in the sale of RBS and Lloyds shares remain undiminished. It may be possible to reduce this cost to around 10%, but cutting out unnecessary intermediation (as suggested here) could get this well below 5%. Some of this could be shared with the investing public – but in a far more targeted way than was used in these old issues. Assuming the Government aims to recover the £66 billion it paid for the shares, a five percentage point saving could be worth £3.3 billion.

4. REDUCING THE NEED FOR UNDERWRITING

This procedure would maximise proceeds to the Treasury and could in principle reduce the need for underwriting. Obviously, we cannot and should not eliminate underwriting for all share issues but if this procedure can be effectively used once, it would set a good example and encourage private issuers in general to insist on a more transparent and competitive procedure than we have seen recently. Although the institutions *might* still succeed in threatening private issuers with a

[1] J Conway et al., *Give us our fair shares*, CPS, 2011.

boycott of the issue, a determined government could surely face them down.

5. WHY HAS THE UNDERWRITING PROBLEM PERSISTED?

Underwriting is needed in many cases. Historically it appears usually to have been a fair charge for a service. More recently, it has often become unnecessarily expensive and has encouraged the deliberate mispricing of issues.

Faced with the criticism that so much of the benefit of under-pricing had gone to financial institutions, the latter argued vigorously that this did not matter as it was claimed that the ultimate benefit accrued to pensioners, investment fund holders and other members of the public. There are three counterarguments.

First, it should be contrary to public policy to give artificial benefits, tax or otherwise, to institutions who should sell their services on supposedly superior performance. Such incentives are at least partly responsible for the decline of the private investor and expansion of large institutional ones which have not always served their beneficiaries, and the interests of good corporate governance, as well as they might.

Secondly, and more seriously, there was little to prevent the lead bankers doling out some of the "priority applicant" privileged shares, to their own firm, its senior management and their friends. Indeed, City gossip during the 1980s privatisations suggested that this was happening (diverting even 5% of the proceeds would have amounted to over £100 million).

Thirdly, even though most of the beneficiaries went to pension, insurance and investment funds, there was certainly some scope for giving more generous allocations to those who gave, or promised to give, reciprocal profitable business to the managers of the issue. The example of the privatisation of water industry illustrates this point. It was reorganised into 10 regional companies, whose shares would trade separately. The public could apply for shares in any or all of them – but as usual only for 44%. Most of the rest were offered to UK "priority applicants" as package units. On the first dealings, there were substantial sales – which could only have come from the "priority applicants" out for a quick profit. This evidence was enough to convince the Ministry sponsoring the later electricity sales that there was a real problem which needed to be (and was) addressed.

6. LESSONS FROM THE BP SALE

The 1989 sale of the Government's remaining holding of BP was (like the forthcoming bank share sales) of shares already listed. There were no priority applicants but some of the shares were issued as rights to existing shareholders. The rest were offered to the public at a price of 330p, payable in instalments coming to (in present value) about 306p, a discount of 13% on the market price of 352p on 15 October when the price was fixed. The real mischief here was that underwriters were paid 1% (3.3p) for what seemed a trivial risk.

19 October was "Black Monday" when there was a general collapse of share prices leaving the underwriters earning their keep for once. Even so, there was pressure for the issue to be pulled, releasing them from their commitments. This was rightly resisted. Insofar as the underwriting had been placed with institutional investors it would have added less than 1% to their total exposure to the crash – those who complained were obviously the market insiders who had pocketed a slice of this apparently great deal for themselves.

7. TWO OTHER RECENT CASES

There are many more recent examples of unnecessarily expensive underwriting but two notorious cases stand out.

National Grid announced on 20 May 2010 a fully underwritten rights issue to raise £3.2 billion by a rights issue at 335p. The underwriters were to be paid a commission of 2% with an extra 0.75% at the company's discretion. The underwriters stood to make £62 million without, or £86 million with, this extra. What risk did they take? As the ex-rights price at the time of fixing was 493p, the share price would have had to fall by 32% for the underwriters to need to take anything up.

The Prudential case was even worse. The company made a deep discounted rights issue at 104p (for shares standing at 171p ex-rights) to acquire the Asian arm of AIG. This would raise £14.5 billion. For taking this non-risk, the underwriters were paid 2.5%, and the Joint Global Co-ordinators 0.25%, a total cost to the company of £400 million. The deal was cancelled but this, and a further £50 million fees to advisers was still paid. For what?

8. CONCLUSION

As soon as market conditions stabilise, and as soon as the banks are themselves in a healthy condition, the Coalition must do all it can to return the shares it bought in the banks to private investors as speedily as possible, and at the best price. It must also wrestle with issues such as encouraging far more competitiveness in the banking sector, addressing "too big to fail" problems and soothing (often justified) public concerns over bankers' pay and bonuses.

None of the above will be easy, not least as there are many competing tensions at play. But in one area, the Coalition does have an easy decision: it should ensure that the sale of the bank shares is made transparently and cheaply by using the tender process described above and avoiding the unnecessary expense of underwriting fees.

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IDEAS MATTER

The following proposals, all originally advocated by the Centre for Policy Studies, are a selection of those which have recently been adopted by the Coalition:

- Increasing tax allowances to £10,000: proposals to increase tax allowances to £10,000 – and to lift millions of people out of paying tax – were first made by Maurice Saatchi and Peter Warburton in *Poor People! Stop Paying Tax!* in 2001.
- Corporation Tax: the 2011 Budget reduced the main rate of corporation tax by 2% this year, with commitments for further 1% reductions each year until the end of the Parliament. Michael Forsyth and Corin Taylor emphasised the pressing need for lower corporation tax in *Go For Growth.*
- Merging NICS and Income Tax: in the 2011 Budget, the Government announced that it will consult on a proposal to merge the operation of NICs and Income Tax. The recommendation to merge the two and simplify the UK's complicated personal tax system was outlined by David Martin in *Abolish NICs.*
- Tax simplification: the Coalition has announced plans for simplifying the tax system, taking up many of the proposals made by Lord Forsyth in his Tax Simplification Committee report, *Tax Matters*, and by David Martin in *Tax Simplification: how and why it must be done* (2007).
- Enterprise Investment Schemes and Transitional Enterprise Zones: these Coalition policies were originally recommended by Charlie Elphicke in *Ten Points for Growth.*
- Abolition of the tripartite regulatory regime: recommendations to abolish the tripartite regulatory regime were first put forward by Sir Martin Jacomb in his 2009 CPS report, *Re-empower the Bank of England.*
- Pension Tax Relief: following Michael Johnson's report *Simplification is the Key*, the Treasury has announced that the annual contribution limit is to be reduced from £500,000 to between £50,000 and £30,000.
- Benefit simplification: proposals for simplification of the benefit system and proposals in the Welfare Reform Bill to reduce the scope for fraud and error both followed the central recommendation of *Benefit Simplification: why and how it must be done* by David Martin (2009).
- Transparent public finances: the decision of the OBR to publish its Fiscal Sustainability Report follows repeated calls from the CPS for greater transparency in government accounting of public sector pensions and PFI liabilities, as highlighted by Brooks Newmark in our *Hidden Debt Bombshell* publications.
- Access to public data: CPS author and fellow Liam Maxwell has now been appointed to the Cabinet Office to implement the policy that he first recommended in his CPS paper *It's Ours: Why we, not government, must own our data*, to allow individuals greater control of personal data.

THE AUTHOR

John Chown, a lifelong supporter of free markets and advocate of the role of capital markets, is a monetary economist and an expert in international tax at both the professional and public policy level. He was a co-founder of the Institute for Fiscal Studies and has advised the Russian and other governments on capital market taxation. He has served on the Technical Committee of the Association of Corporate Treasurers, one of whose tasks was to educate treasurers in getting value for money from the financial services industry. He has been a regular reviewer for the Times Literary Supplement and Central Banking. He gave evidence to OFT enquiries in 1997 and 2010 on underwriting procedures and to the New York Stock Exchange enquiry in 2001.

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