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The creation and sale of Northern Rock plc

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The creation and sale of Northern Rock plc

Key facts

£4.5bn–£6bn	£1.4bn	£480m
estimated additional capital needed in 2008 if Northern Rock continued in its original form	permanent share capital injected into Northern Rock plc by the taxpayer at the start of 2010	midpoint of estimated loss on the creation and sale of Northern Rock plc

£20.6 billion	customer deposits transferred to Northern Rock plc on 1 January 2010
£15 billion	October 2009 business plan target for new gross mortgage lending by Northern Rock plc in 2010 and 2011, the first two years of operation
£9.1 billion	actual new gross lending, in subdued markets, during 2010 and 2011
December 2013	state aid deadline for sale of Northern Rock plc
3.5 per cent to 4.5 per cent	the nominal annual return currently expected on the cash support provided to Northern Rock since 2007. UK Financial Investments Ltd (UKFI) currently expects that the taxpayer will recover the total cash support of £37 billion and a further sum of between £9 billion and £11 billion over the next 10 to 15 years. This means that, in purely cash terms, the taxpayer will recover both the loss on sale and the cost of supporting Northern Rock, including the finance cost of the gilts issued to raise the cash provided, estimated at around 4 per cent a year
£2 billion	projected net present cost of overall support to Northern Rock since 2007 calculated by UKFI – the above rate of return of 3.5 per cent to 4.5 per cent a year is not sufficient to cover the return which a private sector investor would require for the risks taken on or the public sector discount rate which would take account of the deferred receipt of proceeds, both of which are approximately 6 per cent a year

Northern Rock nationalised in February 2008

Loss of £1.4 billion to December 2008

Northern Rock in 2009

Loses a further £0.3 billion in the year to December 2009

Needs £4.5 billion to £6 billion of new capital to continue operating as a bank

Treasury choose to split the bank into two businesses to reduce the amount of new capital required and deliver mortgage lending

Northern Rock plc January 2010

Taxpayer equity £1.4 billion

Customer accounts of £21 billion matched by £10 billion higher-quality mortgages and £11 billion cash

Expected to lend up to £15 billion in first two years of operation

Must be returned to private ownership by December 2013

Losses reduce taxpayer equity by £248 million[1] by the end of 2011

Not expected to be profitable for several years

Lends only £9.1 billion[1]

Sold to Virgin Money in late 2011

A total loss of £480 million[1] on the £1.4 billion taxpayer equity provided in 2010

Northern Rock (Asset Management) plc January 2010

Liabilities include £23 billion outstanding taxpayer loan

No new lending

Remaining £54 billion of mortgages to be gradually wound down

Total profits before tax of £1 billion in 2010 and 2011

Future redemptions of mortgages and realisation of net assets on final wind-down expected to repay the support provided

Taken together

UKFI currently expects the taxpayer to recover the loss on the sale of Northern Rock plc, all the cash used to rescue Northern Rock plus its associated finance cost over a number of years

However, there may be a net present cost of £2 billion if risk and deferred proceeds are considered

NOTE

1 Latest available estimate of Northern Rock plc's lending, 2011 book value and the midpoint of the loss on the sale.

Summary

1 To protect the taxpayer and maintain financial stability, the government nationalised Northern Rock in February 2008. At the time, the bank had assets of just over £100 billion, government guarantees covering customer deposits and an outstanding emergency loan from the government of over £25 billion. In public ownership, Northern Rock was expected to run down its mortgage assets to repay the emergency loan and the deposit guarantees would be removed by the end of 2011. Northern Rock would then enter a period of growth, followed by a return of the business to the private sector.

2 In July 2008, following higher than expected losses, Northern Rock asked the Treasury for £3 billion of additional share capital, potentially increasing to between £4.5 billion and £6 billion if expected losses increased. The Treasury reviewed its options and rejected both immediate closure and continuation of the original plan as poor value for money. The two remaining options reduced the amount of extra capital required by Northern Rock and consequent risk for the taxpayer. The options were:

- **Sell the deposits** to another bank and wind-down all the remaining mortgage assets in a separate, publicly-owned company.
- **Split Northern Rock into two new businesses** by creating Northern Rock plc, a deposit-taking and mortgage-providing bank that could be returned to private sector ownership and Northern Rock (Asset Management) plc (NRAM), to retain in public ownership the majority of the outstanding mortgages that would be wound down.

3 The government decided to implement the split option. The new stand-alone bank would re-enter the mortgage market at a time when lending was falling. During 2009, the Treasury obtained regulatory approval from the Financial Services Authority (FSA) and approval from the European Commission on state aid grounds for the split. On 1 January 2010, the existing £21 billion of retail deposits, matched by £10 billion of the best performing mortgages and £11 billion of cash, were transferred to Northern Rock plc.

4 In 2010, oversight of the new companies transferred to UK Financial Investments Ltd (UKFI). UKFI is a Treasury-owned company responsible for the management of the Treasury's interests in the financial institutions supported directly by the taxpayer. In considering options for the future of Northern Rock, UKFI's objective was to protect and create value for the taxpayer as shareholder and provider of financial support, having regard to financial stability and competition.

5 Following a competition organised by UKFI, the Treasury sold Northern Rock plc at the end of 2011 to Virgin Money for between £863 million and £977 million, depending on the size and timing of future payments agreed as part of the sale.

Scope of this report

6 This report examines:

- the Treasury's decision to create Northern Rock plc;
- the financial performance of Northern Rock plc while in public ownership; and
- whether the sale of Northern Rock plc was the best available option and whether the sale process was handled well.

7 Our methodology is summarised at Appendix One.

8 The report also includes a summary of UKFI's latest estimates of the expected cash flows from NRAM as it winds down the much larger pool of assets retained in public ownership.

Key findings

Creating Northern Rock plc

9 **The Treasury faced significant challenges when considering its strategy.** These challenges included: very serious economic uncertainty at the height of the financial crisis in late 2008 and early 2009; uncertainty around Northern Rock's forecast results; the need to retain and motivate the Northern Rock management team recruited after nationalisation; uncertainty about the impact of impending regulatory changes on the amount and form of capital required; and uncertainty around state aid clearance by the European Commission.

10 **The Treasury did not undertake detailed due diligence before announcing the decision to split the bank or revisit the decision afterwards in 2009.** The decision to split the bank was based on a business plan prepared by Northern Rock management which events quickly showed to have been optimistic. Splitting Northern Rock took longer than anticipated and actual lending was falling short of targets. Nonetheless, the Treasury proceeded to implement the split option without any further detailed analysis of the consequences for the taxpayer. However, our analysis indicates that there remained little difference in financial terms between splitting the bank and selling the deposits.

11 **The Treasury had little flexibility in meeting the capital requirements set for Northern Rock plc by the FSA.** The amount of capital needed by Northern Rock plc was based on the main risks it faced, including implementation of the split and future losses. On the basis of Northern Rock plc's approved business plan, the FSA required the Treasury to purchase £1.4 billion of new permanent ordinary shares in Northern Rock plc.

Performance while in public ownership and preparing for a sale

12 **Northern Rock plc fell short of its lending targets for 2010 and 2011.** Gross mortgage lending for the first two years totalled £9.1 billion, below the £15 billion target in the October 2009 business plan. After taking account of repayments by existing borrowers, net lending of £3.7 billion by Northern Rock plc was equivalent to 22 per cent of all net lending on mortgages in a subdued market during 2010–2011.

13 **Northern Rock plc incurred losses of £248 million which were higher than expected.** The higher losses were incurred because interest rates were lower than anticipated. The cash not used for lending was invested in relatively low-yielding assets and could not be returned to the taxpayer while Northern Rock plc was making losses.

14 **A sale at the earliest opportunity was the best available option to minimise losses.** In 2011, UKFI reviewed a full range of options for the future of Northern Rock plc and concluded that a sale as soon as possible would limit further losses for the taxpayer. As Northern Rock plc was loss-making and unlikely to become profitable before 2013 at the earliest, all disposal options considered by UKFI were expected to result in a further loss for the taxpayer. Options such as turning Northern Rock into a building society or selling shares on the stock exchange were forecast to yield much lower proceeds than a sale to another financial institution.

The sale itself

15 **UKFI handled the sale process well.** Bidders were positive about the sale process, describing it as transparent and fair. Competitive tension was maintained with two final bidders who remained aware that UKFI had alternative means of disposing of Northern Rock plc. In final negotiations, UKFI improved the overall offer from Virgin Money.

16 **The taxpayer is expected to lose a total of £480 million on the original investment of £1.4 billion in Northern Rock plc.** In addition to the £248 million loss in value before the sale, the taxpayer lost a further £232 million at the point of sale. The price paid by Virgin Money represented 80 per cent to 90 per cent of the excess of assets over liabilities (or book value) of £1.1 billion at the time of the sale. Our analysis of the price paid indicates that it compares well with market prices for major UK banks of around 50 per cent of book value. At a discount to book value, the sale price anticipated further losses expected in Northern Rock plc but also reflected a strategic opportunity for Virgin Money to expand its banking operations immediately.

17 After the sale, Virgin Money transferred one of its subsidiaries to Northern Rock plc, freeing cash to fund part of the purchase price. As a stand-alone business, Northern Rock plc was not profitable and the Treasury could not extract any capital in the form of cash before a sale. Combining Northern Rock plc with Virgin Money's profitable operations enabled cash to be released after the sale. It is not possible to separate the value paid by Virgin Money for this cash from the price paid for the business as a whole. Virgin Money told us that it paid full value for the cash released from Northern Rock plc which it used to part-fund the purchase. Our analysis shows that, if the cash freed-up is ascribed full value, the price paid by Virgin Money for the other assets in Northern Rock plc still remains above the market prices of other UK banks, indicating that the price achieved was reasonable.

Northern Rock assets retained in public ownership

18 UKFI currently expects to recover all the support provided to Northern Rock. Most of Northern Rock's assets will remain in public ownership for many years until all the mortgages have been paid off or can be sold to another financial institution. Low interest rates, lower than expected mortgage defaults and actions taken by UKFI since the split have improved the value of the assets. UKFI now expects that the taxpayer will recover all the support provided, including the £1.4 billion invested in Northern Rock plc. It expects the taxpayer will also earn a nominal return of between 3.5 per cent and 4.5 per cent a year, more or less equivalent to the cost to the government of financing the support provided, estimated at around 4 per cent a year.

19 However, there could be a net present cost of some £2 billion on the support. Repayments of the support provided to Northern Rock will be spread over many years and subject to the risk of changes in economic conditions. A private sector investor would require a higher rate of return as compensation for the risks taken on. This is greater than the nominal return of 3.5 per cent to 4.5 per cent which UKFI expects the Treasury to receive. Applying a higher discount rate of 6 per cent a year to the cash flows implies that there may be a net present cost for the taxpayer of some £2 billion by the time the assets are fully wound down.

Conclusion on value for money

20 During the financial crisis, the decision to create a vehicle which had the potential to support mortgage lending was reasonable. In two years of public ownership, Northern Rock plc failed to meet lending targets or deliver the financial performance expected. But no alternative was likely to have been significantly better either in financial terms or in supporting mortgage lending. Although the sale to Virgin Money generated a loss for the taxpayer, it was the best available option to minimise future losses and UKFI handled the sale process well. On this basis, value for money was preserved.

21 The value for money of the overall intervention to support Northern Rock plc depends on the effective management of the larger pool of assets and liabilities remaining in public ownership in NRAM. In purely cash terms, UKFI currently expects that the taxpayer will recover all of the support provided, including the losses associated with Northern Rock plc, as these assets are realised. However, if account is taken of the timing of the expected receipts and risks taken on, there may be a net present cost for the taxpayer of some £2 billion. This should be seen as part of the overall cost of securing the benefits of financial stability during the financial crisis.

Recommendations

a **Given the scale and urgency of the banking crisis, the Treasury lacked sufficient in-house capacity to make the best use of external advice and challenge Northern Rock management effectively.** Departments need sufficient capacity and expertise to be available within government to detect and make effective challenges to over-optimism in business plans. This is particularly important, as in this case, where such business plans require substantial amounts of taxpayer funds to be put at risk. We recognise that in relation to its stakes in banks, the Treasury created UKFI as a source of expert banking advice.

b **Where delays occur before a particular course of action can be implemented, it is essential that departments re-evaluate options before proceeding.** The decision to create Northern Rock plc was taken in January 2009 but the new business took nearly a year to get up and running. Economic conditions and the regulatory environment were changing and business plans were looking over-optimistic, but no formal re-evaluation was undertaken. In our view, the Treasury would have benefited from more effective arrangements for internal challenge of its plans in 2009.

c **When analysing options for restructuring or realising public assets, departments need to have expertise available, preferably within their corporate structure as well as by hiring appropriate external advisers.** The expertise available within UKFI was crucial to the sale process. This was important because UKFI had a clear remit to obtain value for the taxpayer and would be accountable for doing so. While external assistance was needed to administer the sale process, such external help is no replacement for in-house expertise.

d **The Treasury and its advisers should continue to monitor the performance of NRAM and ensure that it has the incentives and resources required to optimise returns for the taxpayer over the longer term.** Returns from the assets still in public ownership have benefited from low interest rates and lower than expected defaults on mortgages but such economic conditions may not persist for the many years these assets are expected to remain with the taxpayer.