National Audit Office

HM TREASURY

The nationalisation of Northern Rock

REPORT BY THE COMPTROLLER AND AUDITOR GENERAL | HC 298 Session 2008-2009 | 20 March 2009

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18 March 2009

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Cover photograph of Northern Rock branch, Stockport town centre, Greater Manchester, courtesy of Alamy.com

SUMMARY

1 Over the ten years to 2007, Northern Rock (the company) had become a stock market listed bank and grown rapidly to become the fifth largest provider of mortgages in the UK, with assets in excess of £100 billion. The company's growth was based on making competitively priced mortgages easily available. To maintain its competitiveness, Northern Rock required access to relatively low cost sources of funds, beyond what could be raised through retail deposits alone.

2 To raise the funds it needed, Northern Rock became reliant on wholesale lenders such as other banks and on selling, rather than retaining, the mortgages it had already issued. In August 2007, credit concerns stemming from bad debts in the US mortgage market caused banks to curb their lending to each other. As a result, Northern Rock began to experience problems in raising short term funds and rolling over existing loans from wholesale lenders. As the market worsened, the company became increasingly concerned that it would not be able to repay its wholesale borrowings as they became due, and asked the Bank of England (the Bank) for financial support in its role of lender of last resort.

3 The failure of a major bank would leave individuals and businesses unable to access savings or meet ongoing payment obligations. A single bank failure has the potential to destabilise other parts of the financial system and the economy generally, through its wider impact on consumer confidence. As banks are pivotal to the financial stability of the UK economy, successive governments have sought to regulate their activities.

4 The Financial Services and Markets Act 2000 created a single regulator for UK financial services, the Financial Services Authority (FSA). Alongside this, the Government also introduced a framework for the protection of financial stability, which set out the roles of the Treasury, the FSA, and the Bank of England (the Tripartite Authorities). In exceptional circumstances such as a major bank in severe financial difficulty, responsibility for the authorisation of a support operation and the use of public funds rests with the Treasury.

5 On 14 September 2007, Northern Rock announced that the Treasury had authorised the Bank to provide emergency support to Northern Rock, in the form of a loan secured against the company's highest quality assets. When Northern Rock's customers became aware of the existence of the support, queues formed outside the company's branches and, over a few days, just over £4.6 billion was withdrawn from depositors' accounts. The Treasury considered that the run on deposits could have an adverse effect on other banks. In response, the Treasury announced on 17 September 2007 that it would put in place arrangements to guarantee retail deposits. These arrangements were subsequently extended to certain wholesale funding and to further emergency support provided by the Bank. The guarantee arrangements covered up to £51 billion of the company's liabilities and allowed Northern Rock time to seek a longer term solution to its difficulties. The search culminated in the company being taken into public ownership in February 2008 **(Figure 1)**. A more detailed chronology of events is at Appendix 1.

1 Summary of key phases in the search for a solution

September – December 2007 | **January – March 2008** | **April 2008**

Stabilisation: In September 2007, the Treasury put in place arrangements to guarantee retail customer deposits and many of the company's wholesale deposits and borrowings. In October, the Bank, indeminfied by the Treasury, made additional support available to Northern Rock and over the course of the following two months the Treasury increased the coverage and scale of its guarantee arrangements.

Search for a long term solution: Following the failure of attempts by Northern Rock to find a buyer, a number of further private sector proposals for the whole or parts of the company were considered, but no private bidder was able to raise the necessary finance to proceed on either basis. In January 2008, the Treasury announced that it would guarantee an issue of bonds by the company to allow a private sector buyer to raise funds and repay the emergency support. Two private sector proposals were received but would have required the Treasury to risk large sums of publc money over an extended period and offered little benefit to the taxpayer in return. In February 2008, the Treasury concluded that the company should be brought into public ownership.

In **public ownership** during 2008 Northern Rock made progress against a three-year plan to repay the emergency support and release the Treasury guarantee arrangements by 2011-12. This was to be achieved primarily by encouraging the early redemption of mortgages, with the aim of a return to private ownership thereafter. In early 2009, to provide support to the wider economy, the Government announced that Northern Rock would increase its mortgage lending activity.

6 The actions taken by the Treasury, working with the other members of the Tripartite, were aimed at:

- **reducing the risk of a serious loss of confidence in the UK banking system, which would have caused wider economic disruption**. The Treasury needed to ensure that Northern Rock's depositors remained confident that their savings would be safe, and that customers of other banks were not prompted to withdraw their savings;
- **minimising the financial risk to the taxpayer** that substantial, taxpayer-backed support to a bank in difficulty would be called or not be repaid.

Scope of this report

7 This report examines:

- actions taken by the Treasury to stabilise Northern Rock and avoid any wider impacts on the financial system (Part 1);
- the search for a longer term solution to Northern Rock's difficulties that protected the interests of the taxpayer (Part 2);
- the oversight of Northern Rock in public ownership (Part 3);
- the capacity of the Treasury to handle a company restructuring which was unusual and highly complex (Part 4).

8 Our methodology is summarised at Appendix 2. This report does not consider:

- the causes of Northern Rock's problems and the implications for the regulatory regime operated by the Financial Services Authority, both of which are outside our statutory audit responsibilities and have been examined in detail by the House of Commons Treasury Committee (see Appendix 3); or
- the consequences for the Bank of England's oversight of stability in the financial system, which is also outside our statutory audit and, along with changes to the framework for handling banks in difficulty, are the subject of the Banking Act 2009.

Key findings

On the actions taken to stabilise the company

9 The Treasury had no choice but to put in place guarantee arrangements for retail depositors, once the run on deposits was underway. This support avoided the immediate risk of instability spreading to other banks. Following media reporting and the company's announcement of the emergency loan from the Bank, retail depositors withdrew around one fifth of their deposits over three days, the share price fell by more than half, and the cost of insuring against default by the company increased. The run on deposits was widely reported, including images of queues of retail customers outside branches. The Treasury decided that there was an increased risk of contagion in the financial markets and that further measures were necessary to maintain stability. The guarantee arrangements put in place removed the queues outside branches, reduced media coverage and avoided immediate potential problems at other banks.

10 Although the initial guarantee arrangements prevented wider financial instability, they did not completely stem the outflow of funds from Northern Rock. From 18 September 2007 to the end of that month, a further £4.4 billion of retail deposits was withdrawn. These outflows necessitated additional borrowing from the Bank and required further guarantee arrangements for deposits and certain wholesale borrowing to be made over subsequent months, all backed by the taxpayer. With each decision to extend public support, the Treasury's intention was to put taxpayers' money at risk only to the extent necessary to stabilise the situation. While the situation did eventually stabilise, the company's finances remained vulnerable.

11 Under the terms of the loans provided by the Bank, Northern Rock was required to put in place a plan to stabilise its business by conserving cash, primarily by reducing the number of mortgages written. The company also required the Bank's approval before entering into any corporate restructuring, making substantial changes to the general nature of its business and paying dividends. The Bank put in place arrangements to monitor compliance with the stabilisation plan and had wide ranging rights to information on Northern Rock's business. **Given the extent of the financial assistance provided from October 2007, the Treasury could have sought to introduce further conditions to limit the company's activities, for example on the risk profile of lending undertaken**.

12 Northern Rock continued to write Together mortgages of up to 125 per cent of a property's value throughout the period that it was receiving emergency support, albeit at a reduced volume. Between September 2007 and February 2008, over £1.8 billion of Together loans were written, around 30 per cent of total mortgage lending, compared with just under £5 billion (26 per cent of total mortgage lending) in the preceding eight months of 2007. Around £1 billion of these new mortgages reflected commitments made by the company to potential borrowers prior to September 2007. As part of the company's stabilisation plan, the terms for Together loans were tightened by the company in October and November 2007. At 31 December 2008, Together mortgages represented around 30 per cent of the mortgage book but about 50 per cent of overall arrears and 75 per cent of repossessions. The Treasury judged that mortgage transactions were necessary to maintain the business while a longer term solution was sought.

13 Indefinite and unlimited public support for Northern Rock was not an option that was available or desirable. Under the European Union rules on state aid, the emergency support provided to Northern Rock had to be notified to the European Commission. The Commission considered that the guarantee arrangements provided by the Treasury were permissible but could not remain in place for more than six months, unless the Treasury submitted a restructuring or liquidation plan by March 2008. In any event, it would not have been in the taxpayers' interest to continue to fund and bear the commercial risks of a private company over which the Treasury had limited control. The Treasury therefore had to find a longer term solution by March 2008.

On the search for a longer term solution

14 The Treasury set itself objectives at an early stage: to protect the taxpayers' interest; keep the company stable to protect depositors; and maintain wider financial stability. The Treasury had to operate under a number of constraints: it needed to be aware of how its actions might be interpreted by volatile financial markets; not put itself in the position of controlling the actions of the company as a shadow director; remain aware of shareholders' rights; and find a solution that would be consistent with European Union state aid rules.

15 In late September 2007, the Treasury identified through a systematic assessment of the available options essentially three choices:

- allowing Northern Rock to fall into administration;
- stopping it taking deposits and writing new mortgages and beginning a process of winding down the company; or
- allowing it to continue to take deposits and write new mortgages while putting in place a longer term recovery plan which would keep the company in business.

A wind-down or a continuation of business could be taken forward with Northern Rock remaining in the private sector, probably under new ownership, or by taking the business into public ownership.

16 Allowing Northern Rock to fall into administration would have prevented depositors from accessing their money and entailed potential taxpayer losses of between £2 billion and £10 billion. There were no special procedures under UK law that would allow depositors in a bank to be treated any differently from the creditors of another private sector business in difficulty. Allowing Northern Rock to enter an insolvency procedure would therefore have resulted in depositors not having access to their savings for a period of months, thereby risking a loss of confidence at other banks and hardship for individuals. The Treasury was also concerned that a rapid sale of the company's assets at reduced prices might mean that part of the emergency support was not repaid. The Treasury and its advisers estimated a potential loss of between £2 billion and £10 billion, the wide range reflecting the uncertainties in estimating the prices that might be obtained for the company's assets.

17 The option of winding down the business was considered, but inadequate IT systems at Northern Rock meant that depositors would have had to wait for their money, risking another major run and potential hardship for those reliant on access to their funds. A wind-down of the business would have involved a sale of the branches, deposits and some of the mortgages to another bank, followed by longer term disposals of the remaining assets to repay creditors. If the sale of the deposits and branches proved impossible, the alternative would have been to implement a scheme for rapid repayment of retail and wholesale deposit accounts. Northern Rock was not, however, able to return depositors' cash quickly. The company operated a manual account closure process and estimated that it would have taken up to 10 to 12 weeks to repay depositors with a likely error rate of 25 per cent. The scope for securing better prices through a more controlled and longer term series of asset sales would have depended on financial market conditions not deteriorating further. The Treasury therefore ruled out an immediate wind-down on practical grounds, although work was put in hand to update the IT systems to enable quicker repayment of depositors if needed at a later stage.

18 In September 2007, the Treasury took a timely decision to commission a team of officials to work on proposals for public ownership, as a contingency measure. While the Treasury considered that public ownership would provide the control over the company necessary to protect the interests of the taxpayer, it did not see it as an immediate response as other options were preferable and should be considered. Public ownership might introduce uncertainty for investors in the UK banking system, as well as risking reputational damage to the UK's standing as a leading international provider of other financial services. There was, at that time, no legislation on the statute book or available in draft form that would allow the Government to take the company into public ownership should it be required at a future date.

19 The Treasury's preferred option was to support the company's search for a private sector solution. Before and after approaching the Bank for emergency support, Northern Rock had searched for a private sector buyer, initially of the entire business and later for parts of it as well. The Treasury considered that the search for a solution was a matter for the Board of Northern Rock which remained in place and was accountable to shareholders. As this initial search failed to find a suitable purchaser, the Treasury asked Goldman Sachs to liaise with the company as it took the process forward. Following legal advice received in September 2007, the Treasury considered that it should avoid taking any actions that were properly a matter for the directors of Northern Rock. The Treasury judged that it could not directly intervene in the process run by the company to find a potential buyer. Bidders reported that the sale process to December 2007 had been frustrating and confused, partly as a result of challenges arising as a consequence of the company employing three sets of financial advisers.

20 During this period depositors continued to withdraw money, despite the guarantee arrangements, with the pace quickening again in November when a total of £1 billion was withdrawn during a week. Amid media reports that the bidding process was in difficulty, Northern Rock, with agreement from the Treasury, announced on 26 November 2007 that discussions would be taken forward with one of the bidders, the Virgin Consortium. The announcement reduced deposit outflows. **But competitive tension in the bidding process was interrupted on the basis of a non-binding bid, which in the event could not be taken forward because of difficulties in obtaining financing**.

21 As financial market conditions worsened the prospect of a sale to a sufficiently well capitalised buyer, who could repay the publicly financed element in due course, became increasingly remote. The Treasury announced in November 2007 that it would consider financing bids on a matched basis with the private sector. Potential buyers, however, were not in a position to arrange private funding for a bid and further public support would be needed if the process was to be taken forward. The Treasury therefore began to take a more active role in finding a solution and announced in January 2008 proposals to replace the emergency support from the Bank with a guarantee covering a bond issue worth up to £27 billion, secured over the company's assets. A new invitation to bid was therefore issued in January. Only two detailed bids were received, from Virgin and from Northern Rock's management team. Across a wide range of criteria, the Treasury considered that these proposals did not meet the test of protecting the taxpayers' interest, and would carry considerable uncertainties over their deliverability as the financing plan was put in place and State Aid clearance sought.

22 The Treasury estimated in February 2008 that if Northern Rock was taken into public ownership for three years it was likely to require a net subsidy of £1.3 billion. On a base case scenario, the subsidy to Northern Rock in public ownership was below the estimate of £1.9 billion to £2.2 billion if one of the two final private sector bids had been chosen.

23 The estimate of public support to Northern Rock was, however, highly dependent on the forecast price of £1.2 billion the Treasury might obtain if the company was restructured and returned to the private sector when market conditions had stabilised. Such an estimate would always be uncertain given its dependence on the economic climate, changes in the housing market and on potential buyers' perceived confidence in the Northern Rock brand. As there were material uncertainties around the deliverability of the private sector bids, the Treasury considered that in all the circumstances the best option to protect the taxpayer interest was a period of public ownership.

24 Northern Rock was therefore placed into public ownership on 22 February 2008 using powers provided by the newly enacted Banking (Special Provisions) Act 2008.

On the oversight of Northern Rock in public ownership

25 Following public ownership the Treasury has maintained oversight of Northern Rock's progress against a new business plan. On entering public ownership, the Treasury appointed two directors to the company's board and soon afterwards a Shareholder Relationship Framework was agreed. The Treasury receives regular updates on the company's performance and holds regular meetings with the management team to review progress.

26 By 31 December 2008, the company had repaid some £3 billion more than planned for that year. One of the key objectives for the company was to encourage existing mortgage customers to move to other lenders, with the resultant repayments used to repay the loans from the Bank. The business plan envisaged full repayment of the loans from the Bank by 2010. As part of the government's financial intervention to support lending in the economy, Northern Rock announced in January 2009 that it would reduce the rate of mortgage redemptions and that repayments of the Bank's loans (which were transferred to the Treasury in 2008) would continue at a slower rate.

27 The Treasury did not challenge with sufficient rigour the company's forecasts of future trading conditions, before approving its initial business plan under public ownership. The timetable for approving an initial business plan for the company was driven by the need to submit an approved plan to the European Commission by the end of March 2008, less than six weeks after it was taken into public ownership. When scrutinising the plan, the Treasury's focus was on the period over which the emergency support would be repaid and the factors that might directly impinge on that objective. It paid less attention to the robustness of the broader business plan. The plan, which had been under development during the last few months of 2007 and early 2008, for example, assumed a five per cent fall in house prices between 2008 and 2011. These assumptions were not updated as the housing market began to turn downwards in early 2008.

28 In the lead up to public ownership, the Treasury did not commission its own due diligence on the company's operations, for example, on the quality of the loan book. The Treasury judged that it could rely on the work of the Bank, supported by its accounting advisers, and the Financial Services Authority as respectively lender to and regulator of the company. The company had capitalised arrears on its mortgage book at a much earlier stage than other lenders which, when changed in May 2008, increased the reported rate of arrears significantly and brought it into line with that reported by other lenders.

29 The company's reported loss at 30 June 2008 of £585 million was £314 million greater than the base case and worse than the recession case used in the plan approved three months earlier. In response to continued volatility and increasing weakness in the financial markets, some banks began to take steps to strengthen their regulatory capital positions. The Treasury announced in August 2008 that, subject to approval by the European Commission for State Aid purposes, some of the outstanding emergency loans to Northern Rock would be converted into an equity investment to bolster Northern Rock's regulatory capital and that the company had estimated that up to £3 billion of debt might need to be converted for this purpose. In March 2009, the company announced a loss of £1.4 billion for the year to 31 December 2008.

On the capacity of the Treasury

30 The Treasury worked with the Bank of England and Financial Services Authority to find a solution and benefited from their advice, but it alone had responsibility for determining what action was in the best interests of taxpayers. UK-based banks have collapsed before, for example BCCI in 1991 and Barings in 1995, but these crises did not involve a run on a significant high street financial institution. The crisis at Northern Rock therefore presented a new situation for the Treasury.

31 The Treasury had been aware of potential shortcomings in the arrangements for dealing with a financial institution in difficulty prior to the crisis at Northern Rock. From 2004 the Tripartite Authorities had undertaken exercises to test their response to a range of scenarios. These exercises had identified the need for further work on how the resolution of an insolvent firm with systemic repercussions would be handled and by whom. As a result, scoping work was done to identify the key issues the UK would face in winding up a financial institution, the practical processes available and therefore the gaps and options to fill them. Prior to 2007, work on improving the existing arrangements was not, however, judged by the Treasury to be a priority in a benign economic environment, compared with other financial crisis response planning. The Treasury started a project in early 2007 to produce a consultation document by Autumn 2007 on how the Tripartite Authorities would deal with a bank in difficulty. Following consultation, new legislation was put before Parliament in December 2008 and received royal assent in February 2009.

32 Once the scale of the crisis was recognised, the appointment of the second Permanent Secretary to lead the Treasury team was crucial to providing clear leadership at official level. The early appointment of a senior responsible owner for the project provided a clear focus for other members of the Tripartite, private sector bidders and others seeking an informed view of the Treasury's likely position.

33 Following the initial guarantee arrangements for depositors, the Treasury brought together a team drawn from across the Department but struggled to maintain continuity in its staffing. The maintenance of financial stability had not, in terms of staff resources, been a major part of the Treasury's work. In dealing with Northern Rock, the Treasury had to respond very quickly to events as they developed. As a result, decision making had to take place largely outside of normal risk management procedures for major departmental projects and made limited reference to the Treasury board, although the board did receive briefing on two occasions over the five months prior to public ownership. The availability of people with relevant skills and experience was severely stretched and resulted in two changes of team leader along with changes to the composition of the team. The Treasury was therefore very reliant on key officials and its advisers for the expertise it needed. In the event, some stakeholders found it difficult to work with the rapid turnover of staff within the Treasury team.

34 The Treasury made extensive use of professional advice for support during the bidding process and preparing the financial analyses of the various options. Professional fees for the Tripartite Authorities have amounted to just under £27 million, including over £9 million on legal advice. Separately from this advice, Northern Rock spent £39 million on advisers to review its strategic options and search for a private sector solution. In addition, the company paid bidders' costs totalling £13 million. With the company in public ownership since February 2008, all the advisory and bidding costs have ultimately been borne by the taxpayer.

35 The Treasury worked closely with its advisers to understand the assumptions underlying the options available but there were weaknesses in the initial contract negotiated by the Treasury with its financial adviser, Goldman Sachs. These weaknesses included, for example:

- An initial agreement by the Treasury that a large part of the firm's remuneration would consist of a success fee, but no clear definition of what success might look like in a complex and evolving situation. Once the decision was reached to take Northern Rock into public ownership, agreement was reached that it would be inappropriate for a success fee to form part of the final sum to be paid.
- Although the Treasury discussed the options analyses prepared by Goldman Sachs and tested the assumptions used, it did not request access to the underlying financial models developed by its advisers, which were regarded as proprietary information. This limited its ability to validate estimates of the costs and benefits of each option.

36 There were also weaknesses in the management of electronic records. Following the decision to take Northern Rock into public ownership, the Treasury had to expend significant time and resources to collate relevant records in an accessible form for litigation and audit purposes.

37 The Treasury applied lessons from its experience of Northern Rock to the handling of Bradford & Bingley. In September 2008, Bradford & Bingley experienced difficulties that necessitated Treasury action. Although there were differences to the Northern Rock case, the Tripartite Authorities were better prepared, having kept a watch on the company before market conditions made action necessary. The scale of the problems in the financial markets and the prospect of prolonged difficulties were by this point apparent. At a practical level, the availability of suitable powers on the statute book proved crucial to the Treasury's ability to take action quickly. The Banking (Special Provisions) Act 2008 allowed the Treasury to take into public ownership or transfer to another owner a bank or building society judged to be a threat to financial stability. The Tripartite Authorities' experience in considering the options for Northern Rock allowed the Treasury to take a course of action to protect financial stability, without having to put large sums of taxpayers' money at stake in a company it did not own and therefore did not directly control, although it now has to manage the risks associated with public ownership.

Conclusion on value for money

38 The crisis at Northern Rock presented the Treasury, and other members of the Tripartite, with a situation that had not been experienced in recent times in the UK. The failure of Northern Rock could have had adverse consequences for the economy through its wider impact on consumer confidence. Once the initial run had started, the announcement of the initial guarantee arrangements slowed the outflow of retail deposits. It took several extensions to the scope of taxpayer support to stabilise the company. The public support protected customers and prevented the liquidity problems experienced by Northern Rock at the time causing wider disruption to financial stability.

39 The Treasury undertook a comprehensive review of a range of options for the longer term resolution of Northern Rock's difficulties. The search for a solution to Northern Rock's problems took place against a backdrop of deteriorating conditions in the financial markets. Public ownership was eventually chosen because it offered the best prospect of protecting the taxpayer from the risk that over £50 billion of public support that had already been provided to Northern Rock would be called upon or not be repaid. The analysis of options that resulted in Northern Rock being brought into public ownership was sufficiently robust. Nevertheless, the action needed to resolve Northern Rock's difficulties stretched the capacity of the Treasury to handle the complex issues involved.

40 Following public ownership, the Treasury put in place adequate systems to monitor the progress of Northern Rock in repaying the public support provided. But the Treasury did not carry out sufficient testing of the company's initial business plan. In light of an increasingly difficult economic context, additional public support has had to be provided to the company. Under the original business plan, the Treasury had expected the emergency loans to be repaid by 2010 and then to be in a position to return the company to the private sector when market conditions stabilised. Any sale and the eventual cost to the taxpayer are dependent on the company's performance in managing its existing mortgage portfolio, its future lending activities, as well as the performance of the UK housing market.

Recommendations

a **Once the initial guarantee arrangements were announced the taxpayer was exposed to risk. As a condition of receiving public support, the volume of mortgage business written by the company was reduced significantly. Throughout the period of that support, however, Northern Rock continued to write together loans of up to 125 per cent of a property's value.** Where it decides to provide support to a company in difficulty, the Treasury should assess systematically the risks to the taxpayer, as distinct from the risks relevant to the responsibilities of the other Tripartite Authorities acting as lender or regulator. It should also identify what information will be needed to monitor those risks and decide how they should be mitigated.

b **Scenario tests conducted by the Tripartite Authorities prior to the collapse of Northern Rock had identified potential weaknesses in the arrangements for dealing with a bank in difficulty.** When reviewing the lessons to be learned from future scenario tests, the Tripartite Authorities, having identified the lessons learned and agreed an action plan with target dates, should take forward the necessary work with vigour. The Tripartite Authorities should review progress against these targets at suitable intervals.

c **The need to revise Northern Rock's business plan so soon in the light of tougher economic conditions illustrates the importance of developing sufficiently robust business plans from the start.** The Treasury should vigorously challenge the assumptions underlying any future business plans presented by Northern Rock. Any financial forecasts should be tested under a sufficiently wide range of economic assumptions, both positive and negative.

d **At the time it took Northern Rock into public ownership, the Treasury had not conducted due diligence on the company, for example on the quality of the entire loan book.** Although the Treasury worked with the Bank of England and Financial Services Authority to find a solution and benefited from their advice, it alone had responsibility for determining what action was in the best interests of taxpayers. The Treasury should use future scenario testing exercises to trial the actions that would be needed in the time available to it to properly assess and validate the information it receives on the quality of the underlying business of a financial institution in difficulty. This assessment can then inform the Treasury's scrutiny of any proposed business plan should an individual institution require public support.

e **In deciding to take Northern Rock into public ownership, the Treasury considered the outcome of its financial analysis to be uncertain and gave due weight to the deliverability of private sector bids**. In any comparable situations in the future, the Treasury should follow the practice adopted here of looking beyond financial estimates to consider the deliverability of the options open to it and the likelihood of protecting the taxpayers' interest.

f **Once the scale of the crisis became clear, the Treasury benefited from assigning responsibility to a senior official for managing its response.** In future crisis situations, the appointed officials, as in this case, should have sufficient seniority to marshal the necessary resources, make clear the Treasury's position to third parties and act as a focus for overseeing the response at official level. The arrangements put in place should also spell out the role of the Treasury board in helping to manage the risks. The Treasury should also examine the training and development it provides its officials to handle such situations, for example drawing on the experiences in other parts of the public sector, for instance in civil and military contingency planning, where preparation for handling a crisis is a key part of staff development.

g **The Treasury required extensive professional advice and was necessarily dependent on its advisers for support in evaluating the available options**. Although the Treasury challenged the underlying assumptions used by external advisers, it should be in a position to validate the analyses prepared for it, particularly in fast moving situations where crucial decisions have to be taken quickly. To this end, it should draw where appropriate on expertise from within the Treasury or from expertise available elsewhere in the public sector, such as in Partnerships UK.

h **The contract with Goldman Sachs included a discretionary "success" fee, which the Treasury and Goldman Sachs ultimately agreed was not appropriate in the circumstances.** Where consultants are appointed at short notice to help with a crisis situation, a robust contract should be put in place at the earliest opportunity. Where a "success" fee is provided for, Departments should agree the criteria by which success is to be determined. If the objectives cannot be adequately specified at that stage, the Department should as in this case stipulate that the payment of such a fee will be at its discretion.

i **There were weaknesses in the Treasury's management of electronic records.** The Treasury should put in place adequate arrangements for filing, storing and accessing the electronic and paper records generated. The Treasury should consider whether its working processes and IT infrastructure is capable of supporting the demands of such a project and take action to address any shortcomings.

PART ONE

Background

1.1 This Part sets out:

- the circumstances leading to the liquidity problems at Northern Rock;
- the responsibilities of the Bank of England, Financial Services Authority and the Treasury (the Tripartite Authorities) for the maintenance of financial stability;
- the guarantee arrangements and other measures put in place by the Treasury to stabilise the company.

The circumstances leading to the liquidity problems at Northern Rock

1.2 The Northern Rock Building Society, based in Newcastle-upon-Tyne, was formed in 1965. Over the following 30 years, Northern Rock expanded by acquiring smaller building societies and converted to a listed bank in October 1997. By 2007, the company had become the fifth largest provider of residential mortgages in the UK. In the first half of 2007, it wrote residential mortgages totalling £10.7 billion, net of repayments, representing an 18.9 per cent share of UK net mortgage lending. The growth in business was based on highly competitive pricing of Northern Rock's mortgage products, which required a narrow margin between what it paid for funds and what its borrowers paid in interest on their mortgages.

1.3 Banks raise funds to lend to mortgage customers by three principal means:

- by the use of funds held on behalf of retail and commercial depositors;
- through short term loans provided by banks and other financial institutions for periods up to one or two years (often called inter-bank lending);
- by selling existing mortgages to investors (usually through a process known as securitisation – **Box 1**).

Whereas retail deposits constituted the main source of financing for Northern Rock when it converted from a building society to a bank, it had funded the growth of its mortgage lending mainly through the wholesale markets for inter-bank lending and securitisations.

BOX 1

The use of securitisations by Northern Rock to raise funds

Securitisation involves the raising of funds by the issue of bonds backed by a bank's assets, usually in the form of outstanding mortgages. Once every three months or so, Northern Rock sold mortgages to special purpose vehicles. Each special purpose vehicle paid for the purchase of the mortgages by the issue of bonds to investors. There were two types of securitisation:

Asset Backed Securities – Investors in the bonds are entitled to interest on their investment and to repayment of capital at the end of the term of the bond, for which the mortgage debt retained in the special purpose vehicle was the security. The payments to bondholders are funded by the interest and principal repayments made under the mortgages involved. In March 2001, Northern Rock established a securitisation structure known as "Granite" (see Appendix 4).

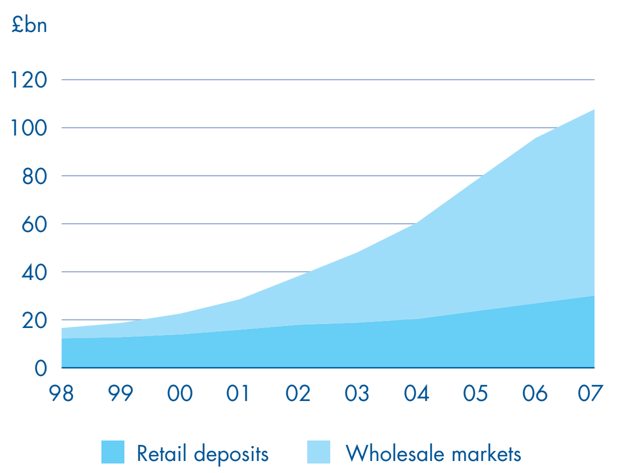
Covered bonds – Northern Rock also used covered bonds to raise money through securitisation. Covered bonds also involve the transfer of a pool of mortgage loans to a special purpose vehicle, which provides a guarantee of the bonds to investors. In contrast to the Granite structure, however, investors in covered bonds would have a claim against Northern Rock assets, if payments under their bonds were at risk.

1.4 Northern Rock's balance sheet structure changed significantly between 1998 and June 2007, supported by funding from the wholesale markets **(Figure 2)**. The use of wholesale markets by banks to raise money, including the use of securitisation, was not unusual. Northern Rock, however, made more extensive use of this funding route. Wholesale funding as a percentage of total funding was more than 70 per cent for Northern Rock, compared with an industry average for UK banks of around 50 per cent.

1.5 The raising of funds through regular securitisations and shorter term inter-bank borrowing enabled Northern Rock to expand its business rapidly. As one source of funding was repaid, the company had to identify further sources of funding on a rolling basis. The success of its business model was therefore dependent on:

- Northern Rock's ability to raise money in the inter-bank and securitisation markets to repay existing short term borrowing and fund additional mortgage lending;
- its ability to pay a lower rate of interest on the money which it borrowed than the interest it charged to mortgage customers.

2 Growth in Northern Rock's sources of funding 1998 to June 2007



Source: National Audit Office analysis of Northern Rock annual reports and accounts

1.6 In the summer of 2007, the world's financial markets entered a period of turbulence triggered by fears of over-exposure to American sub-prime mortgages. Financial institutions and investors started to reduce their purchases of mortgage-backed assets on the wholesale markets. At the same time, banks began to retain cash to meet their own liquidity requirements and to reduce the risk of losses from loan defaults. This combination created a shortage of liquidity that threatened institutions reliant on the wholesale markets to fund their mortgage lending business.

1.7 Northern Rock had planned to securitise around £4 billion of mortgage loans through the Granite structure in the Autumn of 2007. In September, however, deteriorating market conditions caused the proposed underwriter to withdraw and the securitisation did not proceed as planned. Northern Rock was also finding it harder to raise money in the wholesale inter-bank markets. Rollovers of wholesale funding were largely continuing, but at shorter maturities and higher interest rates.

1.8 Northern Rock's difficulties in meeting its funding needs meant that there was a likelihood that it would have to draw on its stock of high quality sterling liquid assets and sell other assets, probably at distressed sale values. In these circumstances, the company's auditors informed the Financial Services Authority on 11 September 2007 that they had reasonable grounds to believe that Northern Rock might cease to be a going concern.

The responsibilities of the Tripartite Authorities

1.9 In 1997, the Government introduced a new system of financial regulation in the UK. The Financial Services and Markets Act 2000 created a single, independent, regulator for UK financial services, the Financial Services Authority (FSA). The Government also introduced a framework for financial stability, under which a Tripartite Standing Committee of the Treasury, the Financial Services Authority, and the Bank of England (the Tripartite Authorities), became responsible for preserving the stability of the financial system. The role of each of the Tripartite Authorities is set out in a Memorandum of Understanding (Appendix 5). In exceptional circumstances such as those facing Northern Rock, ultimate responsibility for the authorisation of a support operation rests with the Treasury.

The Treasury guarantee arrangements and other measures taken to stabilise the company

1.10 Banks take deposits from customers which can be withdrawn on demand and make longer term loans to customers which, in the past, were held to maturity. This combination of shorter term liquid liabilities backed by longer term illiquid assets makes a bank vulnerable if depositors perceive that their money may be at risk and demand immediate repayment of their deposits.

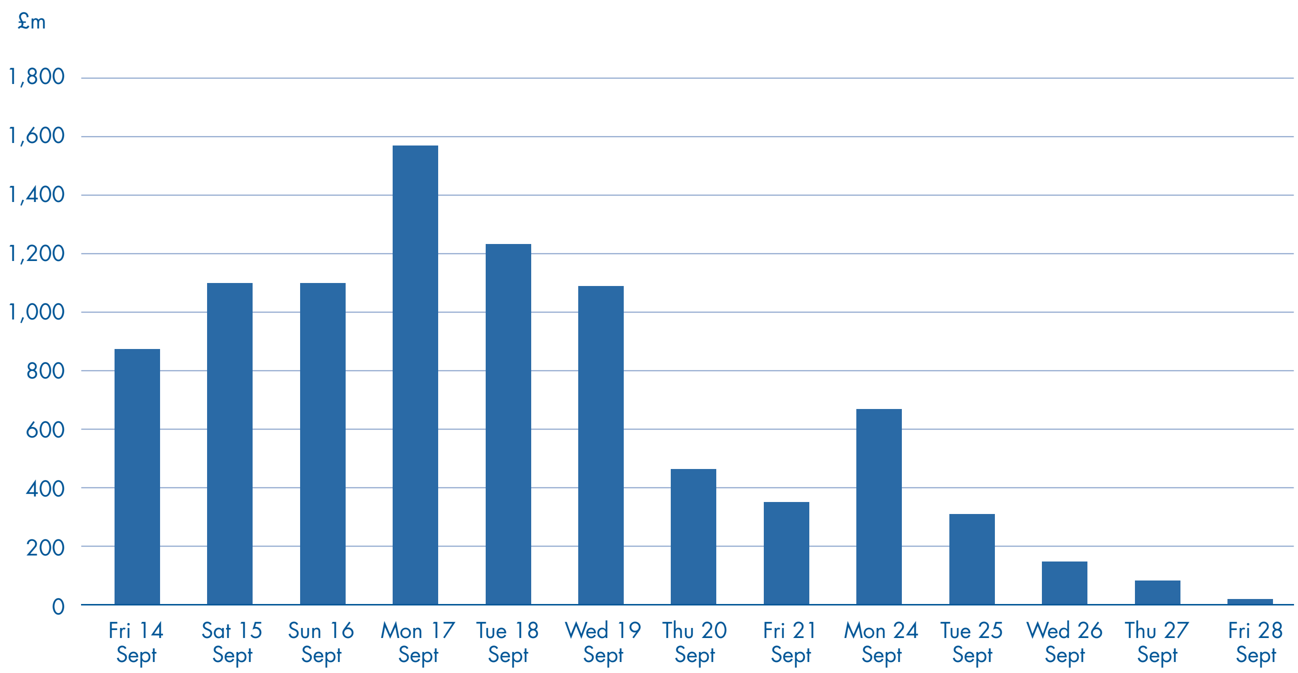
1.11 The Treasury regards banks to be systemically important because deposits held in banks are a key part of the payment mechanism for households and businesses and because they play a central role in the clearing and settlement of large-scale transactions and of securities. The failure of a major bank would leave individuals and businesses unable to access savings, to raise finance or to meet ongoing payment obligations. A single bank failure has the potential to spread to other parts of the financial system (contagion) through its impact on consumer confidence, the inter-bank lending market or other channels. This contagion, in turn, can have knock-on effects for the wider economy.

1.12 By mid-September 2007, Northern Rock realised that continued funding on the wholesale markets was not possible. It sought an assurance of support from the Bank of England, as lender of last resort, for a substantial liquidity facility pending a longer term resolution of its difficulties. This facility, which was uncommitted and on demand, was announced by the company on 14 September 2007 and was granted partly as a loan secured on prime residential mortgages and partly as an agreement for the Bank to buy some of Northern Rock's high quality securities on the understanding that the company would buy them back on demand (a "Repo facility").

1.13 Between the announcement of the Bank's liquidity support facility on Friday 14 September and the following Monday 17 September, Northern Rock's financial situation deteriorated further:

- Retail depositors began withdrawing money and closing accounts. Around £4.6 billion (20 per cent of Northern Rock's retail deposits) was withdrawn over four days (**Figure 3**, Friday 14-Monday 17 September). The company's credit default swap rate[1] increased by around 1.75 percentage points and its share price fell 56 per cent (from 639p to 282p).

3 Outflows of retail deposits from Northern Rock



Source: National Audit Office analysis of documents held by HM Treasury

1 Credit Default Swaps are tradeable financial instruments which provide a form of third-party insurance for lenders against a borrower defaulting on a loan. A higher price for such swaps indicates that the perceived credit worthiness of the borrower has worsened.

- The run on deposits was widely reported, with pictures of queues of retail customers outside the company's branches.
- The risk of contagion increased, credit default swap rates rose for Bradford & Bingley and Alliance & Leicester, the two closest comparators to Northern Rock, and their share prices fell **(Figures 4 and 5)**.

Further measures to stabilise the company

1.14 The Treasury took the view that there was an increasing risk of system-wide contagion in the financial markets and decided that further measures were necessary to maintain stability. On 17 September, the Chancellor of the Exchequer announced that the Treasury would put in place arrangements to guarantee existing deposits in Northern Rock while the instability in financial markets continued. These guarantee arrangements supplemented but did not replace any compensation payable by the Financial Services Compensation Scheme. Appendix 6 provides a summary of the workings of the scheme.

1.15 The guarantee arrangements removed the queues outside Northern Rock branches, reduced media coverage and avoided the potential contagion of other banks and mortgage lenders, whose credit default swap rates fell in line with that of the company (see Figure 4 opposite). The guarantee arrangements did not prevent further, although smaller, outflows of retail deposits or safeguard Northern Rock's access to the wholesale markets, and it continued to experience difficulties in obtaining wholesale funding. The Treasury therefore announced on 20 September that the guarantee arrangements would be extended to cover existing and renewed wholesale deposits and unsecured wholesale borrowing.

1.16 Developments after the emergency liquidity assistance and the Treasury's initial guarantee arrangements made further measures necessary. First, the Bank's facilities were limited by Northern Rock's ability to provide suitable high-quality security. It became clear to the Tripartite Authorities towards the end of September that Northern Rock's eligible assets would be exhausted by around 10 October 2007, which would prevent further borrowing under the Bank's facilities. Secondly, the Bank's loan facility as lender of last resort was at a rate higher than the Bank's usual rate for the provision of liquidity across the banking sector. It was higher than the rate charged on many of Northern Rock's mortgages, however, so the interest payments would gradually erode the capital it needed to meet requirements set by the Financial Services Authority – the company's regulatory capital (Appendix 9).

1.17 The guarantee arrangements did not stem the outflow of customer deposits. By October 2007, customer deposits had shrunk to 15.3 per cent of the company's funding (a drop from £30 billion to £17 billion); and wholesale loans had fallen to 11.8 per cent (from £17 billion to £13 billion). Wholesale funding was maturing and could not be renewed because the market had effectively closed to Northern Rock and the problem was compounded by the fact that retail deposits were shrinking at the same time. Northern Rock was becoming heavily dependent on Bank of England support.

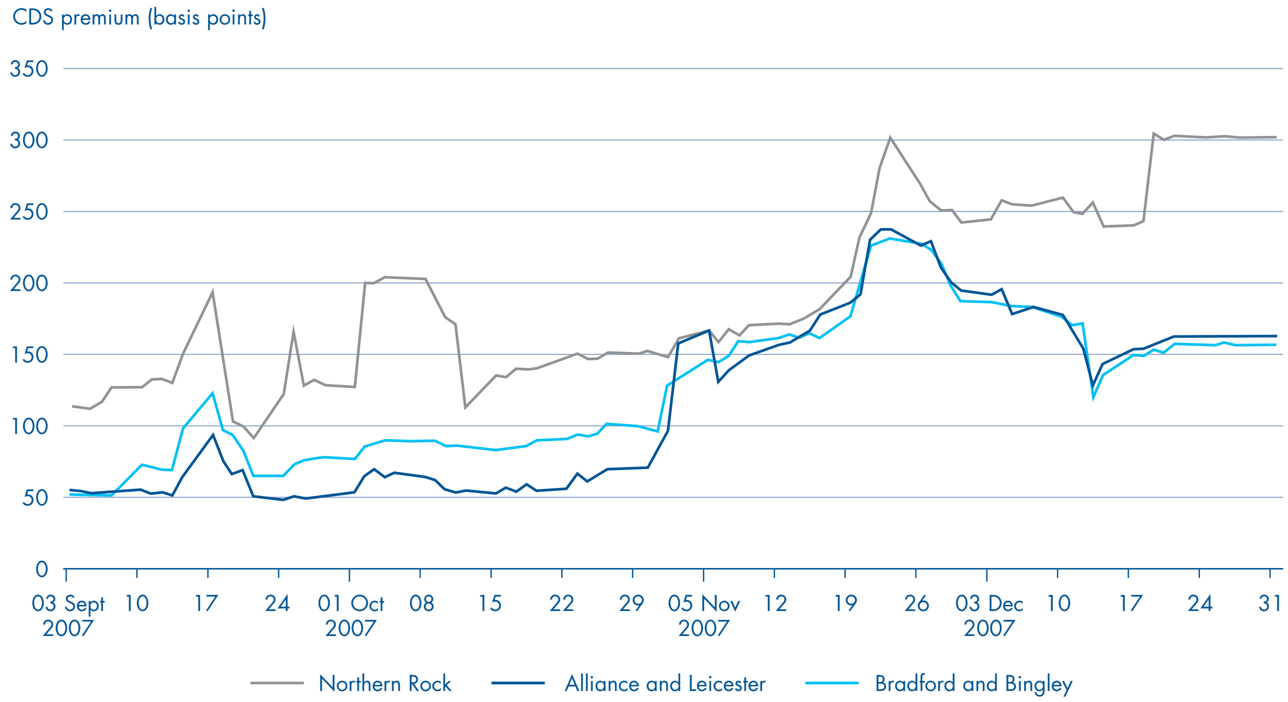
1.18 If Northern Rock's financial position was to be stabilised for long enough to find a longer term solution, further measures were necessary to provide liquidity support and to prevent the company's regulatory capital eroding. The following measures were announced on 9 October 2007:

- At the request of the company, additional financial assistance was made available by the Bank to enable Northern Rock to borrow further money secured against all of its assets;
- The Treasury extended its guarantee arrangements to cover new retail deposits, in return for a fee on the aggregate amount of any new retail deposits accepted. The fee was judged to be sufficient to ensure that Northern Rock would not benefit from any commercial advantage the guarantee arrangements gave it in attracting new depositors;
- The guarantee arrangements would remain in place during the current market instability and until the Treasury gave reasonable notice to depositors that such arrangements were to be terminated.

1.19 The additional facilities offered on 9 October 2007 were different in nature from the facilities granted on 14 September 2007, in that the taxpayer was exposed to a much higher level of risk:

- The new facilities were secured by a fixed charge and a floating charge over all the assets of Northern Rock, rather than just high quality assets, and were not limited to the value of those assets;
- The Treasury granted an indemnity to the Bank so that any losses incurred as a result of a default by Northern Rock in relation to the new facilities would be met by the taxpayer;
- Payment of the margin between the Bank's usual lending rate and the rate charged to the company was deferred for five years. In addition, the deferred interest was subordinated to the claims of other creditors, including depositors, meaning that it would count towards Northern Rock's regulatory capital resources.

4 Credit Default Swap rates for Northern Rock, Bradford & Bingley, Alliance & Leicester

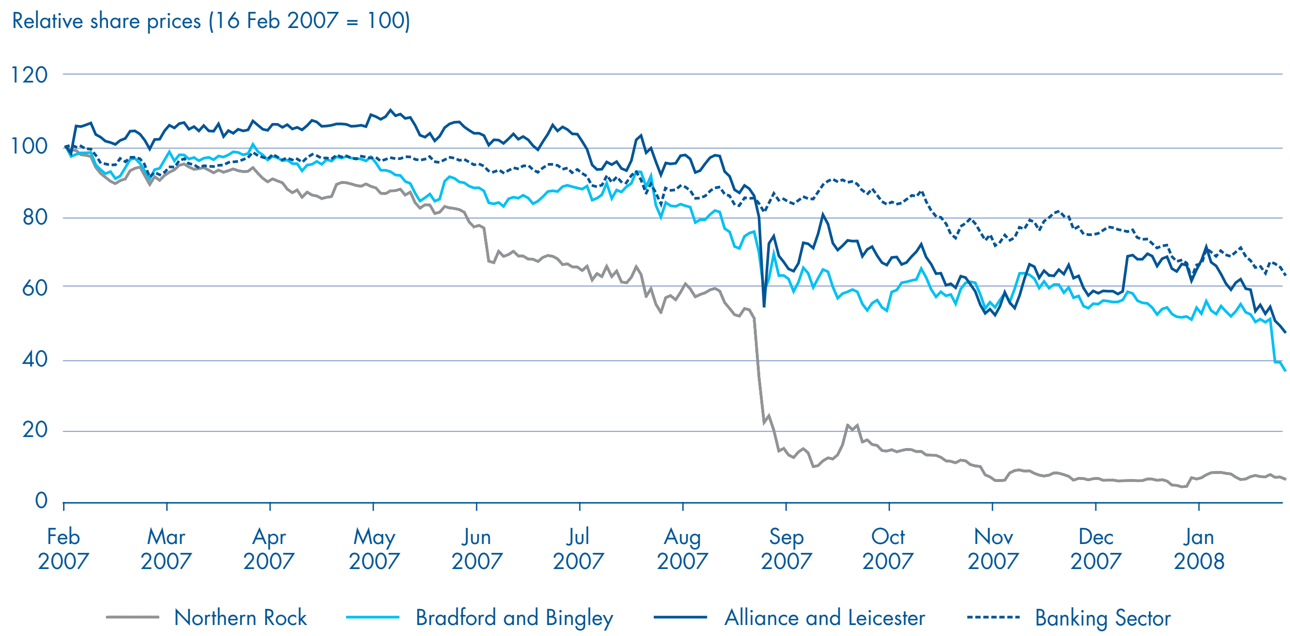


Source: Markit Group Limited

NOTE

The graph shows the premium in basis points (0.01 per cent) for five year senior debt issued by each institution. The price, or premium, of a credit default swap is the annual amount an investor must pay over the length of the contract, expressed as a percentage of the amount insured. For example, if the premium for debt issued by ABC plc is 50 basis points, then an investor buying £10 million of protection must pay £50,000 a year. These payments would continue until either the credit default swap contract expired or until ABC plc defaulted.

5 Changes in share prices of mortgage banks



Source: National Audit Office analysis of published share prices

1.20 To limit the risks for the taxpayer, the company put in place a stabilisation plan agreed with the Tripartite Authorities. As further falls in retail and wholesale funding were expected, a key element of the plan was to conserve cash by reducing the level of mortgage lending from an average of 1,000 loans a day in the first six months of 2007 to less than 200 a day by the last quarter of 2007. In addition, the terms of the loan from the Bank required Northern Rock to obtain the Bank's approval before entering into any corporate restructuring, making substantial changes to the general nature of its business and paying any dividends.

Further and final extension of the guarantee arrangements proved necessary

1.21 On 11 December 2007 Moody's, a rating agency, informed the Tripartite Authorities that it was considering a downgrade of Northern Rock's credit rating. Such a downgrade would have had an adverse effect on the company's financial situation. By this point, third parties that had expressed an initial interest in acquiring Northern Rock had done so on the assumption that there would be no adverse changes to the Granite securitisation programme, which would have happened if the company's credit rating had been downgraded. As a consequence, on 18 December 2007, the Treasury announced further guarantee arrangements to cover additional wholesale borrowing by the company.

1.22 As a result of this emergency support, the taxpayer was now guarantor for a significant proportion of Northern Rock's business. **Figure 6** illustrates how the guarantee arrangements provided by the Treasury to cover the company's retail and wholesale funding and loans from the Bank increased over time. Emergency support on such a scale had never been provided before to a financial institution in difficulty.

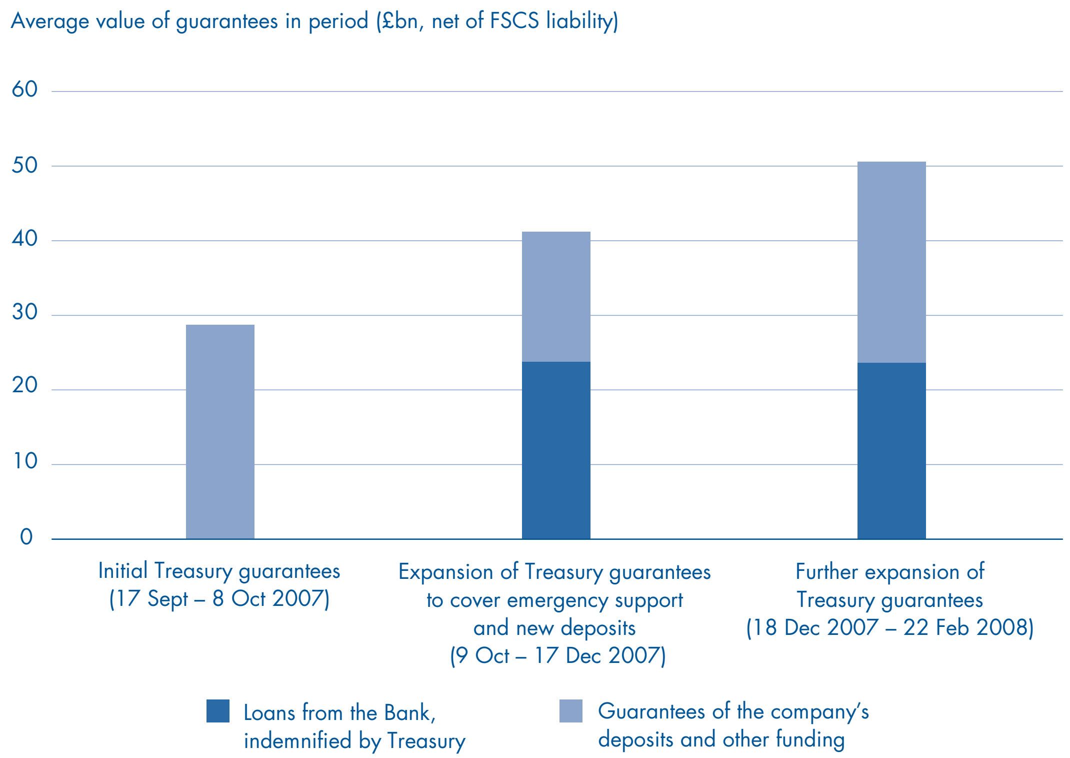
1.23 It was clear to the Treasury that continued indefinite emergency support would not be acceptable:

- A contingent liability would have been created in a private company over which the Government had limited control;
- It was not the role of the Bank, as lender of last resort, to engage in long term lending to a commercial bank. The support provided was intended to safeguard the financial system and prevent damage to the wider economy, and not to subsidise a particular financial institution;
- The emergency support amounted to assistance from state resources and had to be notified to the European Commission. The Commission had accepted that the liquidity provided by the Bank on 14 September 2007 was not state aid, but concluded that subsequent guarantee arrangements and lending facilities provided by the Treasury and the Bank in October 2007 were, albeit that they were permissible as rescue aid. Rescue aid could not, however, be approved for more than six months from the date of the first measure, unless the Government submitted a restructuring or liquidation plan for the company by March 2008. Even then the rescue aid approval would only continue until the Commission reached a decision on the restructuring plan, specifically whether the support to the company continued to be restructuring aid and, if not, whether it needed to be amended or withdrawn. These requirements placed a key time limit on the Treasury's, and Northern Rock's, search for a solution.

1.24 The Treasury therefore sought to work with other members of the Tripartite and the company to enable it to pursue a range of strategic options which would resolve the liquidity problem. This report considers:

- The search for a longer term solution (Part 2);
- Oversight of the company in public ownership (Part 3);
- The Treasury's capacity to respond to and manage events (Part 4).

6 Emergency support for Northern Rock



Source: Goldman Sachs

PART TWO

The search for a longer term solution

2.1 This Part examines:

- the Treasury's assessment of the options for dealing with Northern Rock;
- the Treasury's role in the search for a private sector solution; and
- the decision to take the company into public ownership to protect the taxpayers' interest.

The range of options considered for the future of Northern Rock

2.2 Once the initial guarantee arrangements had been issued, the Treasury set itself objectives to guide its search for a longer term solution. The objectives, announced publicly in October 2007, were to: protect the taxpayers' interest; to protect consumers; and maintain financial stability. These objectives remained unchanged throughout the search for a solution for Northern Rock.

2.3 In late September and early October 2007, the Treasury identified four key options for the future of Northern Rock. These options fell broadly into two groups:

- **Closure.** Stop taking new deposits and writing new mortgages and begin a process of winding down the company to sell assets to pay off liabilities. There were essentially two options:
  - withdraw emergency support and allow Northern Rock to enter administration (an **insolvent wind down**);
  - continue with emergency support and sell assets to meet liabilities – a **solvent wind down**, with the company either remaining in the private sector or being taken into public ownership.
- **Maintain a viable business.** Continue to take new deposits and write new mortgages, realise a proportion of the assets to pay off the emergency support and put in place a longer term recovery plan, which would keep the company in business. There were again two options:
  - find a **private sector buyer for the entire business** who would repay the emergency support immediately or over a few years. Such a sale might be financed entirely by the purchaser or through a mix of private finance and continued public support;
  - take Northern Rock into **public ownership**, allowing a gradual repayment of public support by realising assets and an eventual sale of the remaining business to a new private sector owner.

2.4 The Treasury appointed external advisers to assist its appraisal of the options and its search for a solution. Goldman Sachs and Slaughter and May were both appointed in September 2007 to provide respectively financial and legal advice. Ernst and Young was appointed by the Bank in September 2007 to provide advice to the Bank, and subsequently the other Tripartite Authorities, on the financial position of Northern Rock. The appointment and use of advisers is considered further in Part 4.

Allow the Company to fall into administration

2.5 The Treasury could have withdrawn public support, by terminating or not renewing the Bank's loan facility or removing the guarantee arrangements, thereby forcing the directors of Northern Rock to put the company into an insolvency procedure, such as administration. On entering administration, control of the company would pass immediately to an administrator, who would aim to run the company while selling the assets for the benefit of all creditors.

2.6 In early October 2007, the Treasury's evaluation concluded that the option of administration would not meet its objectives to protect consumers, maintain wider financial stability or protect the taxpayers' interest.

- Depositors' funds would be inaccessible for some months as payments could not be made until assets had been sold and secured creditors had been paid. The Treasury judged that such a delay for Northern Rock depositors could have led to runs on retail deposits at other financial institutions. It considered the possibility of stepping in to pay off depositors quickly by providing funding of around £10 billion, initially from the Bank of England. Such a plan, however, involved greater exposure for the taxpayer and was not risk-free, in part owing to the challenge of preparing and posting many thousands of cheques in a few days.
- It estimated that the proceeds from the sale of assets would probably have fallen short of the liabilities to be paid off, including the emergency support provided by the Bank of England. Any shortfall of funds to repay deposits of up to £35,000 would have been covered by the Financial Services Compensation Scheme. Shareholders would be expected to lose their investment. Under market conditions at the time, the Treasury and its advisers judged that there would be a "firesale" of assets at reduced prices. Goldman Sachs estimated that the loss to the taxpayer might lie in the range £2 billion to £10 billion – the range reflected its assessment of the uncertainties involved.

Allow a solvent wind-down

2.7 The Treasury considered the possibility of winding down the company under private or temporary public ownership. The branch network, deposits and a matched book of mortgages would have been sold to another bank, followed by longer term disposals of the remaining assets to repay creditors. If the sale of the deposits and branches proved impossible, the alternative would have been to implement a scheme for rapid repayment of retail and wholesale deposit accounts.

2.8 Northern Rock, however, relied on a manual account closure process, and therefore was not equipped to pay off retail and wholesale deposit accounts quickly. The company estimated in October 2007 that it would have taken up to 10 to 12 weeks to repay depositors with error rates as high as 25 per cent. This estimate assumed staff working at full capacity, branches closed and customers unable to access their accounts on demand. Northern Rock's management therefore favoured developing a new automated process for closing savings accounts, which it estimated would take three months to develop. The Treasury considered it would be difficult to persuade customers not to close their accounts during the three months needed to develop an automated repayment process, if it was widely understood the bank was closing. It judged that such an event could have caused a further run on deposits, with the possibility of contagion spreading to other banks.

2.9 Whether the company secured better prices through a more controlled and longer term series of asset sales under a solvent wind down than under administration would depend on market conditions not deteriorating further. Goldman Sachs estimated that the risk for the taxpayer was not as great as under an insolvent wind down, ranging between breakeven and a loss of £2.5 billion.

2.10 The Treasury ruled out an immediate solvent wind-down on practical grounds. The option was, however, kept open as a possibility at a later stage if a private sector buyer could be found for parts of the business or other options proved fruitless. To be able to react quickly if the company's position deteriorated significantly, the Bank, Ernst & Young and Northern Rock pressed ahead with developing a new automated process for closing accounts, which was completed in January 2008.

Take Northern Rock into public ownership at an early stage

2.11 In September 2007, the Treasury considered that public ownership was the option most likely to minimise immediate risks to financial stability, while at the same time providing it with the degree of control necessary to protect the interests of the taxpayer. The Treasury, however, did not see public ownership as an immediate response as other options were preferable and should be considered. In addition, two potential drawbacks were identified:

- As there was, in its judgement, a reasonable prospect of a private sector buyer coming forward, taking the company into public ownership might have precipitated action from Northern Rock's shareholders and introduced uncertainty for other investors in the UK banking system;
- It could have led to reputational damage to the UK's standing as a leading provider of international financial services.

2.12 Ministers decided that public ownership of Northern Rock should not be an immediate response. The Treasury did, however, commission a team of officials to work up proposals for putting this option into effect should it be required at a future date, including the task of drawing up, as a contingency, draft legislation that might be put to Parliament. There was at this time no legislation on the statute book, or available in draft form, that would allow the Government to take the company into public ownership. The Treasury believed this presented a significant practical barrier to acting quickly. In the meantime, the search for a private sector solution would be taken forward.

The search for a private sector solution

Northern Rock's search for a buyer prior to receiving emergency support

2.13 Before approaching the Bank of England for emergency support, Northern Rock had been searching for a private sector solution. Merrill Lynch was engaged by Northern Rock to conduct an initial search for a buyer of the business by identifying and contacting UK banks least affected by the closure of the wholesale-funding markets. The Financial Services Authority, as Northern Rock's regulator, had also been involved. On 24 August 2007, the Treasury was informed by the Authority that three banks had expressed an interest in bidding.

2.14 By 6 September 2007, however, two of the three potential bidders had dropped out. The Authority told us that the major UK banks saw little value in Northern Rock. Much of the value in a takeover in the retail banking sector depended on the integration and rationalisation of existing branch networks to eliminate overlaps. As Northern Rock operated a relatively small branch network, it did not offer significant opportunities to consolidate branches and make efficiency savings.

2.15 Shortly afterwards, the remaining potential bidder, Lloyds TSB, stated that it was prepared to consider buying the company if the Bank of England would agree to provide a stand-by facility of between £20 billion and £30 billion over two years at the Bank's official interest rate. Following discussions amongst the Tripartite Authorities, it was decided that the request should be refused on the grounds that a loan on such favourable terms over a long period of time would constitute state aid to a single, liquid party and give it an unfair competitive advantage, unless similar terms were offered to other possible bidders. Lloyds TSB accepted the decision, but also stated that it remained interested in acquiring the company.

2.16 The Tripartite Authorities then agreed that the existing emergency support to Northern Rock could be made available, if needed, to prospective bidders to enable them to purchase the company. Further discussions were held with Lloyds TSB on the size and length of time over which the support would be available. On 17 September 2007, following the initial run on retail deposits, Lloyds TSB assessed the damage to the company's franchise and pulled out of further discussions. It considered that Northern Rock was not a going concern and that an acquisition with the aim of winding the company down would not provide a sufficient return for Lloyds TSB.

The Treasury's role in the subsequent search for a solution

2.17 Following legal advice in September 2007, the Treasury considered that it should avoid taking any actions that were properly a matter for the directors of Northern Rock, in effect acting as a "shadow director" or de facto director of the company. If it did so, the Treasury judged that it would have been open to the risk of litigation from third parties in the event that Northern Rock entered an insolvency procedure such as administration.

2.18 The Treasury saw the search for a solution as a matter for the company and its board, which remained in place and continued to be responsible for the management of the company and accountable to shareholders. To do so, the Northern Rock board had co-opted additional directors with relevant skills and had retained independent financial and legal advisers. The Treasury therefore regarded the Northern Rock board as being in charge of the process and acted accordingly, even though large and increasing sums of public money were at risk.

Northern Rock's new sale process

2.19 After the initial attempts to find a buyer failed, Northern Rock put in place a new sale procedure designed to create and maintain competition from a range of potential buyers for all or parts of the business. While the sale of the whole company remained the main priority, a sale of part of the business was also explored, albeit as a secondary option. The company appointed Citigroup Global Markets Limited from September 2007 to work alongside Merrill Lynch. The strategy adopted was to:

- ask for expressions of interest from potential buyers;
- provide sufficient information to those expressing interest for them to submit non-binding first-round bids;
- select from the bidders a limited number of parties to participate in a second round of bidding which would lead to an agreed transaction.

2.20 A staged process along similar lines has been used many times in the past by departments to privatise public sector organisations. Appendix 7 compares the sale process with good practice published by the Treasury and the Committee of Public Accounts, based on previous sales by government departments. **Figure 7** sets out a chronology of key events.

Expressions of interest and submission of non-binding offers

2.21 Northern Rock and its advisers approached a wide range of potential bidders, exploring both a whole and a partial sale. At the Treasury's direction, Goldman Sachs worked with the company's advisers and any bidder who asked to do so was able to meet the Treasury to discuss the Tripartite Authorities' position. Northern Rock's advisers, however, remained responsible for investigation of the alternatives available to the company and communication with possible bidders. The company set a deadline of 12 October 2007 for the submission of expressions of interest.

2.22 On 12 October, initial expressions of interest were received from 14 potential bidders. Further discussions were also held with Lloyds TSB which focused on the potential execution and legal risks of a potential takeover of the company, but the discussions were inconclusive. At the end of October, following a change of Chairman, Northern Rock appointed Blackstone as a restructuring and financial adviser to the sale process.

2.23 On 2 November 2007, Northern Rock issued an information memorandum and a process note to all those expressing interest, inviting them to submit non-binding proposals for the whole or any part of the business by 16 November 2007. The documents were prepared by Northern Rock with assistance from its advisers but were not approved by the Treasury, although the Treasury commented on them at a relatively late stage in their preparation. Separately, the company also conducted a process to identify prospective providers of finance, recognising that each of the potential bidders would otherwise be approaching the same range of banks for debt funding in what were difficult market conditions.

7 Chronology of the sale process after the emergency support had been provided

Month	Date	Actions
September 2007	17	Lloyds TSB withdrew from discussions on Northern Rock.
	18	Northern Rock initiates a revised sale process, retaining responsibility for investigation of the market and communication with possible bidders.
	21	Treasury appoints Goldman Sachs and Slaughter and May as its financial and legal advisers.
	25	Lloyds TSB shows further interest in acquiring Northern Rock but decides not to take it further.
October 2007	9	Extension of Bank facility and Treasury guarantee arrangements announced.
	12	Northern Rock receives 14 expressions of interest in purchasing Northern Rock or elements of it.
November 2007	2	Northern Rock issues an Information Memorandum to the interested parties.
	16	Northern Rock receives 10 non-binding bids for the company or elements of it.
	19	The Treasury publishes the Tripartite Authorities' Transaction Principles.
	19	A further run on Northern Rock's retail deposits begins.
	26	Northern Rock announced that it would take forward the Virgin Consortium's bid on an accelerated basis.
December 2007	6	JC Flowers withdraws from the sale process.
	7	A detailed proposal is received from Olivant.
	18	Further Treasury guarantee arrangements announced.
	21	Northern Rock management presents its own plan for the restructuring of the company.
January 2008	16	A further proposal is received from Olivant.
	21	A new financing structure is announced, and five companies plus Northern Rock's management team are approached.
February 2008	4	The Virgin Consortium and Northern Rock's management submit bids for the company. Olivant withdraws from the bidding process.
	16	After consideration of the bids, "final and best" proposals are received from the Virgin Consortium and Northern Rock's management.
	17	The Treasury announces that Northern Rock is to be taken into temporary public ownership.

Source: National Audit Office analysis of Treasury records

2.24 **Figure 8** shows the non-binding proposals received by 16 November 2007. All the proposals for the whole company offered the likelihood of a partial repayment of the emergency support with the remainder repaid as part of a planned reduction in the size of the balance sheet over a three-year period. The proposals also required government support in the form of a continuation of all or part of the guarantee arrangements until the company's credit ratings recovered. The proposals for parts of the company were less developed and the Treasury considered that a disposal of part of the business or certain of its assets would have left lower quality assets with Northern Rock, which would be difficult to sell.

2.25 The initial offers of finance for a sale of the whole company were not regarded by the Tripartite Authorities as attractive. Potential funders' proposals provided for lending against prime residential assets and with a low average loan-to-value ratio. In addition, the proposals were on terms and interest rates which were not compatible with the business plans put forward by the potential bidders. In Goldman Sachs' view, the inability to raise sufficient finance was partly because of serious concerns about Northern Rock's business, but mostly due to the distressed state of the financial markets at the time.

2.26 Nevertheless, the Treasury's initial assessment in November 2007 was that the sale of the whole company was likely to be the best option, with the next best option being public ownership. In response to requests from some bidders for greater clarity on the role and objectives of the Tripartite Authorities in any transaction, the Treasury published a statement of principles on 19 November, as shown in **Box 2**, explaining how it would approach proposals for the future of the company. The principles stated that the Tripartite Authorities would prefer a sale of the whole company to a partial sale and that bids which minimised public sector funding would be preferred. The Treasury also indicated that if bidders found it difficult to raise finance, a matched amount of public sector funding might be made available on similar terms to any funds raised in the private sector.

Decision to take forward discussions with the Virgin consortium

2.27 Northern Rock began negotiations with the three companies that had expressed interest in the whole company. Media reporting of the search for a buyer prompted a further run on Northern Rock's retail deposits during the week starting 19 November 2007, with a total outflow of over £1 billion **(Figure 9)**. By 3 December, retail deposits stood at £10.8 billion, compared with £13.2 billion on 16 November, while the bidders had envisaged a minimum level of £8-8.5 billion as necessary for their bids to stay on the table.

2.28 To stop the run, and with the agreement of the Treasury, Northern Rock announced on 26 November 2007 that it would take forward Virgin's bid on an accelerated basis. In effect, Virgin was named as the preferred bidder, although not on an exclusive basis as the other bidders could still submit further proposals. The announcement slowed the retail outflows from £200 million to £43 million a day. This rate of outflow was considerably higher than the £10-15 million a day allowed for by the company in September, and meant the company had to fill the gap by increased borrowing from the Bank of England.

8 Non binding proposals

Type of non-binding proposal	Number of proposals
Whole company (acquisition)	2 (JC Flowers, Virgin)
Whole company (minority interest)	1 (Olivant Advisers Limited)
Prime mortgage company (high quality mortgages and other assets plus deposits and access to cashflows from the Granite and covered bond securitisation programmes)	4 (Apollo Management International LP, Cerberus, Tyne Consortium, Terra Firma)
Deposits and a matched book of assets only	1 (Bradford & Bingley)
Portfolio of selected residential mortgages	2 (ING Direct, Bradford & Bingley)
Lifetime mortgages portfolio alone (generally made to borrowers aged 60 or over, capital and interest rolled up and repaid when property sold)	2 (JP Morgan, Lehman Brothers)
Financing proposals	4 (Citigroup, Deutsche Bank, Morgan Stanley, Royal Bank of Scotland)

Source: HM Treasury and Goldman Sachs

NOTE

During the first half of 2008 Northern Rock sold part of the Lifetime mortgages portfolio to JP Morgan Limited for £2.3 billion.

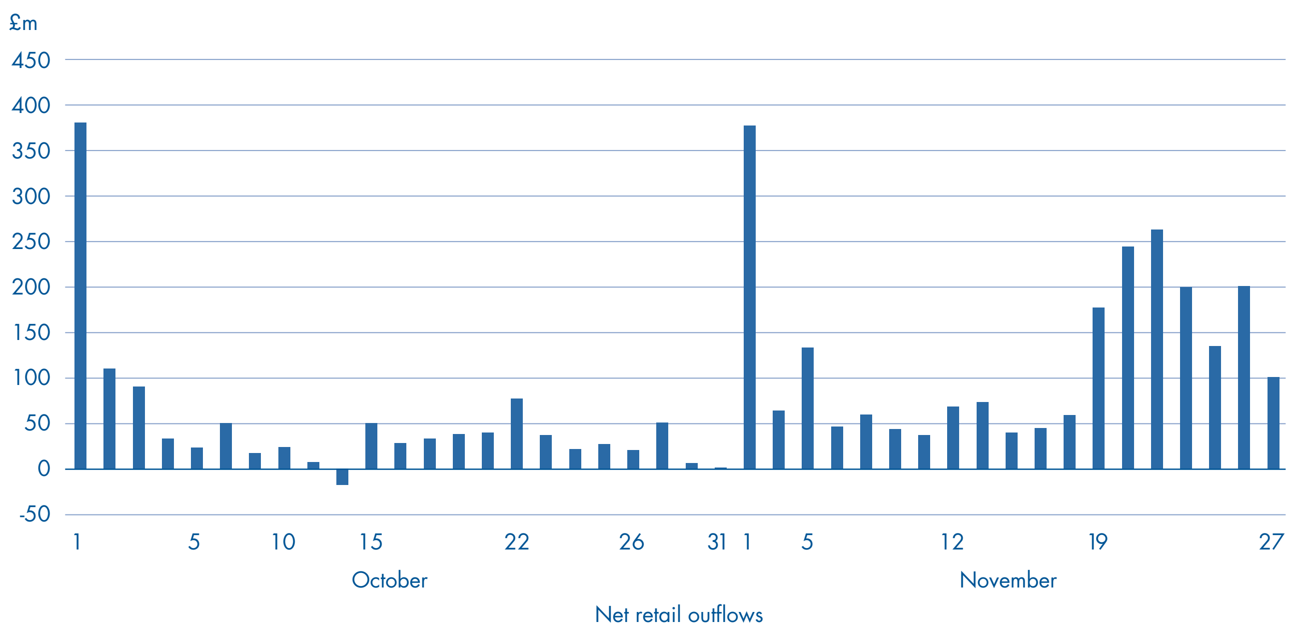
BOX 2

Statement of principles

	Criteria for evaluation
Protection of taxpayers	The Authorities expected the costs and risks associated with Northern Rock to be borne by the current and future private sector providers of capital. All else being equal, the Authorities would view favourably proposals that minimised any residual exposure, involvement or funding from the public sector. Accordingly the Authorities expected to assess: a) the extent, timing and method of the unwinding of the Treasury's guarantee arrangements relating to deposits; and b) the timing of repayment of the Bank of England facility. The Bank of England's funding, together with all other related liabilities, is secured against Northern Rock's assets. The successful proposal would not provide for any payments to subordinated bondholders or shareholders unless such funding had been fully repaid and all other liabilities to the public sector, including the guarantee arrangements, had been discharged.
Ongoing financial stability	The Authorities would assess proposals to ensure that Northern Rock and any proposed buyer have a sustainable long term capital structure that meets the Authorities' stability and policy objectives, including adequacy of credit ratings where applicable; and that the business plan under the proposal is viable in the medium term.
Protection of consumers	The Authorities would view favourably any proposal in so far as it minimises disruption to the service provided to Northern Rock's customers.
Other considerations	The Authorities attached considerable importance to speed and certainty of execution, and would assess proposals in relation to any pre-conditions, risks or approval requirements that could threaten execution within the envisaged timeframe. The Authorities expected the purchaser's equity and debt commitments supporting the successful proposal to be without significant conditions to drawdown or termination rights. Any proposal would be viewed favourably in so far as it was not conditional upon European Commission approval of further aid measures. The Authorities were willing to discuss any proposal that envisages an ongoing role for them beyond their usual statutory and regulatory functions.

Source: HM Treasury

9 Net outflows of retail deposits from October 2007



Source: National Audit Office analysis of information held by HM Treasury

NOTE

The high outflows at the beginning of October and November reflected maturity dates for fixed rate bonds.

2.29 At the time of the announcement, Northern Rock and Virgin planned to sign a deal before Christmas. By 6 December 2007, however, Virgin's financiers were indicating that, because of a further deterioration in market conditions, they would not be able to commit firmly until mid-January at the earliest. In addition, JC Flowers pulled out of the sale process because of concerns surrounding the effectiveness of the sale process, the continuing decline in the company's deposit base and a worsening outlook for house prices. In the light of this withdrawal and the failure to make significant progress with Virgin, discussions with Olivant were intensified and it submitted a detailed proposal on 7 December. On 13 December the Northern Rock board announced that it would focus on developing detailed proposals from Virgin and Olivant.

2.30 At around this time, the Treasury made a separate approach to the major UK banks to explore contingency plans in case the sale process was unsuccessful. The major banks were invited to consider either a funding package for the successful bidder or a joint venture company to take over Northern Rock, leading to a sale of some or all of the company or a run-down over time. Although a solution could not be agreed, the Treasury maintained contacts with the major banks over the following months to continue to explore their willingness to become involved.

2.31 By mid-December 2007, it had become clear to the Treasury that commercial funding on a matched basis would yield too little to repay the Bank of England facility. The funding difficulties were such that both Virgin and Olivant were considering withdrawing from the process. The Treasury had to decide whether its objectives would best be met by continuing with the sale process or by taking the company into public ownership as quickly as possible. Although a draft bill to enable public ownership could have been put before Parliament, for practical and procedural reasons the last date to do so before the Christmas recess was 14 December 2007. The Treasury decided that a new financing package should be developed that would allow the process to find a private sector solution to continue

The final round of bidding

2.32 On 14 December, after discussions with the company and its advisers, the Tripartite Authorities asked Goldman Sachs to investigate the market and if necessary construct a new financing package that bidders could use. In early 2008, Goldman Sachs proposed a new financing structure in which Northern Rock would sell a mixed pool of assets to a newly created special purpose company **(see Box 3)**. The special purpose company would issue bonds to investors and use the proceeds to pay off the Bank of England loans to Northern Rock. The Treasury would guarantee the bonds, although any losses in the asset pool would first be borne by Northern Rock. This financing structure would result in a lower cost of funding for the bidders, while allowing the Bank of England facility to be repaid in full.

BOX 3

Revised financing structure for the sale of Northern Rock and sale conditions

Financing structure

Northern Rock would sell a pool of its assets, consisting of residential mortgages, unsecured consumer loans and certain investment grade securities, to a special purpose financing vehicle. The financing vehicle would fund the purchase of the asset pool by the issue of notes to investors in the capital markets. Each class of notes would bear a market interest rate which reflected the provision of a guarantee by the Treasury.

The asset pool would comprise assets having an appropriate value to support the issue of sufficient notes to make the payments to the Bank of England and to provide adequate liquidity for the company. The Treasury's obligations under its note guarantee would be fully secured by a first priority interest in the asset pool. A fee would be payable by Northern Rock to the Treasury for the note guarantee. All arrangement fees and expenses relating to the issue would also be paid by Northern Rock.

Sale conditions

Business plan	The plan would need to demonstrate that the company could in due course operate without government support and acquire an appropriate standalone credit rating. The plan would also need to provide the Treasury with a fee for its existing guarantee arrangements.
Protection of Treasury interests	Restrictions on dividends. Prohibitions on change of control without Treasury consent.
Additional capital	The company would have sufficient capital and liquidity to meet the Financial Services Authority's requirements under a range of downside scenarios, plus a significant buffer to protect taxpayers' interests.
Equity participation	The Treasury would require an appropriate share in potential increases in the value of the company. The Treasury to share in any gains even after the demise of its guarantees.
State aid	Northern Rock and any buyer to assist the Treasury with the preparation of an appropriate restructuring plan to the European Commission.

Source: HM Treasury

2.33 Ahead of what was to be the final round of bidding, the Treasury obtained further legal advice in January 2008. Given that the bid process was now dependent upon taxpayer support, the advice indicated that the Treasury could impose certain conditions on Northern Rock for the protection of the taxpayers' interest. Such conditions would not be treated as giving instructions to the directors, even if those directors had little practical choice but to act upon such instructions. Following this advice, the Treasury sought to take a direct role in the latter stages of the bidding process. The Tripartite Authorities announced the structure of the package on 21 January 2008 and invited bids.

2.34 There were, however, material risks for the taxpayer:

- the new financing structure would involve significant and continuing public subsidy to the company through the guarantee of its bond issue;
- the taxpayer would be exposed to significant commercial and market risk, while it was possible that the private sector purchaser would make large profits from the deal;
- there would be an extended period while financing was put in place and state aid approval was sought, during which the deal could fail.

2.35 Goldman Sachs approached earlier bidders who might have had an interest in making a bid with the new financing package in place. On 4 February 2008, however, Olivant announced that it was withdrawing from the process as it had been unable to formulate an offer that met its investment criteria and satisfied the requirements of other stakeholders, including the Treasury. The negative publicity surrounding Northern Rock, the failure of previous attempts to generate interest, perceptions surrounding the potential for litigation facing any prospective bidder, together with further material deterioration in the overall economic environment, combined to dampen interest in buying Northern Rock.

2.36 Two detailed proposals were received by 4 February 2008: one from Virgin and the other from Northern Rock's management team. Following further discussions with both bidders, final proposals were received on 17 February (Appendix 8).

Evaluation of final bids

2.37 The private sector proposals were considered against the objectives set out in the statement of principles of 19 November 2007, including the Tripartite Authorities' expressed preference for a private sector deal over public ownership and public ownership over administration.

2.38 Goldman Sachs conducted a financial analysis of the Virgin and Northern Rock management bids, comparing them with each other and with public ownership. It compared the fees offered by the bidders in return for each element of public support with market rates for financial instruments with a similar level of risk. These estimates of the gross subsidy were then adjusted to give a net subsidy under each option:

- for the private sector proposals, by deducting the estimated share offered to the Treasury when the buyer sold the business on;
- for public ownership, by deducting an estimate of the potential sale proceeds from a sale of the company after three years.

2.39 Both the private sector proposals required substantial and ongoing public subsidy, leaving the taxpayer exposed to significant risks. **Figure 10** shows the cashflows to the taxpayer of either Virgin or the Northern Rock management team buying the company compared with its transfer into public ownership and later sale back into the private sector, across three business scenarios. The scenarios were based on a set of stress tests provided by the Financial Services

10 Comparison of cashflow to taxpayer

	Virgin			Northern Rock			Public ownership		
	Downside £ bn	Base £ bn	Upside £ bn	Downside £ bn	Base £ bn	Upside £ bn	Downside £ bn	Base £ bn	Upside £ bn
Estimated gross public subsidy	3.07	2.37	2.37	2.42	2.22	2.23	2.70	2.51	2.51
Less: Guarantee fees	0.27	0.16	0.16	0.09	0.07	0.07	–	–	–
Less: Share of proceeds from onward sale by private sector	–	–	0.08	–	0.23	0.36	–	–	–
Less: Estimated proceeds from sale out of public ownership	–	–	–	–	–	–	0.14	1.24	2.06
Subsidy net of estimated cashflow to taxpayer	**2.80**	**2.21**	**2.13**	**2.33**	**1.92**	**1.80**	**2.56**	**1.27**	**0.45**

Source: Goldman Sachs

Authority and key assumptions made by the Northern Rock management team in putting together its bid. The downside scenario was modelled on the recession and collapse in house prices experienced in the early 1990s. The base case assumed a five per cent fall in house prices during 2008 while the upside assumed no change in house prices during the period 2008 to 2011.

2.40 The estimated net public subsidy under both private sector proposals and under public ownership was substantial, ranging from £500 million if market conditions improved to as much as £2.8 billion in a recession scenario. The Treasury was involved in the development of appropriate assumptions and received presentations setting out the detailed outputs, which were discussed with Treasury officials.

2.41 We examined the assumptions on which the financial analysis was based, but have not had access to the detailed calculations underlying the figures shown above. Under the terms of its contract with the Treasury, the calculations remain the intellectual property of Goldman Sachs. The Treasury itself did not have the detailed calculations. At our request the Treasury asked Goldman Sachs to provide these details. Goldman Sachs declined this request. Our analysis of the assumptions shows that:

- The gross subsidy, in the form of continued lending to the company and the arrangements to guarantee liabilities, under each option was the cost of providing such support based on the indicative costs of funding a private sector bid, as put forward by potential financiers earlier in the bidding process. These costs were then reduced by the fees offered by Virgin and the Northern Rock management team for the support. The assumptions used appear reasonable. The level of subsidy under each option and across the business scenarios was fairly uniform with a slight increase to reflect a higher level of support under the downside scenario;
- When calculating the net subsidy under public ownership, the Treasury assumed that Northern Rock would be less successfully managed in public ownership and therefore sold on at a lower price than a private sector owner might achieve. The assumed price was set at a multiple of 0.75 of the company's estimated book value in 2011, at the lower end of historical trading multiples for the company and comparable mortgage lenders. Such an estimate will always be uncertain, however, given its dependence on changes in the housing market as demonstrated by the much higher net public subsidy under the downside scenario. The sale price would also be dependent on potential buyers' perceived confidence in the Northern Rock brand.

2.42 Although the financial analysis of the bids suggested that public ownership was likely to cost less than choosing one of the private sector bids, the uncertainties surrounding the estimates meant that a decision on what would offer the best value for money needed to take into consideration a range of other factors.

2.43 Ernst & Young provided regular reports to the Bank, which were copied to the other Tripartite Authorities, on changes to Northern Rock's assets and liabilities and such matters were also subject to oversight by the Financial Services Authority as the company's regulator. The Bank, as lender, conducted an appraisal of those assets directly securing its original loan, made in September 2007. Whilst the private bidders had undertaken due diligence on Northern Rock as part of the bidding process, the Treasury did not commission further due diligence work of its own on Northern Rock's assets and liabilities. The Treasury's appraisals of the options available and the likely net costs of public ownership were based on information provided by Northern Rock management throughout the bidding process. The contract with Goldman Sachs excluded any validation work on the information it received and the Treasury did not put in place its own arrangements to validate the information supplied.

The decision to opt for public ownership

2.44 Before reaching a final decision, the Treasury considered a number of factors:

- **Protection for the taxpayer in a downside scenario** – the private sector options offered a degree of risk transfer relative to public ownership by virtue of additional equity injections of £0.7 billion to £1.25 billion, which would provide an extra buffer for the taxpayers' exposure. This protection was, however, relatively small. Under the Virgin proposal the company could sustain a fall in the value of its assets of 12.4 per cent (equivalent to £7.7 billion) before the taxpayer incurred losses. By comparison under public ownership the company could sustain an asset value fall of 10.9 per cent (equivalent to £6.7 billion);

- **The reduction in the size and duration of public support** – the Treasury had envisaged the guaranteed bond issuance being repaid in 3.5 years, but both of the private sector parties sought additional liquidity which would require financial support for up to five years. The size and duration of financial support under public ownership would depend on the business model to be developed by the new board, but it was not clear at the time that it would be substantially greater than under the private sector options. Private sector credit rating agencies had indicated to the Treasury that they might be more reassured by public ownership, and therefore more likely to maintain an A-rating for the company. The latter would have avoided Granite, the funding vehicle used by Northern Rock to raise money on the securitisation markets (see Appendix 4), being wound down (known as "pass-through") and the corresponding cashflow requirement that would entail;
- **The share of any upside on a subsequent sale of the company** – under the Northern Rock management team proposal, a sale of the company in 2011 might have yielded between £230 million and £360 million to the taxpayer on sale proceeds of over £2.5 billion. Under the Virgin proposal, the share of any sale proceeds was expected to be no more than £80 million.

2.45 The Treasury also considered that choosing one of the private sector proposals was not risk free, since the outcome would remain uncertain until final negotiations had been completed and any deal concluded. Moreover, if a private sector proposal failed it could result in a reactive, and potentially less orderly, move to public ownership at a later stage. Another consideration was certainty of execution. There were doubts about the extent to which a deal with Virgin could be successfully executed. Some major Northern Rock shareholders had made clear their opposition to the transaction and their preference for the management proposal. There was also another substantial concern. A major ratings agency had indicated it would downgrade Northern Rock on the completion of a transaction with Virgin. Such a ratings downgrade would trigger events which would raise the funding costs to Virgin and threaten the viability of its proposal. It was not clear to the Treasury whether such events would have been decisive for the viability of the Virgin proposal, but it raised concerns about deliverability. Such a problem was also likely to be an issue for the management team proposal.

2.46 Finally, the Treasury recognised that a private sector party would almost certainly reserve the right to walk away in the event that a satisfactory deal could not be concluded. It was unlikely that a deal could be cleared under State Aid rules and implemented before the end of 2008, resulting in a substantial period of uncertainty and vulnerability to future events.

2.47 On 17 February 2008, the Government announced that the private sector alternatives did not meet the test of protecting the taxpayer's interest and, taking wider considerations into account, concluded that the right approach was to take Northern Rock into a period of temporary public ownership. On 21 February 2008 the Banking (Special Provisions) Act 2008 became law and using the Northern Rock plc Transfer Order, on 22 February the Treasury transferred the ordinary and preference shares of Northern Rock into public ownership.

2.48 The Act required the Treasury to put in place a scheme for determining any compensation payable to former shareholders of a deposit taking institution taken into public ownership. The Act also contains provisions for determining how any compensation payable should be calculated, in particular, an assumption that financial support provided by the Bank of England and Treasury has been withdrawn.

2.49 On 8 September 2008, following an open competition, the Treasury appointed Andrew Caldwell, a partner at BDO Stoy Hayward LLP as the independent valuer for Northern Rock. With the support of a team of staff from BDO Stoy Hayward LLP and other professional firms, the independent valuer is assessing any compensation payable under the Northern Rock plc Compensation Scheme Order 2008. A fee of £4.5 million for the valuation work will be paid by the Treasury, with the intention that it will be reclaimed from Northern Rock when the company is returned to the private sector.

2.50 The assumptions applied to the valuation process were challenged by certain former shareholders. Two hedge funds, SRM and RAB Capital, as well as a Shareholder Action Group (the UK Shareholders Association), representing private shareholders, each applied for a Judicial Review of the Government's compensation guidelines. The former shareholders argued that the Treasury's compensation guidelines were in violation of Article 1 of the First Protocol of the European Convention on Human Rights. The High Court heard the application for judicial review in mid-January 2009 and rejected the shareholders' arguments on the grounds that they did not have any justifiable claim beyond their entitlement under the compensation scheme. The matter is now subject to appeal.

PART THREE

Oversight of Northern Rock in public ownership

3.1 This Part considers:

- the arrangements put in place by the Treasury to oversee the taxpayers' stake in Northern Rock;
- Northern Rock's performance against its business plan.

Oversight of Northern Rock

3.2 Since taking Northern Rock into public ownership, the Government's intention has been to allow the company to operate at arms length from Government on a commercial basis. In April 2008, the Treasury put in place a shareholder framework setting out how it intends to conduct its relationship with the company **(Box 4)**.

3.3 The Treasury appointed a new Executive Chairman, Mr Ron Sandler, for Northern Rock in February 2008. By 26 February the Board had appointed new members and removed old members. The former Chairman, Mr Bryan Sanderson, was appointed on 19 October 2007 on a fixed term contract for two years at an annual fee of £315,000 plus £85,000 a year towards the cost of his London office accommodation and personal assistant. On his retirement on 22 February 2008, he was entitled under the terms of his contract to the payment of the balance of his fee and expenses to October 2009. The Treasury considered whether it should refuse to sanction any such payment but decided on legal grounds not to intervene. In December 2008, the company agreed on a payment of one year's fee only (£315,000) and, at Mr Sanderson's suggestion, the balance of his fee (£210,000) was paid to the Northern Rock Foundation, a charity established by the company in 1997.

3.4 A Competitive Framework was put in place by the company and the Treasury to reduce the risk that the company could use its government-backed position to distort competition in the market place:

- the company will not exploit its public ownership in marketing literature for its products;
- the share of retail deposits will not exceed 1.5 per cent of total retail deposits in the UK;
- the share of gross new mortgage lending will be limited to no more than 2.5 per cent in any one year;
- the company will not rank within the top three of defined range of retail deposit products during 2008.

BOX 4

The shareholder relationship framework

The framework document sets out the structure of how the day-to-day relationship between the company and the Treasury will work. The relationship operates according to the following principles, under which the Treasury:

- appoints the Chairman of the Board and appoints two Non-Executive Directors in consultation with the Chairman;
- gives its consent for the appointment of other members of the Board proposed by the company and agrees the terms on which the Directors are appointed;
- determines the high level objectives of the company set out in a business plan and agrees the plan and subsequent updates with the Board;
- reviews with the Board, from time to time, the company's strategic options;
- requires that the Board is accountable to it for delivering the agreed plan;
- gives the Board the freedom to take the action necessary to deliver the plan;
- monitors the company's performance to satisfy itself that the plan is on track; and
- must give its consent for certain significant actions (such as a disposal of assets).

Source: HM Treasury

3.5 The Chief Secretary to the Treasury committed the Office of Fair Trading (OFT) to publish an annual report assessing any implications for competition of the public support for Northern Rock. The OFT report, published in March 2009, concluded that between February 2008 and February 2009 public support for Northern Rock did not have a significantly adverse impact on competition in the savings and mortgage markets. The OFT will continue to monitor developments to identify any emerging competition concerns.

3.6 The Treasury receives regular updates on the company's financial performance. The information includes updates on key performance indicators along with monthly management accounts. The arrangements also include monthly shareholder meetings with the company's executive management team where performance against the business plan and strategic issues are discussed. In addition, the Treasury received an independent review and commentary in the form of a weekly monitoring report produced by Ernst & Young until late 2008, when this role was taken on by the Shareholder Executive, part of the Department for Business, Enterprise and Regulatory Reform.

3.7 The Treasury has announced that, when appropriate, its interest in Northern Rock will be transferred to a new holding company, UK Financial Investments Ltd. The new company, wholly owned by government, will be responsible for the relationship with Northern Rock and Bradford & Bingley, as well as the government's new shareholdings in other financial institutions. The Treasury will retain ownership and continue to have responsibility for all policy decisions relating to the taxpayers' interest in Northern Rock including, for example, any decisions on what to do with the taxpayers' holding in the future.

Northern Rock's performance against its business plan

3.8 The Treasury approved a new business plan from the newly installed management team on 31 March 2008, less than six weeks after being taken into public ownership. The timetable was driven by the need to submit an approved plan to the European Commission by the end of March ahead of the latter's State Aid investigation which was scheduled to begin in April.

3.9 The strategic aims underpinning the business plan included a rapid repayment of debt and the establishment of a viable private sector entity. To achieve these aims, existing mortgage customers coming to the end of introductory fixed-rate terms would be encouraged to move to other lenders, with the resultant repayments of capital used to repay the Bank of England. At the same time, Northern Rock's reliance on wholesale sources of funding would be reduced, with a greater proportion of funding raised from retail deposits. The detailed targets were:

- a reduction in assets from £109 billion in 2007 to £51 billion in 2011;
- retail deposits to grow from £10 billion in 2007 to £20 billion in 2011;
- new mortgage lending to fall from £30 billion in 2007 to around £5 billion a year in 2008-2011;
- a reduction in running costs of 20 per cent including a fall in staff numbers from 6,345 in 2007 to 4,069 in 2011.

3.10 The plan envisaged that emergency support from the Bank of England would be repaid by around the middle of 2010, and that the Treasury's guarantee arrangements would be removed by the end of 2011. Thereafter, the company would enter a period of modest growth followed by an exit from public ownership, through a sale or flotation.

3.11 The plan was developed by the company using a number of stress tests including:

- further substantial outflows of retail and wholesale funds over periods of up to one year;
- a downturn in the economy leading to increased arrears, repossessions and losses, with a house price fall like that of the early 1990s, the latter was considered by the Financial Services Authority as an appropriate downside case;
- the possibility that there would be unforeseen costs not included in the base case and that the Granite securitisation vehicle might have to be wound down (known as "pass through") if, for instance, losses exceeded a certain level.

Repayment of the Bank of England loan

3.12 By December 2008, the company was ahead of plan in repaying the Bank of England loan. Northern Rock had repaid £11.3 billion compared with a target for the whole of 2008 in the business plan of £8.3 billion **(Figure 11 overleaf)**. As the company experienced an inflow of deposits during 2008, it was able to meet liquidity requirements set up by the Financial Services Authority by placing surplus cash with the Bank and has funded a limited volume of new mortgage lending.

3.13 During 2008, the company implemented a range of measures to encourage mortgage redemptions, including a deal with Lloyds TSB (now Lloyds Banking Group) to offer qualifying customers (loan-to-value ratio, plus other conditions) a range of Lloyds TSB or Cheltenham & Gloucester branded products.

3.14 The redemption programme allowed debt to be paid off more quickly, but carried a risk that good quality customers able to re-mortgage with a new lender would do so, leaving those customers with a high loan-to-value ratio or poor credit histories with Northern Rock. This "adverse selection" would impact on the quality of the loan book. The level of risk posed by adverse selection is dependent on the type of mortgages written and a range of external factors, such as changes in house prices, the availability of loan products from other lenders and the performance of the economy generally.

3.15 At 31 December 2008, Northern Rock's high loan-to-value Together mortgages, described in **Box 5**, represented around 30 per cent of the mortgage book, about 50 per cent of overall arrears and 75 per cent of repossessions. Northern Rock continued to write these high risk products during the period it was receiving emergency support from the taxpayer, albeit at a reduced volume compared to the period prior to September 2007 **(Figure 12)**. Together mortgages with a capital value of £1.8 billion (secured element only) were written between September 2007 and February 2008, when the product was withdrawn ahead of public ownership. Around £1 billion of these new mortgages reflected commitments made by the company to potential borrowers prior to September 2007. The Treasury told us that mortgage transactions, although not necessarily Together mortgages in particular, were necessary to maintain the business, for example to maintain the company's relationship with mortgage brokers while a longer term solution was sought; and to avoid putting the Granite securitisation vehicle into immediate wind-down since the operation of Granite was dependent on the company continuing to generate new mortgage business (Appendix 4).

3.16 The business plan approved in March 2008 had anticipated some degree of adverse selection to arise but not the level experienced during the second half of 2008, which was mostly attributable to a steeper than expected decline in the housing market. **Figure 13** shows that, in the six months to the end of December 2008, the number of mortgages that were more than three months in arrears had more than doubled and that just over 4.5 per cent of Together mortgages were in arrears. Overall arrears were also higher than the industry average.

BOX 5

Together mortgages

Northern Rock introduced the Together mortgage in 1999. The product provided home buyers with the opportunity to borrow up to 125 per cent of the value of the property they wished to purchase. The product combined a secured loan of 95 per cent of the value of the property together with an unsecured loan, which could be used for any purpose, up to a maximum of 30 per cent of the value of the property or £30,000 whichever was the lower. Northern Rock charged the same rate of interest on both the secured and unsecured elements of the loan.

11 Northern Rock's Performance against business plan for repayment of public support, retail deposits and new mortgage lending

	Plan to 31 December 2008 £bn[1]	Actual To 31 December 2008 £bn	Faster/(slower) than plan £bn
Repayment of Bank of England loan	8.30	11.30	3.0
Level of retail deposits	13.00	19.60	6.6
New mortgages written	5.03	2.93	(2.1)

Source: Northern Rock Key Performance Indicators

NOTE

1 Figures from the March 2008 business plan.

Attracting new deposits

3.17 Northern Rock has exceeded its targets for attracting new deposits. At 31 December 2008 net retail funding inflows of over £8 billion had been recorded, boosting total retail deposits to £19.6 billion, some £6.6 billion ahead of the initial target for the whole of 2008 (see Figure 11).

3.18 Northern Rock's deposit taking was significantly affected by the crisis in the banking sector in Autumn 2008. The company was perceived by depositors as a place of safety at the height of the crisis and began to attract significant deposits. The company's ability to grow its retail funding base is, however, constrained by a framework of limits agreed as part of its business plan to reduce the risk of unfair advantage over competitors. As part of the framework, the company had agreed that its share of UK retail deposits would not exceed 1.5 per cent. The high inflow of deposits experienced by Northern Rock in October 2008 put this framework at risk, and the company therefore closed a number of popular savings accounts.

12 Changes in the value of mortgages written between January 2007 and December 2008

Period	Total mortgage completions £m	Together mortgage completions £m	Together mortgage completions as a percentage of all completions
January 2007 to August 2007	21,296	5,618	26
September 2007 to February 2008	6,023	1,818	30
March 2008 to December 2008	1,281	174	14

Source: National Audit Office analysis of data held by HM Treasury

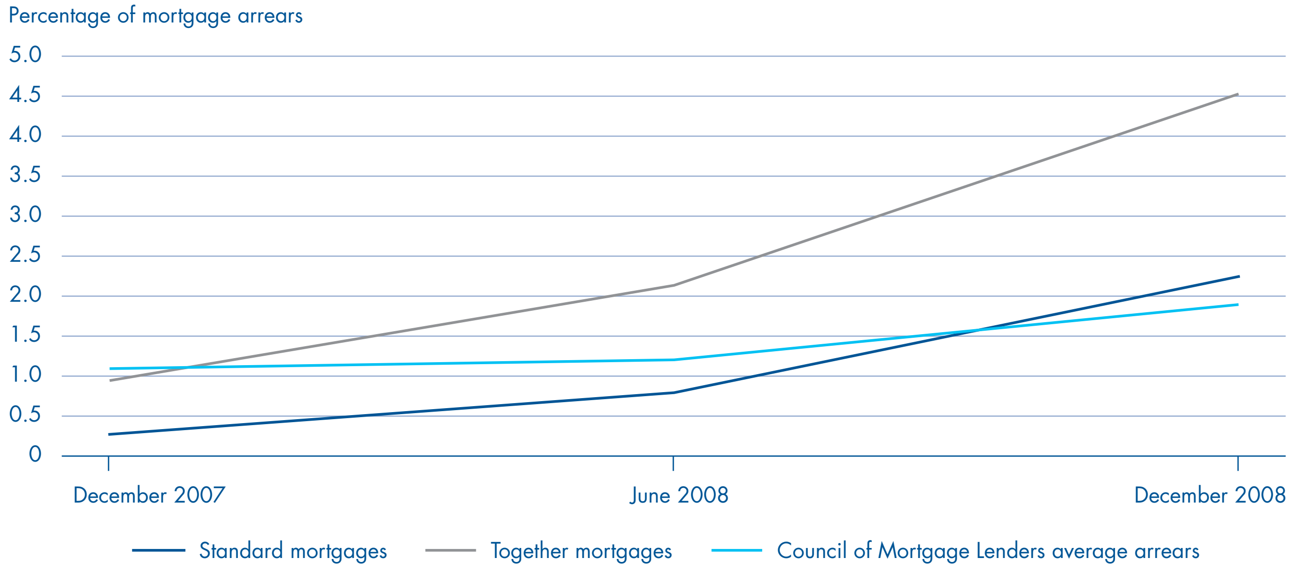
NOTES

1 The value of the Together mortgage lending does not include the unsecured element of the product.

2 As part of the company's stabilisation plan, from 4 October 2007 the maximum that would be advanced under a Together mortgage was reduced from 5.9 to 4.9 times income, the interest rate charged from 29 October 2007 was increased by 0.5 of a percentage point and, from 8 November 2007, new applications were judged against more stringent credit criteria.

3 Together mortgage lending continued after February 2008 because of applications in the pipeline, and also because some customers with a Together mortgage had a contractual right to another Together mortgage when they moved house.

13 Arrears on Northern Rock's standard and Together mortgages compared with the industry average



Source: Northern Rock annual report and accounts for 2008 and Council of Mortgage Lenders published data

3.19 Northern Rock's performance on new mortgage lending and on cutting running costs is summarised in **Box 6**.

Testing of the company's business plan under public ownership

3.20 Northern Rock reported losses in excess of the amounts forecast in the business plan. In August Northern Rock reported losses of £585 million for the six months to June 2008, £314 million higher than the base case forecast in the March 2008 business plan and worse than the recession case used in that plan. By the year ended 31 December 2008, the company had recorded a loss of £1.4 billion, mostly as a result of impairment in the quality of its residential mortgage book due to weakening economic conditions. The loss was higher than that expected under the recession scenario set out in the business plan approved in March 2008 (£463 million) and against a revised forecast of just over £1 billion prepared in August 2008.

3.21 The business case approved in March 2008 had been developed on assumptions made by the Northern Rock management team in the Autumn of 2007 in planning for a wind-down of the company and later as part of the management team bid, using stress tests required by the Financial Services Authority. The base case used in the March plan had assumed that house prices in 2008 would fall by five per cent and remain unchanged for three years thereafter. The recession case was for a 20 per cent reduction over three years. The base case approved by the Treasury in March 2008 tended towards an optimistic view of the housing market when compared with the forecasts available in late 2007 and early 2008 **(Figure 14)**. House price futures data available over the same period **(Figure 15)** shows that trading in residential property derivative contracts during October 2007 to March 2008 indicated that house prices would experience annual falls of eight per cent to 14 per cent, higher than assumed in Northern Rock's business plan over the following four years, under both the base case and recession scenarios. By the end of 2008 house prices had fallen by 13.5 per cent (Land Registry Price Index).

BOX 6

Northern Rock's performance on new mortgage lending and cutting running costs

New mortgage lending

In public ownership, Northern Rock has to strike a balance between repaying the emergency support and restoring the longer term viability of the company. The quickest way to repay the Bank of England loan would be to encourage much higher mortgage redemption rates, increase new retail deposits further by offering market-leading rates of interest and to stop new lending altogether. A temporary cessation of new lending activity would, however, reduce Northern Rock's profile with mortgage brokers who were paid commission to sell the company's mortgage products. The company regarded its presence in the mortgage market as crucial to maintaining its credit ratings and ultimately its value to any future buyers.

The business plan estimated that just over £5 billion a year of new lending activity would be required to maintain Northern Rocks' intermediary channels. The most recent figures to 31 December 2008 show that new lending of £2.93 billion (Figure 11) fell significantly short of this target, on the back of a depressed housing market.

Running costs reductions

The company's programme to cut costs has progressed ahead of plan. By 31 December 2008 the number of staff had reduced from some 6,000 to 4,479 compared with a target at the end of 2008 of 4,610. Operating costs had also been reduced to £285 million for the period 1 January to 31 December 2008 compared with a target of £316 million.

Source: Northern Rock Key Performance Indicators

Additional capital investment in Northern Rock

3.22 The Financial Services Authority requires all financial institutions taking deposits to maintain a pre-determined level of capital as a safety buffer, and to operate above this threshold on day to day business. (Appendix 9 summarises the regulatory capital requirements for UK banks.) Any financial institution which finds itself at risk of breaching the threshold must take action to strengthen its balance sheet.

14 Published forecasts of changes in house prices

Date of Forecast	Prediction for 2008 %	Prediction for 2008 and 2009 %	Forecaster
October 2007	0		Lombard Street Research
October 2007	-5		Capital Economics
November 2007	0		Nationwide
December 2007	0		Rightmove.co.uk
December 2007	-2		Charcol.co.uk
December 2007	-10		BBC
January 2008	-3		Centre for Economics and Business Research
January 2008	-3		Union Bank of Switzerland
January 2008	-10		Invesco Perpetual
January 2008	-10		Institute of Economic Affairs
January 2008		-20	London School of Economics
January 2008		-30	London School of Economics
January 2008	0		United Trust Bank
March 2008		-20	Morgan Stanley
April 2008	-3		Knight Frank
May 2008	-5		Royal Institute of Chartered Surveyors
May 2008	-7		Council of Mortgage Lenders
May 2008	-9		Jones Lang LaSalle

Source: published forecasts

15 Comparison of Northern Rock's assumptions on house prices in the base case and recession scenarios with market traded house price futures

	Annual implied change (%)			
Trading in forward contracts during:	**Year 1**	**Year 2**	**Year 3**	**Year 4**
September 2007	0.0	2.0	3.0	8.0
October 2007	-6.5	-6.5	-6.5	-4.0
November 2007	-8.0	-8.0	-7.0	-4.5
December 2007	-9.0	-10.0	-10.0	-7.0
January 2008	-9.0	-11.0	-11.0	-11.0
February 2008	-8.0	-11.5	-11.5	-9.0
March 2008	-8.0	-13.0	-14.0	-11.0
Northern Rock Business Plan:				
Base case	-5.0	0.0	0.0	0.0
Recession case	-10.7	-2.3	-6.5	1.8

Source: Promontory Financial Group/DTZ Tullett Prebon HPI mid-price derivatives

NOTE

There are limitations on using this information for interpretative purposes: a) these markets are often illiquid; b) they are relatively new; and c) they are dominated by a small number of large banks, mostly seeking to hedge exposures to the property markets and may lead to a downward bias. A more liquid, established market may have indicated a less precipitate change in prices. The futures markets have, however, tended to give a largely accurate indication of actual price declines.

3.23 In July 2008, the Northern Rock management team asked the Treasury for an additional £3 billion capital injection to strengthen its capital base. Subject to approval from the European Commission, which is still pending, the Treasury agreed to:

- convert £400 million of preference shares into ordinary shares;
- swap up to £3 billion of the Bank of England loan into ordinary shares.

3.24 A number of factors had contributed to a weakening of the company's capital position:

- **Impact of declining house prices.** Declining house prices and higher arrears during 2008 meant that the risk weighting of mortgage assets, used to calculate the capital needed to meet regulatory requirements, was likely to increase. For instance, between December 2007 and December 2008, the proportion of the company's residential mortgage book where the amount lent exceeded the value of the property increased from 0.5 per cent to 33 per cent, excluding the unsecured element of Together mortgages **(Figure 16)**;
- **Impact of losses on commercial activities.** The company's profitability and capital had also been exposed to funding risks largely caused by a higher than forecast difference between LIBOR (the rate at which commercial banks normally lend to one another and a benchmark for the cost to Northern Rock of its funding) and bank base rates, on which many of its mortgage products were priced;
- **Understatement of mortgage arrears.** The company had capitalised outstanding amounts in arrears following receipt of three consecutive full monthly payments, whereas other lenders did not capitalise arrears until five or six consecutive payments had been received. Following a review of risk management after public ownership, the policy on arrears capitalisation was changed in May 2008, increasing the reported rate significantly and bringing it into line with reported arrears at other lenders. The review also found that internal controls over discretion to capitalise amounts in arrears when the borrower had paid less than three monthly payments were inadequate, and such discretion was removed;
- **Overstatement of regulatory capital due to misclassification of debt instruments.** Following a routine review of Northern Rock's capital position in June 2008, the Financial Services Authority concluded that the company had overstated by some £300 million the amount of regulatory capital available as a result of a misclassification of some debt instruments within regulatory capital. The impact was, however, temporary as it was addressed by a waiver of the capital rules granted to Northern Rock by the Financial Services Authority at the end of July 2008.

3.25 The further planned support from the Treasury will increase the company's regulatory capital. The conversion of preference shares and the debt-to-equity swap does not provide additional cash to Northern Rock nor does it result in a short term loss to the taxpayer, but it does increase the taxpayers' exposure to risk.

3.26 Following a strategic review of its business plan in consultation with the Treasury, Northern Rock announced in January 2009 that it would aim to reduce the rate of mortgage redemptions and that repayment of the Bank of England loans (which were transferred to the Treasury in 2008) would continue at a slower rate than expected in the business plan.

3.27 As part of the government's financial interventions to support lending in the economy, the Treasury announced in February 2009 that a detailed planning exercise was underway to allow Northern Rock to begin writing new mortgages, expected to be worth £14 billion by 2010. Additional funding to support this lending will be provided in part by an increase in the Treasury's outstanding loan to Northern Rock, with an extended repayment schedule. A restructuring of the company will also be undertaken. In the event of a sale of the restructured company, the value of the newly created ordinary shares will be dependent on market conditions at the time of sale.

16 Loan to value ratios across Northern Rock's residential mortgage book at December 2007 and December 2008

Source: Northern Rock Annual Report and Accounts 2008

NOTE

The figures do not include the unsecured element of Together mortgages (£2.7 billion at 31 December 2008). The value of the residential mortgage book at 31 December 2007 was £91 billion and at 31 December 2008 £67 billion.

PART FOUR

The Treasury's capacity to respond to and manage events

4.1 This Part considers:

- the extent to which Treasury had prepared for a crisis of this nature;
- the action taken by the Treasury to assemble the skills and resources needed to manage the crisis;
- the Treasury's use of external advisers;
- subsequent actions to resolve difficulties at Bradford & Bingley.

Scenario planning

4.2 The events at Northern Rock presented the Tripartite Authorities with a situation unprecedented in the UK in recent times. Although UK-based banks have collapsed before, for example BCCI in 1991 and Barings in 1995, these crises did not involve a run on a significant high street financial institution.

4.3 The Tripartite Authorities had identified weaknesses in the arrangements for dealing with insolvent institutions posing a systemic risk some three years before the crisis at Northern Rock. Since 2004, the Tripartite Authorities have conducted exercises to test their preparedness to deal with a range of scenarios, ranging from the simulation of a cyber attack on financial infrastructure and the impact of flu pandemic to various financial crises. The exercises were intended to test plans and responses to particular scenarios, and provide training opportunities.

4.4 One of the first scenario exercises, in 2004, tested the options available if a major financial institution got into difficulty for liquidity reasons. The report of the exercise noted that thinking was relatively undeveloped as to how the resolution of an insolvent firm with systemic repercussions would be handled and by whom. It concluded that work was required by the Tripartite Authorities to understand the issues they would face in dealing with an insolvent institution posing potential systemic risks to the financial system, which had not been tested directly in the exercise. At this stage, work on improving the existing arrangements was not considered within the Treasury to be a priority, in the benign economic environment then prevailing, compared with other financial crisis planning that was being taken forward.

4.5 Following further discussion, the Tripartite Authorities concluded in 2005 that the existing legislative framework, effectively restricting the available options to letting the institution fail and deal with the consequences or bail it out, would not be sufficient in a crisis situation. As a result, more work would need to be done before the Tripartite Authorities would be in a position to deal with the resolution of a significant financial institution.

4.6 Following further exercises, in December 2006 and March 2007, the Tripartite Authorities decided that a special administration option should be developed. In May 2007, the Tripartite Authorities agreed to develop a consultation document setting out a range of options and potential legislative changes to deal with a financial institution in difficulty. A discussion paper was published in October 2007, followed by a first consultation paper in January 2008.

Assembling a team to tackle the crisis

4.7 Prior to the crisis, responsibility within the Treasury for financial stability and for working with the Tripartite Authorities lay chiefly with its financial stability team, comprising a senior civil servant and a team of 16 officials, plus access to the Department's legal and financial advisers. The unfolding crisis multiplied the demands made upon Treasury resources. Several major strands of work required attention over the period: an assessment of the wider implications flowing from the situation at Northern Rock and the closure of the wholesale funding markets; the recruitment of relevant external advice; an appraisal of the options for dealing with Northern Rock and the initial search for private sector solution; an assessment of the state aid implications of public support; and the preparation of draft legislation for bringing banks in difficulty into public ownership.

4.8 The appointment of the Treasury's Second Permanent Secretary to lead the Treasury team between October 2007 and the decision to take Northern Rock into public ownership was crucial to providing clear leadership at official level. Stakeholders interviewed by us suggested the appointment provided a clear focus for other members of the Tripartite, private sector bidders, banks and others seeking, often at short notice, an informed view of the Treasury's likely position.

4.9 The availability of people with relevant skills and experience within the Treasury was severely stretched. Once the scale of the crisis had become clear, a team was brought together from across the Treasury. By mid-October the Treasury had around 24 officials working on the Northern Rock core team plus support from external advisers. Until these events, the maintenance of financial stability and liaison with the Tripartite Authorities had not been, in terms of staff numbers, a major part of the Treasury's work. Staff on the team did, however, bring other experience including, for example the rescue and restructuring of British Energy in 2003 and dealing with State Aid issues.

4.10 Stakeholders interviewed by us found it difficult to work with the rapid turnover of staff within the Treasury team. Below Second Permanent Secretary level, the Treasury employed, for example, three different team leaders to deal with Northern Rock over the period August 2007 to February 2008 and into public ownership. The three individuals covered, in turn, the initial period to stabilise Northern Rock up until early October 2007; the subsequent search for a solution up until March 2008; and, following a short gap with no post holder, oversight of Northern Rock in public ownership from May 2008 onwards. Other members of the staff joined and left the team as dictated by the work in hand. Stakeholders, whilst praising the talent and versatility exhibited by members of the Treasury's team, considered that corporate knowledge in a fast moving situation was, for a short time, reduced and risks increased as new members of the team got to grips with their new portfolio of work.

4.11 The Treasury's decision-making at official level relied on challenge and counter-challenge within the team, and its advisers, to test the rigour of the solutions that were formulated. At times the Treasury had to respond very quickly to events as they developed. As a result, decision making took place largely outside the Treasury's normal risk management procedures for major departmental projects and made limited reference to the Treasury's board, although the board did receive briefing on two occasions over the six months prior to public ownership.

4.12 There were weaknesses in the Treasury's management of electronic records. Following the decision to take Northern Rock into public ownership, the Treasury had to spend significant time and resources to identify and file relevant records in an accessible form for litigation and audit purposes.

Use of external advisers

4.13 From September 2007 onwards, the Treasury and other members of the Tripartite, bought in specialist legal and financial advice from a number of external sources **(Figure 17 overleaf)**. These advisers brought a range of commercial experience and specialist expertise that would not ordinarily be available within the Treasury, and played a significant part in helping the Department to find a solution for Northern Rock. External advisers continue to assist the Department in overseeing the taxpayers' interest in Northern Rock whilst it remains in public ownership.

4.14 The cost of professional advice has so far totalled just under £27 million, including fees which have been agreed but are yet to be paid. This total excludes £39 million spent by the former Northern Rock management team on professional advice in reviewing its options and the search for a private sector solution. In addition, the company paid bidders' costs totalling £13 million. With Northern Rock in public ownership since February 2008, all the advisory and bidding costs have ultimately been borne by the taxpayer.

4.15 The Treasury used a variety of approaches to recruit the expert advice it needed. Slaughter & May was appointed in September 2007 using a centrally determined framework agreement negotiated by the Office for Government Commerce. The framework agreement process requires potential suppliers to compete for a place on a list of approved suppliers. The framework agreement with Slaughter & May specified an hourly rate as a guideline but allowed it to be flexed depending upon the circumstances, for example the technical demands of the project. To take account of the particular demands presented by Northern Rock, including the need for on-call advice, the Treasury agreed to a 15 per cent uplift to these rates.

17 Advisers to the Tripartite Authorities

	Scope of work	Fees to 28 February 2008 (£m)	Fees from 1 March 2008 (£m)
Slaughter & May	Strategic commercial legal advice and drafting of legal agreements	6.1	3.3
Goldman Sachs	Analysis of private and public sector options and market advice	3.8	1.0
Ernst & Young	Advice on the financial position of Northern Rock, monitoring of its operations, development of a management information framework, reviews of the company's repayment plans for depositors, the option of administration and business plan under public ownership	3.3	1.0
Clifford Chance	Engaged by Bank of England to provide legal advice	1.9	0.5
BDO Stoy Hayward	Appointed in September 2008 to assess any compensation payable under the Northern Rock plc Compensation Scheme Order 2008		4.5
Other Advisers		1.4	–
Total		**16.5**	**10.3**

Source: HM Treasury

4.16 Goldman Sachs was appointed following a limited competition. In late September 2007, the Treasury invited three investment banks at short notice to discuss their services with a panel of senior officials. The Treasury selected Goldman Sachs on the basis of its understanding of the Tripartite Authorities' objectives and the firm's expertise in corporate restructuring. The firm was appointed to provide the Treasury and the Financial Services Authority with analyses of the options available for Northern Rock, strategic advice concerning potential bidders and lenders, as well as input into the issue of State Aid. This procurement approach was consistent with European Union public procurement regulations, which permit the use of a single tender procurement in the context of unforeseen events where there is insufficient time for a full procurement exercise.

4.17 Although Goldman Sachs commenced work in September 2007, a letter of engagement was not signed until 2 November 2007. A fee structure was not agreed by the Treasury until January 2008. The agreement included a retainer amounting to £300,000 a month plus a success fee of up to £4 million. The latter, however, did not specify what might constitute "success" in what was a complex and evolving situation. The Treasury and Goldman Sachs eventually agreed a fee based on:

Advice on the financing plan which would have involved an issue of bonds by the company backed by a Treasury guarantee	£2,000,000
Retainer (£300,000 a month for six months)	£1,800,000
Expenses	£50,000
Total	**£3,850,000**

4.18 Ernst & Young was engaged by the Bank of England, after assessing the suitability of three firms of accountants, to provide advice on the financial position of Northern Rock, review depositor repayment plans and examine potential implications of administration. The initial engagement lasted until 12 October, but was extended to cover the period up to 12 February 2008 to provide ongoing monitoring of Northern Rock's business. The relationship was primarily with the Bank of England, but the advice was shared across the Tripartite Authorities.

4.19 A cost recovery deed was signed by Northern Rock in October 2007, providing indemnities to the Treasury and the Bank for costs incurred in assessing and responding to issues relating to Northern Rock. Northern Rock agreed to pay any expenses incurred from 10 September 2007 onwards. The Treasury also provided the Bank with a separate indemnity covering its fees. Since February 2008, the Treasury has required further legal and financial advice from Slaughter & May, Ernst & Young and Goldman Sachs.

Subsequent actions to resolve difficulties at Bradford & Bingley

4.20 Bradford & Bingley was a medium-sized mortgage savings bank with just over three million retail accounts and 197 branches. The company had specialised in buy-to-let and self-certified mortgages, which were likely to be vulnerable to default in an economic slowdown. The market lost confidence in the company, leading to a sharp fall in its share price. On 27 September 2008, the Financial Services Authority declared Bradford & Bingley to be in default for the purposes of the Financial Services Compensation Scheme (FSCS). On 29 September, following a competitive sale process, Abbey National plc, a subsidiary of the Spanish bank Santander, bought Bradford and Bingley's retail deposits and branches. The remainder of Bradford & Bingley's business was taken into public ownership and will be wound down.

4.21 The Treasury employed Morgan Stanley as its financial adviser at a fixed price of £1.5 million. Morgan Stanley's role was to advise on the transfer of Bradford & Bingley into public ownership and the sale of its retail deposits and branch network. In analysing the options available, Morgan Stanley shared its financial models with the Treasury.

4.22 Although the problems at Bradford & Bingley were different from those encountered by Northern Rock, the Treasury was able to use its experience to put in place a solution that protected financial stability while exposing the taxpayer to fewer risks than had been the case for Northern Rock.

4.23 The Treasury and other members of the Tripartite Authorities were not fully prepared to deal with the problems presented by Northern Rock, and had to react to events rather than leading them. In the case of Bradford and Bingley, the Tripartite Authorities were better prepared, having kept a watch on the company before market conditions made action necessary. The Tripartite Authorities' experience in considering the options for Northern Rock allowed them to plan a course of action and research the potential market for a sale of the business ahead of the need to take action.

4.24 The Banking (Special Provisions) Act 2008 allowed the Treasury to take into public ownership, or transfer to another owner, a bank or building society judged to be a threat to financial stability. Having used the Act for the nationalisation of Northern Rock, the Treasury was in a position to act quickly where financial stability was considered to be at risk.

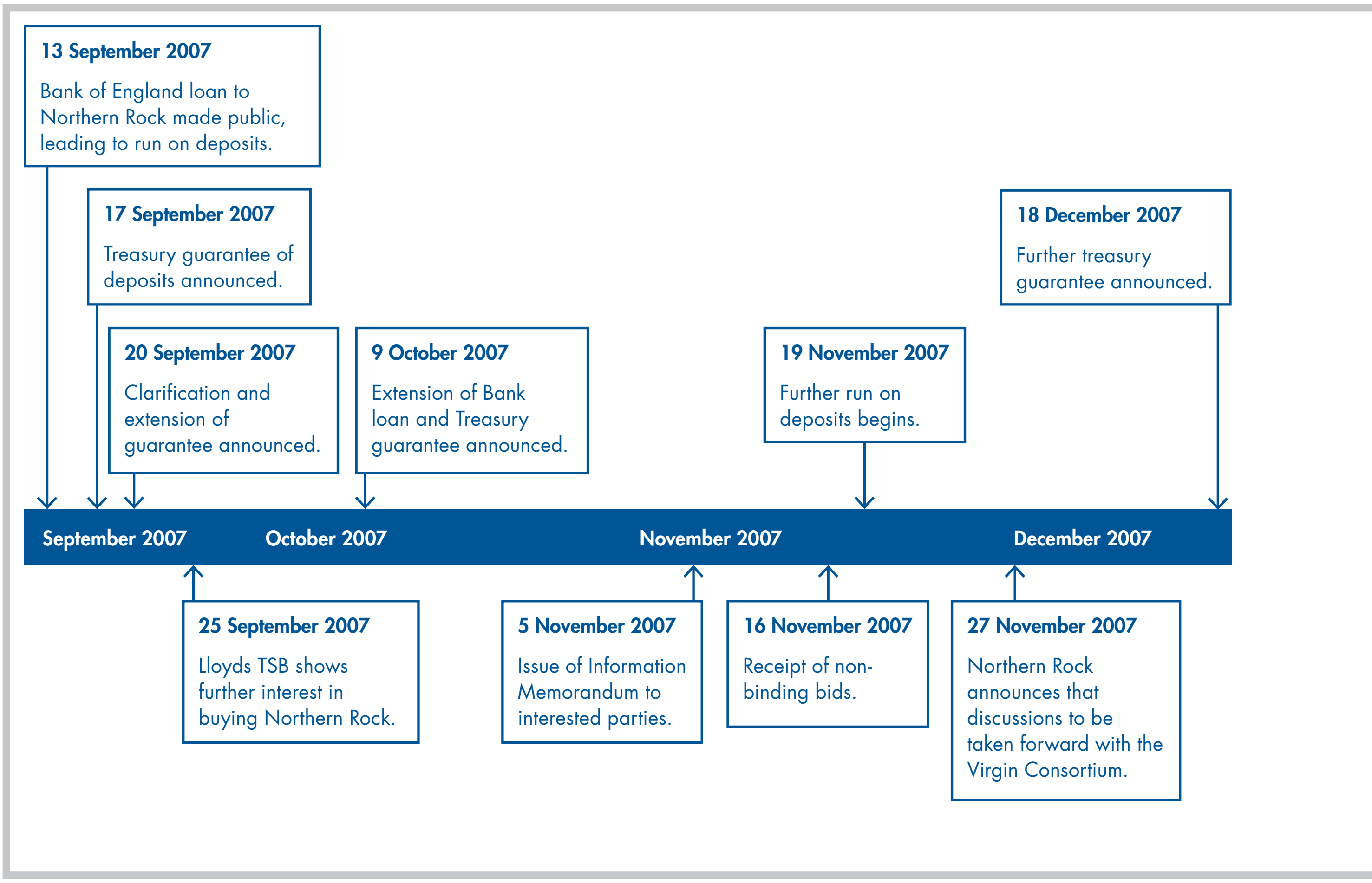
4.25 Unlike Northern Rock, Bradford & Bingley had a higher proportion of retail to wholesale funding. It had been able to withstand a shortage of wholesale funding since September 2007. The company's assets had not been tested, however, by a severe recession and were seen by the market as being at higher risk of default in worsening economic conditions. As market conditions continued to worsen, Bradford & Bingley raised £400 million in a rights issue to avoid the company's capital being eroded. Late in September 2008, following the rescue of banks in the UK and USA and the collapse of Lehman Brothers, public speculation about Bradford & Bingley's continuing viability led to a loss of confidence and a marked increase in customers withdrawing their money.

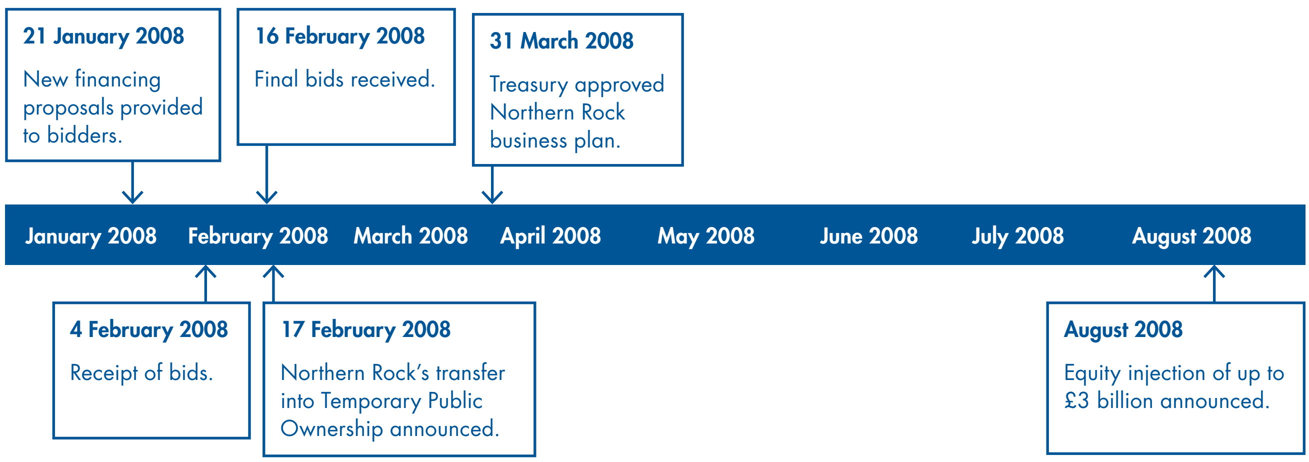
4.26 As market conditions continued to worsen and the company's outlook deteriorated further, without any prospect of improvement in the near future, the Financial Services Authority decided on 27 September that Bradford & Bingley no longer satisfied the conditions needed to continue taking deposits. This decision triggered the operation of the Financial Services Compensation Scheme, an option that was not available in the case of Northern Rock unless the emergency support from the Bank and Treasury was withdrawn. The triggering of the Financial Services Compensation Scheme allowed the Tripartite Authorities to protect financial stability without having to put large sums of public money into a private sector company in difficulty:

- a further run on Bradford & Bingley was avoided by taking it into public ownership and then transferring the deposit book to Abbey National, following a competitive process organised and run by the Treasury;
- the deposit book was funded by a cash transfer to Abbey National by the Financial Services Compensation Scheme, which in turn was funded by a loan from the Bank, since novated to the Treasury;
- the mortgage book will remain in public ownership and the lending to the Financial Services Compensation Scheme will be repaid as the mortgages in the book are redeemed. Any shortfalls are expected to be met by a levy on the commercial banking sector through the Scheme.

APPENDIX ONE

Chronology of key events




21 January 2008
New financing proposals provided to bidders.
16 February 2008
Final bids received.
31 March 2008
Treasury approved Northern Rock business plan.
January 2008
February 2008
March 2008
April 2008
May 2008
June 2008
July 2008
August 2008
4 February 2008
Receipt of bids.
17 February 2008
Northern Rock's transfer into Temporary Public Ownership announced.
August 2008
Equity injection of up to £3 billion announced.

APPENDIX TWO

Methodology

Scope of the study

1 We did not consider in our examination:

- The causes of Northern Rock's problems and the implications for the regulatory regime operated by the Financial Services Authority, both of which are outside our statutory audit responsibilities and have been examined in detail by the House of Commons Treasury Committee; or
- The consequences for the Bank of England's management of overall liquidity and stability in the financial system, along with changes to the framework for handling banks in difficulty.

Key questions for the study

2 We sought to establish whether the Treasury had achieved its objectives through answering the following key questions:

- Did the Treasury put in place adequate project and governance arrangements?
- Did the Treasury evaluate its options well?
- Is the Treasury managing the transfer of temporary public ownership well?

Methodology

3 Our fieldwork took place between June 2008 and January 2009 and comprised the following methodologies:

- advisory panel;
- document review;
- semi-structured interviews;
- analysis of Northern Rock's performance after being taken into public ownership;
- use of a financial consultant.

Advisory panel

4 We employed an advisory panel to help develop and test our study scope and key questions. Members were:

Cavendish Elithorn – Office of Fair Trading
Simon Hinshelwood – Lehman Brothers
John Moulton – Alchemy Partners
David Parker – Cranfield University
Mark Preston – ex Lloyds TSB

Document review

5 Our document review included:

- Treasury submissions made to Ministers starting in August 2007 when the Tripartite Authorities first became aware of Northern Rock's liquidity problems, through to the decision to take Northern Rock into temporary public ownership. We also reviewed some later submissions dealing with Northern Rock in public ownership;
- The advice the Treasury received, principally from Goldman Sachs its financial adviser, which underpinned many of the submissions made to Ministers;
- The e-mail traffic between the Tripartite Authorities and their advisers covering the period August 2007 when the Tripartite Authorities first became aware of Northern Rock's liquidity problems through to March 2008 after the decision to take Northern Rock into temporary public ownership;
- External sources of pertinent data such as the Bank of England financial stability reports, house price forecasts, and share price data.

6 We received some Treasury submissions to Ministers early in our fieldwork. Copies of further submissions relevant to the audit ,were received in November 2008. We gained access to the Treasury's electronic files on Northern Rock on 12 December 2008.

Semi structured interviews

7 To obtain a complete view from the public sector perspective of the steps the Treasury took to meet its objectives, we interviewed senior Treasury staff overseeing work on Northern Rock, and the leaders of the stabilisation, resolution and recovery teams; representatives of the other Tripartite Authorities, the Bank of England and the Financial Services Authority, and representatives of Goldman Sachs and Slaughter & May, the Tripartite Authorities' financial and external legal advisers. We also interviewed Ernst & Young as well as the former Chairman of Northern Rock, Bryan Sanderson, and The Blackstone Group in their role as advisers to the company.

8 We sought to ascertain whether the Treasury had prepared for a bank getting into difficulty, and had the capacity and skills to deal with such a situation. We also sought to ascertain what lessons the Tripartite Authorities had learnt from scenario testing, as well as the lessons learnt from handling the Northern Rock case.

9 We interviewed the current Chief Executive of Northern Rock and several potential purchasers of the company to obtain their views on the quality of the sale process, and their view on the lessons the Treasury should learn from handling the Northern Rock case.

Analysis of Northern Rock's performance after being taken into public ownership

10 We assessed whether Northern Rock was achieving the targets set for it in public ownership through examining the regular returns it was required to make to the Treasury and discussions with the company's present management.

Use of a financial consultant

11 Following competitive tendering, we engaged the Financial Consultants, Promontory, to determine the reasonableness of:

- The view that the credit quality of Northern Rock's closest comparators was affected by the run on retail deposits in September 2007, making intervention by the Treasury to protect financial stability a necessity;
- After the Bank of England support and Treasury guarantee arrangements had been put in place, the assumptions made to quantify the potential risks to the taxpayer if Northern Rock was placed in administration or a solvent wind down;
- The assumptions surrounding the estimate of the public subsidy required if the Treasury had accepted one of the two final bids for the company or taken it into public ownership;
- The amount of "due diligence" undertaken by the Treasury before the decision to take the company into public ownership was made;
- The projections used by Northern Rock in putting together its business plan for the period it is expected to remain in public ownership.

12 In meeting their remit, Promontory reviewed Treasury submissions and advisers' documents, but also took into account external sources of pertinent data.

APPENDIX THREE

The Treasury Committee report on Northern Rock

The causes of Northern Rock's problems and the implications for the regulatory regime operated by the Financial Services Authority were identified by the Treasury Committee in a report published in 2008. The key conclusions are set out below.

Northern Rock's business model

The directors of Northern Rock were the principal authors of the difficulties that the company has faced since August 2007. The high risk, reckless business strategy of Northern Rock, with its reliance on short and medium term wholesale funding and an absence of sufficient insurance and a failure to arrange standby facility or cover that risk, meant that it was unable to cope with the liquidity pressures placed upon it by the freezing of international capital markets in August 2007.

It was unfortunate that the shareholders who acquired their shares as part of demutualization and the staff of Northern Rock have suffered significantly from the fall in the value of Northern Rock shares. However, it is not possible to make a distinction between types of shareholders in the circumstances of Northern Rock. In a market environment, shareholders as a whole must be viewed as taking a risk from which they sought a reward and for which they are now paying a price.

The regulation of Northern Rock

The FSA did not supervise Northern Rock properly. The FSA has acknowledged that there were clear warning signals about the risks associated with Northern Rock's business model, both from its rapid growth as a company and from the falls in its share price from February 2007 onwards. However, insofar as the FSA undertook greater "regulatory engagement" with Northern Rock, this failed to tackle the fundamental weakness in its funding model and did nothing to prevent the problems that came to the fore from August 2007 onwards. We regard this as a substantial failure of regulation.

The events of August and September

The Chancellor of the Exchequer's decision in September 2007 to make a support facility available to Northern Rock should the need arise was the right one. Had he chosen not to do so, there would have been a significant risk of substantial disadvantage to Northern Rock depositors and a very real prospect of contagion whereby the public would lose confidence in the security of holdings across the United Kingdom banking system. Had any other decision been taken, it is quite possible that the events that unfolded from mid-September onwards could have been more damaging to consumers and to the United Kingdom financial system than those that have actually taken place.

Dealing with failing banks

The larger deposit-taking institutions, such as banks and building societies, are "special" organisations in modern life, similar in some ways to utility providers. Banks should be allowed to "fail" so as to preserve market discipline on financial institutions. However, it is important that such "failure" should be handled in an ordered manner, managed in such a way as to prevent further damage to the economy, the financial, system and the interests of small depositors.

The taxpayer should not bear the risks of banks failing. Nor do we believe that small depositors should bear such risk. Rather, the risk of failure should be borne by a bank's shareholders and creditors, but exclude small depositors. The Government must ensure that the framework for handling failing banks insulates taxpayers and that small depositors should also be protected from the risk of banks failing.

APPENDIX FOUR

Northern Rock's use of securitisation and its relationship with Granite

Background

Long term assets such as mortgages are illiquid in the sense that they cannot easily be sold in financial markets for cash. Securitisation provides a mechanism for mortgage lenders to realise the value of mortgage assets prior to their maturity. A pool of mortgages and the cash flow they will generate form the underlying assets for a sale of tradeable securities, such as bonds, to investors.

Such transactions are called securitisations because payments on the bonds bought by investors are dependent on the cashflows from, and are secured over, the illiquid assets. The illiquid assets can be said to have been converted or "securitised" into liquid assets (bonds).

How securitisations are arranged

Securitisations typically utilise a special purpose vehicle (SPV). The SPV buys the illiquid assets (mortgages) from the mortgage lender (the originator) and funds the purchase by issuing securities (bonds) to investors. Repayment of principal and interest on the bonds is directly linked to the repayment of principal and interest on the underlying mortgages.

Once the assets are transferred to the SPV, there is normally no recourse to the originator for repayment of the securities issued by the SPV. On the other hand, the SPV is structured to be 'bankruptcy remote' from the originator, meaning that if the originator becomes insolvent, the assets of the SPV will not be distributed to the creditors of the originator. In order to achieve this, the governing documents of the securitisation restrict the activities of the SPV to those necessary to participate in the securitisation.

Balance sheet treatment of an SPV

Accounting standards govern how a securitisation is treated on the originator's balance sheet. Where the originator has sold the asset pool to the SPV, those assets do not usually remain on the originator's single company balance sheet. Where the SPV is controlled by the originator through contractual arrangements relating to the securitisation, it may be considered to be a subsidiary of the originator. This means that the assets and liabilities of the SPV would be consolidated on to the group balance sheet of the originator.

Northern Rock's use of Granite

Granite is a group of companies which have been set up solely for the purposes of providing an on going source of funding to Northern Rock. The "Granite" companies can be collectively termed as a "securitisation vehicle".

Granite is similar to other securitisation vehicles. Northern Rock sells mortgages to Granite. The Granite vehicle funds the purchases of these mortgages by issuing bonds to investors. The cash that is raised from investors is then used by Granite to purchase the mortgages from Northern Rock.

Northern Rock, however, retains an interest in the mortgages it sells to Granite. The proceeds from the sale of mortgages to Granite will always be at their actual value, but the payment to Northern Rock will be made partly in cash and partly as a share of future receipts from the mortgages (the so-called "seller's share").

The principal reason the seller's share was established was to protect the Granite bondholders if Northern Rock became insolvent. In such circumstances, customers whose mortgages had been sold to Granite might be entitled to set off amounts owed to them (for example, in deposit accounts) against amounts they owed under their mortgages. The seller's share bears this set off risk.

Repayment of Granite bonds

The Granite bondholders can only look to the mortgages in Granite as a source of their repayment, not to the assets of Northern Rock. Because the Government has not guaranteed the Granite bonds, it will not be liable to investors. Granite has two modes of operation.

Granite in normal operation

In its normal mode, regular payments of principal and interest from the mortgages are paid to both the bondholders and Northern Rock. If a mortgage is redeemed and the capital element repaid, the payment will be received by Granite which will pay an amount to the bondholders and an amount to Northern Rock, with any excess cash over and above what is needed to pay bondholders being distributed to Northern Rock.

A worked example is provided below:

- Initial value of mortgages sold to Granite is £1000. The initial share is £100 (10 per cent) for Northern Rock (the seller's share) and the bondholders' share is £900 (90 per cent). On the next payment date for bondholders, say £60 is due to be paid, and on that date assume that Granite has received £100 in payments of interest and principal from the underlying mortgages;
- The bondholders are paid £60. Northern Rock is paid its share of the distribution (10 per cent or £10). The remainder (£30) is then paid to Northern Rock as a further distribution of its share of Granite;
- After the distribution, the value of Granite is now £900 (£1,000 less £100). The seller's share is £60 (£100 less £40) and the bondholders' share is £840 (£900 less £60).

In the above example, if the amount required to pay bondholders was £120, not £60, bondholders would only be paid £100 and Northern Rock would not receive a payment. The bondholders would not have recourse against Northern Rock for the remaining £20 they are owed, but could receive this amount in subsequent collections of principal repayments from the underlying mortgages.

Granite in "pass through" mode

As in the above example, the seller's share can fall on each distribution date. If Northern Rock's share of the trust falls below a threshold level (the minimum seller's share), the Granite structure starts to operate in "pass-through" mode. The effect on Northern Rock would be that it would not receive repayments according to its share of Granite until the bondholders' share had reduced to zero.

In pass through mode, the bondholders still bear the risk that there are insufficient funds in Granite to repay them. Therefore, Northern Rock's share of Granite is preserved but deferred. Taking the example above:

- Value of assets in Granite is £1000, Northern Rock has a 10 per cent share (£100) and bondholders have a 90 per cent share (£900);
- In pass through mode, Northern Rock will not receive any share of principal receipts from the mortgages until the bondholders have been fully repaid from the assets in the pool up to their 90 per cent share;
- However, the bondholders will only receive £900 if there are no defaults on the underlying mortgages. If defaults occur, the mortgage pool will reduce (for example, if there are losses of £200 the pool would reduce from £1,000 to £800 and bondholders will only receive 90 per cent of £800 (£720), notwithstanding they are owed £900;
- Ten per cent of the now £800 pool will go to Northern Rock as well as surplus monies once the bondholders have been paid their 90 per cent share. Northern Rock's 10 per cent share does not go to make up the shortfall for bondholders when the pool value goes down from £900 to £800.

Further use of Granite in certain circumstances

In normal operation, Northern Rock would sell additional mortgages to Granite in two scenarios:

- **To obtain new funding**. Northern Rock would only sell additional mortgages into Granite if it was a better source of financing relative to other sources;
- **To maintain the size of Northern Rock's share of Granite**. If the minimum seller's share is not maintained, Granite will eventually go into "pass-through" mode.

In both scenarios, Northern Rock would receive value for the sale of mortgages into Granite. Since September 2007, no mortgages have been sold into the Granite structure by Northern Rock. If Granite enters "pass through" it would no longer be possible for Northern Rock to sell mortgages to Granite. Granite could not be used to raise new funds in the future as entering "pass through" mode is irreversible.

The ownership of Granite

The holding company is Granite Finance Holdings Limited. The shares in this holding company are held for the benefit of charities under a trust arrangement. The named charity is Down's Syndrome North East Association (UK) and other charities which the company can select. Because Granite was set up as a funding vehicle for Northern Rock, it would not have been appropriate for a third party to own the shares in Granite Finance Holdings Limited. A charitable trust is a method of legally achieving the required result. These structures are commonly used in mortgage-backed securitisations in the UK.

The control of Granite

Northern Rock provides services to Granite which enables it to meet its obligations to bondholders, including mortgage administration and cash management services. Granite is also a special purpose vehicle whose primary purpose is to provide funding to Northern Rock for mortgage lending. The Granite structure has little discretion to act outside of its contractual obligations, though control is ultimately vested in the bondholders and the trustee, rather than Northern Rock. Nationalising the shares in Granite Finance Holdings Limited would not therefore confer any significant advantage in relation to the control of the Granite vehicle or the rights or liabilities of Northern Rock in relation to the Granite structure.

Granite is classified to the public sector while Northern Rock is in public ownership

The Office of National Statistics (ONS) recognised that Granite is a separate legal entity from Northern Rock, but considered that for the purpose of the National Accounts it should be consolidated with the company because Northern Rock is the economic beneficiary of the securitisation. The consequence is that both Northern Rock and Granite are temporarily consolidated in the public sector for the purpose of the National Accounts. The ONS decision mirrors that of the accounting treatment of Granite in Northern Rock's group annual report and accounts.

Ongoing assets and liabilities of Northern Rock in Granite

The following sets out the ways in which Northern Rock is exposed to the Granite group of companies. These exposures arise not from public ownership but from pre-existing contractual arrangements and from Government guarantee arrangements put in place prior to public ownership. Ahead of public ownership, the assets and liabilities offset one another.

Northern Rock had assets in Granite worth around £5 billion

There were four assets in Granite:

- **the seller's share**: Northern Rock's share of the mortgages sold to Granite is calculated using a formula based on the redemptions of mortgages in the pool and therefore fluctuates on a monthly basis, but was worth between £4 billion and £6 billion;
- **Reserve Funds**. Granite maintains reserve funds worth around £800 million which operate as a cash buffer. The funds are used to pay amounts due on the Granite bonds if interest flows on the mortgages are not sufficient and are replenished by receipts from the mortgages only after such payments are made. They are assets to Northern Rock as, once Granite has paid bondholders, the residual sum left in the Reserve Funds will be paid to Northern Rock;
- **Start up loans**. When Northern Rock established Granite it provided start-up funding for the reserve funds outlined above. Each month any excess over what is required to pay interest on bonds and to top up the Reserve Funds is used to repay amounts due on the start up loans;
- **Deferred consideration**. When Northern Rock sells mortgages to Granite for cash it does so at par value. In other words it sells £100 of mortgages for £100 cash minus the seller's share. So there is potentially a difference between the amount of interest the mortgages pay over their lifetime and the interest Granite pays to bondholders. The excess of this interest over and above payments to bondholders is payable to Northern Rock and is known as "deferred consideration" for the sale of mortgages to Granite. However, this asset does not build up over time. Granite is structured so that each month any excess interest over what is required to pay interest on the bonds is paid to Northern Rock.

Northern Rock liabilities

There were three liabilities valued at a maximum of just under £5 billion:

- **the "basis swaps"**. The yield on the mortgages assets in Granite varies as some are fixed but many vary with Bank base rate. In order to match interest amounts received and paid, Northern Rock enters into a swap arrangement where it provides Granite with interest at LIBOR plus a margin and Granite provides it with the actual cash interest on mortgages. Northern Rock then has the option to hedge this interest mismatch, which it does to a certain extent. Northern Rock is therefore exposed to the extent that it is not completely hedged or chooses not to hedge certain risks on the basis that to do so would be poor value. For example, Northern Rock does not hedge the movements between Bank base rate and three month LIBOR. The potential liability was in the order of £200-300 million, depending on changes in the difference between the two interest rates. These swap contracts were covered by the Treasury's guarantee arrangements from 18 December;
- Northern Rock provides **mortgage servicing arrangements** to Granite. These requirements are set out in a servicing contract between Northern Rock and Granite. To the extent that Northern Rock fails to perform the duties set out in this contract it could be required to pay contractual damages for breach of contract;
- **Guaranteed Investment Contract accounts**. These accounts are the bank accounts of Granite. They receive the interest on mortgages and are used to make payments to bondholders. In most cases, the accounts are held with Northern Rock and it has a contractual liability to ensure that the accounts are available where necessary to meet Granite's cash requirements. As with the basis swaps, this liability is covered by the guarantee arrangements announced on 18 December, so there was an exposure to the taxpayer but it was limited to the size of the accounts, which stood at £4.2 billion on 21 February 2008.

Northern Rock announced in November 2008 that its share of Granite (the seller's share) had fallen below the minimum level required on two consecutive dates. As a result of this "non-asset trigger event", Granite moved into pass-through. Holders of Granite bonds will therefore receive the principal repayments from the underlying mortgages within Granite. Northern Rock will not receive any payments of principal from the underlying mortgages until the bond holders have been repaid. Northern Rock's business plan in public ownership assumed that Granite would gradually wind down as the company reduced its balance sheet. The move to pass-through changes the timing and order in which the Granite bonds are repaid.

APPENDIX FIVE

The roles and responsibilities of the Tripartite Authorities

This Appendix sets out the roles and responsibilities of the Bank of England, the Financial Services Authority and the Treasury in maintaining financial stability.

The Bank of England's responsibilities

As well as maintaining a broad overview of the financial system, the Bank contributes to the maintenance of financial stability by:

- making funds available in the markets to deal with fluctuations in liquidity;
- overseeing financial system infrastructure systemically significant to the UK, in particular payments systems whether based in the UK or abroad;
- undertaking, in exceptional circumstances, official financial operations, in accordance with the Tripartite arrangements in the Memorandum of Understanding on financial stability, to limit the risk of problems in or affecting particular institutions spreading to other parts of the financial system.

The Financial Services Authority's responsibilities

The FSA's powers and responsibilities are set out in the Financial Services and Markets Act 2000. It is responsible for:

- the authorisation and prudential supervision of firms providing financial services;
- the supervision of financial markets, securities listings and of clearing and settlement systems;
- the conduct of operations in response to problem cases affecting firms, markets and clearing and settlements systems within its responsibilities, and within Tripartite arrangements in the Memorandum of Understanding on financial stability. For instance, the FSA may change regulatory requirements and facilitate the introduction of new capital into a troubled firm by third parties.

The Treasury's responsibilities

The Treasury is responsible for:

- the overall institutional structure of financial regulation and the legislation which governs it;
- informing and accounting to Parliament for the management of serious problems in the financial system and any measures used to resolve them.

The relationship between the Tripartite Authorities

Through the exercise of their responsibilities, the Bank and the FSA gather a wide range of information and data. Information exchange takes place on several levels. The Bank's Deputy Governor (financial stability) is a member of the FSA Board, and the FSA Chairman sits on the Court of the Bank. At all levels, there should be close and regular contact between the FSA and the Bank, who also maintain a programme of staff secondments to foster a culture of co-operation.

The Treasury has no operational responsibility for the activities of the FSA and the Bank, but there are a variety of circumstances where the FSA and the Bank will need to alert the Treasury. For example, where a serious problem could cause wider financial or economic disruption or where there could be a need for a support operation.

A Standing Committee on Financial Stability is chaired by the Treasury and comprises representatives of the Treasury, the Bank and the FSA. It is the principal forum for agreeing policy and, where appropriate, coordinating or agreeing action between the three Authorities. The Standing Committee meets on a monthly basis at deputies (officials) level to discuss individual cases of significance and other developments relevant to financial stability. Meetings can be called at other times by any of the participating Authorities if there is an issue which needs to be addressed urgently. A sub-group of the Standing Committee coordinates the Authorities' joint work on financial sector resilience and maintains and tests arrangements for crisis management in an operational disruption.

Financial crisis management

In exceptional circumstances, for instance where a support operation is being considered, the Standing Committee meets at principals level, comprising the Chancellor of the Exchequer, the Governor of the Bank and the Chair of the FSA (or senior alternates). Using their expertise, and from the perspective of their responsibilities, the Bank and the FSA will assess the seriousness of the crisis and its potential implications for the stability of the financial system and provide separate assessments to the Treasury, together with their views on the options available to the Chancellor. The Standing Committee may then discuss the most appropriate response and ensure effective co-ordination of response, while respecting formal responsibilities. Responsibility for the authorisation of a support operation in exceptional circumstances rests with the Chancellor of the Exchequer.

In any such exceptional circumstances, the Authorities' main aim would be to reduce the risk of a serious problem causing wider financial or economic disruption. In acting to do this, the Authorities seek to minimise both moral hazard in the private sector and financial risk to the taxpayer arising from any support operation.

The Authorities also maintain a framework for the management of an operational crisis:

- The Treasury will ensure that ministers are kept informed of developments so as to be able to take key decisions without delay and liaise with other UK government departments;
- The Bank will ensure the orderly functioning of the financial markets, including the maintenance of adequate liquidity. As banker to the banking system, the Bank has specific responsibility for maintaining operational contacts with market participants so as to monitor and facilitate the functioning of UK markets. This may include the provision of liquidity assistance or other support operations agreed within the framework;
- The FSA will monitor the health of institutions that fall within its regulatory remit and ensure, as far as is appropriate, continuing compliance with regulatory standards.

APPENDIX SIX

The Financial Services Compensation Scheme

Role of the Financial Services Compensation Scheme

The role of the Financial Services Compensation Scheme (FSCS) is to provide consumers of financial products with a degree of loss protection if a financial firm becomes unable, or is likely to be unable, to pay claims against it. This will generally be because a firm has stopped trading and has insufficient assets to meet claims, or is in insolvency. The existence of the FSCS is meant to give consumers greater confidence in dealings with financial firms.

The FSCS is an independent body created under the Financial Services and Markets Act 2000. It became operational on 1 December 2001. The Scheme covers business conducted by firms authorised by the Financial Services Authority. Customers of European firms (authorised by their home state regulator) that operate through branches in the UK may be protected by the home state scheme but they may also have additional protection from the FSCS in certain circumstances. The FSCS consists of a number of sub-schemes that offer protection against losses on deposits or in connectiom with other regulated activities such as providing insurance policies.

Compensation for losses on deposits

This Sub-scheme covers claims made against failed deposit-taking firms, for example banks, building societies and credit unions. The sub-scheme is triggered when a firm authorised to accept deposits by the Financial Services Authority goes out of business, for example if the firm goes into administration or liquidation, and is unable to repay its depositors. The FSCS can also be involved if the FSA considers that an authorised firm is unable, or likely to be unable, to repay its depositors. Once the FSCS is satisfied that a firm is unable, or likely to be unable, to pay claims against it, the firm is declared to be in default. A declaration of default opens the way for the firm's customers to make a claim for compensation.

The FSCS will meet a proportion of the costs of any deficit if the assets of a firm are insufficient to meet liabilities when depositors' claims are paid out. Prior to 1 October 2007, the scheme offered 100 per cent protection of the first aggregated £2,000 and 90 per cent of the next £33,000, up to a total compensation payable of £31,700 for each depositor. The limit was raised to 100 per cent of the first £35,000 on 1 October 2007, and raised again to 100 per cent of the first £50,000 from 7 October 2008.

Funding of the FSCS

The FSCS does not maintain a standing fund to meet claims when needed. Rather, the FSCS raises levies each year to enable it to meet its anticipated obligations in respect of compensation costs in the following 12 months and to meet management expenses in the current financial year. The FSCS can raise additional levies at any point during the year, as necessary, subject to limits on levies laid down in the rules of the scheme, which the FSA makes. Compensation costs and management expenses (other than general FSCS overheads) fall first on the firms in the same sub-scheme as the defaulting firm. In most cases, if compensation costs exceed the levy limit for the sub-scheme, levies may also be raised from levy payers in other sub-schemes up to the overall levy limit. Specific management expenses fall only on the firms in the same sub-scheme as the defaulting firm and all firms have to contribute to any levy for FSCS general overheads. Within an overall compensation costs levy limit of £4.03 billion, the levy limit on compensation costs for deposit takers in any one year is currently £1.84 billion. The FSCS normally takes over the customers' claims on a failed firm when it pays compensation and it can therefore use recoveries from a failed firm to reduce the levies it needs to raise. Deposit taking firms have benefited from the existence of FSCS coverage without having to pay substantial levies in recent years. Other than for on-going management costs of the Scheme, deposit takers have been levied only once since the FSCS was established, for £3.9 million in 2008-09.

Operation of the FSCS

Following a default and payment of compensation, the FSCS takes over the claims it has paid on equal terms with other similarly ranked creditors of the defaulting firm.

For example, if a bank holds £20 billion of deposits of which £10 billion is in deposits up to the £50,000 compensation limit from FSCS eligible claimants, the FSCS would pay out £10 billion as quickly as possible to eligible depositors using levies and borrowing. The FSCS would then attempt to retrieve all of its payments and costs from its share of the recoveries form the assets of the bank in default, which could take a number of years. If at the end of the wind down only £18 billion had been realised to cover creditors' claims then the levy would be repaid to the banking sector less £1 billion, its share of the £2 billion deficit. Other creditors would be £1 billion out of pocket.

If the Government's guarantee arrangements for Northern Rock had been called, any shortfall of assets to repay retail deposits above the FSCS compensation limit and wholesale deposits included in the arrangements would have been met by the Treasury.

Bradford & Bingley

The FSA determined on 27 September 2008 that Bradford and Bingley no longer met its threshold conditions for operating as a deposit taker under the Financial Services and Markets Act 2000 and FSA rules. In response, the government transferred Bradford and Bingley's deposit book, branch network and relevant staff to Abbey National plc. As the latter did not wish to accept matching Bradford and Bingley assets, the transfer of the deposit book was facilitated by cash from the FSCS and the Treasury.

The FSCS paid Abbey National plc some £14 billion to enable retail deposits held by FSCS eligible claimants in Bradford and Bingley to be transferred. The FSCS financed the payout initially through a short term loan form the Bank of England, now repaced by a loan from the Treasury.

The Treasury paid £4 billion to Abbey (net of £612 million paid by Abbey) for the transfer of retail deposits not covered by the FSCS. In return, the FSCS and the Treasury have acquired rights to the proceeds of the wind down of the assets of the remaining business of Bradford and Bingley in public ownership. The Treasury will appoint an independent valuer to assess compensation payable to Bradford & Bingley's former shareholders.

For the first three years, the FSCS will pay interest on the loans at LIBOR plus 30 basis points and LIBOR plus 100 basis points for the following years. The first payment of interest will be in September 2009, with subsequent payments made at annual intervals, financed by levies on the financial service industry. The principal will be repaid over a number of years after March 2012, depending on prevailing market conditions and how swiftly Bradford and Bingley's business winds down.

As regards the repayment of principal, the banking sector will not be levied by the FSCS until it is apparent, which is likely to be a number of years in the future, whether the amount realised from the sale of Bradford and Bingley's assets covers the amount paid out by the FSCS.

Other defaulting banks

Since the FSA declared Bradford and Bingley to be in default, the FSCS has also been triggered for four other banks: Heritable Bank, Kaupthing Singer & Friedlander, Icesave (the internet based product made available by the UK branch of the Icelandic bank, Landsbanki), and London Scottish Bank. In each case, the FSCS funded its portion of the compensation costs through a short term loan from the Bank of England, now replaced by a loan direct from the Treasury.

Future operation of the Financial Services Compensation Scheme

The Banking Act 2009 includes a number of improvements in the operation of the FSCS, primarily aimed at a swifter payout of compensation to depositors. These include:

- A new insolvency procedure for banks to ensure that depositors who are eligible for compensation under the FSCS receive prompt payment or have their accounts transferred to another financial institution whilst also providing for the winding up of the affairs of a failed bank in the interests of its creditors as a whole;
- The FSA being able to collect information from a firm (and to share it with the FSCS) before default, so that the adequacy of a firm's systems to provide information to assess whether a payout is practical, and to prepare for compensation payments to be made, should a firm fail;
- The FSCS being able to make payments to depositors based on the records of a bank;
- The FSCS having access to immediate liquidity through borrowing from the National Loans Fund;
- The inclusion of powers that would allow the introduction of pre-funding of the FSCS if it was considered appropriate to do so in the future.

APPENDIX SEVEN

Good practice in sales process

Comparison of good practice in the conduct of trade sales and the process used in the attempted sale of Northern Rock.

Action	Good practice	Process used in the sale of Northern Rock
Responsibility for the sale process	Where the institution for sale (the vendor) is not controlled directly, the department with policy oversight should take responsibility for ensuring that the sale arrangements achieve value for money and that all wider questions affecting the public interest are considered.	The final decision on a sale would be made by Northern Rock's shareholders. The sale process was run by the company's board, which appointed its own lawyers and financial advisers. Early legal advice indicated that the Treasury should not become involved in the day to day management of Northern Rock. When it became clear that potential buyers could not arrange private funding for a bid, the Treasury began to take a more pro-active role in trying to find a solution.
	In this role, the department should set its own objectives for the sale and appoint its own expert advisers.	The Treasury developed high level objectives for the sale and appointed expert advisers at an early stage.
Investigation of the market	Maximum value for money will be achieved by promoting the widest possible competition. The sale process should investigate the market to attract as many bidders as possible through advertising the sale, targeting potential bidders individually and employing professional advisers with a knowledge of the industry.	The sale of Northern Rock was publicised widely. Northern Rock received 14 expressions of interest. No major banks expressed an interest in the whole company. Of the three expressions of interest for the whole company, two were from private equity firms and the other was from a relatively small financial services company. The remainder of the expressions of interest were for parts of Northern Rock. Later on, the offer of a public financing option resulted in two bids.
Preparation of an Information Memorandum	Produced by the vendor, this provides a brief trading history of the entity and information on its prospects. It should provide sufficient information to allow prospective purchasers to formulate their initial bids. It should also set out the timetable for the sale process which should be adhered to. The criteria by which a vendor is to evaluate bids should be included in the Information Memorandum to aid bidders in making informed and acceptable bids.	Northern Rock produced an Information Memorandum on which the Treasury had limited opportunity to comment and which only set out a timetable for the receipt of non-binding bids. Northern Rock allowed one bidder extra time to deliver its bid. Where this is allowed, all bidders should be allowed the same extra time. The Treasury had made it clear in October 2007 that any proposal put forward by bidders would be evaluated against its stated objectives. After a request by the bidders, the Treasury made available a set of transaction principles on which it would judge the acceptability of bids. The principles were not made available until after non-binding offers had been made but before the receipt of binding offers.

Action	Good practice	Process used in the sale of Northern Rock
Allow potential bidders the opportunity to seek clarification of matters	Allowing potential bidders to seek clarification of major points will lead them to make more informed and acceptable bids.	One bidder commented to us that it found it extremely difficult to obtain information and answers to its questions from Northern Rock.
Benchmark valuation	Vendors should obtain an accurate and up to date benchmark valuation for the business to be sold. It should not just be used as an estimate of likely proceeds but also as an indication of the level of proceeds below which the vendor would consider carefully whether or not to continue with the sale.	Goldman Sachs produced a valuation for Northern Rock by comparing it to recent sales of other banks. Understandably, those sales were not of banks in receipt of Bank of England support. The valuation formed part of the analysis of the two final bids against the option of public ownership.
Choose bidders to take to the next stage of bidding	The vendor, with the assistance of professional advisers, should assess the initial bids and draw up a shortlist of potential buyers to undertake due diligence and submit detailed bids, including a mark up of the vendor's Sale and Purchase Agreement.	Northern Rock's scope to shortlist potential buyers to take to the next stage of bidding was limited because it only received three offers for the whole company.
Evaluation of formal offers	Vendors should use pre-prepared evaluation criteria linked to their objectives to assess the final bids.	The Treasury assessed bids received against its Transaction Principles.
Selection of preferred bidder	The vendor should only select a preferred bidder once negotiations are practically complete as the announcement of a preferred bidder releases competitive tension, placing the preferred bidder in a strong negotiating position, especially if there is a wide range of matters left to be agreed.	As any final decision would be in the hands of its shareholders, the company could not guarantee that a preferred bidder would be successful. Northern Rock continued discussions with all three bidders, although it chose to take forward discussions with the Virgin Consortium on the basis of the non-binding offers received. When discussions with the Virgin Consortium faltered, a public finance option was offered and fresh bids sought. Negotiations took place with the two bidders who submitted bids on the due date.
Involvement of Management Buyout teams	There needs to be transparency where a management buyout team is involved in bidding so that there is openness and fairness in dealing with all potential bidders. There needs to be clear separation of the functions of vendor and potential buyer, with clear responsibilities between all staff during the conduct of the sale.	The Northern Rock management team became interested in making an offer for the company when the public financing option was made public. To avoid any potential conflict of interest, the Treasury and the other members of the Tripartite Authorities took the lead in evaluating the final bids from the Virgin Consortium and the management team.

Sources: Trade sales including management buyouts (MBOs), HM Treasury July 1996.
Committee of Public Accounts, Getting value for money in privatisations (61st Report of Session 1997-98, HC 992).
Getting best value from trade sales and strategic partnerships, HM Treasury, November 2000.

APPENDIX EIGHT

Summary of bids

Criteria	Virgin Consortium Base case	Northern Rock Management Base case
Size of balance sheet	Total assets reduced from £109 billion (2007) to £49 billion in 2011. Total mortgage book reduced from £92 billion (2007) to £35 billion in 2011.	Total assets reduced from £109 billion (2007) to £43 billion in 2011. Total mortgage book reduced from £92 billion (2007) to £29 billion in 2011.
New mortgage lending	New business of £3.4 billion a year in 2008-2010 and £6.7 billion in 2011.	New business of £2.5 billion to £4 billion a year up to 2011.
Retail deposits	Increase to £20 billion by 2011.	Increase to £16 billion in 2011.
Wholesale funding	New unsecured wholesale financing of £2 billion beginning in 2011 with £500 million increments every quarter.	New third party funding from beginning of 2011 with £500 million of wholesale borrowing.
Profitability	First profitable year is 2009. Profits attributable to shareholders of £15 million, growing to £158 million in 2011.	First profitable year is 2009. Profits attributable to shareholders of £5 million, growing to £138 million in 2011.
Outstanding guaranteed bonds	Issuance of £27 billion of government-backed bonds in March 2008. Bonds repaid in February 2010.	Issuance of £26 billion of government-backed bonds in September 2008, including a £5.5 billion liquidity reserve. The liquidity reserve to remain available until 30 September 2011.
Outstanding guarantees for other liabilities	Guarantee arrangements for liabilities of £30.5 billion at September 2008, growing to £31.7 billion in December 2011.	Initial guaranteed liabilities of £29.3 billion at September 2008. All guarantee arrangements assumed to be withdrawn by April 2011.
Surplus regulatory capital	Surplus capital ranging from £1.9 billion in 2008 to £3 billion in 2011. Cumulative impairment charges of £547 million over 2008-2011.	Surplus capital ranging from £1.4 billion (2008) to £2.5 billion in 2011. Cumulative impairment charges of £100 million over 2008 to 2011.
Amount and source of new equity	Underwritten rights issue of £500 million at 25 pence a share plus cash injection (£500 million) and Virgin Money (£250 million) in March 2008.	Rights issue in May 2008 of £700 million at 35 pence a share.
Treasury share in potential equity returns	Treasury to receive warrants over 10 per cent of the Company's fully diluted share capital following completion, exercisable at 25 pence. The warrant will vest in equal tranches over the period between the second and fifth anniversaries of completion, subject to the share price exceeding 50 to 75 pence. No net proceeds in base case exit assumption.	Treasury to receive warrants over 15 per cent of the company's fully diluted share capital following completion, exercisable at 35 pence. Warrants vest at a share price of 35 pence over a ten year term. Estimated cash proceeds to Treasury on base case exit assumptions in December 2011 of some £230 million.

APPENDIX NINE

Regulatory capital

Capital serves as a buffer to absorb unexpected losses as well as to fund the ongoing activities of a bank. Losses will occur in the normal course of business. When making a loan, or selling any product, a bank will take account of expected losses when determining the price to charge the customer. The bank's income should therefore cover expected losses, as well as any other costs associated with the day-to-day running of the business. Unexpected losses are by their nature unforeseen, so banks will need to hold enough capital to act as a buffer against these losses and to support them during periods of financial stress.

In general, banks hold capital as a mixture of ordinary shares (equity) and debt instruments (such as loan notes) that meets the risk and reward preferences of equity shareholders and debt investors. A bank's capitalisation and gearing are crucial market indicators for potential investors, as well as rating agencies and other interested parties.

Banks often have long term assets, funded by shorter term deposits and liabilities. This can lead to liquidity problems in periods of market turbulence, particularly where banks may have to service large depositor withdrawals. In these circumstances, regulations such as minimum capital requirements help a bank to remain solvent and contribute to its ability to withstand liquidity problems. Given the importance of deposits to consumers and the role of banks in maintaining economic stability, all banks regulated by the FSA are required to hold a minimum amount of capital, usually expressed as a percentage of the value of a bank's risk-adjusted assets.

FSA regulations on capital operate to protect depositors in two main ways:

- By requiring banks to hold capital capable of absorbing unexpected losses while the bank is solvent, thus reducing the probability of a bank failing. Even if there is no loss to depositors when a bank fails, the disruption caused through any temporary difficulty in accessing funds could cause distress for consumers;
- If a bank does fail, capital acts as a buffer in protecting depositors' claims in insolvency. This is achieved by ensuring that capital is subordinated to the claims of depositors. Loss to depositors is minimised, since the first losses will be suffered by the investors in regulatory capital. Such "gone concern" capital also protects other senior creditors and therefore promotes confidence in the financial system.

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