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Stewardship of the wholly-owned banks: buy-back of subordinated debt

Summary

1 Over the course of 2010, the Treasury authorised the taxpayer-owned banks Northern Rock (Asset Management) and Bradford & Bingley to buy back £2.4 billion of their subordinated debt. This debt was part of the banks' capital, meaning it would only be paid in a liquidation if the senior creditors could be paid in full. The debt had been trading far below the price at which it had been issued, due to the market's concerns over when and if the debt and its interest would be repaid.

2 This report focuses on the reasons for the buy-backs, the success of their implementation, and the benefit to taxpayers. It illustrates the way in which the losses of the nationalised banks have impacted in different ways on the Treasury and the different classes of investor in the banks, with the effect that taxpayers have adopted most of the risk. It is one of a series of reports we are publishing on taxpayer support to banking, the most recent being an *Update on the support schemes* and an analysis of the *Asset Protection Scheme*, both published in December 2010.

Background

3 Northern Rock and Bradford & Bingley were nationalised in 2008 when the market lost confidence that they could continue to be funded in the private sector. The Treasury arranged for the sale of the retail deposits (those from individual customers) and branches of Bradford & Bingley to Abbey (part of Santander). By October 2008, the Treasury had guaranteed £33 billion of the two banks' liabilities to depositors and investors and lent £36 billion to the banks. We reported on these nationalisations in our March 2009 report *The nationalisation of Northern Rock*.

4 The Treasury decided that it was not value for money to sell the banks immediately and that it would have to run down at least part of their mortgage books over time, i.e. close to new business, wait for borrowers to repay their mortgages, and use the cash from borrowers' repayments to repay the taxpayer support. The Treasury decided to separate out a fully functional bank from the deposits, branches and some of the mortgages at Northern Rock for later return to the private sector, and wind down the rest in an orderly manner.

5 This left the Treasury as the sole owner of three companies. These are:

a a bank it is holding for return to the private sector – Northern Rock plc; and

b two mortgage providers without retail deposits, closed to new business, and with substantial mortgage books in 'run-down' – Bradford & Bingley and Northern Rock (Asset Management).

6 These last two were integrated in October 2010 under a new holding company, UK Asset Resolution, a subsidiary of the Treasury. Throughout this report we refer to the companies that were nationalised as *the banks* and the three companies they have turned into as *the wholly-owned banks.* The term wholly-owned banks includes the companies being run down, which we refer to as the *mortgage providers*.

7 From 1 January 2010, UK Financial Investments Ltd took over responsibility for the day-to-day management of the taxpayers' shareholdings and loans in the wholly-owned banks. UK Financial Investments is an arm's length body of the Treasury set up to protect and create value for the taxpayer as shareholder and creditor.

8 As at June 2010, taxpayers' investment in the wholly-owned banks, including the shareholders' profit reserves and the loan to the Financial Services Compensation Scheme, had a book value of £54 billion, representing 39 per cent of their total funding.

Scope of this report

9 The overall value to the taxpayer of its investments in the wholly-owned banks depends on:

a the extent to which the investment aids broad policy objectives – including financial stability; and

b the overall net cost or return to taxpayers on the investments, which is determined by the ability of the wholly-owned banks to repay and cover the costs of providing the loans, and the value of the taxpayers' residual equity stakes.

10 Our March 2009 report explored the reasons for nationalising the banks and making the various loans and guarantees in the context of the broad policy objectives. This history is summarised in Part One. The rest of this report focuses on the buy-back of subordinated debt at the Government owned mortgage providers Northern Rock (Asset Management) and Bradford & Bingley, with a particular emphasis on the impact on the net cost or return on the taxpayers' investments. It thus examines:

a the role of subordinated debt in the mortgage providers (Part Two);

b the evolving risk to taxpayers from their investment in the mortgage providers (Part Three); and

c whether the buy-backs of debt by the mortgage providers were well executed and beneficial to taxpayers (Part Four).

11 This report does not focus on the separation out of, or progress with, Northern Rock plc, which the Treasury is preparing to return to the private sector. The success of splitting out Northern Rock plc will largely be determined by the success of the return of the bank to the private sector.

Key findings

On the role of subordinated debt

12 The subordinated debt was part of the banks' capital structure. As such it was exposed to the risk of loss on the banks' failure before the senior creditors (see the creditor hierarchy on page 4) and is likely to have been wiped out had the banks been allowed to enter insolvency procedures.

13 The Treasury decided not to take over the subordinated debt when the banks were nationalised. It was concerned that eliminating the subordinated debt-holders' interest in the banks in 2008 would have spread financial instability to the institutions holding the debt and other banks issuing similar debt. Although the debt lost considerable market value, nationalisation resulted in it retaining some value so long as taxpayer support keeps the mortgage providers afloat.

14 Over the course of 2009, the Treasury developed its thinking on how to apply the principle that the subordinated debt-holders should contribute towards the costs of restructuring the banks. It worked with the European Commission to ensure that appropriate burden-sharing measures were adopted. The Commission is responsible for ensuring the State Aid is compatible with the European Single Market. In trying to minimise the amount of State Aid necessary to support financial stability, the Commission has said that banks' capital investors (including subordinated debt-holders) should bear some of the financial burden.

15 The Treasury thus required the mortgage providers to suspend payment of interest and principal on £2.7 billion of their subordinated debt. In practice, this means payments will be deferred whilst senior creditors are repaid. It also means the debt and accumulating interest loses value over time due to inflation and opportunity cost. The suspension led to a sharp fall in the market value of the £2.7 billion debt affected. We estimate that the economic loss to the original holders of this debt was at least £0.5 billion. It did not affect some £825 million of debt, however, where payment could not be suspended, due to the way it had been issued.

16 So long as payments on the subordinated debt are suspended, the terms of the debt prevent the mortgage providers paying dividends to taxpayers. This means taxpayers cannot extract shareholder profits without paying the subordinated debt-holders. The Treasury can, however, continue to withdraw cash by requiring payment on its loans.

17 Once the taxpayer loans are repaid, the subordinated debt-holders would have seniority to the remaining taxpayers' interest in a liquidation. The subordinated debt-holders would then have to be paid in full if taxpayers wanted access to shareholder profit reserves. Extracting cash from the mortgage providers in the form of loan repayments brings forward the point at which the subordinated debt has seniority.

On the risks to the taxpayer investment in the mortgage providers

18 Nationalisation provided a framework for the orderly restructuring and unwinding of the banks' debts. The Treasury has sought, and continues to seek, to avoid the immediate insolvency of the mortgage providers, initially to avoid financial instability spreading to other banks, and following nationalisation to avoid a quick sale of assets which would have led to low prices and harm to taxpayer value. The wind-down of the mortgage providers could take over 15 years to execute, but with current levels of taxpayer support, it is likely that all creditors will be repaid in full.

19 The Treasury has had to provide assurances to the other creditors, the regulators, and the mortgage providers' directors to allow the providers to continue as going concerns during the orderly wind-down:

- **a** The Treasury gave a series of guarantees to the senior creditors around the time of nationalisation to prevent a downgrade in their credit rating triggering a default.
- **b** The Treasury provided limited assurances to the Financial Services Authority and the directors of the mortgage providers that it would ensure the providers had sufficient capital to continue meet their obligations as they fall due.
- **c** In order for the accounts to be presented on a going concern basis, the Treasury indicated that it was its intention to continue to fund the providers so as to maintain them as going concerns and enable them to meet their debts as they fell due. These indications are time limited and regularly reviewed.

These assurances covered liabilities worth £64 billion as at June 2010. They are small in relation to the nation's overall debt burden, but are nevertheless significant contingent liabilities.

20 The Treasury also provides subsidised loans to the mortgage providers and deferred their repayment. The subsidy ensures the cash generated by mortgage redemptions is sufficient to pay their obligations to senior creditors as they fall due. The Treasury allows them to make such payments to the other creditors before making interest and capital repayments on the Treasury loans. This avoids triggering a default on the providers' debts. The subsidy does not affect the annual amount of cash received by Treasury until its loans have been repaid. Profits generated by the providers as a result of this subsidy will eventually be returned to taxpayers. It means, however, that Treasury is providing an increasing share of the providers' funding and bearing considerable costs in the meantime.

21 We do not know whether the taxpayers' return from the mortgage providers will cover the costs of providing the subsidised loans. The return to taxpayers depends on the value of the taxpayers' equity when the providers are wound-up less the cost of subsidising the loans. The providers forecast the build up of substantial taxpayer profit reserves over time. Against this, we estimate the subsidy has a present value of at least £3 billion, assuming the current forecast repayment schedule and interest rates. This subsidy could be substantially reduced by increases in the interest rates (which UK Financial Investments is already exploring) or future balance sheet restructuring. The Treasury predicted when nationalising Northern Rock that it would cost taxpayers a net present value of £1.3 billion. It has not updated this calculation since.

22 The consequence of the Treasury's current approach described above is that taxpayers are adopting most of the risk on the mortgage providers' liabilities. So long as the Treasury follows its current approach of ensuring the providers wind-down in an orderly fashion effectively, the other creditors, including the subordinated debt-holders, should not lose any of their investment during the orderly wind-down. Treasury is likely to follow this approach so long as it believes that an orderly wind-down would generate the best return for taxpayers. Nevertheless, the other creditors – especially the subordinated debt – still carry two residual risks:

a Economic risk: It is possible that an extreme economic deterioration would reduce the value of the providers' mortgage assets to the point where the Treasury believed it would be better value for money to stop taxpayer support and share losses with the other creditors in insolvency procedures rather than attempt to generate greater profits through an orderly wind-down.

b Policy risk: the Treasury is working internationally to reform capital regulations, and further policy development may enable the Treasury to restructure the mortgage providers' capital in such a way as to result in further loss on the subordinated debt-holders.

On the buy-back of debt

23 The buy-back of debt was opportunistic, although many banks had undertaken similar transactions. It was suggested to take advantage of reduced prices.

24 The buy-backs generated a £1.7 billion increase in shareholder equity, but marginally increased risk to taxpayers. The buy-backs improved taxpayers' shareholder profits, but reduced the overall level of the mortgage providers' capital. It therefore marginally increased the contingent risk of the Treasury needing to provide more capital at a later point.

25 The buy-backs also avoided the full payment of the subordinated debt and its interest at a later point. The mortgage providers paid £821 million in 2010 to buy back the subordinated debt. This reduced the providers' cash available to repay taxpayer support immediately. It also avoided paying an estimated £5.5 billion, assuming the full subordinated debt principal and all the accumulating interest would be paid at the point we assume the mortgage providers' will wind-up.

26 The buy-backs thus furthered the sharing of the costs of the banks' restructuring by crystallising losses on the subordinated debt. We estimate that agreeing to the buy-back offer meant the subordinated debt-holders received at least £1.5 billion less (present value) than they would have done had they waited to receive repayment in full, assuming they would, on the date the mortgage providers predicted.

27 We estimate that the buy-backs benefitted taxpayers by a present value of £1.5 billion, because they avoided interest payments that were unjustified given the level of risk assumed by the taxpayer in the Treasury's current approach. In effect, the buy-backs transferred value from the debt-holders to taxpayers, who are assuming the risk the debt-holders were meant to bear. Our estimate assumes that paying the £5.5 billion could not otherwise be avoided, given that the current Treasury approach. The benefit to taxpayers would crystallise into cash at the latest on the wind-up of the mortgage providers.

28 The buy-backs were well executed and the pricing appears reasonable. The providers, UK Financial Investment, and the advisors had very limited information about the appropriate level at which to set the offer price. Having established the broad pricing with their Board, they followed what they said was normal market practice of deciding the final price at which to offer to buy back the tier II debt (see the creditor hierarchy page 4) during an unminuted conference call with the mortgage providers and their advisors, so we have limited evidence on how they set the exact price. Nevertheless, the prices they chose appear reasonable estimates of those needed to optimise taxpayer return. The return to the taxpayer was more sensitive to the level of uptake than the precise price offered for each debt. Both buy-backs achieved a good level of take-up, although this was greater on the tier II debt than the tier I debt.

29 There remains £1.4 billion of subordinated debt:

a £619 million of subordinated debt-holders did not accept the offer.

b Some £825 million was not included in the offer, because the mortgage providers could not afford to offer to buy back all the subordinated debt. As payment on the £825 million of debt could not be legally suspended they were trading at a higher price and buying them back would have been less value for money than those where payments had been suspended.

The remaining debt remains expensive and provides limited value to taxpayers. It continues to accrue a high rate of interest for bearing the risk of absorbing losses on insolvency. This risk is mainly controlled by Treasury which can decide whether or not to continue taxpayer support. Unless the debt-holders can be made to share the burden for restructuring the mortgage providers, the remaining debt provides limited value to taxpayers for its cost.

On the lessons for UK Financial Investments

30 The separation of Treasury's shareholder and creditor functions into an arm's length body is good practice and provides a better focus on achieving value for money. UK Financial Investments has provided Treasury with greater expertise; a more independent focus and discipline on taxpayer value; and clearer identification of responsibilities for the wholly owned banks. UK Financial Investments advised Treasury on the buy-backs from a taxpayer value perspective. Treasury, with the European Commission, assessed the impact on burden sharing.

31 UK Financial Investments has limited capacity. It has a total staff of fourteen, four of whom focus on the wholly-owned banks. This can limit the team's capacity when handling multiple projects simultaneously, including the split of the bank, the buy-backs and the integration of the mortgage providers, whilst operating in an environment of public accountability and intense scrutiny.

32 UK financial Investments also has an inevitable dependence on advisors. Regulatory requirements, the need to access specialist expertise and UK Financial Investments' business model, make UK Financial Investments inevitably heavily dependent on using advisors. There is a limited pool of these advisors, particularly for specialised transactions, and maintaining competitive pressure can be challenging. UK Financial Investments managed to apply some competitive pressure in its choice of advisors for the buy-backs, despite only approaching two for fear of tipping off the market about its intentions.

Conclusion on value for money

33 We believe that the buy-backs represented value for money. This is principally because the buy-backs avoided the need to pay future interest that was excessive in relation to the risk the subordinated debt bore. This conclusion assumes that these interest payments could not otherwise be avoided, given the approach currently taken by Treasury to wind the mortgage providers down in an orderly manner means the providers would pay out to all their creditors.

34 If it transpires that the mortgage providers can avoid paying out on the remaining subordinated debt, perhaps due to a significant economic deterioration or a change in Government policy, then the value for money of the buy-backs would be more questionable.

Recommendations

35 Now that the mortgage providers have strengthened their capital position, the split of Northern Rock is finalised, and the formation of UK Asset Resolution is complete, there is a number of opportunities to enhance value for money. We make the following recommendations:

a **If the mortgage providers eventually pay back all the taxpayer loans, it would leave the subordinated debt-holders senior to the taxpayers' interest as shareholders.** At that point, taxpayers would be unable to benefit from shareholder profits that would be generated under the Treasury's current approach without paying the subordinated debt-holders. UK Financial Investments should attempt to preserve the senior claim of the taxpayers' interests in the providers over the subordinated debt, by charging as high an interest rate on its loans as feasible. In years to come, this will preserve the options it has for extracting cash from the providers without paying all the subordinated debt-holders. We understand it is already exploring ways of enhancing the interest rate.

b **The remaining subordinated debt represents a cost for little benefit to taxpayers.** UK Financial Investments should continue to explore ways of eliminating the remaining subordinated debt. In doing so, Treasury should come to a view on whether it believes that further payments to the subordinated debt-holders represent a moral hazard – creating expectations amongst debt-holders that reduce their incentives to avoid risk – and whether there are other ways of eliminating the subordinated debt.

c **The Treasury's original estimate that nationalising Northern Rock would cost taxpayers a net present value of £1.3 billion is now out-of-date.** Much has happened since and new information is available. UK Financial Investments should renew its estimate of the net subsidy or return to the taxpayer of nationalising Northern Rock and Bradford & Bingley based on the current plans and forecasts. We recognise that it will be difficult for UK Financial Investments to publish the taxpayer value in Northern Rock plc whilst it is preparing the bank for sale. However, UK Financial Investments should publish an estimate of the net cost or return to taxpayers expected from Northern Rock (Asset Management) and Bradford & Bingley.

d **UK Financial Investments did not fully document how it came to its final decision to price the first tender offers.** Although it argued it is common market practice for clients to make final decisions in an unminuted conference call with the banks and advisors, UK Financial Investments faces intense public interest and needs to uphold rigorous standards of public administration. It has agreed to document all its key decisions in future.