REPORT BY THE
COMPTROLLER AND
AUDITOR GENERAL

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SESSION 2010–2011

18 MARCH 2011

HM Treasury

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

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National Audit Office

HM Treasury

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

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Amyas Morse
Comptroller and
Auditor General

National Audit Office

15 March 2011

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.

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This report can be found on the National Audit Office website at www.nao.org.uk/stewardship-of-banks-2011

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The creditor hierarchy

The order in which creditors are paid in a liquidation is known as the creditor hierarchy. The lower a creditor is in the hierarchy, the riskier their investment.

Senior creditors

Senior creditors provide the majority of funding for a bank. They have the right to be amongst the first to take their share of a bank's assets if the bank is wound up. Their investments are therefore normally considered relatively safe. Northern Rock and Bradford & Bingley had two types: deposits and senior debt.

Depositors

Retail banks normally source the majority of their funding from their depositors – individual savers and companies using savings accounts. In addition to their senior creditor status, eligible depositors are guaranteed up to £85,000 by the Financial Services Compensation Scheme.

Senior debt

Banks also raise money from money markets and institutional investors, collectively known as wholesale funding markets. Much of this is in the form of different types of bonds. Securitised and covered senior debt is matched against specific pools of assets, much as a mortgage is collateralised by a building. Unsecured debt is not matched to specific assets.

The Treasury loans to Bradford & Bingley and Northern Rock are senior debt.

Capital

Banks must maintain a certain amount of capital – funding from investors that in the event of the bank's insolvency is most likely to take a loss. The minimum level of capital required is calculated as a capital to assets ratio, where the value of the assets is adjusted depending on their riskiness.

Capital in a bank is categorised into tiers, depending on the order in which it would absorb any loss the bank makes. These categories range from the lowest category, Core Tier I through Tier I, Upper Tier II, and Lower Tier II, to the highest category Tier III. The lower the tier, the earlier the capital is exposed to the risk of loss, and, from the point of view of the bank, the higher the quality of capital. Banks must currently hold at least a quarter of their capital as Core Tier I, although new rules will require increasing amounts by 2019.

There were two broad categories of capital in Bradford & Bingley and Northern Rock at the point of their nationalisation: subordinated debt and equity.

Subordinated debt

Subordinated debt normally acts exactly like senior debt – it generally has a set interest rate and is tradable on the market. However, it is subordinate to the senior debt in the event of liquidation. That means that if the banks are wound up, subordinated debt-holders would only receive the money owed to them if there are assets left over in the banks once the senior creditors have taken their share. Subordinated debt is therefore considered a less secure investment and attracts a higher interest rate.

Northern Rock's and Bradford & Bingley's subordinated debt was divided between tiers I and II.

Equity (mainly shareholder funds)

Equity is the proportion of the business's assets belonging to shareholders and a few similar types of investor. It includes the amounts originally invested by ordinary and preference share holders, the accumulated profits and losses of the business, and reserves such as revaluation adjustments.

Equity holders receive the remaining share of assets in the event of liquidation, after all the other creditors. It is thus Core Tier I, the highest quality capital. Investments in equity often go down as well as up in value.

Taxpayers own all of Northern Rock's and Bradford & Bingley's shares and thus any residual value once all other creditors are repaid.

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.

Part One

Background

The nationalisation of Northern Rock

1.1 Northern Rock was formed as a building society in 1965 and converted itself into a bank in 1997. By 2007, Northern Rock had become the fifth largest provider of residential mortgages in the UK.

1.2 Northern Rock first encountered difficulties in raising wholesale finance in September 2007, at the outset of the financial crisis. The Bank of England began to make loans to Northern Rock, secured on high quality assets. When news of this was reported in the media, customers lost confidence in the bank. Between 14 and 17 September 2007, customers withdrew £4.6 billion of deposits from Northern Rock and queues formed outside Northern Rock branches.

1.3 The Treasury responded by guaranteeing Northern Rock's retail deposits and some of its wholesale deposits and other senior creditors. Despite the Treasury's guarantees, customers continued to withdraw deposits and over the next two months the Treasury extended its guarantees to more of Northern Rock's wholesale debt. The Bank of England also increased its loans to Northern Rock. The Treasury gave the Bank of England an indemnity against losses on these loans.

1.4 The Treasury tried to find a private sector purchaser for Northern Rock, but concluded that given the financial crisis no bid which met its criteria would be forthcoming. It nationalised Northern Rock in February 2008, using powers in the newly enacted Banking (Special Provisions) Act 2008.

1.5 At the time of nationalisation, the Treasury had given £24 billion of guarantees and the Bank of England had made £27 billion of loans to Northern Rock. The Bank of England transferred its loans to the Treasury during 2008.

The nationalisation of Bradford & Bingley

1.6 Bradford & Bingley, which had also been a former building society that had converted itself into a bank, encountered increasing financial difficulties during 2008.

1.7 The Treasury nationalised Bradford & Bingley in September 2008. It organised the sale of Bradford & Bingley's retail deposit liabilities and branches to Abbey (part of Santander), leaving behind its mortgage assets and other liabilities in public ownership. The Financial Services Compensation Scheme provided £18.4 billion to facilitate the transfer (paragraph 3.2).

1.8 The statutory valuers appointed to determine the amount of any compensation due to Northern Rock and Bradford & Bingley shareholders each decided that the shares had no value, and no compensation should be paid. These valuations used the statutory assumption that all public support would be withdrawn at the point of nationalisation.

Separating Northern Rock into two parts

1.9 Northern Rock lost over £1.3 billion in 2008 which eroded the minimum regulatory capital that it was required to maintain. The Financial Services Authority gave Northern Rock a temporary waiver from its capital requirements whilst the Treasury considered how best to meet the requirements.

1.10 In late 2008, the Treasury embarked on a review of Northern Rock's performance and the options for the future, given its deteriorating capital and trading position. It decided not to undertake a quick sale or simply invest more capital, but to create a new, smaller bank out of Northern Rock which would hold Northern Rock's branches, deposit liabilities and some of its better quality mortgage assets. In February 2009 the Treasury therefore announced that it intended to split Northern Rock, with the new bank planning to lend up to £14 billion in its first two years.

1.11 The Treasury applied for European State aid approval for the plan, which it received in October 2009 subject to a number of conditions.

1.12 The Treasury implemented the split of Northern Rock with effect from 1 January 2010. The new bank was named Northern Rock plc. The remaining assets and liabilities were left in the original Northern Rock, which changed its name to Northern Rock (Asset Management). The Treasury invested an additional £9.9 billion to capitalise and fund the new bank (paragraph 3.2).

1.13 Northern Rock (Asset Management) and Bradford & Bingley changed their regulatory status to become regulated mortgage providers. This reduced their capital requirement.

Restructuring ownership and oversight

1.14 UK Financial Investments took over responsibility for the day-to-day management of the taxpayers' shareholdings and loans in the wholly-owned banks from 1 January 2010. UK Financial Investments is an arm's length body of the Treasury and is tasked with developing and executing a strategy for disposing of taxpayers' investment in the wholly-owned banks, and protecting and creating value for the taxpayer as shareholder and creditor. The separation of shareholder and creditor functions from policy and regulatory functions is consistent with our previous recommendations and we consider it to be good practice.

1.15 During 2010, UK Financial Investments decided to create a single management team for Northern Rock (Asset Management) and Bradford & Bingley. This was implemented in October 2010 when a new subsidiary of the Treasury, United Kingdom Asset Resolution, acquired both Bradford & Bingley and Northern Rock (Asset Management). It now intends to integrate their operations on a single IT platform. The Treasury expects to save £125 million by eliminating the need for duplicate functions.

Part Two

Subordinated debt

2.1 Banks must hold a set percentage of their risk-adjusted assets as capital, so that they can absorb losses before the senior wholesale creditors and depositors take a loss. Subordinated debt was issued by banks to form part of their regulatory capital. Its chief advantage was that it paid a set interest rate and was therefore potentially cheaper than equity, not sharing in any growing returns in the business. However, because in the event of a liquidation it would only be paid back if there were assets remaining after the senior creditors had been repaid, that interest rate was relatively high compared to senior debt.

2.2 Most subordinated debt was purchased by institutional investors such as other banks, pension funds, and insurance companies, attracted to its relatively high return. Some tier I debt (see the creditor hierarchy, page 4) was held by sophisticated individual investors, and was issued when the mortgage providers were still building societies.

Protection of the subordinated debt

2.3 At the point of nationalising Northern Rock and Bradford & Bingley, the Treasury's valuation of the businesses estimated the banks' losses exceeded their entire capital. This is consistent with the statutory valuers' assessments in determining the value to the shareholders. The Treasury thus believed that if the banks were allowed to become insolvent all the capital investors (the shareholders and subordinated debt-holders), would lose their full investment and that the banks' senior creditors would take a large loss. The Treasury sought to avoid such a insolvency, however, to protect financial stability.

2.4 In its transfer orders for Northern Rock and Bradford & Bingley, the Treasury obtained control of the banks by acquiring the shares. It did not acquire the subordinated debt. Whilst it believed the subordinated debt would have had no value in insolvency, the Treasury, Financial Services Authority and Bank of England believed that cancelling the subordinated debt at that point could have had a significant market impact that could spread financial instability to institutional holders of the banks' subordinated debt and other financial institutions issuing subordinated debt.

The principle of burden sharing

2.5 The Treasury continued to develop its policy on banking resolution after the nationalisation of the two banks. It considered that it was important in principle to maintain the normal creditor hierarchy (page 4) and in particular ensure that subordinated debt-holders did not benefit from the nationalisation of the banks at the expense of taxpayers.

2.6 Meanwhile, the Treasury worked with the European Commission which was developing its policy on the response to the financial crisis. EU national governments must obtain approval from the European Commission when providing State Aid to troubled companies, to ensure the State aid is compatible with the European Single Market. In October 2008 the European Commission published guidance on the application of the State aid rules in the banking crisis, which emphasised the need to limit "moral hazard" when financial institutions were being wound down, including by excluding shareholders and possibly certain creditors from receiving the benefit of state aid.

2.7 In guidance published in July 2009, the Commission issued rules generally requiring bank's capital holders, including subordinated debt-holders, to contribute towards the costs of restructuring, and stating that banks should not use State aid to remunerate own funds (equity and subordinated debt) when their activities do not generate sufficient profits. This implies that subordinated debt-holders as well as former shareholders should bear some losses.

2.8 In February 2009, Treasury legislated to alter the terms of much of Bradford & Bingley's subordinated debt so that the mortgage provider could suspend all payment of principal and interest on the debt, until the provider had repaid its statutory loans. This was extended to Northern Rock (Asset Management) in August 2009 where contractually possible and, in October 2009, the Treasury and European Commission formalised this as part of the State aid agreement for the restructuring of the bank into two companies.

2.9 Payments on both mortgage providers' subordinated debt were suspended at different points depending on the precise contractual terms of each bond. To date £258 million of bonds have passed their maturity or call date without being repaid.

2.10 Under the terms of the subordinated debt as originally issued, the mortgage providers are not allowed to pay dividends to the Treasury as shareholder whilst payment on the subordinated debt is suspended.

2.11 The suspension of payments led to a fall in market value of the debt by at least £317 million.[1] We estimate the suspension of payment of interest and principal provided an actual economic loss of at least £500 million to the bond-holders. This estimate is sensitive to two assumptions:

a that the holders expected a yield equal to the coupon on the debt instrument (i.e. needed an interest rate of 8 per cent to be satisfied with an 8 per cent bond). This is a prudent assumption because interest rates had fallen since much of the debt was issued; and

b that the debt and accumulated interest would be paid in full in 2025. Whether it will be paid in full is subject to the risks set out in paragraphs 3.3-3.5.

International reform of capital requirements

2.12 In 2010, the G20 group of countries approved reforms to international capital requirements for banks under a new agreement known as Basel III. These will be implemented over the next decade, and will eventually no longer recognise subordinated debt in its current form as a capital instrument. Banks are being encouraged to develop new forms of capital instruments, including Contingent Capital. Contingent Capital is intended to work like subordinated debt up to the point the bank comes into a predetermined definition of distress. It will then compulsorily convert into equity, reducing the debt and improving the capital position, whilst making the debt-holders more likely to absorb a loss.

1 This only includes the bonds where we have data on the price immediately before and after the announcement that payments would be suspended. A simple extrapolation of this to all the bonds would indicate a fall in market value of £556 million.

Part Three

The investments in the mortgage providers

3.1 Taxpayers had £54 billion invested (book value) in the wholly-owned banks as at June 2010, when they last published accounts (**Figure 1** overleaf). The bulk of taxpayer funding is in the mortgage providers. This part of the report explains the risk to taxpayers in relation to the other investors.

Taxpayers' investment in the banks

3.2 The Treasury provided four types of investments to the wholly-owned banks:

a It injected £1.4 billion of share capital in Northern Rock plc. This had reduced to a book value of £1.3 billion after losses by June 2010. The share capital of the mortgage providers was transferred at the point of nationalisation to the Treasury at nil cost. It had a book value of £2.9 billion as at June 2010.

b It lent £18.9 billion directly to Northern Rock to replace wholesale funding on nationalisation and an additional £8.5 billion to cover the shortfall between asset and liabilities transferred to Northern Rock plc. These loans were retained by Northern Rock (Asset Management) and stood at £22.7 billion as at June 2010. The loans are repayable on a week's notice.

c It has provided £14 billion of working capital facilities to fund the providers' on-going operations and liquidity. Bradford & Bingley was using £8.6 billion of this as at June 2010.

d The Financial Services Compensation Scheme and Treasury provided £18.4 billion to Bradford & Bingley cover the retail deposits transferred to Abbey (part of Santander). The Treasury lent this money to the Scheme, which will recoup the principal from Bradford & Bingley. £2.7 billion of the £18.4 billion relates to deposits above the £35,000 then covered by the scheme. The other £15.7 billion is underwritten by the sector under the Scheme. The Scheme will recoup any shortfall and interest on the £15.7 billion from the banking sector through a levy.

Figure 1
Investments in Northern Rock and Bradford & Bingley (June 2010)

	Bradford & Bingley (June 2010)		Northern Rock (Asset Management) (June 2010)		Northern Rock plc (June 2010)		Total (June 2010)	
	(£m)	(%)	(£m)	(%)	(£m)	(%)	(£m)	(%)
Total Assets	**46,558**		**69,885**		**19,779**		**136,222**	
Funded by								
Taxpayers								
Shareholder capital (includes retained profits and other reserves)	2,051	4	835	1	1,266	6	4,152	3
Direct loan	2,762	6	22,670[1]	33			25,432	19
Working Capital Facility	8,564	18					8,564	6
Financial Services Compensation Scheme	15,654	34					15,654	11
	29,031	**62**	**23,505**	**34**	**1,266**	**6**	**53,802**	**39**
Other creditors								
Depositors	2,869	7	4,670	7	17,865	91	25,404	19
Secured wholsesale funding	5,577	12	26,069	37			31,646	23
Covered wholesale funding	4,867	10	9,607	14			14,474	11
Unsecured wholsesale funding	2,309	5	2,997	4			5,306	4
Other creditors	1,384	3	1,645	2	648	3	3,677	3
Subordinated debt	521	1	1,392	2			1,913	1
	17,527	**38**	**46,380**	**66**	**18,513**	**94**	**82,571**	**61**
Total liabilities and equity	**46,558**	**100**	**69,885**	**100**	**19,779**	**100**	**136,222**	**100**

NOTES

1 This includes a £150 million facility shown as subordinated debt in Northern Rock (Asset Management) accounts.

2 Depositors at the mortgage providers include trade accounts and interbank deposits, but not retail customers.

3 These figures include the results of the first buy-backs of June-July 2010 but not those of November-December 2010.

Source: Published June 2010 Accounts (unaudited)

An orderly wind-down of the mortgage providers

3.3 Since nationalisation, the Treasury has sought to avoid the mortgage providers becoming insolvent to preserve taxpayer value. Insolvency would probably require an accelerated sale of the assets, which would be unlikely to realise the full value that would be gained if they are held to maturity. With continuing taxpayer support at current levels, it is likely that both mortgage providers will be able to remain solvent as they run their asset books down, maximising the return to the taxpayer, and enabling all the creditors to be repaid in full.

3.4 The Treasury is likely to follow this approach so long as it considers an orderly wind-down to be the best way of preserving taxpayer value. It could, however, change its approach. In effect, the Treasury controls whether the mortgage providers enter insolvency procedures because it could remove taxpayer support on a week's demand. It would then rely on its legal status as a senior creditor to recover the loans through insolvency. The other creditors, and especially the subordinated debt-holders, thus remain subject to two key risks:

- **a** Economic risk. The mortgage providers have applied the Financial Services Authority's assumptions for stress testing to their business plans to determine that they have sufficient capital and liquidity to survive deteriorating economic conditions and still pay creditors. These assumptions only test the next five years, however, and it is possible that extreme economic deterioration could affect the Treasury's judgement that it is better to support the bank's orderly wind-down than immediately liquidate the providers.
- **b** Policy risk. The mortgage providers are only able to continue as going concerns with taxpayer support. Withdrawal of that support would be likely to trigger a default on the mortgage providers' debt, leading to their insolvency. The Treasury is working with international bodies to reform banking capital regulations and it is possible that it may later decide to further restructure the mortgage providers' debts.

3.5 Following the current approach, it could take the mortgage providers over 15 years to repay the taxpayer support. Whilst the providers' assets cover their liabilities, their main assets are mortgages, some of which last 25 years or more. Whilst mortgage borrowers normally redeem their mortgages early, many of the borrowers from the providers have high loan to value ratios (the ratio of their loan to the value of their property) and may have difficulty finding mortgages elsewhere. It may, therefore, be many years before they are able to remortgage. In addition, many have deals with low interest rates and thus little incentive to change their provider.

Assurances on the liabilities

3.6 Avoiding insolvency and keeping the mortgage providers operating as going concerns required the Treasury to make a series of assurances.

3.7 Treasury guaranteed much of the banks' wholesale debt and depositors over the course of 2007 and 2008. These guarantees aimed:

a to stop the run on Northern Rock's deposits in 2007;

b to keep Northern Rock in the private sector. Treasury sought to avoid nationalisation up to the beginning of 2008, which required it to have access to financial markets for funding; and

c to avoid the insolvency of the banks. This would have increased losses and increased the likelihood of instability spreading to other banks.

To achieve these aims, the mortgage providers need to maintain high credit ratings to avoid triggering a default of the terms of their debt agreements. Of these debts, £20.22 billion remain outstanding as at December 2010, meaning that were the providers to default on these liabilities taxpayers would have to pay any shortfall.

3.8 The Treasury gave limited assurances to the directors of the mortgage providers and the Financial Services Authority that it would support the providers' capital as the providers continued as going concerns. The providers' capital had remained low since nationalisation. The Treasury:

a promised the Financial Services Authority, on the reorganisation of Northern Rock into two banks, that it would provide up to £1.6 billion of additional capital to Northern Rock (Asset Management) were it later to be required; and

b also promised the Bradford & Bingley directors that were that bank's capital to come under strain they would "discuss with the Financial Services Authority the means by which the capital position could be maintained". Treasury recognises an unquantified contingent liability in its accounts for this latter assurance. The Treasury and Authority are discussing how to revise the form of this assurance to address any implications of any change in Bradford & Bingley's capital requirements since becoming regulated as a mortgage provider.

3.9 The directors and auditors of the mortgage providers also needed assurance on the mortgage providers' ability to operate as a going concern so they could prepare the accounts on a going concern basis. 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 debt as they fell due, for a period of no less than 18 months from the balance sheet dates of the providers' accounts. It will review these statements for each reporting period.

The implications of supporting an orderly wind-down for the repayment of taxpayer support

3.10 In order to ensure the mortgage providers can continue to meet their obligations as they fall due, Treasury has subsidised its loans and guarantees to the mortgage providers and deferred the repayment of taxpayer support. The Treasury allows the mortgage providers to use any cash generated from their mortgage books to make any due payments to their other creditors and liabilities, before it makes a payment of interest or loan principal on the taxpayers' loans. There is no penalty on the providers for missing a payment to the Treasury, except the accumulation of further interest. This avoids triggering a default on any of the providers' debt. Under this approach, the other senior creditors will be paid-off before the taxpayer loans.

3.11 The subsidy on the loans and guarantees ensures that the mortgage providers retain sufficient capital to remain solvent (**Figure 2** overleaf). There are three subsidies:

- **a** Whilst the average cost of new government debt issued in 2008-09 was 3.83 per cent, the Treasury provided the loans to the mortgage providers at variable rates equivalent in the current market to a fixed rate of 2.84 per cent. We estimate that this subsidy will cost taxpayers a present value of £3 billion a year, assuming the repayment profile in the providers' business plans. The actual subsidy is far greater than this, because the direct cost to taxpayers does not include the subsidy for providing the loans without a premium for credit or liquidity risk. However, it could be significantly reduced by future increases in the interest rate or balance sheet restructuring.

- **b** Whilst the Treasury has charged fees to the mortgage providers for the guarantees of deposit and wholesale funding, the fees for Northern Rock (Asset Management) were set on the provider's ability to pay rather than the credit and liquidity risk. Market rates, in the absence of taxpayer support, would be significantly higher.

- **c** The Treasury has not received a fee for its assurances on capital and short-term payments (paragraph 3.8 and 3.9).

3.12 These subsidies do not necessarily mean that taxpayers will receive less overall from the mortgage providers, since they enable the providers to generate profits which will be eventually given to Treasury as shareholder. However, the subsidies mean that taxpayers have an ongoing carrying cost of holding onto the mortgage providers whilst the other creditors are paid-off.

3.13 Assuming support continues at the current rate, it is likely that the mortgage providers will accumulate substantial profit reserves as they use money generated from their mortgage assets to pay off their debts. These profits could be several billions of pounds. These profits will be returned to the exchequer at the latest on the wind-up of the providers.

Figure 2
The interest and fees currently charged to the mortgage providers

	Outstanding support (December 2010) (£bn)	Interest rate currently charged	Equivalent fixed rate over life of support [1] (%)	Estimated cost of subsidy to taxpayers over life of support [2] (£bn)
Loans				
Northern Rock (Asset Management)				
Direct loan from Treasury	21.86	Bank of England base rate plus 0.25 percentage points	2.77	1.51
Bradford & Bingley				
Financial Services Compensation Scheme loan[3]	15.66	12-month LIBOR[4] plus 0.3 percentage points	3.55	0.30
Direct loan from Treasury	2.76	Interest free	–	0.77
Working Capital Facility	8.55	Bank of England base rate plus 1.5 percentage points	2.51	0.48
Total loans	**48.83**		**2.84**	**3.06**
Guarantees				
Northern Rock (Asset Management)				
Guaranteed debt and deposits	14.72	Flat fee of £12m per year		
Bradford & Bingley				
Guarantees on covered bonds	4.88	1.2 percentage points (fixed)		
Other guaranteed liabilities	0.62	3 percentage points (fixed)		
Total guarantees	**20.22**			

NOTES

1 The equivalent fixed rate is the rate we estimate is equivalent, from the taxpayers' point of view, to the variable rate actually charged to the mortgage providers. This uses the prevailing market forecasts of future changes in base rate and LIBOR over the life of the support, and the profile of repayments in the providers' business plans.

2 The estimated cost of subsidy to taxpayers is based on the repayment profile in the providers' latest business plans, and compares the equivalent fixed rate to the 3.83 per cent average cost of debt issued in 2008-09. The precise cost of providing these loans to the mortgage providers is difficult to identify, because the government does not hypothecate (match) its borrowing to specific programmes. It is therefore possible to use a variety of different measurements of the cost of government debt. For instance, the assumed cost of capital used in Government Financial Reporting for the estimation of provisions is 2.2 per cent real (5.011 per cent including inflation) which would produce an estimate of the cost of the subsidy of £6.7 billion. On the other hand, the current yield on mid term gilts (those lasting 5 to 10 years) is 3.43 per cent, which would produce an estimate of the cost of the subsidy of £1.83 billion. The use of 3.83 per cent provides a reasonable mid range estimate.

3 The interest on the Financial Services Compensation Scheme loan is charged to the Scheme and funded through a levy on the banking sector. Bradford & Bingley pay no interest on the loan.

4 12 month London InterBank Offered Rate is an interest rate benchmark for 12 month wholesale borrowings by financial institutions, calculated by the British Bankers' Association.

Source: NAO Analysis of data from Treasury and UK Financial Investments

3.14 Once all the other creditors have been repaid, several years hence, the mortgage providers are likely to be left with significant residual mortgage assets generating cash, matched against substantial taxpayer profit reserves and the remaining subordinated debt. If all the taxpayers' loans have been repaid, the remaining subordinated debt-holders' claim to the assets will be senior to taxpayers' interest. If it is possible to increase the interest on the taxpayer loans in future, then the taxpayers' senior claim can be preserved and enhanced for longer.

3.15 We do not yet know whether the ultimate value of the mortgage providers' equity will outweigh the subsidy given through the loans, to produce a net gain or a net loss to taxpayers. On the nationalisation of Northern Rock, Treasury estimated that there would be a net loss to the taxpayer of £1.3 billion (net present value). Since then, however, the Treasury has nationalised Bradford & Bingley, market conditions have deteriorated, and Treasury has invested further funds in the wholly-owned banks, so the loss may be more. On the other hand, the Treasury now knows more about the wholly-owned banks and together with UK Financial Investments has taken actions to improve taxpayer value (see Parts One and Four).

Part Four

The buy-back of debt

4.1 Over the course of 2010 Northern Rock (Asset Management) and Bradford & Bingley bought back £2.4 billion of their outstanding subordinated debt for £821 million in cash. This part explains these buy-backs and their benefits to taxpayers.

The market price for the debt

4.2 The debt was trading at substantially below its nominal value (i.e. the amount originally advanced by the investors), principally because:

a It is not known if and when the principal and accumulated interest will eventually be paid. This makes it difficult for investors to value the debt and makes the bonds particularly unattractive to investors who seek a short-term investment.

b Although the debt continues to accumulate suspended interest into a sum to be paid once the providers had returned all the taxpayer support, the terms of the debt do not allow interest on the interest (it is non-compound). Consequently the value of the debt and its interest falls with inflation and the money value of time.

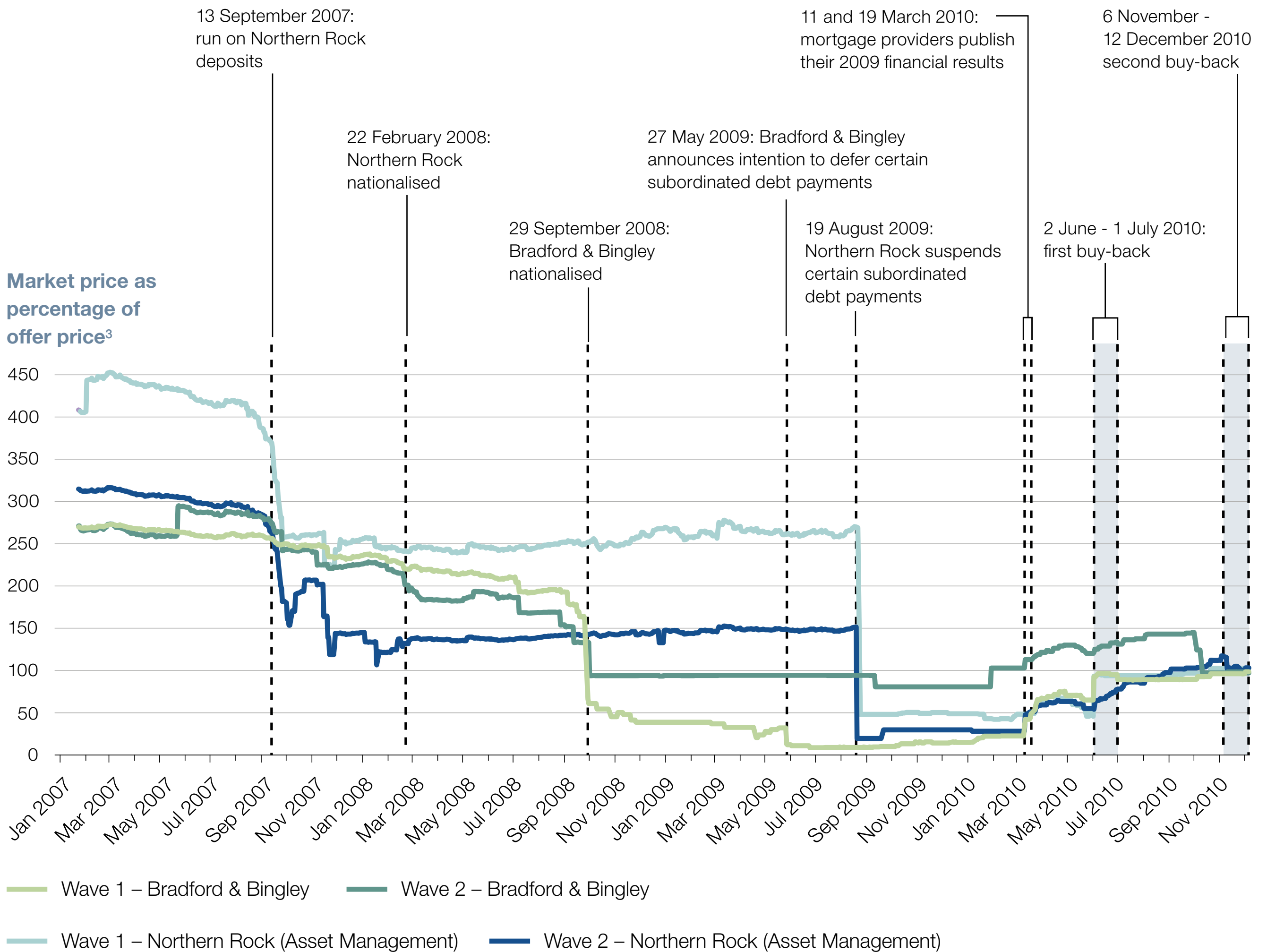
c There is still uncertainty regarding possible future government intervention and the potential for the Government to remove its loans, guarantees and assurances.

d More generally, market risk remains high for the mortgage sector, and in particular there continue to be concerns about the quality of the mortgages in the mortgage providers' books.

4.3 The trading price of the debt had begun falling when markets lost confidence in the banks during the summer of 2007. It fell further on nationalisation, and further still when payment of interest and principal was deferred (**Figure 3**). The price had started to increase following the publication of the 2009 accounts in March 2010. These accounts improved the markets' perception of the mortgage providers' underlying profitability.

4.4 The price of the bonds increased further after the announcement of the first buy-backs. The bonds in the June tender offer rose to the offer price and the remaining bonds increased in value, presumably due to speculation that there would be a second offer. The remaining bonds after the buy-backs continue to trade at around the tender price-offers, although there are few such transactions.

Figure 3
The market value of the subordinated debt fell when payments were suspended



NOTES

1 The lines represent weighted averages of the bonds in each wave comparing market price to offer price.

2 Some of the debt was only rarely traded, so market pricing is not continuous. Straight lines indicate a lack of trades and a "stale" price. For example, the prices quoted for some Tier I securities purchased in wave 2 were close to the issue price for much of 2009 and 2010, whereas RBS and Deutsche Bank consider that the tender price was a more accurate reflection of their value at the time of the tender offer. We were unable to find market pricing for two of the bonds.

3 100 per cent = price paid to buy back the debt.

Source: National Audit Office analysis of Bloomberg data

The planning of the buy-back

4.5 UK Financial Investments started to plan the buy-backs at the beginning of 2010. Although Bradford & Bingley had suggested undertaking buy-backs in 2009, initiating an offer to buy back the debt in one mortgage provider would have raised questions about the Government's intentions in relation to the other and allowed the market to move accordingly. UK Financial Investments decided to wait until the split of Northern Rock was finalised on 1 January 2010 to start planning parallel buy-backs across both providers. This planning ran into the 2010 General Election campaign period, and the plans were approved by the incoming Financial Secretary in May 2010.

4.6 UK Financial Investments decided to structure the exercise in two waves:

a tendering for tier II debt held by institutions in June 2010, completing July 2010; and

b tendering for the tier II debt held by individual investors and all the tier I debt in November 2010, completing December 2010.

Because tier I debt is subordinate to tier II debt, had the mortgage providers sought to repurchase tier I debt in the first offer, it would have indicated to the market that the tier II debt retained substantial value. UK Financial Investments also considered the buy-back of tier II debt held by individual investors to be more challenging and thus worth delaying to the second wave, because the individual retail investors are harder to reach than institutions.

4.7 The mortgage providers hired investment banks RBS and Deutsche Bank to advise on and manage the buy-backs. The investment banks were paid 0.17 per cent of the purchase price. UK Financial Investments did not hold an open competition for this work because it was concerned about signalling the existence of the buy-back plans to the market which could have increased the price. However, it selected the two investment banks from a pool of potential advisors who had previously submitted ideas for similar transactions and maintained some competitive tension until a late stage in the selection process. It also consulted an independent fee advisor, Venn Partners, who advised that the fees were at the lower end of the market norm.

4.8 UK Financial Investments allowed the mortgage providers to reappoint the same advisors for the second wave. It chose not to retender for new advisors on the basis that RBS and Deutsche Bank had already built up useful experience completing the first wave and had already done some of the work for the second wave during the first buy-back. It negotiated a reduction in the fee to 0.166 per cent.

The tender offers and the level of take-up

4.9 Establishing a fair price for the subordinated debt was difficult as there had been limited recent market activity in the mortgage providers' debt.

4.10 The offer price depended on the precise characteristics of each bond (see Appendix Two). The mortgage providers offered tier II debt-holders between 25 pence and 47 pence per pound of their bonds, and achieved an average price of 31 pence in the pound. This represented a premium of between 10 per cent and 16 per cent above the quoted market price where available. 91 per cent of tier II debt-holders accepted the offer (£2.066 billion of £2.280 billion).

4.11 UK Financial Investments' board considered likely ranges and sensitivities of return for the offer price. However, it did not document the meeting where it, the mortgage providers, and their advisors decided on the exact final prices to offer for the debt in the first wave. Nonetheless, on the basis of the information they had prepared, we believe the prices offered for the tier II debt were a reasonable estimate of the price needed to optimise the return in the absence of robust information, because:

- **a** The taxpayers' return was more sensitive to the extent of take-up than an increase in the premium – increasing the average premium by a penny was worthwhile if it increased the acceptance of the offer by more than £0.044 billion (2 per cent of the bonds). It was thus more important to achieve a high take-up than pay a low premium.
- **b** The mortgage providers' advisors advised that the reported market price did not represent the amount that the majority of investors would be willing to sell for, and that to achieve a significant level of take-up would require a significant premium to the reported price;
- **c** The advisors' believed that institutional investors would tend to accept the offer only if they felt there was momentum behind the tender: if investors thought the offer would have a low take-up they would refuse in the hope of another higher offer, but if investors thought the offer would have a high take-up they would accept for fear of otherwise being left with an illiquid asset. This is consistent with market commentary during the tender offer and the pattern of take-up achieved.

4.12 The second tender offer achieved an average price of 42 pence in the pound, and a take-up of 48 per cent (£371 million of the £775 million outstanding). This meant that the Bradford & Bingley debt was purchased at close to the then last traded price and the Northern Rock (Asset Management) debt was purchased at a discount to the then last traded price.

4.13 It was harder to calculate a fair price for the second tender offer. Much of the debt had been sold to sophisticated retail investors who very rarely traded their holdings. UK Financial Investments decided to price the tender offer to produce a return of between 14 and 15 per cent for each bond, on the basis that the investors for each type of bond should bear an equal amount of loss.

4.14 We believe that the offer prices for the second tender are also a reasonable estimate of that needed to optimise the return to taxpayers, on the basis that:

- **a** the offer gave the bond holders a consistent return with the first tender offer;
- **b** the offer was not far from the prices at which the debt had recently traded; and
- **c** the lower take-up was primarily driven by the nature of the holders and averse media and blog commentary.

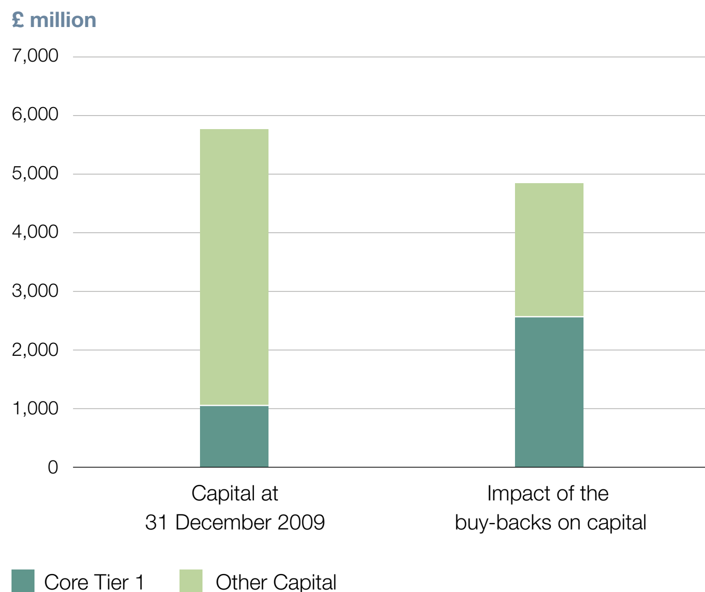
However, it did not account for the different classes of investors or tiering of the debt involved.

Impact on capital and taxpayer risk

4.15 The buy-backs reduced the mortgage providers' overall amount of capital by the £2.4 billion subordinated debt that was bought-back and eliminated, but added £1.5 billion (after tax) to the shareholders' profit reserves (**Figure 4**). The profit reserves are a higher quality capital – Core Tier I – than the subordinated debt.

4.16 Reducing the overall level of capital marginally increased the risk of the Treasury exercising its limited assurances on the capital (paragraph 3.8). UK Financial Investments did not consider these risks significant because it felt confident that the mortgage providers were able to meet their capital requirements, even under economic stress, as shown by the application of the Financial Services Authority's stress test assumptions to the providers' business plans.

Figure 4
The buy-backs increased the mortgage providers' core capital, but decreased their overall capital



Source: UK Asset Resolution

The economic return to the taxpayer

4.17 The buy-backs together provided a total increase in accumulated accounting profits of £1.7 billion. This consisted of £1.6 billion from redeeming the debt for less than its book value and £0.1 billion from other accounting adjustments including exiting hedging arrangements and avoided accrued interest.

4.18 A better measure of value for money is the economic return to the taxpayer. The economic return depends on the likelihood of whether the mortgage providers would have had to pay all the money owed to the subordinated debt-holders had the buy-backs not taken place. This ultimately depends on whether or not Treasury continues taxpayer support (Part Three).

4.19 Assuming the Treasury continues its current approach to the orderly wind-down, then had the buy-backs not occurred, the mortgage providers would pay the full £2.4 billion of debt, plus all the accumulated interest to the holders when the mortgage providers were liquidated. For the purpose of this calculation, the providers assumed that the date of liquidation would be around 2025, by which time interest due on the debt would accumulate to £3.1 billion. The benefit of the buy-backs to the taxpayer can therefore be estimated as the benefit of paying £821 million in 2010 to avoid paying £5.5 billion in 2025.

4.20 The annual rate of return of paying £821 million now to avoid paying £5.5 billion in 2025 is 14.2 per cent a year. We estimate that this provides a benefit to taxpayers with a present value of £1.5 billion. This calculation is sensitive to two assumptions:

a that the date of liquidation is 2025. The benefit to taxpayers increases if this is brought forward and decreases if it is deferred (**Figure 5**);

b that the mortgage providers would have had to pay the debt and accumulated interest in full at the point of liquidation, had they not done the buy-backs.

4.21 This £1.5 billion benefit reflects the benefit of avoiding the interest payments to the subordinated debt-holders which cannot be justified by the risk transferred to them. This is because:

a Taxpayers bear the costs of supporting the mortgage providers in an orderly wind down;

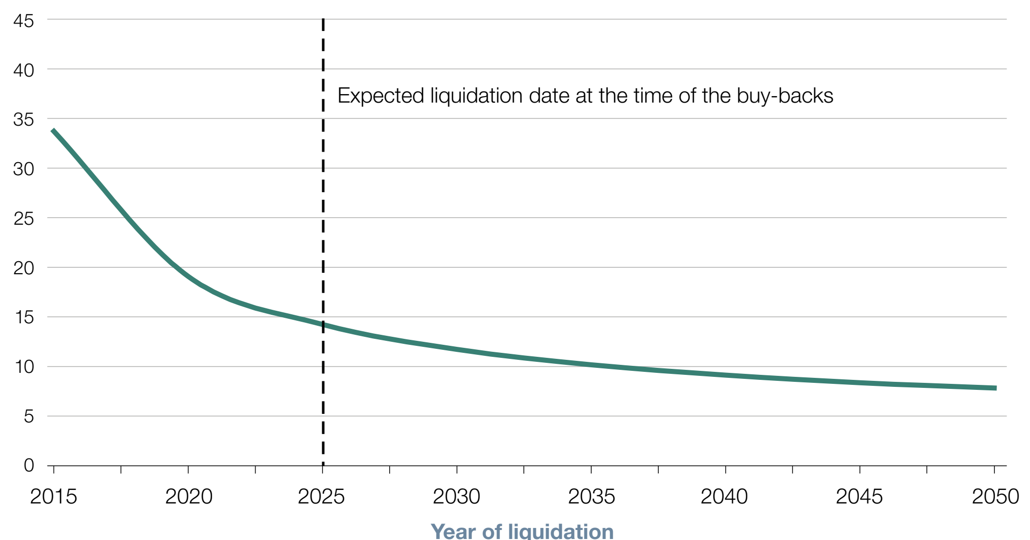
b Treasury controls the risk that the subordinated debt-holders bear, namely that Treasury might force the mortgage providers into insolvency which could wipe out the subordinated debt-holders interest; and

c Allowing the subordinated debt to accrue a high nominal interest rate therefore serves taxpayers no benefit, unless the debt can be made to bear a loss.

Figure 5

Taxpayer yield on the buy-backs is sensitive to the date of liquidation

The overall return decreases if the banks take longer to wind down



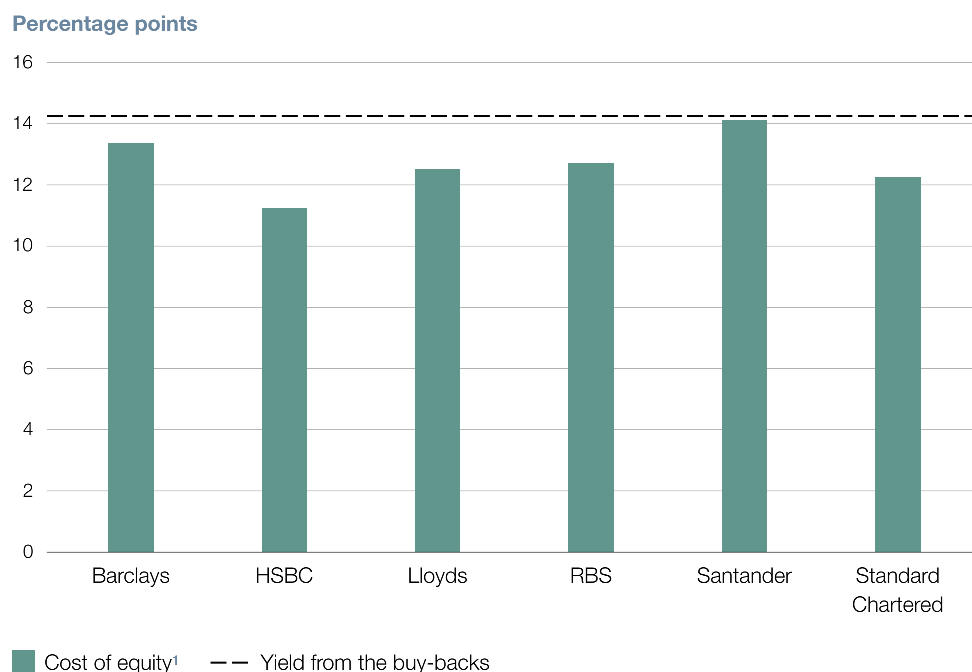
Source: National Audit Office analysis

4.22 On the other hand, if the Treasury changes its approach to the orderly wind-down of the mortgage providers, then it would be very uncertain that the subordinated debt holders would have received the full £5.5 billion in 2025. This would make the benefit to the taxpayer of the buy-backs more questionable.

4.23 If the Treasury did not control the main risk to the subordinated debt-holders, then we would have concluded that the return was reasonable but not extensive. The 14.2 per cent return is comparable to the market's expected rate of return on a bank's equity, and thus the market's valuation of the risk of investing in a bank (**Figure 6**). If we thus consider the return a private investor would have wanted on a similar transaction, but where the private investor did not control the risk, then it is reasonable to conclude that the buy-backs generated a reasonable economic return which justified the marginal increase in risk explained in paragraphs 4.15 –16.

Figure 6

The yield on the buy-backs compared to the required return on a bank's equity



NOTE

1 Figure shows each bank's average cost of equity over 2000-2010, as calculated by Bloomberg using the Capital Asset Pricing Model.

Source: National Audit Office analysis of Bloomberg

Impact on the subordinated debt-holders

4.24 We also estimate that the buy-backs created a loss to the holders of the subordinated debt of £1.5 billion. This estimate is sensitive to the same assumptions as above. This loss may have been shared between various historical holders of the debt, and some may even have made a large profit if they purchased the debt at its lowest priced point in 2009.

4.25 It is not possible to ascertain who was holding the debt at the time of the buy-backs because most of it was held in blind trust accounts. Much of the debt, however, was held by institutional investors, with more than half the tier II debt bought back held by only ten institutions.

4.26 Holders of £619 million of subordinated debt chose not to accept the mortgage providers' offers to buy the debt back. A further £825 million of subordinated debt, where for various legal reasons payment had not been suspended, was not included in the tender offers. The mortgage providers could not afford to buy back all the debt and chose to only offer to buy back those bonds where payments were suspended and the return to the taxpayer would be greatest.

Appendix One

Methodology

Method	Purpose
1 Document review We reviewed documentary evidence provided by the Treasury and UK Financial Investments, including key submissions and supporting papers.	To identify: • The Treasury's objectives • The options considered by the Treasury • The Treasury's assessment of the risks • UK Financial Investments' views of the buy-backs • The reasoning behind key decisions
2 Financial Analysis We reviewed the mortgage providers' published financial statements and market information, as well as internal financial information on the debt buy-backs and in the providers' management accounts. We produced our own financial modelling of the impact of the buy-backs and the subsidy on the loans.	To identify: • The risk to taxpayers • The interrelationship of the different investor classes • The accounting and economic return of the buy-backs • The cost of subsidising the mortgage providers
3 Interviews We interviewed officials from: • Treasury • UK Financial Investments • Financial Services Authority • UK Asset Resolution	To identify: • Actions currently taken by the Treasury and others • The outlook for the mortgage providers • The motivation and events behind the buy-backs

Appendix Two

The debt instruments repurchased by the mortgage providers

Description								Offer		Take-up			
Bond number	Instrument	Book value of nominal outstanding before buy-back (£m)	Coupon (%)	Issue date	Maturity	Tier	Payment of coupons suspended	Price (pence in the pound)	Estimated premium (pence in the pound)	Book value of nominal accepting the offer (£m)	Acceptance (percentage of book value) (%)	Book value of debt not repurchased (£m)	Cash paid for nominal (£m)
Bradford & Bingley – Wave I													
XS0276330643	£250m 5.5% Fixed Rate/Floating Rate Callable Step-up Dated Subordinated Notes due January 2018	250	5.500	01/12/2006	15/01/2018	Lower II	YES	45	12	233	93	17	105
XS0167366433	£250m 5.625% Fixed Rate Step-up Undated Subordinated Notes	250	5.625	29/04/2003	Perpetual	Upper II	YES	25	11	211	84	39	53
XS0159302255	£200m 5.75% Fixed Rate Step-up Subordinated Notes due 12 December 2022	200	5.750	10/12/2002	12/12/2022	Lower II	YES	45	13	169	85	31	76
XS0181867309	£200m 6% Perpetual Subordinated Callable Step-up Notes	200	6.000	10/12/2002	Perpetual	Upper II	YES	25	12	167	83	33	42
XS0087993423	£125m 6.625% Subordinated Notes due 16 June 2023	125	6.625	16/06/1998	16/06/2023	Lower II	YES	45	16	95	76	30	43
XS0108194407	£125m 7.625% Subordinated Notes due February 2010	125	7.625	16/02/2000	16/02/2010	Lower II	YES	47	10	97	78	28	46
Bradford & Bingley Wave I total		**1,150**						**37**		**971**	**84**	**179**	**363**
Northern Rock (Asset Management) – Wave I													
US66567HAA68	$650m 6.594% Perpetual Fixed to Floating Rate Subordinated Notes	407	6.594	25/06/2007	Perpetual	Upper II	YES	25	13	406	100	1	109
US66567GAW06	$700m 5.6% Perpetual Fixed to Floating Rate Subordinated Notes	397	5.600	29/04/2004	Perpetual	Upper II	YES	25	13	388	98	9	115
XS0098556961	£200m 6.75% Fixed Rate Step-up Undated Subordinated Notes	195	6.750	17/06/1999	Perpetual	Upper II	YES	25	11	189	95	6	47
XS0125284777	$100m Undated Subordinated Floating Rate Notes	69	Variable	21/02/2001	Perpetual	Upper II	YES	25	No data	69	100	–	17
XS0097551526	$100m 8% Undated Subordinated Notes	62	8.000	19/05/1999	Perpetual	Upper II	YES	25	No data	43	69	19	12
Northern Rock (Asset Management) – Wave I total		**1,130**						**25**		**1,095**	**97**	**35**	**300**
Wave I total		**2,280**						**31**		**2,066**	**91**	**214**	**664**

Continued overleaf

The debt instruments repurchased by the mortgage providers (*continued*)

Description								Offer		Take-up			
Bond number	Instrument	Book value of nominal outstanding before buy-back (£m)	Coupon (%)	Issue date	Maturity	Tier	Payment of coupons suspended	Price (pence in the pound)	Estimated premium (pence in the pound)	Book value of nominal accepting the offer (£m)	Acceptance (percentage of book value) (%)	Book value of debt not repurchased (£m)	Cash paid for nominal (£m)
Bradford & Bingley Wave II													
XS0148804536	£150m 6.462% Guaranteed Non-voting Non-cumulative Perpetual Preferred Securities Series A	150	6.462	29/05/2002	Perpetual	I	NO	55	1	104	69	46	57
GB0002228939	£60m 13% Perpetual Subordinated Bonds	55	13.000	07/10/1991	Perpetual	Upper II	YES	38	2	13	24	42	5
GB0002233913	£50m 11.625% Perpetual Subordinated Bonds	50	11.625	20/07/1992	Perpetual	Upper II	YES	36	2	14	29	36	5
Bradford & Bingley Wave II total		**255**						**51**		**131**	**52**	**124**	**67**
Northern Rock (Asset Management) – Wave II													
XS0117031194	£300m 8.399% Step-up Callable Perpetual Reserve Capital Instruments	300	8.399	21/09/2000	Perpetual	I	YES	25	- 8	143	48	157	36
XS0152710439	£200m 7.053% Callable Perpetual Core Tier One Notes	200	7.053	21/08/2002	Perpetual	I	NO	57	- 1	90	45	110	52
GB0001524957	£20m 12.625% Perpetual Subordinated Notes	20	12.625	30/06/1992	Perpetual	Upper II	YES	33	8	6	32	14	2
Northern Rock (Asset Management) – Wave II total		**520**						**37**		**239**	**46**	**281**	**90**
Wave II total		**775**						**42**		**371**	**48**	**404**	**158**
Overall total		3,055						32		2,437	80	619	821

NOTE

1 Figure totals do not add up due to rounding.

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