National Audit Office

REPORT BY THE
COMPTROLLER AND
AUDITOR GENERAL

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HM Treasury

The creation and sale of Northern Rock plc

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National Audit Office

HM Treasury

The creation and sale of Northern Rock plc

Report by the Comptroller and Auditor General

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Amyas Morse
Comptroller and Auditor General
National Audit Office

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Following the nationalisation of Northern Rock, the business was split into two companies. A new stand-alone bank, Northern Rock plc, was sold to Virgin Money at the end of 2011. The second company, Northern Rock (Asset Management) plc, manages the assets and liabilities retained in the public sector.

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Appendices two and three can be found on our website at www.nao.org.uk/northern-rock-2012

The National Audit Office study team consisted of:
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This report can be found on the National Audit Office website at www.nao.org.uk/northern-rock-2012

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Key facts

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

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

Northern Rock nationalised in February 2008

Loss of £1.4 billion to December 2008

Northern Rock in 2009

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

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

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

Northern Rock plc January 2010

Taxpayer equity £1.4 billion

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

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

Must be returned to private ownership by December 2013

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

Not expected to be profitable for several years

Lends only £9.1 billion[1]

Sold to Virgin Money in late 2011

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

Northern Rock (Asset Management) plc January 2010

Liabilities include £23 billion outstanding taxpayer loan

No new lending

Remaining £54 billion of mortgages to be gradually wound down

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

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

Taken together

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

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

NOTE

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

Summary

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

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

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

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

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

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

Scope of this report

6 This report examines:

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

7 Our methodology is summarised at Appendix One.

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

Key findings

Creating Northern Rock plc

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

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

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

Performance while in public ownership and preparing for a sale

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

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

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

The sale itself

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

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

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

Northern Rock assets retained in public ownership

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

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

Conclusion on value for money

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

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

Recommendations

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

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

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

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

Part One

The creation of Northern Rock plc

1.1 This part of the report:

- summarises the original business plan for Northern Rock;
- examines the options considered by the Treasury to restructure Northern Rock in response to deteriorating economic conditions;
- reviews the decision to split Northern Rock into two businesses, one to be retained in the public sector and the other to be sold; and
- summarises the implementation of the split.

The original business plan

1.2 Northern Rock was nationalised in February 2008. It had assets of just over £100 billion, government guarantees covering the majority of its savings products and an outstanding emergency loan from the taxpayer of over £25 billion.

1.3 Northern Rock's original post-nationalisation business plan envisaged that the outstanding emergency loan would be repaid by around the middle of 2010, and that the guarantee arrangements would be removed by the end of 2011. Existing mortgage customers would be encouraged to move to other lenders, with the repayments of principal used to repay the emergency loan. Thereafter, Northern Rock would enter a period of modest growth followed by a sale to another bank or a flotation of shares on the stock exchange.

1.4 The business plan had been developed on assumptions made by the Northern Rock management team in the autumn of 2007, using stress tests required by the FSA. These assumptions were reviewed following nationalisation. The base case assumed that house prices in 2008 would fall by 5 per cent and remain unchanged for three years thereafter. The recession case was for a 20 per cent reduction over three years. We set out in our previous report[1] that:

- the Treasury had not undertaken due diligence before nationalising Northern Rock; and
- the base case approved by the Treasury in March 2008 tended towards an optimistic view of the housing market, when compared with house price forecasts available in late 2007 and early 2008.

1 Report by the Comptroller and Auditor General: *HM Treasury: The nationalisation of Northern Rock,* Session 2008-09, HC 298, National Audit Office, March 2009.

Restructuring options considered in response to deteriorating economic conditions

1.5 The FSA requires all financial institutions licensed to take deposits to maintain a pre-determined level of capital as a safety buffer against unexpected losses and to operate above this threshold on a day-to-day basis. Any financial institution that finds itself at risk of breaching the threshold must take action to strengthen its balance sheet. If a financial institution is not licensed to take deposits, its regulatory capital requirements are significantly lower.

1.6 In July 2008, Northern Rock reported to the Treasury that it was at risk of breaching its capital requirements and asked for an additional £3 billion to strengthen its capital base. A number of factors had contributed to a weakening of the company's capital position, including:

- declining house prices and higher arrears, which meant that losses on Northern Rock's mortgage assets were higher than forecast; and
- profitability had been affected by lower than assumed net interest income.

1.7 In August 2008, Northern Rock reported losses of £585 million for the six months to June 2008, £314 million higher than the base case forecast in the March 2008 business plan and worse than the recession case. Northern Rock recorded a loss of £1.4 billion for the full year ended 31 December 2008.

1.8 The Treasury considered whether its objectives would be better achieved by closing the business or providing additional support. On the basis of a revised plan prepared by Northern Rock, the Treasury decided to continue to operate the whole business and sell it later on. Closing down the business, paying off depositors and selling the assets immediately could have resulted in an estimated net loss for the taxpayer of £5 billion. This option was poorer value for money than the probable outcome of a sale in three to four years, which ranged from a profit of £1 billion to a loss of £1.6 billion.

1.9 To allow the Treasury time to consider its options, the FSA granted Northern Rock a temporary waiver on its capital position. Three options were evaluated in 2008 and early 2009:

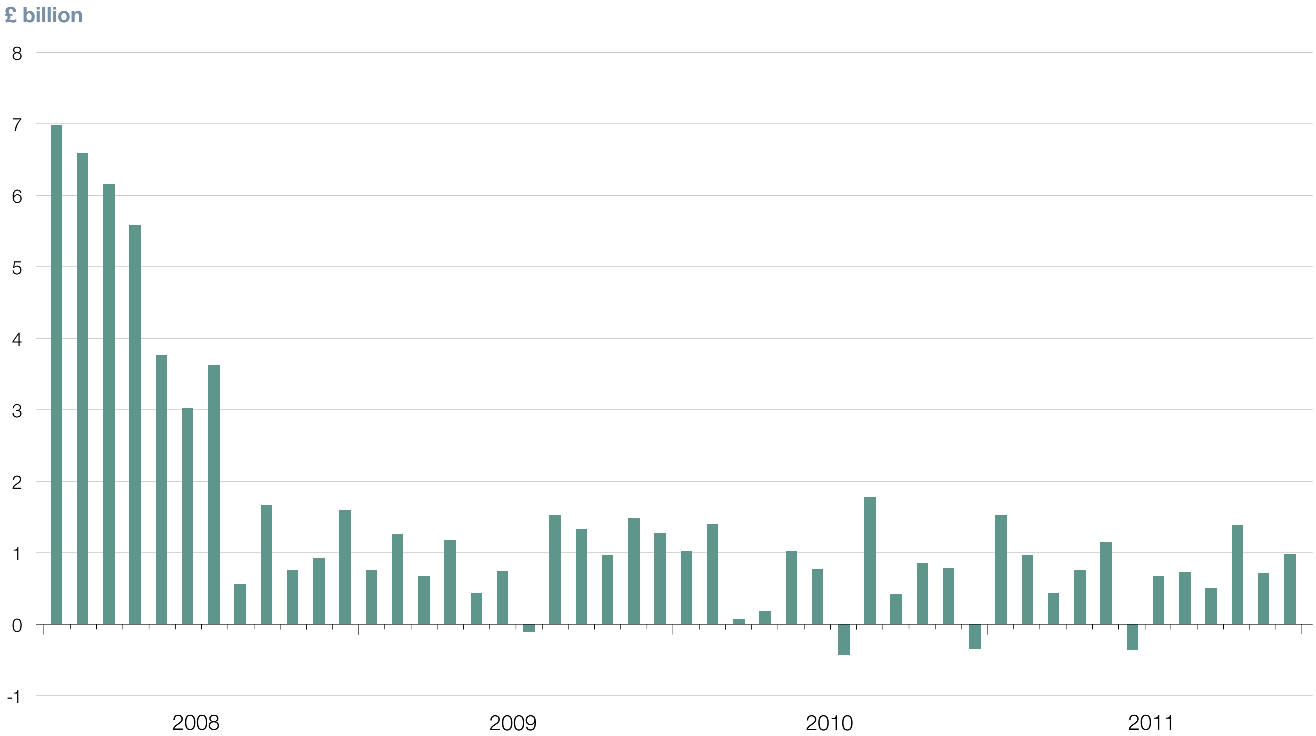
- **Inject additional capital and continue with the existing plan to sell the business in a few years.** Against a background of rapidly declining house prices, the FSA calculated that Northern Rock would need a capital injection of between £4.5 billion and £6 billion. The likelihood of a further deterioration in market conditions and forecast poor profitability[2] indicated that the prospects of finding a buyer for Northern Rock in its entirety were low, especially without continuing government guarantees on deposits. The Treasury therefore ruled out this option as poor value for money.

- **Sell the deposits and branches to another bank and wind-down the remaining assets over time in a separate, publicly-owned company.** This would be a similar approach to that taken when Bradford & Bingley got into difficulty in September 2008. The key advantages were that capital requirements and the costs of administering the remaining assets and liabilities in public ownership would be lower. However, this option would require an immediate cash injection to match the deposits being transferred.[3] The management of Northern Rock considered that this option removed an opportunity to return the business to profit and eventually to private ownership and would have an adverse impact on its employees and the North East.

- **Split Northern Rock into a stand-alone bank for eventual return to private sector ownership and wind-down the remaining assets over time in a separate, publicly-owned company.** The government was aware that mortgage lending had fallen significantly since 2008 (**Figure 1** overleaf) and considered using Northern Rock as a conduit to increase lending for wider economic policy reasons. The bank for sale would hold the retail deposits and branches plus the support systems for mortgage processing and a selection of high-quality mortgage assets. The creation of a functioning, although much smaller bank, with targets to lend on residential property was Northern Rock management's favoured option and would reduce the amount of capital that the Treasury would have to provide.

2 Actual loss for the year ended 31 December 2009 was £0.3 billion.
3 For a bank, deposits are liabilities as customers can withdraw their cash, usually at short notice. A sale of deposits (liabilities) to another bank would therefore require a matching transfer of assets, such as cash or mortgages.

Figure 1
Net monthly mortgage lending 2008–2011



Source: Bank of England

Deciding to split Northern Rock into two businesses

1.10 Analysis commissioned by the Treasury indicated that the option to sell the deposits could cost the taxpayer an estimated £1.7 billion and creating Northern Rock plc as a small stand-alone bank could cost £1.8 billion. Both estimates were based on analyses of business plans prepared by Northern Rock management, but the key assumptions underlying the plans were not subjected to detailed scrutiny. At the time, the outlook for the economy was very uncertain. The analyses included estimates of the costs of retaining the much larger back book of mortgages and liabilities in the public sector under both options (**Figure 2**). Given the inevitable uncertainties surrounding the calculations, the relatively small difference in estimated costs was not seen by the Treasury as a deciding factor.

1.11 If the deposits were sold to another bank, the level of permanent share capital required under regulations set by the FSA for the assets remaining in public ownership would be lower. However, funding in the form of additional lending to Northern Rock of around £21 billion would have been required to match the deposits sold. The analysis assumed that the deposits would be sold without any discount or premium to their face value. In September 2008, the Treasury transferred Bradford & Bingley's branches and somewhat higher quality deposits to Abbey National in a deal that yielded a premium of 2 per cent (£400 million) over the cash value of the deposits.

Figure 2
The Treasury's analysis of the two restructuring options

	Sell deposits and wind-down remaining assets	Create a stand-alone bank and wind-down remaining assets
Estimated net cost to the taxpayer[1]	£1.7 billion	£1.8 billion
Lending	Buyer of deposits could use them to fund additional mortgage lending, although this was uncertain and outside Treasury's control.	Stand-alone bank could be used to sustain new mortgage lending.
Taxpayer risk	No further financial exposure to the on-going business, and no immediate requirement to inject further capital into the run-off book once the deposits are sold. The remaining risk is in the ability of the run-off book to repay the loan from the redemption of mortgages.	The taxpayer retains exposure to the assets in wind-down but also has to inject capital into the stand-alone bank immediately and keep it adequately capitalised in any down-turn. The taxpayer also retains the risk that the stand-alone bank fails to deliver its plan.
Funding requirement	Buyer unlikely to accept mortgage assets and would therefore require up to £21 billion of gilts to be issued to fund the deposits transfer.	Cash funding requirement reduced to around £10 billion as deposit transfer could be accompanied by the provision of high-quality mortgage assets.
Timing of returns	The return comes from repayment of the taxpayer loan using redemptions of the retained mortgages and from the realisation of any remaining net assets.	The overall return is still driven by redemptions of the retained mortgages. The sale of the stand-alone bank was likely to crystallise a loss against the capital injected even though it would bring in more cash than the sale of deposits.

NOTE
1 Assumes that the interest rate on the outstanding government loan is increased to match the discount rate applied to the cash flows in and out of NRAM.

Source: National Audit Office analysis of Treasury papers

1.12 In the option to split Northern Rock, where deposits would be retained in public ownership until the new stand-alone bank could be sold, a higher level of capital would be required but substantially less debt funding. If economic conditions deteriorated and the plan turned out to be over-optimistic, this capital would be at risk from losses on operations and falls in asset values. The Treasury was aware that Northern Rock's plans in early 2009 for a split included much higher growth in lending and deposits than in previous plans put forward in late 2008. Also, Northern Rock's assumptions on the interest margin achievable remained identical, while losses on lending by the new stand-alone bank were expected to be negligible.

1.13 To maintain the attractiveness of Northern Rock to potential buyers and comply with state aid requirements, new lending by the stand-alone bank would be targeted at high-quality borrowers and priced commercially. The new lending could displace other banks' lending to some degree, depending on whether:

- other banks were restricting the supply of loans, in which case the lending would help fill a gap in the market; or
- demand for loans had fallen due to uncertainty over future house prices and borrowers' employment prospects, in which case the lending would be competing with other lenders.

1.14 It was unclear at the time whether the decline in mortgage lending had been caused by a fall in supply or demand or both. Given the extreme economic uncertainty, the Treasury was concerned about the fall in lending. In addition, the Bank of England had also expressed concern to the Treasury at the impact of shrinking Northern Rock's lending and that Northern Rock should not withdraw from the market altogether. The government therefore decided to split Northern Rock. It considered that the additional risk involved would be offset by the wider, but unquantifiable, policy benefits of stimulating lending within the economy.

1.15 Weakness in bank lending since 2007 reflected a combination of restricted supply and weaker demand. The Bank of England reported in December 2010 that restricted supply was likely to have been the dominant influence. Although it was difficult for the Bank to assess the relative contribution of demand and supply more precisely, in our view the research suggests that new lending by Northern Rock may have been in addition to lending provided by other banks.

1.16 In early 2009, before the decision to split was taken and later in the year, while preparations for a split were under way, the Treasury's advisers reviewed the business plans presented by Northern Rock management and highlighted a number of risks, including:

- Assumed losses on new mortgage lending of only 0.02 per cent could be seen as too low. Higher than expected losses would reduce proceeds from an eventual sale.
- Competition was also likely to be high for retail deposits meaning that the interest that would have to be paid was likely to be higher than assumed.
- Competition from larger lenders for high-quality mortgages was likely to be high, raising questions whether Northern Rock could achieve the volume of lending forecast at the interest margins expected.
- Planned cost reductions were ambitious compared with the ratios of cost-to-income at other banks and building societies.

1.17 At the height of the financial crisis in late 2008 and early 2009, the Treasury had to give priority to dealing with financial stability issues and appointed external advisers to assist in this. It was not possible, however, for the Treasury to maintain sufficient internal expertise to pose a strong challenge to the detailed assumptions made by Northern Rock's management.

1.18 In mid-2009, in the light of reduced lending and continuing uncertainty over whether the lower targets could be met, the Treasury required Northern Rock management to develop a lower-growth strategy for lending and deposit taking which would limit taxpayer exposure. The Treasury did not conduct a full reassessment of the decision to proceed with the split because by late 2009 there was uncertainty as to whether a deposit sale could be conducted successfully. In addition, negotiations on the split with the FSA and the European Commission were well advanced.

1.19 We have compared the potential costs and receipts from a deposit sale with the outcome of the sale of Northern Rock plc and UKFI's current expectations of cash flows from NRAM. Subject to the inevitable economic uncertainties, our analysis indicates that there is still little difference between these options in financial terms. A sale of deposits might have resulted in a small premium of up to 2 per cent (£400 million) of the deposits sold, but the overall outcome would still have been a loss for the taxpayer because:

- A buyer of the deposits could have taken the branch network but was unlikely to have wanted the mortgage origination and other support services, leaving the cost of closing down these operations shortly afterwards to be met by the taxpayer.
- It was also unlikely that a buyer of the deposits would have accepted matching mortgage assets rather than cash, meaning that additional cash would have to be raised to facilitate the sale of deposits, as had been the case for Bradford & Bingley. The most likely scenario would have required the Treasury to borrow additional gilts from the market to fund a new £21 billion taxpayer loan to NRAM, which would be repaid over time from the redemptions of mortgages.
- UKFI's current estimate of the performance of NRAM suggests that this additional loan would have been repaid in full. However, any return from redeemed mortgages in excess of the cost of providing the loan and repaying private holders of debt in NRAM, would not be received until NRAM was wound up. Applying a discount rate of 6 per cent to the receipt of the return on wind-up in, say 2022, results in a loss for the taxpayer.

1.20 Although Northern Rock plc incurred losses during 2010–2011 and there was a further loss on its sale, the creation of Northern Rock plc required less up-front funding than a deposit sale. Furthermore, the eventual buyer, Virgin Money, acquired all of the support operations alongside the deposits and branches, in return for an up-front price that was higher than any premium from a deposit sale.

Implementing the split

1.21 In February 2009, the Chancellor of the Exchequer announced the reversal of the previous strategy of shrinking Northern Rock's balance sheet to pay off the emergency loan. It was also announced that up to £14 billion of new mortgage lending would be undertaken in 2009 and 2010. The Treasury expected that the split would be completed by July 2009, but restructuring Northern Rock's IT and other systems and obtaining state aid approval delayed the process until the end of 2009.

1.22 In May 2009, on the basis of strong doubts that the support proposed was consistent with its state aid guidelines, the European Commission extended the scope of its investigation of the split proposal. Following negotiations, the state aid agreement in October 2009 which resolved these concerns required:

- restrictions on the volume and competitiveness of lending;
- the guarantees of customer deposits to be lifted in 2010;
- operational separation from the parts of Northern Rock remaining in public ownership by the end of 2010; and
- the Treasury to sell at least 50 per cent of Northern Rock plc by a confidential deadline of 31 December 2013.

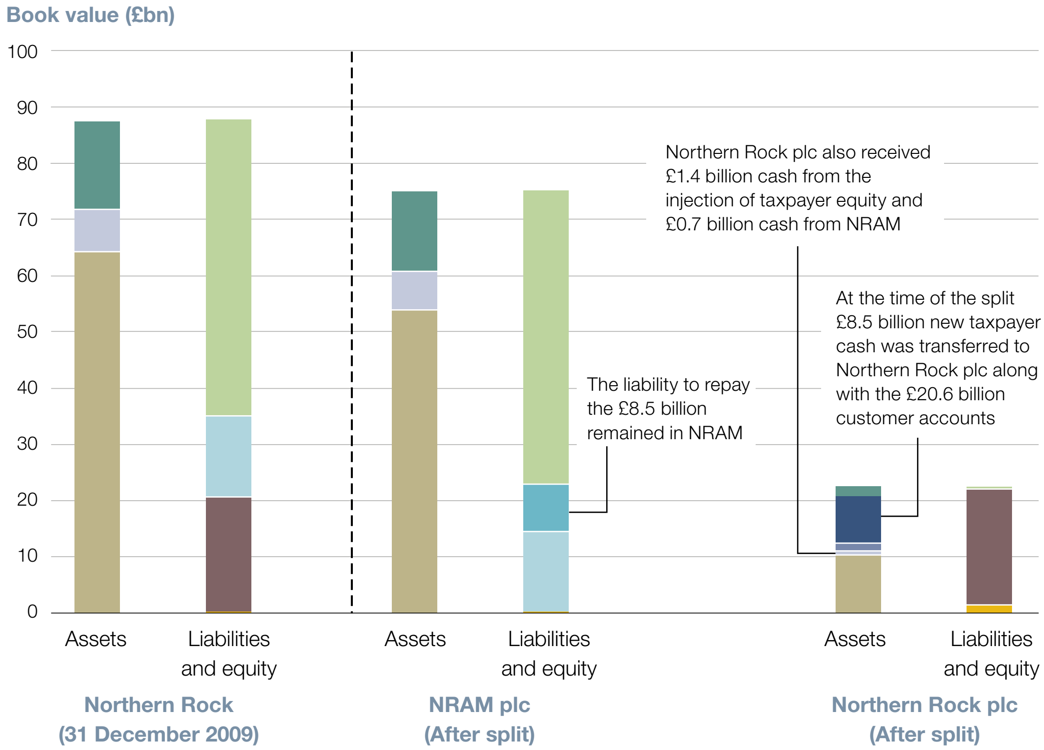
1.23 In the autumn of 2009, the FSA had to decide how much capital and cash liquidity Northern Rock plc would need. On the basis of the approved business plan, the FSA required Northern Rock plc to hold £9 billion of its assets in government bonds or on deposit at the Bank of England. This was a substantial buffer over and above that for other banks to ensure that, after the removal of the government guarantees on customer deposits, any large-scale withdrawals could be met quickly.

1.24 The initial level of capital that Northern Rock plc should hold was also set by the FSA after reviewing the business plan. The capital required was set at £1.4 billion, all in the form of permanent ordinary shares.

1.25 The split into the new bank, Northern Rock plc, and the renaming of the remaining mortgage business as NRAM took place on 1 January 2010, when liabilities and assets were transferred (**Figure 3**). The key features of the split were:

- The existing £21 billion of retail deposits were transferred to Northern Rock plc.
- To match the deposits, Northern Rock plc also received £10 billion of the best performing mortgages and £11 billion in cash (of which £8.5 billion was borrowed by NRAM from the Treasury).
- The Treasury injected £1.4 billion of cash into Northern Rock plc in the form of new shareholder capital.
- The injections of cash from the Treasury were funded by issuing government bonds (gilts) paying interest of around 4 per cent a year.

Figure 3
The transfer of assets and liabilities



	Northern Rock (31 December 2009) Assets	Northern Rock (31 December 2009) Liabilities and equity	NRAM plc (After split) Assets	NRAM plc (After split) Liabilities and equity	Northern Rock plc (After split) Assets	Northern Rock plc (After split) Liabilities and equity
Other assets including intangibles	15.7		14.2		1.5	
Cash from new loans					8.5	Total cash in Northern Rock plc, £10.6 billion
Cash from injection of taxpayer equity					1.4	
Cash	7.5		6.8		0.7	
Mortgages	64.2		53.9		10.3	
Other liabilities[1]		52.6		52.2		0.4
Additional taxpayer loan on split			Total taxpayer loan £23.0 billion	8.5		
Taxpayer loan		14.5		14.5		
Customer deposits and other accounts		20.6				20.6
Taxpayer reserves (equity)		(0.3)		(0.3)		1.4
Total	87.4	87.4	74.9	74.9	22.4	22.4

NOTE

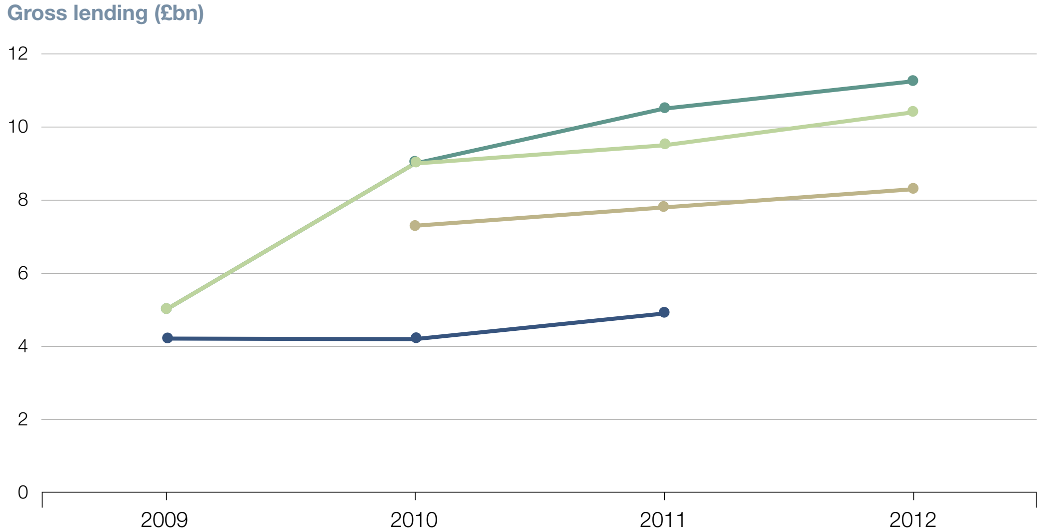
1 Other liabilities include subordinated debt classed as equity.

Source: National Audit Office analysis of Northern Rock published accounts

Northern Rock plc's lending targets

1.26 Northern Rock plc planned to use the cash from the Treasury, an increase in retail deposits and a return to borrowing in the wholesale markets to undertake new mortgage lending. During 2009, lending targets were progressively reduced as gross UK mortgage lending contracted (**Figure 4**).

Figure 4
Lending targets were revised down over 2009



	Original Northern Rock	Northern Rock plc		
	2009	2010	2011	2012
March 2009[1]	5.0	9.0	10.5	11.3
June 2009[1]	5.0	9.0	9.5	10.4
October 2009[1]		7.3	7.8	8.3
Actual gross lending	4.2	4.2	4.9[2]	

NOTES
1 Planned gross lending set at various points over 2009.
2 Forecast figure.

Source: Northern Rock plc business plans and published accounts

Staff incentives for a successful exit from public ownership

1.27 At the time Northern Rock was nationalised, the Treasury put in place incentives linked to the return of the entire bank to the private sector. All staff were entitled to payments based on a percentage of salary, at a total estimated cost in excess of £20 million. As the original incentive arrangements related to a return of the entire bank to the private sector, UKFI negotiated a new incentive scheme for the staff of Northern Rock plc, a much smaller stand-alone bank which had been recapitalised and provided with high-quality mortgage assets and cash by the taxpayer. The new incentive arrangements were based on the performance of Northern Rock plc and a successful exit from public ownership. To reflect the fact that planned lending had not been achieved, the amounts payable were reduced and totalled £4.5 million, of which £2 million was for more junior staff in branches and support functions.

Part Two

Financial performance of Northern Rock plc and preparations for a sale

2.1 This part examines the financial performance of Northern Rock plc during 2010 and 2011, and the Treasury's decision to launch a sales process in 2011.

Losses in 2010 were slightly lower than expected, but lending fell short of target

2.2 UKFI took over responsibility for managing the taxpayer's investments in the wholly-owned banks, including Northern Rock plc, from January 2010. The initial priorities were to complete the separation from NRAM and lift the taxpayer guarantees on customer deposits, with the business then expected to return to profitability in 2012.

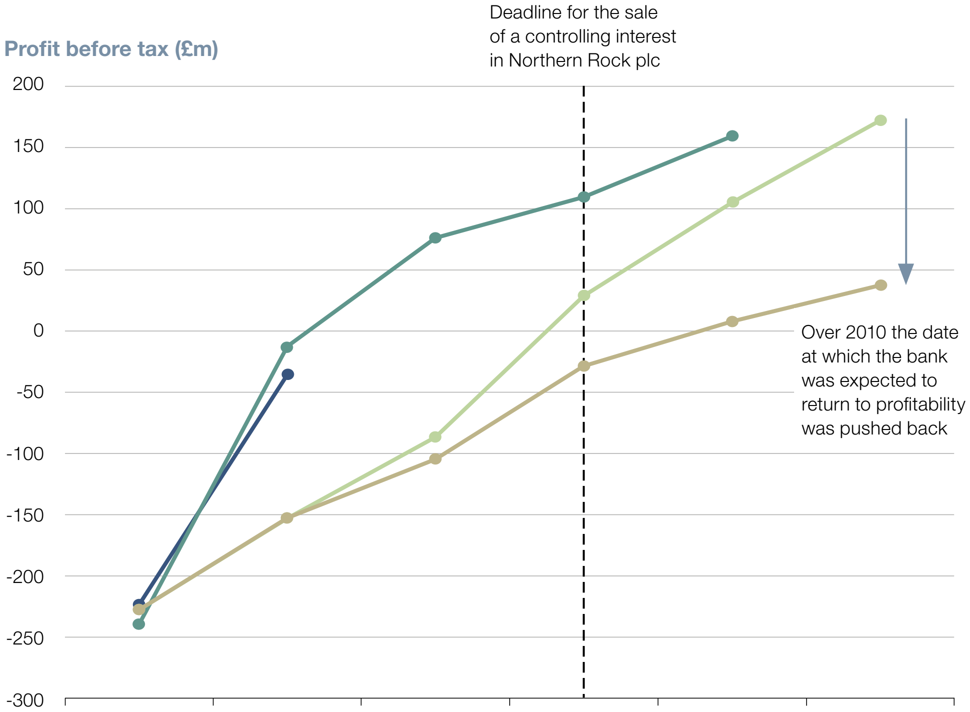
2.3 Northern Rock plc recorded a loss of £224 million for 2010, slightly better than forecast. However by late 2010, a return to profitability was not expected to occur before 2013 (**Figure 5**). In 2011, Northern Rock plc recorded a further loss and its book value at December 2011 was £1.1 billion, a reduction of £248 million during public ownership.

2.4 During 2010 and 2011, Northern Rock plc lent £9.1 billion gross, well below the £15 billion set out in the October 2009 business plan. Deducting repayments, net lending by Northern Rock plc was £3.7 billion (equivalent to 22 per cent of UK net mortgage lending during 2010-2011). This statistic does not take account of redemptions of mortgages remaining in NRAM. Adjusting for these redemptions shows that Northern Rock's overall contribution was a net repayment of £5.6 billion.

Profitability was hindered by unexpectedly low interest rates

2.5 Northern Rock plc did not need all of the cash liquidity required by the FSA because customers did not withdraw as much cash as forecast when the government guarantee on retail deposits was removed. Liquidity requirements were later reduced by the FSA but mortgage lending in 2010 fell some £3 billion short of target. Most of Northern Rock plc's cash not lent as mortgages earned just 0.5 per cent a year on deposit at the Bank of England. As a retail bank, the key driver of Northern Rock plc's profitability is its net interest margin, that is, its ability to charge a higher interest rate to borrowers than it pays to depositors. Competition for deposits meant Northern Rock plc had to continue to pay a high rate to attract depositors, while earning a very low margin on new mortgage lending. As a result, Northern Rock plc's net interest income was negative until it invested some of its cash in gilts in 2011.

Figure 5
By the end of 2010, profit forecasts were revised downwards



	2010	2011	2012	2013	2014	2015
October 2009 business plan	-239	-12	76	110	159	
December 2010 business plan	-228	-153	-87	29	105	172
December 2010 business plan with lower growth assumption	-228	-153	-105	-29	8	37
Actual results	-224	-36[1]				

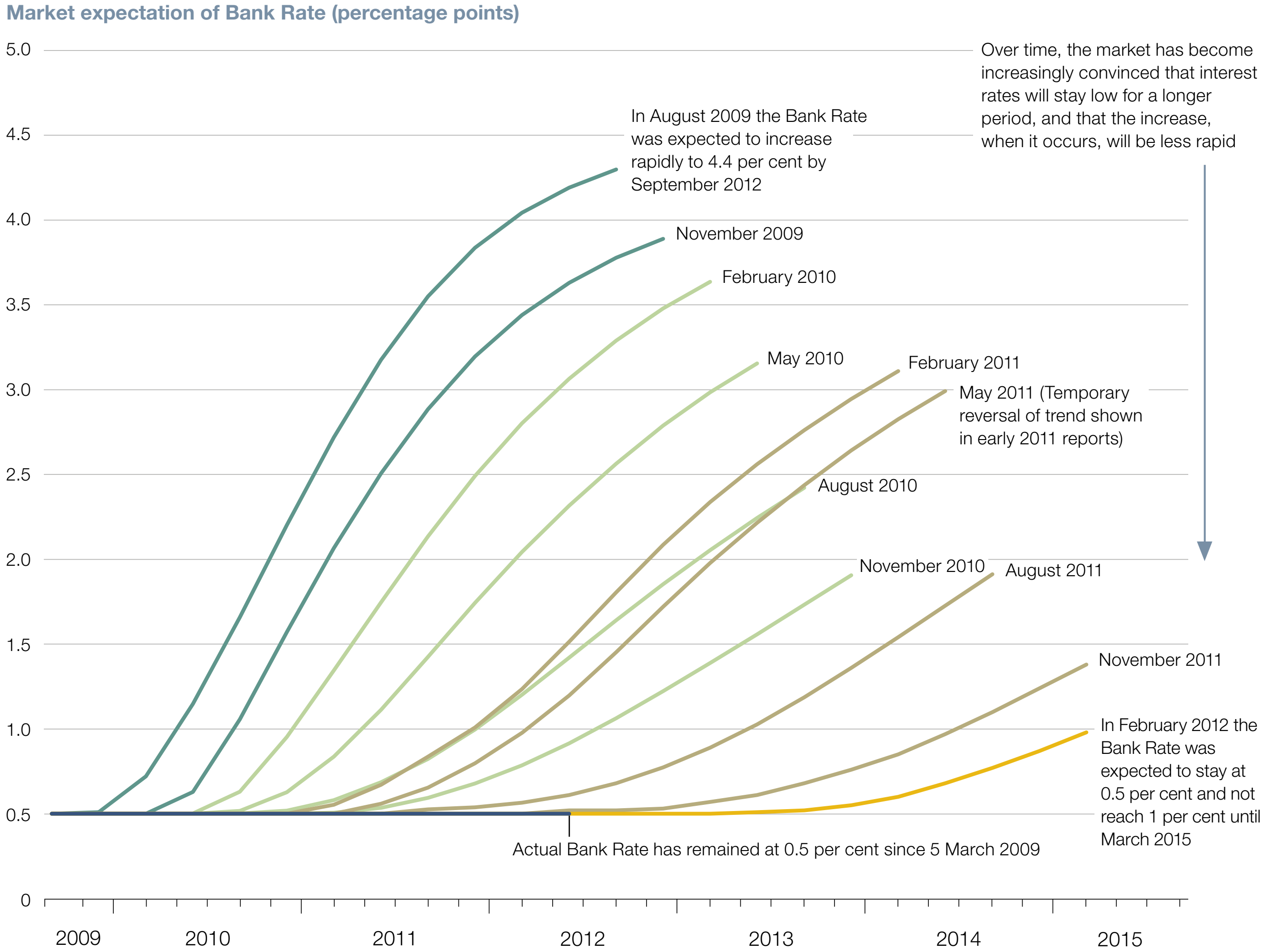
NOTE

1 Forecast figure.

Source: UKFI analysis of Northern Rock plc business plans

2.6 Our analysis of Northern Rock plc's business plans demonstrates that an improvement in net interest margins was dependent on an increase in the Bank of England's Bank Rate, but the rate stayed low for longer than market participants had anticipated (**Figure 6**). This low interest rate environment benefited NRAM through lower than expected rates of mortgage default. Over 2010 and 2011, NRAM made underlying profits totalling £1 billion.

Figure 6
Bank Rate remained at 0.5 per cent for longer than expected



NOTE

1 Graph shows the market's view of future Bank Rate at various points between 2009 and 2012.

Source: National Audit Office analysis of Bank of England data

UKFI asked for a revised business plan in late 2010

2.7 Northern Rock plc's June 2009 business plan had assumed that when the guarantee on retail deposits was lifted there would be a £4 billion outflow and overall deposit growth of just under 12 per cent a year over 2010 to 2013 (a rate above market expectations and comparable to the pre-crisis period). In late 2010, UKFI asked Northern Rock plc to provide a revised business plan containing more realistic assumptions on deposit growth and a reduction of its cost base, which was higher than similarly sized UK banks. The revised business plan, agreed in May 2011, envisaged deposit growth of 13 to 16 per cent over 2012-15, significantly higher than market growth since the financial crisis. In March 2011, Northern Rock plc announced plans for 680 staff redundancies.

The decision to sell Northern Rock plc was taken after UKFI and the Treasury considered a range of options

2.8 In early 2011, UKFI appointed advisers to consider whether taxpayer value would be best served by an early sale process. Because Northern Rock plc was no longer expected to recover value before the 2013 deadline (**Figure 7** overleaf), UKFI concluded that an early sale was the best way to recover some of the taxpayer investment. In designing a sale process, UKFI considered whether combining with the separate but concurrent sale by Lloyds Banking Group of part of its business would add value.

2.9 In May 2011, UKFI and its financial adviser, Deutsche Bank, analysed a comprehensive range of disposal options (**Figure 8** on page 27):

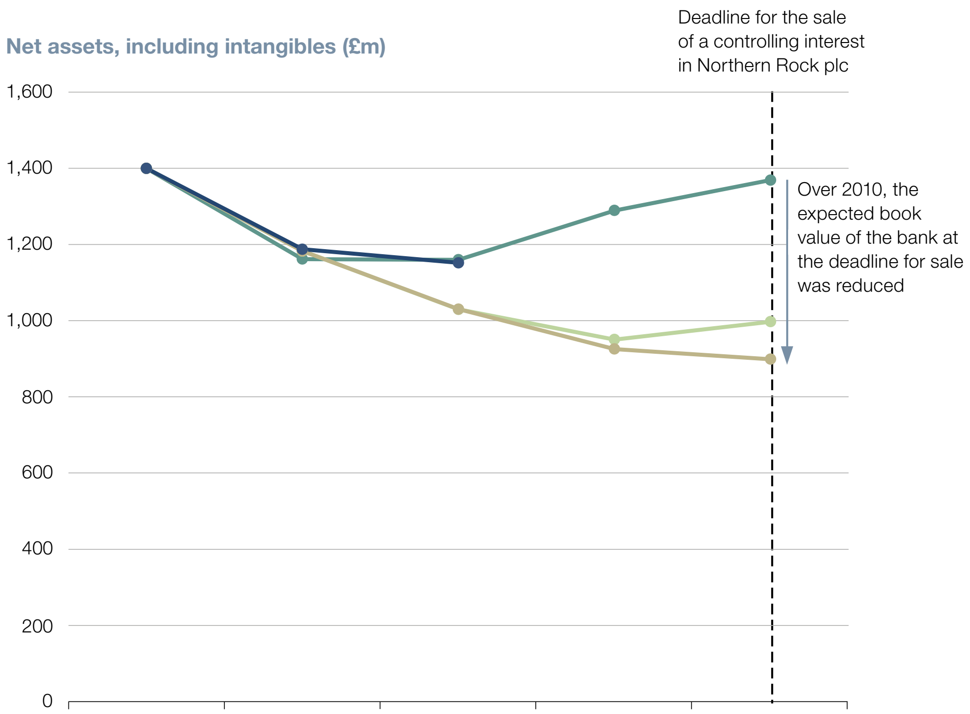
- **Mutualisation** – turn Northern Rock plc into a mutual institution owned by its customers in a similar way to a building society. Such an option would be complex to implement and likely to yield proceeds of £500 million to £600 million.
- **Sale** – to another bank, a building society or private investors. A relatively straightforward option valued at £750 million to £1,250 million, based on any synergies available to a buyer.
- **Sale of deposits** – with a sale or wind-down of the remaining mortgages. Similar to the option considered in 2009 and valued at £590 million to £680 million.
- **Initial Public Offering** – would involve listing Northern Rock plc shares on the London Stock Exchange and likely to yield £650 million to £750 million.

2.10 In line with our recommendations on past asset sales, UKFI also estimated a value of £750 million to £1,050 million for retaining Northern Rock plc beyond the 2013 deadline for sale, to be used as a baseline.

2.11 No option was expected to return the £1.4 billion of capital injected into Northern Rock plc by the Treasury in January 2010, but the range of values suggested that a sale was the best way to minimise the loss for the taxpayer. The Treasury announced in June 2011 the start of a process to transfer the business to private ownership. This included an expectation that the taxpayer would receive up to £1 billion, a target consistent with the valuation attached to the sale option.

Figure 7

Northern Rock plc's business plan indicated that it would not recover value before the 2013 sale deadline



	2009	2010	2011	2012	2013
October 2009 business plan	1,400	1,162	1,160	1,289	1,369
December 2010 business plan	1,400	1,183	1,030	951	997
December 2010 business plan with lower growth assumption	1,400	1,183	1,030	926	899
Actual results	1,400	1,188	1,152[1]		

NOTE

1 Forecast figure.

Source: UKFI analysis of Northern Rock plc business plans

Mutualisation would have been complex and proceeds uncertain

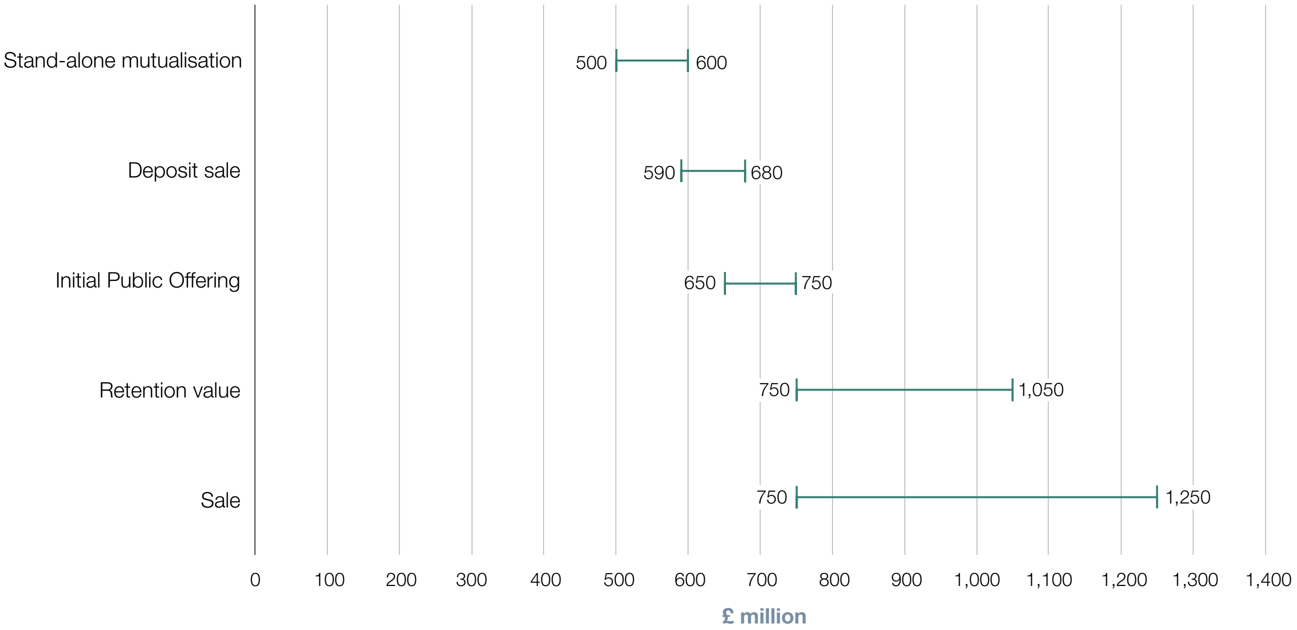
2.12 A mutualisation of Northern Rock plc would involve cancelling the £1.4 billion share capital and granting control of the business to its customers. In return, Northern Rock plc would issue other financial instruments to the Treasury which would qualify as regulatory capital and which might be repaid or sold at a future date.

2.13 New rules to be introduced by 2019 require any such instruments to be either permanent risk-bearing capital or compulsorily convertible to risk-bearing capital when losses are sustained. The only examples issued to date by mutual institutions were forced on existing creditors when the mutual institution got into financial difficulty.

Figure 8

UKFI concluded that a sale held the greatest value for the taxpayer

Initial assessment of options (26 May 2011)



Source: Deutsche Bank assessment of options, May 2011

2.14 UKFI considered therefore that it would have been difficult to design a compliant capital instrument for a mutual which was also attractive to investors. In our view, this meant mutualisation offered little value, and suggested existing mutuals would have limited interest in bidding as they would be unable to finance a purchase by selling capital instruments on the open market.

Combining Northern Rock plc with assets being sold by Lloyds Banking Group was regarded as problematic

2.15 The state aid conditions for the public support given to Lloyds Banking Group required it to sell some of its assets by November 2013. In April 2011, the Independent Commission on Banking noted in an interim report the possibility of combining Northern Rock plc with the Lloyds Banking Group assets to create a stronger challenger to existing banks.

2.16 Discussions were held with Lloyds Banking Group, at the time just over 40 per cent owned by the taxpayer. However, it was not clear that any benefits from the combination would outweigh the costs and loss of flexibility. UKFI also considered that it did not have sufficient control of the voting rights to compel Lloyds Banking Group to combine the sale of its assets with Northern Rock plc. The only realistic way of combining the two disposals would be for a single purchaser to acquire both businesses in separate transactions. The Independent Commission on Banking's final report published in September 2011 did not include any recommendation on the proposed combination.

The choice of exit strategy would be determined by financial value

2.17 The objectives of the sale process were to achieve value for the taxpayer, maintain financial stability, promote competition in financial services and not leave the government as a permanent shareholder. The Treasury and UKFI, after consultation with the European Commission, concluded that the choice of exit strategy had to be taken on financial value. This decision was soundly based because accepting a lower value bid could be regarded as providing state aid to the new owners, which was likely to be regarded as unacceptable by the European Commission.

2.18 UKFI and the Treasury performed a comprehensive financial stability and competition assessment in 2011. Lending to small- and medium-sized businesses and the provision of personal current accounts were the key areas of concern. The assessment concluded that, based on rules usually applied by the Office of Fair Trading, Northern Rock plc's market share in these sectors was too small to be an impediment to selling to any bank, regardless of their market share.

Part Three

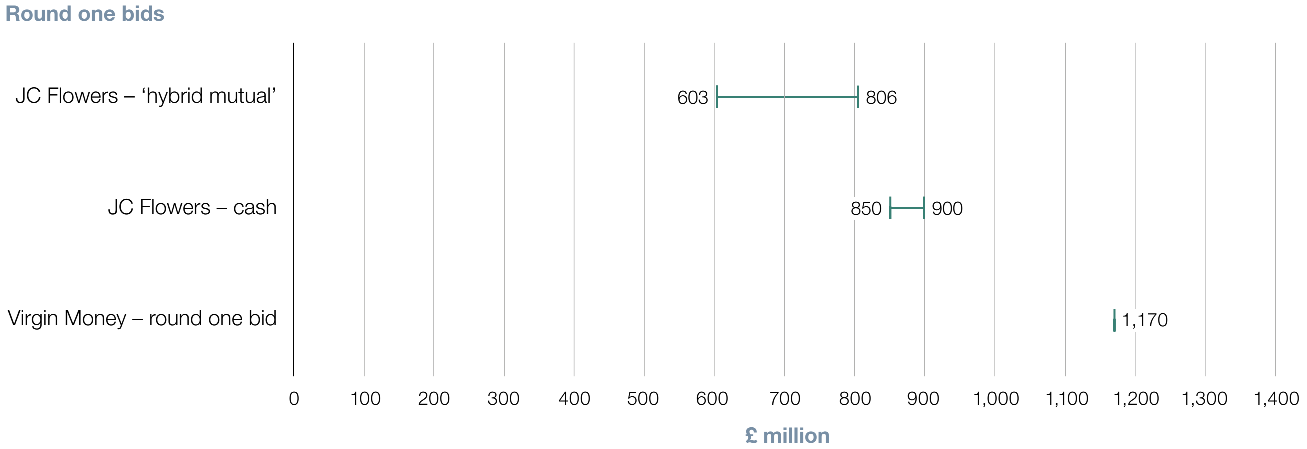
The sale of Northern Rock plc

3.1 This part examines how UKFI managed the sale process; the decision to sell the business to Virgin Money in 2011; the loss to the taxpayer; and the expected return from the assets remaining in NRAM. A timeline of key events is at **Figure 10** overleaf.

Preliminary bids were received from two parties

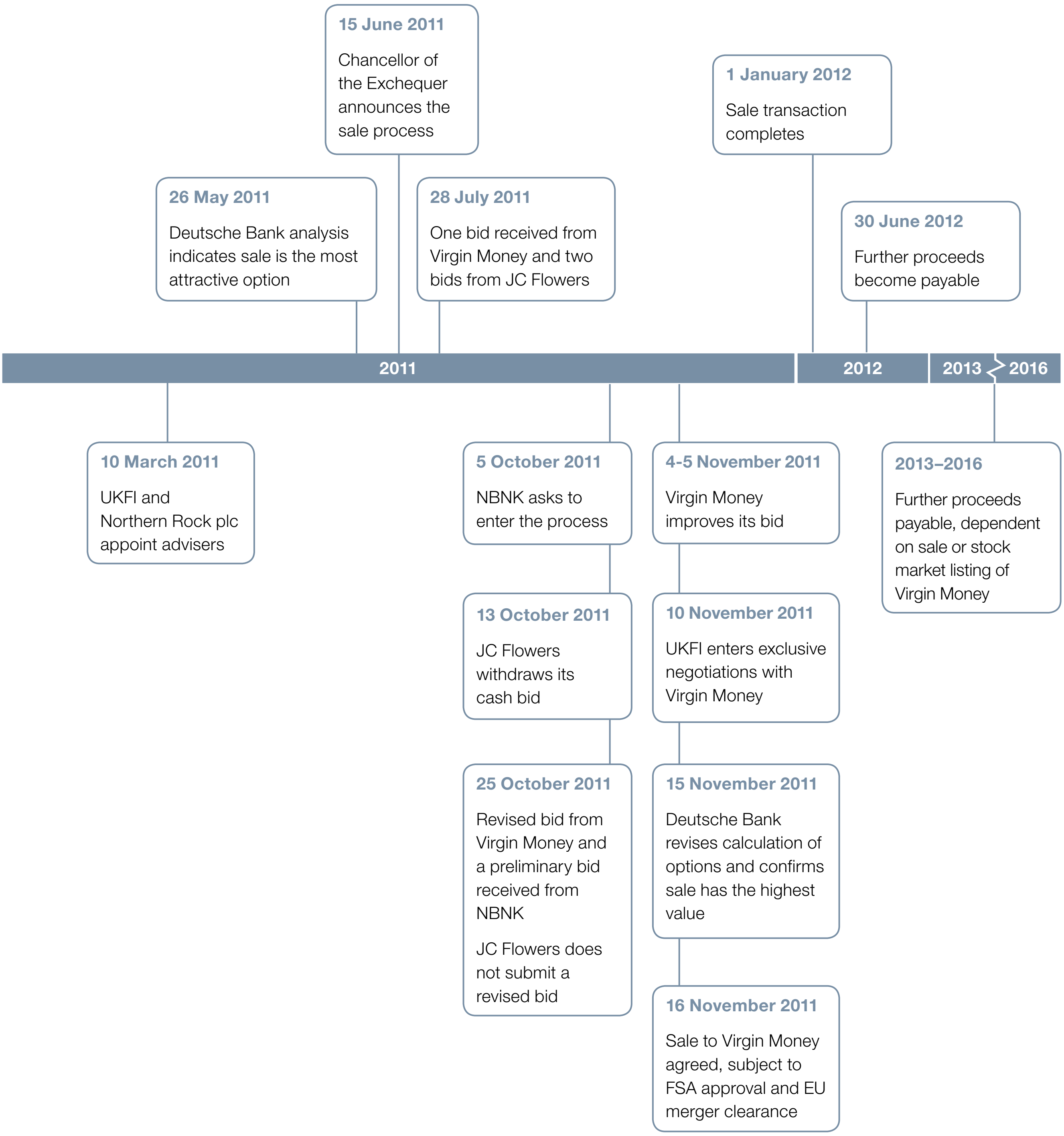
3.2 In June 2011, UKFI's financial adviser approached 52 potential bidders and 26 parties requested and received detailed information on the sale. Of these potential bidders, only two, Virgin Money and JC Flowers made indicative bids by the 28 July deadline (**Figure 9**).

Figure 9
Two parties provided three bids by the round one deadline



Source: Deutsche Bank analysis of round one bids

Figure 10
Timeline of the sale transaction



Source: UKFI and HM Treasury

3.3 JC Flowers submitted a cash bid and a separate 'hybrid mutual' proposal to merge Northern Rock plc with One Savings Bank (a bank, owned by an industrial and provident society and JC Flowers, which was established through a recapitalisation of the Kent Reliance Building Society). If successful, the proposal would have created an institution whose ownership would be split between the customers, JC Flowers and the Treasury (**Figure 11**).

3.4 UKFI took all three bids from the two bidders to a second round, and set a 25 October deadline for bidders to provide revised bids. The deadline gave bidders time to discuss capital and liquidity requirements with the FSA and conduct due diligence on detailed information about Northern Rock plc.

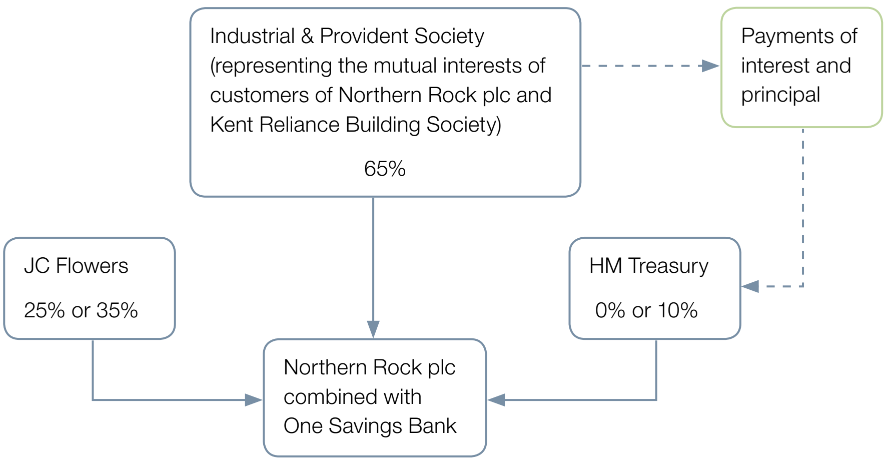
By late October 2011, one bidder had dropped out but another had joined the sale process

3.5 By 13 October 2011, JC Flowers had dropped its cash bid to concentrate on the mutual option. JC Flowers and One Savings Bank were joined by another party in pursuing the 'hybrid mutual' proposal but were not able to finalise terms with their new bidding partner and withdrew from the sale process.

3.6 In November 2010, the chief executive of Northern Rock plc left and subsequently joined NBNK plc as chief executive in 2011. NBNK was a new investment vehicle created to acquire UK banking assets, particularly those being sold by Lloyds Banking Group and possibly Northern Rock plc. As potential bidders for Northern Rock plc might have concerns that NBNK's new chief executive would have commercially sensitive knowledge of Northern Rock plc, NBNK agreed not to bid for the business until November 2011.

Figure 11

JC Flowers proposed combining mutualisation, private and public ownership in a 'hybrid mutual'



Source: National Audit Office analysis of the JC Flowers proposal

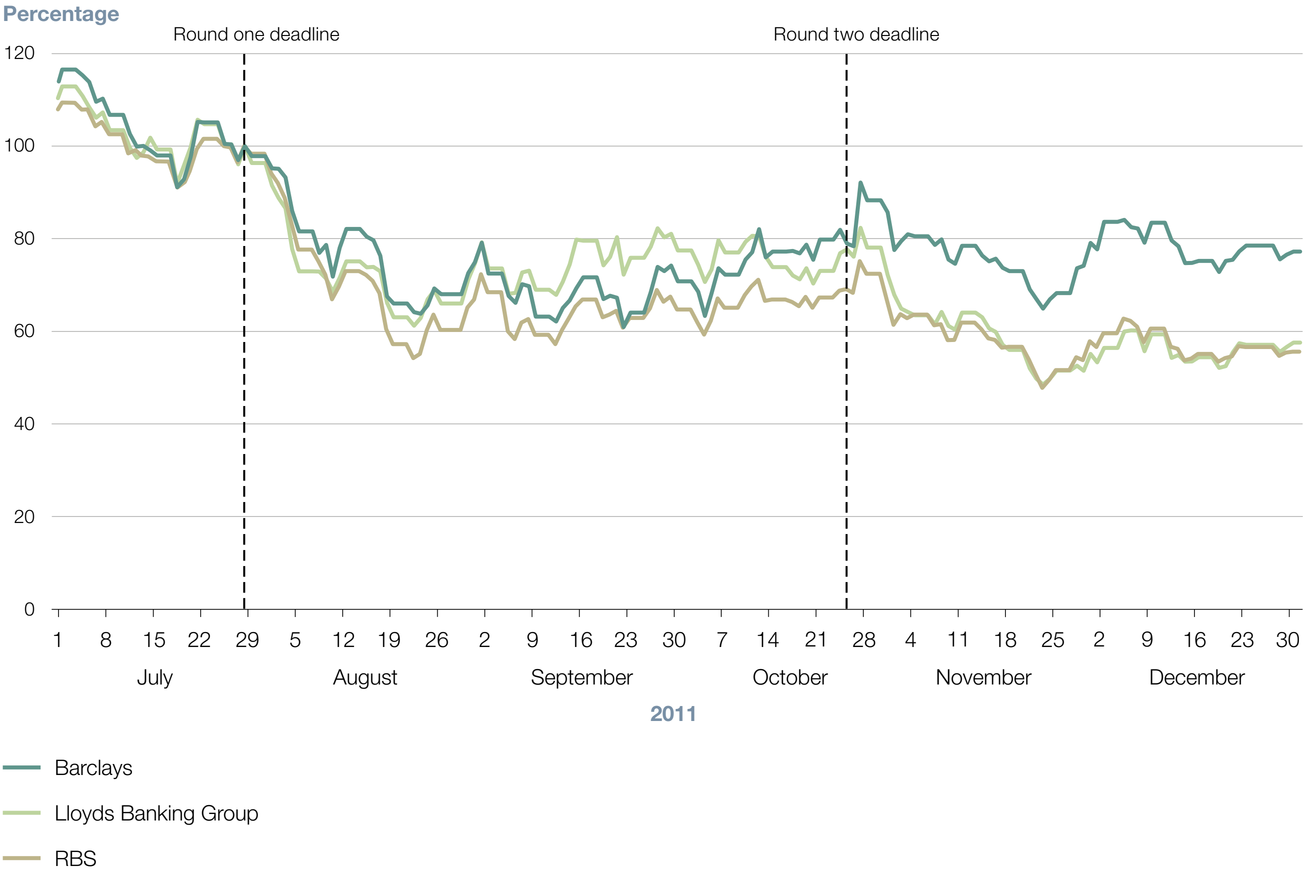
3.7 On 5 October 2011, however, NBNK requested the prohibition be lifted four weeks early so it could consider a bid for Northern Rock plc. To maintain competitive tension in the bidding process, UKFI and the Treasury accepted this proposal and NBNK submitted a preliminary bid which was entirely cash based. The bid was, however, contingent on NBNK receiving exclusivity on both Northern Rock plc and the Lloyds Banking Group disposal and on raising the proceeds from a share sale. The NBNK bid was valued by UKFI at £829 million to £846 million. The valuation included an assumption by NBNK that the Treasury could extract £142 million to £159 million from Northern Rock plc before any sale. Such an extraction of capital would have required FSA approval.

3.8 On 25 October 2011, Virgin Money submitted a revised bid which was valued by UKFI at £800 million to £866 million. This was some 26 per cent to 32 per cent lower than its previous bid reflecting the results of due diligence and worsening economic conditions that saw major UK retail banks' share prices fall by some 20 per cent to 30 per cent between July and October 2011 (**Figure 12**).

Figure 12

Share prices in major UK retail banks fell between July and October 2011 as economic conditions deteriorated

Share price, indexed to 28 July 2011 = 100



Source: National Audit Office analysis of Bloomberg data

UKFI negotiated an improvement to the non-cash elements of Virgin Money's revised bid

3.9 In line with good practice on past asset sales, UKFI aimed to maintain competitive tension amongst the bidders, emphasising that the sale process could be cancelled or postponed should the price offered be considered unsatisfactory. Virgin Money told us that it believed NBNK to be credible competition and did not know whether there were other bidders in the competition or whether UKFI had other feasible options to a sale.

3.10 The final Virgin Money bid was initially valued by UKFI at £863 million to £977 million (**Figure 13** overleaf) comprising cash payments on completion and in June 2012. Also, there might be further proceeds depending on business performance and any onward sale of Virgin Money.[4] The bid can be broken down as follows:

- **a** **£747 million cash** paid at completion of the sale on 1 January 2012.
- **b** **Further cash,** depending on the book value of the business at completion. As Virgin Money's final bid was based on a forecast of book value, the final amount is currently expected to be £50 million to £74 million.
- **c** **A residual economic interest in Virgin Money** in the form of debt issued to the Treasury with a principal value of £150 million and discretionary interest payments of 10.5 per cent a year from 2013. The debt was valued at £66 million to £117 million but may change in future. The low valuation reflected uncertainty over the saleability of the debt and, in line with regulatory requirements, its highly subordinated nature. The debt could also be converted into shares on a successful sale or listing of Virgin Money or if its capital ratio falls below a fixed level.
- **d** **A clawback clause** through which a successful sale or listing of Virgin Money before 2016 would result in payments to the Treasury of up to £80 million. This was valued at £0 to £39 million to reflect the time value of money and likelihood of a sale or listing.

3.11 As part of the proceeds would be deferred, UKFI commissioned high-level due diligence on the Virgin Money business plan. The exercise concluded that it was reasonable to assume that interest on the debt would be paid and that the clawback clause could yield additional proceeds. NBNK's preliminary bid was not improved. NBNK told us that the final Virgin Money bid was above what it would have been prepared to pay.

4 In purely cash terms, the proceeds amount to just over £1 billion.

Figure 13
Comparison of bids

	Virgin Money (round two) (£m)[1]	Virgin Money (final) (£m)[1]	NBNK (£m)[1]
Cash	735	747	687
Deferred cash (estimate)	–	50–74	–
Assumed cash extraction ahead of sale	–	–	142–159
Capital instrument	65–95	66–117	–
Contingent payments	0–36	0–39	–
Total (present value)	**800–866**	**863–977**	**829–846**
Terms of capital instrument	Tier one note (£130 million principal paying 8 per cent from 2012). Redeemable after 5 years. Converts to equity if Virgin Money gets into financial difficulty.	As round two, but £150 million principal, paying 10.5 per cent from 2013. Mandatory exit on sale or stock market listing of Virgin Money.	–
Terms of contingent payments	Up to £50 million – £80 million (dependent on date) if sale delivers a return above 15 per cent by 2016.	As round two, but payment triggered by any profitable sale by 2016. Additional £5 million if coupons on the capital instrument are deemed tax deductible.	–
Conditions	FSA approval and EU merger clearance.	As round two.	NBNK also receiving exclusivity for the Lloyds disposal. FSA approval, including for capital extraction.
Expected completion	1 January 2012.	1 January 2012.	March–April 2012.
Other potential benefits (not part of valuation)	Move operational headquarters to Newcastle. Maintain branch and headcount numbers at levels set out in business plan. Maintain Northern Rock Foundation agreement until 2013.	As round two.	Merging Northern Rock and the Lloyds assets would have created a larger bank. However, it would still have been too small to challenge the existing UK banks.

NOTE
1 Bids valued at 1 January 2012 using a 12 per cent (nominal) discount rate.

Source: Deutsche Bank comparison of bids

Northern Rock plc was sold to Virgin Money in November 2011

3.12 The final Virgin Money bid was £23 million to £148 million higher than the NBNK bid and contained fewer conditions (Figure 13). Deutsche Bank re-evaluated the other options. All of the options had declined in value, reflecting the fall in bank share prices between July and October 2011. Deutsche Bank concluded that a sale to Virgin Money represented the best value (**Figure 14** overleaf).

3.13 After one week of exclusive contractual negotiations, UKFI proposed that the Treasury accept Virgin Money's offer. The sale was announced in November 2011 and completed on 1 January 2012.

The sale resulted in a further loss to the taxpayer of £232 million

3.14 The full value of the loss from the sale depends on the eventual cash flows from the deferred and contingent parts of the proceeds. The present value of the loss would be between £175 million to £289 million based on the £1.1 billion net assets of Northern Rock plc at the time of the sale and Treasury's latest estimates of the proceeds. The £232 million loss on the sale is the midpoint of this range and is in addition to the reduction in book value of £248 million while Northern Rock plc was trading, a total estimated loss of £480 million (**Figure 15** on page 37).

A delayed sale would not have been better value

3.15 UKFI considered that delaying a sale to the end of 2013 would have yielded a present value of £650 million to £735 million, a much lower price than Virgin Money was prepared to pay in late 2011. Our review of this analysis showed that even if Northern Rock plc succeeded in stemming losses and there was some recovery in bank valuations, these improvements would be more than offset by the delay in receiving sale proceeds in conditions of significant economic uncertainty. It was also not certain that bidders would be willing to participate in a second or extended sale process.

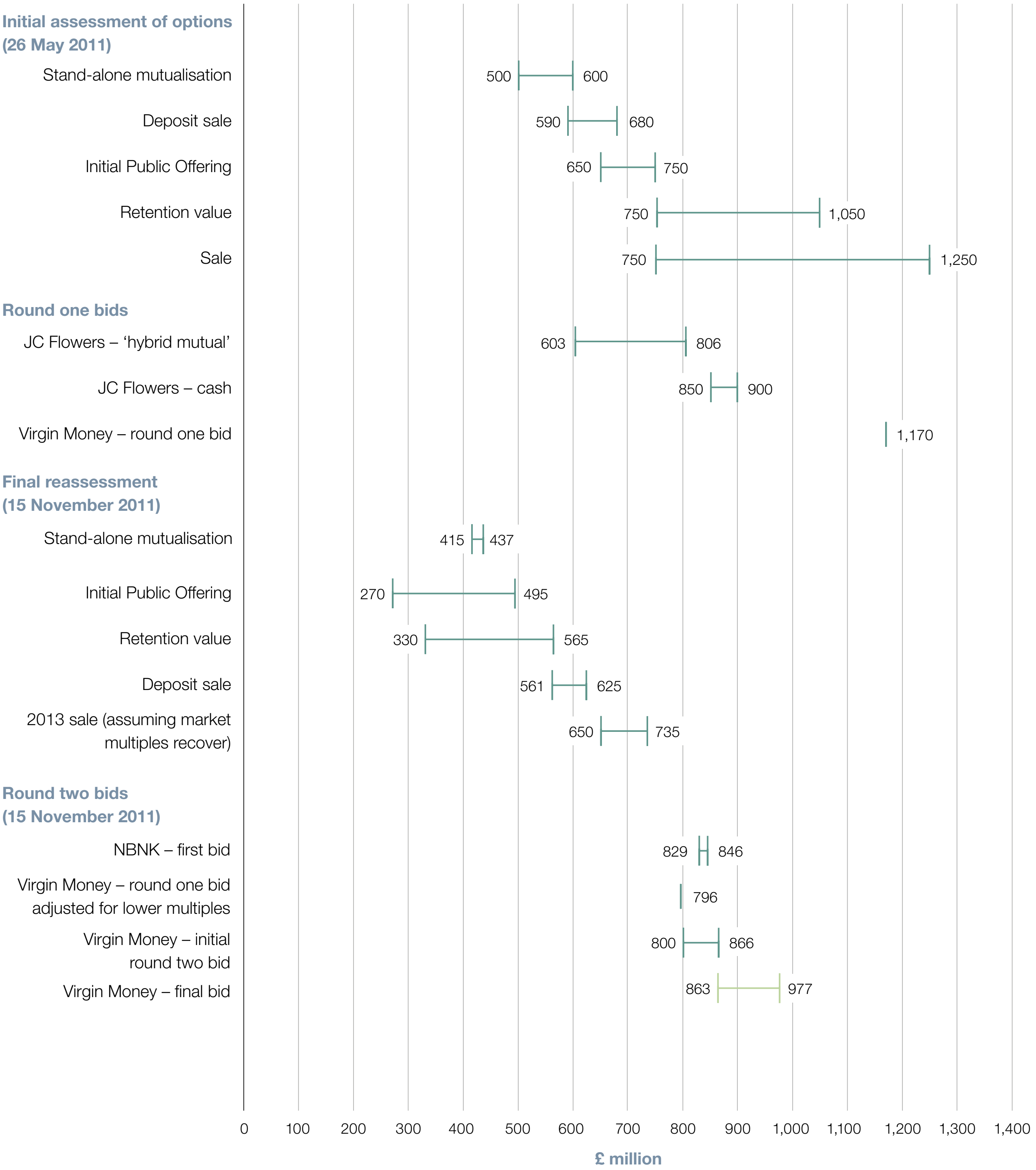
Virgin Money part-funded the sale with cash in Northern Rock plc

3.16 To fund the purchase, Virgin Money raised £772 million consisting of:

- Cash of £150 million.
- Cash from issuing shares to: the UK parent of Virgin Money (£50 million); WL Ross IV VM LLC, a United States investment fund owned by Wilbur Ross (£269 million); and Stanhope Investments, a venture capital fund based in Abu Dhabi (£50 million).
- Short-term debt finance of £253 million provided by two banks and repaid using cash extracted from Northern Rock plc.

Figure 14

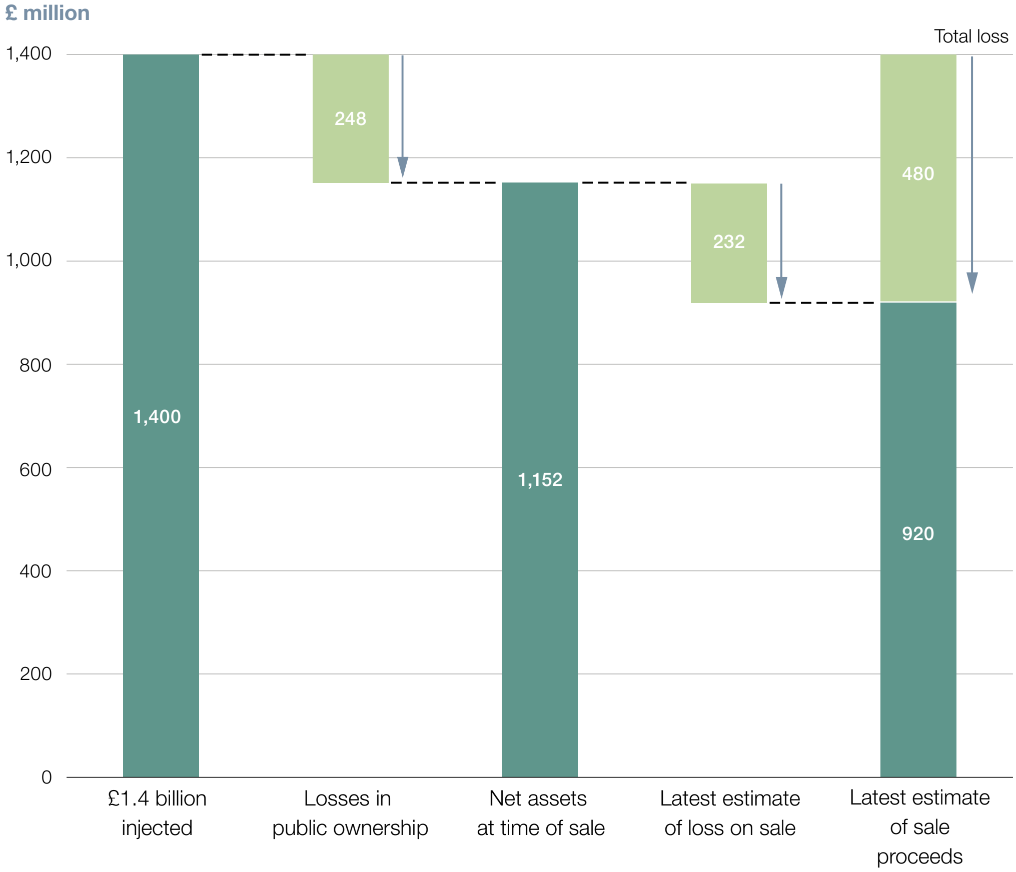
UKFI reassessed disposal options and concluded that a sale to Virgin Money was the best outcome



Source: Deutsche Bank, UKFI

Figure 15

The total loss on the £1.4 billion taxpayer equity is currently estimated to be £480 million



Source: National Audit Office analysis

3.17 This funding covered the initial £747 million paid to the Treasury and left Virgin Money with £25 million to cover its transaction costs, including stamp duty.

3.18 After the sale, Northern Rock plc became a subsidiary of Virgin Money and, on a combined basis, the FSA decided that less capital was required than had been the case for Northern Rock plc on a stand-alone basis. By transferring one of its subsidiary companies to Northern Rock plc, Virgin Money was able to free-up cash to repay the short-term debt finance. This internal transfer of assets swapped £253 million of cash in Northern Rock plc for £330 million of shares in the subsidiary. The balance of £77 million due from Northern Rock plc could then be used to fund the payment to the Treasury of the deferred elements of the agreed sale price.

3.19 In examining previous privatisations, the Committee of Public Accounts has recommended that sellers extract surplus assets, including cash, from a business before sale. Northern Rock plc's losses during 2010 and 2011 reduced the value of its initial capital from £1.4 billion to £1.1 billion. Any extraction of capital in the form of cash ahead of a sale would reduce this capital value further. Although the FSA had reduced the capital requirement of the business on a stand-alone basis, the reduction was not large enough to allow the Treasury to extract capital in the form of cash before a sale.

3.20 Virgin Money and UKFI consider that the cash freed-up from Northern Rock plc once it had been combined with Virgin Money's other businesses was reflected fully in the price paid. Banks are generally valued by investors as a multiple of their book value. It is not possible to separate the value attached to the internal asset transfer from the overall price paid by Virgin Money. However, if full value is ascribed to the cash freed-up, the adjusted multiple of book value paid for Northern Rock plc's other assets falls slightly from 0.76-0.86 to 0.66-0.80. It is difficult to find another bank similar to Northern Rock plc, but our analysis shows that large UK banks were trading below the adjusted ratio of bid to book value when the sale occurred, suggesting that the price achieved was reasonable (**Figure 16**).

The sale process was well organised

3.21 We compared the sale against lessons learned from our reports on past privatisations and asset sales. The sale was handled well and a detailed assessment is contained in Appendix Three at www.nao.org.uk/northern-rock-2012. Bidders told us that they felt that the sale process benefited from:

- full and comprehensive information being made available;
- UKFI setting clear objectives;
- clear personal ownership of the process by the head of the wholly-owned banks section of UKFI;
- a clear separation of roles between UKFI and the Treasury; and
- all parties adhering to non-disclosure agreements. During the process, information about the value of bids was restricted to a limited number of people in the Treasury and UKFI, and within Northern Rock plc to just the executive chairman and the legal department.

Figure 16

Virgin Money's final bid was reasonable, compared with multiples of book value at which major UK banks were trading

Source: National Audit Office analysis of Bloomberg data, Virgin Money bid and Northern Rock plc forecast book value at December 2011

UKFI expects to recover the loss on the sale of Northern Rock plc from NRAM

3.22 Since 2007, the government has provided a total of £37 billion[5] of funding for Northern Rock plc and NRAM. The remaining assets and liabilities of Northern Rock are held in NRAM, which has been merged with Bradford & Bingley under common management since October 2010.

3.23 In 2010, we recommended that UKFI calculate the expected return to the taxpayer of the support. In February 2012, UKFI published[6] its current expectation that the cash generated from Northern Rock plc and NRAM will represent a return of between 3.5 per cent and 4.5 per cent (nominal). Over the next 10 to 15 years, UKFI currently expects that £46 billion to £48 billion in cash will be returned to the taxpayer. This means that, in purely cash terms, the taxpayer will recover both the loss on sale and the cost of supporting Northern Rock, including the finance cost of the gilts issued to raise the cash provided.

3.24 The return is sensitive to how well NRAM delivers its business plan. It is also sensitive to the economic assumptions within those plans and on the ability to convert the residual value in NRAM into cash once the taxpayer support is repaid. The calculation also reflects beneficial actions taken by UKFI to manage the balance sheets of the wholly-owned companies, including exercises to buy back debt issued before the financial crisis and reductions in running costs.

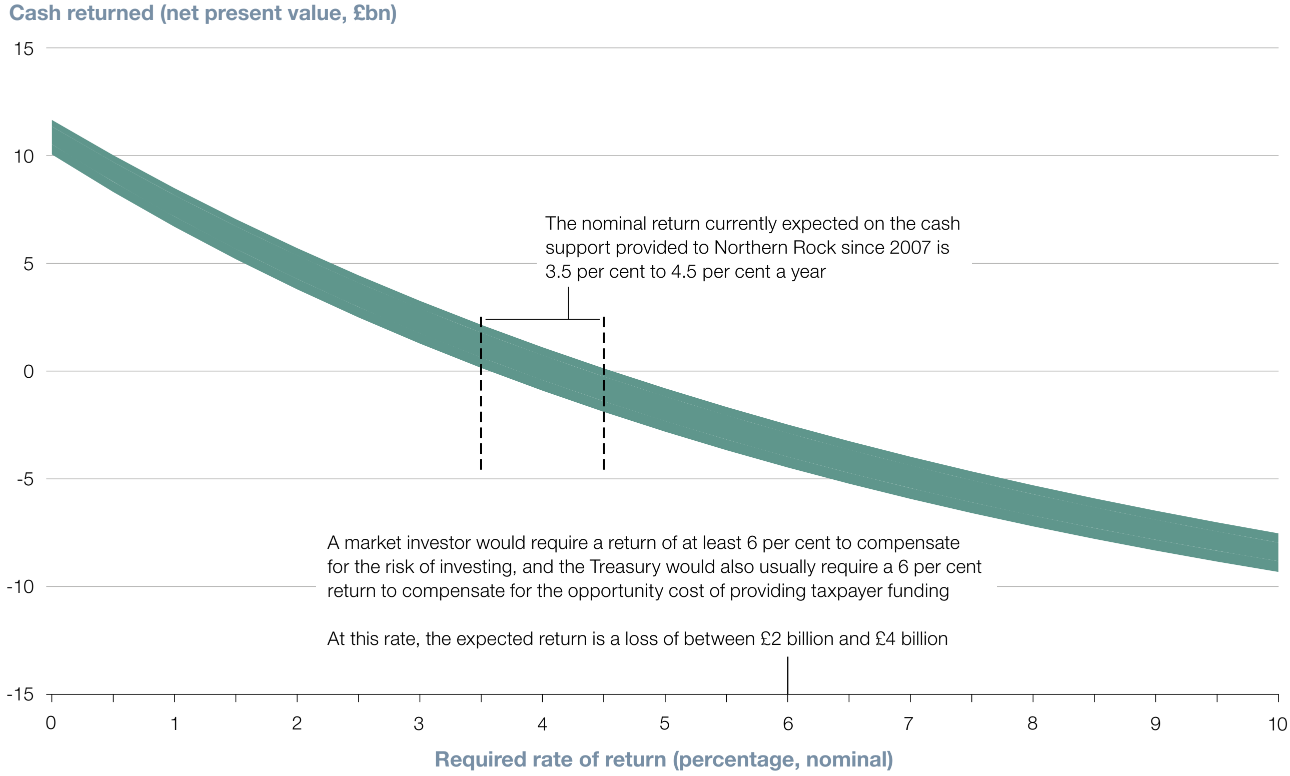
The taxpayer will not be compensated for the risks taken on

3.25 As repayments of the support provided to Northern Rock will be spread over many years and subject to the risk of changes in economic conditions, a private sector investor would require a higher rate of return as compensation for the risks taken on. The nominal return to the taxpayer which UKFI expects the Treasury to receive is not sufficient to cover these factors. Applying an appropriate discount rate, which we estimate at 6 per cent (nominal), would result in a net present cost of £2 billion on the support provided to Northern Rock since 2007 (**Figure 17**).

5 A loan of £27 billion in 2007 plus £8.5 billion loan to NRAM and £1.4 billion equity in Northern Rock plc on 1 January 2010.
6 Available at http://www.ukfi.co.uk/releases/UKFI%20report%20on%20sale%20of%20Northern%20Rock_2012.pdf

Figure 17

UKFI calculate that NRAM will return all the cash support, but that the taxpayer has not been compensated for the risks assumed



Source: National Audit Office analysis of UKFI data

Appendix One

Methodology

Study scope

We reviewed the decision to split Northern Rock; the financial performance of Northern Rock plc during public ownership and its sale at the end of 2011. Fieldwork was carried out between January and March 2012.

Further details are available in Appendix Two at www.nao.org.uk/northern-rock-2012.

Methods	Purpose
Document review	
We reviewed key submissions and documentation from HM Treasury, UKFI and their advisers.	To identify the objectives and the key events in the creation and sale of Northern Rock plc.
We also reviewed previous reports from the NAO and the Committee of Public Accounts on asset sales.	To compare the sale to previous asset sales.
Financial analysis	
We analysed accounts and financial information from key stakeholders in the sale.	To evaluate the bids received and to establish the performance of Northern Rock plc under public ownership.
We evaluated options available to the Treasury in 2009 and in 2011.	To scrutinise the Treasury's and UKFI's appraisals and evaluate the cost and return from possible alternatives to the creation and sale of the bank.
Semi-structured interviews	
We interviewed key stakeholders including: • Treasury and UKFI officials; • UKFI's advisers; • bidders for Northern Rock plc; • Northern Rock management; and • the FSA.	To establish the chronology of events, the options available, the Treasury's understanding of the risks, the planning and management of the project, bidders' perspectives on the sale and the regulatory constraints.
Use of in-house expertise	
We drew on NAO staff with experience of: asset sales, corporate finance and the banking interventions.	To provide advice and compare the sale to previous asset sales.

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