



National Audit Office

HM Treasury

The creation and sale of Northern Rock plc

Appendix Two

MAY 2012

Appendix Two

Detailed methodology

1 This document accompanies the Comptroller and Auditor General's report *The creation and sale of Northern Rock plc*, published in May 2012. It adds further detail to the methodology in Appendix One of the main report.

Study scope

2 The report examines:

- the Treasury's decision to create Northern Rock plc in 2009;
- the financial performance of Northern Rock plc while in public ownership; and
- whether the sale of Northern Rock plc at the end of 2011 was the best available option and whether the sale process was handled well.

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

4 The report is the third NAO report covering Northern Rock assets and liabilities since its nationalisation in 2008:

- *HM Treasury: The nationalisation of Northern Rock*, Session 2008-09, National Audit Office, 20 March 2009, HC 298.
- *Stewardship of the wholly-owned banks: buy-back of subordinated debt*, Session 2010-11, 18 March 2011, HC 706.

5 The NAO has also published a series of work on the full taxpayer support to banks:

- *Maintaining financial stability across the United Kingdom's banking system*, Session 2009-10, 4 December 2009, HC 91.
- *Maintaining the financial stability of UK banks: update on the support schemes* Session 2010-11, 15 December 2010, HC 676.
- *HM Treasury: The Asset Protection Scheme*, Session 2010-11, National Audit Office, 21 December 2010, HC 567.

- *The Comptroller and Auditor General's report on HM Treasury's 2010-11 Resource Accounts*, Session 2010-11, part of the Certificate and Report of the Comptroller and Auditor General on *HM Treasury Annual Report and Accounts 2010-11*, HC 984, July 2011.
- A summary of our work on taxpayer support to banks is available on the our website at http://www.nao.org.uk/banking_faq.aspx.

Methodology

6 Our main methods were the review of key documents relating to the decisions to create the bank in 2009 and sell it at the end of 2011; financial analysis to evaluate the decision to create and then sell Northern Rock plc against alternative courses of action, semi-structured interviews with the main stakeholders in the sale, and the use of NAO expertise on asset sales and banking.

7 Fieldwork took place between January and March 2012.

Document review

8 We reviewed key documents to establish the chronology of events, the objectives for creating Northern Rock plc, the options for returning the bank to private ownership, and the financial proceeds from the sale.

9 The documents reviewed included:

- submissions from Treasury and UKFI to Ministers on the decision to create Northern Rock plc in 2009 and relating to the sale process at the end of 2011;
- the results of due diligence reports commissioned by the Treasury when deciding to create Northern Rock plc;
- UKFI Board meeting minutes and papers, particularly reports commissioned from their advisers on the decision to sell, the choice of sales method, and the evaluation of the bids;
- other project management documentation relating to the sales process, including papers relating to the completion of the sale to establish the cashflows and likely proceeds from the sale; and
- previous NAO and PAC reports on asset sales and banking.

Financial analysis

10 We used the NAO's options appraisal toolkit to evaluate the Treasury's appraisal of whether to split the bank or sell its deposits in 2009.

11 We used UKFI's estimate of the return from NRAM to assess the cost of a deposit sale in 2009 instead of the creation of the bank 2009 and sale at the end of 2011.

12 We reviewed accounts and published financial results and drew on evaluations performed by UKFI to establish the performance of Northern Rock plc under public ownership.

13 We reviewed UKFI's model for options available for returning the bank to private ownership (sale, mutualisation, delaying a sale until the 2013 deadline, deposit sale either funded through the market or folding the assets into NRAM).

14 Analysis of market data and information from the Bank of England to understand the UK retail banking and lending markets, to benchmark the proceeds from the sale against the share price of large UK banks and to test the assertion that the Virgin Money bid had valued the capital at full book value.

15 We used UKFI's model of the cashflows from the wholly-owned banks to calculate the current expected net present cost of the intervention in Northern Rock.

16 We used information from the NAO's financial audit of the Treasury Resource Accounts, and reviewed the accounts and financial results from parties involved in the sale process, including HM Treasury, UKFI, UK Asset Resolution (holding company of NRAM), the Virgin Money group and the other bidders.

Semi-structured interviews

17 We interviewed:

- Treasury and UKFI officials to understand the chronology of events and the objectives for the bank, and whether the 2013 deadline could have been renegotiated.
- UKFI's corporate finance and legal advisers to understand how they evaluated the options for returning the bank to the private sector.
- Bidders involved in the sales process, including Virgin Money, NBNK and JC Flowers to understand their bids and how they viewed the management of the sales process.
- Management and former management of Northern Rock plc to understand their perspectives on the creation, sale and performance of the bank.
- The FSA to understand the regulatory constraints on the level and type of liquidity and capital provided by the taxpayer to the bank on its creation, whether it could have been extracted before the sale and whether alternative forms could have been provided.

Use of in-house expertise

18 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. (see Appendix Three).