



National Audit Office

Report

by the Comptroller
and Auditor General

HM Treasury, UK Financial Investments, UK Asset Resolution

The £13 billion sale of former Northern Rock assets

Key facts

£13.3bn	£74m	£5.5bn
nominal value of mortgages and loans sold by UK Asset Resolution Ltd	premium paid over the nominal value of assets	cash proceeds to the taxpayer

Additional key facts on the transactions

£13 billion	reduction in government debt in 2015-16 due to sale
18 months	time from appointment of advisers to close of transaction
3	number of final-round bidders after 63 expressions of interest
£15.5 million	cost of advisers

Key facts about the assets sold, as at 30 June 2015

91%	proportion of the value of the asset portfolio made up of mortgages in the Granite securitisation vehicle
72.4%	average indexed loan-to-value ratio of Granite mortgages, with an average loan size of £100,214
4.50% to 5%	interest rate that 85% of Granite mortgages pay
3%	Granite mortgages in arrears by more than three months
270,808	mortgages and loans in the portfolio sold ¹

Note

1 Number of mortgages and loans is higher than the total number of customers owing to some customers having multiple loans.

Summary

1 In 2008 Northern Rock (NR) was nationalised because of the financial crisis as it was unable to fund itself through the securitisation and wholesale funding markets. A request for emergency funding from the Bank of England led to a run on its deposit base. As a result, the taxpayer acquired all of the bank's assets and liabilities, including a special purpose vehicle called Granite. This report is about the sale of a £13 billion asset portfolio, including Granite, which represents the government's largest-ever financial asset sale.¹

2 UK Asset Resolution Limited (UKAR) owns NR's legacy assets. The government established UKAR in 2010 to facilitate the orderly management of NR's assets and those of another bailed-out bank, Bradford & Bingley. HM Treasury owns UKAR, and UK Financial Investments Limited (UKFI) supervises it. UKFI manages the government's shareholdings in the financial sector. It is part of UK Government Investments (UKGI), which HM Treasury also owns. UKAR is consolidated into the government balance sheet so any changes in its income, expenditure and levels of indebtedness directly affect the public finances.

3 UKAR's over-arching objective is to protect and create value for the taxpayer. Since 2014 HM Treasury and UKFI's primary objective in relation to UKAR has been to shrink the size of its balance sheet as swiftly as possible, while demonstrating value for money on a case-by-case basis.

4 In November 2015, following a competitive process, UKAR announced the sale of a £13.3 billion asset portfolio to affiliates of Cerberus Capital Management LP (Cerberus). The assets sold were a combination of mortgages and unsecured loans and included liabilities consisting of private sector debt. The sale resulted in the repayment of the taxpayer loan provided to NR before it was nationalised. The mortgages sold were riskier than average UK mortgages, with higher loan-to-value and arrears ratios, but they offered investors above average yields.

5 The deal, which closed in May 2016, resulted in Cerberus paying a £74.3 million (0.6%) premium to the nominal (or par) value of the assets.² After discharging the liabilities and other adjustments, UKAR received £5.5 billion of cash proceeds from the sale. The transaction reduced government debt by £13.3 billion.

¹ HM Treasury, *Final completion of record-breaking £13 billion sale of former Northern Rock mortgages*, May 2016. Available at: www.gov.uk/government/news/final-completion-of-record-breaking-13-billion-sale-of-former-northern-rock-mortgages

² The par value (also referred to as the nominal or face value) is the value of the outstanding loans without any adjustment made for expected losses, and it amounts to £13.3 billion. The carrying, or book value, is the value of the loans in the financial accounts which include downward adjustments for expected losses, and it amounts to £13.1 billion. The assets were sold at a £280 million premium to carrying value.

Scope

6 Government policy is to return UKAR's assets to the private sector as quickly as possible. This means the government follows a 'sell' rather than 'hold' approach. When the government sells income-generating assets like UKAR's, there is an impact on public finances. Selling them reduces public sector net debt in the short term but it also surrenders a future income stream, which will increase the deficit. Holding assets to maturity might maximise financial returns but comes with risks, for example borrowers may default. Conversely, selling assets removes these risks but at the expense of future profit - higher risks often mean higher returns. Our value-for-money conclusion needs to be seen in the context of the government's policy to sell.

7 This report considers whether the sale of the £13.3 billion asset portfolio provided value for money given the government's objective to reduce its balance sheet. The report is structured as follows:

- Part One provides the background and context of the sale;
- Part Two examines the preparation for the sale;
- Part Three reviews the sales process and proceeds from the sale; and
- Part Four examines the valuation of the transaction.

8 UKAR conducted two additional transactions at the same time as this sale. These were the sale of its mortgage servicing operations (Project Phoenix or OpCo) and a bond buy-back (Project Cheviot). This report does not evaluate these transactions.

Key findings

9 UKAR sold more than £13 billion of assets in a single transaction, reducing its balance sheet at May 2016 to £42 billion of assets. The sale is in line with UKAR's objective to reduce the size of the balance sheet, and is in line with HM Treasury and UKFI's revised 2014 objective for UKAR to shrink the balance sheet swiftly. This objective was agreed between HM Treasury and UKFI following a strategic review of UKAR's objectives after UKAR was reclassified as a central government body in 2013 (paragraphs 1.7 to 1.10 and 3.11).

10 The sale price exceeded UKAR's fair value calculation of the assets, which was based on some conservative assumptions. UKAR achieved a sale price of £74 million (0.6%) above the par value of the loans and £450 million (3.6%) above UKAR's fair value calculation. The fair value calculation was around the mid-point of the adviser's valuations and based on a similar cost of capital. UKAR's underlying assumptions to calculate the cost of capital were different, in particular around cost of debt, and debt to equity funding split. The cost of equity assumption which UKAR used gave the fair value a conservative bias. UKFI challenged these assumptions and came up with a fair value that was closer to the winning bid (the top end was £94 million, or 0.7% below the winning bid). With hindsight, it can be seen that bidders used more aggressive assumptions than UKAR and UKFI (paragraphs 3.10, 4.2 to 4.6).

11 UKAR acted opportunistically in responding to a market enquiry for its assets. While preparing and carrying out other transactions, investors expressed an interest in buying Granite. This was a larger asset pool than UKAR had ever previously considered selling. UKAR, UKFI and HM Treasury reacted quickly and obtained relevant approvals to pursue this opportunity. There was no single asset disposal strategy document or single business case to consider the evidence supporting the option chosen against alternatives. The desire to move quickly and take advantage of investor demand and benign market conditions, in our opinion, contributed to some of the key findings of our report, for example, on timely consideration of alternatives and how it tendered for advisers (numbers 13 and 15) (paragraphs 1.13, 2.14 and 2.15).

12 A sale of this scale is unprecedented, which limited the number of potential bidders. UKAR partially addressed this by reducing the bidders' financing risk:

- a** To mitigate the risks due to the size of the sale, UKAR reduced the financing risks associated with the transaction. Granite had around £8 billion of financing in place. A buyer could take on this financing, significantly reducing the amount it would need to raise. This was particularly attractive to private equity buyers, as they rely more on the third-party funding than banks, which can also use customer deposits. In the end, all final-round bidders were able to refinance Granite's funding structure and raise more than £12 billion of finance (paragraphs 2.8 to 2.10, and Figure 12 on page 30).
- b** Owing to the size of the sale and the nature of the assets, there was no single buyer interested in the entire portfolio. Bidders with complementary interests formed consortia. There was limited retail bank participation in the bidding process: one bidder told us that some information it was seeking in preparing its bid was not available, but this did not affect its decision not to bid. Nevertheless, sufficient competitive tension was maintained throughout the process (paragraphs 2.9 to 2.11 and 3.7).

13 UKAR identified an alternative sale option which had a higher theoretical valuation. It judged that the alternative would expose it to slower balance sheet reduction, and greater execution and market risk. At the option evaluation stage, Credit Suisse found that large sales scored lowest in terms of taxpayer value, but highest in terms of balance sheet reduction. To sell Granite assets in smaller tranches would have required HM Treasury to repay the £8 billion private sector debt attached to the Granite assets, and would have removed the existing financing available to prospective purchasers, potentially limiting their number. As a result no detailed quantification was made at this stage. During the bidding process, UKAR realised that certain bidders would seek to refinance Granite's funding structure rather than keeping it intact, which meant the existing financing would no longer be an issue if such a bidder won. As a result, UKAR quantified the alternative sales option and estimated that multiple, smaller transactions would have increased the theoretical valuation by up to £300 million,³ but would have taken up to 27 months longer to execute; adjusting this valuation for the market execution risk, UKAR and UKFI estimated the increase only to be £98 million⁴ with potential further downside risk which it considered outweighed any potential benefit of delay. UKAR also stated that it did not have enough staff capacity to run multiple transactions concurrently (paragraphs 2.4, 2.5, 4.10 to 4.13).

14 The sales process was well run and competitive. The deal took 18 months from appointment of advisers to final close in May 2016. Sixty three parties expressed interest. First-round bidding resulted in six bids, which ranged from 96.9% to 103% of the asset's par value. Four credible bids went through to the second round, which resulted in three final bids that were above, or very marginally below, the par value of the assets. The number of bidders at each stage, the convergence of bid prices, the willingness of bidders to incur high transaction costs, and their acceptance of key terms and conditions of the sale agreement, was evidence of competitive tension. The bids reduced between rounds one and two but this was mainly because of worsening market conditions rather than a lack of competition (paragraphs 3.5 to 3.10).

15 UKAR's limited competitive tendering in the procurement process for its financial adviser was not good practice. The financial adviser was involved in the early phase of another project on a pro bono basis and subsequently won a tender against a small number of pre-selected competitors to provide advice on the sale of UKAR's servicing activities and this asset sale. During the sale process, the adviser's scope and fee were increased to reflect changes in the transaction. The changes included permitting the adviser to act as financing bank to bidders. Due to a potential conflict of interest, this had not been permitted under previous sales. UKAR permitted it this time because it felt the size of the transaction required all major players to be available in the securitisation market to facilitate the financing (paragraphs 2.2, 2.3 and 2.16 to 2.18 and 3.7).

³ This represents 2.3% of the par value of the assets.

⁴ This represents 0.7% of the par value of the assets.

16 Customers who have loans and mortgages that were sold in the transaction have been protected in the short run. Treatment of customers was one of the criteria in selecting bidders and was a pass or fail test. UKAR also included protections in the sale agreement, such as a 12-month restriction on changes to the standard variable rate and maintaining UKAR's debt management principles. In the longer term, UKAR relies on Financial Conduct Authority (FCA) regulation to protect customers. While the mortgages and loans are currently owned by FCA-licensed entities, they, like any UK mortgage, could be sold in the future to an entity which is not regulated. If this were the case and customers needed to seek redress, they would have to do so under the Consumer Rights Act (paragraphs 3.15 to 3.20).

Conclusion on value for money

17 UKAR and UKFI carried out a complex transaction professionally within a tight timeframe and took advantage of benign market conditions. They considered a wide range of options for disposing of the assets, but at the point of choosing a sales structure they had not fully assessed the value of the alternatives. Some alternatives may have achieved higher proceeds at the expense of slower balance sheet reduction and increased market and execution risk. Once UKAR had decided on the structure of the sale, the sales process achieved competitive tension. This resulted in a price above the par value of the assets and the government's valuation. All participants were complimentary about UKAR and felt that government had achieved a good price from the sale. In the context of swiftly reducing the balance sheet, by selling £13 billion of assets in a single transaction, the sale achieved value for money.

Recommendations

18 UKAR's main objective is to create and maximise value for the taxpayer, and the government's policy preference is to dispose of assets. This means it is important to identify and manage the trade-off between receipts now and longer-term income, including any risks. HM Treasury, UKFI and UKAR could be more transparent in how they balance these objectives. Our recommendations should be seen in this light.

19 UKAR's strategic documents were not drawn together in a single place. Moreover, we found it difficult to identify the objectives HM Treasury, UKFI and UKAR were working to, as some were published, some were not, and some had changed but were not reflected in documentation. We recommend that:

- a** UKAR should publish its framework agreement and set out annually its high-level strategy for external audiences; and
- b** HM Treasury, UKFI and UKAR should ensure that objectives are aligned across all parties, and formalise any changes in writing promptly once they have been agreed.

20 For any portfolio assets which government intends to dispose we expect to see a consideration of the following areas clearly articulated in a set of documents which are grouped together and periodically reviewed. These need to consider:

- c** how the size and type of assets can be optimised to maximise competitive tension and price;
- d** where appropriate, the impact of a sale on the value-at-risk in the remaining portfolio of assets for sale;
- e** the trade-offs between simple and complex transaction structures, for example in transaction costs for both sellers and bidders;
- f** the potential value that different sale options create, in sufficient detail, before deciding on a specific sales structure;
- g** the establishment of a valuation framework for the sales structure(s), ideally based on multiple valuation methodologies where possible, before launching a sale and a consistent application through the key stages of the sales process;
- h** the evidence supporting valuation assumptions to derive a fair value; and
- i** a plan to maximise value from the use of advisers that balances the need for continuity and speed of appointment with the risk of over-reliance on particular firms.

21 The formation of UKGI presents an opportunity to bring together expertise in asset disposals from across government and target it where capability or capacity may be limited. HM Treasury with UKGI, and in consultation with public bodies that have asset disposal plans, should:

- j** develop guidance on business cases for asset sales and encourage their use across government – current guidance relates mainly to investment decisions rather than sales; and
- k** consider establishing an independent valuation committee that brings together experienced individuals to review and challenge the assumptions used in fair value and sell valuations.